REASSESSING THE CASE OF ECUADOR’S DOLLARIZATION

David A. Matthews, Sam Houston State University
Balasundram Maniam, Sam Houston State University
Hadley Leavell, Sam Houston State University
Claudine Burke, Sam Houston State University

ABSTRACT

The purpose of this paper is to conduct a cost/benefit analysis of Ecuador’s decision to dollarize its economy in 2000. The study begins with a review of the literature pertinent to dollarization. The following section discusses the factors that led Ecuador to dollarize its economy. The study next discusses the benefits of dollarization through comparisons of economic theory with empirical data and select competitiveness rankings for the period 1997-2002. The study further continues the assessment of dollarization by comparing the costs with the empirical data available for the same period. The final section summarizes the study.

INTRODUCTION

The currency of nations serves three necessary functions: as a unit of exchange, as a store of value, and as a unit of account. All three functions must coexist for the currency to fulfill its proper role in the national economy. However, in the course of macroeconomic shocks to a particular nation’s economy, a currency may lose one of these indispensable properties and, therefore, cease to function efficiently. These macroeconomic shocks may be the resultant outcome of high interest rates or high inflation that undermines the public confidence in the value and/or exchangeability of money, which leads to a loss of domestic and international support in the ability of money to serve its properly intended purpose.

This paper explores the tumultuous political-economic situation of Ecuador during the late 1990s and early 2000s. During this period, Ecuador experienced a near-total breakdown of its monetary system, through both exogenous and endogenous macroeconomic shocks, which ultimately led the country to abandon its national currency, the sucre, and adopt the U.S. dollar. This adoption process is
referred to as dollarization. More generally, official dollarization occurs when one nation adopts and recognizes the currency of another nation as the legitimate tender for all transactions, domestic and foreign, while simultaneously abolishing its own national currency. The process of dollarizing a nation is perhaps the most drastic monetary action that a nation can undergo; a subsequent reversal is virtually impossible.

For politicians and economic pundits alike, the idea of dollarizing a national economy has become in recent years the subject of wide and controversial debate, fraught with misconceptions and substantiated with vague empirical evidence. Current political-economic thought has reached no consensus as to the full extent of benefits and costs that can be attributed to the nation that pursues monetary dollarization, as each is quite extensive and extremely difficult to quantify. This general lack of qualified agreement has created a void in the understanding of the consequences associated with the decision to adopt a policy of dollarization. This void offers the distinctive opportunity for this paper to examine the economically accepted costs and benefits of dollarization and to measure each with the costs and benefits that have actually been observed to exist in the Ecuadorian economy since dollarization. Each theoretical cost and each theoretical benefit will be assessed using a scorecard of macroeconomic variables and competitiveness rankings to test whether or not the economy has achieved the anticipated benefits and costs in each area. For all elements of comparison, the data have been selected and compiled for the years 1997-2002 from the Global Competitiveness Report and the Latin-Focus group.

LITERATURE REVIEW

Much research has been conducted in the last few years on dollarization and its costs and benefits. LeBaron and McCulloch (2000) found dollarization a positive monetary arrangement for nations whose anti-inflationary policies lack the requisite credibility to be effective. They further argued that emerging economies that have pegs or currency boards are able to most effectively benefit from dollarization, especially if other variables, such as seigniorage-sharing agreements, are accounted for. Bogetic (2000) looked at the experience of Panama under dollarization, concluding that the nation had achieved highly beneficial gains from the program. Panama has been free of the banking crises that have continually plagued other Latin American nations. Bogetic concluded that the benefits of dollarization substantially
outweigh the costs, due to technological innovations that have reduced money
demand and, therefore, lessened the losses from seigniorage.

Calvo (2001) found that policymakers in Latin America generally have non-
credible policies, which results in extremely volatile and high interest rates. As an
extreme form of fixed exchange rate regime, dollarization is a plausible and
beneficial choice to adopt in these nations. Dollarization may potentially offer these
non-credible nations an increased credibility in their policy making. Calvo (2002)
looked also at dollarization and concluded that it has positive economic effects if
there exists a complete understanding of the initial conditions of the adopting nation.
Emerging markets that are highly liability dollarized are, through their liabilities,
poised for official dollarization without little incurrence of costs. Additionally,
dollarization may aid in the creation of a more competitive domestic economy
through reducing the risks of devaluation that cause high interest rates.

