

Ecuador's New Deal:

Reforming and Regulating the Financial Sector

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Executive Summary

Since President Correa took office in January of 2007, the government has embarked on a series of reforms to transform and regulate the financial system. Some of these reforms and goals were included in the 2008 Constitution, which was overwhelmingly approved with 64 percent of the vote; others were embodied in laws and regulations described below.

The government built up a liquidity fund for banking system emergencies that is funded by taxes on the banks themselves, which is now at \$1.2 billion dollars. It also established procedures for resolving insolvent banks.

The Central Bank, which had previously been independent of the government, was made part of the executive branch's economic team. This also included a new Economic Planning Ministry (*Ministerio Coordinador de la Política Económica*), created by President Correa during the second month of his administration. These changes, especially with regard to the accountability of the Central Bank, have proven very important to the implementation and coordination of new economic policies in Ecuador.

The Correa administration wanted the Central Bank to regulate interest rates, and this was achieved at the end of 2007. Average real (inflation-adjusted) lending rates have come down considerably during the Correa Administration, from a high of 8.28 percent in April 2007 to 3.85 percent today.

The new constitution defined the financial sector as composed of the public, private, and popular and solidarity-based sector, which includes cooperatives, credit unions, savings and loan associations and other member-based organizations. The government set a goal of expanding the popular and solidarity-based financial sector, creating the *Programa de Finanzas Populares* in 2008 to expand lending to smaller financial cooperatives, so that they could lend more to small businesses. In January 2007 co-op loans stood at 11.1 percent of private bank lending; by July 2012 this percentage had nearly doubled, to 19.6 percent. Co-op loans have also seen a large increase in the absolute total amount, tripling in real (inflation-adjusted) terms during this period.

A number of regulatory measures were adopted to protect consumers and the public interest, for example placing maximum fees on various financial transactions.

In May of 2009 the government established a Domestic Liquidity Coefficient, which required that 45 percent of all banks' liquid assets had to be held domestically. This was increased to 60 percent in August of 2012. The purpose was to require Ecuador's banks to keep more of their assets in the country; some hundreds of millions of dollars were brought back as a result of this regulation during the first year. This proved to be extremely important in the government's response to the 2009 world recession.

The government also placed a tax on capital leaving the country. Since its implementation, this has become a key source of transparency and also a significant share of government revenue, increasing from less than 1 percent of revenue in 2008 to over 10 percent in 2012.

The government also took measures to limit the economic and political power of the financial sector. Before Correa's election, banks owned most of the major TV media; this was prohibited.

Also, a Glass-Steagall-type provision in the Anti-Monopoly Law from October of 2011 prohibited combining multiple banks or different types of financial institutions, so deposit institutions, investment banks and insurance firms had to be separate. A regulatory body was also created to enforce anti-trust legislation.

These and other reforms described below appear to have contributed greatly to the economic success of the Correa government, as well as improvements in various social indicators.

One of the most important effects of the reforms was seen during the world financial crisis and recession. Ecuador was particularly hard hit by the crisis, since oil is its most important export and source of government revenue; and remittances from Ecuadoreans living and working abroad were also an enormous source of revenue in the current account. Oil prices collapsed in the second half of 2008, falling by 79 percent before beginning to recover in early 2009; at the time, oil revenues accounted for 62 percent of export earnings and 34 percent of government revenue, collapsed in the second half of 2008, falling by 79 percent before beginning to recover in early 2009.

The fall-off in remittances was another enormous shock to the economy. These shocks combined were comparable to the falloff in private demand in the U.S. from the collapse of the housing bubble that caused the Great Recession. Without a strong policy response, Ecuador could easily have experienced one of the worst recessions in the hemisphere, and a slow recovery as well – few, if any countries were hit harder.

Yet Ecuador experienced only a mild downturn, losing about 1.3 percent of GDP during three quarters of recession. A year later, or 7 quarters from the onset of the recession, the economy had returned to its pre-recession level of output (this took four years in the United States). Ecuador's recovery owed much to a successful stimulus plan, amounting to nearly 5 percent of GDP in 2009, one of the biggest in the hemisphere.

It is safe to say that this kind of stimulus would not have been possible without the financial and regulatory reforms that were made. The measures to restrain capital flight and the domestic liquidity requirement were extremely important in allowing the government to pursue an expansionary fiscal policy, while at the same time avoiding balance of payments problems. Control over the Central Bank, to ensure its cooperation with all of these efforts, was also essential. President Correa's forcing the Central Bank in 2009 to repatriate more than a billion dollars of reserves held abroad (rising to a total of \$2 billion by last year, was another example of the importance of this reform. It must be emphasized that the task of countering the 2009 downturn was much more difficult for Ecuador because of dollarization, since it could not use exchange rate policy or some of the most important monetary policy options that other countries have (e.g. the quantitative easing the U.S. Federal Reserve has used successfully since 2008).

The financial reforms contributed significantly to the unprecedented rise in government revenue, from 27 percent of GDP in 2006 to more than 40 percent in 2012. This not only allowed for expansionary fiscal policy, but also a large increase in social spending. The biggest increase was in housing, but there were also significant increases in health care spending and other social spending. The government's most important cash-transfer program (the *Bono de Desarrollo Humano*) increased by one-fourth. Education funding more than doubled, as a percent of GDP, from 2006-2009.

By the last quarter of 2012, unemployment had fallen to 4.1 percent, its lowest level on record (for at least 25 years). The national poverty rate fell to 27.3 percent as of December 2012, 27 percent below its level in 2006.

Overall, it appears that the Correa government's sweeping financial reforms have been successful, not only in achieving their intended goals but in aiding macroeconomic stability, growth, employment, and very significant improvements on a range of economic and social indicators. What is most remarkable is that many of these reforms were unorthodox or against the prevailing wisdom of what governments are supposed to do in order to promote economic progress. Taking executive control over the Central Bank, defaulting on one-third of the foreign debt, increasing regulation and taxation of the financial sector, increasing restrictions on international capital flows, greatly expanding the size and role of government – these are measures that are supposed to lead to economic ruin. The conventional wisdom is also that it is most important to please investors, including foreign creditors, which this government clearly did not do. While not all of Ecuador's reforms went against orthodox policy advice – its measures to resolve insolvent banks, anti-trust legislation and the creation of an enforcement body, and deposit insurance reforms, for example, are widely accepted – the bulk of them clearly did, and yet they succeeded.

