SAE./No.31/April 2015

Studies in Applied Economics

THE DOLLARIZERS

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Johns Hopkins Institute for Applied Economics,
Global Health, and Study of Business Enterprise

The Dollarizers

by Tristana Santos

About the Series

The *Studies in Applied Economics* series is under the general direction of Prof. Steve H. Hanke, Co-Director of the Institute for Applied Economics, Global Health and Study of Business Enterprise (hanke@jhu.edu).

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Summary

In Ecuador, we believed that the story of how we came to dollarize our economy had been told in detail, but 15 years later, I discovered that a key chapter was missing from our newspapers and history books; the role played by two American economists, Steve Hanke and Kurt Schuler, who traveled the world promoting a radical plan to stop inflation and achieve stability: to abolish central banks in emerging market countries.

Acknowledgments

I thank Professor Steve Hanke and Dr. Kurt Schuler for sharing their story; and Burt Hubbard and Nayomi Chibana for their invaluable help and comments.

Introduction

The little-known story of how two 'dollar evangelists' tried to replace Latin American currencies with the greenback; the efforts of Ecuadorian economists who promoted dollarization; and the phone call that could have changed the course of history for Ecuador:

In Ecuador, few people know who Steve Hanke and Kurt Schuler are, even though their work as economists is partly responsible for the fact that everyone in the country now buys, sells and gets paid in dollars. In fact, if things had gone according to their plan 15 years ago, today, everyone in Latin America would be using the dollar.

On January 9, 2000, in the middle of the worst economic crisis in Ecuadorian history, President Jamil Mahuad astonished the country by announcing on a Sunday night televised address that Ecuador was adopting the dollar as its official currency. This spelled death for the sucre, the country's currency since 1884, which had depreciated dramatically, especially in the last year when it went from about 7,000 to 28,000 sucres per dollar. The sucre's departure abruptly ended the devaluation and inflation cycles that had dragged more than half of the country's population into poverty.

Panama had already used the dollar for a century, so Ecuador became the second Latin American country to adopt the innovative measure. El Salvador would follow soon after, and it was believed then that dollarization would expand throughout the continent.

Mahuad's announcement was a personal triumph for the Ecuadorian economists who had worked intensely to promote dollarization, despite resistance from the President and his administration. Joyce de Ginatta, president of Guayaquil's Chamber of Small Industries, led a movement to promote dollarization. It had been championed by scholars such as Franklin López Buenaño and Pablo Lucio Paredes, monetarists like Carlos Julio Emanuel, and liberal economists who were part of the Ecuadorian Institute of Political Economy, created by Dora de Ampuero.

Less known, but also important, is the role played by two American economists -- Steve Hanke and Kurt Schuler -- with a high level of influence in the U.S. Congress and the Treasury Department, who were travelling the world promoting currency boards and dollarization.

A radical solution

The first time Franklin López Buenaño, now a retired Tulane University professor, ever heard about convertibility was in New Orleans in 1990, at a conference given by a young economist named Kurt Schuler. "The project was called Currency Board and it was being considered by the governments of Argentina and Mexico," he recalls.

Schuler, now a 54-year-old economist at the Office of International Affairs in the U.S. Treasury Department, was then a postdoctoral fellow at The Johns Hopkins University in Baltimore, Maryland, where he worked under the direction of Steve Hanke, a Professor of Applied Economics at Hopkins and a Senior Fellow at the Cato Institute in Washington D.C.

Hanke, now 72, and Schuler had just written a book that contained a Currency Board proposal for Argentina, a country that would peg the peso to the dollar the following year.

Having previously served with President Ronald Reagan's Council of Economic Advisors and as a Senior Advisor to the Joint Economic Committee of the U.S. Congress, Hanke had conducted extensive studies on the positive effects of fixed exchange rates in emerging nations.

