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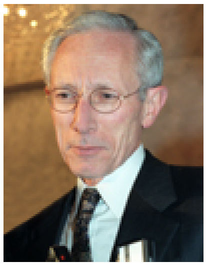

Stanley Fischer

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Ecuador and the IMF

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Ecuador and the IMF -- Address by Stanley Fischer

May 19, 2000

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Hoover Institution Conference on Currency Unions
Palo Alto, California
May 19, 2000

Ecuador's decision to dollarize was taken in January 2000 by then President Jamil Mahuad, who only a few days before had described the idea as "a jump into the abyss." So it seemed. But although President Mahuad lost his job within two weeks of taking the jump, dollarization in its early stages has turned out more successfully than almost anyone expected. However, the story is not yet over, and in the words of the IMF's unofficial motto, "complacency must be avoided."

I will outline some of the key economic events and decisions leading up the dollarization decision; describe what has happened in the Ecuadorian economy since then; and note some of the challenges that the Ecuadorian government still faces.

Ecuador's economic history has not been a happy one. A lack of national cohesion has dogged the country ever since it opted for independence from Simon Bolivar's Grancolombian Federation in 1830. From the start there was fierce rivalry between the residents of the highlands, centered on the capital Quito, and those on the coast, centered in Guayaquil. Fortunately, though, these rivalries did not lead to violent confrontation, and Ecuador's history, although turbulent, has been peaceful. However, the deep split between the interests of the coastal and highland regions has at times-and certainly during the last five years-made it almost impossible for the government to pursue a coherent economic policy.

In the mid-1990s, Ecuador's GDP was about $20bn, with exports amounting to 20 percent of GDP. Half these exports were oil, which was discovered in the 1960s and came on stream in the 1970s. Bananas and shrimp were important too. By 1998 GDP had fallen to less than $18.5bn and by 2000 the massive overdepreciation of the currency had sliced this to $13 billion-for a population of 12.5 million. In 2001 GDP will probably rise to more than $17 billion.

Ecuador's last good year economically was in 1994, during the presidency of Sixto Duran Ballen. GDP grew by 4 percent and inflation was 27 percent. The Duran administration also decided to adjust gasoline prices monthly and automatically by indexing them to world prices. Up to that time, the adjustment of gasoline prices was always a potential political problem. However, in 1995, Ecuador fought a border war with Peru, increasing military spending and moving what had been an approximately balanced budget into significant deficit. The Duran administration lost credibility as the Vice President, who had been a major force in economic policy, fled to Costa Rica to evade arrest on charges of corruption.

Popular discontent ushered in the colorful presidency of Abdala Bucaram-who was called El Loco-in the 1996 election. Bucaram came to office as a populist, but almost immediately invited Domingo Cavallo to advise him. He seemed to be moving in the direction of President Carlos Menem in Argentina-who came to office apparently a populist, only to institute a serious stabilization and reform program. After visiting Ecuador, Cavallo concluded that the country did not yet meet the preconditions necessary to institute a currency board successfully. President Bucaram lost credibility as a result of other actions, including alleged corruption and cronyism.

In February 1997 the situation deteriorated into a general strike and in a last desperate bid for survival Mr. Bucaram undid some of the reforms he had implemented; he also stopped the indexation of energy prices. Eventually Mr. Bucaram found himself barricaded into his palace and Congress voted to remove him on grounds of "mental incapacity." For a brief confusing period three people claimed to be president: Mr. Bucaram, his vice president and the leader of Congress. In the end it was the congressional leader Fabian Alarcón who was appointed interim president. Lacking authority and a clear mandate, he made no effort at reform and instead tried to bolster his popularity with concessions to unions and regional lobbies. More bad luck followed with El Niño in 1997, which caused severe crop damage and destroyed infrastructure in the coastal region, at a total cost of about 13 percent of GDP.

The situation did not degenerate into a full-blown economic crisis during the Bucaram and Alarcón governments in part because private sector investors were still willing to finance emerging markets-particularly a country with oil-in the face of falling US interest rates. Chase Manhattan gave Ecuador a $300m bridging loan in December 1996 and-just three months after the ousting of President Bucaram-Ecuador managed to issue a $500m eurobond. It is perhaps symbolic of the emerging market euphoria at the time that Moody's gave Ecuador the same credit rating as Brazil and Argentina-and this at a time when Ecuador was in arrears to its official creditors in the Paris Club.

When Jamil Mahuad was elected president in July 1998, it looked for a while as though things might change. Mr. Mahuad, a man of intelligence, charm and integrity, had established a reputation for reform during two terms as mayor of Quito. He took office in August 1998, and his authority in the country was enhanced when he signed a final peace agreement with Peru in October of that year. But it was during his presidency that the economy degenerated into crisis.