Ecuador's success shows that a government committed to reform of the financial system, can – with popular support – confront an alliance of powerful, entrenched financial, political, and media interests and win. The government also took on powerful international interests as well, in its foreign debt default, its renegotiation of oil contracts, and its refusal to renew the concession for one of the United States' few remaining military bases in South America. Its accomplishments have implications not only for much of the standard policy prescriptions that are offered to developing countries but also for the prospects of any democratic government that is elected on a reform program and wants to chart a new path to growth and development. The conventional wisdom is developing country governments have relatively limited policy options in an age of “globalization,” increased mobility of capital and international competition. Ecuador is a relatively small, middle income developing country with an open economy that does not even have its own currency. Yet in five years it has accomplished some of the most comprehensive financial reforms of any country in the 21st century. This indicates that a wider, potentially more successful set of policy options are available to developing (and high-income) countries than is commonly believed.

Introduction

Prior to the election of President Rafael Correa in 2006, Ecuador suffered from a number of economic problems, many of them shared by most of Latin America since 1980. Economic progress was slow: from 1980-2000, GDP per capita fell by 14 percent, as compared to 110 percent growth in the prior 20 years¹. After a series of reforms that deregulated the financial system, there was a severe financial crisis at the end of the '90s, with the economy shrinking by 5.3 percent and inflation at over 60 percent in 1999. The country adopted the U.S. dollar in January of 2000, and while this may have helped to stabilize the economy, it also introduced a set of long-term problems in terms of the government's loss of control over monetary and exchange rate policy. The country also suffered from high levels of poverty, inequality, and unemployment.

Correa pledged to use the resources of the government to pursue economic development that would benefit the majority, and reduce poverty and inequality. He blamed the neoliberal policies of the prior decades for the economic and social failures of the country, and promised an alternative. Part of his platform was also a new constitution that would embody these economic and social goals, and make it easier for the government to pursue them; and also to help democratize the country, which had previously been ruled mostly by a small, wealthy elite.

This paper focuses primarily on one part of the government's promised change: reform and regulation of the financial sector. It will look at the purpose and implementation of the reforms and, where possible, their impact.

Transforming the Purpose of the Financial System

The general purpose of financial intermediaries, including banks and other financial institutions, is to channel savings – primarily from households and businesses – to productive investment. As was seen most vividly in the set of financial crises of 2008 and world recession of 2009, there are many ways in which a financial sector can stray from this textbook function. In the extreme case, as in the United States in recent decades, it can become huge, enormously wasteful, engage in activities that increase economic instability, redistribute income upward, and drain resources away from productive investment. It can become politically powerful enough to transform the legal and regulatory structure in its own favor² – “too big to fail” and “too big to jail” – despite engagement in “criminal enterprise,”³ and have an enormous influence on macroeconomic policy that is often to the detriment of employment and economic growth.⁴ While the United States in recent years is perhaps an extreme case of these financial and regulatory failures, much of Latin America, including Ecuador, has also suffered from some of the same phenomena.

The Correa Administration's financial and regulatory reform sought not only to correct the failures and avoid the pitfalls of the past, but also to transform the financial sector so that it would serve the public interest in ways that were not conceived of by previous governments. The purpose was not to have a state-owned financial sector, but one that was heavily regulated, with the regulations driven

1 Weisbrot et al. (2006).

2 Johnson and Kwak (2011).

3 Ferguson (2012).

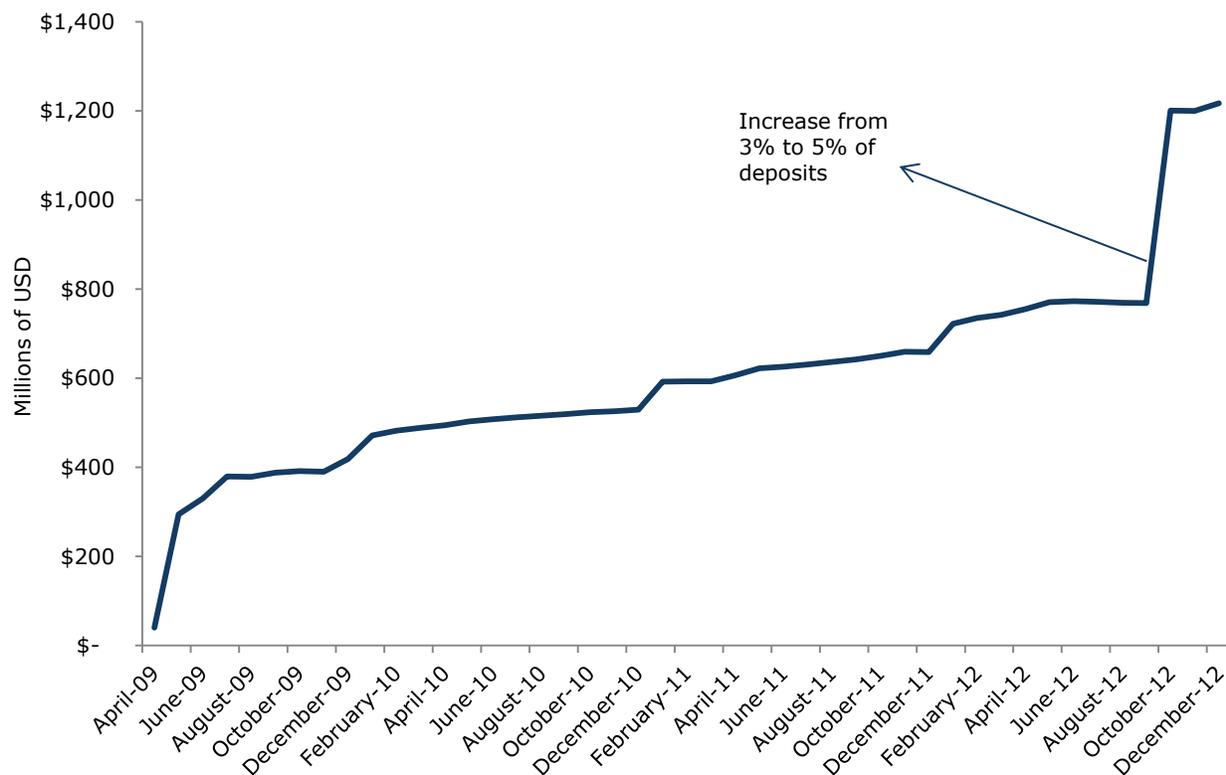
4 Baker (2011).

by social goals. These include traditional functions such as maintaining price stability and sufficient liquidity in the financial system, but also include such goals as encouraging socially and environmentally responsible investment, building up the “popular and solidarity-based” financial sector, limiting the political and market power of banks, regulating capital flight, promoting domestic and public investment, and overall getting the financial sector to serve the government’s development strategy.

