

## **Dollarization in Latin America: Wave of the Future or Flight to the Past?**

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Latin American economic policy during the 1990s was guided by the “Washington consensus,” which embodied the orthodox model’s espousal of free trade and economic liberalization (Williamson 1990). Macroeconomic performance improved over the lost decade of the 1980s, aided by new capital inflows. However, Nancy Birdsall and Augusto de la Torre (2001, 6) noted that “in economic growth, poverty reduction, income distribution, and social conditions the results were discouraging.” This outcome is no surprise to institutionalists and those not committed to the orthodox model (Lichtenstein 2000; Schneider 1999; Went 2000).

The Washington consensus left the issue of exchange rate regime open, suggesting “that achieving a ‘competitive’ exchange rate is more important than how the rate is determined” (Williamson 1990, 13–14), although floating rates had “some support in Washington . . . as the more important [principle]” (13). However, David Felix (1997/8) documented increased exchange rate volatility and its detrimental effect on trade, investment, financial stability, and macroeconomic policy in Latin America. Taking a Keynesian perspective, he pointed to capital mobility after the demise of Bretton Woods as the main contributor to this discouraging performance.

Orthodox economists placed the onus on bad domestic policy or faulty choice of exchange rate regime. After the collapse of their pegged rates in the Asian miracle economies, orthodoxy demanded that countries operate in a bipolar world, either floating their currencies or adopting a hard peg such as dollarization (Fischer 2001a). In addition, the successful European transition to the euro, active research on optimal

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currency areas (Panizza, Stein, and Talvi 2003; Courchene and Harris 2000), and widespread use of the dollar in Latin America combined to suggest dollarization as a solution to the problems noted by Felix. Ecuador undertook official dollarization in 2000 when it destroyed its own currency, the sucre, and adopted the dollar. El Salvador converted all financial instruments to dollars, and Guatemala now allows transactions to be carried out in any currency. Both assumed that the dollar would soon displace their domestic currencies. This experience suggests that dollarization may become progressively easier for other countries. Indeed, there are numerous predictions of a completely dollarized Western Hemisphere (Schuldt 2003; Trejos 1999; "La Dolarización Será Una Realidad en la Próxima Década," by Eduardo Tuculet, *Tiempos del Mundo*, July 19, 2001, B24–27).

Will other countries in the Western Hemisphere implement official dollarization this decade? Could Latin America become an official dollar bloc, with the dollar as the common currency? Alternatively, will dollarization be a momentary phenomenon, whose promise is tarnished by the economic performance of countries that have chosen hard pegs?<sup>1</sup>

In answering these questions, I use the methodology of "pattern models" described in Wilber and Harrison 1978. My model, and point of departure, is to characterize Latin America's international financial relations as a "dollar bloc," an informal but powerful system that binds their currencies to the dominant currency, the dollar (Jameson 1990). This relation, and its supportive institutions such as the International Monetary Fund and the World Bank, dominates Latin America's international economic relations. Whether official dollarization becomes the general choice of exchange rate regime in Latin America in this decade depends on the extent to which dollarization becomes one of the rules of the dollar bloc; it is a question of the institutional evolution of the dollar bloc (Jameson 2001).

I structure the argument as follows. In the first section I place dollarization in historical context, since dollarization is path dependent and the historical experience will affect how the dollar bloc evolves. In the main body of the paper, I examine the most extreme contemporary dollarization program, that of Ecuador. Any future dollarization decision will not result from bloodless calculation of costs, benefits, and optimality of the chosen exchange rate regime. Rather, issues of power and of the political goals of actors and institutions will play the dominant role. In turn, they will be heavily influenced by contemporary experience with dollarization. I treat Ecuador's experience in four dimensions. I document the Ecuadorian macroeconomic performance that spawned dollarization and then describe the powerful interests that developed and pushed dollarization as the preferred response to its economic problems. Next, I assess Ecuador's economic performance under dollarization, which leads finally to a discussion of possible alternative policies. The conclusion is that dollarization has had a number of positive elements; however, both the contemporary economic performance and the future prospects for Ecuador are modest and completely dependent on external

trends. Dollarization has not addressed the central economic issues of Ecuador. In the final section, I conclude that dollarization will not become a policy of choice for dealing with the problems of exchange rate instability unless the major international players begin to push and support that policy. There are few signs at present of pressure in this direction.

### ***Dollarization Past and Present***

Official dollarization, the formal adoption of the dollar as the domestic currency, is not a new phenomenon, and unofficial dollarization has long existed in Latin America.

Panama was the first country in the Western Hemisphere to dollarize officially. When it became an independent nation in 1903, the balboa was established as its official currency, based on the gold standard at "1.5046 grammes of pure gold" (Crosby 1915, 23). However, the dollar was already a familiar currency in the country, and because of the U.S. role in Panama's creation, the government allowed the dollar to circulate freely at \$1 = 1 balboa, as agreed in the dollar association treaty with the United States. In addition, the \$10,000,000 paid to Panama for the right to build the Panama Canal, augmented by a \$250,000 payment per year and expenditures by canal personnel, made dollars abundant (McCullough 1977, 612). Although the balboa could still be traded in New York at a ¼ percent discount in 1915, it was naturally supplanted as the medium of exchange because of dollar availability and the existence of a dollarized economy in the Canal Zone. There was a short-lived populist effort in 1941 to restore the national currency by printing paper balboas. Its failure relegated the balboa to its current status as supplemental coinage.

Panama's economic performance has often been used to argue for dollarization in other countries. Juan Luis Moreno-Villalaz (1999) claimed that low interest rates, low inflation, good GDP growth, and a stable real exchange rate were evidence that dollarization can improve macroeconomic performance. A more detailed study found the evidence mixed (Goldfajn and Olivares 2001). Inflation in a dollarized economy does decline, and it may provide some insulation from external shocks. However, Panama's low interest rates may be the result of its internationalized banking system rather than dollarization. More important, dollarization has not enforced fiscal discipline, reduced GDP growth instability, nor removed the volatility of interest rate spreads on sovereign debt. Indeed, Sebastian Edwards suggested that the major effect of dollarization has been to give Panama a preferred position in the dollar bloc, allowing Panama to use the IMF as a "lender of first resort" ("The IMF is Panama's Lender of First Resort," *The Wall Street Journal*, September 24, 1999, A15).

