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Dollar Democracy: The Politics of Dollarization in Latin America

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DOLLAR DEMOCRACY: THE POLITICS OF DOLLARIZATION IN LATIN AMERICA

by

CORI MADRID

A dissertation submitted to the Graduate Faculty in Political Science in partial fulfillment of the requirements for the degree of Doctor of Philosophy, The City University of New York

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This manuscript has been read and accepted for the
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Abstract

DOLLAR DEMOCRACY:
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by

Cori Madrid

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The state's right to print money and control monetary policy is among its most powerful abilities: it allows the state to manage the economy, raise revenue, and reward political allies. Since the establishment of the Westphalian state system, the state's monopoly of money within its borders has been a source of wealth and within the last century, influence over the macroeconomy and local actors. Nevertheless, in the year 2000, Ecuador and El Salvador surprised the world by announcing that they would officially dollarize their economies, replacing their national currencies with the dollar. What can explain why countries, such as Ecuador and El Salvador, would voluntarily subjugate themselves completely to another country's monetary regime? Given its dramatic impact on the power of the state, why would any independent country choose to dollarize?

Up until now, scholarly attempts to explain dollarization have focused on its theoretical economic “advantages” and “disadvantages”: its impact on lowering interest rates, greater access to credit, the economic benefits of currency stability versus reductions in seigniorage and the loss of monetary sovereignty. In the case of Ecuador, economists and political scientists, alike, agreed that dollarization was the only option available: it was a sheer act of desperation divorced from social or political considerations other than the desperate need for quick stability. However, these answers fall flat, as they ignore 1) the relationship between local struggles over dollarization and financial globalization, 2) the differential ways in which dollarization impacts various societal groups, creating winners and losers with strong interests in influencing policy adoption, and 3) the ways in which internal political struggles and coalitional alliances impact the outcome of these struggles. Differing monetary regimes create concentrated groups of winners and losers and where there are winners and losers, actors will work to impose their preferred policies.

Through detailed case studies of two countries where a campaign for dollarization was successful (Ecuador and El Salvador) and one case study of a country where dollarization was defeated (Argentina), this dissertation shows that struggles over dollarization reflect sectorial distributional struggles that are intrinsically related to processes of financial globalization.

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DOLLAR DEMOCRACY:
THE POLITICS OF DOLLARIZATION IN LATIN AMERICA

TABLE OF CONTENTS

Lists of Tables	<i>viii</i>
Introduction	1
Ecuador	36
El Salvador	100
Argentina	146
Conclusion	195
Appendix	229
Bibliography	247

LIST OF TABLES

Introduction

Table 1. Indicators of International Financial Integration, Emerging Markets (percent of GDP)	19
Table 2. Features of Selected Exchange Rate Regimes	34

Ecuador

Table 1. Total Credit From Private Banking Sector (Millions)	95
Table 2. Total Unsecured Debt From Private Banking Sector to Firms (millions)	96
Table 3. Total Credit From Private Banking Sector Home Loans (millions)	96
Table 4. Private Bank System Deposits (Constant 2010 Sucres-Millions)	97
Table 5. Total Private Banking Sector Quasi-Money (National and Foreign)	97
Table 6. Private Credit in Foreign Currency (FX) (Millions of 2010 Sucres/2010 dollars)	98
Table 7. Private Debt Instrument Emissions in Foreign Currency (FX)	98

El Salvador

Table 1 Remittances	107
Table 2: Domestic Bank Assets by Country	108
Table 3. El Salvador GDP by Economic Sector (% of nominal GDP)	109
Table 4. External Sector 1991-1999 (in millions of US dollars)	112
Table 5. Private Bank Profitability	129
Table 6. Net Banking Spreads	130
Table 7. Nominal and Real Interest Rates	133
Table 8. Foreign Debt Stock of Private Financial Institutions	136

Argentina

Table 1. Share of GDP by Selected Sectors	156
Table 2. Private Sector Credit (in millions of Aug. 1999 pesos)	157
Table 3. Percentage of Private Sector Loans in Domestic and Foreign Currency	158
Table 4. Market Share by Type of Institutions (%) - December 2000	170
Table 5 :Big Business in Argentina: Exportation of Goods by Principal Economic Activity	172
Table 6. Big Business in Argentina: Number of Companies that Export by Principal Economic Activity	173
Table 7. Big Business in Argentina: Profits of Companies Belonging to Economic Groups: 1993-2001	174

CH. 1: INTRODUCTION

I. INTRODUCTION

The state's right to print money and control monetary policy is among its most powerful abilities: it allows the state to manage the economy, raise revenue, and reward political allies. Since the establishment of the Westphalian state system, the state's monopoly of money within its borders has been a source of wealth and within the last century, influence over the macroeconomy and local actors. Nevertheless, in the year 2000, Ecuador and El Salvador surprised the world by announcing that they would officially dollarize their economies, replacing their national currencies with the dollar.¹ Countries that fully dollarize give up their ability to print their own money (although they may mint coins or very small bills). Instead, they rely on a foreign currency to conduct all transactions, foreign and domestic. Dollarization removes any vestige of monetary sovereignty by eliminating the Central Bank's monetary policy duties.

Prior to 2000, only the smallest economies, often territories or protectorates of the country whose currency they adopted (i.e. Puerto Rico, Guam, etc.), were fully dollarized. Panama, which had been the largest dollarized country prior to 2000, adopted the US dollar as its currency in 1904, while still under US tutelage. What can explain why larger and sovereign countries, such as Ecuador and El Salvador, would voluntarily subjugate themselves completely to another country's monetary regime? Given its dramatic impact on the power of the state, why would any independent country choose to dollarize?

¹ Despite its seeming specificity to the US Dollar, the term, *dollarization* is also the generic term for when a country replaces its currency with that of any other country, whether it be the US dollar, the Euro, or otherwise.

Argentina presents us with an important comparison: as a country that had implemented a currency board in 1991, Argentina was considered by a number of scholars and political figures to be an excellent candidate for dollarization. In fact, after Argentina's president Carlos Menem announced his government's intention to explore dollarization in 1999, the US Congressional Joint Economic Committee, led by Senator Connie Mack, held a series of hearings to determine what the US' official stance on dollarization should be. Senator Mack eventually proposed the International Monetary Stability Act, otherwise known as the Mack Bill (Cohen 2003a), with the goal of promoting dollarization by creating a mechanism for the US to share seigniorage² with dollarized countries. Ultimately, the US government never took an official stance on dollarization and Mack Bill never made it out of committee in the Senate or the House, despite several reintroductions. Nevertheless, Argentina's potential dollarization took center stage during the hearings. The controversy over whether Argentina should dollarize came to a head in 2001-2002 during an economic crisis that plunged more than half of argentinians into poverty and threatened the future of its currency board, popularly known as Convertibility. Despite the country's highly financialized economy and the emergence of a strong globally oriented financial sector, Argentina chose not to dollarize and, in fact, abandoned its fixed exchange rate system all together.

Until now, the literature on dollarization paid scant, if any, attention to the politics of dollarization. Instead, it has remained largely technical, focusing on its economic pros and cons, conditions for implementation, and impacts on economic growth. However, removal of such a powerful tool as the state's right to print and monopolize money will

² The term seigniorage refers to the difference between the value of money and the cost to produce it. Often the cost to produce currency is less than the value of what the currency can buy, in which case the state makes an economic profit.

surely impact power dynamics within the dollarizing country, creating winners and losers. Therefore, official dollarization requires a political economy analysis to understand its causes and effects.

This study argues that struggles over official dollarization in sovereign states are a byproduct of global financialization. In fact, unilateral dollarization by sovereign states would not be possible without global financialization. As discussed later in this chapter, the collapse of Bretton Woods, financial liberalization, and the emergence of Eurodollars permitted money to flow free from the constraints of gold and regulations of the home state. Advances in technology, such as the internet and high-speed computers capable of processing transactions at lightning speed, as well as the creation of new financial instruments (especially highly complex derivatives) consolidated these policy shifts by permitting individual parties to transfer large sums of capital across the globe in seconds.

Similarly, policies put into place by governments to encourage financial integration, based in the international consensus that a strong and integrated financial sector would lead to overall economic development, resulted in a dramatic shift in the locus of the economies studied, from export to speculation based in global financial accumulation.

In each of the countries studied (Ecuador, El Salvador, and Argentina), the financial sector whose interests were embedded in global financial accumulation came to dominate the local economies. Within the context of global financial integration, the financial sector sought dollarization as a means of locking in its interests in avoiding devaluation at all costs and, if possible, locking in appreciated real exchange-rates as well as improving access to cheap foreign loans, often to take advantage of arbitrage

opportunities. For example, during the era of Convertibility, Argentine businesses drove profits by borrowing US dollars from abroad at low interest rates and then depositing them domestically, where interest rates were much higher.

States facilitated these structural shifts within their economies, influenced by the ideology of global finance that took hold during the 1970s and became popular in Latin America during the 1980s and 1990s, in large part through policies promoted by the US and International Financial Institutions (IFIs). To this end, all three countries implemented structural adjustment policies aimed at facilitating the development of a globally integrated financial sector under the premise that financial development was a prerequisite for overall economic development. In each case, these shifts resulted in unprecedented levels of financial integration and the ascendancy of a financial sector rooted in the global economy.

However, the interests of the newly powerful financial sectors soon came into conflict with the interests of more traditional economic sectors, particularly export. Export sectors had a critical interest in maintaining a depreciated exchange rate to maintain global competitiveness, which meant a tendency to favor more flexible exchange rate regimes that would allow for devaluation—the exact thing the financial sector sought to avoid. Thus, in each country a struggle for the future of the country's exchange rate regime and with it, a struggle over economic models, ensued. Which group prevailed ultimately depended upon a complex mix of economic, social, and political factors. To a large extent, the ability of the financial sector to join forces with other economic sectors (in particular, the presence of an influential commercial/import sector) as well as its relationship to the political power structure were critical elements in

determining the success of the financial sector's drive for dollarization. Thus, while financial globalization was a necessary component for the proliferation of dollarization, it was not sufficient. The cases studied in this study demonstrate the importance of the influence of locally-based economic elites (as distinguished from international elites) with established ties to political parties and the national community in mobilizing support for dollarization. Where the financial sector did not have these close political and community-level ties, as was the case in Argentina, the drive for dollarization failed despite its economic power.

II. LITERATURE ON MONETARY AND EXCHANGE RATE POLICY

Scholars and politicians have long recognized the utility of monetary policy in manipulating political outcomes. Politicians may employ inflationary policies during an election cycle to temporarily boost the economy (Hayek 1991; Desai and Olofsgard 2003; Schamis and Way 2003). They may depreciate or appreciate the currency to spur or slow down the growth of certain sectors of the economy or to favor various sectors of society. Moderate inflation reduces nominal debts, which, some scholars predict, benefits the poor and working class (Eichengreen 1996; Kelsey 2003; Hampton 2006) while others claim that inflation disproportionately hurts the poor and working class, as they have less access to offshore bank accounts (Schuler 2003, Hinds 2006). Whatever the policy, it will likely create winners and losers, thereby creating political contention.

Despite recognition of these political impacts, for too long, the subject of monetary policy has been the almost exclusive domain of economists and technocrats. Seen as secondary to the "real economy" (i.e., trade) for centuries, political scholars and citizens have been left to believe that decisions over such seemingly arcane policies as interest and exchange rates are

made within apolitical bubbles based on some clear standard of efficiency. However, as Kirshner (2000, 2003) monetary policy are ambiguous and, therefore, the choice of one policy over another must be political.

The literature on the political economy of exchange rate³ policy, in particular, is perhaps the least developed related to macroeconomic policy but is growing in importance. Unlike trade policy, which as Frieden and Stein (2001) point out, has a wealth of well-developed theories and empirical studies concerning the interaction of politics, interest groups, and elections on policy development, the literature on exchange rate policy has remained focused on the economics of exchange rates. The economic approach assumes that a government implements exchange rate policies to maximize the welfare of all its citizens, ignoring the distributional conflicts and resulting political pressures such policies may entail (Frieden 1991, 1994?; Hefeker 1996). However, given the real and uneven distributional impacts of exchange rate policy, such an assumption is naïve, at best. As Keynes points out in his *Treatise on Money*, changes in the money supply do not affect all people equally but lead to redistributions in purchasing power that have social and economic consequences (Keynes 1976). Where policy outcomes affect income distribution, as in the case of exchange-rate policy, affected parties have a strong incentive to attempt to influence policy adoption and implementation.

Several studies have shown the impact of interest groups on the choice of exchange rate regime and the level of exchange rate (see Frieden 1991, 1994, Frieden and Stein 2001; Frieden, et. al. 2010; Hefeker 1996; Schamis and Bonilla 1999; Leblang 2002; Wise 2000). Thus,

³ “An exchange rate, as a price of one country’s money in terms of another’s, is among the most important prices in an open economy. It influences the flow of goods, services, and capital in a country, and exerts strong pressure on the balance of payments, inflation and other macroeconomic variables. Therefore, the choice and management of an exchange rate regime is a critical aspect of economic management to safeguard competitiveness, macroeconomic stability, and growth” (Yagci 2001: 1). For more a description of the features of major types of exchange rate regimes, see Table 2 at the end of the document.

Kirshner (2000) urges students of politics to concentrate on the differential effect that these policies impose, as “it is the differential, political effects of macroeconomic phenomena that provide the missing link in the relationship between ideas and interests and clarify the extent to which the choice of a ‘legitimate’ economic policy may be of greater political than economic consequence” (Kirshner 2000: 428).

To be sure, the distributional impacts of exchange rate policy are cross-cutting and complex, and thus, require detailed study of the economic interests and political structures of the countries studied. For example, political economists have theorized that those most exposed to cross-national economic flows will be most interested in monetary stability (associated with a fixed exchange rate) over flexibility (associated with a floating exchange rate) to reduce the uncertainties associated with cross-border trade, particularly in the absence of hedging opportunities, and this is the case for many developing economies (Hefeker 1996, Eichengreen and Frieden 1993, Pereg and Steinherr 1989).

Nevertheless, tradables producers⁴—whether producing for the foreign or domestic markets—generally prefer a depreciated currency, which raises the relative price of foreign goods and, thus, improves competitiveness, pointing to a potential preference for an exchange-rate regime that permits greater flexibility (Frieden 1991, 1994; Frieden and Stein 2001; Hefeker 1996; Schamis and Bonilla 1999). The ability to devalue is even more essential for tradable producers in developing economies with low-levels of productivity where currency devaluation is one of the few short or medium-term ways to improve competitiveness. On the other hand, importers and international investors generally prefer an appreciated currency, which makes foreign goods and assets cheaper. In general, tradable producers prefer a depreciated exchange

⁴ Tradable goods are those that can be exported or imported. In this study, the term *tradables producers* refer to those who produce for export or produce goods for the domestic market that compete with imported goods.

rate, while internationally oriented investors and non-tradable producers prefer an appreciated exchange rate (Frieden 1994, Frieden and Stein 2001)

Workers face an even more complex set of calculations. On the one hand, barring continuous improvements in productivity, maintenance of currency alignment to prevent overvaluation of the currency and competitive prices for tradables would largely rest on downward adjustment to wages. However, while workers, as a class, may benefit from a more flexible exchange-rate system they also suffer real wage reductions when exchange-rate devaluation leads to inflation without requisite increases in nominal wages. In many small economies, where consumers are dependent on imports, exchange-rate devaluation means a direct increase in the cost of living while an overvalued exchange rate has the opposite effect. In this way, workers experience multiple cross-cutting pressures that make it difficult to clearly identify their self-interest. To this end, workers often support the interests of the sectors through which they are employed (Frieden 1991, Hefeker 1996).

Literature on Dollarization

Full, or “official,” dollarization is defined as the replacement of a country’s currency with that of another country. Full dollarization is distinct from partial, or “spontaneous,” dollarization, in which the government does not legally recognize the use of a foreign currency, despite widespread use, and continues to print its own money. Full dollarization entails the loss of seigniorage (the profit gained from printing one’s own currency), surrender of monetary policy to the country whose money is being adopted, and the inability of the Central Bank to finance deficits by printing money. As such, the Central Bank’s ability to affect monetary policy is completely eliminated and the dollarizing country must rely on fiscal policy to manage its

economy. Monetary Union, another hard fix, while also extremely difficult to reverse, at least provides the premise that member countries will have some form of input into the union's policy and that this policy will be set in the interest of the union as a whole. Dollarization as a unilateral act on the part of the dollarizing country, on the other hand, has no such premise.

Approximately 30 countries are now officially dollarized, using mainly the US dollar, the Euro, or the Australian dollar (Levy Yeyati and Sturzenegger 2003). Most of these countries are not independent states but territories of the country whose currency they have adopted. Of the current dollarized sovereign countries, Panama, Ecuador and El Salvador are the biggest and most stable. While Panama dollarized upon its US-sponsored secession from Colombia in 1904, it did so under the tutelage of the United States.

At this point it might be instructive to discuss how currency boards fit into this fixed exchange rate continuum, as this arrangement is sometimes considered equivalent to dollarization. While many currency boards, including the one described in Argentina, do involve a certain level of informal dollarization, there are key differences that distinguish this type of hard fixed exchange rate regime from dollarization. In fact, as the case studies of Argentina and Ecuador will show, these differences may be critical to the future of the economy.

Like dollarization, currency boards are often implemented as an anti-inflationary policy. Currency boards combine three core elements: an exchange rate that is fixed to an "anchor currency," convertibility (domestic currency can be exchanged for the anchor currency whenever desired), and some mechanism of long-term commitment to make it difficult to reverse (i.e. the arrangement is set out by law or is written into the constitution) (Enoch and Gulde 1998). An "orthodox" currency board is limited to issuing domestic currency that is fully backed by a foreign reserve currency and prohibits independent monetary policy (Burdekin 2008). Thus, the

amount of domestic currency in circulation is dependent upon the amount of reserve currency the country can attract through trade, investment, or borrowing. However, as Burdekin (2008:102) notes, “not all currency boards operate in such an orthodox fashion... Many modern currency boards, as with Argentina’s April 1991–January 2002 experience, have expanded functions that may include acting as a lender of last resort, regulating commercial banks, and financing government spending—while not always requiring 100 percent foreign reserve coverage.” As the case of Argentina demonstrates and pro-dollarizationists in Ecuador point out, the fact that the local currency still circulates means that currency boards are vulnerable to “tweaking” around the edges, which leaves the regime vulnerable to potential devaluation.

With few exceptions, the literature on official dollarization has focused on its technical merits, often balancing dollarization’s pros against its cons. Such literature is firmly rooted within Mundell’s (1961) theory of Optimum Currency Areas (OCA), which analyzes factor mobility and economic synchronicity between countries to determine whether they could benefit from a common currency. The OCA literature argues that small, open economies are more likely to benefit from such arrangements, as they have reduced capacity to alter their real exchange rates via devaluation and have a small non-tradable goods sector (Bell 2003; Karras 2003; Starr 2000); thus, their economies are already oriented towards capturing foreign currency through trade.

The most commonly cited costs of full dollarization are 1) *the loss of monetary autonomy*: without the ability to print its own money or to monetize debt, governments of dollarizing countries will lose an important tool for buffering the effects of economic shocks, maintaining competitiveness in the face of other devalued currencies, and will limit their ability to run fiscal deficits; 2) *the loss of seigniorage*: the profit countries earn on the sale of the

currency it prints. Such revenue can add up to percentage points of the GDP and has been an historic tool for governments in need of revenue. Seigniorage added up to approximately 1.3% of GNP in El Salvador (Towers and Borzutzky 2004) and 2.51% of GDP in Ecuador (Matthews et al. 2006); 3) *political dependency* on the country whose currency it has adopted. The attempts to oust Noriega in Panama by holding back dollars serves as the preeminent example of the type of political vulnerability a dollarized country may face (Berg and Borensztein 2003; Cohen 1998, 2000; Kelsey 2003; Eichengreen 2003; Jameson 1990). The US dollar sanctions shut down the well-developed Panamanian banking sector within a matter of weeks, effectively halting the economy (Germani 1988).

The most commonly considered benefits of dollarization are 1) the guarantee of *exchange rate stability*, which will prevent residents from experiencing large short-term losses in income and wealth due to depreciation, 2) the *reduction of administrative costs* associated with maintaining one's own currency as well as the transaction costs involved in monetary exchange, 3) a *reduction in interest rates* due to the reduction in currency risk from devaluation; low rates will supposedly give citizens of the dollarizing country greater access to affordable credit (Bell 2003; Berrios 2006, Calvo 1999, 2000; Cohen 2000; Hinds 2006; Hira & Dean 2004).

Dollarization proponents assert, however, that dollarization will have even more far-reaching economic benefits. Exchange rate stability should encourage *long-term investment*, as investors will be able to predict rates of return, free from fears of devaluation, since the country can no longer print inflationary amounts of money (Hinds 2006; Berrios 2006; Chang 2000; Ecuadorian Institute of Political Economy; Brea, et. al. 2001). Dollarization should also lead to a *sounder banking sector*, as integration with the US financial sector will lead to increased

efficiency and, thus, improved service (Cohen 2000; Berg & Borsztein 2003; Hinds 2006; Moreno-Villalaz 2005; Starr 2000).

Above all, some proponents claim, dollarization would promote *global economic integration* in both the realm of trade and finance. In terms of trade, using a common currency lowers transaction costs and encourages trade opportunities with the issuing country as well as any other economy using the same currency (Brea et, al. 2001; Berg and Borsztein 2003; Cohen 2000). On the financial side, adoption of a widely recognized international currency would allow developing economies to take advantage of new financial instruments, such as hedging and derivatives used to curtail risk and raise capital (Hinds 2006). However, in light of the current world economic crisis, which is strongly associated with the use of derivatives, access to such instruments may not be entirely unproblematic. At the same time, some theorists claim that concern over the loss of monetary autonomy is overstated: within the context of global economic integration characterized by the free mobility of capital, surrender of monetary sovereignty is the cost of maintaining a stable currency (Andrews 1994; Schuler 2003; Jameson 1990), particularly for small developing countries (Hinds 2006; Von Furstenberg 2003).

