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TURNAROUND

The Political Economy of Development and Liberalization in Ecuador, 1984–88

Francisco X. Swett

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PREFACE

This essay, by Francisco Swett, is the twentieth of the Center's Occasional Papers, which feature reflections on development themes by policymakers and economists.

Dr. Swett tells the story of his experience as Ecuador's Minister of Finance under President Febres Cordero, when he initiated a general liberalization of Ecuador's economy. He shows that although sound economic policies can generate appreciable results in the short run, achieving steady economic growth often takes longer. This essay shows the classic economic policy trade-off between present costs and future benefits to the entire country once economic growth is regained.

The experiences Dr. Swett describes illustrate the dominant role that political forces play in economic policy and also show how uncontrollable events, such as the devastating Ecuadorian earthquake, can undo the best-laid plans. The paper makes a valuable contribution to our understanding of the real world of policy-making, integrating the most advanced insights of the economics profession's academic understanding with the policymaker's real country experiences.

Nicolás Ardito-Barletta
General Director
International Center for
Economic Growth

Panama City, Panama
August 1989

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ABOUT THE AUTHOR

In his distinguished career of public service, Francisco X. Swett Morales has contributed to Ecuador's development in many ways. He is currently a Congressman and has previously held a wide variety of other positions in the Ecuadorian government; these include Economic Advisor to the President, Minister of Finance and Public Credit (from August 1984 to June 1986), Economic Advisor to the Central Bank, and President of the National Board of Planning and Economic Coordination. He has served as a consultant to the World Bank, the Inter-American Development Bank, the U.S. Agency for International Development, UNESCO, the Food and Agriculture Organization, the Economic Commission on Latin America, the International Council for Educational Development, and other groups. He has served as a member of several government committees, a director for a number of corporations, and an advisor to various public- and private-sector groups. His publications include *The Development of Capital Markets in Ecuador* and *Fiscal Policies in Ecuador*.

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FRANCISCO X. SWETT

Turnaround

The Political Economy of Development and Liberalization in Ecuador, 1984–88

From 1984 to 1988, serious policy reform and liberalization produced a radical turnaround in economic management in Ecuador. Although the commitment to reform weakened over the period, a fundamental change of direction nevertheless occurred: the increasingly stifling state intervention and bureaucratic control over day-to-day economic activity gave way to an increasing reliance on prices and markets to allocate resources.

The process of reform passed through several stages of success and doubt, in the midst of economic catastrophes brought about by the dramatic fall in oil prices in February 1986 and the effects of a devastating earthquake that crippled Ecuador's oil-production capacity for six months during 1987. Political resistance to the experiment and to President Febres Cordero's style of management was ferocious and

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This is an updated version of an earlier paper, entitled "Turnaround," covering the period 1985–86. Special thanks are due to the Council of the Americas and the Tinker Foundation, under whose auspices the original project was carried out. Valuable editorial assistance was provided by Margaret Daly Hayes and Arnold C. Harberger. The author benefited from comments offered by participants at seminars in both Washington, D.C., and New York.

unrelenting, based in a legislature dominated by the opposition. Democratic stability and continuity were severely threatened throughout most of the period, and even the President's life hung in the balance when he was kidnaped by partisans of a military commander turned political leader. To understand the turnaround and its implications for the future, we must consider the historical roots of the experiment, both politically and economically.

Structuralism: Theory and Practice

In the last quarter-century, Latin America has produced economic models ranging from Cuba's rigid socialism to Chile's near-orthodox laissez-faire capitalism. Between these two extremes the common denominator of economic policy has been active state intervention in the production of goods and services. The ideological and analytical underpinnings of this model, set forth by the ECLA structuralist school of thought led by Raul Prebisch,[1] claimed that since the terms of trade of Latin America (the periphery) were worsening secularly *vis-à-vis* the developed countries (the center), the region had no choice but to produce its own goods, thereby decreasing the need for expensive imports, reducing its dependency, and generating its own dynamic of growth.

The idea of turning growth inward appealed to the nationalistic feelings of many Latin Americans, but the political economy of decision-making through the years involved more than the subjective appeal of self-sufficiency and collective solidarity. Within each country the Latin model has bestowed important advantages on certain members of the private sector, including overvalued exchange rates, which distorted the intersectoral terms of trade and favored the development of

[1] The ECLA (Economic Commission for Latin America; in Spanish, la Comision Economica para America Latina, or CEPAL) model itself did not recommend exchange-rate overvaluation or interest-rate administration. Prebisch later criticized excessive protection and recognized the need for promoting exports of manufactured goods. The argument in this paper is that the model itself, in order to be sustained, required the administration of exchange rates, interest rates, and protective tariffs. The evidence is that, theoretical discussions to the contrary, such conditions were met.

manufacturing at the expense of agricultural production; the repression of financial markets, which provided a subsidy favoring the use of capital and made access to credit a function of influence rather than of economic efficiency; and a wall of protection, which ensured captive markets and very high rates of return on industrial investment. Government and the private industrial sector found the model very much to their liking, appealing both to politicians' egos and to private concerns for maximizing profits in the short run. The model was applied fairly consistently throughout Latin America despite the political instability in most countries and the diversity of their economies.

The "bending" of market forces to accommodate these policies had a number of effects:

- Labor markets were fragmented by legislation that favored those employed in the modern (manufacturing) sector of the economy. Workers sought to increase their "share of the pie" through protective labor measures, strengthening the bargaining power of labor unions, closing shops, and pushing labor costs in the modern sector above market-clearing rates.

