

CAN DOLLARIZATION CONSTRAIN A  
POPULIST REGIME?  
THE CASE OF RAFAEL CORREA IN ECUADOR

**Nicolás Cachanosky**

Metropolitan State  
University of Denver

**Alexander W. Salter**

Texas Tech University

**Ignacio Savanti**

Universidad del CEMA

# Introduction

- 21<sup>st</sup> Century populism in Latin America literature
  - What do we know?
    - Rafael Correa's presidency (2007 – 2017) is one of the iconic left-leaning populist regimes in the region
    - He seized significant political power
    - Empirical work estimates significant economic costs produced by these populist regimes ...
    - ... except for Ecuador
  - Ecuador is the only dollarized economy in the sample
    - Dollarization is a monetary constitution
    - Can dollarization constrain (to some degree) a populist regime?

# Introduction

- Why did Ecuador dollarize its economy?
  - Serious financial and economic crisis in the later 1990s
  - No foreseeable alternatives (for instance, a currency board)
- Who dollarized
  - The public (private sector) first [informal dollarization]
  - Then the government followed [formal dollarization]
- Dollarization survived
  - Correa's populist regime and an attempt to issue digital currency
  - The 2008 financial crisis
  - How can dollarization constrain a populist regime?

# What is dollarization

- A country adopts a foreign currency
- Domestic central bank ceases its operations
- Dollarization works as a monetary constitution
  - Not possible to monetize deficits
  - Not possible to run domestic monetary policy
  - The central bank cannot operate as a lender of last resort
  - Ecuador's situation is “similar” to that of a US state with respect to the Federal Reserve
  - Dollarization is a non-reversible reform

# Populism in Ecuador

President	Term	Global Populism Database	V-Party
José María Velasco Ibarra	1968 – 1973	1.67	N/A
Gustavo Noboa	2000 – 2002	0.23	0.74
Lucio Gutierrez	2003 – 2005	0.97	N/A
Alfredo Palacio	2005 – 2006	0.39	N/A
Rafael Correa	2007 – 2009	1.25	0.98
Rafael Correa	2009 – 2013	1.73	0.96
Rafael Correa	2013 – 2017	1.53	0.96

# Ecuador versus other populist regimes

- Other populist regimes
  - Argentina
  - Bolivia
  - Nicaragua
  - Venezuela
- Looking at:
  - Institutional indices: Ecuador performs equal or better than the other populist regimes
  - Economic indicators: *Still to be included...* ☹️

# Dollarization versus Correa

- Two examples of how dollarization constrain a populist regime
  - Through a stricter budget constrain
  - The failed attempt to issue digital currency

# Dollarization as a stricter budget constraint

- Let
  - Government spending:  $G$
  - Taxes:  $T$
  - Government debt:  $\Delta B$
  - Monetization:  $\Delta M$
  - Other forms of wealth extraction:  $X$ 
    - Confiscations
    - Expropriations
    - Nationalizations



# Dollarization as a stricter budget constraint

Type of government	Example	How to finance spending
Developed economy with strong institutions	United States	$G = T + \Delta B + \Delta M$
Populist regime with domestic currency	Argentina	$G = T + \Delta B + \Delta M + X$
Populist regime in a dollarized economy	Ecuador	$G = T + \Delta B + X$

- Financing the deficit
  - For the political leader,  $T$ ,  $\Delta B$ ,  $\Delta M$ , and  $X$  are not perfect substitutes
  - If monetization is not possible, then we should expect the populist leader to behave differently

# Dollarization as a stricter budget constraint

- Government spending under Correa
  - Fiscal expenditures (in terms of GDP)
    - 2006: 14.9%
    - 2017: 23.3%
  - Paid with
    - Some taxes
      - Tax (5%) on capital outflows
      - 10% of tax revenues
    - But mostly with debt
      - Foreign + Domestic debt in terms of GDP
      - 2006: 26.5%
      - 2017: 41.3%