Eichengreen (2002) suggested that countries should implement policy
reform before dollarizing their economy, because dollarization may not in itself lead
to policy reforms. Once policy reforms have been implemented and strengthened,
dollarization can serve as the principle that ensures their permanence. Dollarization,
additionally can strengthen the banking system, but must not be seen as a cure-all.
Supervision, regulation, and foreign openness, must also exist, and be enhanced by
the support of dollarization. Fischer (1982) looked at the seigniorage loss costs of
dollarization and the cost of giving up national autonomy in money creation. It was
concluded that dollarization usually is implemented in nations whose policies are
highly inflationary. This, weighed against the costs, is a primary benefit for the
adopting nation in that discipline is imposed on what might otherwise be a nation’s
highly inflationary monetary policies.

Gale and Vives (2002) found, through their examination of the costs and
benefits of dollarization, that some East Asian and Latin American countries would
benefit greatly from dollarization through a strengthening of their banking system.
Among these nations that would benefit, it was pointed out that the costs would be
substantially less of a burden for the East Asian tigers, Ecuador and Chile than they
would be for other countries. Hanke (2003) contended that dollarization is highly
beneficial for nations whose national monetary systems fail to follow the rule of law.
Dollarization was postulated to enhance the country through stability and credibility.
Additionally, Hanke laid out six national reforms that must be undertaken to achieve
the full benefits of dollarization: a change in banking regulations, an implementation
of fiscal controls, a simplification of the tax system, a change in voting systems, a
scheme for national deregulation, and a scheme for privatization.
Jameson (2003) postulated that not many countries would willingly choose to follow Ecuador’s decision to dollarize by noting that the short-term success of Ecuador may primarily be due to specific conditions prevailing in its economy. Argentina’s recent abandonment of its fixed rate regime in the face of economic adversity is a reminder that countries fear irreversible policies such as dollarization. In light of his research, Jameson concluded that other countries may undertake dollarization only as a last ditch policy option. Larrain and Tavares (2003) benchmarked the decision of nations to dollarize against the success and the particulars of the European Union. In their study, real exchange rate volatility measures were found to be highest in South America, indicating that Latin American countries had a higher level of integration with the U.S. than with each other and would therefore naturally tend to adopt the U.S. dollar as opposed to creating their own regional currency.

THE DOLLARIZATION OF ECUADOR

During the late 1990s, a complex series of shocks to the macroeconomic well-being of Ecuador ultimately forced the nation to abandon its domestic currency, the sucre, and dollarize its monetary system. Beckerman (2002) attributes the causes of this “predollarization” crisis to eight distinct, yet interrelated, shocks:

“Structural problems that clearly affected the evolution of the crisis [include] (a) the dependence of public revenue on volatile oil earnings, (b) the banking system’s exposure to volatile and risky activities, (c) bank borrowers’ exposure to exchange-rate depreciation, (d) inadequate banking supervision, (e) the massive public debt, (f) political fragmentation, (g) weak public administration, and (h) the government’s tendency to revert to energy subsidization.” (p. 59)

Initially, the roots of the monetary crisis in Ecuador were attributable to exogenous shocks. These shocks affected Ecuador’s ability to control its domestic supply of circulating money and the rising level of domestic price. Ecuador was also unable to stem the precipitous fall of its exchange rate. These results occurred as the public deficit of Ecuador, due mainly to lower oil revenues and a reduced tax base, began rising during 1998. As the government increasingly faced budgetary shortfalls of its own, the domestic banking sector began facing liquidity problems because of bad loans and retracted foreign credit. The government, in an effort to control its deficits and to ensure the soundness of and confidence in the domestic
banking system, began a process of insuring the majority of banking deposits, imposing a freeze on account withdrawals, and allowing the domestic currency to freely float on the open market (Beckerman and Solimano, 2002).