Cuba's Monetary Law of 1914 allowed the dollar to circulate freely at a fixed rate with the peso and banned transactions in Spanish or European currencies (Wallich 1960). As late as 1931, dollars constituted more than 80 percent of Cuba's currency.<sup>2</sup> In the early 1920s, a proposal to establish a branch of the Federal Reserve Bank of Atlanta

in Havana was seriously considered since the country had no central bank. The Fed's agency in Cuba took responsibility for providing needed liquidity until 1938. Despite efforts to increase reliance on the peso starting with the Great Depression, in 1947 dollars and dollar deposits still accounted for 45 percent of the Cuban money supply (153).

Mexico provided an example of "unofficial" dollarization during the last century. The country had switched from a silver-based currency to the gold standard in 1905, "and the system worked splendidly from the time it was put into effect until the year 1913" (Crosby 1915, 19). At that point, competing insurgent groups began to issue their own currency and there were as many as twenty-one different currencies in circulation in Mexico. Finally, the only generally acceptable monies were gold or silver coins, for the most part minted in the United States. Monetary stability gradually returned after 1925, though as late as 1933, 33 percent of deposits were in foreign currency (dollars). This share fell rapidly, to 6 percent by 1937, after the depression interrupted dollar flows and the exchange rate was fixed. The 1937 devaluation and float led to an increase in the dollar deposit share until a new fixed rate was established in late 1940, when it fell back to 6 percent (Ortiz 1982, 441–443).

These experiences suggest that unofficial dollarization will occur under three circumstances:

- When there is ample availability of dollars to the domestic economy.
- When domestic instability affects the health of the financial system and the confidence of domestic economic actors.
- When government policy allows a dollarized sector to exist within the domestic economy.

These elements contributed to the unofficial dollarization of much of Latin America in the 1970s and 1980s. First, international financial institutions facilitated petro-dollar recycling and provided access to dollar-denominated loans from 1973 to 1980. Loans to Latin America increased five-fold, from \$48 billion in 1973 to \$220 billion in 1980. Debt and interest payments increased from \$2.7 billion to \$21 billion per year.<sup>3</sup> Second, even prior to the debt crisis of 1982, economic instability had increased throughout the hemisphere because governments attempted to postpone the reckoning for increased oil prices. Oil producers such as Mexico were not immune, for after the peso's devaluation in 1976 the share of dollar deposits began to rise rapidly. Finally, when Latin American governments reduced exchange controls in the 1970s, the third element became a reality. For example, foreign currency deposits in Uruguay rose from 5 percent in 1973 to 45 percent by 1977. In 1984, dollar-denominated deposits were 74 percent of total deposits in Peru (Jameson 1990, 523). This reversed a conscious policy by Latin American governments to restrict the use of non-national currencies, which had been encouraged by the post-World War II, U.S.-based "money doctors" such as Robert Triffin (Helleiner 2003b, 5).

The post-1973 experience affected the relation of Latin America to the dollar in several ways, creating the informal “dollar bloc” that currently exists. First, generating dollar revenues became a major concern of all governments, for the debt had to be paid. Defaults, such as those of the 1930s, were not acceptable and were very costly as discovered by Ecuador in 1999 and Argentina in 2002. Second, the mechanisms for moving between dollars and the domestic currency were now well known to domestic actors, facilitated by the availability of “dollar deposits” in the liberalized national banking systems. Thus, it became very difficult for governments to constrain the behavior of domestic economic actors, who could often avoid policy changes by going to the dollar sector. In addition, after 1987 the Federal Reserve Board’s policy of targeting short-term interest rates increased international dollar liquidity. The share of U.S. currency held outside the USA may be as high as 66 percent (Carlson and Keen 1996).

As a result, the exchange rate regime became a central policy issue in all Latin American countries. The case studies in Frieden and Stein (2001) and Wise and Roett (2000) document that the wide range of policies that Latin American governments had used to maintain international equilibrium have been superseded by the requirement to establish and maintain a credible and competitive exchange rate. When it became progressively more difficult to utilize the “fixed but adjustable,” or “crawling peg,” regimes that had been characteristic since the demise of Bretton Woods in 1973, the orthodox position was that countries must choose between floating rates or a hard peg—such as dollarization (Fischer 2001a). For orthodoxy, the central task of governments was to reassure international capital markets, given mobile capital. Dollarization could succeed in this regard, since it allowed no independent monetary policy and was very difficult to reverse.

On the other hand, Carol Wise and Riordan Roett (2000) showed that neither fixed nor floating regimes guaranteed superior economic performance during the 1990s. Despite highly placed supporters such as Stanley Fischer, who was the deputy managing director of the IMF, the argument for dollarization remained far from compelling. So we must learn from actual experiences. In that regard, Ecuador’s official dollarization provides an exceptional laboratory to study the effects of such a hard peg. Let us turn now to examine the four aspects of Ecuador’s dollarization noted above.

### ***Ecuador’s Dollarization***

When President Jamil Mahuad announced a vague dollarization program on January 9, 2000, few of the criteria for entering an optimal currency area were met (Panizza, Stein, and Talvi 2003). The major exceptions were that Ecuador was a small, open economy and that its Central Bank had low credibility in economic policy matters. Indeed, no economic policy maker had credibility after sixteen months of Mahuad’s administration. Since purely economic factors did not necessitate dollarization, we must look to power relations and to institutional forces for our explanation.

Let us first review Ecuador's economic performance as part of the dollar bloc to show how that system dominated domestic performance and laid the basis for the dollarization demanded by powerful coastal interests.<sup>4</sup>

### *Economic Instability: The Road to Dollarization*

Ecuador has not been a strong economic performer. Only in the 1970s, with its first significant oil production, did Ecuador's growth exceed the Latin American average GDP growth rate (table 1). As a result Ecuador's per capita GDP in 1997 was almost the same as in 1980, and it had fallen relative to average GDP in Latin America. The investment pattern was similar.