- In general, nations favored manufacturing at the expense of agriculture, though Latin America's comparative advantage lies in the latter, not the former. High rates of protection accorded to industry were paired with negative rates for agriculture. Capital intensity displaced labor to the point where the region's incremental capital/output ratio today varies from five to seven (while in East Asia and the Pacific it is between three and four).

- The overvaluation of domestic currency, combined with high protection and financial repression, resulted in extremely high margins on domestic as opposed to foreign sales. Consumption was favored at the expense of savings; financial, labor, and production markets became increasingly fragmented, leading to structural rigidities that made the Latin economies more vulnerable to international price fluctuations and more dependent on capital transfers from abroad to finance national investments—precisely the opposite of what was intended.

- Latin development also resulted in the marked differentiation of sectors: within Latin America there coexist modern and pre-industrial models of production; highly sophisticated and primitive social and economic organizations; enclaves and backward regions; growing megalopolises and fading countrysides.

In other words, during the past quarter-century Latin American nations have not fully integrated their economies or societies. The region as a whole has lagged in development compared to its standing in the world at the beginning of that period. In the last fifteen years Latin America has been buffeted by convolutions in trade (with both upward and downward oil-price shocks) and the onset of the debt crisis, leading many to call the 1980s a lost decade.

The 1970s: Oil and Easy Money

Ecuador's development followed this pattern during the 1970s. Successive governments embraced the basic tenets of import substitution: exchange-rate overvaluation, financial repression, and industrial protection, made feasible by high petroleum prices and the increased flow of capital through external debt.

Ecuador makes an interesting case study of public- and private-sector aversion to discretionary changes in economic management. During the 1970s the Ecuadorian administration adopted passive policies toward economic decision-making:

- The exchange rate was fixed during 1970–82, notwithstanding a real appreciation of the *sucre* in relation to the dollar of at least 40 percent.

- Interest rates for the most part also remained fixed during that twelve-year period. Various preferential rates were given in response to pressures from numerous sectors; at one point there were eighty-five different rates.

- Industrial protection favored imports of capital goods and raw materials at the expense of finished goods. A wide gap between effective and nominal protection rates appeared. Industrial investment was promoted, and producing for the domestic market became highly profitable with margins on domestic sales six times as high as those on exports.

- The terms of trade between agriculture and other productive sectors deteriorated sharply. Effective protection rates for basic crops such as rice, maize, cacao, and coffee grew highly negative—in the range of 20 to 30 percent. Price controls and defective marketing mechanisms contributed to the decapitalization of the sector and to income transfers between sectors.

- The country's income became increasingly dependent on the price and volume of petroleum exports. Tax collection lagged considerably, and Ecuador came to have one of the lowest tax yields in Latin America.

- The external debt increased roughly from US$0.5 billion in the mid-1970s to US$7 billion by the mid-1980s. The debt profile turned from one of a development orientation with long-term fixed interest rates to a commercial orientation with short-term floating interest rates. In the public sector, a significant amount of external debt was used for budget support as public savings dwindled despite oil prices that ranged from US$35–40 per barrel. The private sector, including the banking system, became highly leveraged in external debt.

The repression of the price mechanism misallocated market signals throughout the economy, causing many of the economic maladies of the 1980s. The fixed exchange-rate regime operated just as price controls do on the supply and demand of any good or service, making supply scarce and demand abundant. This might not be terribly important if one were only talking about the price of milk, but in a small and open economy such as Ecuador's the exchange rate (i.e., the price of the dollar) is the most ubiquitous and important price.

Ecuador became a country of consumers, not producers. During the 1970s imports grew at an annual rate of 26 percent, while non-oil exports grew at 19.9 percent. The increase in total exports was largely caused by improvements in the terms of trade brought about by favorable trends in the price of petroleum, cacao, and coffee, not by increases in the volume or diversity of production.

More than 80 percent of imports were used to build up the industrial sector's productive capacity (in the form of plant and equipment, and raw materials), while manufactured exports were at no time more than 5 percent of industrial imports. Ecuadorian industrial development thus became highly dependent on imports, which in the "new" industries constituted more than 60 percent of the value of raw materials. In the meantime, agricultural production lagged and productivity fell as returns on investment dwindled and reform threatened the land-tenure system.

In the financial sector, the administration of interest rates had the effect of subsidizing the use of capital. As inflation climbed above the prevailing interest rates, firms became highly leveraged, with debt-to-equity ratios averaging more than six to one. The banking system's capacity for financial intermediation was eroded, and savings deposits (which paid negative real rates of interest) decreased from 55 percent of current-account deposits at the beginning of the 1970s to 18 percent at the end of the 1970s. Financial savings were thus diverted to other uses such as land purchases, capital flight, or simple consumption.

Ecuador has had a tradition of openness in foreign-exchange transactions. Except for a short period during 1971, a parallel dollar market has always existed, sanctioned by law, with no restrictions to access. Under the fixed exchange-rate system and financial repression, the private sector embarked on an aggressive process of acquiring external debt. Credit was generous and persistent, and the banking system found a very good source of income in borrowing abroad and lending at home. At the same time, it became more common to utilize credit lines from the Central Bank. The net position of the Ecuadorian commercial banks with the Central Bank, positive until 1977, became increasingly negative. The financial system's external debt climbed to the permitted limit of fifteen times capital and reserves. The number of banks increased from fifteen to thirty, the institutions were not sufficiently capitalized, and there was mounting evidence of increasing credit diversion as borrowers took cheap production credit to invest in speculative ventures, engage in conspicuous consumption, or send capital out of the country. In 1987 it was estimated that more than US$3 billion in Ecuadorian assets were deposited abroad.