Table 1. Ecuadorian Macro-Performance Indicators, 1997-2002

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<tr>
<td>GDP (US$ bn)</td>
<td>23.6</td>
<td>23.3</td>
<td>16.7</td>
<td>15.9</td>
<td>21.0</td>
<td>24.5</td>
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<tr>
<td>GDP per capita (current US$)</td>
<td>2,117</td>
<td>2,039</td>
<td>1,431</td>
<td>1,339</td>
<td>1,729</td>
<td>1,975</td>
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<tr>
<td>GDP (annual variation in %)</td>
<td>4.1</td>
<td>2.1</td>
<td>-6.3</td>
<td>2.8</td>
<td>5.1</td>
<td>3.4</td>
</tr>
<tr>
<td>Unemployment (% of active population)</td>
<td>9.2</td>
<td>11.5</td>
<td>14.4</td>
<td>9.0</td>
<td>10.9</td>
<td>9.2</td>
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<tr>
<td>Inflation (CPI, annual variation in %)</td>
<td>30.7</td>
<td>43.4</td>
<td>60.7</td>
<td>91.0</td>
<td>22.4</td>
<td>9.4</td>
</tr>
<tr>
<td>Interest rate (benchmark %)</td>
<td>8.7</td>
<td>10.9</td>
<td>9.1</td>
<td>7.7</td>
<td>5.1</td>
<td>5.0</td>
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<tr>
<td>Exchange Rate (vs. US$, end-of-period)</td>
<td>4,428</td>
<td>6,825</td>
<td>20,243</td>
<td>25,000</td>
<td>25,000</td>
<td>25,000</td>
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<tr>
<td>Trade Balance (US$ million)</td>
<td>523</td>
<td>-1,035</td>
<td>1,545</td>
<td>1,399</td>
<td>-397</td>
<td>-1,004</td>
</tr>
<tr>
<td>Exports (annual variation in %)</td>
<td>8.7</td>
<td>-19.6</td>
<td>4.6</td>
<td>12.0</td>
<td>-5.4</td>
<td>8.6</td>
</tr>
<tr>
<td>Imports (annual variation in %)</td>
<td>21.9</td>
<td>10.4</td>
<td>-44.5</td>
<td>23.1</td>
<td>41.6</td>
<td>19.6</td>
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<tr>
<td>International Reserves (US$ million)</td>
<td>2,270</td>
<td>1,796</td>
<td>873</td>
<td>1,180</td>
<td>1,074</td>
<td>1,008</td>
</tr>
<tr>
<td>International Reserves (months of imports)</td>
<td>5.6</td>
<td>4.0</td>
<td>3.5</td>
<td>3.9</td>
<td>2.5</td>
<td>2.0</td>
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<td>External Debt (US$ million)</td>
<td>14,918</td>
<td>15,140</td>
<td>15,902</td>
<td>13,110</td>
<td>14,360</td>
<td>16,288</td>
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<tr>
<td>External Debt (% of GDP)</td>
<td>63.1</td>
<td>65.1</td>
<td>95.4</td>
<td>82.3</td>
<td>68.3</td>
<td>66.4</td>
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<td>Moody's</td>
<td>Baa3</td>
<td>Baa3</td>
<td>Ba2</td>
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<td>Standard and Poor's</td>
<td>BBB-</td>
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<td>BB+</td>
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<td>Fitch Ratings</td>
<td>-</td>
<td>BBB</td>
<td>BBB+</td>
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The decision to float the sucre precipitated a monetary free fall as market-correcting forces brought the currency to its true value. In fact, the value of the sucre fell from 6,825 sucres per US dollar in 1998 to 20,243 per US dollar in 1999 (see Table 1). Subsequently, the exchange rate was fixed at 25,000 in 2000. Table 1 lists selected measures of Ecuadorian macroeconomic performance for the years 1997-2002. The governmental insurance of deposit accounts was a measure designed to bolster domestic confidence in the banking system. However, the moratorium placed on withdrawals served only to increase depositor concerns and
eventually led to massive cash withdrawals and flight of capital as the freeze was lifted.