One problem was a rapidly deteriorating fiscal position. The public sector deficit ballooned from 2.6 percent of GDP in 1997 to 6.2 percent in 1998. Ecuador's external debt of more than $16bn was also large relative to GDP. Three factors were crucial: revenue weakness from falling oil prices, the low nonoil tax base, and big public sector wage rises. The rapidly worsening condition of the banking system further complicated the situation. Action was needed urgently to reduce the deficit, allow lower interest rates, stop the accumulation of external arrears and reduce debt service to sustainable levels. President Mahuad visited the IMF in September 1998, and explained that he preferred to manage without an IMF program.

By the time we began our 1998 Article IV discussions in late September, the government had cut energy subsidies, raised gasoline prices, hiked interest rates and devalued the exchange rate band by 15 percent. But it was clear that much more had to be done. We argued that the fiscal deficit should be halved and expressed serious concern about the health of the banking system-noting a rise in non-performing loans, the drying-up of external credit lines and too much lending in U.S. dollars to sucre-based borrowers. In response, the authorities explained the political barriers to fiscal tightening and said we were overstating the problems in the financial sector. Nonetheless, on October 2, the authorities said that they did want to negotiate an IMF-supported program.

We then entered an exceptionally long and difficult period of negotiation. IMF teams were in Quito at least half the time between November 1998 and March 2000; we had an agreement in September 1999 that did not work out; and we were ready to conclude another agreement in January 2000, just before dollarization.

There were two basic difficulties in the way of an agreement. First, recurrent banking sector problems were met through a series of ad hoc actions, including a deposit freeze in March 1999, and government bailouts typically carried out without consultation. Second, related fiscal problems. Not only was it difficult to get agreed programs implemented, but political and social problems prompted further counterproductive fiscal measures, for example the replacement of the income tax with a financial transactions tax in November 1998.

By the time an IMF mission went to Ecuador in March 1999, the country's exchange rate band had been abandoned after high interest rates and $250m in intervention had failed to save it. The finance minister had also resigned after fiscal tightening measures were withdrawn from the budget before it was sent to Congress.

Nonetheless, this mission made some progress. The authorities sent a tax reform package to the Congress that included the re-instatement of income tax and a broadening of the VAT base. We also agreed on the principles of a bank resolution strategy. However, the resignation of the central bank president and three board members made it impossible to reach agreement on monetary policy. The authorities also continued to favor direct bail-outs of favored banks with public money. When there was a run on the Banco Progreso, the second largest bank in Ecuador (in terms of assets), the authorities declared a five-day bank holiday and froze all deposits and loans in the bank for a year.

Two months later, the Congress had approved a weakened tax package and our team was back in Quito. Despite some progress, agreement on a full program again proved impossible. With the fiscal deficit still on course for 6 percent of GDP, the president refused to push for further tightening because of looming congressional elections. Energy price rises were rolled back and the authorities were not willing to submit legislation to protect the banking reform strategy from political interference.

By late June, we were embarked on our fourth mission visit in seven months. Agreement was reached on many elements of a program, including the main details of a banking strategy. But on this occasion the discussions were interrupted by social unrest, prompting the President to freeze energy prices for a year.

We finally reached agreement on a program in August, conditional on congressional approval for the tax strategy and progress in banking reform. We expected to finalize a program by October, but knew that the Ecuadorians had significant interest payments to make on external debt in late September. The authorities asked us what they should do. We said that the decision was up to them: if they defaulted, then there was a risk of disruptive legal challenges; if they paid, it would be difficult to sustain a viable cash flow position.

In the end, the authorities delivered their Letter of Intent to the Fund on September 29, announcing on the same day that they were deferring interest payments on some of their Brady bonds due the following day. A little less than a month later, the Ecuadorians also announced they would not make a eurobond payment due on October 28 and unilaterally rescheduled part of their domestic dollar-denominated debt.

Throughout this period, public support for Mr. Mahuad was declining steadily from the peak of more than 60 percent he achieved in the wake of the peace agreement with Peru. With the sucre heading south rapidly-and Ecuador in the midst of a recession that would see output decline by more than 7 percent in 1999-frustration was mounting. The social impact of the country's problems were clear to see. The proportion of Ecuador's population in poverty reached almost 45 percent in 1999, up by a third since 1995. Meanwhile, unemployment had doubled to 17 percent since the beginning of 1998. In November and December the sense of crisis was heightened as inflation accelerated and the sucre's decline gathered pace.

Addressing the nation at the end of the year, the president promised a drastic change in course-only to see the sucre fall another 25 percent over the next few days. His approval rating plummeted with it, reaching just 7 percent. By the time Mr. Mahuad announced the decision to dollarize on January 9,the sucre had lost almost 80 percent of its dollar value in the 16 months since he had taken office. The dollarization decision did produce some recovery in the president's poll rating, but it was one last blip. On January 21 he was ousted in a civilian-military coup.

