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MONOGRAPH

**“20 YEARS OF THE COLLAPSE OF THE BANKING SYSTEM IN ECUADOR:
BACKGROUND, CAUSES AND CONSEQUENCES.”**

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Gratitude

I would first like to thank God, who is the one that gave me the opportunity to live, have an exemplary education, and a great family and friends. I want to thank this great country that has giving me a home, that has given me a flag to represent and to fight for and a sense of nationalism that I will always carry. Thanks to my parents who are always guiding and pushing me to overcome and be a better man. Thanks to all my teachers than have been forming me throughout the years in this great institution and thanks to miss Patricia Sanchez and my tutor Mauro Mackay that are the ones who are showing the way to make of this monograph an excellent one.

Summary

In this monographic work there will be an intense look at the events leading up to this financial crisis Ecuador had back in 1999, also to what happened next and a chapter concentrating solely in the dollarization that the Ecuadorian way out of this crisis.

In the first chapter we can appreciate what happened before those five days no financial transaction could be done in the country and how a lot of external events, corruption, and a neoliberal system that was forcedly introduced into the Ecuadorian economic model, causing tremendous outcomes. In the second chapter we take a look at some of the consequences that happened between and after those 5 days of chaos that was this country and how the country was left broke and opted for the better solution that was the dollarization, that it is what is about the third and final chapter, in this chapter it will detail out how the Ecuadorians reacted and behave to this outrageous, at the time, change. We also take a look at the benefits of this measure and how this also affected the economy and how it all transcended to this day that we use the dollar as our national currency. Here you will find a recollection of the events leading up to the collapse of the banking system, the events during this crisis and how the country handled and got out of this situation with the dollarization.

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Introduction

This monograph includes information about the financial crisis Ecuador suffered 20 years ago, ergo the name “*20 years of the collapse of the banking system in Ecuador: background, causes and consequences.*” It is very important to the history of Ecuador because it was a crucial time for the future of this country that is today.

The purpose of this monograph is to know the reasons that took this country to its biggest financial crisis in history, analyzing the facts of this crisis and the consequences that it caused on the Ecuadorian society to comprehend the decisions that made Ecuador adopt the US dollar as their currency, therefore, to inform what happened and how it was handled by the government. This work also tends to explain how this banking crisis damaged and benefitted the Ecuadorian economy analyzing the economic and political effects of this financial crisis.

There has been a lot of studies about this financial crisis and the dollarization that is the biggest consequence that this crisis had, for this monographic work this are some of the authors and respective work where information has been gathered and analyzed to write this monograph: Mancero, D.(2003) .La crisis bancaria ecuatoriana ¿una crisis diferente?; León, M., & Ponce, J., & Pilar, M., & Velasco, M., & Brborich, W. (2000). Ecuador 1999 crisis económica y protección social; Schuler,K. (2002). El futuro de la dolarizacion en Ecuador; Gastambide, A. (2010). El camino hacia la dolarización en Ecuador.

The collapse of the banking system in Ecuador happened in 1999 but it was a result of worldwide crises, external crisis, poor management of the government, corruption, a poorly introduced system to the economic model and a lot of chaos.

This monograph breaks down to three chapters: the first one is about the background and what caused the collapse of the banking system with a clear division in the economical causes and the political causes; the second chapter is about the economic , social and political consequences of this financial crisis; the third is solely about the dollarization in Ecuador and how the country took this hit to the economy.

Chapter I

Background and causes

1.1 Background

1.1.1 Situation of Ecuador before the collapse of the banking system.

It all started back in 1995 during Sixto Duran Ballen's presidency from a financial crisis that Ecuador had dragged for some years by that time, the inflation of the Sucre, Duran Ballen had an idea to try to fix the inflation of the Sucre that was the local currency at that time, this idea was to increase the interest rate so that the country could get foreign investment and savers could put the money in banks so that they could have enough to loan and therefore reactivate the economy. This created a neo-liberal system liberalizing the monetary system. Martinez (2005) says "Between 1992 and 1995, a neo-liberal administration had enacted a drastic stabilization plan and liberalized the financial system" (p.1). This was a key factor to the collapse since it started a series of events that ultimately resulted in the collapse of the banking system. This started to destabilize the economy and brought along a lot other problems.