One of the most basic needs was to ensure the solvency and security of the financial system, and to avoid the financial crises of the past. This was made more difficult by the fact that Ecuador did not have its own currency, having adopted the dollar as its national currency – thus the central bank was limited in the extent to which it could create money when acting as a lender of last resort. The government therefore established a bailout fund for banks operating within the country, to be financed by the banks themselves. This was part of the Law Creating a Financial Sector Safety Net, passed in December 2008. Banks and other financial institutions were required to contribute 3 percent of their deposits that were subject to reserve requirements. This was increased to 5 percent in 2012, and is scheduled to rise by 1 percent annually, reaching 10 percent in 2017.⁵

Figure 1 shows the growth of assets in this liquidity fund, which reached \$1.2 billion in December of 2012.

FIGURE 1
Liquidity Fund Assets



Source: Superintendencia de Bancos y Seguros del Ecuador, Boletines Mensuales Bancos Privados, Mutualistas, Sociedades Financieras (Various years).

⁵ Banco Central del Ecuador (No Date).

This law also reformed the deposit insurance system, which had been created in the 1990s but had been unlimited, including offshore accounts. This was changed to cover the first \$27,000 of deposits held by account holders, then raised to \$31,000, which now covers 99 percent of depositors.⁶

These changes were part of the mandate of Ecuador's new constitution, which was approved overwhelmingly by voters, with 63.9 percent of the vote, in September of 2008.⁷ The 2008 Constitution was designed to allow for a new economic development strategy, as well as the democratization that Correa had promised, including financial and regulatory reform. The Financial Sector Safety Net law embodied not only the constitutional mandate "to provide the necessary means of payment for the economic system to operate efficiently," but also that the law "shall not transfer the responsibility of bank solvency, nor imply any guarantee by the State. Managers of financial institutions and those controlling the capital thereof shall be held liable for the solvency of said institutions." This is a 'no bail-out' provision that was prompted in part by the taxpayer bailout of the banks during the 1999 financial crisis. That crisis also prompted a constitutional provision that "the freezing or arbitrary or widespread withholding of funds or deposits in public or private financial institutions is forbidden," to avoid a repeat of such events.

The Financial Sector Safety Net law also created a procedure for dealing with insolvent banks, with the disposal of assets modeled on the Resolution Trust Corporation set up in the United States in the aftermath of the Savings and Loan Crisis of the 1980s. A facilitation mechanism was set up whereby banks deemed unviable are passed for administration to a solvent bank.

Accountability of the Central Bank

One of the fundamental principles of the neoliberal economic orthodoxy that has prevailed, increasingly, since the 1970s has been that central banks should be "independent." The reasoning behind this argument is that a central bank that is responsible to the executive or legislative branch of the government will succumb to political pressures and allow inflation to get out of control, or at least to rise quickly enough that it will hurt economic growth. There are many problems with this argument, from an empirical,⁸ economic, historical,⁹ and political point of view. From the point of view of political democracy, it is important to note that this is not an argument for independence of an institution such as the judiciary, which is based on a theory of checks and balances, in order to protect constitutional rights or the rule of law. The argument for the independence of the central bank is more of an elitist argument; it is essentially saying that monetary policy is too important to be influenced by the views or desires of the electorate. The same argument could be made for fiscal policy (spending and taxes), trade or commercial policy, or any other governmental economic policy – or non-economic policies for that matter.

Having a central bank that is unaccountable to the elected government can be quite harmful; an extreme case can be seen in the eurozone today, where the European Central Bank has played a major role in pushing Europe into its second recession in three years, with record levels of

6 Corporación del Seguro de Depósitos (No date).

7 Carter Center (2008).

8 Alesina and Summers (1993); Pollard (1993).

9 Epstein (2006).

unemployment.¹⁰ In most cases, being “independent” does not mean being independent of political influences; more often, central banks tend to favor the interests of the financial sector. Since there is often a tradeoff between growth and employment, on the one hand, and keeping inflation from rising, this can be a significant problem. The financial sector generally favors minimizing inflation, and is willing to sacrifice growth and employment much more than the electorate or in many cases a responsible government would be willing to do, even to avoid small increases in inflation. The tendency in recent years has been to enshrine “price stability” as the central bank’s principal (and in practice, sometimes sole) mandate; and such central banks may target inflation that is too low from the point of view of moving towards full employment.¹¹

A central bank that is part of the government’s economic team can play an important role in promoting growth and development. For example, it will sometimes make good economic sense – especially when inflation is not a threat – for the central bank to create money in order to finance government borrowing. This allows the government to finance its spending without increasing its net interest or net debt burden. The Federal Reserve in the United States has done this recently,¹² creating more than \$2.3 trillion dollars since 2008, without any significant increase in inflation. Central banks can also play an important role in targeting the exchange rate,¹³ which is a fundamental variable for determining a country’s tradable goods and services; or they can play a less supportive role by using the exchange rate to target inflation, thus hurting the industrial sector.¹⁴

Since Ecuador does not have its own currency, and the central bank cannot create dollars or target the exchange rate, the role of the Central Bank is less important than in most other countries. But it is still hugely important for many of the policy changes described in this paper, as well as the government’s strategic goals: the financial sector safety net, promoting domestic investment and increased credit to targeted sectors such as rural areas and the popular and solidarity based economy, regulating interest rates, the domestic liquidity coefficient, reducing capital flight, and other efforts.