# Dollarization as a stricter budget constraint

- Going around the budget constraint
  - Buy-back debt
    - Exaggerate populist (anti-market) rhetoric and behavior
    - Have the price of bonds fall (higher country-risk premium)
    - Get money from your friend Chávez in Venezuela and buy-back bonds
  - Default!
    - Claim some debt is illegitimate because it was issued by past illegitimate governments
    - Default those bonds
    - Issue now debt with China (to be paid back in oil)

# Dollarization as a stricter budget constraint

- Populist turns on populist: Conviction or necessity...?
  - In 2015 Correa's popularity starts to decline (so does the growth of the economy)
  - Oil price start to fall
    - Cut on public spending
    - Proposal to impose an inheritance tax of 77.5%
  - Correa appoints Lenin Moreno to be his successor
    - Moreno was his Vice President between 2007 and 2013
    - Moreno wins the presidential elections

# Dollarization as a stricter budget constraint

- Populist turns on populist: Conviction or necessity...? (cont...)
  - As long as the economy is growing, there are new resources to distribute among interest groups
    - Political coalition
    - Labor unions
    - Legislators
    - Judiciary
    - Armed forces
  - When the economy stagnates (or worse, falls), the “printing press” is not available to “buy” political loyalty
    - Interest groups must fight and turn against each other to secure resources from shrinking source

# Dollarization as a stricter budget constraint

- Populist turns on populist: Conviction or necessity...? (cont...)
  - Lenin Moreno almost immediately turns against Correa
  - The market-friendly turn must be credible
    - Reduce subsidies
    - Remove some import tariffs
    - Re-instate limited presidential terms (goodbye Correa for good)
    - Sign deals with the IMF and the World Bank
    - Remove political appointees still loyal to Correa
  - Seems that Moreno's turn may have been more because of necessity than conviction

# Dollarization as a stricter budget constraint

- Populist turns on populist: Conviction or necessity...? (cont...)
  - Other regimes
    - Argentina: Populism continues with increasing (and very high) inflation rates
    - Bolivia: Evo Morales' presidency was interrupted
    - Nicaragua: Daniel Ortega manages to have low inflation
    - Venezuela: Populist regime continues with very high inflation rates

# Digital currency

- Correa: “Dollarization is a monetary suicide”
- 2014: Digital currency is launched
  - Issued and stored at the central bank
  - Managed through a phone app that only state-owned telephone company was allowed to distribute
  - Prohibit the use of other cryptocurrencies (such as Bitcoin)
- Less than three years later, the digital currency is discontinued
  - Despite tax benefits to users
- Expectation versus reality
  - Expected 500,000 accounts
  - Open account: 410,000
  - Active accounts: 205,000



# Digital currency

- How did the program work?
  - Central bank issues digital claims to US dollars
  - It is similar to a commercial bank that holds fractional reserves on US dollar deposits
- The success of issuing claims to US dollars depends on the trustworthiness of the issuer
  - In this case, Correa by now a well-known populism
  - Recent default in 2008
    - Including cease of payments to bonds held by the central bank
  - Distrust seems to have been rational
    - The government mandated commercial banks to re-patriate their foreign deposits
    - The government mandated the central bank to lend US dollars to the treasury