Ecuador at that time faced a number of events that did not help in fact worsened the economy of the country like the phenomenon of El Niño that caused a series of inconvenient to the country because of the flooding and the damaged to the farming industry being one of the pillars of this economy, the war with Peru that caused political and economic instability. According to Ramos (2012) "The Ecuador-Peru war drained US \$ 600 million from the national treasury and unbalanced the fiscal accounts" (p.1). The global petroleum crisis that affected us directly because it is our main export product being the backbone of our economy and the Asian crisis that affected a lot of trade treaties, all of these were factors that influenced the actions that the

government took and debilitated an already crippled economy. This and the idea of the increase of the interest rate were the main reasons that branched many other problems that contributed to the collapse of the banking system, this actions had some reactions, that we are going to analyze later, that did not were in favor of Ecuador crippling the economy even more to the breaking point that was this collapse. In 1998 Jamil Mahuad becomes president of Ecuador with an already debilitated Ecuador , with the Sucre at 500 per dollar and with a crisis that he couldn't stop, but in which he took part.

1.2 Causes

1.2.1 Economical causes.

During the presidential period of Sixto Duran Ballén, the interest rate for savings accounts reached up to 270%. This new law and system of neo-liberalization that the state had adapted opened a window for new banks to begin operations. "The liberalization law made opening a new bank very easy, which led to financial fragility" (Martinez, 2005, p.7). People began to put their money at savings accounts to generate more money because of the high interests that all banks were paying at that time money from foreign investments, this new interest rate brought, started to circulate in our economy so the new macroeconomic politic started to look good, people saw more profitable putting money in their banks than doing productive or commercial activities.

"The number of banks grew by 57% during liberalization while the overall number of financial institutions increased by 180%"(Martinez, 2005, p.7).This was crucial for this financial crisis because of the new policy a lot regulations were dropped so with more money coming into

banks, owners started to loaned it to their friends and companies associated to them, with no guarantee whatsoever. These bank owners soon started to develop mining companies, shrimp companies, farms, etc. Simultaneously, the phenomenon El Niño happened alongside with the global crisis of petroleum, the Asian crisis and the war with Peru, this affected our economy. Soon, people went running to the banks to withdraw their money but as it turned out there was no money to give back to people.

There is a law here in Ecuador that obligates the central bank (BCE) to give what is called a liquidity loan to the banks that have run out of money to give back to the bank users in events like these, alongside with this loan there were plenty of other loans that the state required the central bank to do. This devaluated even more an already weak Sucre. Some of the banks began to declare themselves in bankruptcy giving alarms to all the savers account. . In order with these events the central bank injected liquidity money in the banks, they gave credits in Sucre to the bank and they rapidly turned it to dollars and got, it out of the country, this devaluated the Sucre in an aggressive way. This was called the bank bailout, with this the Sucre started devaluating 100% every 3 months. In 1999 the Sucre reached the S/.19.000 per Dollar.

1.2.2 Political causes.

1.2.2.1 Main responsible.

Jamil Mahuad was highly criticized over his health conditions to govern the country had he just had a stroke and a mid-face paralysis. It is said that he was taken as a puppet, disappointing as this was because Mahuad was a highly capable man having studied a master's degree in Harvard and having been in the Ecuadorian politics for as long as he had been, for the bankers as he had

tight relationships with them that at that time in 1998 had the actual power of the country and with political movements sponsored by these bankers that made him the president.

Fernando Aspiazu was the president of the Banco del Progreso, he made a controversial donation to Mahuad's campaign for 3 million dollars. In Mahuad's cabinet there were some popular recognized bankers like Guillermo Lasso (at that time president of the Banco de Guayaquil and he had been a representative of the private banking in the monetary board years before) as the new Minister of Economy, Alvaro Guerrero (Banco La Previsora) as the president of the CONAM (National board of modernization), Fernando Guerrero (Banco La Previsora) goes to the central Bank. Among other bankers that ended up with political jobs because of Jamil Mahuad. In Mahuad period there was a lot of speculation later confirmed that the bank owners deviated money into ghost companies and that was one of the primarily reasons banks ran out of money to give back to bank users. Guillermo Lasso was perfectly informed of all the things banco continental did and their bailout because of his double condition as a member of the government and a private banker and so he had been actively involved in this. (Ramos, 2012). Banco Continental was the first bank to bankrupt in 1996 marking the start of this financial crisis. As said before it was required by law to the central bank to in a way save this poorly administrated banks so with that excuse and to pay the savers of those banks the DGA (Deposit Guarantee Agency) is created in 1998.