The Onset of Crisis

The permissiveness of the 1970s, made possible by high petroleum prices and easy credit, began to sour in the 1980s. The initial cause of problems was external: international interest rates climbed to unheard-of levels bordering on 20 percent, immediately affecting the current account and prompting more borrowing to pay interest charges. In 1979–80 oil prices climbed from US$12.80 per barrel to US$40.00. The government used the additional income to increase current spending, putting upward pressure on domestic prices. In addition, the minimum monthly wage was increased 100 percent, from S/. 2,000 (equivalent to US$80 at the time) to S/. 4,000, and the work week was reduced from forty-four to forty hours. Over a two-year period, public spending increased by more than 100 percent and inflation inched forward from 10 to 16 percent.

The day of reckoning came in 1982. During 1981 oil prices had softened, declining from US$40 to US$30. The loss of international monetary reserves between 1981 and 1982 bordered on US$600 million, or approximately 75 percent of then-existing net reserves. The current-account deficit climbed steadily to 10 percent of GDP and the fiscal deficit reached an unheard-of 7 percent of GDP. But the policy response was tardy and rigid, with many political and ideological obstacles to changes in the established economic-management model.

In May 1982 the sucre was devalued from S/. 25 to S/. 33 per U.S. dollar, the monetary authorities imposed widespread restrictions on imports, and the Central Bank began dragging its feet on the processing of import papers as arrears on external trade payments began to build up.

In August 1982, Mexico announced the cessation of interest payments on its external debt, provoking the immediate closing of credit flows to nearly the entire region as it became evident that the "Mexican Syndrome" was widespread. It also became clear that Ecuador was, in relative terms, one of the worst cases, whether the measure was the ratio of total debt to GDP (70 percent), that of debt service to exports (125 percent), or that of interest services to GDP (9 percent). The private sector was in disarray as a result of the closing of credit lines, the widespread import prohibitions, the reimbursement delays by the Central Bank, and the mounting labor pressures.

To complicate matters still more, Ecuador suffered one of the worst natural disasters in recorded history during 1982–83, with heavy flooding provoked by the El Niño current. Over a twelve-month period, more than 7,000 millimeters of rain (the normal range is 1,500 to 2,000 mm) fell on the coastal region, devastating banana plantations, destroying shrimp farms, flooding rice fields, cutting off roads and bridges, and causing production losses estimated at US$350 million, or 2.5 percent of GDP. The following year, 1983, marked a low point for Ecuador's economic performance. GDP fell by 3.3 percent and inflation climbed to an all-time high of 48 percent. Debt-rescheduling negotiations began immediately after the authorities announced the cessation of payments on principal in November 1982 and lasted throughout most of 1983, while all external credit ceased to flow.

The government initiated a stabilization program assisted by the International Monetary Fund. In the fiscal accounts, public spending was cut by 5 percent and spending flows were administratively delayed. The sucre was further devalued from S/. 33 to S/. 42 to the dollar, and a regime of pre-announced mini-devaluations pegged at 40 percent per annum was put into effect from February 1983 to September 1984. The private sector debt was "sucretized," that is, the Central Bank absorbed the dollar debt of the private sector, giving it sucre obligations in return.

This swap entailed an automatic foreign-exchange risk transfer to the Central Bank.

The 1983 stabilization program succeeded in lowering the fiscal deficit (0.5 percent of GDP by year's end) and in reducing the current account deficit (3 percent of GDP). But the economic management model remained substantially intact, with previous rigidities augmented by still further distortions brought about by the accelerated depreciation of the currency. Interest rates turned strongly negative. With a pre-announced 40 percent rate of devaluation and 20 percent interest levels it became profitable to acquire sucre debt and buy dollars, thus encouraging capital flight. Continuing price controls together with the resurgence of agrarian reform issues on the political scene impeded agriculture's recovery from the effects of the 1982 floods.

The structure of protection and tariff distortions continued, bringing about a brisk business for contraband, illicit imports, and overinvoicing of imports as well as underinvoicing of exports. A regressive price subsidy on fuel consumption continued to drain resources at the rate of 5 percent of GDP. The financial system was in shambles and the government's capability for fiscal administration remained highly inefficient as taxes declined in relation to national product.

Liberalization Strategy, 1984–85

The traditional import-substitution model was severely undermined by the crisis of 1982–83 and the continuing disarray in 1984. Leon Febres Cordero took office with a mandate to "reconstruct" the economy after a bitterly fought and narrowly won election against Rodrigo Borja, the center-left candidate. The economic tasks facing the Febres Cordero administration were enormous. A former executive, the President was a quick-tempered and wily politician who well understood the extent of the economic reforms the nation needed. But with a congressional majority in the opposition, a fragile economy, the negative levels of exchange reserves, the relative youth and political inexperience of his economic team, and the anticipated short-term shocks that any fundamental changes in the economy would cause, Febres Cordero decided that the reforms would have to be carried out gradually.

The economic authorities, in turn, understood from the outset that a new economic management would require drastic changes in the old model, including:

- Overhaul of the exchange system;
- Progressive abandonment of financial repression, which required instituting a structure of positive real interest rates;
- Strengthening fiscal administration and achieving significant increases in non-petroleum taxes;
- Restructuring tariff rates; and
- Refinancing the external debt.

The initial objective was a return to a normal economic environment both within Ecuador and in the international sphere. But the public's initial expectations, fed by the political opposition, were that economic policy would be radical, closely resembling the Chilean model with its supposed uncertainties and regressive income distribution.