Under the 1998 constitution, Ecuador’s central bank was formally independent of the government and its primary responsibility was to maintain price stability.¹⁵ The 2008 constitution changed that:

*The drafting of monetary, credit, foreign exchange and financial policies is the exclusive power of the Executive Branch and shall be implemented through the Central Bank. The Central Bank is a legal entity governed by public law, whose organization and operation shall be established by law.*¹⁶

Then in 2009 the Ley Reformatoria a la Ley de Régimen Monetario y Banco del Estado changed the selection process for members of the Board of Directors of the Central Bank. They were previously chosen by the president for fixed terms, and had to be approved by the Congress. Under this law the Board is now composed of representatives from various branches of the government involved with economic policy: the Minister of Economic Policy, the Minister of Production, a representative from public financial institutions working in development, the Secretary of National Planning, and

10 Weisbrot (2012).

11 Blanchard et al (2010).

12 Baker (2012).

13 Blanchard et al (2010).

14 Serrano and Summa (2011).

15 Constitución Política de la República del Ecuador (1998), Article 261.

16 Constitution of the Republic of Ecuador (2008), Article 303.

the Minister of Finances. In addition, a representative from the presidency presides over the Board, and casts a vote only in the event of a tie.

Thus the Central Bank was made part of the executive branch's economic team, which also included a new Economic Planning Ministry (*Ministerio Coordinador de la Política Económica*), created by President Correa during the second month of his administration.¹⁷ These changes, especially with regard to the accountability of the Central Bank, have proven very important to the implementation and coordination of new economic policies in Ecuador.

Domestic Economic and Regulatory Policy

President Correa came to office promising to lower interest rates, in order to stimulate domestic investment, growth, and employment. While there were laws against usury, banks often got around them by adding commissions to loan agreements. In 2007, the Congress attempted to fix this by passing a law prohibiting the commissions and setting rules for maximum interest rates; but this was struck down by the Constitutional Court. The Correa Administration wanted the Central Bank to regulate interest rates, and this was finally achieved at the end of 2007. As shown in **Figure 2**, average real (inflation-adjusted) lending rates have come down considerably during the Correa administration, from a high of 8.28 percent in April 2007 to 3.85 percent today. Unlike some other central banks, the Ecuadorean central bank did not raise nominal interest rates when inflation spiked in 2008 because the government correctly saw the inflation as temporary, driven by external factors; thus average real interest rates declined sharply as seen in Figure 2. Within different categories, maximum nominal rates have also been lowered: the maximum rate for small business loans is 11.8 percent, microcredit ranges between 25.5 and 30.5 percent (depending on the disbursed amount), the maximum annual rate for home loans is 11.3 percent, and consumer loans are capped at 16.3 percent.¹⁸ Prior to these reforms, there were microcredit interest rates up to 100 percent annually, and credit card rates as high as 30 percent.

The constitution also defined the financial sector as composed of the public, private, and popular and solidarity-based sector, which includes cooperatives, credit unions, savings and loan associations and other member-based organizations.¹⁹ The government set a goal of expanding the popular and solidarity based financial sector, creating the *Programa de Finanzas Populares* in 2008 to expand lending to smaller financial cooperatives, so that they could lend more to small businesses. As of July 2012, the popular and solidarity based sector accounted for 16.5 percent of deposits and nearly 23 percent of loans, not including previously unregulated smaller cooperatives.²⁰

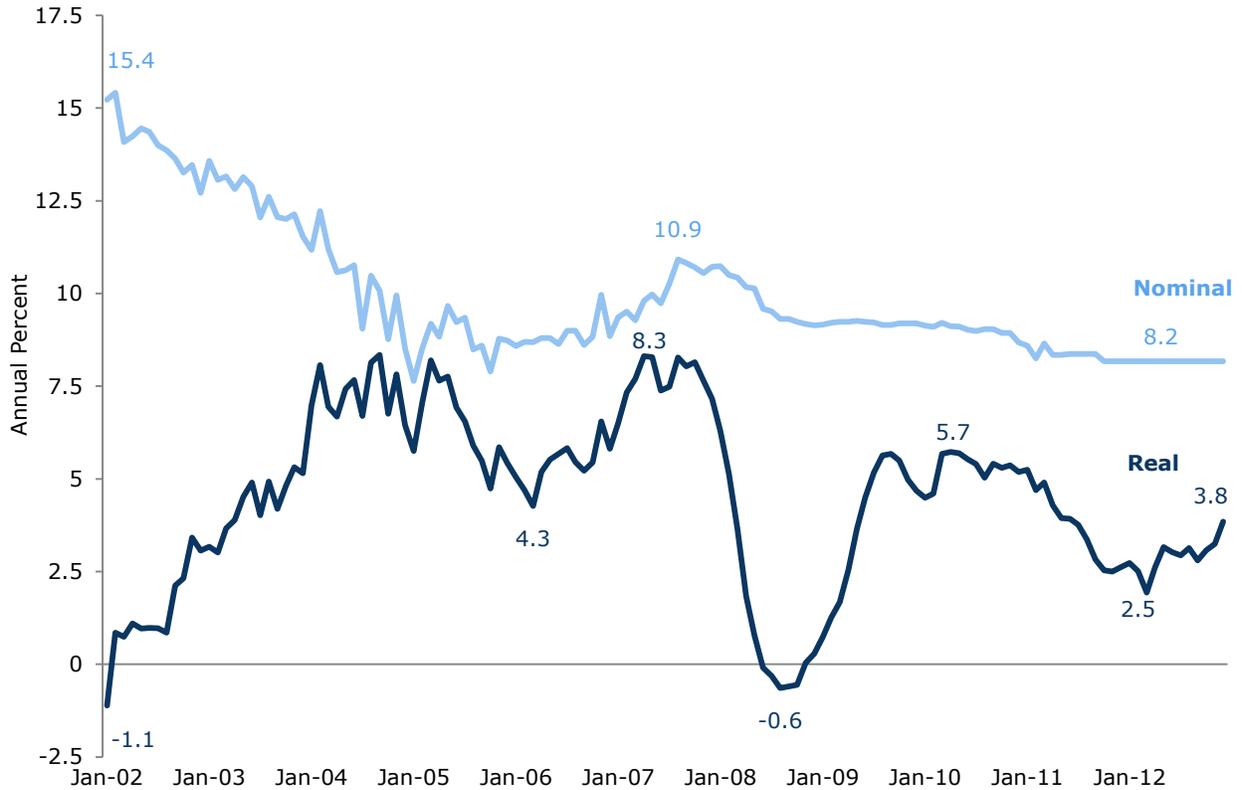
17 Correa Delgado (2007).

18 Banco Central del Ecuador (2013a).

19 Constitution of the Republic of Ecuador (2008), Article 311.

20 Superintendencia de Bancos y Seguros del Ecuador (Various years); Superintendencia de Bancos y Seguros del Ecuador (Various years-a).