Political Aspects of Dollarization

With the exception of a few articles, the dollarization literature focuses on the supposed pros and cons, even when considering political aspects, such as the loss of monetary autonomy. For this reason, Cohen (2003) and Schuldt (2003) have called for greater discussion on the political causes and effects of dollarization, lamenting that the debate has remained far too technical and economically oriented. Schuldt contends that while economic arguments may be a rationale, geopolitical, political, social, and cultural factors have a greater impact on the adoption and

implementation of policy. In most cases, only countries that are ready, technically, will dollarize; however, the actual conversions will take place during periods of political and/or economic crisis. The driving rationale for most of these conversions will be “fear of losing place in the international economy” (p.240), although some will convert in an effort to impose otherwise unpopular structural adjustment policies. Similarly, Cohen argues for the importance of analyzing domestic politics in the choice to dollarize. He argues that scholars must pay attention to domestic distributional politics, contending that stable exchange rate regimes, such as monetary union or dollarization, will benefit externally-oriented investors and producers, while monetary autonomy maximizes domestic stability benefits for domestically-oriented investors and producers.

In their articles, Hira and Dean (2004) and Towers and Borzutzky (2004) do investigate the initial socioeconomic impacts of full dollarization. Both articles point to discontent among the Ecuadoran and Salvadoran citizenry in the wake of dollarization. Towers and Borzutzky also point to the sectors that appear to have benefited from El Salvador’s dollarization: El Salvador’s powerful financial sector and highly concentrated big businesses, which are better able to take advantage of the lower interest rates resulting from convergence with the US. Lower interest rates not only help local big business but also aid in the further transnationalization of the banking sector, as banks with access to low interest rates in El Salvador can use this advantage in their dealings in neighboring Latin American countries.

Hira and Dean conclude that, in Latin America, the benefits of dollarization will likely be limited to those sectors of the economy that are most outwardly oriented in terms of trade and investment, as they will be less subject to currency risk, and the necessary hedging to offset such risk, and will be able to import factor inputs more cheaply. Nevertheless, dollar appreciation may

negatively impact exporters who would lose competitiveness unless there was simultaneous downward pressure on domestic wages. They also suggest that, in Latin America, dollarization is being “sold” as a means of circumventing the implementation of politically controversial fiscal, tax, and regulatory structural reforms needed to maintain monetary and economic stability, a contention supported by Kelsey (2003).

III. THE IMPACT OF GLOBALIZATION

The Mundell-Fleming “trilemma” (also referred to as the “unholy trinity” or the “impossible trinity”) indicates that countries cannot maintain a fixed exchange rate, monetary autonomy, and capital mobility at the same time. At most, only two of these conditions are achievable. Frieden (1994) explains that under the conditions of mobile capital, interest rates cannot vary among countries and, thus, monetary policy must operate primarily through the exchange rate.

According to Frieden (1994: 4), as economies become more open the “the distributional impact of exchange rate movements increases,” leading to greater politicization of currency policy (Frieden 1994:3). Whereas, in a closed economy, in which monetary policy operates mainly through interest rate mechanisms, policy shifts often pitted savers versus lenders, in an open economy, in which monetary policy operates mainly via exchange rates, policy shifts impact nominal prices by changing the price of tradables and non-tradables. Unlike a closed economy, monetary policy shifts in an open economy affect well-defined and concentrated economic interests, thus, raising the prospect for political mobilization by interest groups. Similarly, greater trade openness increases the intensity by which the trade-offs of the trilemma are felt, as more actors are affected by shifts in the exchange rate: “Even non-tradables producers care more about exchange rates as the economy is opened to trade, for the import component of their inputs rises,

as does the effect on them of the expenditure-switching caused by exchange rate movements (Frieden 1994:5).”

Given the unprecedented levels of global financial integration that have taken place over the past 35 years, as discussed further below, it is not surprising that struggles over exchange rate policy have become more acute and the proposed solutions more extreme. Today, “money leads and the real economy must follow.... [M]oney, once the handmaiden of the modern economy, has become its mistress.” (Kirshner 2000: 407) And while there have been periods of heightened global trade and financial integration in the past, most notably during the decades leading up to WWI, the depth and extent of the current era of globalization, particularly the level of capital mobility is unprecedented (Bordo, Eichengreen, Irwin 1999; Bairoch and Kozul-Wright 1996; Wheeler and Pozo 1997; Held, McGrew, Goldblatt, and Perraton 1999). Thus, struggles over monetary policy should be particularly acute, as globalization has magnified the distributional costs of exchange rate policy.

Thus, Cohen (1998), predicting the growing separation between state and currency in a globalized world asks, “What happens to structures of power when currencies are no longer territorial?” (Cohen 1998: 119). To which he predicts that the biggest change will be a shift in the relationship between the state and the market, not between states. In general, governments will have less power in relation to social actors than they had in the past: “the shift in the structure of power generated by cross-border currency competition has not so much diminished as *transformed* the role of the state in money’s newly deterritorialized geography. Governance is now uneasily shared between the public and the private sectors” (Cohen 1998: 131). In particular, governments will be under even greater pressure not to provoke the exit of mobile capital to other currencies (Cohen 1998).

Already, by the onset of the 1990s, Frieden (1991) observed that:

“A trade-off between national macroeconomic policy autonomy and exchange rate stability has developed, with international investors and traders more willing to give up autonomy for stability and with the nontradables and domestically oriented sectors more interested in autonomy than in fluctuations in the exchange rate.... Conflict has intensified not only over the flexibility but also over the level of the exchange rate. While support for monetary expansion and depreciation has tended to come from producers of tradable goods, support for monetary contraction and appreciation has come from international investors and producers of nontradable goods and services" (Frieden 1991:27).

This assertion certainly predicted the basis for support and opposition of dollarization within the countries studied. In each, divisions over dollarization versus devaluation fell mainly along sectorial lines, with groups anchored in globalized finance and importers leading the charge for dollarization and groups anchored in export and import-competing industries supporting a more flexible regime with some form of devaluation.

This study seeks to open the black box of the state in order to understand how domestic interests shaped the policy preferences of sovereign countries considering dollarization. Using the cases of Ecuador, El Salvador, and Argentina, it will be shown that the struggles over dollarization in these countries reflected sectorial distributional struggles over the future direction of each country's economy that pitted tradable producers (mainly exporters) against a dominant financial sector (and in some cases with the support of the import sector). These were not simply technocratic battles over arcane policy but rather struggles over the country's very economic model: an export-led model versus a global finance-led model. As can be expected in such critical battles, each side mobilized its full economic power and political ties in their bids for supremacy.

Thus, this study supports the political economy literature that places exchange rate policy at the center of economic and political conflict—at least in the developing world—but also

illuminates how these conflicts manifest themselves within the political arena. Each case study demonstrates the ways in which political conflicts both between and within political parties reflected economic conflicts over the future of the economic model, as embodied in the struggle over dollarization. In the cases of Ecuador and El Salvador, the countries' powerful financial sector, with the support of the import sector, exploited their economic dominance and close--often corrupt--relationships with the ruling political parties to win dollarization. In Argentina, however, the export sector, although less economically powerful than the financial sector, was able to pool its economic power with its superior political ties to fight off the dollarization onslaught.

Global Financialization

Beyond illustrating the way in which distributional struggles were manifested in the political arena, these case studies also illuminate the role of global financialization in creating these conflicts. Financial globalization has led to financialization on a global level, in many cases shifting the center of economic power from exports and industry to outwardly-oriented financial sectors. As Epstein (2005) notes, there is not common agreement on the definition of "financialization." While some use the term to refer to the ascendancy of capital market financial systems over bank-based financial systems, others use it to refer to the increasing political and economic power of the rentier class. Epstein (2005:3) defines financialization as "the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies." Similarly, Milberg (2008) uses the term financialization to refer to "the greater share of GDP in industrial economies accounted for by the financial sector, the growth of gross international capital flows at faster rates than world

output and trade in goods and services, and the increased involvement of nonfinancial firms in finance instead of production as a source and use of its funds” (as quoted in Tabb 2012 p. 21).

On the other hand, Nölke and Perry (2007) divide the process of financialization into two components: profit financialization and control financialization. The first component refers to the relative growth in profitability of the financial sector and the growing proportion of profits that nonfinancial firms earn through financial transactions. As Deeg and O’Sullivan (2009:757) note, some studies have estimated that in the 2000s financial activity accounted for nearly 40% of profits of nonfinancial corporations, a 400% increase compared to the 1950s and 1960s. The second component refers to the process of shareholder value maximization—maximizing the returns to shareholders as opposed to maximizing company market share, etc.--as the primary objective of corporate management (Deeg and O’Sullivan 2009).

This study utilizes Tabb’s (2012:20) definition, which sees financialization as

“dominance of the financial sector in the totality of economic activity such that financial markets determine the state of the overall economy and financial sector demands dictate nonfinancial company behavior. . . . It represents the increased power of abstract capital as opposed to productive capital.”

To this end, the logic of financial accumulation dominates all aspects of capital accumulation, even among traditionally nonfinancial firms and industries. Thus, Tabb (2012) notes that, in the era of financialization, it is financial people who set company strategies, not those involved in production or sales. Similarly, Cerney (1993: 10) asserts that the: “transnationalization of finance has not only become an *autonomous* process—in Margaret Thatcher’s words that ‘You can’t buck the markets’—but also that in a range of highly significant ways it is actually in the *ascendency over the real economy*. In this sense, then, the development of the transnational financial structure is setting growing constraints on both state and private actors, increasingly

subordinating both government intervention and industrial decision-making to specifically financial criteria.”

One does not have to look far for evidence of the increasingly dominant role of finance within the world economy in recent history. The Bank of International Settlements (BIS) reports that between 1989 and 2004 the daily volume of foreign exchange increased from \$570 billion per day to \$1.9 trillion per day. Similarly, funds raised on international financial markets as a percentage of world exports rose from 0.5% in 1950 to over 20% in 1996 (Epstein 2005:4). Financial markets across the world have also deepened dramatically since the turn of the century. In 2000, 11 markets had financial assets totaling greater than 350% of their GDP but by the end of 2007 that number more than doubled to 25, including some developing countries (Farrell, et. al. 2008). As Table 1 shows, the role of financial markets has increased dramatically not just among the major industrialized economies but among developing economies as well.

Table 1. Indicators of International Financial Integration, Emerging Markets (percent of GDP)

	1982	1992	2002
Average external assets	15.8	24.9	55.5
Foreign Exchange Reserves	5.7	10.9	19.6
FDI + Portfolio Equity	1.3	3.0	12.1
Average external liabilities	48.4	49.4	81.7
FDI + Portfolio Equity	7.4	11.1	32.9

Source: Lane and Milesi-Ferretti (2004: 29)

There are numerous cases of nonfinancial firms that have come to rely on financial transactions to carry out daily business and for profit. Millman (1995) documents the growth of Dow

Chemical's homegrown trading floor, which it uses daily to trade futures, swaps, options, and other financial instruments in a bid to protect Dow from adverse currency, interest rate, and oil price movements. Dow has also used the trading floor to engage in profit-making speculation. Millman (1995) notes that speculation among nonfinancial firms has become much more common, however many corporations keep it quiet. For companies like Sears and General Electric, credit cards and financing soon became their central profit driver. In both cases, the firms used profits to purchase major real estate and financial companies, such as Caldwell Banker and Dean Whitter, purchased by Sears, and Kidder, Peabody, by GE (Tabb 2012).

For some theorists, financialization is a phenomenon of our time due to the centrality of shareholder-value maximization and dominance of capital markets as its key components. Malinowitz (2009:1), explicitly defines dollarization as "the increased domination of the power and logic of finance in the neoliberal period" (as quoted in Tabb 2012, p.21). However, forms of financialization, as defined by this study, are not new. Arrighi (1994) traces four periods of financialization, which he refers to as "financial expansions," throughout capitalist history, each expansion marking the "autumn" of a world hegemon: Genoa, Holland, Great Britain and, now, the USA. According to Arrighi (1994:8):

“...financial expansions are taken to be symptomatic of a situation in which the investment of money in the expansion of trade and production no longer serves the purpose of increasing the cash flow to the capitalist stratum as effectively as pure financial deals can. In such a situation, capital invested in trade and production tends to revert to its money form and accumulate more directly...”

While financialization offers the global economic hegemon a reprieve from the dwindling returns of production and trade it eventually leads to the end of the hegemonic rule, as production shifts to new, more profitable economic centers:

“Over time however, financial expansions have promoted the geographical relocation of the centers of capital accumulation by rerouting surplus capital to states and regions capable of ensuring a more secure and profitable spatial-temporal fix to the overaccumulation crisis. Previously dominant centers have thus been faced with the Sisyphean task of containing forces that keep rolling forth with ever renewed strength” (Arrighi 2004: 536).

Despite the cyclical nature of financialization, this period of financialization differs greatly from those before (Arrighi 2004). Of critical importance is convergence of financialization with globalization. Thus, this period of financialization, although US-led, has not been confined to the US or even the leading world economies but has become the dominant logic of accumulation on a global scale. Contrary to arguments that the current era of globalization has yet to reach the scale of globalization of the pre-WWI era (Zevin 1992, Sachs and Warner 1995) there is evidence that globalization in the post-Bretton Woods world is more extensive and far deeper than it was prior to WWI (Bordo, Eichengreen, Irwin 1999; Bairoch and Kozul-Wright 1996; Wheeler and Pozo 1997).

Although contested in the past (Wade 1996, Hirst & Thompson 1996; Hirst 1997), the concept of economic globalization has become widely accepted. Globalization is characterized as containing “five basic elements: 1) new technology, 2) the centrality of information made possible by instant communication, 3) an increasing trend toward the standardization of economic and social products, 4) growing cross-national integration, and 5) mutual vulnerability stemming from greater interdependence” (Savitch 2002). This new era of economic and political relations may be seen as beginning in the 1970s, with the collapse of Bretton Woods and the surge of multinational corporations (Greider 1997; Sassen 1991; Robinson 2004).

In a series of papers, Bordo and Eichengreen (1999) demonstrate that while trade as a proportion of GDP may be smaller than it was prior to WWI, trade is actually more

important to tradable goods than it was a century ago: the percentage of tradable goods exported (not sold in the domestic market) has doubled for the US and other OECD countries. The definition of tradable good has also expanded to include new economic sectors. Whereas pre-WWI trade in services was limited to tourism and shipping, today trade in services includes royalties and fees, military transfers, education, finance, insurance, telecommunications, as well business, professional, and technical services. However, while the depth of foreign lending may have been greater as a proportion of GDP in the pre-WWI era, the scope was certainly much smaller.

Foreign investment was high as a proportion of GDP during the pre-WWI but was directed to a much narrower set of endeavors, often used to develop infrastructure; governments financing the construction of railroads and other public works did most of the borrowing (Bordo, Eichengreen, Irwin 1999; Turner BIS 1991; IMF 1997). Today, there is a much greater emphasis on foreign lending and investment by and to private financial institutions and companies producing commercial goods and services (Bordo, Eichengreen, Irwin 1999). In 2007, cross-border capital flows reached \$11.2 trillion, or 20.5% of global GDP, while ownership of financial assets by foreigners reached \$96.2 trillion. By 2008, 25% of equities, 25% of private debt securities, and 30% of government bonds worldwide were held by foreign owners. Since 1990, cross-border investments have grown at a faster rate than world trade, GDP, or total financial assets (Farrell, et. al. 2008). As Tabb (2012) notes, FDI and portfolio holdings have become much more important on a global scale. Speculative transactions, currency movements, and the sale of derivatives of all kinds on international market have led to declining levels of investment going towards productive investment. Deregulation of the financial markets

within the context of technological innovation has allowed for the dramatic growth of a shadow financial system of special investment vehicles, highly leveraged hedge funds, and private equity.

Perhaps most critical for the purposes of this study is the globalization of finance during the Post-Bretton Woods era; financialization is not limited to simply the most developed economies but has entered into the developing world as well. According to Tabb (2012: 34):

“Financialization occurred in a context of globalization and there has been growth in the importance of finance within countries. Between 1990 and 2006 the number of countries whose financial assets exceeded the value of their GDP more than doubled (from thirty-three to seventy-two). By 2006 all the industrial economies and the largest emerging market countries had financial markets at least twice the size of their GDP.”

Prior to 1914, the form of investment and number of countries on both the sending and receiving end were limited. Cross-border investment consisted primarily of bank lending and portfolio investment, with limited levels of foreign direct investment, which was channeled almost exclusively through off-site free-standing companies linked to the lending economy. These investments usually occurred within the confines of the capital exporting economy's empire (Eichengreen, Bordo--1999). By contrast, Global FDI reached record levels in 2007 at \$1.83 trillion. Even after an estimated 21% decline in the wake of the current financial crisis, it was \$1.45 trillion in 2008, distributed chiefly among 18 developed economies (\$1.25 trillion) and 19 developing economies (\$499.9 billion) (UNCTAD 2009). Contrary to past capital flows, which were generally unidirectional, a growing portion of FDI is emanating from developing economies: in 2006, outward FDI from developing economies accounted for 13% of outward global

FDI (UNCTAD 2009). Similarly, the geography of financial hubs is also expanding. While London, New York, Tokyo, and Switzerland still account for the lion's share of financial activity, financial centers in Singapore, Mumbai, São Paulo, Shanghai, and Madrid are gaining in size (McKinsey 2008).

The Collapse of Bretton Woods and the Rise of Eurodollar Markets

The growth of Eurodollar markets⁵ is a critical component to the growth and integration of global financial sectors in developed and developing economies. The creation of Eurodollars and the quantity with which they have been pumped into the global economy is the result of global financialization, without which, this story would not be possible. In 1944 Western Europe and the United States negotiated the Bretton Woods system, a financial structure that would allow the top industrialized economies to coordinate an adjustable peg, centered on the US Dollar, which would remain fixed to gold at \$35/oz; the system also allowed for temporary current-account and capital controls.

A critical flaw to the Gold Standard that contributed to its demise was the constraint it placed on the possibilities for economic expansion. With the creation of money linked to the availability of gold, finite quantities of the precious metal meant limited money supply and, thus, limited sources of capital. Because most currencies were pegged to the US dollar during the Bretton Woods era, international economic growth became dependent not on gold but a growing supply of dollars sent abroad; as the primary reserve currency, the world economy could not grow unless the US ran a current

⁵ The term Eurodollar refers to US dollars deposited in financial institutions outside of the United States. Originally, the term referred to dollars deposited in Europe but has since come to be applied to any location. For example, US dollars deposited in banks in Latin America are still referred to as Eurodollars. While the US dollar is the most popular privately held currency worldwide, other currencies have also been "euro-ized": for example, the euroyen.

account deficit. However, ballooning debt put pressure on the US' ability to maintain its par value with gold (Cohen; Millman 1995). In an effort to reduce the tremendous outflow of US dollars without stifling domestic growth by imposing higher interest rates, the US government put in place an interest equalization tax meant to increase interest rates for foreign borrowers. While the tax was successful in stemming the hemorrhage of dollars caused by foreign borrowers, it also contributed to financial globalization through the explosion of the Eurodollar market, fed by petrodollars deposited into European banks.⁶ In the end, a combination of pressure on the US dollar to maintain par value with gold while providing sufficient supply to support international economic growth and diminished monetary control in the face of globalizing capital, led to Bretton Wood's collapse. On August 15, 1971, President Nixon suspended the US dollar's convertibility into gold. By February 1973, international currencies were allowed to float (Cohen).

What is often referred to the "petrodollar" boom was really the first Eurodollar boom; it was the result of a syndrome of policies and events that would come to define financial globalization: 1) the end of Bretton Woods, which freed the US dollar from the constraints of the gold standard, allowing the US to pump more US dollars into its domestic and global economy, particularly in its efforts to fight the Vietnam War, 2) incipient reductions on capital controls within the developed world, and 3) the "privatization" of the US dollar market, and soon all currencies, through the institutionalization of the Eurodollar markets. The Eurodollar markets became "...a vast pool of short-term capital, outside the control of any monetary authority, which was ready and able to move with lightning speed in and out of different currencies." (Dickens

⁶ In discussing the origins of globalization, we should not forget the active role governments have played in promoting financial globalization, as argued by Helleiner (1995). In the case of Euromarkets, Helleiner points out that the US actively supported their development and encouraged US corporations to finance their overseas operations through London as a means of satisfy both national economic and US corporate interests, which were expanding onto the international scene.

2005: 216). Since these markets were outside national control, banks could and did provide loans at the interest-rates lower than those offered in the US. With the onset of the Euromarkets, the world moved away from a state-based international monetary system to a market-based international monetary system (Dickens 2005).

The freeing of capital on such a large scale also meant new opportunities for financial sector growth and integration on a global scale. No longer dependent on the state for access to foreign credit, financial transactions and advances in financial technology exploded. Financial institutions, particularly in developing economies, were no longer dependent on the state for access to foreign credit. In fact, the opposite was now true, with private banks gaining clout and earning large fees for their role in channeling foreign credit to governments.

In addition to giving private financial institutions and, thus, private citizens greater access to foreign currencies—a requirement for unilateral dollarization—emergence of Euromarkets also meant greater financial fragility for many developing economies. As Euromarkets grew, so too did the number of offshore and shadow financial institutions, creating ever-easier ways for firms and high net-worth citizens to flee their national currency. With such an ease of exit, states and local financial systems became evermore vulnerable to financial market pressures.

Role of the US, Other Industrialized Countries, IFIs, and Local States in Promoting Financialization

Of critical importance to the globalization of finance in this era, was the role of structural adjustment policies required by the IMF and World Bank before they would lend to developing countries. These conditioned loans placed financial sector reform and financial liberalization as a central component of economic reform. This approach reflected an emerging global consensus

that placed increased financial depth and global financial integration, achieved through the antithetical strategies of financial stability and financial liberalization, at the center of an economic model that was supposed to foster economic rationalization but, instead, fostered speculation, economic tertiarization and dominance of the financial sector.