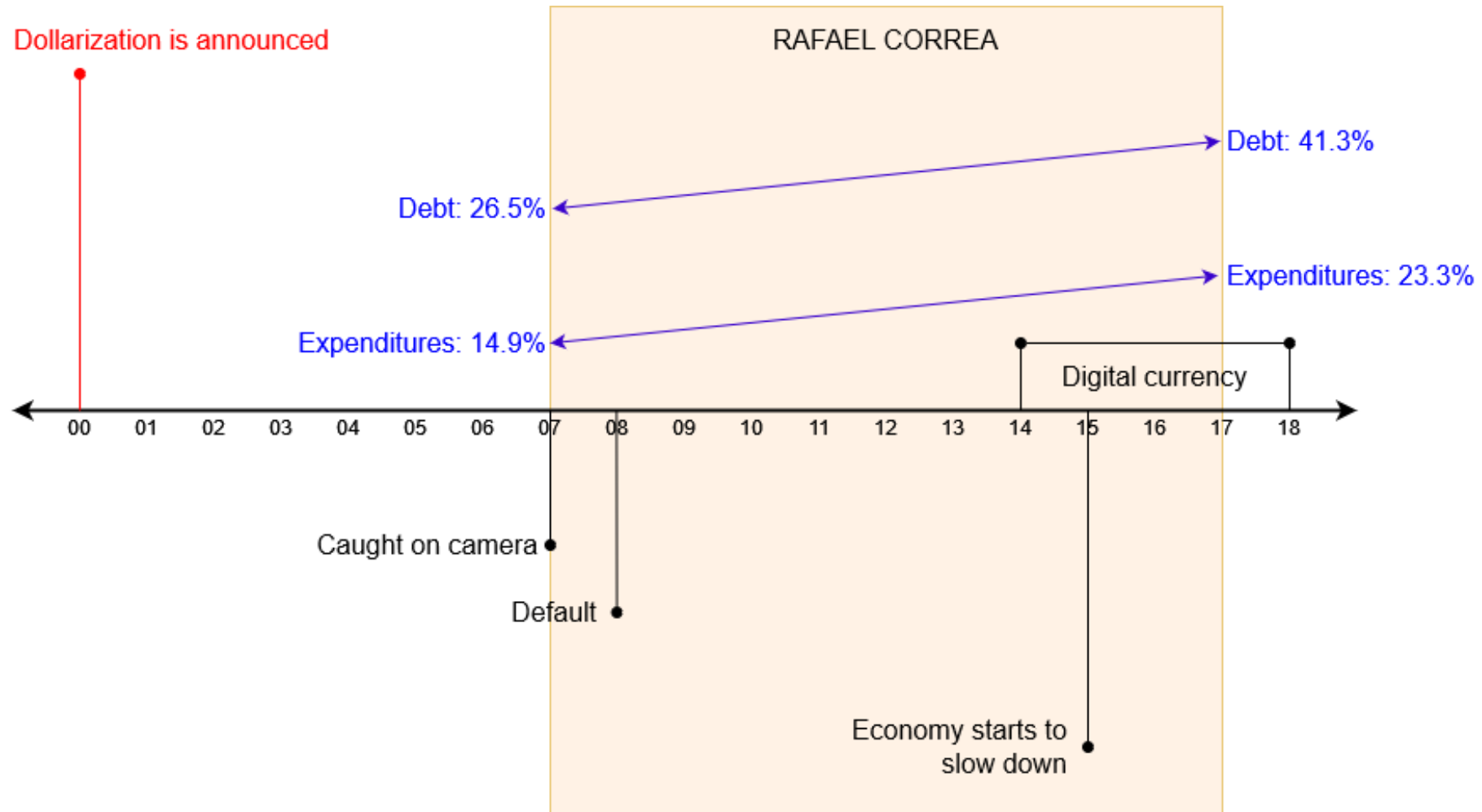
# Digital currency

- Three previous initiatives to restrict the use of US dollars
  - 2008: Issue of low denominations T-bills intended to be used as currency to make payments
    - Pay to government contractors
    - Did not allow to pay taxes in T-bills
    - Circulation increased when in 2016 government allowed to pay taxes in T-bills
  - 2009: FactoRepo
    - A B2B “bond points”
    - Combine invoices of buyers and sellers and credit “bond points” to the net creditor
    - Use “bond points” for payments
  - 2012: Mobile Payment System
    - Mobile (digital) money to be issued by the central bank
    - Private banks pushed-back

# Digital currency

- Motivations
  - De-dollarization
    - Unlikely it would succeed in the short-run
  - Fiscal resource
    - The more digital currency circulates, the more of an interest rate free loan the government gets
    - EMBI+ climbed from 510bp in 2014 to 1000bp in 2015/2016
    - Retail payments: 10% by bank transfers
    - More individuals with mobile phones than with bank accounts

# Timeline



# Next steps

- Things we still want to work on
  - More background on the process of dollarization
  - Include economic variables of Ecuador and other populist regimes
  - More information on the failed attempt to issue the digital currency

Q&A