On the other hand, the degree of disequilibrium in the economy was far less than the average in Latin America. Inflation rose after the 1970s but, *on average*, was relatively stable in the 1980s and 1990s at 35 percent. Government's share of GDP was less than average and the government generally ran a surplus, in contrast to persistent deficits in other countries.

Underlying the stability, however, were changes that would become the source of later problems. The external debt grew rapidly from \$600 million in 1973 to \$16.4 billion in 1998. Per capita debt was \$100 in 1973 and grew to \$1,360 in 1998; as a percentage of GDP it grew from 20 percent in 1973 to its high point of 118 percent in 1998.

**Table 1. Latin American and Ecuadorian Economic Performance**

	Latin America/Caribbean		
	1971-80	1981-90	1991-97
Per capita GDP growth	3.3	-0.4	1.6
Per capita GDP (US\$) <sup>a</sup>	2900	2653	3025
Average inflation	46.7	192.1	268.0
Gr. dom. invest. growth	7.6	-1.7	5.9
Govt. exp. (% of GDP) <sup>a</sup>	19	22.5	23
Govt. deficit(% of GDP) <sup>a</sup>	2.2	1.7	1.5
	Ecuador		
	1971-80	1981-90	1991-97
Per capita GDP growth	6.3	-0.6	1.5
Per capita GDP (US\$) <sup>a</sup>	1378	1264	1392
Average inflation	13.8	36.6	34.9
Gr. dom. invest. growth	10.7	-5.1	2.3
Govt. exp. (% of GDP) <sup>a</sup>	14.2	15.6	18.5
Govt. deficit (% of GDP) <sup>a</sup>	-1.4	-2	-1.3

Sources: IDB, *Economic and Social Progress in Latin America*, 1998; World Bank, *World Development Report*, 1984, 1990, 1992, 1994; ECLAC, *Statistical Yearbook for Latin America and the Caribbean*, 1988, 1999.

<sup>a</sup>Last year of period.

In addition, the international sector began to reflect the normal dollar bloc pattern: dramatic fluctuations in current and capital account balances, growing reliance on foreign direct investment and portfolio investment, and instability in total reserves (table 2). The evolution of the dollar bloc opened Ecuador to shocks transmitted through international capital markets (Atkinson 1999). Most notably, international reserves were subject to dramatic swings. For example, in 1996, reserves increased by \$245 million as a result of capital inflows; in 1999, the outflow on capital account caused reserves to decline by \$215 million.

The deterioration in economic performance after 1997 was dramatic (table 3). Since dollarization was spawned between 1997 and 1999, let us examine those years in more detail. The underlying causes of the deterioration were in the international and financial sectors. Despite devaluation and a depreciated real exchange rate, exports declined in 1998, mainly as a result of the oil price decline. They barely increased in 1999. However, the current account deficit of 11 percent of GDP in 1998 became a

**Table 2. International Dollar Flows to Latin America and Ecuador**

	Latin America				
	1980	1985	1990	1996	1999
Trade balance	-1,548	33,082	30,509	2,197	-19,700
Service balance	-29,333	-38,149	-6,582	-11,806	-14,650
Income balance	-20,285	-35,416	-35,564	42,902	-54,455
Current account balance	-29,508	-1,440	-1,541	-37,115	-56,370
Cap/fin account balance	35,005	2,584	16,807	63,745	43,490
Direct investment	5,709	4,132	7,029	37,824	70,725
Portfolio investment	13,565	-1,669	-1,586	-12,276	
Change in Reserves ("+" = Increase)	-2,321	1,142	-15,123	-27,015	3,480
	Ecuador				
	1980	1985	1990	1996	1999
Trade balance	303	1,294	1,009	1,220	1,655
Service balance	-974	-1,225	-112	-91	-145
Income balance	-524	-936	-1,374	-1,308	-1,725
Current account balance	-642	149	-360	111	885
Cap/fin account balance	980	-203	345	1,449	-1,485
Direct investment	70	62	126	447	655
Portfolio investment	79	0	219	995	
Change in reserves ("+" = Increase)	270	-24	-195	-245	215

Sources: IDB, *Economic and Social Progress in Latin America: 1980: 1985 Report; 1985: 1989 Report; 1990, 1996: 1998 Report.* ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean, 1999* (Santiago, Chile, 1999): 1999-estimated.

surplus of 6.9 percent because import demand collapsed along with the domestic economy. Imports nearly halved, to \$2.7 billion from \$5.2 billion. Foreign investment increased as a share of the declining GDP. Though it rose from \$69 million in 1997 to \$82 million in 1998, it then fell to \$63 million in 1999. International debt fell slightly but increased as a share of GDP, to 118.3 percent. So the pressure that membership in the dollar bloc placed on Ecuador's economy increased. The only way to remain current on debt repayment, as demanded by the dollar bloc, was to draw down reserves, which nearly halved. The sovereign debt spread increased five-fold.

The international deterioration triggered defensive domestic economic policies that were incapable of confronting the problems. Per capita growth was only 0.4 percent in 1998 and crashed to -7.3 percent in 1999. Inflation began to accelerate to 43 percent and then to 61 percent. The exchange rate collapsed to 6,825 sucres per dollar and then to 20,242 in 1999, devaluations of 54 percent and 197 percent. The rate of investment halved to 12.9 percent of GDP, and unemployment increased from 11.8 to 15.1 percent.