As Table 1 shows, the international reserves of Ecuador continually declined from 1997 through 2000, both in total and as measured in months of imports. In addition to the loss of cash, capital and foreign reserves, the government exacerbated the domestic rate of inflation by printing excess quantities of money as it attempted to insure the deposits of increasingly unsound banking institutions. The Ecuadorian rate of inflation rose from 43.4 percent in 1998 to 91.0 percent in 2000 at the height of the crisis. The proverbial straw the broke the camel’s back occurred in August of 1999, when the situation in Ecuador worsened and caused the nation to default on its Brady bond issues. The amount of this default amounted to approximately 6.5 billion dollars, or one-half the public external debt. By the end of 1999, the economy of Ecuador was in such a state of disarray that the government had lost the ability to control its domestic money supply, its domestic price level and the exchange rate. The external debt and unemployment rate of Ecuador had continued to rise while necessary credit and financing was siphoned out of the nation’s financial institutions. Ecuador had only two policy choices: either a total adoption of the dollar or a devastating bout of hyperinflation (Beckerman and Solimano, 2002). It was during this tumultuous crisis that Ecuador’s president, Dr. Jamil Mahuad, announced in January 2000 the intent of the government to follow a process of complete dollarization of the economy. Dr. Mahuad was immediately forced out of office; his successor Gustavo Noboa completed the transition. (Bureau, 2006)

**ASSESSING THE BENEFITS OF DOLLARIZATION**

The benefits of dollarization on the macroeconomic well-being of the adopting nation are extremely difficult to quantify, and, therefore, must be measured from the theoretical and rational point of view in order to more fully understand their significance in the macroeconomic aspects of the Ecuadorian economy. Unlike the short-term measurable costs, the benefits of adopting the dollar are long-term in nature and have few well-studied precedents to offer clues as to their proper measurement. Therefore, this section will merely pose the theoretical benefits most accepted by the political and economic subject experts, and measure those facets in against the World Economic Forum’s *Global Competitiveness Ratings* for the years 1997-2003, as indicated in Table 2. These measures assess the competitiveness and
credit of Ecuador relative to 102 other nations, with number 1 being the highest-rated nation and number 102 being the lowest-rated nation.

| Table 2. Ecuadorian Competitiveness Ratings, 1997-2003 |
|-----------------------------------------------|-----|-----|-----|
|                                               | 1999 | 2001 | 2003 |
| Country credit rating                         | 58   | 71   | 81   |
| Access to credit                              | 54   | 75   | 91   |
| Soundness of banks                            | 58   | 75   | 98   |
| Macroeconomic stability                       | N/A  | N/A  | 83   |
| Growth competitiveness                        | 53   | 68   | 86   |
| Recession expectations                        | N/A  | N/A  | 71   |


**Policy Credibility**

The first, and perhaps most common, among the agreed upon hard-to-quantify benefits of dollarization is the extent of the stabilizing effect on the economy and political atmosphere of the adopting nation (Mendoza, 2001 and Eichengreen, 2002). This stabilizing effect or “credibility,” is associated with the permanence and irrevocability of the decision to adopt the dollar (Berg and Borensztein, 2003). This governmental credibility springs from the durability of dollarization and the many difficulties involved in reversing or altering such a policy decision, as is possible with other exchange rate regimes, in the face of adverse economic situations. Hanke (2003) notes the increased confidence, domestic and foreign, attributable to dollarization, and the subsequent increased financial and political stability and economic performance. Chang (2000) argues that through the adoption of an exogenous national currency such as the dollar, which is acknowledged to be of strong economic superiority, the adopting nation may attain greater stability in a great many aspects of its economy. This credibility can result in lower and more predictable rates of domestic inflation through the imposition of the monetary policy of the more stable country, thus shielding the adopting nation from idiosyncratic shocks. These shocks include, “fiscal shocks, pressure by interest groups to devalue the currency to gain competitiveness, [and] temptation to use
monetary policy to dilute the real value of nominal commitments” (Panizza, et al, 2003, p. 177).

Lower rates of inflation and interest can open the door to longer-term domestic financing in the country, such as other dollarized nations enjoy (Bogetic, 2000). As can be seen in Table 1, inflation has indeed diminished greatly in the period immediately following dollarization. In the year 2000, inflation soared to unprecedented levels as the sucre was valued at an artificially low 25,000-to-1 exchange rate; however, after the initial shocks, the Ecuadorian rate of domestic inflation was brought under control, subsequently dropping to historic lows. These credibility benefits, like the other benefits of dollarization, are extremely complicated and remain quite difficult to measure because of their broad scope and the long-term nature of their assessment (Chang, 2000). Further, the primary benefit of credibility is qualitative. The intransigence of monetary matters offers assurance to investors, domestic entities, and others that the currency will not be abandoned or debased. In fact, nations utilizing other exchange rate regimes may be tempted, in the face of such deteriorating economic conditions, to abandon such regimes in favor of a short-term solution. Dollarized economies like Ecuador, to the contrary, if tempted to abandon their dollarization, would be faced with the cost-prohibitive option of issuing new domestic currency to exchange for dollars (Chang, 2000).