While ideas related to the critical role of the financial sector in economic development can be traced back to Joseph Schumpeter (1912), it was not until the 1970s when these ideas gained widespread traction in the Development community. As financial sectors in the industrialized economies ascended, studies by economists focusing on the positive role of liberalized finance in economic growth, such as Shaw (1973) and, particularly McKinnon (1973), were influential in reshaping views on the relationship between the financial sector and economic growth and the role of government in the financial sector (Jaramillo, et al. 1993, Corbo and Fischer 1995, Khan and Senhadji 2000, World Bank 1985, 1989). Under the Import Substitution Industrialization (ISI) model that dominated the developing world during the 1950s through the 1970s, the financial sector was seen as a developmental arm of the State. Governments throughout the developing world, including Ecuador and Argentina, used State development banks, imposition of below-market interest rates, as well as subsidized and directed credit to support investment in targeted sectors. Nevertheless, as the ISI model reached its limits, many economists and policymakers concluded that these policies, which suppressed interest rates, led to a stunted private financial sector and low levels of savings (financial depth). A critical support for this conclusion was McKinnon's (1973) study of Argentina, Brazil, Chile, Germany, Indonesia, Korea and Taiwan in the Post WWII era, which found that a better functioning financial system supported faster growth, the main policy implication being that government restrictions on the

banking sector (i.e. interest rate ceilings, directed credit, etc.) hinder financial development and, hence, reduce economic growth (Khan and Senhadji 2000).

Financial sector development came to be seen as the key to investment and, therefore, economic growth, with a wave of economic literature supporting the prominent role of an “efficient” (read liberalized) financial sector as essential to development (Corbo and Fischer 1995). By 1989, the World Bank declared in its World Development Report that, "The biggest difference between rich and poor is the efficiency with which they have used their resources. The financial system's contribution to growth lies precisely in its ability to increase efficiency (2)." In essence, a well-functioning financial sector would provide positive real interest rates for deposits that would attract savings. Higher levels of savings would result in lower interest rates on credit, leading to increased investment and greater financial depth. Higher levels of financial depth would lead to the improved productivity of investment and, hence, higher rates of growth (World Bank 1989). Thus, private finance was given a vanguard role in economic development. The growth of the private financial sector and insertion into the global economy was seen as an essential component of structural adjustment.

To this end, throughout the 1980s and 1990s, the US and the IFIs advocated for financial sector reform as part of Structural Adjustment and Sectoral Lending programs that sought to increase the size, profitability and competitiveness of the banking sectors in developing countries by controlling inflation; liberalizing deposit and credit controls; and liberalizing interest rates, controls on foreign investment, investment abroad, and foreign borrowing (Corbo and Fischer 1995); increasing the number of universal banks (banks that provide commercial and investment services); removing direct taxes on banks and the requirement of banks to hold noninterest-bearing reserves at central banks; ending directed lending programs; improving design and

enforcement of loan contracts to make it easier for banks to foreclose; access to a wider range of financial instruments; and improved supervision of the banking sector. The World Bank (1989) also championed greater use of swaps in managing risk, market-based instruments to control money supply and the development of money and capital markets as a means of boosting savings and investment in developing countries. Between 1980 and 1991, the World Bank alone made 258 structural adjustment loans to 75 countries (Corbo and Fischer 1995). Thus, throughout the 1980s and 1990s, a “wave of deregulation,” disinflation and interest rate liberalization passed over Latin America, encouraging private capital inflows (Vasudevan 2009). By 1997, the IMF set out to amend its constitution “to make the promotion of capital account liberalization a specific purpose of the IMF and give it jurisdiction over capital movements.” (as quoted in Kirshner 2000, p. 433; see “IMF Wins Mandate to Cover Capital Accounts” IMF Survey May 12, 1997, 131-2)

The US-led Brady Plan also played a critical role in Latin America’s financial liberalization wave. The Brady Plan, which began in 1989 with Mexico and quickly spread to other debt-ridden countries in the region, provided debt reductions and access to credit in exchange for financial liberalization measures (Vasquez 1996). Aside from promoting financial liberalization, however, it also created an infrastructure to package and trade Third World sovereign debt:

“It promoted debt-equity swaps that allowed the transformation of debt into tradable bonds—Brady bonds—that facilitated the diversification of sovereign risk away from commercial banks and more widely across international capital markets. A Brady bond is essentially a structured derivative product” (Vasudevan 2009: 297).

As a result, banks shifted away from syndicated loans to the much more liquid Brady Bonds. As banks began to extend Brady Bonds to other developing countries, there was a surge in lending,

particularly through derivative contracts, which allowed US institutional investors (i.e. Mutual and Pension Funds) to circumvent taxation, regulation, and requirements to invest only in “investment grade” products. Thus, the 1990s became a period of rapid financial integration for Latin America and the rest of the developing world, consolidating the role of global finance on a local and international level.

Governments in each of the countries studied embraced the ideology of finance that preached the importance of the financial sector and global financial integration. By implementing policies aimed at supporting and liberalizing the financial sector, these governments initiated structural economic changes resulting in the emergence of a dominant globally-oriented financial sector within each country’s economy with an inherent interest in dollarization as a mechanism to 1) prevent the possibility of devaluation that would negatively impact foreign-currency holdings, 2) help maintain lower interest rates on foreign borrowing, and 3) assist in the development of local consumer credit markets (i.e. auto loans, credit cards, etc.) that required long-term price and interest-rate stability. However, as the case studies will demonstrate, despite the role of financial globalization in the struggles for dollarization, the decision to ultimately dollarize or not was dependent on additional domestic political factors. Thus, while financial globalization and local economic financial integration is a necessary component of the decision to dollarize, it is not sufficient. Rather, as this study shows, the struggle over dollarization is intimately connected with not only the economic but also the political power of the financial sector versus the tradables sector.

IV. Structure of Dissertation

This study is divided into three case studies. The first two analyze the political economy of full dollarization in Ecuador and El Salvador, where dollarization was implemented in 2000 and 2001, respectively. In Ecuador, dollarization was adopted amid the worst financial crisis in the country's history while, in El Salvador, dollarization was adopted within the context of financial stability and a long history of low inflation. In both instances, dollarization came rapidly and surprised scholars and policymakers around the world, who saw Ecuador's dollarization as a desperate ploy by its country's president to remain in power and El Salvador's as unnecessary, given its history of stability. The third case, that of Argentina, presents a country that many had thought of as a prime candidate for dollarization after a decade of Convertibility (the popular name for Argentina's currency board), where dollarization opponents not only prevailed but also replaced Convertibility with a floating exchange rate.

Each of these three case studies will demonstrate the ways in which global financialization set into motion structural economic transformations that displaced each country's traditional dominant economic sector with a globally-oriented financial sector. They will also show how these structural changes led to an eventual political battle over the national economic model as embodied in the country's monetary and exchange-rate regimes. In Ecuador and El Salvador, policies implemented during the 1980s and 1990s that put financial depth, through the antagonistic strategies of financial stability and financial liberalization led to dramatic increases in the power and global integration of the financial sector. In both Ecuador and El Salvador, a powerful nationally-based financial sector was able to assert not just economic but political power through the formation of powerful economic groups that blended familial connections, links with other critical economic sectors (i.e. media, oil, export, import, etc.), alliances with other nationally-based groups, and was even able to exploit regional-based

rivalries. These characteristics made the sector extremely difficult to oppose politically. By the time of the crisis, many of Ecuador's most powerful economic groups held banks and other financial institutions as their cornerstone. In economies increasingly dominated by consumption, particularly of imported goods, finance, importers and retailers became natural allies, pushing aside the previously hegemonic agro-export sector.

However, these transformations were not smooth but fraught with tension, as the financial sectors fought for monetary and exchange-rate policies that reflected their economic interests. In both cases, close, and often corrupt, ties between the financial and political sectors resulted ultimately in dollarization. In Ecuador, dollarization came as the culmination of several years of conflict over the monetary regime between the declining export sector and the rising financial sector; the former advocating for continued devaluations and the latter advocating stable money policies. Although Ecuador's highly liberalized and permissive financial environment led to the worst financial crisis in the country's history, it was able to take advantage of the crisis and its close ties to the government to impose dollarization. In the case of El Salvador, the financial sector was originally skeptical of dollarization, in large part because of the vast profits it earned from exchanging the local currency for dollars. However, once the country's most powerful financial groups expanded their sights beyond their own borders dollarization became a very tempting way to improve the sector's international competitiveness. Dollarization also had the added benefit of heading off the export sector's growing campaign to effectively devalue the local currency, which would have cost the import sector and the highly dollar-indebted financial sector greatly. Due to the financial sector's almost complete capture of the country's ruling ARENA party, once the leadership of the Salvadoran financial sector bought into dollarization, adoption and implementation were swift.

The case of Argentina demonstrates the critical importance of local political structures in determining the outcome of struggles over dollarization and reminds the reader that, while global financialization is a critical condition in the dollarization equation, it is not sufficient. Thus, the reader will note important similarities between Argentina, Ecuador, and El Salvador, such as the implementation of policies aimed at growing the financial sector and liberalizing the economy—especially financial liberalization—that resulted in the growth of a powerful and globally integrated financial sector. Like Ecuador and El Salvador, the economy became heavily financialized, with finance accounting for much of the country’s economic growth during the period. Even Argentina’s large non-financial firms depended on financial transactions to drive profits. Despite the high levels of financialization that pervaded the economy, unlike Ecuador and El Salvador, local economic groups remained largely outside of the financial sector. Thus, the financial sector was not only contained in terms of its direct ownership of other key economic activities but was also dominated by foreign conglomerates with little historic connection to Argentina or its political leadership. Meanwhile, local economic groups, which did have historic close ties to the political system, retrenched themselves in the agro-export sector. As the contradictions of convertibility culminated, so did the tensions among the financial and agro-export sectors over the future of the exchange rate regime, with the financial sector advocating dollarization and the export sector pushing for a floating exchange rate. Despite the financial sector’s economic power, anti-dollarization forces, led by the tradables sectors, were able to exploit their ties with major political parties and feelings of nationalism to defeat the dollarization and impose a flexible exchange rate regime.

The conclusion and discussion section will summarize results as well as what inferences we may make about which countries are likely to face dollarization campaigns and, of those,

which are likely to be successful. Similarly, what conclusions may we draw concerning the future of dollarization and other hard fixes, such as monetary unions, particularly given the current turmoil faced by members of the European Monetary Union? Finally, the conclusion will also suggest areas for future study.

Table 2. Features of Selected Exchange Rate Regimes

Exchange Rate Regime	Main Characteristics
Independent Float	The exchange rate is determined in the market freely by demand and supply. The monetary authority does not intervene in the foreign exchange market. Monetary policy is independent of the exchange rate regime and can be used freely to steer the domestic economy.
Managed Float	The monetary authority intervenes actively in the foreign exchange market without specifying or precommitting to a preannounced path for the exchange rate. Intervention may be direct (sterilized and non-sterilized) or indirect through changes in interest rates, etc. It may operate like an unannounced crawling broad band. Monetary policy is relatively free to be used to steer the domestic economy.
Crawling Peg	The exchange rate is adjusted periodically according to a set of indicators. The rate of crawl can be set at a preannounced fixed rate at or below the projected inflation differentials (forward looking). Maintaining a credible crawling peg imposes constraints on monetary policy.
Fixed Peg	The exchange rate is pegged at a fixed rate to a major currency or a basket of currencies (or to Special Drawing Rights). The monetary authority is not committed to the peg indefinitely. The peg is adjusted (devaluation) when misalignment becomes unsustainable. The monetary authority stands ready to defend the peg through direct intervention and monetary policy. Traditional central banking functions are possible but the degree of monetary policy discretion is limited.
Currency Board	Strict exchange rate regime supported by a monetary system based on legislative commitment to exchange domestic currency for a specified foreign currency at a fixed rate. Domestic currency is issued only against foreign exchange. There is almost no scope for independent monetary policy.

Dollarization	Another country's currency is used as the only legal tender. Monetary autonomy is fully surrendered. There is no scope for independent monetary policy.
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Source: Yagci (2001)

Ch. 2: ECUADOR'S DOLLARIZATION

I. INTRODUCTION

On January 9, 2000, Ecuador's President Jamil Mahuad surprised the world by announcing that the country would voluntarily renounce its currency, the sucre, and officially dollarize in an effort to end a nearly two-year long financial and currency crisis. Mahaud's announcement was a dramatic event not only because it was a drastic measure but because it was the first time that a sovereign country had completely renounced its currency to unilaterally take on that of another. Almost immediately, political scientists and economists of all stripes characterized the move as a "desperate" attempt to maintain political power (Jameson 2003, Beckerman and Solimano 2002) or claimed that Mahuad had no other choice given the country's dire situation (Cohen 2000, Nazmi, Beckerman and Solimano 2002). Papers, chapters, and entire books were dedicated to analyzing the mechanics of how the financial crisis unfolded: its triggers, governmental policies to ameliorate the situation, and of course, the currency crisis that resulted in record inflation, all pointing to the inevitability of dollarization as a policy response.

However, as this chapter will show, nothing about Ecuador's dollarization was inevitable; it was one of several policy alternatives (Acosta 2006, Jameson 2003, Acosta and Schuldt 1999). Rather, the choice to implement dollarization reflected a convergence of structural and political factors which favored a hard-currency response. To this end, incipient financial globalization promoted by the IFIs and the United States through numerous financial reforms aimed at strengthening, liberalizing, and integrating the Ecuadoran financial sector led to both increased economic and political influence of the financial sector. Ecuador's banks, which had previously served the government and agricultural sectors, expanded into new markets with new alliances. Of critical importance was the expansion of Ecuador's banks into consumer credit, which

required long-term currency stability. This expansion helped ally the financial sector with the commercial and import sectors as well as middle-class consumers by lowering the prices and providing access to financing options on a range of products. Similarly, the interest rate speculation bubble that emerged during the 1990s, due to the extreme competition created in the banking sector, resulted in a large portion of the middle class living off of interest rate payments. As Frieden (1994) predicts, when faced with the choice of monetary regime, they sided with the regime that most benefited their source of income: a hard money solution, epitomized by dollarization.

Politically, the members of the financial sector leveraged their growing economic power and historic ties to political parties and personal connections to politicians. To this end, Ecuador's financial sector provided critical support to one of their own--Jamil Mahuad--through extensive contributions. Key financial groups, such as Grupo Isafías, also bought up media outlets through which they could transmit support for their favored policies and politicians. Further, members of the financial sector also leveraged their historic ties to Ecuador's political parties. As not only contributors but also constituents, members of the financial sector participated in political mobilizations, choosing political candidates, were appointed as government officials, and became party leaders.

Section II of this chapter demonstrates the role of financial globalization in setting the stage for an emergent Ecuadoran financial sector rooted in global currency flows that would eventually contest the traditional export sector's power. This process of financial globalization in Ecuador began as far back as the 1970s, with the incipient globalization of the financial sector during the Petrodollar boom. The development of Eurodollar markets facilitated the redistribution of Petrodollars throughout the world, and advances in financial technologies (i.e.

syndicated loans) helped channel them to Latin America. Later, Ecuador--like so many other Latin American countries facing insurmountable debts resulting from these loans--embraced IMF, World Bank, and other IFI structural adjustment policies that placed financial sector reform and global financial integration as the lynchpin of development. Bolstered by an emerging global consensus that financial development would lead to overall economic development, Ecuadoran leaders implemented policies to grow Ecuador's financial sector, resulting in its eventual displacement of the agro-export sector as the dominant economic sector during the 1990s. Policies put in place to encourage the free flow of capital across borders resulted in the Ecuadoran public amassing US dollars during the 1990s. Ecuador's middle class and economic elites contracted loans for business, homes, cars, and household appliances in US dollars. To a heightened degree, Ecuadoran citizens and businesses, even those that produced and sold locally, were tied to the global financial markets.

Not only did Ecuador's financial sector become one of the largest and most profitable private industries in the country, banks and other financial institutions became the lynchpin for powerful economic groups that used finance as a platform to expand into and form alliances with other profitable sectors, including media outlets and the importation and distribution of consumer goods. Thus, the financial sector was able to exploit its economic power and personal political connections to obtain its preferred policies.

However, as Sections III and IV show, global financialization, while necessary, is not sufficient to explain Ecuador's decision to dollarize or the crisis that provided dollarization-supporters with the platform to push for its implementation. Rather, national politics played a crucial role in Ecuador's dollarization. The financial sector not only exerted economic power through the formation of powerful economic groups that blended familial connections, links with

other critical economic sectors (i.e. media, export, import, etc.), and alliances with other nationally-based groups, its members exerted political power. As a nationally-based sector, the financial sector had organic ties to Ecuador's largest political parties. Bankers maintained friendships and working relationships with party leaders and, in many cases, were political leaders themselves. Bankers also utilized corruption to obtain their desired policy outcomes. Section III shines a light on the role of politics and coalitional alignments through the exploration of a failed attempt to implement an Argentine-styled currency board under President á Bucaram in the early 1990s.

Section IV analyzes President Mahuad's response to the unfolding financial crisis that devastated Ecuador prior to dollarization. The Mahuad administration, which had been captured by the financial sector, opted to save finance at the expense of the nation through repeated bailouts, cuts to social spending, bank holidays, and deposit freezes. These pro-finance policy choices exacerbated the crisis, leading to hyperinflation. Although the banking sector was the root cause of Ecuador's financial crisis and suffered during this period (although, as demonstrated, the bankers fared well!), the financial sector was able to utilize the crisis to mobilize public opinion towards its preferred economic policies. Of particular importance was the work of non-affiliated movement of academics, economists, and business leaders calling itself the *Foro Económico* deftly used the crisis to advocate for full dollarization, arguing that for far too long, Ecuador's political sphere had been held hostage by special interest groups and could not be trusted to implement policies to benefit the country's economy overall; the only solution was to permanently remove monetary policy from political interference through dollarization. Despite its outward rejection of Ecuador's irresponsible financial sector, many members of the *Foro*

Económico subscribed to a doctrine of financial and economic liberalization in line with the interests of Ecuador's financial sector.

II. GLOBALIZATION AND THE RISE OF THE ECUADORAN FINANCIAL SECTOR

Historically, two opposing economic and political interests have divided Ecuador's economy regionally and economically. In the Sierra, large landholders raised crops and manufactured textiles and goods for domestic consumption. On the Coast, large and small landholders grew cocoa, coffee and, most importantly, bananas for export. For a large part of Ecuador's modern history, these outward oriented and inward oriented models have vied for domination, with export as the dominant sector for much of the last century. Nevertheless, with the onset of financial globalization in the 1970s, Ecuador saw a new sector come into its own: the financial sector. While different financial institutions clustered along the same regional fault-lines as the rest of Ecuadoran society, with certain banks dominating the Coast and others the Sierra, the growth of this sector inserted another complex of interests into the mix. As will be shown, it became dominant within Ecuador through the tutelage of the increasingly dominant global financial sector. First, Ecuador's incipient financial sector fed at the teat of the "petrodollar boom" that resulted from the unleashing of the Eurodollar markets and then it matured as a power group through the implementation of IFI structural adjustment policies and neoliberal ideology that carved out a vanguard role for finance in local development. Finally, it consolidated its power in the 1990s, shaping the events that would lead to dollarization.

Eurodollars Feed the Ecuadoran Banking Sector

The growth of the Ecuadoran financial sector is rooted in the globalization of finance that began, in earnest, during the 1970s. Key to Ecuador's financial development were two factors: 1) revenue generated by the high price oil exported by Ecuador's nationalized oil sector in the first half of the decade and of greater importance, 2) during the second half of the decade, the emergence of the Euromarkets and incipient financial deregulation spurred by the collapse of Bretton Woods. What is often referred to the "petrodollar" boom was really the first Eurodollar boom; it was the result of a syndrome of policies and events that would come to define financial globalization: 1) the end of Bretton Woods, which freed the US dollar from the constraints of the gold standard, allowing the US to pump more US dollars into its domestic and global economy, particularly in its efforts to fight the Vietnam War⁷, 2) incipient reductions on capital controls within the developed world, and 3) the "privatization" of the US dollar market, and soon all currencies, through the institutionalization of the Eurodollar markets. Growth of the Eurodollar markets was reinforced by the emergence of new instruments for international finance, particularly the creation and growth of syndicated loans during the 1970s,⁸ which could channel the unprecedented quantities of "petrodollars" that needed to be invested.

Thus, the Ecuadoran government was able to obtain unprecedented sums of low-interest loans from private banks without having to turn to turn to other States or International Financial Institutions (IFIs) with their onerous political and economic conditions. With incredibly low

⁷ For an excellent discussion in the role of states in developing the Eurodollar markets, see Helleiner (1995).

⁸ Syndicated loans are credits that are provided by a group of financial institutions to a borrower. Every member of the syndicate has a claim on the debtor, although there is only one loan contract, which is usually arranged by a larger international institution that has an ongoing relationship with the borrower. The grouping of loans allows creditors to reduce their institution's individual risk; it is also an easy way for smaller financial institutions without an international presence to obtain exposure to higher yielding international debt (Gadanecz 2004). The agglomeration of financial institutions also permitted the transfer of large sums of capital, as institutions felt protected from overexposure to risk.

interest rates and a frenzy-like atmosphere, the private sector also partook in the international lending binge. Between 1971 and 1983, the country's debt grew 30 fold (Naranjo Chiriboga 2007).

Nursing the Financial Sector Back to Health

Ecuador's borrowing boom eventually ended in bust during the first half of the 1980s as international interest rates soared and lenders became skittish in the wake of Mexico's announcement that it could not service its debt in 1982. Cutoff from additional loans and unable to pay the increasing cost of the loans it already had, Ecuador soon followed suit as did a number of its neighbors in similar situations. As such, the 1980s is often referred to as the "Lost Decade" for Latin America. Massive defaults and economic crises led a number of Latin American economies to be cut off from international capital markets and face the imposition of drastic austerity plans and structural adjustments promoted by IFIs like the IMF and World Bank.