The financial sector also destabilized. Contrary to the position of the "new institutional economists," the liberalized financial institutions of Latin America have yet to attain stability. This highlights the importance of understanding institutional development from a traditional institutionalist perspective, or "original institutionalist economics" in Geoffrey Schneider's terms (1999, 325). The major banks became insolvent through a combination of fund diversion and insider dealing. Uncollectibles rose from 9.6 percent of outstanding loans to 40.4 percent in 1998. Pressure came from the fiscal side as well, where the deficit increased from 2.6 percent of GDP to 6.1 percent, falling slightly to 5.9 percent in 1999. The government forced the constitutionally independent Central Bank to finance the deficit, as well as a bank rescue program of the ill-conceived deposit guarantee agency. Thus the monetary base increased by 41 percent in 1998 and 174 percent in 1999. There was disintermediation as M2/GDP fell from 32.5 percent to 23.2 percent. The decline might have been far greater but for a freeze on bank deposits imposed in March 1999.

Unsurprisingly, the political situation also destabilized. The finance minister resigned in early 1999 because the opposition demanded a 1 percent financial transactions tax; then the Central Bank unilaterally floated the sucre on February 12. Inflows of official international resources can often stabilize such situations, and Ecuador hoped to gain access to \$2 billion in multilateral loans by midyear. Congress stifled the required reforms and held up the loans, which led in October 1999 to a unilateral declaration that Ecuador would postpone payment on its Brady bonds and would restructure all of its debt, except that owed to multilateral institutions.<sup>5</sup>

One element of the moratorium was the acquiescence of international agencies, as part of their nascent efforts to make private lenders bear some of the losses on bad loans. Ecuador may have been used as the guinea pig in this experiment, for the IMF authorized a \$400 million standby loan despite the moratorium. The private sector held the stronger hand, however. It forced an official default on one class of Brady bonds,

**Table 3. Ecuadorian Macro Performance, 1997–2002 (est.)**

	1997	1998	1999	2000	2001	2002 (e)	2003 (e)
<b>External sector</b>							
Exports,mm\$	5,264	4,203	4,451	4,846	4,685	4,581	5,702
Imports,mm\$	4,666	5,198	2,786	3,212	5,232	5,602	5,980
Curr acct/GDP	-3.6	-11.0	6.9	10.1	-4.3	-7.6	-1.8
For. inv./GDP	3.5	4.2	4.6	5.2	7.4	8.1	6.0
For debt, mm\$	15,099	16,400	16,282	13,458	14,410	14,640	14,620
For debt/GDP	76.4	83.2	118.3	98.6	80.1	72.9	65.5
Reserves, mm\$	2,093	1,698	1,276	1,180	1,074	1,004	1,337
Reserves, mos.	4.3	3.2	4.4	3.5	1.9	1.7	2.2
<b>Fiscal %GDP</b>							
Revenues	23.8	20.4	25.5	29.0	27.2	25.1	24.5
Expend.	26.3	26.5	31.5	28.6	26.8	25.9	24.0
Fiscal surplus	-2.6	-6.1	-5.9	0.4	0.4	-0.8	0.5
Primary surplus	2.5	-1.1	2.7	8.2	7.1	5.2	6.1
<b>Money sector</b>							
Inflation—Dec.	30.7	43.4	60.7	91.0	22.4	12.8	8.4
Exch rate—Dec	4,428	6,825	20,423	25,000	25,000	25,000	25,000
Devaluation	21.8	54.1	196.6	23.5	0.0	0.0	0.0
Money base growth	31.6	41.2	174.0	-58.1	10.5	7.1	10.1
Credit growth	49.6	37.0	144.1	-1.2	22.6	14.6	16.1
Bad loan %	7.1	9.6	40.4	47.8	39.6	21.0	15.0
M2/GDP	30.9	32.5	23.2	29.7	28.2	29.4	32.8
Sov. debt spread	597	1,334	2,754	1,435	1,186	988	603
Moody rating	B1	B3	Caa2	Caa2	Caa2	Caa2	Caa2
Real exch. rate—'97=100	100.0	99.6	138.3	155.4	109.4	97.2	94.3
Real return—\$	2.5	22.8	144.8	-59.8	-17.4	-6.8	-2.3
<b>Real sector</b>							
GDP,mm\$	19,760	19,710	13,769	13,649	17,981	20,093	22,310
GDP per cap \$	1,655	1,619	1,109	1,079	1,396	1,532	1,671
Real GDP growth	3.4	0.4	-7.3	2.3	5.4	3.6	5.2
Inv./GDP	19.0	24.7	12.9	16.8	24.1	26.7	26.2
Saving/GDP	15.4	13.7	20.0	26.9	19.8	19.2	24.4
Urban unemp.	9.3	11.8	15.1	10.3	10.4	10.9	9.5

Sources: 1997–2000: Cornell 2001. 2001–2003: Dr. Xavier Arcos, country economist for Ecuador and Mexico, Corporación Andina de Fomento.

and so Ecuador could no longer renegotiate and restructure portions of its debt. “Cross-default clauses” in agreements forced Ecuador into default on its external bonds while removing access to additional funds. One international financial player said, “The bottom line is that Ecuador won’t have access to private credit until the foreign debt is restructured. . . . There is no question that the level of economic deterioration is going to increase very, very quickly” (“Ecuador Faces More Hurdles to Resolution of Debt Woes,” by Thomas T. Vogel, *The Wall Street Journal*, October 5, 1999, A25).

This led President Mahuad to make his desperate dollarization declaration. “Desperate” is an apt description because he had dismissed dollarization only days before, the policy was opposed by the Central Bank, which had characterized it as “rushed, crazy measures” (Notisur 2000), and it led to the resignation of the Central Bank president and of the entire cabinet.

Let us now ask whether there were other options to deal with the turmoil and, if so, why dollarization was the course chosen.

### *Dollarization and Economic Power*

While drastic steps were necessary, there were alternatives to dollarization. Some of the potential alternatives were political, for example, dismissing Congress in a “Fujicoup” such as President Alberto Fujimori undertook in Peru in 1992, in order to implement a coherent economic policy. A convertibility program and a currency board to counter inflationary expectations were economic alternatives. Either would have allowed greater policy flexibility and would have provided credibility, based on the post-1991 Argentine experience. The most viable alternative was a direct attack on the financial liberalization that was at the center of instability by “suetretizing” financial accounts, restricting capital flows, and fixing the exchange rate.<sup>6</sup>

When President Mahuad announced dollarization, he was giving in to well-orchestrated pressure by powerful interests, located mainly in Guayaquil, the country’s main port. It is economically powerful, closely linked to the international economy through exports of bananas and shrimp and its domination of the import trade.