Since 1998, 14 banks accounting for about 65 % of the system's assets had to be seized by the state, done via the controversial DGA. Then, in September 1999, Ecuador became the first country to default on the Brady deal that recently restructured around US\$6 billion of public commercial debt. (Patiño, 2001, p.37)

3 days later another bank is seized, Filanbanco followed by Sol Banco, Banco De Prestamos and Banco de Tungurahua in the same year. With this and the Bank Bailout the Sucre started devaluating very fast and because it was the actual currency and it lost its value in an incredibly rapid way it started to affect people almost immediately devaluating the salaries, the retirement pension, the assets in companies, etc. The government to try to stop the devaluation and to prevent the withdrawal of the money in a massive way, the Government decree to give a “holiday” of one day to freeze the financial activities in the country. This holiday was extended to 5 days.

Chapter II

Consequences of the collapse of the banking system

2.1 Economic consequences

Monday march the 8th of 1999, during a national broadcast the Superintendent of banks declared that for that day all financial activity in all financial entities would not carry out their normal day of business. This ended up lasting 5 days. Three days later alongside the discomfort of the Ecuadorians and the freezing of the banking system and the closing of some banks the government decree that all deposits would be arbitrarily seized. In order to solve the financial chaos generated in the country, the government concentrated on assisting the banks, granting subordinated loans through the Central Bank. In addition, the freezing of public deposits and the bank holiday were ordered, with the State assuming control of 70% of private banking. (Manceno,2001, p.6).

The Ecuadorian economy lost eight billion dollars with this event. Banco del Progreso was the first bank to bankrupt in this financial crisis, 20 more banks Bankrupted in that year affecting only the citizens of Ecuador, leaving them with no savings and without money. Mancero (2001) affirms :“the weakness of regulation and supervision has been "the favorite cause" of national analysts in commenting on the Ecuadorian banking crisis, basically attributed to the enactment in 1994 of the General Law of Financial Institutions”(p.4) .This was an act of corruption, prior to this freeze of assets, banks started to persuade costumers to move their money that they had just cashed out into a accumulative policy where they were going to get money from a high interest rate, some people had to move deposits into saving accounts because the bank obligated them, some financial institutions, powerful people and their customers were aware with this crisis , they had privileged information and they had a chance to get their money out , but a working class man did not have this opportunity and fooled by the banks they lost all their money and that resulted in total chaos in the streets an that affected the economy.

The economy suffered so much during this time that the Sucre was devaluating by the day and it reached a point where the Sucre devalued one hundred percent on a quarterly basis. This was a terrible year for the Ecuadorian economy and history , this was a year when families lived on less than the minimum wage , when people killed themselves because they lost all their money, when people would riot outside bank and government buildings, dreadful economy uncertainty, chaos , instability, anger, sadness, frustration, no bank declared losses and the ones who survived even had utilities declared in their taxes. Jamil Mahuad saw one only way out of this crisis and that was the dollarization.

2.2 Dollarization and political consequences

The dollarization was an idea given by Jamil Mahuad, it was a way out that's how he sold it to the Ecuadorian people, with the Sucre devaluating by the minute President Mahuad stopped it by settling an exchange at 25000 Sucres per dollar. January 9th of 2000 was the day that the dollarization became official, with over five billion dollars frozen in banks deposits, banks started to return some at an exchange rate of 25000 Sucres per dollar, losing most of their money and some all of their money having to stand there hopelessly in front of the biggest robbery of our economy our history can hold accountable.

People did not take it well, there was a great deal of uncertainty and confusion. This decision from the government resulted in massive chaos and riots up until the overthrow of Jamil Mahuad from the presidency, Mahuad with no popularity at this point and with the whole country against him, a group of natives took over the congress in compliance with the army and it didn't took long before they forced Jamil Mahuad resignation under the leadership from Lucio Gutierrez who later become the president of Ecuador. Vice president Gustavo Noboa took over the power after the resignation of Mahuad and one of his first acts as president was to reiterate the dollarization. It wasn't after it passed some time that the AGD started to returned some money to the people but because there weren't so many printed dollars the AGD had to come up with the solution to print regular paper and use it as dollars to try to recompensate those who lost it all.