In Ecuador, the once growing banking sector now faced massive defaults on its dollar debts, as did the rest of the private sector that contracted much of that debt. However, as we shall see, while the 1980s definitely represented a setback for the Ecuadoran financial sector, it by no means was a "lost decade." To the contrary, the 1980s laid the foundation for the Ecuadoran banking sector's preeminence during the 1990s. Through a combination of local political pressure and the implementation of policies encouraged by the IFIs and the prominence of the financial sector globally, reflected in economic doctrine that saw financial liberalization as the foundation for economic development, the Ecuadoran financial sector became a cornerstone of the country's economy and politics.

Of critical importance was the role of structural adjustment policies favored by the IMF and World Bank that placed financial sector reform and financial liberalization as a central component of economic reform. This approach reflected an emerging global consensus that placed increased financial depth (increased pools of domestic savings from which to lend) and global financial integration, achieved through the contradictory strategies of financial stability and financial liberalization, at the center of an economic model that was supposed foster economic rationalization but, instead, fostered speculation, economic tertiarization, and dominance of the financial sector.

Bailing out the Banks

The first steps taken towards reform were a string of costly bailouts to save the banking sector. Encouraged by the IMF and World Bank in 1983, the Ecuadoran government, under President Osvaldo Hurtado, assumed the private sector's dollar denominated debt (Acosta 2006, Miño Grijalva 2008). Under what has come to be known as "sucretization," the State took responsibility to pay back foreign debts in dollars (approximately \$1.5 billion), while the private sector paid back its debts to the State in sucres at favorable rates. Essentially, the State took on the private sector's currency risk: between 1982 and 1983 the exchange rate nearly tripled from 29.4 sucres per US dollar to 83.57 sucres per dollar (Miño Grijalva 2008: 245).

The Central Bank's Monetary Board also used "Stabilization Credits," issued by the Central Bank to private banks and financial institutions as a means of refinancing private foreign debt. The Stabilization Credits provided yet another mechanism by which the private financial sector converted its dollar debt into sucres at a conversion rate of 65 to 85 sucres per dollar, passing the exchange-rate risk onto the Central Bank (Naranjo 1999: 43). Between 1986 and 1989, spanning both the Febres Cordero presidency (1984-1988) and that of his successor, Rodrigo Borja (1988-

1992), 140 debt conversion operations were carried out through "la compra de cuentas especiales en divisas" (special foreign exchange account purchases), by which the Central Bank sold bonds on the secondary market that could be bought at discounted prices but cashed in at the Central Bank at par value, reducing private banking sector debt by \$435 million (Acosta 2006: 174).

Structural Adjustment

Throughout the 1980s and 1990s, Ecuador undertook a series of economic adjustment programs either as preconditions for funding from IFIs or as projects supported by IFI funding. As discussed above, financial sector reform was a key component of reform, which became increasingly prominent in the early 1990s. While private banks maintained a high dependence on the government during much of the 1980s (Naranjo 1999), reforms implemented by successive governments in concert with the IFIs laid the foundation for the Ecuadoran financial system's rise to power during 1990s, in line with shifts in power toward the financial sector that were taking place in the developed economies during the 1980s and 1990s. The early stages of such reform focused on increasing interest rates, which had been maintained at real negative rates by the government to support investment, to attract savings and reducing the role of the government in the financial sector and introducing long-term savings instruments, such as Certificates of Deposit (Miño Grijalva 2008: 246).

In 1988, the Superintendency of Banks reformed the General Banking Law (*Ley General de Bancos*) to stimulate the fusion of financial companies with banks, encouraging the formation of universal banks and helping to set the stage for the emergence of a financial sector, not simply a banking sector. The explicit objective of the reform was to increase bank size to take advantage of economies of scale, with profits that would permit reductions in financial spreads (Naranjo 1999:45).

Despite being on the verge of continued crisis due to high debt burdens, a precipitous drop in the price of oil, and several natural disasters, including an earthquake in 1987 that damaged and shut down the country's oil pipeline for 6 months, the banking sector continued to grow under the tutelage of the State. The Central Bank of Ecuador (BCE, by its acronym in Spanish) carried out several bank bailouts and continued to provide subsidized credit to the banking sector through the Central Bank and programs sponsored by the IFIs. Small Scale Enterprise (SSE) loans by the World Bank between 1980 and the first half of the 1990s were channeled through the private banking sector with “very generous margins” built into the projects for both the banks and the second tier institution” (WB SSE Impact Evaluation 1998:7), ensuring substantial profits for the sector.

Overall, liberalized capital and trade policies, as well as the massive bank bailouts put into effect during this period, contributed the growth of the banking sector during the 1980s. By 1990, the sector had grown in offices, personnel, fixed-assets and in the provision of complementary services. In fact, according to the World Bank’s SAPRI report (Naranjo 1999), by the beginning of the 1990s the banking sector was oversized.

Consolidation of the Financial Sector

The 1990s saw consolidation of the growing financial sector. The decade began with the implementation of a structural adjustment package that had been negotiated with the IMF in 1989 to put into place some of the most profound liberalization reforms Ecuador had seen up to that time. The package included fiscal reforms aimed at reducing the deficit, privatization of several state-run enterprises, tariff reductions and other measures to liberalize foreign trade. It also included the liberalization of domestic and external financial flows, monetary reform focused on reducing inflation, and exempted dividend profits from the income tax (Naranjo 1999), incentivizing financial investment.

In 1992, Ecuador implemented the first of several comprehensive financial sector reforms, with the passing of the Ley de Régimen Monetario y Banco del Estado (Monetary Regime and State Bank Law), which redefined the role of the Central Bank and how it relates to the State apparatus. Thus, the BCE was converted from a development bank to a bank for banks that would act as a lender of last resort. Similarly, in an effort to stave off inflation, the law prohibited the BCE from monetizing State debt and increased the institution's independence from the Government. The Corporación Financiera Nacional (National Financial Corporation) was transformed from a first tier to a second tier bank, channeling development credit through the private banking sector. These reforms increased the role of the private financial sector in the economy by reducing investment in state-run development banks and channeling more state credit through the private financial sector. They also brought the Ecuadoran financial sector into greater alignment with international norms. Ecuador, like many other developing countries subscribing to liberal doctrine at the time, hoped that such changes comfort investors, leading to greater foreign investment.

Under President Sixto Duran Ballén (1992-1996), the financial sector consolidated its increasingly dominant role in the economy and politics. Within the first year of his presidency, Duran Ballén, with the support of the IMF, implemented aggressive financial reform, beginning with the complete liberalization of the capital account just one month after taking the Presidency in 1992. He also initiated a stabilization plan to stop inflationary tendencies, which, in addition to eroding buying power also erodes financial savings and investment. After a “disproportionate” devaluation, Duran Ballén's team nominally anchored the currency. The plan was premised on the idea that, given fiscal discipline, the anchored currency would also anchor inflation rates (Falconi and Oleas 2004:36). The Government also began a process of divestment from State-owned banks; passed legislation permitting the use of private national banks to manage public sector accounts, which gave the private banking sector access to millions in public funds (Ley de Presupuestos del Sector Público Ley 18, El Comercio 7/29/1999); relaxed quantitative restrictions on levels of foreign debt and investment and liberalized restrictions on foreign

ownership. At the same time, the Central Bank eliminated the margin ceiling between deposits and loans and intensified its usage of open market operations (Naranjo 1999).

However, the most profound reforms to take place in the finance sector came with the Capital Markets Law (LMV by its acronym in Spanish), passed in 1993, and the Law of General Financial Institution Systems (LGISF by its acronym in Spanish), passed in 1994. These laws transformed Ecuador's financial sector by reorganizing the sector, introducing new instruments for financial intermediation and capital accumulation, reducing the role of the state in oversight, encouraging the formation of financial sector groups, and, perhaps most importantly from the perspective of dollarization, opened up Ecuador to global capital flows. Both pieces of legislation explicitly sought to integrate Ecuador's financial sector and economy into the global economy and to make Ecuador's national financial sector more competitive. In this case, more competitive meant larger, more profitable, mobile and powerful; in these respects, they were successful.

Capital Markets Law

Passed in May 1993, the Capital Markets Law (LMV) completely overhauled Ecuador's two stock markets, one in Guayaquil and one in Quito. It modernized the exchanges with the creation of a clearinghouse and a legal framework for the creation of corporations to qualify risk. The law also established the creation of brokerages for market intermediation (Endara 1999) and, controversially, permitted banks and other financial institutions ownership in up to 25% these new entities.

The LMV also broadened the scope of financial intermediation by introducing new legal concepts for the management of domestic and global capital, including the creation of holding

companies; investment funds constituted by persons or corporations; the establishment of Commercial Trusts; and international investment pools, constituted with foreign capital for the purpose of domestic or foreign investment and profits from which could be remitted at any time. To make it easier to access foreign capital, the LMV also eliminated requirement for prior approval of foreign investment in entities regulated by the Superintendency of Companies (i.e. publicly traded corporations, partnerships, limited liability corporations, etc.) and the sale and purchase of foreign currency with a fixed value set beforehand as a means to cover risk (Naranjo 1999). Some of these new instruments were explicitly directed at productive investment, such as the establishment of collective investment funds for investing in productive projects. However, others seem more linked to financial speculation, such as the establishment of investment funds for investing in highly liquid stocks that would permit investors to enter and exit the fund at any time (Endara 1999). In the absence of a stable currency, the LMV created the Unit of Constant Value (UVC), a unit of account indexed to inflation and adjusted on a daily basis to encourage longer-term savings and the provision of long-term credit. Ecuadorans could save and contract debt using the UVC, including consumer debt and home loans. Thus, as early as 1993, the financial sector sought instruments to provide stability for medium and long-term debt, including consumer debt.

The General Law of Financial System Institutions

In May 1994, Congress passed The General Law of Financial System Institutions (or the LGISF, by its acronym in Spanish), which sought nothing less than the wholesale restructuring of the private financial regime that had been codified in the country's 1972 Banking Law (Ley de Bancos). The measure, which enjoyed widespread support from the financial sector, was

introduced by Duran Ballén as an emergency economic measure and passed with the support of the PSC, Movimiento Popular Democrático, ID, Democracia Popular, PRE and Duran's party, Unidad Republicana.

From its inception, the LGISF contemplated the insertion of the Ecuadoran financial system and economy into the global economy through financial liberalization in accordance with changes taking place within the global financial structure. According to its introductory text, “one of the greatest changes confronting the world in the last two decades has been the liberalization of financial systems through deregulation, free competition among agents participating in the market, and technological advances” (this author’s translation) (Endara 1999: 145). The text continues, “the majority of countries in the region, as an indispensable requirement for insertion into the new world economic order, have already undertaken implementation of liberalization policies intended to achieve greater financial deepening and strengthening of the systems of supervision and control” (this author’s own translation) (Endara 1999: 146). Thus, “deepening” of the financial sector was seen as a key mechanism to increasing Ecuador’s ability to compete in the global economy. Ecuador’s financial sector, like its counterparts throughout much of the world, was given the privileged role of leading the country’s economic development.

In doing so, the LGISF reconfigured Ecuador’s financial system; it legalized (and encouraged) the creation of Universal Banks (commercial banks that provided a wide range of services, including investment activities that had previously been restricted to non-banking financial institutions) and permitted financial corporations to emit credit cards and utilize other financial instruments. The LGISF, also further opened up the country to international capital flows by giving financial institutions the ability to conduct operations using foreign currencies,

including the ability to take deposits and concede loans in foreign currencies. The use of offshore accounts was legalized, as was the ability of Ecuadoran banks to maintain their own offshore branches, facilitating the inward and outward flow of capital. The LGISF also gave foreign investors equal protection under the law and loosened regulations on the investment of Ecuadoran capital in foreign financial institutions (both new and pre-existing).

The LGISF legalized the formation of financial groups⁹ and eased restrictions on connected lending, loans to natural and juridical persons linked to members of a bank's Board of Trustees. The ratio of connected lending permitted was increased from 30% to 100% of a bank's technical reserves (in 1996, this level was reduced to 60%) (El Expreso 30/03/1999). The law also mandated “bank secrecy,” requiring banks not to disclose information about any type of deposit to anyone other than the depositor or their legal representative. At the same time, the LGISF eased administrative controls and reduced the regulatory power of the Superintendency of Banks (Miño Grijalva 2008), relegating it to a supervisory role. The Superintendency was limited to analyzing banks from a distance, using Basle ratios, with little power to condemn or rescue banks. Meanwhile, banks were entrusted to propose their own recovery plans (Martinez 2006).

Impacts of the LMV and LGISF

With the passage of the LMV and LGISF Ecuadoran banks experienced a rapid expansion in deposits. Between 1992 and 1994, bank savings deposits (including time deposits) increased 52.5%, from \$3.29 billion to \$5.02 billion, a trend that continued until the banking crisis in 1998, at which time the private banking sector held \$7.07 billion in savings (see Table 4). Most of the growth in deposits was due to an influx of US dollar deposits. After the passage of the LGISF, which legalized foreign money deposits and loans, foreign money deposits accounted for 12% of

⁹ Agglomerations of financial institutions were categorized as a financial group if the parent company possessed an entity regulated either by the LGISF or LMV.

all deposits, growing to 31.5% of deposits by 1997. By the height of the financial crisis in 1999, dollar deposits made up more than 50% of bank deposits (see Table 4). Along with the passage of the LGISF in 1994, the deposit reserve rates that banks had to maintain were also unified and reduced. Deposit reserve rates were reduced to 10%, from 28% for demand deposits in domestic currency and 35% for foreign currency deposits (Jacomé 2004:15), freeing up money for investment.

The increase in access to foreign and domestic capital, eased regulation, and introduction of the UVC led to a credit boom and the rapid expansion of the financial sector. Between 1993 and 1996, the number of banks grew from 31 to 44. Similarly, the number of non-deposit-taking financial institutions increased from nine in 1992 to 45 in 1995 (Jacomé 2004:13). Private bank credit to the private sector reversed from contraction and stagnation to an expansion of 42.8% in 1993 and another 49.5% in 1994. In real dollar terms, private sector credit grew from \$2.29 billion in 1992 to \$4.89 billion in 1994. By 1997, it had reached \$7.12 billion (see Table 1). Lower inflation coupled with the ability to contract loans in UVCs and foreign currencies, particularly US dollars, led to a dramatic increase in consumer credit and home loans. In 1993, private banks contracted \$270 million in home loans, accounting for 8.2% of private bank credit. The following year, 1994, that amount nearly doubled to \$521 million, accounting for 10.7% of private credit. By 1997, the share of private bank credit allocated to the home loans increased to 18.9%, or \$1.35 billion, a four-fold increase from 1993 (Table 3).

Thus, it should be of little surprise that, upon the passage of the LMV and LGISF, most Ecuadoran banks experienced immediate windfalls in their profit margins: between 1993 and 1995, private banking sector profits grew 177%, from \$70.16 million for the sector as a whole, to \$194.62 million while assets grew 88%, from \$6.01 billion to \$11.3 billion during the same

period. Some of the most powerful banks, such as Banco Pinchincha, La Previsora, Progreso, and Popular, experienced profit increases of 300 to 500 percent! However, even smaller banks experienced anywhere 100%-400% growth in profits during this time.

The LMV and LGISF gave the Ecuadoran private sector explicit access to international capital, resulting in a palpable increase in foreign-currency denominated currency in circulation and credit that continued until Ecuador's eventual dollarization in 2000. In 1993, \$355 million in foreign-denominated quasi-money (mainly US dollars) circulated through the private banking sector system; by the 1995, it was up to \$1.18 billion, accounting for a fourth of all quasi money¹⁰ (see Table 5). Similarly, levels of private sector loans in foreign currency also exploded, jumping from \$69.8 million (3% of private credit) in 1991 to \$1.8 billion (28.3% of private credit) in 1995 (see Table 6). As noted above, an increasing portion of these foreign money denominated loans went to home loans and consumer financing of goods, such as cars and home appliances, contributing to a boom in the automotive and retail sectors.

Increased dollar-denominated lending was supported by increases in dollar deposits, which increased dramatically from \$356.25 million in 1993 (9.1% of all deposits) to \$1.18 billion in 1995 (20.2% of all deposits) (BCE data). Similarly, legalization of the use of offshore accounts also boosted the presence of foreign currency in the Ecuadoran economy. While exact data is difficult to obtain, due to strict secrecy laws in many offshore financial havens, Jacomé estimates that, "Including deposits held in the offshore, total foreign currency deposits made up roughly two thirds of the system deposits, exceeding the amount of CBE's [Central Bank of Ecuador] net international reserves." (Jacomé 2004:10). The influx of dollar-denominated deposits did not just support the increase demand for dollar-denominated loans, which were provided at lower interest

¹⁰ Quasi money, also referred to as near money, includes any asset that can be quickly converted to cash. Quasi money often refers to savings accounts, bonds (especially near maturation), and US Treasury Bills.

rates, but also encouraged the financial sector to make such loans in an effort to cover their growing foreign currency liabilities (Beckerman 2001, Pablo Lucio Paredes interview¹¹). As a result, many banks began to contract dollar denominated loans to companies and individuals earning revenue in sucres, thus, increasing currency risk exposure in the case of devaluation (Jacomé 2004, Lucio Paredes interview).

Passage of the LMV and LGISF reflected the growing importance of Ecuador's financial sector, which had, up until this point, been quietly growing under the tutelage of the Ecuadoran government and support of the IFIs. These laws consolidated their growing power and helped transform finance into a dominant sector with its own interests separate from those of the sectors it served, namely the export sector, whose preference for continual devaluations ran counter to finance's need for a level of monetary stability to thrive.

Referring to financial reform during the early-mid 1990s, Endara (1999) observes:

“This has been one of the few spheres in which the government has been able to embody the interests of the dominant sectors. The legal reforms that gave rise to liberalization and financial sector promotion were implemented, almost without opposition, because, the domestic financial sector was able to achieve internal social consensus, a legislative majority, and the will of the executive to encourage them... finance became the economic, political, and ideological hegemonic social sector” (Endara 1999: 134, this author's translation).

The LMV and LGISF formalized the existence of economic and financial groups, permitting heightened levels of concentration through mergers of banks with brokerages and investment funds as well as the increased legal limit of connected lending. During this period, the financial sector emerged as the dominant sector, not only through increased economic strength but also through the emergence of powerful economic groups with links to the sector through a myriad of

¹¹ Pablo Lucio Paredes, interview by author, Quito, Ecuador, October 7, 2010.

arrangements, from ownership of banks and fund administrators to consumer financing companies. The impact of these laws on the growth of the financial sector, its grip on political power, and its levels of corruption, were directly connected to the financial crisis that precipitated dollarization.

III. GLOBAL MONEY, LOCAL POWER

Not surprisingly, growth in the financial sector's economic power was paralleled by growth in political power. Leadership of Ecuador's economy has been historically characterized by close-knit economic groups, dominated by familial ties and personal relationships. By economic group we mean, "business conglomerates whose interests are not found tied to just one economic activity, but rather span a group of sectors: agroindustry, industry, banking, commerce, services, the media, etc" (Fierro Carrión 1991: 237). According to Fierro Carrión's in depth study of Ecuadoran economic groups during the 1970s to mid-1980s, in most cases, a financial entity acts as the brain of the group. Although there are also cases in which the group consists of a vertical or horizontal productive monopoly (Fierro Carrión 1991). However, economic groups were not so much institutions as oligarchies, with the evolution of complex economic interests as members married into different groups or acquired new assets. As Ecuador's economies modernized and family-owned firms incorporated, much of this oligarchic structure remained, albeit transformed onto interlocking directorates.

Economic and Financial groups of the 70s, 80s and 90s

During the 1970s, a number of domestic economic groups that consolidated their power during the oil boom bought up or established banks to gain access to subsidized credit lines for

their own businesses (Miño Grijalva 2008). By 1985, four of the 10 top national economic groups were centered around financial institutions, each one linked to powerful family groups: Filanbanco (Isaías Groups and to a lesser degree, Dassum, Anton and Kronfle), Cofiec (a financial corporation formed by other banks, with extensive links to Banco de Pichincha, owned by Egas Group), Banco del Pacifico (Maspons Group and to a lesser degree, Nebot Group) and Banco Continental (Conticorp/Ortega Trujillo). Another five groups in the top 10 were heavily linked to one or more banks and financial institutions: Noboa Group (Banco de Credito e Hipaticario, Banco Litoral, Banco del Pacifico), PROINCO/Wright Group (Banco del Produccion), Pinto Group (Banco Popular, Cofiec), Morisaenz Group (Uninvest, which later became Unibanco) and Elijuri Group (Banco del Austro) (Carrion Fierro 1991).

The growing profits and role of financial institutions in major economic groups meant increased political power for the financial sector as a whole, as new and old economic elites sought to protect and expand their financial interests. Groups that developed around financial institutions expanded their reach into the media, real estate and even exporting as their profits grew. For example, by 1993, Aspiazu Group, which grew around the Guayaquil-based Banco del Progreso established by Fernando Aspiazu Seminario in 1981, had expanded to the energy sector with its purchase of Empresa Eléctrica del Ecuador (Emelec) and had founded Costa Trading, a banana exporting company run by future President of the National Congress, Juan Jose Pons of the Democracia Popular party (1998-2000). By 1996, Azpiazu also owned several prominent media outlets, including newspapers, television and radio stations and was considered one of the richest men in Ecuador (La Revista Vistazo 1999). Similarly, Isaías Group, owners of one of Ecuador's largest banks, Filanbanco, bought up some of Ecuador's largest media outlets in television and print, as well as commercial, agricultural, real estate and energy companies. This

empire made Isiais one of the 10 most powerful families in Latin America (Pérez 2008, Cooperativa.cl 2008).