Joyce de Ginatta (2001) of the Chamber of Small Industry (Guayaquil) provided one account of the process. According to her, interest in dollarization began with a December 1995 study on “Ecuador: To the New Century and Millennium.” One of those magical/real experiences of Latin America came next. Abdalá Bucaram of Guayaquil was elected president in 1996. Shortly after taking office in August, he met with Domingo Cavallo, until then economy minister of Argentina and architect of their convertibility program, enlisting him to “transmit the Argentine experience.”<sup>7</sup> Economic and political instability made Bucaram’s December 1996 announcement of an Argentine-style convertibility program, to go into effect in July 1997, appear to be a desperate attempt to save his regime. The economic basis for his program was not clear.<sup>8</sup> Convertibility had succeeded in stopping Argentina’s hyperinflation, but Ecuador’s inflation was only 24 percent and had been relatively stable. The program did not

address the underlying fiscal, labor, production, and political problems. So at issue was economic and political power, and Bucaram lost. He was removed from office in February 1997, and the idea of convertibility went with him into exile in dollarized Panama.

Nonetheless, interest in dollarization continued. De Ginatta's organization went on record in favor in September 1998, and there were several conferences on dollarization in 1999, initially with Ecuadorian speakers. Next came the international experts: Kurt Schuler from the United States, who was working with Senator Connie Mack on legislation supporting dollarization, Jose Luis Cordeiro from Venezuela, Martin Krause of Argentina, and Juan Carlos Leal of Mexico<sup>9</sup> (de Ginatta 2001).

As a result, in a replay of 1996, a desperate politician facing mounting opposition proposed a radical exchange rate regime, dollarization. There were alternatives that might have made more economic sense, such as sucretization with capital controls. However, none of them had the support of economic interests as powerful as those pushing dollarization. It was an ironic twist that dollarization only hastened Mahuad's departure, for he was soon overthrown in a popular/military insurrection.

Dollarization stayed, however, at the behest of the new president, Gustavo Noboa, a former university president from Guayaquil. He was aided by sudden congressional willingness to pass the necessary legislation and by immediate offers of technical assistance from the IMF. This promised a solution to Mahuad's major failure, his inability to gain access to international financial resources. By September 10, 2000, the dollar became the official currency, and the sucre now exists only as supplemental coins.

Dollarization provided the dollar bloc's "good housekeeping seal of approval" necessary to free the IMF stabilization funds. Ecuador began to draw on a \$304 million standby loan on April 1, 2000 (\$114 million), which opened access to \$2 billion from other multilaterals, despite private bondholders' opposition. This allowed restructuring of the external debt, exchanging Brady bonds for bonds with a face value 40 percent less.<sup>10</sup> The second installment of the IMF loan, \$41 million, accompanied the completion of dollarization on September 10. Policy turmoil did not end, however. The economy minister resigned in December because of disagreement with the IMF on the size of the Value Added Tax (VAT) hike, so the IMF held up the third disbursement of \$42 million. Street demonstrations erupted against IMF-mandated adjustments; calm was restored only when they were partially rolled back. The carrots of \$240 million from the World Bank and IDB and of a \$1.3 billion debt restructuring by the Paris Club did not mobilize congressional action. Finally, on May 31, 2001, the government implemented an increase in the VAT to 14 percent, which freed \$49 million from the IMF and \$70 million from the World Bank.<sup>11</sup> The IMF agreed to disburse the remaining \$96 million of the standby loan in December 2001.

So dollarization has become a reality, and its end result for Ecuador's economic policy makers has been greater access to the international capital flows needed by members of the dollar bloc. Political fatigue has diminished protests and allowed a return to some semblance of normality—without dealing with any of the fundamental

underlying problems of the country. Let us now examine Ecuador's economic performance under dollarization through 2001, noting the lessons for other countries that might consider dollarizing.

### *Assessment of Dollarization*

Since Ecuador's dollarization is only three years old, any assessment will necessarily be tentative. In addition, its political genesis caused other problems. One exponent of dollarization and currency boards, Steven Hanke, called Ecuador's law "vaguely worded and foolishly ambitious" and added, "Success will hinge on the implementation and whether someone in the government actually takes a leadership role and gets the momentum going" (Notisur 2001). Proponents also claim that the Central Bank hampered the program by actions ranging from poor publicity to failure to provide sufficient coins for small transactions.

On the other hand, as shown by Argentina in 2002–2003, economies rebound after shock-induced recessions. Significant improvement in the economy after 1999 was expected, and this was the case in 2000–2001. The underlying question is whether this implies that the Ecuadorian economy is on a different and more successful path as a result of dollarization. Table 3 provides information on economic performance, including projections for 2002–2003.

Increased access to foreign dollar flows, to foreign saving, has been the crucial factor in recovery. Dollarization has succeeded in that regard. The current account balance improved to 10.1 percent of GDP in 2000, as oil export revenues increased more rapidly than imports. However, in 2001 imports accelerated, especially in durable goods, which resulted in a current account deficit of 4.3 percent of GDP. One notable dollar inflow has been emigrant remittances, which rose to \$1.4 billion in 2000 and became the second largest earner of foreign exchange. Foreign investment increased to 7.4 percent of GDP and continued strong in 2002 as work on a new oil pipeline progressed. The debt load decreased as a result of the debt restructuring and payments moratorium. However, international reserves continued their slow decline to \$1 billion, and their import coverage declined to 1.9 months. Fiscal pressures remained under control as a result of greater revenues from oil sales and improved value added tax collections. Nonetheless, budget deficits returned in 2001 and 2002, though there was a primary budget surplus in both years.

GDP grew by 2.3 percent in 2000, by 5.4 percent in 2001, and more than 3.0 percent in 2002, though per capita GDP is returning only to its 1997 level. Investment returned to its 1998 rate and unemployment decreased to 10.4 percent, aided in part by the continuing emigration of skilled and unskilled labor.