Exchange-rate policy was the cornerstone of the program. The legacy of the previous government was a system of multiple exchange rates, payment arrears on the order of US$400 million, a negative level of foreign-exchange reserves, and a system of pre-announced minidevaluations that encouraged capital flight and left the free-market rate highly volatile. On September 4, 1984, the first fundamental changes in the exchange-rate system took place. Where some fifteen effective rates had previously applied, the number was cut to three: an official rate at which "preferred" transactions took place; an intervention rate (in effect, a managed float by the Central Bank) at which approximately 80 percent of all transactions took place; and a free-market (street) rate for all other transactions.

The new policy structure was designed to promote the competitiveness of non-oil exports, make imports more expensive, and improve the terms of trade between agriculture and the rest of the economy, giving clear signals to further export promotion. In deciding how the sucre's depreciation would affect producer prices, the authorities sought to bring about a degree of income redistribution in favor of the myriad of small agricultural producers that comprise the bulk of Ecuador's economically active population. Concurrent with the reforms of the exchange system, the authorities lifted price controls on some forty-five products, mostly agricultural, retaining loose controls on only five products (salt, sugar, milk, medicines, and cement), the supply of which was considered highly concentrated or of a sensitive political nature.

Next began the gradual freeing of interest rates in order to encourage domestic savings, wean the banking system from its dependence on the Central Bank, and rationalize resource use to achieve higher efficiency in production and avoid credit diversion. To achieve this the authorities allowed the financial system to issue a certificate of deposit bearing market-determined interest rates. The authorities also approved regulations governing a system of adjustable rates in long-term operations. The structure of interest rates was streamlined, and four basic rates were established: a certificate-of-deposit rate, a commercial-bank asset and liability rate, a discount rate of the Central Bank for bank borrowing requirements, and a preferred rate for production loans for agriculture and housing development. Finally, the rates were brought closer into line with anticipated inflation.

Pricing policies also had to be rationalized in the pricing of labor, in order to align wage and salary increases with anticipated inflation and to strengthen progressively collective bargaining at the enterprise and occupation level, thereby demystifying the issue of minimum wages. But this proved to be a principal bone of political contention for the opposition Congress, which was bent on re-enacting the 1979 doubling of the minimum wage. After deft and forceful political maneuvering by the executive, the wage increase for 1985 was set at 26 percent, very much in line with anticipated inflation, and with a small purchasing-power increase of 2 percent.

The administration also increased the price of gasoline and oil derivatives by an average of 66 percent, reducing significantly a regressive subsidy though not eliminating it entirely. Gasoline pricing in Ecuador has always been a highly charged political issue, and successive administrations had approached it with ambivalence and hesitation, causing great price distortions in the economy. Despite this one-time effort, Febres Cordero was adamantly opposed to any further revision, and with continuing currency depreciation the subsidy again grew large, despite the drop in international oil prices.

The fourth element of economic policy was the strengthening of tax administration and the control of public expenditures, made possible by petroleum price stability during 1985, the exchange-rate depreciation that increased the number of sucres received for each dollar value of exports, the sharing of oil revenues, and the refinancing of the external debt. The results were remarkable: income and sales-tax collections during 1985 increased 60 percent in nominal terms over 1984, yielding a real increase of more than 30 percent. Customs collections increased 75 percent, with a real rate increase of 31 percent above the average currency depreciation (i.e., the tax base) for the year. Government spending was held in check, though public investment in development projects increased by 3 percent of GDP. The result was that during 1985, the public sector showed a surplus of 2.3 percent of GDP, an achievement last recorded in 1974, the year Ecuador began exporting oil.

The dismantling of the old system also required reducing significantly both the nominal and effective rates of tariff protection, especially to improve further the domestic terms of trade between agriculture and industry. Although the process was a protracted one, in the end the new system of tariffs lowered the top rate of nominal protection to 60 percent and decreased the spread between manufactured and nonmanufactured goods, thereby reducing effective protection. Import prohibitions decreased from 600 items to somewhere around 200, and some prior licensing requirements were replaced with straight tariff protection. Significantly, customs tax yields increased in real terms, despite the lowering of rates.

Finally, a strategy for debt refinancing was designed to achieve a gradual return to normal operating conditions in the financial markets. The authorities presented to the financial community a set of projections of the Ecuadorian economy for the period 1985–90, arguing that without refinancing the debt-service ratio would be 66 percent of exports, an intolerably high rate. The case was also made for a multiyear refinancing agreement (MYRA) instead of a single-year agreement. In the end, MYRAs were reached both with the commercial banks and with the Paris Club. The agreement with the banks refinanced 95 percent of the country's commercial debt and serially repriced the Republic's debt from 2¼ over prime to 1¾ over LIBOR (the London Interbank Offering Rate), saving Ecuador some US$250 million in debt servicing charges for the duration of the agreement. The normalization of the Republic's relations with the banks signaled the possibility of an eventual return to voluntary lending (since 1982 all new lending by the banks had been forced and universal). Thus in mid-1986 a facility was set up to finance Ecuador's oil sales in advance, the so-called oil-acceptance facility, which arranged for participation on a voluntary basis. The MYRA reached with the Paris Club was the first and only such agreement by a debtor country with Western governments.