In his view, central banks in many countries are "the enemy." Hanke says that in small, unstable countries, the best prescription is to take away the Central Bank's discretionary capacity to print bills. This, he proposes, can be achieved through a Currency Board, which is a monetary institution that issues units of local currency backed on a one-to-one basis by a strong currency, like the dollar; or through straight dollarization, which replaces the troubled, weak domestic currency, with the dollar. This implies much more than just a currency change, writes Hanke in his paper 'Money and the rule of law in Ecuador'. When a country is "incapable" of safeguarding the value of its domestic currency, "it should replace it with a high-quality foreign currency. By doing so, a country will replace a weak (or nonexistent) domestic rule of law with a stronger foreign one."

Argentina, however, didn't adopt the orthodox currency board proposed by Hanke and Schuler, but rather a more flexible version that allowed the country to eventually revoke the "convertibility system." "In 1991, I warned that was going to happen," Hanke said in a phone interview. "Argentina's experience with convertibility had an enormous influence on Ecuador's decision to dollarize."

During the 90's, Hanke and Schuler, together and separately, advised countries such as Estonia, Lithuania, Bulgaria, Montenegro, Bosnia-Herzegovina and Venezuela. As a state counselor, Hanke held cabinet positions in Lithuania and Montenegro and was advisor to numerous presidents, for example President Stoyanov of Bulgaria. They spent a good amount of time in Mexico, Costa Rica, Peru and El Salvador. They worked pro-bono, but did receive grants from liberal think tanks, such as the International Center for Economic Growth, and the Atlas Economic Research Foundation to finance the publication of more than 20 books that they co-authored on currency reform.

"Hanke and I did the work because we strongly believed in the idea," writes Schuler in an e-mail about his experiences in Ecuador. "We never received any funding from the U.S. government to promote currency boards." In fact, a few years later, when both economists proposed a currency board for Indonesia, where Hanke was President Suharto's chief advisor, Hanke was criticized by the Clinton administration because he had encouraged the country's officials to reject the International Monetary Fund's reform plan.

In 1995, Hanke advised Venezuelan president Rafael Caldera, who was considering dollarizing the economy to halt climbing inflation. The elites were fiercely against it, Hanke said. In Venezuela, economist and M.I.T. engineer Jose Cordeiro became involved in the process and wrote the book *The Second Death of Bolívar and the Rebirth of Venezuela*. He would latter publish local versions of the same book in Ecuador, Mexico and Costa Rica. "Inflation is a tax in disguise," wrote Cordeiro. "When the government prints more money, it's stealing part of the value of our savings and our salaries."

"The idea quickly spread to other countries in the region," remembers Cordeiro in an interview during a recent visit to Guayaquil. The word got out among Latin-American scholars that a group of economists were preaching a radical solution to stop inflation: abolishing central banks. Hanke was "the one who sold the idea in a very efficient way," remembers Cordeiro, while Schuler "kept a low profile, but was an expert on the matter."

Headed for Ecuador

Steve Hanke's first contact with Ecuador was in 1995, when he presented his theories to Édgar Terán, the Ecuadorian ambassador to the United States during the presidency of Sixto Durán-Ballén. They became friends and visited regularly. "Teran told me that he agreed with my diagnosis and solutions for Ecuador and that he would convey those sentiments directly to President Sixto Durán-Ballén. He did this on a regular basis," Hanke said.

In 1996, when Abdalá Bucaram was running for president, Hanke travelled to Guayaquil to present a convertibility project. Later, he returned during Bucaram's administration but this time with a dollarization plan.

"Bucaram himself had the idea of applying the convertibility system, undoubtedly inspired by what he saw during his years of exile in Panama," said Carlos Julio Emanuel, who served in Bucaram's administration as president of the Monetary Board. Following Emanuel's suggestion, Bucaram invited Domingo Cavallo, the Argentine finance minister who instituted the convertibility system in Argentina, to advise the Ecuadorian government. "We were ready to adopt convertibility. It was to be put into place on July 1997, with a parity of 4,000 per dollar," said Emanuel. By then, Hanke had already been advising Domingo Cavallo and was preparing, along with Schuler, a new economic program based on dollarization for Argentinian president Carlos Menem. Hanke met Menem in 1989, "when he had just been elected president and was looking for an antidote to hyperinflation," published the Argentine newspaper *El Clarín*, calling the two American economists "as controversial as they are influential."