This modest improvement disguises growing imbalances. Dollarization promised to make domestic inflation converge to international rates. In actuality, inflation accelerated to 91 percent in 2000 as a result of the inflationary effects of the devaluation, of inertial inflationary impulses, of changes in relative prices toward inter-

national prices, and of price-setting behavior by monopolistic sectors in the economy, including public utilities. Inflation has decreased but was still 22.4 percent in 2001 and almost 10 percent in 2002. This slow and partial convergence to international inflation rates will further undermine competitiveness. The exchange rate had appreciated to its 1997 level by 2002. In 2000, non-petroleum exports had fallen by one-third from the 1997 level, and their trajectory for 2001 was again downward, though more slowly.

Financial indicators have not improved. The final failure of the largest bank, Filanbanco, in July 2001 added to that instability.<sup>12</sup> Ecuador's debt rating remains poor, Caa2, in the middle of the third from lowest category. The one contribution of dollarization was the decline in the interest rate spread from 2,700 basis points to 1,186 because dollarization reduced exchange rate risk. Nonetheless, country risk remained quite high.

What can we conclude about dollarization's effects on Ecuador's economic performance? From a political-economic standpoint, it has succeeded in providing access to international dollar resources, in other words, to foreign saving. Dollarization was largely responsible for the debt renegotiations, the renewal of official flows of loans, and new foreign investment projects. Inflation does appear to be decreasing toward international rates. In addition, the entire process, including the pressure from the IMF, has lowered the fiscal deficit and has prevented the government from monetizing the most recent bank failure.

In the medium to long term, how will the economy function? For the moment, access to foreign saving is supportive: IMF support of the new Gutierrez government and ongoing negotiations with creditors, combined with stable oil income and remittances. The list suggests how insecure these sources are, however. Oil's price has been unstable, though increased production may stabilize revenues. Emigrant remittances remain dependent on economic performance of industrial countries. Foreign investment has been for specific projects and will decline upon their completion. Agreement with creditors will increase the dollar drain, as payments resume. Finally, exports that are price-sensitive are declining and will continue to do so, for other countries competing for foreign markets will be able to change their real exchange rate to aid their producers.<sup>13</sup> In the medium term the economy may continue to improve; however, it will progressively move toward the limit of its access to foreign saving, the major contributor to improved economic performance. Decreased remittances, lower oil prices, or higher debt payments would hasten the arrival of the date.

How sustainable will this situation be? Ecuador's underlying political problems remain: unequal income distribution—both size and regional, deteriorating public services, peasant unrest, and political instability. The medical doctors who had not emigrated were on strike for much of the middle part of 2001, protesting salaries in the public health system that were a maximum of \$180 per month. A state of emergency was declared in January 2002 to protect work on the new pipeline. Elements of the Gutierrez coalition had already moved into opposition by April 2003. Domestically, dollarization may have only exacerbated political tensions. For example, the ongoing

bank bailout has been widely perceived as protecting the interests of certain powerful political and banking interests at the cost of the common depositor. In addition, the loss of seigniorage, estimated at \$897 million, or 6.2 percent of the GDP (Baquero 2000), reduces government's ability to effect an improvement in income distribution through its expenditure policies. The coastal importers have benefited, but even others in the international sector, for example, exporters and tourism vendors, are being hurt by the appreciation of the real exchange rate.

So the future of Ecuador under dollarization does not seem to differ greatly from its past. Most elements of political controversy remain, and new ones are being added. Prices for basic goods are still set by the government, and removal of subsidies, which affects large portions of the population, occasion demonstrations, resistance, and rollbacks of price increases. Salaries of government employees are low and are often not paid, so strikes are common and continual, and the fiscal policy flexibility is severely constrained. Independent monetary policy has disappeared, and the economy depends almost entirely on its international reserves for its monetary base. The Central Bank might affect the monetary system through changes in bank regulations, but given the weakness of the banking system there is little room to maneuver in this regard. This is further limited by the scrutiny of the international organizations and international capital providers.

Political stability and international support have certainly aided economic performance. When and if that changes, the pattern seen in Argentina is likely to appear: slower growth, increasing unemployment, structural fiscal deficits, and continuing appreciation of the real exchange rate. A crisis like Argentina's is very likely within several years.

One possible solution to all these problems is increased productivity and competitiveness. Some feel Ecuadorian coastal agriculture could improve its productivity. However, it is very unlikely that, even with low inflation and a stable real exchange rate, Ecuador could become an "Andean tiger." The best case for Ecuador may be the "Bolivian pattern," a relatively stable but stagnant economy in which incomes grow minimally and then only in response to international market conditions. For example, if the price of oil remains high, growth may continue. But Ecuador will be hard pressed to improve international competitiveness in products like cut flowers, bananas, or shrimp enough to offset an appreciated exchange rate. Domestic deflation could accomplish the same thing, but this has its own problems and is far in the future.

Let us turn finally to how Ecuador's macroeconomic policy may evolve in coming years, as the current experience is assimilated.

### *Are There Alternatives for Dollarized Ecuador?*

Dollarization has removed one element of conflict from Ecuador's political scene: the exchange rate. Based on the preceding analysis, the only realistic way performance can improve is through reducing the burden of the debt owed to the international

financial system, thereby increasing the resources that can be dedicated to domestic needs. Dollarization promised increasing inflows of capital to Ecuador, since exchange rate risk disappeared with the sucre. In the short run, it delivered on the promise. However, larger economic forces will dominate and will disadvantage Ecuador in the long run.

Are there any alternatives for a country that has dollarized, or adopted a hard peg, and whose economic performance is inadequate? This is an ongoing debate in Ecuador, and there are several positions.