**Risk and Credit**

Dollarization, through the stabilizing effects of reducing currency-devaluation risk, may lower the cost of foreign credit available to the adopting nation (Larrain and Tavares, 2003 and Bogetic, 2000). Risk compensation is twofold. First, the spread for devaluation risk, which is a premium to compensate lenders for the risk that the currency of the borrower may be worth less tomorrow than it is today. Secondly, the sovereign risk is a premium to compensate lenders for the risk that the borrowing country may default on its debt repayment (Chang, 2000). Although devaluation risk may decrease, sovereign risk may still exist and thus the benefits of risk reduction may be hard to quantify. However, through the reduction of currency-devaluation risk, lender nations are able to receive signals that the stability of the dollarized nation is of a higher quality of permanence than that of the nation whose currency is subject to the speculative disruptions of currency traders and ill-founded governmental policy decisions (Berg et. al, 2003). From a medium-term political-economic perspective, the dollarization of Ecuador has been positive and effectual, as Ecuador has obtained easy access to foreign savings and
other dollar resources. However, Ecuador’s access to and ability to borrow from the foreign credit markets, which have driven in a large part its economic turnaround, may be coming to an end (Jameson, 2003). As can be observed in the Global Competitiveness indicators in Table 2, Ecuador’s country credit rating and its access to credit has fallen relative to the other 102 nations assessed throughout the 2000s. Table 1 shows that the credibility of Ecuador’s bond issues has barely risen since the introduction of the US dollar into the economy as the official currency. Although the competitive trend is flat or downward for the credit of Ecuador, it is quite difficult to ascertain what portion of this decline is attributable to dollarization and its after-effects and what portion is attributable to other macroeconomic and political phenomena occurring in the country.

ASSESSING THE COSTS OF DOLLARIZATION

The costs of dollarization revolve around the common theme of a powerlessness and loss of control in domestic matters. Generally, these costs of dollarization are relatively easier to measure in the short term than are the benefits. Although dollarization entails such costs as the loss of national symbolism on monetary instruments and mixed public sentiment, this section examines only those costs believed to have a significant impact on the overall macro-political context of Ecuador.

Independent Monetary Policy

The loss of independent monetary policy control may be the most worrisome consequence of dollarization, in that the adopting nation loses its ability to effectively combat inflation and respond aggressively to economy-wide shocks (Bogetic, 2000). It is through its monetary policy that a nation is able to increase or decrease the quantity of money in circulation and, thus, affects the domestic rate of inflation (Chang, 2000). Beckerman and Solimano contend that the main impetus for the dollarization of Ecuador was to halt the stratospherically high domestic inflation. Inflation rose very rapidly after the initial announcement of dollarization for two primary reasons. First, the exchange rate of sucres for dollars, fixed at 25,000 sucres to one dollar so as not to break the international reserves of Ecuador, required approximately a 300 percent fall in the value of the sucre. On an annualized basis, inflation rose to 91 percent in 2000, just after the announcement of the dollarization proposal, after which it dropped to 22.4 percent, and 9.4 percent,
respectively in 2001 and 2002. Since 2000, the rate of inflation has continued to fall, as can be seen in Table 1. This correction of the inflation rate of Ecuador demonstrates that, despite a lack of monetary policy with which to influence inflation, the stability afforded by dollarization works in such a manner as to lower the rate. Therefore, the loss of independent monetary policy may be a benefit of dollarization as opposed to a cost (Hanke, 2003).