FIGURE 2
Ecuador: Real and Nominal Interest Rates



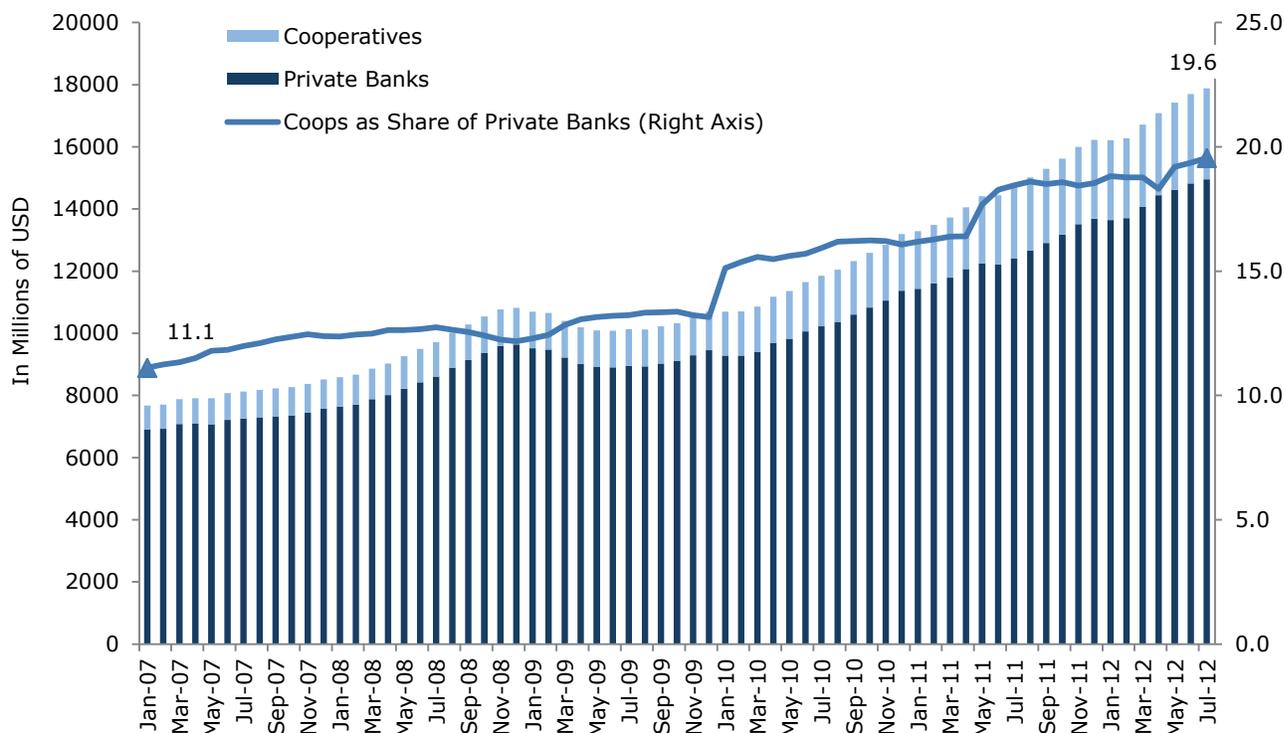
Source: BCE, Información Estadística Mensual.

Within this sector there are a large variety of institutions, from big co-ops to very small *cajas de ahorro* (savings banks), so they have different needs, including different rules and regulations. In the past many of these institutions were considered illegal, although the government often didn't have the capacity to shut them down. The new constitution recognized them as an instrument for development, allowing for regulation and also support, including second-tier loans from public banks, technical assistance, software, and other support. In May of 2011, a public body was created for the popular financial sector, in order to ensure appropriate regulation and support.²¹

As can be seen in **Figure 3**, there has been a substantial increase in the loans made by cooperatives relative to private banks during the Correa Administration. In January 2007 co-op loans stood at 11.1 percent of private bank lending; by July 2012 this percentage had nearly doubled, to 19.6 percent. Co-op loans have also seen a large increase in absolute total amount, tripling in real (inflation-adjusted) terms during this period.

²¹ Corporación Nacional de Finanzas Populares y Solidarias (No date).

FIGURE 3
Ecuador: Total Loans from Cooperatives and Private Banks; Cooperative Lending as a Percent of Private Bank Lending



Source: SBS, Captaciones y Colocaciones Cooperativas; SBS, Captaciones y Colocaciones Bancos Privados

Other regulatory measures were adopted to protect consumers and the public interest. For example, the maximum ATM fee was set at 50 cents, when a customer does not use their own bank's machine and it was eliminated when the customer uses their own bank's network.²² (This has probably had a significant impact; although there are no figures for Ecuador, even in a high-income country like the United States, ATM and other transaction costs, like check-cashing fees, can take a substantial percentage of income from lower-income groups.) Charges for maintaining checking and savings accounts were eliminated. Because of these maintenance fees, interest rates that banks paid on low-income families' savings were *de facto* negative. Maximum fees were also established for other financial services (issuing credit cards, transfers between banks).

New financial products or services are now required to get approval from the regulatory authorities. This faced opposition on the grounds that it might stifle financial innovation (similar arguments prevailed against such regulation in the U.S., in the run-up to the financial crisis and Great Recession).²³ However it was passed by Congress in an article included in the Financial Sector Safety Net law.

²² Superintendencia de Bancos y Seguros del Ecuador (2012).

²³ Kain (2011).

The government also took measures to limit the economic and political power of the financial sector. A provision in the 2008 Constitution prohibited “financial entities or groups, along with their legal representatives, board members and shareholders” from owning any controlling shares in the media.²⁴ Further, by referendum vote in 2011, the Constitution was amended to establish that private financial institutions and private media companies are prohibited from owning shares in any company outside the financial industry or the media industry, respectively. The article in the 2008 Constitution applies to the companies themselves, as well as their Boards of Directors and major investors. According to the report from the Radio and Television Frequency Audit Commission, the limit on cross-ownership would affect 118 bankers with links to 201 media outlets²⁵. The audit found that Ecuador’s media landscape was dominated by 8 main groups, most of which had links to financial sector entities.²⁶ Also, a Glass-Steagall-type provision in the Anti-Monopoly Law from October of 2011 prohibited a single financial group from being made up of more than one bank, or by two or more different types of financial institutions, such as investment banks, financial societies or insurance firms.²⁷ A regulatory body was also created to enforce anti-trust legislation. Finally, the government seized assets related to former bankers who had fled the country after they had benefitted from the \$8 billion taxpayer bailout following the late 1990s financial crisis. These and other²⁸ legal changes were designed to make sure that the banks would not be powerful enough to block regulatory and other public interest economic reforms in the future.