The mainstream suggestion is that structural transformation of the economy must continue and be completed, that “illiberal enclaves” must be rooted out. Full integration of Ecuador into the international economy will provide improved economic performance. Paul Beckerman (2001, 35) wrote, “The structural reform agenda remains large. Much of it involves changes to mitigate the vulnerability of the fiscal accounts and banking system to Ecuador’s unusually broad array of contingencies.” Ecuador should also learn from Panama that “it needs to ensure solid international backing for its banking system” (36). Understanding of institutions and their evolution suggests that this program should be regarded with a high degree of skepticism.

Augusto de la Torre (2001, 3) suggested that the economy requires labor market flexibility and institutionalized cushions. The first would facilitate within-country mobility and downward wage adjustment.<sup>14</sup> The second would implement rules for fiscal discipline, some fiscal stabilization, internationalization of the banking system with prudent norms, and diversification of the risk of natural disasters. The goal would be to avoid the “high cost/low productivity trap” that our analysis suggests is Ecuador’s future.

Abelardo Pachano (2001) carried the cushion concept further. He proposed diverting any increased oil revenues from the new pipeline and putting them into several stabilization funds. Such a step would permit active stabilization policy and would direct resources into areas that could increase productivity. He also addressed the reality that Ecuador’s overvalued exchange rate will destroy domestic production and so Ecuador must protect segments of import-competing industries, using escape clauses and modifying the rules of international integration in Ecuador’s favor.

Controversy over dollarization in Ecuador continues, and opponents are developing alternative programs, despite President Gutierrez’s support for continuation of dollarization. At this point the most interesting proposals have come from the “Foro Ecuador Alternativo” in Quito (Valencia 2001). They note that currently the only way to stimulate the economy is through added external borrowing or more government spending financed by higher taxes. Their central proposal is to restore to the Central Bank the power to create currency—sucres, Andean pesos, or Ecuadorian dollars—under strict limitations and at a one-to-one parity with the dollar. This would stimulate efforts to develop a common currency among the Andean countries. Much of the rest of their sixteen-point program specifies how these funds would be used to raise productivity, especially through regional and social development, how oil revenues could be used to

buy back debt and raise capital formation, how domestic industry should be protected, and how productivity could be increased by better economic policy and knowledge formation.

There are two questions about these proposals. First, could this expansion of the Central Bank's ability to stimulate the economy be carried out without reducing Ecuador's access to the international capital that has become its basis for growth? Second, is there any reason to believe that the stimulus such a program could provide would actually result in higher productivity and greater competitiveness, in contrast with the experience of the country to date?<sup>15</sup> The latter question brings to the fore the political factor in any policy change for the country.

Ecuador's experience should influence other countries' decision on dollarization. Let us return to our main question: Will other countries in Latin America move toward dollarization as a result of the experience of the official and complete dollarization of Ecuador, and will this eventually result in a formal dollar bloc?

### ***Will Latin America Dollarize?***

Latin America has adapted to the reality of the Western Hemisphere dollar bloc, to the economic and financial power of the United States. The process was costly in the 1980s, the lost decade; the 1990s saw significant improvements. The first decade of the twenty-first century appears to be more like the 1980s than the 1990s. The system is again generating instability throughout the hemisphere. The Brazilian real has crashed, going from a stable 1.9/\$ to more than 3/\$ before stabilizing at that level. The Chilean peso has hit new lows, Argentina and Venezuela continue in economic turmoil, and Colombia is engulfed in political/military conflict. Growth projections for Latin America have been lowered yearly, and GDP fell by 0.5 percent during 2002. Foreign investment in Latin America was down by 50 percent during 2001. This reflects the worldwide slowdown and is exacerbated by Argentina's default on portions of its \$141 billion debt.

Will Latin America follow Ecuador and dollarize in order to avoid a repeat of the 1980s? As a starting point, we need to realize how atypical the 1990s were in the United States and, by extension, in Latin America. It was a time of unprecedented growth that is unlikely to be repeated, with extensive corporate restructuring and realignment of the location of world production facilities. The result was increased multinational corporate involvement in Latin America, partly because of privatization efforts but also because of the globalization of finance and production. The dollar bloc analysis suggests that, at this point, the key to stability and growth is the ability of countries to balance their dollar incomes with their dollar demands, represented largely by their debt repayment obligations. Capital inflows of equity or portfolio investments, remittances from migrants, and exports provide dollar inflows. Access to multilateral loans is the key to being able to adjust to imbalances in dollar inflows and outflows. The policy

challenge is to generate the resources needed for stability and growth, while continuing to function as a national economy rather than as a simple dependency of the United States.

If the dollar bloc continues unchanged, Latin America will continue to be at the mercy of international capital flows. A shock in one country or area can affect capital flows to many other areas, though the Bush administration tried to minimize its importance. Former Treasury Secretary Paul O'Neill stated, "Exaggerating the possibility of contagion leads to too-frequent intervention because, in effect, we convince ourselves we don't have a choice" ("Volatility Isn't Infectious, Say Bush Advisers," by Michael M. Phillips, *The Wall Street Journal*, July 10, 2001, A2). The Bush administration contributed to Argentina's default by supporting the IMF refusal to disburse funds in December 2001.

If there are no fundamental changes in how the dollar bloc functions, we can expect a continuation of the pattern seen during the last twenty years: instability generated by capital flows, domestic economies forced to adjust to those shocks, and continued inability to deal with the distributional imbalances that grew during the 1990s. The mediocre performance of the 1990s would be the best that could be hoped for, and the likely outcome is much worse (Birdsall and de la Torre 2001).

Ecuador has differentiated itself from the rest of Latin America by adopting dollarization, the extreme of the hard peg. In its first three years, the balance has been positive, almost entirely because it has given the country greater access to international dollar resources. Nonetheless, a more detailed look at its economic performance suggests that the factors that have aided performance are unreliable and that underlying trends in international competitiveness are very negative. Thus the country may soon reach the limits of its debt-carrying capacity and the dollar drain may again drag down the economy. In addition, aggregate economic activity is likely to stagnate in coming years, and there are few policy tools to attack this problem.