By 1994, financial institutions accounted for 16 of the 25 most profitable firms in Ecuador (measured by rate of profit to equity), according to economic magazine, *Gestión*. Financial institutions also accounted for 12 of the country's biggest earners, alongside multinationals, such as Nestle and Constructora Norberto Odebrecht as well as Ecuador's most important national producers for the domestic market (i.e. *Compañía de Cervezas Nacionales*, *La Cemento Nacional*, etc.). It is interesting to note that, despite Ecuador's large agro-export sector, only one company on these two lists comes from this sector, the sugarcane producer/processor, *Sociedad Agrícola and Industrial San Carlos*.

The relationship between the commercial sector and the financial sector became more intertwined as the availability of consumer credit grew throughout the 1990s. Between 1993 and 1994, some financial institutions launched special lines of credit for domestic appliances, travel, and other personal needs. In 1996, banks consolidated this incipient market for non-credit card consumer credit by standardizing credit limits, payment plans, goods that could be purchased and interest rate packages (Ambram 1997). Economic Groups, such as *Grupo Favorita/Wright*, owners of Ecuador's top supermarket chain, *Supermaxi*, delved deeper into the world of finance through the development of a consumer credit card, *Magna*, in conjunction with one of the group's financial institutions, *Procrédito*. *Magna* was primarily aimed at *Supermaxi* clients who could get discounts using the card (Salazar Cordova 1994). By 1997 banks and other financial institutions were in the midst of a competitive war for the consumer credit frontier, particularly in terms of credit cards. Around this time, there were a wave of alliances and restructuring among credit card providers. *Magna* fused with the transnational credit provider, *Mastercard*.

Filancard, property of the Filanbanco, obtained the rights to administer American Express and the country's top credit card provider, Diners Club, which formed part of Banco de Pichincha, sought to expand its domain to Peru and Colombia (Diario Hoy 11/21/1997) and Banco del Pacifico entered the market with the emission of a corporate credit card for banana producers (Diario Hoy 05/05/1997).

The increased focus of the financial sector on consumer credit moved the interests of the financial sector in closer alignment with the import and retail sectors and further away from the interests of the export sector. An increased focus on consumer credit increased the importance of lower rates of inflation for the profits of financial institutions. High levels of inflation impacted not only the length of time for which credits could be offered but also interest rates that would attract or deter consumers. Lower rates of inflation would permit financial institutions to offer more long-term credit at lower rates of interest that would attract a wider array of consumers, not just the elite who traditionally had access to credit cards. This position would put the financial sector in direct opposition to the export sector, which profited from inflation, particularly due to currency devaluation and actively pushed for such policies.

Bucaram's Cavallo Plan: First Attempt at a Financial Coup

Ecuador's attempt at implementing convertibility during the Bucaram presidency reflects a first attempt by some of Ecuador's financial sector, in alliance with the commercial sector, at implementing a stable monetary regime to eliminate the common enemy of inflation and, most importantly, devaluation, and promote the use of longer-term credit, particularly consumer credit. At the behest of the export sector, Ecuador allowed the value of the sucre to fall steeply. Between 1990 and 1995 alone, the exchange rate increased from 887 sucres per US dollar to

2.922 sucres per US dollar (Naranjo 2007). By the time Bucaram announced his plan in January 1997, the conversion rate was already up to 3,600 sucres per US dollar. Thus, the 1997 “Cavallo Plan,” as it was called (after Argentina’s Domingo Cavallo, who was invited to Ecuador to design the plan) was a precursor to dollarization. Analysis of Bucaram's base of support, the Coastal financial and import sectors, and the reaction to the proposal by other economic and political elites is instructive in helping understand the socioeconomic base of support for dollarization in 2000 and the alliances that permitted the more drastic policy of dollarization to pass just three years after rejection of convertibility. Similarly, this event demonstrates that dollarization was not simply a response to the crisis later generated by the financial sector but was part of an ongoing discussion within the financial sector related to monetary stability.

Elected on a populist platform that railed against the traditional Ecuadoran "oligarchy" that excluded the Lebanese, blacks, indigenous and poor from power, Abdula Bucaram was elected President in 1996. He ran as candidate for the PRE (Partido Roldosista de Ecuador), which he founded in 1983, and which he still leads as “Supreme Director.” His campaign style was brash: he infamously accused his rival from the PSC, ex-President Leon Febres-Cordero, of being effeminate and having watered-down sperm; he recorded an album, "El loco que ama" (The crazy man who loves), and put on political events that were public spectacles. Yet, despite his populist rhetoric, Bucaram’s economic plan was rooted in neoliberalism. Formed in close consultation with the architect of Argentina’s convertibility regime, Domingo Cavallo, the economic plan included privatization of PetroEcuador and the Ecuadoran Social Security Institute, increased tax on cigarettes and alcohol, a 2% tax on automobiles, extension of the Value Added Tax (IVA, according to its acronym in Spanish) to agricultural goods and an increase in the prices of electricity, domestic gas and telephone rates and labor flexibility laws.

Central to the proposal was implementation of a currency board to halt Ecuador's growing inflation problem. However, the plan was never implemented. By February 1997, Abdalá Bucaram was declared mentally unfit to hold office by the National Congress and fled to Panama, where he remains, to escape charges of corruption.

The PRE's traditional base of support came from the Coast. Bucaram's self-proclaimed status as an outsider fighting the Ecuadoran oligarchy appealed to the poor as well as the Lebanese community, many of whom, like Bucaram, were recent descendants of immigrants who had been marginalized and discriminated against by "high society," despite their economic success. Referred to pejoratively as "turcos," the Ecuadoran Lebanese community has often been looked down upon as "nouveau riche" and shut out of political power by the more traditional coastal elite. According to Freidenberg and Alcántara Sáez (2001), the PRE,

"...Represents a large part of the emergent social sectors, marginalized groups and business strata that arose outside of the traditional oligarchic circles from the Coast. These nouveau riche have pressed to enter the oligarchy but its closed nature has not allowed them to join." (p.179, this author's translation).

Unlike the more traditional coastal oligarchy, which made its money in agro-export, members of Ecuador's Lebanese community made the bulk of their money in the textile, imports and finance sectors. Thus, the PRE can be seen as a response to a growing desire of a sector of the coastal Lebanese community for a political voice of its own, separate from the hegemonic Social Christian Party (PSC, by its acronym in Spanish) to advocate for economic policies beneficial to its interests (De la Torre 1998, Friedenberg and Alcántara Sáez 2001, Peagam 1996).

By all accounts, the PRE is a populist party based on personalistic ties and clientelism, with Abdalá Bucaram pulling the strings, even during his various self-imposed exiles to Panama (he also fled to Panama from charges of corruption during his tenure as Mayor of Guayaquil).

Family members and close friends hold all of the party's major positions. During his brief tenures as Mayor of Guayaquil and President of Ecuador, Bucaram filled top governmental offices with family members, close friends and financial associates on a scale that raised eyebrows even in Ecuador, where conflicts of interest among officeholders and officials are common. Given the role of personal relationships and clientelism in the PRE, it is reasonable to assume that Bucaram's proposed policies, particularly his economic plan, which centered on convertibility, benefited his supporters, at least those with sufficient economic or political power. To this end, it is instructive to look at Bucaram's close associates. Aside from family members, Bucaram surrounded himself in office with several close friends and business associates, many of which were closely tied to the import and finance sectors.

Eduardo Azar, considered by Bucaram to be a close personal friend and trusted advisor (Freidenberg and Alcántara Sáez 2001), was appointed as President of the State Bank and Solidarity Fund but never reported for work. Instead, "from the first day that Bucaram assumed power, Eduardo Azar always appeared by the side of the president of the Republic" (Diario Hoy 03/2/1997, this author's translation). He also owned the mansion where Bucaram lived while in Ecuador. Of Lebanese descent, Azar made his fortune as an importer and distributor for his chain of wholesale and retail stores, Almacenes Eduardo Azar, as well as international brands, such as Miller beer and Dano milk (Diario Hoy 11/09/1996).

Alfredo Adum, had been a close friend of Bucaram's since childhood and a longtime supporter. The child of Lebanese immigrants, he is a major importer but has also expanded to

construction, development and real estate; shrimping for the export sector; cattle ranching; and even television and radio. He, reportedly, contributed two to three million dollars to Bucaram's campaign (De La Torre 2010) and underwrote Bucaram's self-imposed exiles to Panama (Moreno Mendoza 1996, Peagam 1996).

Similarly, Victor Hugo Sicouret, Bucaram's close friend and confidante who was appointed Minister of Housing, was deeply connected to the construction and real estate development sectors, responsible for major public and private construction projects. Sicouret was a strong supporter of the Bucaram convertibility plan, which would have likely reduced interest rates and promoted access to mortgages and other development-related credits. Hugo continued to advocate for convertibility during the financial crisis that led to dollarization (Diario Hoy 04/Marzo/1999).

Bucaram's economic team, which worked with Domingo Cavallo to develop and implement convertibility, was made up of close friends and associates from the financial sector. Bucaram appointed his ally, Roberto Isaías Dassum, as his chief economic adviser. Roberto was the President of the now-defunct, Filanbanco, Ecuador's largest bank at the time. Roberto and his brother, William, also controlled one of the country's most powerful economic groups, Grupo Isaías, which made its fortune primarily through finance and the media.

Economist Pablo Concha, Bucaram's brother-in-law, was appointed as the Minister of the Economy (Ministerio de Finanzas). Concha is linked to the finance sector, holding several positions in both the public and private financial sector, his last position prior to working for Bucaram being Executive Vice President-General Manager of the financial group Grupo Finver-Banco del Tungurahua (Vargas Pazzos 1996). Concha was an avid supporter of convertibility

(Diario Hoy 12/20/2004) and later joined with Joyce Higgins de Ginatta's, Foro Económico, the mission of which was to implement official dollarization in Ecuador.

Alvaro Noboa Ponton was appointed chairman of the monetary board. Now the richest man in Ecuador, at the time he was just coming out of a long and drawn out battle for control of his father's banana empire (which, in addition to exporting bananas, is involved in importing and distribution of brands, such as Quaker; banking; insurance; sugar refining; shipping; international investments, etc.), which he took over in 1997. Prior to obtaining his father's empire, Alvaro made his own fortune in construction, real estate, banking and international investments.

David Goldbaum was appointed president of the National Financial Corporation, the State's development bank. Goldbaum and his brother, Roberto, own and run one of the most powerful insurance companies in Ecuador, Seguros La Union, and owned Banco Territorial. The Goldbaum brothers were personal friends of Abdalá Bucaram and actively supported convertibility (Goldbaum II 02/2/2008). In fact, it was Roberto Goldbaum who invited Cavallo to Ecuador to begin talks with the Bucaram government and accompanied him throughout his stay.

The Bucaram convertibility plan represented the ideological but also economic interests of his power base: his close friends and allies from the financial and commercial sectors of Guayaquil, both of which stood to benefit from exchange-rate stability, if not overvaluation, and greater access to international financial markets. Many of these allies also supported dollarization in 1999, under President Jamil Mahuad. While Bucaram's base of support was limited mainly to the Coast, the broader import and financial sectors were supportive of the concept of convertibility. According to the Roberto Cuesta, a Quito-based banker and, currently President of the Association of Private Bankers, the finance community in both Guayaquil and

Quito were actively discussing plans to stabilize Ecuador's monetary regime: convertibility, and later, dollarization, was the focus of a great deal of attention:

“It was imminent that something was going to happen; something had to happen... that bubble was going to have to explode, on some side it was going to have to explode. Banks were already protected, in some form, other than their equity. Equity, you could protect, though, by putting it into buildings, you could protect it in several ways but not necessarily have dollarized equity.

“When President Bucaram came to power, everyone pushed to look for a different monetary framework-- a managed convertibility scheme. He brought Domingo Cavallo here from Argentina. Unfortunately, it did not happen because there was another political crisis. So, they removed him from office and we had another interim government.”¹²

Bucaram's inability to implement convertibility came from his inability to unite the financial and commercial sectors against the still-powerful export sector that opposed such a move. According to General Paco Moncayo, who was a representative for the ID (Izquierda Democratica, or Democratic Left, in English) in the Legislative Assembly at the time, exporters overwhelmingly opposed the idea of convertibility:

“And in this crisis, well in all political crises, there are always winners and losers. In this case, there were some who were very opposed to implementing what was called the Cavallo Policy, which would have been much less drastic than dollarization....

“At that time, remember, the president of the Monetary Board was Alvaro Noboa. He drove convertibility and he was an exporter, right? Well, Alvaro Noboa is not *just* an exporter; he is an exporter, importer, national producer! He has always had a basket so that if he loses on one side he gains on the other side. But for most of the exporters, of course, they did not want a hard currency. Devaluations were always political, not a technical; it permitted them to have lower prices and be more competitive. Just look at productivity levels: we are the largest exporter of bananas and shrimp but not because of productivity. If you look at productivity per hectare, you will see that we are much less productive than Costa Rica. So, the inefficient have survived without having to modernize and they were happy because they were exporters thanks to the devaluations and not the competitiveness of their businesses.”¹³

¹² Roberto Cuesta, interview by author, Quito, Ecuador, October 14, 2010.

¹³ Paco Moncayo, interview by author, Quito, Ecuador, October 8, 2010.

The PRE's naked corruption and support of allies to the exclusion of other power groups enabled those who opposed Bucaram's policies (exporters, those benefitting from protectionism, Labor, the indigenous) to unite with those who feared that they would not be invited to the party. According to General Paco Moncayo: "...the [opposition to Bucaram] called themselves the pick-up truck because onto the pick-up truck jumped leaders from the Right and the Left. [Bucaram] committed some real big errors" (Moncayo Interview).

Bucaram's flagrant attacks against "the oligarchy," which often happened to be economic rivals of his allies, made him enemies in nearly all sectors of the economy. As the PSC, the Guayaquil-based party with close ties to both the banking and export sectors noted at the time, they did not oppose convertibility but the man who would implement it. According to Alfredo Arizaga, former Vice President of Banco La Previsora and, later Minister of Economy under Mahuad and Noboa Bejarano, tasked with implementation of dollarization:

"The issue with convertibility is that it requires a lot of confidence in the government carrying it out; if there is not confidence you will have the situation like what happened in Argentina. The problem was that no one had confidence in Bucaram. If he had proposed dollarization, he might have gotten more traction."¹⁴

According to Cuesta, economic interests informed some of the opposition to the Bucaram plan:

"Important pressure from the economic sector, I believe was part of the reason that it did not happen. If it would have been implemented at the time the social cost would have been much smaller because you are talking about conversion rates, at the time, of 8,000 or 10,000 sucres to the dollar, versus 25,000 [at the time of dollarization] but the political issue and the economic power groups were very strong" (Cuesta Interview)

When asked which groups he was referring to, Cuesta implies that exporters were the culprits:

"The world is divided between two worlds: that of the exporter and the importer. One benefits

¹⁴ Alfredo Arizaga, interview by author, Quito, Ecuador, October 12, 2010.

from a certain regime and the other benefits from a different regime. Between these two worlds the economic groups from one side or the other, each press for their side.”

Regionally, exporters, with the exception of the cut flower industry, are from the Coast while producers for the domestic market and importers are, mostly, from the Sierra.

Nevertheless, while Bucaram had the support of coastal importers, most of whom were allies from the Lebanese community, his regionalist political rhetoric and party’s entrenched clientelism alienated many of his potential supporters in the Sierra, permitting the broad opposition coalition that eventually led to his ouster in February 1997.

While the popular sector worried about labor flexibility laws and privatization, domestic producers complained that, without a monetary buffer, their businesses would collapse in the face of competition from imports. Still others opposed the measure not because of the proposal itself but because of the man proposing it. While certain members of the business sectors, particularly those that had benefitted from protectionism and devaluation, feared liberalization others lacked confidence that the Bucaram government could implement reform in an ordered way and feared that anyone outside of Bucaram’s inner circle would lose out on the benefits to be had (Cazar and Ospina Peralta 2003).

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However, despite its failure to pass, Bucaram's convertibility proposal represents the first steps towards dollarization and points to the sectors most interested in its passage: importers and, above all, the financial sector. At the time, the power of the export sector coupled with distrust of Bucaram blocked convertibility's passage. By the time of the economic crisis, however, the export sector was weakened and, despite a banking crisis that claimed some of Ecuador's most powerful banks, was still unable to exert its preferences over those of the domestic financial sector.

The 1998 Constitution and the AGD

By 1998, the Ecuadoran financial sector was beginning to feel the weight of risky investments, over-leveraging, and the inability of coastal exporters to pay off loans in the aftermath of the El Niño rains that decimated crops and infrastructure. Nevertheless, the financial sector continued to flex its political muscle. In 1998, Ecuador adopted a new constitution, one that strongly reflected financial sector interests and paved the way for creation of the AGD (Deposit Guarantee Agency, in English), which would be used to bail out failing banks at a very high cost to the country.

Ecuador's 1998 Constitution, the first adopted since the 1978 Constitution formalizing the transition to democracy, represented a dramatic shift in the way the State related to the Ecuadoran economy. As other scholars have noted, the 1998 constitution shifted the economic role of the State from national development through public sector development and the equitable distribution of resources to one in which the State's economic function was to guarantee the stability and transparency necessary for markets to function. It also elevated the role of international and domestic investment. This shift reflected the change of ideological context: the

1978 constitution reflected a State-led developmentalist ideology steeped in the ISI model, whereas the 1998 constitution reflected the neoliberal fetishism of markets and the role of globalization, enshrining the equal treatment of foreign and national private investment. It also reflected the influence of the financial sector. According to economist Marco Naranjo Chiriboga, who developed the plan for Ecuador's dollarization: “That constitutional assembly was very tied to the finance sector. There is no transparency in Ecuador. Laws are passed to benefit power groups. The power group in that system was the finance sector.”¹⁵

Among other reforms, the 1998 Constitution gave the Central Bank complete autonomy and made monetary stability its sole objective for which the BCE had at its disposal the use of monetary, financial, credit and exchange-rate policies as tools to achieve this objective (Art. 261). The new mission of the Central Bank built upon reforms implemented in 1996, which added to the Monetary Board the function of watching over the country's monetary stability and fiscal solvency (Art 69). This Constitution also prohibited the Central Bank from conceding credit or purchasing bonds or other financial instruments from any State agency except in the cases of a State of Emergency due to war or natural disaster (Art 265). However, fiscal responsibility was a concept limited only to the Public sector, not the private sector and certainly not the private financial sector. Thus, the Central Bank was given the ability to offer stability and solvency credits to financial institutions in crisis for up to two years as well as provide deposit guarantee to depositors whose banks entered into liquidity crisis (Transitory Disposition 42). This clause provided the space for the creation of AGD later that year, which guaranteed 100% of deposits. Finally, the new Constitution introduced a new Chapter entitled "On Investment" (Chapter 7, Art. 271), which specified that the State would guarantee national and foreign capital

¹⁵ Marco Naranjo, interview by author, Quito, Ecuador, October 8, 2010.

invested in production and, in a separate paragraph, that the State may establish guarantees and special securities with investors that would not be modifiable by laws or any other type of order.

The focus on monetary stability should be understood within the context of financialization and, particularly, Ecuador's attempt to develop its capital markets and encourage foreign investment. Monetary instability affects the profitability of capital markets and discourages the medium and long-term financial investment required not only to attract deposits and lower the cost of capital but also to utilize more advanced financial instruments, such as securities, a market that was in the process of being developed in Ecuador during the mid to late 1990s.

IV. THE ECUADORAN FINANCIAL CRISIS

The financial crisis that helped lead to dollarization had its roots in both external and internal crises. Externally, Ecuador was negatively impacted by a border war with Peru in 1995, estimated to have cost the country half a billion dollars in addition to paralyzing commercial flows (Naranjo Chiriboga). In 1997, the country was then hit with a decline in the price of oil, Ecuador's largest export and the State's main source of revenue. The decline resulted in a loss of revenue equal to about 3.5% of Ecuador's 1998 GDP (Offerdal and Cortes 2000: 8). This loss in revenue was compounded by the closing off of international lines of credit due to international financial crises coming out of Russia and Brazil at the time as well as devaluations by these and other countries that reduced Ecuador's competitive edge in its primary export markets (MG 2008, Beckerman & Solimano 2002, Offerdal and Cortes 2000).

These incidents could not have taken place during a worse time: just as Ecuador's Coast, the center of its export economy and the principal generator of foreign currency, was ravaged by rains from El Niño that hit the country at the end of 1997 into the beginning of 1998. The storms wreaked havoc on the coastal infrastructure, destroying 19 bridges and 2,500 km of road, not to mention export-producing plantations. Estimates of the cost of the El Niño damage run from overall losses equal to 13% of

Ecuador's 1998 GDP (IMF Country Report 2000) to costs of 14.5% of GDP (\$2.8 billion) in damages alone in addition to another \$1.1 billion in export losses (Cazar & Ospina Peralta 2003). Regardless of the exact figure, what is clear is that El Niño devastated coastal business, which led to increased rates of default on bank loans, most of which were contracted from Guayaquil-based banks.

However, while it may be tempting to blame these factors for Ecuador's financial crisis, these events were nothing more than triggers, setting off a domino effect that was put into place by a decade of policy choices that favored the financial sector, particularly the coastal financial sector, which had much greater links to international capital than its counterpart in Quito (although Quito-based banks also benefitted from liberalization policies implemented during the 1980s and 1990s). In particular, there were three broad internal causes of the crisis: high rates of connected lending, high rates of dollar-denominated debt, and policy responses that turned a banking crisis into a full-fledged financial crisis. The first two internal causes can be directly linked to policy shifts implemented during the previous 10 to 15 years to reduce financial sector regulation and liberalize capital flows. However, all three of these internal causes reflect the growth in power of Ecuador's financial sector, which acted through the Ecuadoran government to save itself by any means necessary. The Mahuad administration was aligned with the financial sector; its policies, aimed at saving the financial sectors at all cost, helped plunge the country into chaos and, ultimately, created the conditions for dollarization.