Concern exists that the adopting nation will incur a cost in being fully subject to the monetary policies and economic consequences of the prevailing conditions in the adopted currency’s country of origin (Chang, 2000). As a dollarized nation, the monetary policies and actions of the United States’ Federal Reserve System have implications, through the dollar currency in circulation, on the macroeconomic well-being of the Ecuadorian economy through ripple effects. If the competitiveness of the U.S. dollar was suspect, Ecuador would suffer the ill consequences that such an event would occasion by its explicit economic association through dollarization. Indeed, any macroeconomic destabilization in the United States could quite possibly equate into macroeconomic destabilization in countries, such as Ecuador, that use the dollar (Bogetic, 2000). It is interesting to note, however, that although the US entered into a mild recession in the early 2000s, Ecuador was unaffected. This may be attributable to myriad causes, such as the small volume of trading conducted with the United States as well as other economic and political factors prevailing in the economy of Ecuador. Indeed, Calvo postulates that dollarization instead increases the size of the adopting nation (Ecuador) relatively, resulting in more certainty and increased incentives, as well as increased predictability and credibility in monetary policy matters (Calvo, 2002 and Larrain and Tavares, 2003).

**Competitiveness**

Beckerman and Solimano observe that the dollarized nation, although becoming perceptibly more stable in many respects, faces an increased likelihood of becoming less competitive in the global trading arena. The competitiveness of the dollarized nation must be seen in relation to the exchange rate mechanisms of neighboring countries, and the ability of those countries to alter the value of their currency in response to global and regional trade conditions. As an example, Peru and Colombia each have floating exchange rate systems, and are able to adjust the value of their currencies downward to remain viable and competitive in the face of adverse economic conditions. Ecuador does not possess such a freedom under
dollarization, and must, whether agreeable or not, maintain prices in accordance with the value of the dollar even at the risk of losing trade value. The Global Competitiveness ratings show the global competitiveness of Ecuador, as calculated in an intricate variety of ways, has continually fallen relative to other nations throughout the period of measurement. Due to the multi-faceted nature of the political-economic atmosphere of Ecuador, it appears unlikely that dollarization will have any quantifiable impact upon the competitiveness of Ecuador into the near future.

Lender of Last Resort

It is widely believed among economic pundits that the dollarized nation, in forfeiting the ability of its central bank to create new money, loses its ability to act as the lender of last resort for domestic financial institutions. In theory, this inability of the central bank to lend money and prevent financial institutions from failing may lead to potential widespread insecurity and distrust of financial intermediation and an increased inability to control domestic inflation (Chang, 2000). Calvo (2000 and 2001), as well as others (Hanke, 2003 and Bogetic, 2000), dismisses this reasoning, arguing that a central bank does not necessarily need to print money to fulfill the lender of last resort function, only that the bank must be able to lend money. This means only that the dollarized economy must continually “engage in more planning than advanced economies” (p. 323) in order to have a reserve of currency sufficiently available to bail out financial institutions in the event of instability. Calvo further argues that the inability of the dollarized nation to print money may actually benefit the stability of the economy. He asserts, “if the central bank can freely turn the wheels of the money-printing machine, a Damocles sword will hang on the economy every time there is a slight suspicion that the [lender of last resort] is preparing for action. And the sword is, of course, an inflationary explosion” (Calvo, 2001). Berg et. al further suggest that stability in the banking system will come from domestic faith in the strength of dollar-denominated deposits and the institutions that hold the dollars. They recommend enhancing the faith in the dollar by increasing bank liquidity requirements and bank access to quick sources of funds from which to draw in the event of a banking crisis. However, these increased liquidity requirements would augment the costs associated with financial intermediation (Berg et. al, 2003). As noted in Table 2, the soundness of the Ecuadorian banking system has continuously fallen in relation to the other 102 surveyed countries. Although no sizeable institutional failure has occurred, Ecuador
ranks a dismal 98 out of 102 countries in the 2003 survey. Gale and Vives (2002) further contend that risk taking and shirking on the part of bankers will decrease as the likelihood of massive bank bailouts and other lender of last resort protections diminishes, which is consistent with the lack of bank failures in Ecuador since dollarization.