The plan with this dollarization was to prevent us of any inflation because of the strong currency we have and to try to get the market flowing again by having a valid currency. The country hasn't recovered in a definitive way (Manceno,2001).

2.3 Social consequences

2.3.1 How it affected on people.

On that day, march the 8th, President Jamil Mahuad said that there will be no money seizure and this “bank holiday” will last 24 hours. All banks were closed that day people was confused, mad, complaining and later rioting.

This caused tremendous uncertainty in the country’s economy, nobody knew anything about anything that was going on, the banks in the week before had asked and obligated some clients to move their money to a savings account so that they could get the interest that was before mentioned and that they would start to get interest on next Monday, but the next Monday was this bank holiday and in that same day it was announce again by the superintended of banks that the bank holiday was going to be prolonged another day.

In all parts of Ecuador there was chaos , there were people gathered outside banks complaining about the situation, there were lootings in shopping centers because of the terror of people not having money , in the streets there were money exchange from Sucre to dollar with no precedent ,people just sold the dollar at whatever cost they thought it costed .People were frustrated, sad , angry , they felt useless and hopeless, some people took their own lives, some stole, some riot , some protested, some cried in tv praying that they would be heard, some didn’t know what to do , but this was something that affected the whole country and no one was happy about it.

People were hurt, some of them had lost their lives savings , some lost all their money and had nothing to maintain their family or pay hospital bills, this collapse of the banking system caused a lot of deaths, when people found out some had heart attacks , some couldn’t take the burden of starting over and having nothing to give to their family so they killed themselves. The situation

in Ecuador got worse and worse with the dollarization people reduced all the money they had left for a lot less because of the currency exchange , they didn't understand it, people started selling everything at any price , they would sell a tomato or a fruit in the street for one dollar because of that confusion and no regulation, a lot of middle class families had to live like the low class families changing where they live and some renting if they even had a house so they could live with that rent money , this led to a massive wave of emigration , a lot of families solution to this problem was to leave, to leave the country they grew up in, to look to a brighter future in countries like Spain , Italy , United States , etc. The Ecuadorian population took a big hit in this financial crisis.

Chapter III

Ecuador after the dollarization

3.1 Economy after the dollarization

3.1.1 How it has affected the Ecuadorian economy

With this new currency besides all the confusion and the fear people felt for changing into a new economic model and structure, the Ecuadorians are afraid this as it was our way out, we might have put ourselves in an straightjacket by not having our own currency and not being able to make any decision regarding the dollar as it is not Ecuadorian. Immediately after the dollar was introduced as our new currency and the Sucre was set at 25000 Sucre per dollar, the country was a complete chaos, the people were confused about the currency exchange, there was a lot of people who had lost it all because they had investments in Sucres and because of the exchange they lost it.

One of the disadvantages that comes with not having your own currency is that there is not much economic freedom in relation to other countries like Chile and Peru that have stood out in Latin America for their economic models, Ecuador does not have an economic freedom like these countries. (Calderon, 2015).

With all of this, the confusion, the fact that people had lost it all or the little they had was turned to almost nothing in the Sucre-dollar exchange, the incessant crisis that our country had, one disaster after the other, so with this, the dollarization was threatened but the main threat to the dollarization was not the deficit in the trade balance, the oil prices or the amount of dollars we received in the remittances, no, the main threat became this continued growth of public spending. Each additional dollar of spending increases the temptation to return to the original monopoly.

3.1.2 How it has benefitted the Ecuadorian economy.

The dollarization was the key factor to stabilization after the collapse of the banking system. “The dollarization was the government's last desperate attempt to stabilize the economy. After many other policies that had been tried and failed for a long time” (Schuler,2002, p.5). The acceptance rate of the dollar as our national currency is over 90%, there will always be some patriachs that see having a national currency as a symbol of our country and are opposed to the dollar being our national currency and there are the politicians, because with the dollarization the central bank cannot print money at will, such as Venezuela that prints money just because making the inflation grow even more every time, and by changing to the dollar you are giving up the privilege which the central bank can alter and manipulate the pricing system therefore, in a way, shielding the country from another crisis like the one we had.

