Discussion of the History of Ecuador

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As its title suggests, this chapter provides an overview of the main fiscal and monetary developments in Ecuador between 1950 and 2015. Covering sixty-five years of history in forty pages is no small feat, particularly so for a country like Ecuador, which—like many of its Latin American neighbors—has been on an economic roller coaster over the last half century. During this period, Ecuador repeatedly experienced commodity booms and busts, sudden stops, large financial crises, and even two armed conflicts with neighboring Peru! In such a volatile economic environment, it is no wonder that fiscal and monetary policy also fluctuated wildly and included two large-scale government bailouts to the private sector, three sovereign defaults, and multiple changes in the monetary regime that ended in outright dollarization in 2000.

Let me therefore start by commending the authors on the great job that they have done in summarizing and analyzing this rich history. In these comments, I first provide a bird's-eye view of the history described in the chapter. I then discuss what, in my view, are the key takeaways from the analysis and the main questions that it raises.

A Bird's-Eye View of Ecuador's Recent Economic History

Based on the chapter, we can divide Ecuador's economic history since 1950 into four distinct periods, which I will refer to as pre-oil, oil, debt crisis and aftermath, and dollarization.

During the *pre-oil period*, which extends from 1950 to 1971, Ecuador mostly exported agricultural products (bananas made up 40 percent of its total exports). The country exhibited modest yet relatively stable growth (approximately 2 percent in per capita terms), and more importantly from the perspective of fiscal and monetary policy, it was characterized by a small government and relatively low inflation. During this period, the fiscal deficit averaged 0.9 percent of GDP, and average inflation was low at 3.7 percent.

In 1972, Ecuador began exporting oil and everything changed. During the *oil period*, between 1972 and 1981, the economy boomed. Per capita growth averaged 6 percent, and

oil provided a substantial windfall for government finances. Despite the massive growth in revenues, spending increased even faster, and the fiscal deficit averaged 2 percent. In a world awash with liquidity, this deficit was largely financed by issuing foreign debt: as a result, total public debt increased by approximately 25 percent of GDP during the period (from 25 percent to 50 percent of GDP). Meanwhile, inflation also increased substantially to an average rate of 13 percent, fueled partly by the use of loose monetary policy to fund the fiscal deficit. In a nutshell, the oil boom brought about tremendous economic growth, but fiscal and monetary policies put the economy on a vulnerable path of rising imbalances.

These vulnerabilities surfaced in 1982, when Ecuador suffered the double blow of falling oil prices and rising interest rates in the United States. That is, just when they were most needed, the country found itself cut off from international financial markets. To make things worse, the private sector had also borrowed excessively from abroad during the boom years and now faced the specter of massive defaults and bankruptcies. The government intervened by partially nationalizing the private debt, which—coupled with the economic crisis—led to a discrete jump in public debt (approximately 30 percent of GDP in one year, from 50 percent to 80 percent) that ended with a sovereign default in 1982. The crisis also led to a large devaluation of the currency and to a spike in inflation, which rose to 48 percent in 1983.

This *debt crisis* had long-lasting reverberations on Ecuador's economy, and much of the following two decades was spent dealing with its legacy. Despite attempts at implementing reforms to boost growth and bring public finances in order, the 1980s were characterized by considerable fiscal deficits that were largely financed through seigniorage. Average inflation remained high, exceeding 34 percent throughout the decade. Public debt, meanwhile, grew as the country accumulated substantial arrears on foreign payments (by 1990, public debt stood at approximately 120 percent of GDP). During the 1990s, as elsewhere in Latin America, Ecuador embarked on a series of market-friendly reforms that included financial liberalization. Between 1997 and 1998, however, a sequence of natural and economic shocks—the El Niño phenomenon, low oil prices, and a tightening of international financial conditions following the East Asian and Russian crises—ultimately led to the worst financial crisis in the country's history. Output contracted by 7 percent in 1999, and the deficit of the public sector, which had to bail out the banking system, rose to 5 percent. Finally, inflation reached 67 percent by the end of the year.

By 2000, Ecuador's real GDP per capita was basically the same as in 1982. This year gave rise to the *dollarization period* as the country adopted the U.S. dollar and passed a series of fiscal responsibility laws to ensure the sustainability of the regime. This proved very successful in curbing inflation and jump-starting growth. Between 2007 and 2015, Ecuador experienced a new oil boom as commodity prices rose throughout the world. Once again, the boom was accompanied not only by economic growth but also by public deficits, which—given the lack of seigniorage in a dollarized regime—were financed with domestic and foreign debt.

What are the key takeaways from the chapter's analysis of sixty-five years of economic history? I divide my comments into three brief sections: what I knew, what I did not know, and what I would like to know.

What I (Thought I) Knew

This presumptuous title does not imply that I knew much about Ecuador before reading the chapter. It is instead meant to illustrate that the main guiding threads of Ecuador's economic history are common to many Latin American economies and not too surprising to anyone versed in the continent's recent past.

First, the country has persistently run fiscal deficits, which have been financed through the path of least resistance. During the 1970s, when international liquidity was abundant, the country financed deficits by issuing foreign debt; in the 1980s and 1990s, when access to international markets was curtailed, deficits were financed instead through seigniorage and, to some extent, through domestic debt.