Bucaram never got to implement convertibility. In February 1997, the former Ecuadorian president – nicknamed El Loco (the crazy one) – was removed from office after being declared "mentally unfit to rule" by the National Congress of Ecuador. In August 1998, Jamil Mahuad, a Harvard educated centrist and former mayor of Quito, was sworn in as president.

Meanwhile, in Guayaquil, Foro Económico, the citizen movement that promoted dollarization as a way to stabilize the country, grew stronger. "When Bucaram was overthrown, and I saw that Mahuad was more of the same, I said no more, we need to dollarize now," said Joyce de Ginatta, who in 1999 organized a series of conferences with international guests to discuss possible solutions to the Ecuadorian crisis. Two of the key speakers were Hanke and Schuler.

A few months into Mahuad's administration, the country's financial system, which operated with little to no oversight, began to fall apart. The Central Bank transferred millions of sucres to back the deposits of the troubled private banks, but about 70 percent of the financial institutions went bankrupt, one right after the other. The rules regulating the financial sector were so lenient that bankers could even give out loans to themselves. Former bankers who fled the country after the collapse of the banking system were tried in absentia and convicted of embezzlement.

The sucre began to depreciate at an even faster rate. The dollar jumped from 4,000 to 10,000 sucres. "You would go to the bank to buy dollars and while you were waiting in line, you'd see the value of the sucre drop," said Dora de Ampuero. She had been Kurt Schuler's classmate at George Mason University and so she invited him to give conferences on dollarization. Dora's institute paid for Schuler's plane ticket and he stayed as a guest at her house, but he did not charge for the speaking engagements.

Schuler was very active in Guayaquil. His article "Why the sucre is not as good as the dollar" was published in a local newspaper. "Economists had talked about official dollarization a little bit for many years, but gave no sustained attention to the subject until 1999, and I believe that my work was in part responsible," writes Schuler. "My article appeared at the time a dollarization movement was beginning to stir in Ecuador. Dora's institute became the focal point for developing the intellectual case for dollarization, and issued a number of publications to that end, including translations of some papers I wrote. Joyce de Ginatta tirelessly gave speeches, organized conferences, and used her extensive contacts—she seemed to know everyone in Ecuador—to make business leaders and politicians aware of the dollarization option."

José Cordeiro also stayed at Dora de Ampuero's home during the three months that it took him to write *The Second Death of Sucre and Ecuador's Rebirth*. He worked in the small office of the Instituto Ecuatoriano de Economía Política, which Dora had built right next to her house in Urdesa, a middle class neighborhood. The book was printed in Venezuela by the Centro de Divulgación de Conocimiento Económico para la Libertad, CEDICE, and was published in Ecuador with a coupon to claim a "manicho" (a local chocolate bar). Cordeiro has a unique sense of humor. When he told the press that the sucre was already too "mahuadito," government officials asked him to leave the country. "I said, 'I don't care that Mahuad is throwing me out because he's the one who's going to get thrown out. But before, he'll dollarize.' It was prophetic."

In early 1999, Franklin López Buenaño published *Por Qué y Cómo Dolarizar* (Why dollarize and how to do it), the first Ecuadorian book on the subject. "We didn't conduct public opinion surveys but I believe we had great public support," he said. In order to convince the skeptics of the benefits of dollarization, he would pose the question, "how do you want to get paid, in sucres or dollars?

Dollar activists had been lobbying for some time, but when the moment came to officially present the dollarization project to President Mahuad, Carlos Julio Emanuel was appointed to do it. During the presentation, at the Governorate of Guayas, Mahuad, sitting beside Governor Guillermo Lasso, didn't look up from the notebook where he jotted down a few words. At the end, he thanked everyone and left without making comments. Emanuel was puzzled. There were rumors about the deteriorating health of the President, who had suffered a brain injury two years before.

Deposit freeze

Knowing they would need massive support, members of Foro Económico persuaded political leaders to come aboard. Former Presidents León Febres-Cordero and Abdalá Bucaram, and Jaime Nebot, now mayor of Guayaquil, all eventually supported dollarization.