The results during 1984–85 were highly promising: in both years the economy grew at approximately 4 percent and inflation was lowered to 28 percent and 24 percent respectively. The level of monetary reserves increased, and by the end of 1985 they had reached US$350 million net. The debt was refinanced. The budget showed a surplus. Public spending provided an important impetus to growth, and many public works projects attested to the government's commitment to its campaign promise of reconstruction. Private-sector expectations began to change with regard to the purpose and intent of the economic reforms. Even though there were widespread apprehensions and protests about the rising levels of interest rates and the scarcity of credit, entrepreneurs nonetheless were satisfied with a number of changes: the government had refinanced the external debt, the terms of the sucretized debt had been extended from three to seven years, and the "rules of the game" were unequivocal with no overt or covert bias against private enterprise. In the financial sector the loosening of the interest-rate structure promoted savings: deposits increased by 20 percent in real terms in a single year, improving banks' capacity to carry out financial intermediation.

At this time the government's political prestige was very high, with approval ratings of 60 to 70 percent. It seemed the President had outmaneuvered Congress at every turn, and the four-vote minority of the 1984 Congress became a six-vote majority in 1985. Using every source of power available under the law, the executive not only controlled all of the important levers of the economy (exchange rates, interest rates, tariff duties, and public spending), but also promoted legal reforms. A total of seventeen laws were changed, including a revised petroleum law that resulted in seven new exploration and production contracts where none had been signed since 1973. Reforms of the banking law and the monetary regime gave the monetary authority greater freedom to set financial and credit policies; tax discrimination against foreign investment was ended; and investment insurance agreements were reached with the Overseas Private Investment Corporation in the United States and with other Western governments. Ecuador became the first country to ratify the World Bank's Multilateral Investment Guarantee Agency Convention. The President vetoed every congressional proposal contrary to the purpose and design of reordering the economy.

The Crisis of 1986

At the beginning of 1986, the prospects for Ecuador's economy seemed bright. The stabilization and recovery of 1985 brought robust growth prospects of 6 percent, with inflation declining toward 15 percent, a comfortable balance of payments position, anticipated gains of US$250 million to US$300 million in exchange reserves, and completion of a number of public works projects initiated in 1984–85.

But the economic plan had not foreseen two critical developments: the disastrous fall in oil prices in 1986 and the convulsive political response. There had been rumblings of a softening of the oil market during 1985; the authorities' initial expectations were prices in the vicinity of US$23 per barrel, with a worst-case scenario at US$21. No scenarios were drawn up for prices lower than US$18. At the time it was thought that there were too many factors at work against a protracted and chaotic price collapse.

Still, there was no overoptimism involved. Although in November 1985 the Central Bank implemented an exchange-rate unification of the official and intervention rates (involving a 44 percent depreciation of the sucre since the administration took office), a new, further depreciation of 15 percent took place at the end of January 1986. New projections of public spending were made, tightening up the approval of new outlays, postponing a number of projects, and delaying the administrative flow of spending authorizations. A general order was issued and detailed plans were made to increase tax collections, targeting a nominal goal of an 80 percent rise in non-oil revenues for 1986.

The authorities tried to maintain the impression that despite serious problems, policy was steady. Unfortunately, contradictory statements were heard at the highest levels of the government that the crisis was terrible—the worst ever experienced. The political opposition responded by proclaiming apocalypse and implicitly blaming the government. The traditional cry of "social costs" once again became fashionable: the government should denounce the external debt-refinancing agreement and immediately stop all debt payments, enact price controls, re-establish widespread import prohibitions, and decree a general increase of wages and salaries. The oil-price crisis put the government on the political defensive, and a succession of political events began to tarnish what had been a brightening image and performance. While the administration's economic management was generally effective, politics had unceasingly been an arena of brutal confrontation between the executive and legislative powers. The government's hard-line position of no negotiations created severe tensions.

The breaking point was reached in March 1986. A simmering personal feud between the Minister of Defense and the Commander of the Air Force became a public brawl, which turned into a rebellion, and eventually degenerated into a succession of attempted *coups d'état.* Public opinion was that the government treated the episode in a cavalier fashion, charges of corruption were leveled against some officials, and the opposition took the initiative. The March episode and the political scandals that ensued severely weakened the political standing of the government as mid-term congressional elections approached. The government had earlier called for a referendum on whether independent candidates could run for office; all opposition leaders, as well as some who were aligned, pronounced against the proposal. The June 1, 1986, referendum and elections became the focal point for accepting or rejecting the government; the government was rejected, and the opposition emerged once again with a majority in Congress despite solid advances by the government in some parts of the country. More significantly, the apparently innocuous proposition that independents should have a right to run for office went down to a resounding defeat by a nearly three-to-one margin.

The political defeat did not, however, affect economic policy-making. The authorities had long contemplated setting up a system of floating exchange and interest rates. The reform was considered to be radical and opinions were divided on its extent and timing; the less orthodox felt that financial and exchange markets would work imperfectly and total freedom would lead to more, not less, distortions. The onset of the oil crisis favored the orthodox solution, as the Central Bank fast began losing reserves and the budget went into the red. Under the pre-oil-price-collapse targets, and with no austerity program in place, the public-sector deficit would have reached a level close to 9 percent of GDP, with a current-account deficit of 11 percent of GDP. The revision of the financial and credit program of the Central Bank and the reordering of public-spending and revenue targets were aimed at lowering the fiscal deficit to 5 percent and the current-account deficit to 3 percent of GDP.