The Mahuad Administration: The Bankers' President

In August 1998, former two-term mayor of Quito, Jamil Mahuad, from the Popular Democracy party (DP, by its acronym in Spanish) was inaugurated President of Ecuador. Prior to entering politics, Mahuad had worked in the world of finance as the Deputy Director of Banco de Producción (aka Produbanco), later run by close DP colleague and dollarization supporter,

Abelardo Pachano.¹⁶ Despite his affiliation with the Sierra-based DP, Mahuad's campaign aggressively organized an independent base of support on the Coast, particularly among the financial sector, that helped finance his campaign.¹⁷ Thus, Mahuad was able to bridge the traditional regional divide that plagued Ecuadoran politics.

Mahuad's ties to the financial sector were reflected in his political appointments: bankers permeated the Mahuad administration. He appointed Alvaro Guerrero Ferber, President of the Guayaquil-based Banco La Previsora, and a reported member of his inner circle, as the Head of the National Council of State Modernization (CONAM, by its acronym in Spanish), which ran the State's privatization efforts. Guillermo Lasso, President of Banco de Guayaquil, was named Governor of Guayas (the Ecuadoran state in which the city of Guayaquil is located) and, later, Superminister of Economy. Medardo Cevallos Balda, President of Bancomex, was appointed Ambassador to Mexico. Mahaud appointed former President of the Ecuadoran Association of Private Banks (ABPE, by its acronym in Spanish), Ana Lucia Armijos¹⁸ as Minister of the Department of Government and later Minister of Economy and Finance. Likewise, he appointed Carlos Larreátegui, also a former ABPE President, as the Superminister of Social Development.

Thus, even before Ecuador's economic crisis unfolded, Mahuad signaled that he was a friend of the financial sector. The policies he would later adopt to save the most powerful members of that sector reflected this affinity: Mahuad was the bankers' president. However,

¹⁶ Produbanco and its financial affiliates are owned by the PROINCO group, of which former DP Mayor of Quito and Presidential Candidate in 1996, Rodrigo Paz Delgado, is a principal shareholder (Fierro Carrion 1991).

¹⁷ This fact that would come back to haunt Mahuad, when Fernando Aspiazu, President of the Guayaquil-based Banco de Progreso, admitted that he illegally contributed \$3.1 million to Mahuad's electoral campaign (Freidenberg and Saéz 2001).

¹⁸ Armijos had also served as General Manager of the Central Bank under Sixto Duran Ballen, during which time she was party to the unilateral signing the infamous Tolling Agreement along with Mario Ribadeneira, Minister of Finance and Public Credit, and Miriam Mantanilla, Ecuador Consul in New York. The Tolling "Agreement" recognized Ecuador's external commercial debt just before the debt was set to expire, and waived any rights it would have had under the statute of limitations (Correa 2009, Comisión para la Auditoría del Credito Publico 2008)

Mahuad's alliance with finance was not exceptional but, rather, reflected finance's economic and political dominance at the time.

Bailing Out the Banks at All Costs

Even before Mahuad took office, the financial sector, dominated by the coastal banks, were feeling the weight of the fall in oil prices and the crisis affecting the agricultural sector, magnified by their own risky investments and, in a number of cases, fraudulent activity. Even though the Monetary Regime Law of 1992 and the recent 1998 Constitution banned the Central Bank from financing state debt or providing financial institutions with monetary support other than short-term credits to alleviate liquidity, the framers of the new Constitution provided the government with the power to intervene in the banking sector for a two-year period via Transitoria 42. By the time Mahuad took power in August 1998, several smaller banks had already shut down. Within this context, the administration began looking for a framework within which to salvage the sector, leading the government to propose The Law for Restructuring Economic Matters in the Area of Tax-Finance, which would allow for the creation of the Deposit Guarantee Agency (AGD, by its acronym in Spanish), an independent government agency with the authority to clean up financial institutions and protect depositors.

The AGD

The stated goal of the AGD was to protect Ecuador's depositors by directly intervening in the administration of financial institutions to rehabilitate, restructure, and, if necessary, reorganize financial institution assets and liabilities. Institutional reorganization could mean fusion with another institution, sale to a buyer or even asset liquidation. As part of its mission to protect

depositors, the AGD guaranteed all deposits without limit. The funds to cover these endeavors would come from financial institution assets and the State (Falconí Puig 2002, Falconí Puig interview¹⁹, Miño Grijalva 2008). Thus began what Ecuadorans would come to refer to simply as the *salvataje* (the bailout).

Passage of the Restructuring Law to enact the AGD would not prove an easy task for Mahuad. Rather, it became an act of desperation for his administration. By November 1998, the banking crisis had become apparent. Worst of all for the Mahuad administration was the impending implosion of Ecuador's largest bank, Filanbanco, which was looking for a bailout. The Isaías Group, which owned the Guayaquil-based bank, was one of the most powerful economic groups in Ecuador and one of the wealthiest families in Latin America. In addition to the bank it also owned credit card companies, brokerages, and other financial institutions; several important national media outlets, including Gamavisión, TC Televisión, Cable Noticias-CN3, and the national newspaper, El Diario Hoy; as well as companies in the energy, commercial, importing, construction, agriculture, and real estate sectors, totaling around 195 firms in all (Cooperativa.cl 2008, Pérez 2008). The Central Bank had already provided several liquidity loans and was running out of options for dealing with the severe crisis faced by the bank. Meanwhile, Filanbanco was holding on in anticipation of the government creation of AGD (Almeida and Imbaquingo 2008, Falconí Puig 2002).

It was a race against time for the Mahuad administration, as some of the most powerful financial institutions faced the brink of collapse. The Minister of Economy and Finance, Fidel Jaramillo, and the Superintendent of Banks, Jorge Egas Peña, wrote to the National Congress urging them to pass the bill, claiming that the agency would cost the country nothing and would

¹⁹ Juan Falconí Puig, interview by author, Guayaquil, Ecuador, October 1, 2010.

be no worse than a generalized financial crisis that would surely develop without the AGD (Correa 2009). However, there was contention over how to fund the AGD. The DP had proposed a combination of tax loophole elimination, differentiation of tax rates for agricultural producers depending on size, and the elimination of certain deductions and tax exemptions (Diario Hoy 07/Octubre/1998). However, the PSC, led by Jaime Nebot, put forth an extreme alternative: a one percent tax on financial transactions and complete elimination of the income tax. Nebot reasoned that the financial transaction tax would be easier to collect, reducing evasion, and would collect an estimated \$7 billion²⁰ per year, approximately double that collected through the income tax (Diario Hoy 07/Octubre/1998, El Tiempo.Com Nov 12, 1999).

The urgency with which the Mahuad administration sought the creation of the AGD provided the PSC with significant leverage. Since Mahuad's election, the DP and PSC had worked together as allies within the National Congress. The DP did not have enough congressional seats to pass legislation on its own and depended on PSC support to pass the Law of Reorganization in Economic Matters in the Area of Tax-Finance that would create the AGD.

Predictably, the financial sector was livid. Of particular concern was Nebot's insistence that the tax be extended to off-shores, which, the financial sector argued should not be taxed because they were, technically, not in Ecuador. But Nebot was committed to the proposal, for which he had begun to campaign publicly two months earlier. The DP countered with a mixed package that included an annualized financial transaction tax to complement a reformed personal income tax (Reforma Tributaria Dos Tesis Sin Consenso; Jaramillo Canta Victoria) but Nebot refused any compromise (El Comercio 10/20/1998; El Comercio 10/30/1998).

It is hard to know the exact motivations of the PSC in its staunch insistence on the one

²⁰ Although, many argued that this was a wildly inflated figure.

percent financial transaction tax. On the one hand, the PSC traditionally represented the coastal oligarchy, entrenched in the agro-export sector, which would have benefitted from the removal of the income tax. In fact, a large section of the business sector on both the Coast and Sierra supported the Nebot plan. However, as a representative from the Coast, the PSC was also deeply connected to Guayaquil's powerful financial sector, which would have clearly been adversely affected by the tax. Public statements by Nebot point to a belief that, given the large number of Ecuadorans who used the financial system, the tax would not lead to disintermediation. As Jacomé (2004) notes in his study of the crisis, such taxes had been adopted with success in other parts of Latin America at the time, although under different conditions, with narrower tax bases and at lower tax rates. And while Nebot insisted that offshores be included in the tax, bank secrecy for offshore depositors was maintained, providing relative cover for the wealthy to evade the tax. What this struggle suggests is that, despite the ascendance of the financial sector in Ecuador, its power continued to be actively contested by other power groups. The dual and conflicting allegiance of the PSC to both the agroexport sector and the financial sector is, therefore, well-illustrated by its support for the AGD and its push to implement the financial tax.

With time running out and in need of votes to pass the legislation, the DP agreed to the finance tax with minor adjustments. The Law for Restructuring Economic Matters in the Area of Tax-Finance (*Ley de Reordenamiento en Materia Economica en el Area Tributaria-Financiera*) was passed on November 28, 1998 with votes from the DP and PSC. Mahuad could have implemented a partial veto to remove the financial tax. However, as Mahuad pointed out at the time, such a move would have required the law to be returned to Congress in a process that would require at least another 30 days before a bill would come across his desk and that was too long to wait. Similarly, the PSC threatened complete withdrawal of support if the President

implemented a partial veto, leaving the Mahuad administration the difficult task of forming a new alliance (El Comercio 11/30/1998). Despite strong disapproval from Mahuad's Minister of Finance, Fidel Jaramillo, and the IFIs, Mahuad allowed the bill to pass into law (El Tiempo.com 1999, Diario Hoy 11/19/1998 El Comercio 10/30/1998). On December 1, 1998, the The Law for Restructuring Economic Matters in the Area of Tax-Finance went into effect, creating the AGD. On December 2, 1998, Filanbanco voluntarily submitted itself to the AGD for restructuring.

As economist Pablo Lucio Paredes recalls:

“...but then comes the collapse of Filanbanco... which was the first big bank to collapse and then began the pressure to bail out those who had lost their money in Filanbanco. So, this absolutely absurd formation is created, the Deposit Guarantee Agency, with a deposit guarantee of 100 percent! Crazy! But at the heart of it were the big economic groups that lost a lot of money in Filanbanco who said ‘I don't want to lose my money!’ so they created this deposit guarantee.” (Pablo Lucio Paredes interview).

The day after Filanbanco sought help, the AGD loaned the institution \$140 million; a few weeks later, it loaned Filanbanco an additional \$400 million to pay off its loans to the Central Bank. In February 1999, the AGD emitted an additional, although not final, payment of \$276 million despite a January audit by Price Waterhouse Cooper asserting poor use of the funds and an overall lack of documentation and information on the part of Filanbanco related to the loans (Falconí Puig interview).

While Juan Falconí Puig, Superminister of Production during the Mahuad administration and Superintendent of Banks during the Noboa administration, asserted that “The AGD was created by the December 1998 Reorganization Law, edited to suit the only real bankruptcy of Filanbanco” (2002:11, this author's translation), the AGD went beyond the bailout of just one bank. Between its creation in December 1998 and the announcement of dollarization, the AGD

intervened in 16 banks, representing 65% of the banking sector's onshore assets (IMF 2000: 23—SELECTED ISSUES). Ecuador's Congress even extended the AGD's "blanket deposit guarantee" to customers of Banco de Prestamos, which had closed before the AGD was created. According to the IMF, the extension cost the State approximately \$200 million (IMF SELECTED ISSUES 2000, note 29, p.30). In fact, between August 1998 and December 1999, the State transferred approximately \$6 billion to the banking sector, most of which was carried out through the AGD, a sum representing 23% of Ecuador's annual GNP, the largest in the world for that type of operation (Acosta 2006) and the equivalent of what the Ecuadoran government spent on education for the previous 13 years. The extent of the State's resource transfer to the financial sector is even more stark given that during the same time, real social spending fell by about 50 percent, even as unemployment doubled (Lucero 2000: 162). For this reason, Falconí Puig also asserts that the AGD was created to benefit various banks:

“But it is not only a question of whether some manager or functionary of the AGD has been inefficient but rather that... [the AGD] was created precisely so those bankers and ex-bankers remain unpunished; if not criminally... at least economically...” (Falconí Puig 2002: 11).

As banks prepared to turn themselves over to the AGD, a number of them made last minute loans to connected firms and shell companies and reprogrammed other existing loans for extended periods at low or no interest (Acosta 2006). Filanbanco, for example, reprogrammed loans to 36 companies owned by the Isafías family and contracted a 2.1 billion sucre loan to a connected company at zero percent interest before transferring these liabilities to the AGD and receiving more than \$500 million for recapitalization (Halac and Schmuckler 2004: 44-45).

To fund the AGD, the State created AGD bonds that were bought up by the Central Bank, resulting in a massive injection of sucres into the system. Together with the liquidity it was

supplying to the faltering banks, transfers to the financial sector led to a 41% increase in monetary base in 1998 and 136% increase in 1999 (Correa: 57). The result was a 400% depreciation of the sucre between January 1999 and January 2000 (Martin-Mayoral 2009). As Correa points out, the AGD became a tool to transfer the impact of the crisis off of the bankers and squarely onto the State and public:

“(…) In other words, it is the banking crisis and political power of bankers to transfer the weight of the crisis to the State that generates the depreciation of the sucre and the monetary crisis. From an intelligent and in-depth analysis of the 1998-1999 crisis (…) the fundamental conclusion should be, then, the need to free the State from the power groups that control it.” (Rafael Correa, as quoted in Martin-Mayoral 2009, this author’s translation)

However, much to the dismay of the financial sector, the Capital Circulation Tax adopted as the price of passing the AGD had a devastating effect on banking. As feared by some, the 1% tax led to a reduction in the usage of financial services and accelerated the crisis (Jacomé 2004, Acosta 2006, MG 2008, Naranjo Chiriboga 2007). Thus, the banking crisis, which had originated on the Coast²¹, Ecuador’s financial center, began to spread to the more cautious and, generally, less powerful banks in Quito.²²

The Banking Holiday and Deposit Freeze

²¹ Prior to the Crisis, Guayaquil-based banks dominated the highly concentrated Ecuadoran financial sector. Despite the presence of 41 banks, by the mid-1990s, just 10 accounted for approximately 70% of the sector’s assets, deposits, and loans. Of the top 10, those based in Guayaquil accounted for 46% to 50%. One of the major impacts of the crisis, aside from dollarization, was a shift in the center of the banking industry from Guayaquil to Quito, as a number of the banks that closed were from the Coast.

²² One significant exception to this power bias, was the Banco Pichincha, owned by the Egas Peña family. This Quito-based bank was Ecuador’s third largest bank throughout the 1990s and converted itself into the country’s number one bank since dollarization. Since Ecuador’s IRS began tracking the assets of economic groups in 2006, Grupo Banco Pichincha has held the number one spot, surpassing Grupo Noboa, Ecuador’s largest banana exporter, which has held on to number 7 on the list between 2007 and 2009 (the last updated listing).

Over the weekend of March 6, 1999, the Mahuad government learned that the Banco de Progreso, based in Guayaquil was on the verge of imminent collapse. Even with liquidity funds from the Central Bank, Progreso barely had enough funds to attend its clients (MG 2008). That Monday, March 8, 1999, the Mahuad administration announced a weeklong bank holiday for the entire country. There is little debate that the banking holiday was implemented to save Banco de Progreso (Acosta 2006, Ginatta Higgins--Dolarizacion, Miño Grijalva 2008, Roberto Cuesta interview, Paredes Lucio interview, IMF Country Report 2000). In addition to having the country's largest deposit base, its President, Fernando Aspiazu, was a part of the Coastal power structure²³ and had contributed \$3.1 million to Mahuad's electoral campaign, a contribution that was never reported to the Supreme Electoral Tribunal (Miño Grijalva 2008). This fact, however, was not made public until late October 1999, a month after Aspiazu was jailed on fraud charges.

On March 11th, before the country's banks had a chance to reopen, the government announced a deposit freeze: half of depositors' checking balances were frozen for 6 months, savings deposits over \$500 were frozen for 6 months, and time deposits and repurchase agreements were frozen for at least 1 year (Jacomé 2004: 22). The freeze was accompanied by fiscal adjustment measures, including increased gas prices and a tax package aimed at closing the deficit (Miño Grijalva 2008). The exact motive for freeze is unclear. Whether it was concern that the government did not have enough resources to keep open Banco del Progreso (IMF 2000 Country Report), realization that the bank holiday to save Banco del Progreso removed any vestige of public confidence in the financial sector (Interview with Roberto Cuesta), or whether

²³ In addition to Banco de Progreso, Aspiazu also owned the Guayaquil Electrical Utility (Emelec); the television channel S1TV and the Newspaper and Radio chain, El Telégrafo; the banana export company Costa Trading (run by the DP Representative and President of The National Congress from 1998-2000, Juan Jose Pons), and the Soccer Team named for his electric company, Club Sport Emelec.

it was the work of Banco La Previsora President and member of Mahuad's inner-circle²⁴, the result was the same: the country plunged deeper into a crisis and the crisis was beginning to spin out of control.

Ultimately, the deposit freeze bought the government time to clean up the banking sector but at a terrible cost to the public²⁵ (Jacomé 2004). In addition to soaring inflation, Real GDP fell to 1977 levels; poverty increased to 40% and extreme poverty rose to 15% (IMF 2000—Country Report p.10), leading to the exodus of nearly 2.5% of the population to the US and Spain in search of better opportunities (Jacomé 2004:5, note 4). While the public suffered, though, billions continued to be funneled to the banks. As Cazar and Ospina (2003) note: “The banks were bankrupt but not the bankers” (this author's translation). In fact, a number of bankers and their connected firms profited from the crisis, as troubled banks reprogrammed and contracted new debts at extremely favorable rates in anticipation of intervention by the AGD (Halac and Schmuckler 2003, Acosta 2006).

THE ECUADORAN MIDDLE CLASSES: FINANCIERS

A key aspect contributing both to the power of the domestic financial sector and the development of a broad-based coalition supportive of dollarization was the extent to which the Ecuadoran

²⁴ Joyce de Ginatta Higgins, interview by author, Guayaquil, Ecuador, October 4, 2010.

²⁵ It should be noted that, for the most part, large-scale depositors, who kept a large portion of their savings in offshore accounts legalized through the bank reform of 1994 were able to escape the effects of the deposit freeze thanks to the funds provided by the Central Bank. By the mid-1990s, the offshore sector was approximately 70% the size of the onshore sector (Halac and Schmuckler 2004). As Halac and Schmuckler (2004) demonstrate: “...the evidence suggests that withdrawals in the offshore system were financed by central bank liquidity. First, offshore banks lacked other liquidity sources to face the deposit run since external credit lines had dramatically dried up (falling from almost 2.5 billion dollars in August 1998 to near 1 billion dollars in December 1999). Second, as already mentioned, the Ecuadorian central bank was providing extensive liquidity assistance to onshore banks (2.3 billion dollars between August 1998 and December 1999), at the same time that onshore deposits were actually increasing. It is thus likely that onshore banks transferred central bank liquidity assistance to their offshore affiliates, allowing larger depositors to take their funds out of the system. This redirection of liquidity from onshore to offshore banks is reflected in the capital flight of near 730 million dollars between December 1998 and December 1999 (as reported by central bank of Ecuador), compared to a deposit fall of around 1.6 billion dollars in the offshore system during that period” (p.39)

public had become integrated into the financial sector as depositors and as debtors. By the 1990s, banks had entered into fierce competition with each other to attract liquidity. Many banks, particularly on the Coast, offered extremely high interest rates to depositors (Martinez 2006).

In the words of Vicuña:

“On the other hand, during the eighties and nineties, there was a relaxation in banking regulation and financial laws in general. In addition, interest rates were considered downwardly inflexible due to a lack of competition in the financial sector, for which reason banks and financial institutions were permitted to open indiscriminately, without taking into account the size of the market and the operating costs. As a consequence, there existed more than 100 banking entities in a market that did not surpass the five million dollars in deposits. The established ‘rivalry,’ instead of lowering interest rates it increased them, since banks and other financial entities tried to take in deposits through elevated rates.

“Unfortunately, the authorities did little to watch the use of the received funds, for which many financial institutions engaged in not very orthodox practices, such as pyramidization, financing their other businesses, generating loans to family members and associates and investing in offshore offices²⁶” (as quoted in Naranjo Chiriboga 007:145).

With nominal interest rates as high as 60-70%, the Ecuadoran middle and upper classes were encouraged to shift their money out of productive activities and into bank accounts that produced more profitable rates of return (Naranjo Chiriboga 2007, Ginatta Higgins). The middle class, in essence became a rentier class.

As Raúl Mendizíbal, former President of the Chamber of Small Industry of Pichincha remembers:

“... at the time there was no more lucrative business than to deposit money in the bank and obtain returns from the interest produced by the capital. It got up to

²⁶ Leonardo Vicuña. Política Económica del Ecuador. Dos décadas perdidas. Los años 80 – 90, ESPOL, Guayaquil, mayo, 2000

140%.... So, a lot of people sold their properties, some sold their industries, and dedicated themselves to speculation, to speculate on interest rates.”²⁷

However, it was not only business owners who turned to interest rates as their primary source of income, rather, large sections of pensioners and former government workers who had been laid off invested their retirement income and their severance packages in profitable coastal banks.

According to General Paco Moncayo:

“Quito was the capital and with the neoliberal wave they began to buy resignations (buy-outs) in keeping with the Washington Consensus to shrink the state.... So here, the people who sold their resignations put the money in the banks and, of course, they were happy because they were earning interest of 80, 90 percent” (Moncayo interview).