The decision to dollarize was taken in desperation. The authorities did not consult with us, although they did take advice from some outside advisors including the Argentine consulting group, Mediterranea, and Guillermo Calvo. If they had asked us, we would have said that the preconditions for making a success of dollarization were not in place. In particular the banking system was unhealthy and the fiscal position was weak.

However, once the decision to dollarize had been made, the best choice was to try to help it succeed: we spoke to the President and the finance minister on the day after the dollarization announcement and said that we would do what we could to help. Thereafter we have worked very closely with the Ecuadorian government, seeking to help them ensure that dollarization does succeed, and that the stability it has brought so far (albeit not yet to prices) is maintained and strengthened.

President Mahuad's successor was the former vice-president Gustavo Noboa. He opted to stick with dollarization, reflecting the widespread conviction that all reasonable alternatives had now been exhausted. After demonstrations during which a group of indigenous peoples with the support of some members of the army, occupied the Congress, an event that drove home the need for national coherence, the administration also managed to muster support for a broad-based program of economic reform, symbolized by passage of the so-called "trolleybus law" through the Congress. As a result our board was finally able to support Ecuador's program on April 19, approving a 12-month standby credit of $304m. With additional support from other multilateral lenders, this offered Ecuador around $900m over the next 12 months, with up to $2bn possibly available from official lenders over the next three years.

Given Ecuador's large external financing needs, it was clear that private sector creditors would have to play their part. The country needed both cash flow relief and debt reduction to secure a sustainable external and fiscal position for the medium term. In line with our existing policy, we were willing to lend to Ecuador while it was in arrears to its private creditors, on the basis of an agreed program and provided the country is engaged in good faith negotiations with the creditors. Ecuador managed to secure a successful debt exchange in August. Ecuador offered to exchange all of its Brady and Eurobonds (with a combined face value of $6.5 billion) for a combination of new 30-year and 12-year bonds. Some 97 percent of all bondholders accepted the exchange offer, which gave Ecuador substantial debt reduction (by about 40 percent of the face value of the bond debt) as well as significant cash flow relief in the initial years. In September, official Paris Club creditors agreed to grant Ecuador a rescheduling/deferral of about $800 million in arrears and maturities due in 2000.

Private sector players have criticized our approach to Ecuador's debt problems on a number of grounds. Some claim that the IMF bullied Ecuador into defaulting on its Brady debt last year. This is not true: we made it clear that private sector involvement would be necessary, but we did not advise them what to do about specific payments.

There is a grudging acceptance now among most market participants that some co-ordination-or coercion-of private sector creditors may be necessary on occasion to resolve financial crises. But there are still complaints that we are too vague about the approach we will take in particular cases. This is an unfortunate consequence of the fact that individual cases vary widely and that a flexible approach is essential. On most occasions, the combination of a robust policy program and short-term financial help from the Fund should be enough to restore access to private capital markets. But more concerted action to coordinate creditors may be necessary if a country faces a large short-term financing requirement and has little hope of early access to capital markets-or if its medium-term debt profile looks unsustainable.

It is interesting to note that some market participants predicted that the sky would fall in if this approach was followed. But debt reschedulings have taken place for both Ukraine and Pakistan without the disruptive litigation that many predicted.

The early (and largely unexpected) success of dollarization has helped restore confidence in the banking system, promoting a rise in bank deposits and an increase in bank reserves with the central bank. But indigenous groups remain wary of the policy and it is not yet clear that the government has finally managed to assemble the durably stable legislative coalition that has so long eluded its predecessors. It is that stability that will rekindle confidence at home and abroad and lay the foundations for an enduring recovery from the country's torturous economic problems. These foundations should include a sensible tax reform so as to replace existing highly distortionary taxes (the financial transactions tax and an import tariff surcharge) and to avoid excessive reliance on oil revenues. They also include implementation of corporate debt restructuring in a manner that does not bail out large borrowers at taxpayer's expense, and a comprehensive revamping of the financial sector. And both sustainable growth and a stable political situation will be more likely with policies that invest in critical social sectors.

There is much food for thought in the story of Ecuadorian dollarization—not least, that the early success of what was a desperation move, taken in haste, without most of what were thought of as the necessary preconditions being in place, requires us to reconsider the conditions under which such a switch in the monetary system will succeed. But I should conclude with a final word of caution: it is less than a year since the dollarization decision was taken, and much work remains to be done to put in place a strong banking system, the other monetary and fiscal institutions, and the political consensus, that will ensure the longer-term success of this remarkable change in monetary regime.

[1]This is an edited version of a talk given at the Hoover Institution conference on Currency Unions on May 19, 2000. The style reflects the informal nature of the original presentation. I am grateful to Tom Dawson, David Goldsbrough, John Thornton, and Robert Chote of the IMF for their advice and assistance. Views are those of the author and not necessarily of the IMF.

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