Second, and contrary to what standard economic theory would suggest, fiscal policy in Ecuador has been largely procyclical with respect to the price of oil, its main export commodity. The oil booms of the 1970s and the 2000s were accompanied by large increases in government spending, fiscal deficits, and public debt. Jointly considered, these two points suggest that—in Ecuador—favorable economic conditions (e.g., high oil prices and abundant international liquidity) have not been used to correct but appear rather to have exacerbated fiscal and monetary imbalances.

Third, the high inflationary periods of the 1980s and 1990s were characterized by large increases in money supply, mostly from the monetization of the fiscal deficit. At least to a first approximation, Ecuador appears to confirm Milton Friedman's dictum that "inflation is always and everywhere a monetary phenomenon."

What I Did Not Know

Beneath the surface, however, this familiar story has some unexpected aspects. Perhaps the most surprising one uncovered by the chapter refers to the evolution of fiscal variables, especially the components of the deficit and the dynamics of public debt.

Between 1950 and 2000, the Ecuadorian government was consistently in the red: according to Table 1 in the chapter, its annual financing needs averaged 1.8 percent of GDP during the pre–oil boom period, 2.5 percent of GDP during the oil boom period, and 3.56 percent of GDP during the debt crisis and its aftermath. One may suspect that these needs were the result of irresponsible government spending. And yet, a relatively small share of them originated in *primary* deficits. During the debt crisis and its aftermath, in fact, Ecuador actually ran an average primary surplus of 2.47 percent of GDP! Where, then, did the financing needs originate? The chapter's answer is twofold: debt servicing and transfers.

Debt servicing is easy to explain. During the 1980s especially, as I have already mentioned, Ecuador's public debt grew as a consequence of high interest rates and accumulated arrears on foreign payments. Transfers are harder to pin down. Formally, they are defined as financing needs that go beyond the primary deficits and debt servicing. It is hard to know exactly what these transfers contain because they are not properly recorded in official statistics and are instead obtained as a residual in the authors' calculations. Some of the largest transfers coincide with Ecuador's hardest years, however, and they can be traced to large "fiscal shocks" such as the nationalization of private debt in the 1980s or the bailout of the banking system in 1999. To get a sense of these magnitudes, consider that Ecuador's debt-to-GDP ratio peaked at 130 percent in 1999: according to the authors' calculations, it would have been only 60 percent in the absence of transfers!

This is a fascinating and thought-provoking fact. Most theories of sovereign debt depict governments as borrowing to smooth consumption in the face of cyclical shocks or to increase the consumption of their constituents. This chapter, however, raises another possibility—namely, that a substantial share of countries' debt, in Latin America and elsewhere, is the result of financial crises and public bailouts. I am not aware of any systematic attempts to document the origin of public debt, but if this fact were verified for a broader set of countries, it could greatly influence our view of public debt. Traditional models of sovereign debt assume that countries face exogenous shocks and smooth them by issuing debt. According to these models, a central problem is that governments lack commitment, which may limit their ability to issue debt or expose them to costly debt crises: to solve this problem, countries should improve their "commitment technology" (e.g., by building institutions or exposing themselves to foreign sanctions). But Ecuador's experience suggests an alternative view, by which public debt is largely driven by financial crises. According to this view, the main problem is one of vulnerability to such crises, and the solutions lie in adequate crisis prevention and management.

What I Would Like to Know

As I said before, the chapter does a great job of documenting Ecuador's recent economic history. Yet two aspects leave the reader wanting more.

The first refers to data availability, and it largely escapes the control of the authors. All the statistics on fiscal policy refer to the central government because this is apparently the only level of government for which reliable data are available. This is unfortunate, because local finances (e.g., at the state or provincial level) have been important contributors to the aggregate fiscal deficit in many Latin American countries. It would be interesting to know how the primary deficit of the consolidated public sector behaves once other levels of government are taken into account and whether the needs of local governments can in part account for central government transfers. The composition of transfers is another aspect where perhaps more could be done. The chapter does a fantastic job of documenting the importance of transfers, their contribution to the buildup of public debt, and their relationship to major macroeconomic crises in Ecuador. But it

would be interesting to know more. One possibility would be to complement the analysis in the chapter with archival work, which would enable the authors to identify the main drivers of transfers in years in which they were especially large.

The second aspect that could be further explored refers to the broader effects of dollarization. This is a recurrent debate in Latin America that resurfaces whenever a major crisis occurs. The chapter adequately documents the evolution of major macroeconomic, fiscal, and monetary variables during the dollarization period, but—given that Ecuador represents a fantastic case study—I was left wanting more. For instance, conventional wisdom suggests that dollarization enhances stability by providing a nominal anchor, but it may also be destabilizing by reducing the country's ability to respond to shocks. Can Ecuador's experience teach us anything about this trade-off? Also, given the large effect of financial crises in the past, how does a dollarized economy prepare for such crises? Can the central bank effectively fulfill its role as a lender of last resort? How has Ecuador dealt with these challenges?

But these are minor quibbles about an otherwise very thorough chapter Anyone interested in Ecuador's and, more broadly, in Latin America's recent economic history should definitely read it!

Note

This chapter should not be reported as representing the views of the European Central Bank (ECB). The views expressed are those of the author and do not necessarily reflect those of the ECB.