Meanwhile, those with dollarized or UVC (inflation indexed) debt but sucre income were hit doubly hard, as their debt ballooned with the plunge in value of the sucre. As discussed above, levels of dollarized debt increased dramatically during the 1990s with the elimination of capital controls. Unlike the past, dollarization was endogenous: as dollar deposits flowed into Ecuadoran banks, these banks sought to cover their liabilities by extending dollar credits. By the end of March 1999, 67% of the onshore credit portfolio was dollar denominated but less than 25% of borrowers had dollar-denominated income (IMF Country Report 2000: 25). Over a short period, Ecuadorans with dollar and UVC denominated debt saw their obligations increase 400% to 500 percent. At the same time, banks that contracted out dollar loans saw rates of non-performance and foreclosed assets increase from 4% to nearly 50% of their total dollar loans, which, in turn, further undermined equity (Jacomé 2004: 34).

“People saved in dollars. So, then, obviously, the bankers made loans in dollars from what they received in dollar deposits. They had dollar deposits so they made loans in dollars. So, for many years there had been matching so it wasn’t a problem. But then, the curves changed a lot in the last two years [prior to

²⁷ Raul Mandizobal, interview by author, Quito, Ecuador, October 13, 2010.

dollarization]; those years were very complicated. And, of course, many people were indebted in dollars and those people, with the devaluation, could not pay their debts.” (Pablo Lucio Paredes Interview)

“The middle class was being pulverized. Not only by the deposit freeze but also by their own situation of instability and uncertainty. A prestigious doctor, with seven children, decides to build his home...He could pay one thousand dollars, the equivalent of six million sucres. Suddenly the dollar began to rise, rise, and rise until the one thousand dollars was equal to 25 million sucres. The doctor increased his work hours, tried all of the legal means to increase his income, but his clients could not pay more because they were sucretized and he could not increase the consultation price. So, his costs increased and his income decreased” (Ginatta Higgins: 23, this author’s translation).

Such stories were common across the middle class, even among the military. General Paco Moncayo describes how soldiers whose home and car loans were often contracted in UVCs suffered with each slide of the sucre:

“The military was in a complex situation as well because there was already a hard currency, [the UVC]. So, it affected many who were indebted because when they contracted the debt, what the Security Department paid them, it was 20% of their salary, then it was 30% of their salary, then it was 40%, then it was 50% of their salary. But after dollarization came they benefitted because there was no longer that unit of account and so they liquidated the debts that they had” (Paco Moncayo Interview).

In this sense, the financial sector reconfigured economic relations within Ecuador and with the rest of the world, shifting the middle and upper class’ interests away from the export sector, which depended upon devaluation, and into greater alignment with the financial sector, which required a stable currency. Of course, this alignment was also filled with contradictions. On the one hand, the middle and upper classes had an interest in saving the banks that held their savings and provided income flows. On the other hand, these same groups suffered tremendously due to the ensuing high rates of inflation and the deposit freeze. As Raúl Mendizíbal recalls of friends and colleagues at the time:

“It was terrible for those indebted in dollars. They lost their possibilities, their futures. Along with them were those who deposited money in the banks. The banking holiday wiped them out.... Some committed suicide, others lost their mind. Many were in crisis...” (Raúl Mendizíbal Interview).

What these groups, particularly those with dollarized and UVC debts, did have in common with the financial sector (and the import sector), was a strong interest in Ecuador’s adoption of a hard currency, such as the dollar, that would end the hemorrhaging of both their personal finances and help stabilize the many banks that had contracted both dollar-denominated debt and dollar and UVC-denominated loans.

Considering Dollarization, Convertibility and Other Options

As 1999 progressed, the economy continued to spiral out of control, made worse by rapidly increasing levels of unofficial dollarization, which stunted the State’s ability to get ahead of the crisis²⁸ (Beckerman 2001, Jacomé 2004). In addition, a number of banks took advantage of the State’s support structures to speculate on the sucre, which had slid to nearly 20,000 per dollar. With a deposit freeze still in effect, many businesses were unable to function and were forced to close their doors. Those that were able to remain open began pricing their goods in dollars and, in a number of cases, would only accept dollars as payment. Conditions for the poor were worsened by IMF-supported austerity measures that increased the prices of basic goods, such as cooking gas. As a result, indigenous groups, unions, and other social movement groups staged regular mass protests. On several occasions indigenous groups, whose members were hardest hit by the economic crisis and austerity measures shut down the country’s major highways. On the Coast, the crisis had reignited regional tensions, of which Guayaquil-based bankers, such as

²⁸ For a more detailed discussion of the ways in which unofficial dollarization interfered with Ecuador’s ability to stabilize the crisis, see Beckerman 2001.

Fernando Aspiazu, took advantage to make the case for additional support from the Central Government.

With the country plunged into crisis, the Mahuad government sought new ways to decisively exit the crisis. Mahuad's popularity had fallen as steeply as the sucre, a situation made worse by later allegations by Aspiazu that he had secretly contributed \$3.1 million to Mahuad's electoral campaign. Given Ecuador's recent history of military dictatorship and the removal of one President (Bucaram) just two years' prior, the threat of a coup was palpable. For this reason, a consensus has emerged within Ecuador and the literature, that the Mahuad government's decision to dollarize was a last minute desperate act to remain in power. In fact, with the exception of those who participated in the Mahuad government, all of those interviewed for this project agreed that dollarization was Mahuad's final attempt to hold on to power.

However, just because the Mahuad administration was desperate, given the desperate situation, does not mean that the decision was unstudied or that it did not represent the preferences of certain powerful groups over others. To the contrary, one of the reasons that dollarization was successful in passing through congress and calming the economic situation is because it had the support of a range of groups that had been discussing, analyzing, and advocating for the measure for several years, going back to former President Bucaram's proposal to implement convertibility in early 1997.

“But it's not like this happened quickly. The economic advisors had been talking about this along with some of the representatives from Mr. Mahuad's the government--Christian Social [PSC] and Popular Democracy [DP] government--which represented the interests of powerful economic groups. So, they had been talking about it. There had been propaganda. They brought people to make exhortations to the congress about the conveniences and the advantages of dollarization. So it was nothing improvised. But when the *total* crisis came, well they took advantage of the moment to dollarize.” (Paco Moncayo Interview)

“Convertibility had been studied going back five years in Ecuador, since the Bucaram government. It was not implemented at the time because there were not enough dollars in the monetary reserve to back the exchange rate of that time—to back up the local money in circulation. That is why it was not done four or five years ago. But in the last six months, it was being analyzed with the participation of international academics from various foreign universities. They were analyzing the alternative of dollarizing the economy.” (Alfredo Arizaga Interview)

And, similar to Bucaram’s tenure, the financial sector was broadly supportive of the measure.

While dollarization’s most vocal supporters were economists and business leaders from the Coast, the Quito-based banking sector also supported the measure, although, less publicly. As a key representative from the Banana Export Association (AEBE) recalled, due to Ecuador’s traditional regional divisions, the Quiteño banking sector thought it best to provide quiet support.

According to Ecuadoran economist, Franklin Lopez, dollarization was not an “imposition” on its citizens but “a culmination of intellectual ferment from below” (Lopez 2002). Lopez, as part of the Institute of Ecuadoran Political Economy (IEEP in Spanish), together with Joyce de Ginatta, President of the Guayaquil Small Business Chamber, mobilized likeminded intellectuals and business leaders, through the Foro Economico, to press for dollarization in the years leading up to and during the country’s financial crisis. Many of these supporters viewed dollarization not just as means to stopping devaluation and reducing inflation but also as a way of forcing the country to commit to controversial structural changes (i.e. debt-reduction, labor flexibility, privatization and increased free trade). Between December 1998 and September 1999, Ginatta, as the face of the Foro Económico and the Guayaquil Small Business Chamber, organized six conferences and debates on dollarization, featuring well-known national economists, ex-government officials and private sector leaders as well as international experts. Ginatta’s strategy was to first convince prestigious personalities in the national milieu of the advantages of dollarization, then the public and, lastly, policy makers (Interview with Ginatta). Between March

1999 and January 10, 2000, at least 78 articles on dollarization appeared in the mainstream printed press.

Originally, Lopez and Ginatta supported the Bucaram convertibility proposal. However, they became concerned that even strict convertibility would not be enough in a country with a history of corruption, like Ecuador. By 1998, the idea of dollarization as a policy alternative began stirring among several Latin American and US intellectuals. In May 1998, the economist and currency board expert, Kurt Schuler, wrote an article, at the prodding of Dora Ampuero, the founder and President of the IEEP, about dollarization and orthodox currency boards as alternatives to Central Banking for Ecuador. Ampuero translated the article and it was published in the Ecuadorian press (Schuler 2011). It was around this time that Ginatta began collaboration with Lopez on a national economic plan rooted in dollarization to be released later that Fall (Ginatta). While many analysts rejected the proposal to surrender the country's national currency as absurd, the idea gained popularity among intellectuals, particularly those based in the historically free-market city of Guayaquil. Many of these supporters viewed dollarization not just as means to stopping devaluation and reducing inflation but also as a way of forcing the country to commit to controversial structural changes (i.e. debt-reduction, labor flexibility, privatization and increased free trade).

Later that year, Ginatta formed the Foro Económico along with Ampuero, Lopez and 14 other economists and private sector leaders from Guayaquil and Quito. The Foro's purpose was to promote dollarization on a national level. (Ginatta 2010). Ginatta, herself, took every opportunity presented to her to talk about dollarization's advantages. Between December 1998 and September 1999, Ginatta, as the face of the Foro Económico and the Guayaquil Small Business Chamber, organized six conferences and debates on dollarization, featuring well-known

national economists, ex-government officials and private sector leaders as well as international experts. Ginatta's strategy was to first convince prestigious personalities in the national milieu of the advantages of dollarization, then the public and, lastly, policy makers (Ginatta 2010).

In late 1998, when the economic crisis was coming to a head in Ecuador, policy debates focused on convertibility. Between October 1999 and March 1999, articles in the mainstream printed press (Diario Hoy, El Universo, El Telégrafo, El Comercio) on convertibility outpaced those on dollarization by nearly two-to-one; most of the dollarization articles that did appear during that time were negative. However, around March 1999, the tide began to turn. It was around this time that the IEEP brought the Venezuelan economist and dollarization proponent, José Cordeiro, to tour Ecuador. While in Ecuador, Cordeiro met with politicians, including ex-President Osvaldo Hurtado, and members of the private sector (El Comercio 1999). The visit generated interest among leaders but, most of all, it generated press about dollarization. Between March 1999 and January 10, 2000, at least 78 articles on dollarization appeared in the mainstream printed press compared to just 19 on convertibility during that same period. Dollarization was now firmly on the policy agenda.

Ginatta and Members of the Foro Económico continued to organize events, give interviews and write articles. In June 1999, Ginatta and Lopez collaborated once more to release a revised economic plan built around dollarization. The release of the plan coincided with the release of Lopez' book *Por Qué y Cómo Dolarizar* (Why and How to Dollarize) in August, with a prologue by Ginatta. The book sketched out the arguments for dollarization and the steps the country might take to implement it. Meanwhile, outside of the public eye, in Spain, an economist from the Ecuadoran Central Bank, Marco Naranjo, was developing a concrete plan to dollarize Ecuador as part of his doctoral thesis. The dissertation became the blue print for dollarization in

Ecuador. While Naranjo was not connected to the Foro Económico, he was certainly aware of their work and the dollarization debates going on throughout Latin America and his own country. In his book, *Dolarización Oficial y Regímenes Monetarios* en el Ecuador, based on his dissertation, he cites Lopez extensively in his theoretical arguments in favor of dollarization. Now there was a plan to which the Ecuadoran government could turn to implement dollarization.

Within the government, dollarization was also being discussed. According to former members of the Mahuad government and the Central Bank, the administration had begun analyzing the possibility of dollarization at least six months before Mahuad's announcement in January 2000 a fact they say was kept quiet by the government to avoid further speculation on the sucre (interviews with Alfredo Arizaga, Juan Falconi Puig, Marco Naranjo Chiriboga). There was disagreement within the government and the Central Bank as to dollarization's preferability, with Minister of Production, Juan Falconí Puig, and Superintendent of Banks, Jorge Guzman, its main supporters within the administration and Central Bank President, Pablo Better, its main opponent (Juan Falconí Puig interview).

According to Arizaga, the Minister of Finance at the time dollarization was announced, the administration was considering two extreme yet opposite policy alternatives: 1) imposition of capital controls and State takeover of the banking sector and 2) full dollarization.

“...we were left with only two options: the first was for the State to take over the banks and put in place capital controls and the other was to accept this high rate of de facto dollarization that had already occurred and to fit the legislation to that reality. Much of the prices in Ecuador were already being set in dollars. Around 50% of bank loans were in dollars and 75% of bank deposits were also denominated in dollars, so that was a reality. The first option of a State-takeover of the banking sector and capital controls was evaluated and we saw that the State did not have the capacity to administer this large number of financial institutions and the experience of Mexico and other countries that had gone down that route was disastrous. In the end, the fiscal cost was very high. And for that reason we decided to go for dollarization.” (Alfredo Arizaga Interview)

However, there were other complications besides cost (which had certainly not stopped the administration from bailing out the financial sector in the first place) for the Mahuad administration in adopting such a plan, which is that this plan could not guarantee support from a wide enough coalition. The government could have counted on the support of the export sector, which vehemently opposed dollarization²⁹ and sought a solution that would maintain the government's ability to devalue, and what was left of domestic producers who sought protection from the import sector. However, this approach would have alienated certain powerful sectors, such as the import sector (particularly the car import sector) and what remained of the financial sector, whose leaders still maintained control over significant portions of the media and other critical industries.

On the other hand, dollarization was supported by the financial and import sectors³⁰ (Interviews with AEBE, RC, IP, MN, etc.), which would benefit from an overvalued exchange rate, monetary stability, lower-interest rates, and, potentially, increased access to international capital. These groups were also connected to certain powerful domestic producers of consumption goods. For example, the PROINCO group (Wright Group), owned Ecuador's largest supermarket chain, which had a large stake in the financial sector through its stake in the consumer credit industry, from which its supermarkets also benefited. Beyond the business sectors, dollarization would also provide relief to those with dollar and UVC denominated debt but sucre-denominated income; this last group included businesses but also the middle class at large.

²⁹ Interviews with leaders of the Ecuadoran export sector confirmed that exporters were terrified by the dollarization proposal, many of whom considered that that dollarization would destroy their business. In the words of one exporter, "Our first thought was, 'We're screwed!'"

³⁰ For a more detailed look at some of the top economic groups at the time of dollarization see Table 8.

The discretionary actions of the Mahuad government and the associated corruption scandal strengthened the argument of those favoring dollarization: clearly one could not trust Ecuadoran politicians to maintain the best interest of the public in the face of powerful interests. As was the case with Bucaram, it was argued that even a monetary regime as restrictive as convertibility could be not be trusted as long as there was any room for discretion. More and more the business leaders, columnists and government officials began to call for dollarization; the Foro Económico went so far as to take out a full page ad on the matter. And now, with Naranjo's dissertation a roadmap, the administration could swiftly put the plan into practice. Not so suddenly, Mahuad had a quick fix.

Unlike the Bucaram plan for convertibility, the export sector was not strong enough to topple a plan for dollarization in the face of more widespread support, especially given its own weakness resulting from the destruction of El Niño and the financial crisis, itself. However, another component of the dollarization plan proposed by Mahaud helped to cushion the blow: the conversion rate set for dollarization included one last maxi-devaluation to 25,000 sucres to the dollar. While the conversion rate was set for technical reasons (this rate ensured that the Central Bank would have enough dollars to buy back all of the sucres in circulation) not political ones, this final devaluation did ensure that the export sector would enjoy a competitive advantage in the global market for at least the next two years, making the move more politically feasible.

On January 9, 2000, President Mahuad announced that he planned to legally replace the sucre with the US dollar at a rate of 25,000 sucres to one US dollar, nearly four and half times its value when the crisis began in August 1998 (Banco Central de Ecuador Boletín Estadística Mensual Septiembre 1998). The announcement quickly calmed large swathes of the population, particularly the middle class, who had seen their savings disappear and real incomes shrink to

unsustainable levels. However, less than two weeks later, a group of mid-ranking military officers, led by Colonel Lucio Gutierrez, joined with the highly mobilized indigenous group CONAIE to remove Mahuad from power and install a triumvirate, consisting of Gutierrez, Antonio Vargas from CONAIE, and Carlos Solarzano, politician and former Supreme Court judge. The triumvirate, which had claimed power lasted just three hours before the military removed its backing, although the Armed Forces withdrew its protection of President Mahuad. As these events unfolded, Vice President Gustavo Noboa was being flown out from Guayaquil to Quito by the Armed Forces and was sworn in before congress and the Armed Forces as Mahuad's successor (Paz y Miño 2005). Despite the change in leadership, the policy path remained the same: Noboa quickly announced his intention to maintain dollarization and Congress passed the dollarization legislation as planned.

As we know, the story of dollarization did not end at its announcement. The Economic Transformation Law passed in March 2000 that legalized dollarization also put into effect a wide range policies to support the new monetary regime, including an interest rate ceiling of 1.5 times the banking system's weighted average lending rate meant to reduce the contraction of risky loans at high interest rates but which some claimed was a measure aimed at discouraging new entry into the sector and could have been better accomplished through regulatory supervision (Beckerman and Cortes-Douglas 2002). The law also included reforms to public finances and financial regulatory agencies as well as measures to increase labor flexibility and to privatize the areas of telecommunications, electricity, and hydrocarbons. A follow-up transformation law adopted in September 2000 put into place even more far-reaching structural reforms shrink the State and increase private sector participation.

V. CONCLUSION

The story of dollarization in Ecuador is the story of financial globalization. Depending on whom you talk to it is a story of financial globalization gone right or gone amok. The Ecuadoran economy, and particularly the financial sector, mirrored the growth of finance globally. As Eurodollars flooded the globe in search of profit during the latter part of the 1970s, unfettered by the limitations of the gold standard or capital constraints placed on them by the US government, they filled the coffers of the Ecuadoran banking sector. Ecuador's financial sector would have never grown in power to the extent that it did without financial globalization, led by the US and Europe, and imported through global organizations like the IMF, World Bank, IDB and WTO. Ecuador's banking sector exploded in the 1970s, fed by the low hanging fruit of the "petrodollar" frenzy. During the 1980s and 1990s, it followed the advice of the IFIs and a new emerging global consensus that put financial depth, through the contradictory strategies of financial stability and financial liberalization, at the center of an economic model that was supposed to develop the export sector by putting into place structural reforms that nursed back a banking sector injured by the Latin American debt crisis.

The 1990s saw consolidation of the financial model for Ecuador for a domestic financial sector that had grown in power under the tutelage of the Ecuadoran government combined with a complex of academics committed to financial globalization. This group put into place far-reaching laws that, at least momentarily, placed the financial sector at the pinnacle of the Ecuadoran power pyramid, replacing the historically dominant export-sector. Policies put in place to encourage the free flow of capital across borders resulted in the Ecuadoran public amassing US dollars during the 1990s. These policies helped lead to the ascension of Ecuador's financial sector, which would come to dominate the Ecuadoran economy and politics during the 1990s. Ecuador's financial sector became one of the largest and most profitable industries in the country, displacing agro-export.

Perhaps even more importantly, banks and other financial institutions became the lynchpin for economic power groups that used finance as a platform to expand into and form alliances with other

profitable sectors, including media outlets and the importation and distribution of consumer goods. The middle and upper classes contracted loans for business, homes, cars, and household appliances in US dollars. Unlike the 1980s, these loans were funded not by money borrowed from foreign banks but by the population's own dollar deposits. As savings and checking accounts in US dollars grew, so too did the need of banks to cover those dollar-based liabilities with dollar-based assets. To a heightened degree, Ecuadoran citizens and businesses, even those that produced and sold locally, were tied to the global financial markets. The disaster that ensued and led to dollarization was the direct result of this shift towards financialization.

Financial globalization helped destabilize Ecuador's fragile economy. With no capital controls and the legalization of foreign money deposits and offshore banking, dollars flowed into Ecuadoran banks. Banks looking to cover their dollar liabilities increased their dollar denominated loans, even to those who did not have dollar income. The integration of offshore banking allowed the financial sector to engage in systematic fraud and high risk connected lending, as banks shifted money through an intricate maze of shell companies. With banks pushing lower-interest dollar-denominated loans to cover liabilities and offering high-interest rates on deposits to attract liquidity, the interests of Ecuador's middle and upper class became entrenched in these global financial flows. The gravitational pull of the financial sector shifted the orbit of Ecuador's economy away from export.

Yet, as the case of Ecuador demonstrates, although the conditions for dollarization were set in motion by financial globalization, they interacted with national political conditions to ultimately give rise to dollarization. Factors, such as political instability and continual economic crises caused by border wars and natural disaster, contributed to the circumstances that unfolded at the end of the century. But more important for the fate of dollarization was the role of Ecuador's local financial sector. As the financial sector grew and sought greater financial liberalization, its need for monetary stability began to directly contradict the historically hegemonic export sector-supported policies of exchange-rate devaluation and inflation. Aligned with the import sector, which also had an interest in a stable exchange rate and

conditions to support consumer financing, the financial sector began its public bid to end the years of expansionary monetary policy with President Bucaram's proposal for convertibility. However, Bucaram, whose power was rooted in regionally-based clientelism, could not unite the rival Coastal and Sierra-based banks in the face of opposition from the export sector. Despite overall support for such a policy from the financial sector, Bucaram's extreme cronyism and populist rhetoric inspired more fear than trust by those not in his inner-circle and he was promptly dismissed from office.

In 1998, however, the financial sector did unite around former Quito-mayor and bank executive, Jamil Mahuad. The Mahuad government was completely captured by Ecuador's financial sector. A combination of economic power, personal and political connections, and exploitation of regional divisions helped powerful factions within the financial sector to extract their preferred policies. Unfortunately, for the Ecuadoran public, these policies only deepened the unfolding economic crisis. After a year and half of disastrous policies aggravated by increasing levels of dollarization and a revolving door of top government officials, the time came for a drastic solution, the features of which were greatly influenced by the power and interests of the local financial sector. Despite the devastating effects of the crisis on a number of financial institutions, the sector still wielded tremendous power through its connections to other key industries, politicians and, especially, the national media. Perhaps, most importantly, though, was the way in which growth of the local financial sector within the context of increasing financial globalization impacted the very structure of the Ecuadoran economy, altering business and the public interest. In an economy no longer driven by private sector export, it was politically more viable for the Mahuad administration to organize a pro-dollarization coalition, which would benefit not just the financial sector but also the import and retail sectors—sectors largely connected to the financial sector through co-ownership and strategic alliances—and would stop the hemorrhaging of the dollar and UVC-debt burdened middle class.