The change was tough but with a strong currency as the dollar in the firsts years as our currency from 2000 to 2006, the economy was favorable to the private business sector and in consequent the private investment. In the period 2007-2014 the government takes its role back and its predominant in the economy, by this time the majority of Ecuadorians accepted the dollar but as always it depends of who is in charge, of who controls that money and which laws are passed and which are not, and how they are handled.

Why is it important for politicians the imposition by force of a national currency? Because there is no superstition powerful enough to scam the people by liquefying your real salary and/or savings through the unpleasant double devaluation/inflation. If people had the freedom to reject a coin that evidently is being devalued to finance public expenditure, all of which monetary policy tool would become ineffective.

(Calderon, 2015, p.2)

Of course besides this there are plenty of reasons why Ecuador having the dollar is great for our development as a country, one would be how because the value of the dollar is not entirely up to us we are avoiding a crisis and inflation, nevertheless, this could happen because we are in charge of our own economy but with the dollar we have a strong suit. Therefore, the dollarization is a great achievement for the Ecuadorian economy and development.

3.2 Politics after the dollarization

3.2.1 How this financial crisis changed the politics in our country.

The politics in our country after the dollarization started with the overthrow of Jamil Mahuad and then, since the banks had no money to return to the people the AGD had to come up with something since the banks did not have enough printed bills so they started to hand out pieces of paper that they gave the value which contributed to the inflation and the general thought that the government did whatever they wanted with the economy and the future of this country with an already dollarized economy. “As the basic economy tells us, that monetary creation in excess, sooner or later, generates inflation and devaluation” (Paredes, 2017, p.4).

Simultaneously, large bank debtors created escrows to pay off their accumulated debts. People were filled with uncertainty, with fear and terror of the new economic model, sadden and angry by the loss of their money and outrageous at the government feeling absolutely useless, but what they did what was best for the country although it has its downsides and although the government was the first involved in this crisis, the dollarization is the one good thing we can rescue about

this tragedy, the dollar right now is keeping us together and preventing us from ending up like Venezuela.

The whole process of the dollarization took time and determination, is not easy to change the currency of an entire country, so this process had to be handled very carefully and very straight forward. Dollarize the economy, meaning, that there already is a monetary intermediary such as the central bank, but dollars enter and leave the economy only through the hands and direct decisions of economic agents. Dollarization is not a strict rule, it is just a different system, so we adapted this to our economy model and the monetary distrust was completely broken, and very quickly the monetary and real disaster was stopped. However, the inflationary process lasted a couple of years because it is a long process to get out completely from a different currency, but it has helped us very deeply in the long run.

Conclusion

To conclude this monographic work, it would have to be said that the collapse of the banking system was a crucial moment for the Ecuadorian economy.

- It divided the history of Ecuador as the beginning of a new era: the dollarization.
- As it was chaotic it was beneficial but limiting for example, the third chapter divides the

differences about what make the dollarization good and what makes it bad, it is good as said

before because it gives us a kind of mattress to land if we go into another depression, with

this being said it is still possible to have a crisis like the one described in this monograph but

not as intense because of the dollarization what we would have to do is to run out of physical money and start giving out pieces of paper as currency , hence devaluation ,but, as the dollar itself cannot be devaluated by us, we would have to make a loan to or the money elsewhere and our national debt would go up and there would be an economic disaster but with all this aside and besides the obvious benefits of having one of the most powerful currencies in the world as our currency it holds us back from true development like for example look at Chile or Brazil, they are the most developed countries in Latin America and have their own currency and have reached further than us.

- In the first part of this monograph is detailed out what background the country was in at that time to try to situate the reader into understanding what happened and maybe to understand why the government decisions looked good at the time.
- Then the causes of this crisis are explained and how it all adds up. In the second chapter the consequences are reviewed, whilst the consequences are not good, but in fact chaotic what this work is intending to give out to its readers is to trying to understand why this all happened to make sure it never happens again.

Recommendations

- It is recommended to read this information thoroughly and objectively and to use this for the future of our country being this monographic work for the leaders of tomorrow.
- Here it will be found crude information about the disastrous crisis that was the collapse of the banking system and how in some way helped the country move forcedly yet in a righteous way towards dollarization to help heal our economy.
- To help fulfill the purpose of this monograph is to internalize the information given and to know a crucial time of the Ecuadorian history to not repeat it in the future a let us not as the people of this great country be played with again.

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Codigo QR