The conclusion is that the attraction of dollarization for most economies will be relatively minor. Argentina's economic problems, leading it to abandon convertibility, should further call into question the desirability of such hard pegs. While El Salvador and Guatemala merit further attention, it appears that the success of Ecuador was so specific to its circumstances that other governments would be unlikely to dollarize unless they had no other option.<sup>16</sup>

Two changes could alter this conclusion. Ecuador has hitched its cycle to the dollar at a time when the U.S. economy has weakened. If the U.S. economy were to recover and return as the engine of world growth, Ecuador's economic performance would improve and dollarization would appear more appealing. Second, if the IMF, the World Bank, and the U.S. Treasury climbed on the dollarization bandwagon and supported it with specific resources, other countries would have an added incentive to dollarize. There is no evidence that such a change in policy is forthcoming. The U.S. stance on dollarization has been neutral to supportive in public, while at the same time asserting

vigorously that U.S. monetary policy will be operated completely independently of the desires and needs of dollarized economies. The position that the United States will never act as a lender of last resort for a dollarized economy that may face a liquidity crisis has been even more strongly expressed (Summers 1999). The IMF was quite willing to allow Ecuador to be the guinea pig in defaulting on its Brady bonds and in dollarizing, without taking a formal position. There were even indications that, as he left the IMF, Stanley Fischer was softening his “bipolar” view that countries need either floating rates or hard fixes (2001b). This implies weakened support for dollarization.

The remaining question is whether dollarization will act as the “seal of approval” for the international system that would give an implicit default guarantee to international capital. In reality, Ecuador’s dollarization has played that role, encouraging both private and public capital flows that contributed to improved performance in Ecuador in 2000–2002. However, it is not clear that such a guarantee would be effective for other countries or for the hemisphere as a whole. Simply because a country dollarizes says nothing about its ability to repay international obligations, just as convertibility did not prevent debt default. So unilateral dollarization, with the implied loan from the Latin American countries to the United States, will not change the nature of the dollar bloc nor solve the problem of instability and mediocre economic performance. Only changes in the nature of the dollar bloc could give that result, changes that do not appear to be in the offing.

### Notes

1. The “hard peg” position was certainly weakened in 2002 when Argentina abandoned convertibility after ten years and regained stability within the year. This has underlined the “trilemma” of a fixed rate with capital mobility and resulting impotence of monetary policy. Argentina’s current predicament supports the cautions about global finance expressed by Glen Atkinson (1999) and illustrates Dani Rodrik’s (2000) “augmented trilemma.” He suggested that “global federalism,” the kind of institution advocated by Atkinson, might be able to address the contradictions of this bipolar world, while encouraging international economic integration. Tangible U.S. support of a formal dollar bloc would be a radical departure in this direction, though there is no indication it will be forthcoming. See Helleiner (2003a, 2003b) for insightful historical treatments of U.S. policy toward dollarization.
2. In an ironic turn, the dollar resumed its importance in Cuba in the 1990s after the fall of the Soviet Union. One of the current tensions in the Cuban economy is the effect that access to dollars has on relative real incomes.
3. The debt problem reflects Latin America’s historic tendency to rely on foreign saving to offset its own low domestic saving rates (Hausmann and Reisen 1997). Disruptions to flows of foreign saving are reflected in domestic economic performance.
4. The next sections draw on a series of reports from the Latin American Data Base Notisur and from international news reports archived in “Academic Universe of Lexis-Nexis” (Lexis-Nexis, 2000, 2001).
5. Paul Beckerman (2001) has provided a readable and very careful economic interpretation of this era. He focused on “semi-dollarization” as the accelerant in this debacle. I find the main source to be the continuing international debt drain and the constraints it imposed on domestic economic performance and policy.

6. Economists at the Central Bank had developed a plan for secretization and had presented it in convincing fashion to international policy makers prior to the dollarization declaration. (Personal communication to the author.)
7. Abdalá Bucaram told critics, "I ask all you economic geniuses out there who are grumbling and questioning [Domingo Cavallo's visit] just what medicine it is they take. If they take any medicine to save their lives, they found it abroad, not here" (Notisur 1997). History was certainly on Bucaram's side regarding foreign influence on Ecuadorian economic policy.
8. Former Vice President Alberto Dahík, from his exile in Costa Rica, provided the most telling view of the underlying political pressures for dollarization: "Society needs to understand that this is not a change in the monetary and exchange rate system. It is a reconquest and renewal of ecuadorian society. . . . It is a new order insisting on privatization and elimination of the privileges of bureaucratic sectors" ("No Habrá Perdón de Dios," by Martin Pallares, *El Universo*, January 17, 2000, 7).
9. The title of one of the conferences gives the tenor: "Dollarization Is the Only Option" (de Ginatta 2001).
10. The face value of \$6.65 billion in Brady and Eurobonds was reduced by 40 percent, to \$3.95 billion. However, this only reduced the debt service on the total debt of \$13.4 billion by 10.8 percent annually over the 2001–2005 period (Cornell University 2001, 4).
11. In August 2001, the Constitutional Tribunal ruled the VAT hike unconstitutional, and the government rolled it back to 12 percent. Increased tax revenues from oil and the economic recovery, along with increased emigrant remittances, had provided a fiscal cushion that removed fears that the fiscal deficit would spiral out of control.
12. The July 2001 closure of Filanbanco, after being taken over by the Deposit Guarantee Agency in December 1998, led President Gustavo Noboa to claim that he had been misled on its status until October 2000. His admission sparked widespread comment.
13. The recent depreciation of the dollar will help Ecuador's competitiveness in Europe, which accounts for 30 percent of exports. It will not aid trade with the United States (36 percent) or with other Latin countries.
14. Increased out-migration and the apparent decline in real wages suggest that the labor market has already made significant adjustments, without changing overall economic performance. For example, the May 2001 real minimum wage was 20 percent below its value of August 1996.
15. Argentina's productivity actually increased quite rapidly under convertibility, but that was insufficient to avoid its collapse into chaos.
16. Although former President Carlos Menem had espoused dollarization as the route to Argentina's stability, that proposal had little support by the elections of 2003, given the return of stability. Menem downplayed dollarization in his unsuccessful presidential campaign.

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