The revised targets for 1986 implied a severe macroeconomic adjustment. To counter the recessionary effects produced by stabilization and to bring about future growth, it was decided that the old system of exchange and interest-rate administration had to be abandoned in favor of a policy that fostered export diversification and financial savings. The authorities further decided that, with international reserves quickly disappearing, the Central Bank would have to withdraw from external trade transactions to minimize damage to the country's external credit rating. Finally it was decided that a conventional devaluation would be very costly and would not help to solve the problem of speculation against the sucre.

It was against this background that on August 11 the Monetary Board approved sweeping changes that did away with fifty-six years of monetary, financial, and legal practice in Ecuador. The new system established a full flotation of the sucre, as private-sector exports and capital flows were paired against private-sector imports and capital transfers. Interest rates paid by banks on deposits and charged on loans were also deregulated, although the authorities reached an "understanding" with the banks to set the rate at a predetermined level.

The program had two objectives: first, to provide clear market signals to exporters that export activities were favored and that diversification was expected, and second, to stimulate financial savings, thereby increasing opportunities to finance private investment. The Central Bank's role in foreign transactions was limited to the servicing of the external debt and the imports of the public sector. Its external accounts were in turn fed by the production of petroleum exports and disbursement of the government's external credits. The new system required exporters to trade their dollars in commercial banks. Importers were required to obtain their import permits from the Central Bank and purchase their foreign exchange at the market rate in the private banking system. No restrictions were placed on capital transactions. Furthermore, the mechanism was designed to do away with most overinvoicing of imports and underinvoicing of exports. It was anticipated that a futures dollar market would be established to reduce uncertainty and smooth the flow of transactions.

The key control variable for economic management thus became the control of liquidity in the system. With the reforms in place, foreign-trade transactions in the private sector no longer created new money through the Central Bank, and sucres were traded for dollars in the financial system. The reform of the Central Bank's financial program was designed to keep credit growth in check and maintain an attractive rate of return on sucre financial assets.

Aftermath: Natural Disasters and Weakening Resolve

Political turmoil reached a fever pitch following the implementation of the August 11 policies. In late July the exchange rate in the free market had climbed to S/. 175, while the intervention rate of the Central Bank was at S/. 147. In the following days expectations changed sharply, and within three weeks the free rate had dipped below the intervention rate and would eventually fall as low as S/. 132.

In the meantime, the Minister of Finance, purported to be the *éminence grise* behind the entire scheme, was called to Congress for impeachment proceedings. With the new opposition firmly in the majority and in a hawkish mood, the result was a foregone conclusion. But the Minister gave a highly detailed justification, both legal and technical, of the polices that had been adopted; his reply lasted nearly five weeks and carried public opinion in his favor, while opposition congressmen sat in silent fury waiting for the moment when votes would be counted.

Congress eventually voted to censure and remove from office the man it thought to be the main culprit, but the Minister won a moral victory that catapulted him to national political prominence. The system was firmly in place and repeated political interferences did nothing to change the course of economic policy for the next eighteen months; the results of 1986 were quite encouraging even in the midst of the oil-price collapse. The declared value of non-oil exports increased from around US$800 million to US$1,200 million. Financial savings were up significantly, and by the end of the year they had climbed to 11 percent of GDP, allowing the banking system to strengthen its role of financial intermediation. Agricultural production showed an impressive performance of 7 percent, and the government continued its aggressive public-works policy.

By the close of 1986 the Ecuadorian economy grew at 3.2 percent, with the balance-of-payments gap of US$900 million financed largely by additional credits of the World Bank, the Inter-American Development Bank, and the International Monetary Fund. Inflation declined further to a yearly rate of 26 percent. The delicate economic situation was tolerable, and the main problem appeared to be the financing of government operations. The fiscal situation continued to be very tight and payments on the country's commercial debt would cease until oil prices firmed up again. Prices had been inching upward, and with the inflow of some 30,000 additional barrels per day it was expected that the economic picture would brighten yet again.

These hopes were dashed within the next few weeks, however. The political confrontation had continued unabated, with the former Commander of the Air Force, imprisoned for his role in the rebellion against the government, the main symbol of the opposition. On January 16, 1987, a failure of military intelligence led the President and his entourage into the midst of a violent attack by rebels at the Taura Air Force Base. The President, the Minister of Defense, the Commanders of the Army and the Air Force, and several other high-ranking officials were taken hostage. After twelve harrowing hours the President proclaimed under his own authority and responsibility that, in order to save innocent lives, he was ordering the freedom of the former Air Force Commander and that no action would be taken against the rebels. The incident shattered the foundations of national authority and command and put at extreme risk the institution of democratic government.

The aftermath weighed very heavily on the President. Although he received many statements of solidarity, the political opposition proclaimed that the "tough, macho man" was but a cowardly chicken. The Congress, in an outrageous decision, put the entire blame of the episode on the President, demanding his impeachment and elevating the rebels to the status of national heroes.

Febres Cordero's stature as a statesman would continue to be tested in the weeks and months to come. He dismissed calls and pressures to do away with constitutional government and assume absolute power, steadfastly adhering to the decision to serve his term and hand power over to a democratically elected government—a course of action that may be his single most important legacy as President. But his administration was beset on all fronts: the economy was weak, the opposition appeared to have taken the initiative, and the best and the brightest were gone from the government. On March 6, 1987, a major earthquake measuring 6.9 on the Richter scale devastated the oil-producing region of Ecuador, killing nearly 1,000 and severing the Trans-Andean pipeline along 60 kilometers of right of way. The damage and destruction affected directly the lives of some 25,000 people even though the epicenter of the tremor was sparsely populated.