International Economic and Regulatory Policy

In a country without its own currency, it is perhaps even more important than normal to regulate capital outflows, since the government of Ecuador cannot issue U.S. dollars, and is limited in its ability to create domestic money. To some extent, dollarization should reduce capital flight in that domestic economic actors are not worried about currency depreciation. But for a variety of reasons, including tax avoidance and political reasons, capital flight can be a potential problem. The Correa government also wanted to promote domestic investment and development, and therefore had another reason to regulate capital outflows; as well as to avoid balance of payments difficulties.

In May of 2009 the government established a Domestic Liquidity Coefficient, which required that 45 percent of all banks’ liquid assets had to be held domestically. This was increased to 60 percent in August of 2012. The purpose was to require Ecuador’s banks to keep more of their assets in the country; some hundreds of millions of dollars were brought back as a result of this regulation during the first year. This proved to be extremely important in the government’s response to the 2009 world recession (see below). Since the legislation was implemented, banks have actually increased their percentage of liquid assets held domestically to a level greater than that which is required by the government. In June 2009, soon after the regulation was implemented, only 33.4 percent of banks’ assets were held domestically, this figure now stands at 69.7 percent.²⁹

24 Constitution of the Republic of Ecuador (2008), Article 312.

25 Erazo (2010).

26 UNESCO International Programme for the Development of Communication (2011); Comisión para la Auditoría de Frecuencias de Radio y Televisión (2009).

27 Asamblea Nacional (2011).

28 Most recently, the *Ley Orgánica de Redistribución de los Ingresos para el Gasto Social* included an article that allows the Government to limit bankers’ compensation, a provision included to avoid moral hazard and tax avoidance.

29 Banco Central del Ecuador (2013).

The regulation also set additional requirements for special categories of assets that must be included in the make-up of a bank's minimum liquid reserves. The purpose of this regulation was to direct the banks' excess funds to finance productive investment via government and private sector issued securities. For example, banks in Ecuador must have 3 percent of their total funds in deposits in the Central Bank, in Central Bank bonds, or bonds of other public financial institutions; and 2 percent of their total funds subject to minimum liquidity requirements need to be invested in fixed income assets from non-financial national public institutions.³⁰

The government also placed a tax on capital leaving the country.³¹ This was set at 0.5 percent in 2008, and raised in steps to 5 percent in 2011. Since its implementation, this has become a key source of transparency and also a significant share of government revenue, increasing from less than 1 percent of revenue in 2008 to over 10 percent in 2012. In the same legislation, the government established a windfall profits tax for concessions made to companies for the exploitation of domestic natural resources. This windfall tax raised over \$500 million for the government in 2010. In addition, the government introduced a tax on assets held abroad, which has raised an average of \$33 million annually over the last four years. Together these reforms helped contribute to the Ecuador's large increase in government revenue during the Correa administration, from 27 percent of GDP in 2006 to over 40 percent of GDP in 2012.

In November, the National Assembly approved the *Ley Orgánica de Redistribución de los Ingresos para el Gasto Social*, which includes new taxes to be levied on banks and the elimination of certain financial sector tax exemptions, from which the revenue will be used to increase the monthly payout through the *Bono de Desarrollo Humano* (BDH). The BDH is a cash-transfer program for those in the lower 40 percent of the income distribution who are mothers of children under age 16, are above the age of 65, or are disabled. As of January 2013, there were over 1.9 million beneficiaries.³² The new tax, 3 percent of banks' taxable income, will be used to partially cover an increase in the monthly BDH payment from \$35 to \$50.

Two other changes in financial policy would prove economically important for Ecuador in the last few years. In 2009, President Correa ordered the Central Bank to repatriate what amounted to about \$2 billion in international reserves held abroad, beginning with about \$1 billion in the first year. This was a very significant increase in domestic liquidity. The Central Bank used these repatriated reserves to increase domestic investment. Since 2009 the Central Bank has allocated nearly \$3.5 billion to five public banks to finance investments in the construction, mortgage lending, agricultural, microfinance industrial and infrastructure sectors.

The second was Ecuador's decision to default on about one-third of its foreign debt. Article 290 of the 2008 Constitution, on public borrowing, contains this provision:³³

Debts declared unlawful by the competent authority shall be challenged. In the case of declared illegality, the right to recovery shall be exercised.