Then, the government imposed a freeze of bank deposits which was another blow to the nation's confidence. "Cavallo's Mediterranean Foundation had been consulting with President Mahuad, advising him that convertibility a la Argentina was superior to dollarization. In early 1999, Argentine advisers went to see Mr. Mahuad, thinking they had already sold him on a convertibility scheme that would begin with a three-day bank holiday. Instead, the president got the jitters. On March 8, he closed the banks and froze bank accounts but failed to follow through with a change in currency policy," reported *The Wall Street Journal*.

The banks remained closed for a whole week to avoid massive withdrawals, and when they finally opened, accounts with more than 500 dollars remained frozen for six months.

"When a part of the money was released, people immediately bought dollars," said Pablo Lucio Paredes, Director of Economy at Universidad San Francisco de Quito. "Then the Central Bank applied a policy of high interest rates as an incentive for Ecuadorians to keep their money in sucres. It did not work. The exchange rate went from 15,000 to 25,000 in three or four weeks. The situation was desperate." The sucre was devalued by 400 percent between January 1999 and January 2000, and inflation reached 60.7 percent.

According to Paredes, Mahuad, who by then had an approval rating of only 7 percent, was contemplating three options: apply convertibility, dollarize, or follow the advice of a group that opposed dollarization, led by economist Alberto Acosta, who proposed passing a strict monetary law that would reduce the number of excess sucres in circulation. "If Foro Económico had not promoted dollarization, it probably would not have been contemplated by the government," Paredes said.

But Mahuad was seriously considering another way out: simply resigning. "Mr. Mahuad is hardly a model of decisiveness," published *The Economist*.

The phone call

Two days before announcing that Ecuador was officially adopting the dollar, with the country in a state of emergency and huge pressure to resign, President Mahuad told the press that dollarizing would be "a leap into the void."

“Let’s remember that neither the IMF, nor the World Bank supported dollarization,” said Paredes, “high ranking officials in the Central Bank were opposed and were fighting against it.” “Two days before, if someone had asked me if Ecuador would adopt the dollar, I would have said no. I remember I was watching TV like all Ecuadorians and wondering, ‘what is he going to announce?’” said Paredes.

What made Mahuad change his mind about dollarization? According to Steve Hanke, it was a telephone conversation he had had with Lawrence Summers, then Secretary of the U.S. Treasury.

Months before, in April of 1999, Summers had testified in the U.S. Senate at the Hearing on Official Dollarization in Emerging-Market Countries, where he said that if a Latin-American country should decide to adopt the dollar, the United States could expect to benefit in a number of ways, especially if dollarization became a “regional trend.” “The fact of sharing the same currency would reduce the cost of doing business with the dollarizing country and reduce uncertainty about future exchange rate changes. There might be greater capacity for capital and trade flows in both directions as a result,” said Summers. “If dollarization helped to achieve greater economic stability and growth in countries in our hemisphere which have suffered so much instability in the past, it would clearly be in the economic and broader national interest of the United States.”

Before Mahuad’s announcement, Hanke received a telephone call from someone who wanted to be the first to congratulate him for Ecuador’s move to dollarize. Hanke, who was then in Argentina, was informed by his acquaintance - “someone with authority and credibility” – of a few details. “Mahuad was on the verge of resigning his Presidency and Summers said ‘no, do not resign but instead announce that you were going to stop Ecuador’s currency crisis by getting rid of the sucre and replacing it with the dollar’”.

“Mahuad did not need formal permission from the U.S. Treasury to dollarize, but an informal green light was very critical for someone who was unsure of himself,” Hanke explained.

A *New York Times* piece published on Monday, January 10 confirms that not only Summers but also President Bill Clinton had called Mahuad the previous Friday to express his support. “That was before Mr. Mahuad decided to adopt the dollar,” published the newspaper.

Whether or not that phone call was a determining factor in Mahuad’s decision to dollarize, only the former president knows. Both Dr. Mahuad and Dr. Summers declined to comment for this story.