This was the last straw for the government, which suffered both external and domestic financial collapse within hours of the quake. The loss of oil production cost Ecuador approximately US$600 million of income (60 percent of public-sector exports at 1987 prices) and approximately 40 percent of government revenues. The damage to the oil-producing infrastructure was assessed at close to US$300 million; another US$250 million of physical infrastructure, including schools and roads, was lost; and damages to private and public property were in excess of US$500 million. Faced with an extremely grave situation, the government's only recourse was to take a loan from the Central Bank in the amount of the loss of operating income. Venezuela and Nigeria agreed to provide approximately 13 million barrels of oil, of which some 7 million were utilized for local consumption and the rest compensated for the loss of exports. The oil pipeline was connected with the Colombian pipeline, and within forty-five days, working around the clock, some 40,000 barrels of oil were flowing daily through Colombia. International assistance was also forthcoming: within sixty days the World Bank approved a loan of US$100 million for the repair of the pipeline. The oil facility that had been put in place in September 1986 was fully utilized and US$210 million were drawn to continue government operations. The government also increased the price of fuels by an average of 52 percent, bringing them once again into line with the levels prevailing in December 1984, the time of the last rise.

The combined effects of political instability and economic collapse made citizens increasingly pessimistic about the future of the country. Gone were the days of government confidence and optimism; the President's original objective, reconstructing the country and the economy, was scaled down to finishing the term in power in command of the country. Meanwhile, opposition from Congress and other sectors continued relentlessly. The authorities were charged with corruption for nearly every decision taken and every contract signed. Scandal and muckraking became the order of the day, and in two cases former Cabinet members were convicted and received jail sentences, eventually leading to their flight from the country. The attacks weakened the administration's position and the President's image suffered from the behavior of his subordinates. The congressional majority used its powers to impeach and remove from office virtually the entire cabinet, further destabilizing the administration. The Court of Constitutional Guarantees handed down a politically motivated decision declaring the policy framework of August 11, 1986, unconstitutional, including the flotation of exchange and interest rates. The administration, however, ignored this decision, resulting in charges of constitutional tyranny and dictatorship that added to the general feeling of instability and uncertainty as elections approached.

The opposition argued that the nation's situation was due to economic policies. The debilitating effects of low oil prices and the earthquake on the state of public finances were forgotten. Market-oriented policies, they argued, worked exclusively in favor of the few, while the poor majority was further impoverished by the lack of jobs and climbing rates of inflation. The opposition believed the state should take charge of foreign-exchange transactions, interest rates should be frozen at a lower level, and the government should stop spending lavish amounts of money on white-elephant projects such as the Guayaquil beltway and the Santa-Elena irrigation and agricultural development program.

The government countered by continuing its aggressive public-works policy and by dismissing opposition charges of unconstitutionality in its actions. With the ever-growing gap between income and expenditure, the administration increased the public sector's demand of credit and lowered the level of deposits from the Central Bank, resulting in inflation that eventually caused the collapse of the vulnerable economic system that had so painstakingly been set up. The government believed the aggressive public-works policy was the only way to maintain a tolerable level of economic activity. Resources from the Central Bank were made available through credit, grants, or purchase of government paper by the monetary authority. The administration's main theme was that of reconstruction, and the President decided to continue to build the legacy of his tenure in power, notwithstanding the new economic realities. To stop the construction of infrastructure would mean half-built roads, schools, housing projects, water works, and electric power grids, adding to the political liabilities of the government.

Breakdown: Politics Takes Over Economic Management

The combined effects of natural catastrophes, phenomenal economic losses, unrelenting political opposition, and the government's decision to continue its aggressive spending policies aborted the market-oriented policies that had been put in place since 1984. The policy framework that was adopted in August 1986 established a liberal regime for foreign-exchange transactions, but it did establish a similarly flexible regime for monetary policy. The exchange rate became highly dependent on capital flows, which in turn are dependent on expectations and on the structure and concentration of factor markets. When returns on sucre-denominated assets carried high real rates (24 percent from August 1986 to February 1987), there was not only stability but strengthening in the position of the sucre. But when the perceptions on these returns changed as a result of political uncertainty and of the great economic damage caused by the earthquake, the position of the sucre quickly eroded.

Financial policy, meanwhile, remained underdeveloped and exacerbated the segmentation of markets. In the private sector, approximately half of all credit operations were carried out at Central Bank–administered rates (which at 25 percent were approximately 15 points below market-clearing rates), bringing about credit concentration and diversion. Subsidized credit was granted on the grounds of privilege, not economic efficiency. As expected, it was not utilized for productive purposes, but for currency speculation and hedging.

In the public sector, there was no effort to integrate the government's borrowing requirements into the overall economic picture and conditions of the country, and a great opportunity was missed to have the public sector become the pacesetter of economic activity. The insatiable demands of the government for Central Bank credit turned the latter into a giant cash-dispensing machine, eventually pushing the private sector out of the credit markets and quashing all possibility of capital deepening in the economy.

The effects of fiscal and monetary policy, coupled with the lack of controls, led to widespread abuses. One example was the debt-capitalization scheme, set up in the latter part of 1986, to allow banks and private companies to swap debt for equity by surrendering dollar-denominated debt titles of the Central Banks. The program allowed the beneficiaries to take full benefit of the very deep discount (60–70 percent) at which Central Bank notes were traded in the secondary financial markets, while the Bank recognized the debt swap at full face value. In the course of the program it was learned that a number of beneficiaries (mostly banks) had depleted their reserves or diverted resources (some of which were provided at cheap rates by the Central Bank) to take advantage of the scheme. The abuses became so offensive that the President ordered the termination of the program.