30 Banco Central de Ecuador (2012).

31 Asamblea Constituyente (2007).

32 Programa de Protección Social (No date).

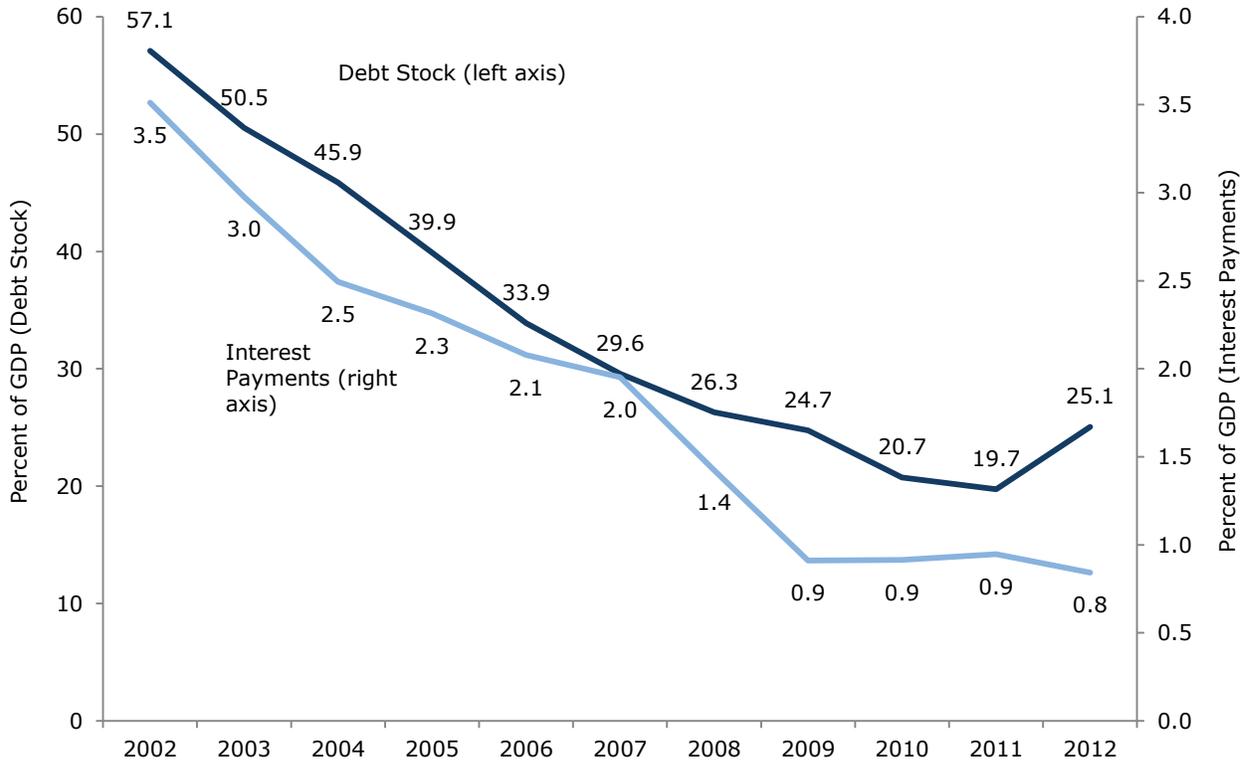
33 Constitution of the Republic of Ecuador (2008).

Correa had made a campaign promise to set up an international commission on the country's foreign debt. It was established in July 2007 with a mandate to determine its "legitimacy, legality transparency, quality, efficacy and efficiency."

In November of 2008, the commission found a number of irregularities and illegalities in the contracting of various portions of the country's public debt. On the basis of the commission's findings, the Correa administration stopped payment on \$510 million of its Global 2012 bonds in December 2008, and then on \$2.7 billion of Global 2030 bonds in February 2009, for a total default of \$3.2 billion. The government then bought back the defaulted bonds at about 35 cents on the dollar, thus clearing about one-third (\$3.2 billion) of its debt off the books.³⁴

The decline in Ecuador's public debt and debt service payments, as a percent of GDP, is shown in **Figure 4**. Since the foreign debt that was cleared had higher interest rates, the interest burden of the debt fell more than the debt/GDP ratio. By 2009 it was less than 1 percent of GDP, a low foreign debt burden that provided more policy space for Ecuador to respond to the impact of the world recession.

FIGURE 4
Ecuador: Debt Stock and Interest Payments as Percent of GDP



Source: BCE, Información Estadística Mensual, IMF WEO and Authors' Calculations
 Note: 2012 interest payment data was only available through October.

34 Weisbrot and Sandoval (2009).

Results and Conclusion

In evaluating Ecuador's financial reforms, there are several things to examine. First, did they succeed in achieving certain specific goals for which they were implemented? Second, did they contribute to the broader goals of macroeconomic stability, growth, and economic and social progress? And lastly, how did Ecuador's economy fare in light of conventional wisdom about the adverse effects of such reforms?

As to specific goals, we have seen that the government has built up a liquidity fund for banking system emergencies that is funded by the banks themselves. It has also established procedures for resolving insolvent banks. Although there has not yet been a financial crisis to test whether these measures are adequate, the fund and other institutional changes to prevent and mitigate such crises are in place. We have also seen significant growth in the popular and solidarity part of the financial sector, with the loan portfolio of co-ops tripling in real terms over the past five years.

The political and media power of the financial sector has been limited and anti-trust legislation has been passed. Regulatory reforms have also helped lower real interest rates and significantly lower financial transactions fees for consumers. They have also succeeded in requiring banks to keep billions of dollars in the country that would otherwise have left. And revenues to the government from the financial sector have increased very significantly as a result of the reforms.

Have these measures helped the economy or society more broadly? One of the most important effects seems to have been during the world financial crisis and recession. Ecuador was particularly hard hit by the crisis, since oil is its most important export and source of government revenue; and remittances from Ecuadoreans living and working abroad were also an enormous source of revenue in the current account. Oil prices, which accounted for 62 percent of export earnings and 34 percent of government revenue, collapsed in the second half of 2008, falling by 79 percent before beginning to recover in early 2009.

The fall-off in remittances was another enormous shock to the economy. As can be seen in **Figure 5**, workers' remittances from abroad peaked at 7.6 percent of GDP in 2007, falling to 4.5 percent of GDP by 2010 and continuing to fall to 3.5 percent of GDP by mid-2012. These shocks combined were comparable to the falloff in private demand in the U.S. from the collapse of the housing bubble that caused the Great Recession. Without a strong policy response, Ecuador could easily have experienced one of the worst recessions in the hemisphere, and a slow recovery as well – few, if any countries were hit harder. We would also expect significant capital flight in this situation as well.

Yet Ecuador experienced only a mild downturn, losing about 1.3 percent of GDP during three quarters of recession. A year later, or 7 quarters from the onset of the recession, the economy had returned to its pre-recession level of output (this took four years in the United States). Ecuador's recovery owed much to a successful stimulus plan, amounting to nearly 5 percent of GDP in 2009, one of the biggest in the hemisphere.

FIGURE 5
Workers' Remittances from Abroad (Quarterly, Seasonally-Adjusted)