By then, Mahuad had consulted with Venezuelan economist Ricardo Haussman and Panamanian economist Juan Moreno, an economist who possessed expert knowledge of how dollarization was implemented in his country.

All of Latin America

When Ecuador dollarized, Argentina was on the verge of doing it. Menem, who was seeking a third term, had toured Washington D.C. and had enthusiastically announced his intention to dollarize. A bill that was being discussed in the U.S. Congress gave the "dollar evangelists" the confidence to forecast that most, if not all Latin-America would dollarize in a few years.

The International Monetary Stability Act, written by Kurt Schuler and Robert Stein for Senator Connie Mack, then chairman of the Joint Economic Committee of the U.S. Congress, proposed sharing seigniorage (the revenue a government earns from printing its own currency) with officially dollarized countries.

The Senate bill did not pass in the House of Representatives. Secretary Summers was opposed to the idea of sharing seigniorage because doing so would "raise a number of complex political, economic, foreign policy issues" he wrote in a letter to Senator Mack. Dollarizing should be a "unilateral sovereign decision," he added.

"Without U.S. support, official dollarization withered as a political possibility in Argentina. In Ecuador, though, dollarization was successful in immediately ending fears about hyperinflation and in providing financial stability as I witnessed on the spot during its first week of existence," writes Schuler.

The dollar gave Ecuador a boost of confidence, but it didn't save Mahuad, who was overthrown by military soldiers and indigenous groups on January 21, 2000. He fled to the United States to avoid charges of embezzlement for ordering the deposit freeze. In 2014, he was sentenced in absentia to 12 years in jail. His defense has challenged the sentence and to this day he insists that he's being "politically persecuted."

Mahuad was succeeded by his vice-president, Gustavo Noboa, who made Carlos Julio Emanuel Minister of Finance in 2001. Hanke came back to Ecuador that year to serve as Emanuel's advisor. At that time, Hanke said, he was briefing the Undersecretary of the U.S. Treasury and the Deputy Managing Director of the IMF on developments concerning dollarization. "These interactions at a high level were important because they gave those at U.S. Treasury and the IMF confidence that Ecuador knew what it was doing and that the implementation of dollarization was in good hands. In consequence, the U.S. and the IMF kept full support."

For his contributions, Steve Hanke received an honorary doctorate at the Universidad San Francisco de Quito in 2003, and the University of Azuay in Cuenca named him Profesor Asociado (the highest honor awarded to international experts of acknowledged competence) for his contributions in Ecuador.

It is easy to gauge the enormous impact of Hanke's work in Ecuador. However, Hanke wanted to go after even bigger fish because Ecuador, then a country of only 12 million people, was a small piece in the global puzzle of monetary power that is still being assembled. Hanke and Cavallo still see each other over the summers in Tuscany, at Nobel laureate Robert Mundell's (whose theories inspired the creation of the euro) palazzo, where global economy brains meet to talk, among other things, about how to create a world with fewer currencies.

Both Hanke and Schuler acknowledge that the Ecuadorian economists of Foro Económico promoted dollarization effectively. "The strong public support in favor of dollarization in Ecuador today is the main reason politicians will not get rid of it. Any politician who wants to get rid of it would be committing political suicide," said Hanke. Ever since socialist president Rafael Correa took office in 2007, the fear of "de-dollarization" has been recurring. Correa had stated repeatedly that the lack of monetary policy, the impossibility to emit and devalue a currency, is a "straitjacket" that is holding back the economy and making Ecuadorian products less competitive.

Hanke disagrees. Without the dollar, Ecuador's reality would be similar to Venezuela's nightmare, Hanke said. He forecasts that Venezuela, where in December 2014 he estimates annual inflation rose to 170 percent, the highest in Latin America, will collapse sooner or later and might just dollarize. In Ecuador, the annual inflation rate last year was 4.11 percent and the economy has grown at a stable pace of 4 to 8 percent each year in the last decade, performing better than the regional average. "Dollarization is the only reason for Ecuador's stability. Stability isn't everything, but everything is nothing without stability," Hanke said.

Originally published in Vistazo Magazine, No. 1137, January 15, 2015.