The deterioration of the economy was immediately reflected by pressures against the sucre, whose value quickly eroded in the latter part of 1987 during the political campaign. The electoral results of January 31, 1988, left the candidate of the Social Christian Party, Sixto Durán Ballén, a former mayor of Quito, out of the running, and in the May run-off election Ecuador elected Rodrigo Borja, a center-left social democrat and arch-rival of Febres Cordero, to serve as President from 1988 to 1992.

Meanwhile, from the latter part of 1987 through August 1988 the monetary and fiscal authorities maintained the existing levels of fiscal spending with no further adjustment or stabilization of the economy. Economic management surrendered to the pressures of politics. Following natural disasters, the political sectarianism and virulence of the opposition, the abuses of prominent members of the private sector, and the obsessive desire of the executive to complete its public works program, the economy collapsed; the rate of growth for 1987 was –5.2

percent, possibly the worst ever recorded. The rate of inflation climbed to nearly 60 percent and the money supply increased at a yearly rate of 56 percent. The fiscal deficit reached a level of 12 percent of GDP. Interest rates surpassed 50 percent in the free market, the dollar in the free market went up from S/. 150 in March 1987 to S/. 500 in August 1988, and the Central Bank used up US$195 million of reserves in an attempt to control the rise of the dollar in the last quarter of 1987. No further revisions were made in the price of gasoline and fuels, and the value of the fuel subsidy climbed back to 8 percent of GDP. Electricity rates were frozen at June 1988 levels (they had been climbing at the rate of 3 percent per month for the last six years), pending the results of a study to determine a new structure.

On March 3, 1988, the exchange system that had been set up on August 11, 1986, was dismantled. Although private banks continued to intermediate foreign-exchange transactions, the free flotation of the exchange rate was ended and a range was adopted based on the intervention rate of the Central Bank (set at S/. 250) plus a 10 percent tolerance level (which put an upper limit of S/. 275 for such transactions). No further revisions of the rate were made until the new administration took over. This situation provoked its own distortions and under-the-table deals, in clear violation of the philosophy of economic liberalization based on principles of honesty and integrity.

By the end of this cycle much of the early vision had been blurred. What began as a revolution in ideas, policies, and attitudes had been weakened not so much by an abdication of principles as by the force of extraordinarily adverse circumstances that produced resentment and disillusionment in the minds of the main protagonists and resulted in recourse to political expediency. In the end, despite the tempestuous script of the final two years, the transition of power was fairly smooth and orderly, and the new administration was inaugurated on August 10, 1988. Notwithstanding the unceasing chain of conflicts and the conspiracy of controllable and uncontrollable factors, the feeble democracy of Ecuador passed a formidable test of endurance.

Epilogue: Turn Back?

The incoming administration did not define in precise terms how it would deal with the economic crisis of mid-1988. Unlike in 1984, the new administration has a comfortable majority in the Congress, and its task is largely one of management, rather than of confrontational politics. The attitude of the legislature has changed radically and the bitter feuds of the past have given way to an attitude of support for the executive's initiatives. The new economic policy began to take shape on August 31, and the single, outstanding message is that of economic stabilization. In foreign-exchange policy, the intervention rate of the Central Bank was devalued from S/. 250 to S/. 390 per dollar. All foreign-trade transactions returned to the Central Bank. Exports are liquidated at a rate 5 percent below the intervention rate, and imports are authorized at a rate 5 percent higher than the intervention rate. A crawling peg is set at the rate of 30 percent per year. Importers must pay a prior deposit of 50 percent and 80 percent of customs duties at the time they have their permit approved by the Central Bank. They must wait a period of thirty days before they may enter a round of foreign exchange sales at the Central Bank, at which time they get 50 percent of their dollars; the rest is forthcoming after a period of one-hundred-twenty days.

In interest-rate and financial policies the credit program of the Central Bank is being reordered. A nineteen-point spread has been established between the asset and liability rates of floating rate operations in the private banking system. In fiscal policy, substantial adjustments have been made in all administered rates and prices. The prices of gasoline and fuels have been increased by an average of 120 percent; electricity rates have been increased by an average of 50 percent with increases determined by tariff tranches based on consumption; telephone rates are to increase by an average of 400 percent; air fares have gone up 50 percent; bus fares are now 25 percent higher; and intercity fares have been deregulated, determined by supply-and-demand conditions.

It has been announced that the government budget will increase in nominal terms by 45 percent, although a final figure of 60 percent is more likely by the time it emerges from Congress. A new increase of 15 percent in the minimum wage has been approved, on top of an earlier increase of 25 percent in June, under the Febres Cordero administration.

The adjustment is a major one, and it should reduce the public-sector deficit to 4 percent of GDP. The objective is to bring down the level of inflation to 30 percent in the next twelve months. While its orientation is orthodox, the adjustment in the instruments of exchange and financial policies is rigid. The future course of stabilization will be determined by the level of public spending and the extent to which the new public income policy can sustain an improved government financial position. Still to be defined are policies regarding the management of the country's external debt, the design of reforms to taxation of income and consumption, and the level of customs tariffs. The shape of the reforms provides evidence that the "right wing" of the government is in command of economic policy. Its endurance depends largely on the success and effectiveness of the policies in lowering inflation and getting the economy on the path of growth and employment generation.

At this writing the old model is nowhere to be found. No turnback is evident, and the turnaround that began in 1984 has paradoxically been renewed by those who were least expected to carry it out, just at the moment when those who inspired the early reforms had lost their resolve under the weight of adversity, in the name of politics.

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