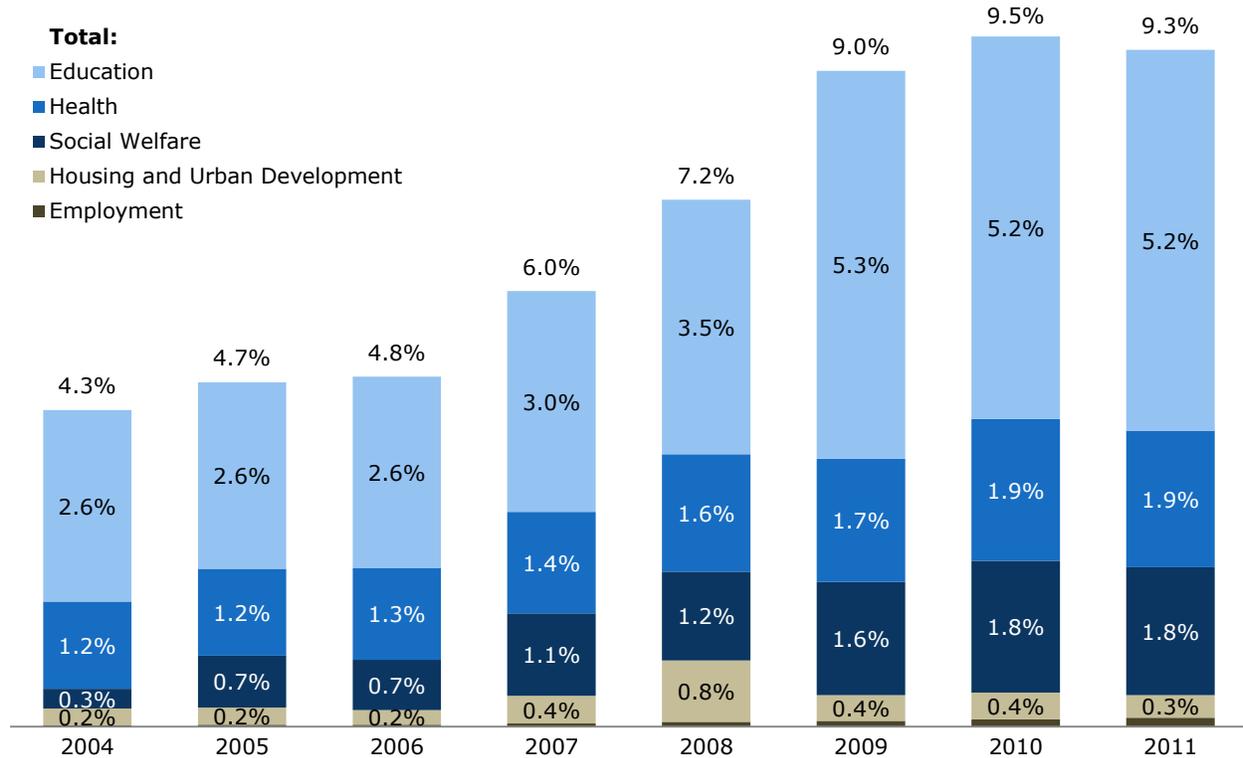


Source: Banco Central del Ecuador (No Date - c), International Monetary Fund (2012), and authors' calculations.

A big part of the stimulus was housing, with a 47 percent increase in housing credits from 2008-2009. Since the private sector contracted lending, more than 100 percent of this increase in housing credit, some \$599 million, came from concessional lending by the government's Social Security Institute (IESS) under the *bono de la vivienda* program. This commitment continued into 2010 and 2011, with construction accounting for 40 percent of economic growth in 2011.

It is safe to say that this kind of stimulus would not have been possible without the financial and regulatory reforms that were made. The measures to restrain capital flight and the domestic liquidity requirement were extremely important in allowing the government to pursue an expansionary fiscal policy, while at the same time avoiding balance of payments problems. Control over the central bank, to ensure its cooperation with all of these efforts, was also essential. President Correa's forcing the Central Bank in 2009 to repatriate more than a billion dollars of reserves held abroad (rising to a total of \$2 billion by last year, was another example of the importance of this reform. It must be emphasized that the task of countering the 2009 downturn was much more difficult for Ecuador because of dollarization, since it could not use exchange rate policy or some of the most important monetary policy options that other countries have (e.g. the quantitative easing the U.S. Federal Reserve has used successfully since 2008). So it was very important that the government of Ecuador was able to use as many available tools as possible, including regulating interest rates, in order to counteract the damage from the world financial crisis and recession.

FIGURE 6
Public and Social Spending (Central Government), in Percent of GDP



Source: Ministerio de Finanzas del Ecuador (No Date).

As noted above, the financial reforms contributed significantly to the unprecedented rise in government revenue, from 27 percent of GDP in 2006 to more than 40 percent in 2012. This not only allowed for expansionary fiscal policy, but also a large increase in social spending. This is shown in **Figure 6**. The biggest increase was in housing, but there were also significant increases in health care spending and other social spending. The government's most important cash-transfer program (the *Bono de Desarrollo Humano*) increased by one-fourth. Education funding more than doubled, as a percent of GDP, from 2006-2009.³⁵

By the last quarter of 2012, unemployment had fallen to 4.1 percent, its lowest level on record (for at least 25 years). The national poverty rate fell to 27.3 percent as of December 2012, 27 percent below its level in 2006.

Overall, then, it looks like the Correa government's sweeping financial reforms have been successful, not only in achieving their intended goals but in aiding macroeconomic stability, growth, employment, and very significant improvements on a range of economic and social indicators. What is most remarkable is that many of these reforms were unorthodox or against the prevailing wisdom of what governments are supposed to do in order to promote economic progress. Taking executive control over the central bank, defaulting on one-third of the foreign debt, increasing regulation and taxation of the financial sector, increasing restrictions on international capital flows, greatly expanding the size and role of government – these are measures that are supposed to lead to

³⁵ Ray and Kozameh (2012).

economic ruin. The conventional wisdom is also that it is most important to please investors, including foreign creditors, which this government clearly did not do. While not all of Ecuador's reforms went against orthodox policy advice – its measures to resolve insolvent banks, anti-trust legislation and the creation of an enforcement body, deposit insurance reforms, for example, are widely accepted – the bulk of them clearly did, and yet they succeeded.

Ecuador's success shows that a government committed to reform of the financial system, can – with popular support – confront an alliance of powerful, entrenched financial, political, and media interests and win. The government also took on powerful international interests as well, in its foreign debt default, its renegotiation of oil contracts, and its refusal to renew the concession for one of the United States' few remaining military bases in South America. Its accomplishments have implications not only for much of the standard policy prescriptions that are offered to developing countries but also for the prospects of any democratic government that is elected on a reform program and wants to chart a new path to growth and development. The conventional wisdom is developing country governments have relatively limited policy options in an age of “globalization,” increased mobility of capital and international competition. Ecuador is a relatively small, middle income developing country with an open economy that does not even have its own currency. Yet in five years it has accomplished some of the most comprehensive financial reforms of any country in the 21st century. This indicates that a wider, potentially more successful set of policy options are available to developing (and high-income) countries than is commonly believed.

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