**Seigniorage**

The nation that adopts the currency of another nation consequently loses the seigniorage to which it would otherwise be entitled as an originator of money. Beckerman and Solimano (2002) define seigniorage as, “the difference between the real command of resources that the creation of money entails and the low cost of producing (paper) money” (p. 9). The actual costs of the dollarization of Ecuador were measured and quantified arriving at a true cost of implementing the scheme. The two-fold dollarization costs associated with loss of seigniorage could approach 6.2 percent of GDP, or approximately 897 million dollars. This seigniorage cost is composed of two distinct, yet related, costs. First, the costs of immediately exchanging existing stocks of sucre into dollar bills – this cost amounts to roughly 3.7 percent of GDP, or 536.4 million dollars. Secondly, the loss of seigniorage income to the nation from the inability to print new money in the future is roughly 2.51 percent of GDP, or 360.6 million dollars over eight years. The stock and flow costs of the loss of seigniorage over the 1991-97 period, were 12.2 and 7.4 percent of GDP, respectively. Although seigniorage from paper money will be lost to the U.S., it is acknowledged that the loss will not include coinage, which the Central Bank of Ecuador will retain the power of minting and of which it will derive a small seigniorage (Baquero, 2000). The losses attributable to loss of seigniorage may be substantial and, therefore, impose constraints upon the budgetary resources of the adopting government. Calvo has suggested that the losses of seigniorage can be made up with a tax on wealth or some other tax that provides the government with revenue, while Hanke maintained that the losses are primarily offset though decreases in debt service costs and interest rates (Calvo, 2001 and Hanke, 2003).

**Startup Costs**

The economy of the dollarized government is saddled with the extremely high start-up costs of exchanging all domestic bills and coins into dollarized bills and coins. This high cost not only includes the actual seigniorage loss mentioned.
above but also includes opportunity costs such as any post-dollarization laws needed to ensure the proper functioning of the dollar economy. There also arise one-time costs associated with changing equipment such as cash registers, vending machines and computers from domestic currency to dollars. Additionally, legal contracts and refinancing agreements must be rewritten to reflect the new currency, adding to the one-time cost (Bogetic, 2000). As mentioned previously, the amount of the exchange of domestic sucre in Ecuador into U.S. dollars initially totaled 536.4 million dollars; the other costs are non-quantifiable.

THE FUTURE OF DOLLARIZATION AND ECUADOR

The list of economic benefits and costs believed to be associated with official dollarization continues to be quite extensive and the subject of great misconception. The process of dollarization does not occur in a vacuum where all things are equal; myriad other macro issues such as policy implementation and economic cycles must also be considered to fully understand the effects of dollarization. In addition to understanding the effects, there remains great disparity in the confidence of quantifiable measurements. This paper has attempted to measure, the various outcomes, both theoretically and empirically, that dollarization has had on the Ecuadorian economy since its adoption.

In light of the evidence presented in this paper, it is argued that Ecuadorian dollarization, in the short-run period of its existence, has had minimally perceptible benefits to the economic well-being of the nation beyond that of an initial stabilizing effect. Inflation, unemployment and external debt have all declined while economic growth has resumed, showing signs of economic recovery in Ecuador. However, it would be imprudent to attribute an undeserved portion of this recovery to the effects of dollarization without more extensive research into measurement of the benefits. Likewise, the costs, although somewhat more measurable than the benefits, appear also to have had a relatively minor overall impact on the economy of Ecuador. From a competitiveness standpoint, Ecuador’s credit rating, access to credit, soundness of banks and growth competitiveness have all fallen, despite the argument that dollarization adds an element of stability to the domestic economy of the adopting nation. In light of these findings and the finding of other researchers, it appears to be most difficult to conclude that the dollarization of a national economy is a panacea to the monetary and political problems of extremely dysfunctional governments. Dollarization should, therefore, be adopted only after a thorough assessment and with great caution.
SUMMARY AND CONCLUSION

This paper has looked at the benefits and costs attributable to Ecuador’s decision to dollarize its economy during 2000. It was shown that the benefits of dollarization are more long term in nature and quite difficult to measure; however, Ecuador was shown to have attained a degree of credibility, which translated into lower rates of domestic inflation. Ecuador has obtained increased access to foreign credit during the years immediately following dollarization. Some of the costs looked at included the loss of independent monetary policy, global competitiveness, loss of lender of last resort ability, seigniorage costs, and various other start-up costs. Seigniorage loss was the most influential of the costs, while losses of independent monetary policy and lender of last resort ability may entail few, if any, actual costs for non-credible governments, and, therefore, serve a primarily beneficial purpose. Dollarization has had minimal overall impact on Ecuador’s economic and political atmosphere.

REFERENCES