Ironically, dollarization did not save Jamil Mahuad from falling in a coup d'état orchestrated by a group of junior military officers in alliance with Ecuador's embattled indigenous movement just days

after announcing the dollarization plan. However, the fact that the coup government quickly fell apart and power was passed on to Mahuad's Vice President, Gustavo Noboa, who pledged to continue with dollarization, is a testament to the power of the pro-dollarization coalition. Despite opposition to dollarization by the export and popular sectors, these groups did not have the political or economic strength necessary to break the power of the financial sector, even in the midst of the worst financial crisis in Ecuadoran history.

TABLES³¹

TABLE 1. Total Credit From Private Banking Sector (Millions)			
Year	TOTAL CREDIT Constant 2010 Sucres	TOTAL CREDIT Constant 2010 Dollars (\$25,000/\$1)	Change in TOTAL Credit
1986	\$92,737,891.35	\$3,709.52	
1987	\$90,793,046.48	\$3,631.72	-2.10%
1988	\$56,319,469.18	\$2,252.78	- 38.00%
1989	\$49,856,892.11	\$1,994.28	- 11.50%
1990	\$48,330,327.09	\$1,933.21	-3.10%
1991	\$56,914,145.90	\$2,276.57	17.80%
1992	\$57,268,414.49	\$2,290.74	0.60%
1993	\$81,788,811.39	\$3,271.55	42.80%
1994	\$122,252,500.82	\$4,890.10	49.50%
1995	\$156,407,035.16	\$6,256.28	27.90%
1996	\$155,517,760.58	\$6,220.71	-0.60%
1997	\$178,049,326.38	\$7,121.97	14.50%
1998	\$170,100,931.45	\$6,804.04	-4.50%
1999	\$162,019,117.77	\$6,480.76	-4.80%

³¹ Calculations for tables based on data from the Banco Central del Ecuador (www.bce.fin.ec).

Table 2. Total Unsecured Debt From Private Banking Sector to Firms (millions)

Year	TOTAL CREDIT Constant 2010 Suces	Change in TOTAL Credit
1986	\$53,429,313.39	
1987	\$57,824,952.62	8.20%
1988	\$37,554,274.74	-35.10%
1989	\$37,571,598.74	0.00%
1990	\$36,400,601.72	-3.10%
1991	\$39,383,957.08	8.20%
1992	\$43,686,934.49	10.90%
1993	\$61,768,740.78	41.40%
1994	\$68,751,740.86	11.30%
1995	\$78,341,682.99	13.90%
1996	\$84,792,705.33	8.20%
1997	\$96,940,359.46	14.30%
1998	\$87,431,681.29	-9.80%
1999	\$84,969,309.46	-2.80%

Table 3. Total Credit From Private Banking Sector Home Loans (millions)

Year	TOTAL CREDIT Constant 2010 Suces	Change in TOTAL Credit
1986	\$9,543,231.25	
1987	\$8,590,030.02	-10.00%
1988	\$5,671,254.12	-34.00%
1989	\$4,529,013.30	-20.10%
1990	\$3,802,800.62	-16.00%
1991	\$5,727,379.61	50.60%
1992	\$5,029,958.84	-12.20%
1993	\$6,744,149.58	34.10%
1994	\$13,030,272.09	93.20%
1995	\$23,893,186.69	83.40%
1996	\$27,260,173.64	14.10%
1997	\$33,668,002.16	23.50%

1998	\$37,416,408.78	11.10%
1999	\$48,992,325.89	30.90%

TOTAL		Savings Deposits		Time Deposits (4)			
National Money		Foreign Money		National Money		Foreign Money	
	a=c+e	b=d+f	C	D	E	f	
1988 Dec.	\$37,242,116.16	\$104,500.72	\$19,260,378.56		\$17,981,737.60	\$104,500.72	
1989 Dec.	\$37,219,594.86	\$44,036.78	\$18,928,168.82		\$18,291,426.04	\$44,036.78	
1990 Dec.	\$45,438,127.30	\$29,451.48	\$20,888,541.07		\$24,549,586.23	\$29,451.48	
1991 Dec.	\$49,542,446.23	\$166,182.90	\$23,063,623.21		\$26,478,823.02	\$166,182.90	
1992 Dec.	\$50,325,945.42	\$1,518,971.86	\$25,041,600.31		\$25,284,345.12	\$1,518,971.86	
1993 Dec.	\$56,918,104.65	\$3,516,300.18	\$31,212,255.14	\$86,114.91	\$25,705,849.51	\$3,430,185.27	
1994 Dec.	\$73,883,654.82	\$7,693,618.61	\$27,386,545.55	\$835,422.48	\$46,497,109.26	\$6,858,196.13	
1995 Dec.	\$77,557,669.62	\$19,126,789.47	\$28,386,857.87	\$4,206,095.60	\$49,170,811.75	\$14,920,693.87	
1996 Dec.	\$92,871,738.60	\$30,097,902.38	\$32,169,634.42	\$6,342,228.71	\$60,702,104.18	\$23,755,673.67	
1997 Dec.	\$84,405,329.33	\$53,971,954.79	\$33,095,738.53	\$14,473,128.85	\$51,309,590.80	\$39,498,825.94	
1998 Dec.	\$71,534,254.06	\$47,761,903.43	\$22,690,202.51	\$16,080,378.55	\$48,844,051.55	\$31,681,530.60	
1999 Dec.	\$56,065,588.08	\$71,277,437.50	\$14,575,057.28	\$18,086,987.54	\$41,490,530.80	\$53,190,446.40	

Year	TOTAL QUASI-Money	National Money 2010 US\$ Mill	Foreign Money 2010 US\$ Mill	% Foreign Exchange Quasi-Money	% Foreign Exchange Quasi-Money
1986	\$1,991.67	\$1,850.45	\$141.21	7.10%	
1987	\$2,248.62	\$2,099.50	\$149.12	6.60%	5.60%
1988	\$1,711.24	\$1,570.62	\$140.62	8.20%	-5.70%
1989	\$1,718.05	\$1,550.11	\$167.94	9.80%	19.40%
1990	\$2,024.42	\$1,872.37	\$152.04	7.50%	-9.50%
1991	\$2,291.90	\$2,118.84	\$173.06	7.60%	13.80%

1992	\$2,384.22	\$2,125.44	\$258.78	10.90%	49.50%
1993	\$2,824.86	\$2,469.62	\$355.24	12.60%	37.30%
1994	\$3,843.70	\$3,241.19	\$602.51	15.70%	69.60%
1995	\$4,888.35	\$3,705.07	\$1,183.28	24.20%	96.40%
1996	\$5,754.35	\$4,142.21	\$1,612.14	28.00%	36.20%
1997	\$6,029.09	\$3,803.75	\$2,225.34	36.90%	38.00%
1998	\$6,110.02	\$3,436.95	\$2,673.07	43.70%	20.10%
1999	\$6,785.50	\$2,761.42	\$4,024.08	59.30%	50.50%

Table 6. Private Credit in Foreign Currency (FX) (Millions of 2010 Sucres/2010 dollars)

Year	Constant 2010 Sucres	Constant 2010 US\$	% Change in FX credit	% Private Credit in FX
1988	\$1,007,386.95	\$40.30		1.80%
1989	\$931,353.67	\$37.25	-7.50%	1.90%
1990	\$803,216.22	\$32.13	-13.80%	1.60%
1991	\$1,745,550.43	\$69.82	117.30%	3.00%
1992	\$4,067,765.27	\$162.71	133.00%	6.80%
1993	\$11,258,773.98	\$450.35	176.80%	13.40%
1994	\$25,502,852.74	\$1,020.11	126.50%	20.30%
1995	\$45,176,080.17	\$1,807.04	77.10%	28.30%
1996	\$52,098,793.77	\$2,083.95	15.30%	32.80%
1997	\$82,832,444.24	\$3,313.30	59.00%	45.10%
1998	\$100,180,496.87	\$4,007.22	20.90%	58.90%
1999	\$138,717,240.10	\$5,548.69	38.50%	85.60%

Table 7. Private Debt Instrument Emissions in Foreign Currency (FX)

Year	Constant 2010 Sucres (mill)	Constant 2010 US\$ (mill)	% Change in FX Emissions	% of Emissions in FX
1990 (2)				0%
1991				0%
1992				0%
1993	\$90,400.99	\$3.62		3.30%
1994	\$184,955.85	\$7.40	105%	5.80%
1995	\$2,970,354.52	\$118.81	1506%	32.20%

1996	\$10,615,916.18	\$424.64	257%	56.30%
1997	\$12,192,415.98	\$487.70	15%	57.50%
1998	\$9,635,089.06	\$385.40	-21%	77.00%
1999	\$9,296,251.49	\$371.85	-4%	91.10%

Ch.3: El Salvador

I. INTRODUCTION:

On November 22, 2000, El Salvador's President Francisco "Paco" Flores stunned his country by announcing that he was putting forth a bill to implement dollarization in January 2001. With almost no discussion at all surrounding the bill, the measure passed just a few weeks later with a simple majority--not enough to alter the country's currency, which would require a super majority of two consecutive Legislative Assemblies. Given the dubious name of "Law of Monetary Integration" (LIM, by its Spanish acronym), the Flores Administration claimed that the measure did not require constitutional change, as it did not alter the national currency but simply introduced the dollar alongside the colón, the constitutional currency, a proposition belied by the content of the law: it removed the Central Reserve Banks' power to print new bills and mandated that banks retire colones from circulation and that all contracts and bank accounts be converted to US dollars. By the end of 2001, 50% of the currency in circulation was in US dollars (Reyes 2001). Despite large inflows of remittance in dollars, Salvadorans had not used the foreign money in any significant way. Unlike other countries, where the dollar often serves as a parallel currency, Salvadorans had preferred the colón. Therefore, forced substitution measures were necessary to achieve complete dollarization. Today, no colones are in circulation.

Aside from the hasty timeline, people were also surprised by El Salvador's drastic move because, unlike Ecuador, which had dollarized less than a year earlier, El Salvador was not in acute financial crisis. In fact, despite El Salvador's high levels of poverty, it had one of the most stable economies in the region, boasting just 5% inflation over the span of the previous decade. Similarly, while interest rates were higher than those available in the United States, they were not exorbitant for the region and remained lower than its neighbors (Schmitt and Stanley 2001).

Dollarization was not a new proposal for El Salvador; it originated as a proposal almost five years prior to its implementation, the brainchild of economist and Treasury Minister, Manuel Enrique Hinds. At the time, it was roundly rejected but five years later, it enjoyed the support of key sectors, particularly the financial sector. The question is then, given its financial stability—the cause célèbre for dollarization advocates--why did El Salvador implement official dollarization?

This chapter asserts that dollarization in El Salvador represents the economic and political dominance of a globalizing local financial sector that saw dollarization as a key component to continuing its outward expansion. El Salvador's financial sector used its close political ties to the ruling ARENA party to implement its preferred policies and veto those it found unacceptable to its interests. Despite opposing an initial attempt at dollarization in 1995, by 1999 the financial sector saw dollarization as a strategy to not only further its immediate economic interests but as a means of maintaining its sectoral dominance in the face of political threats emanating from both the Left and elements within the ARENA party, itself, that remained tied to the country's deteriorating agro export sector.

Section II of this chapter traces the evolution of El Salvador's economy during the 1980s and 1990s, from one based in a semi-capitalist agro-export model to one based in global finance and commerce. This rapid shift occurred, in part, due to circumstances associated with the country's 12-year civil war (1980-1992) and, in part, due to the heavy influence of the ideology of finance, which pervaded US AID, El Salvador's greatest source of aid. Part III looks at El Salvador's first attempt at dollarization in 1995 when President Calderón Sol's administration, guided by a group of finance-oriented economists, proposed dollarization as the central component of the country's new economic plan. The proposal, though, was short lived due to

tough opposition from both the export and the financial sectors. But just five years later, President Francisco Flores would swiftly succeed where Calderón Sol failed. Part IV describes how Flores secretly crafted and garnered support for dollarization. In particular, this section demonstrates the critical role of financial sector support for the measure in moving forward: without financial sector approval, there would be no dollarization. However, unlike the previous attempt, this time the financial sector gave its blessing, as financial groups came to see dollarization as a means of not only furthering their incipient regional expansion but also as a way of securing a finance-led economic model in light of threats from both the Left and the Right.

II. EL SALVADOR'S TRANSITION: FROM COFFEE TO FINANCE

Since the beginning of its civil war in 1980, El Salvador has undergone tumultuous changes that have transformed the basis of its economy from a traditional agro export model to one dominated by the financial sector (Schmitt and Stanley 2001, Segovia 2002, Lemus 2000, Vidal 2009). El Salvador's main exports are finance capital, which its banks channel throughout the region, and labor in the form of documented and undocumented émigrés, the latter of which support El Salvador's booming import and financial sectors through the remittances they send home. To this end, El Salvador's post-war economy is based in circuits of global financial flows and accumulation that promoted the domination of an increasingly globalized local financial sector, which turned to dollarization as a means of projecting itself onto the global arena and insulating itself from potential attacks on the finance-led economic model.

To understand the transformation that led to financial sector hegemony, we must review the ways in which the Salvadoran Civil War (1980-1992) reshaped the Salvadoran economy and

its elite structure. Prior to the war, a tightly enmeshed agricultural elite, based in the export of coffee and other primary products, dominated the Salvadoran economy. Often referred to as “the fourteen families” (although, in reality there were closer to 30), this oligarchy utilized a pre-capitalist hacienda system to extract profit from the peasant population (Albiac 2007, Dalton 2000). Vast income inequalities and the regular use of brutal repression to keep the peasant labor force in line laid the basis for the ensuing 12-year civil war, led by the Leftist guerrilla army, the FMLN (*Frente Farabundo Martí para la Liberación Nacional*), that ended in 1992 with the Chapultepec Peace Accords.

During the war, a series of actions and circumstances converged to alter El Salvador’s economic structure. First, were a series of anti-insurgency measures encouraged by the US and carried out by the Salvadoran military-civilian junta, which included nationalization of the export of agricultural goods (growers had to sell their products to the State, which would then export the products), redistribution of approximately 20% of cultivatable land, and nationalization of the banking sector, which had been in the hands of the coffee oligarchy. The agricultural sector was also negatively impacted by the war itself. A significant portion of land owned by the oligarchy was in areas either in disputed territory or territory controlled by FMLN forces. While a few paid out protection money to actively cultivate their property in these areas, most left their lands fallow. The decision to reduce cultivation was reinforced by a dramatic decline in the international price of coffee during the latter part of the 1980s, which fell from around 73¢ per pound in 1985 to 34¢ in 1989. As a result, by 1989, agricultural employment had decreased 70% from its 1979 level and total coffee exports fell from \$675 million to just \$228 million (Asociación Equipo Maíz 2003-- PAE).

As capital shifted away from agriculture, so too did the composition of the elite. In addition to members of the traditional elite who diversified their investments, middle class businessmen and large portions of the Palestinian community in El Salvador--who were heavily invested in retail, services, and industry--climbed the ranks of economic and political power. As one business sector elite commented in 1992:

“The structure of capital has changed. The big capitalists have left agriculture, they’ve left the countryside broken up by the agrarian reform. There are still some in agro industry and exporting, in coffee mills and cotton gins. Medium capitalists have also changed their way of thinking and of investing quite a bit; they’re diversifying as they recapitalize the country. Now it’s the Arabs [a term referring to Salvadorans of Middle Eastern origins] who are the strong capitalists. They’ve little in land, but they have the assets in the biggest textile factories and in fast food—in MacDonald’s, Biggest, Mr. Donut, and Wendy’s” (as quoted in Woods 2001:874).

The ascension of this emergent group to power is most associated with the rise of the Right-wing ARENA party to the presidency in 1989. The victory of ARENA’s Alfredo Cristiani, whose fortunes were linked to insurance and pharmaceuticals, placed those connected to retail, services, and industry at the helm of the ARENA party and the country (Wood 2000, 2001; Robinson 2003; Albiac 2007).

The Cristiani government began to immediately implement neoliberal reforms, including privatizations, tariff reductions, and reduced support for the agricultural sector, which supported the emerging industrial and commercial sectors and ultimately gave rise to a hegemonic financial sector. According to Wood (2000, 2001), it was this change in the economic character of the elite that helped pave the way for an end to the country’s brutal civil war: elites tied to the industrial and commercial sectors came to see a negotiated peace as necessary for attracting foreign capital. Cristiani’s dogmatic implementation of neoliberal policies also minimized the need for the

outwardly coercive tactics previously required under the hacienda system in keeping down the costs of labor.

Neoliberalism, Emigration, and International Financial Flows

A key component to the Cristiani's agenda was public sector privatization. At the top of the list for privatization was the banking sector (Rivera Campos 2000), the process for which began as early as 1990. Bank privatization was promoted by USAID, the IFIs, and El Salvador's own neoliberal think tank, FUSADES (established with the support of USAID) (Robinson 2003). As Rivera Campos (2000:18) notes, the "urgent" nature of the bank privatization was centered in the economic ideology that placed financial liberalization at the center of economic development.

"A theoretical element frequently used at the time was to point to the importance of bank privatization to eliminate the financial repression to which the economy was subjected. This concept dates back to the seventies. MacKinnon (1972) argued that the growth of developing countries was limited by what he called financial repression.... The solution to this problem, then, lied in financial liberalization. This would bring with it the formation, by means of the market, of positive real interest rates with the resulting stimulation of savings. This theoretic principle was also the basis of the bank privatization proposal in the nineties."

Thus, within the first year of his presidency, Cristiani began the process of banking sector privatization. The first step taken was passage of the Foreign Currency Exchange Law in April 1990, which legalized and established regulations for private currency exchanges. Passage of the Currency Exchange law allowed private financial institutions to exploit the growing levels of US dollars entering the country in the form of family remittances. The law both encouraged the transmission of remittances and destroyed the black market for currency exchange that had developed (Segovia and Larde 2003). The next step was passage of the Law of Commercial Bank and Savings and Loan Reorganization and Fortification and the Law of Commercial Bank

and Savings and Loan Privatization, passed in December 1990, which set out the framework for bank privatization and which created the Fund for Financial Restructuring and Strengthening (FOSAFFI, by its acronym in Spanish) to rehabilitate the nationalized banks' poorly performing portfolios before selling them. FOSAFFI was allotted 1.4 billion colones (approximately \$175 million US dollars) through the emission of bonds by the Central Bank to clean up the accounts, although critics have charged that the process surpassed that sum (Vidal 2009).

Despite stipulations and rhetoric that the sales of bank shares would be targeted to bank employees and small investors, thereby democratizing finance, the banks quickly came to be controlled by a small number of powerful families³² (Vidal 2009, Rubio-Fabian, et al. 2000, Goitia interview³³). President Cristiani, himself, became one of the largest shareholders of one of El Salvador's largest banks, Banco Cuscatlán, through the privatization process during his presidential tenure. Bank privatization, completed in 1992, marked a decisive break in the composition of dominant groups (both economic and political) and the implementation of a new economic project anchored in global financial flows and dismantlement of the state.

While the Cristiani government originally implemented several policies to reinvigorate the agricultural sector, including the elimination of export tariffs (Aguilar 1996) and allowing the exchange rate to depreciate a little more than 60% (from 5 to 8.10 colones per dollar)³⁴, many other policies implemented by Cristiani, and later ARENA governments, had a deleterious effect on the agricultural sector. Cristiani slashed agricultural import tariffs from rates of 230% to as low as 20% (under the next ARENA presidential administration of Calderón Sol tariffs would

³² Some of these families came from the traditional coffee oligarchy, which had diversified its investments, such as Llach, Dueña Regalado, Escalante, Sol-Millet. Others, however, rose from families outside of the oligarchy, whose wealth was associated to a greater degree with commerce or industry, such as Simán, Meza, and Zablah Touché (Goitia 2006). See Table Appendix 1 for a listing of El Salvador's top eight economic groups.

³³ Alfonso Goitia, interviewed by author, San Salvador, El Salvador, April 15, 2010.

³⁴ Carlos Villalona, interview by author, San Salvador, El Salvador, April 16, 2010.

again be cut, this time to 15%) and closed the Institute of Regulatory Supplies, which bought corn, beans, and rice from smaller landowners at above-market wholesale prices to sell abroad (Equipo Maíz 2003). Bank privatization also marked a blow to the agricultural sector in that it reduced lines of credit previously available. Development banks were replaced with second-tier banks that channeled funds through the newly reprivatized banking sector, most of which were directed towards higher yield investments in the emerging services and manufacturing sectors.

Agriculture had been El Salvador’s greatest source of employment; as the sector deteriorated, so too did job prospects for thousands of Salvadorans, prompting a mass exodus from the country. Ironically, more Salvadorans emigrated after the 1992 Peace Accords than during the brutal 12-year civil war³⁵. The outflow of Salvadorans, mainly to the US, further shifted the country’s changing economic and social structure. As Table 2 shows, émigrés in the US sent home millions of dollars in remittances each year to support family members that remained in El Salvador. Remittances quickly became a major source of national revenue that benefitted the financial sector in two critical ways: 1) remittances artificially increased Salvadoran household buying power, which helped perpetuate a post-war consumption boom that underpinned the bank-enriching credit boom (remittances in El Salvador are disproportionately spent on immediate consumption, often cheaper imported products) (Cáceres and Saca 2006, López 2011) and 2) remittances were largely channeled through the private financial sector, boosting liquidity and financial sector profits from exchanging dollars into colones.

Table 1 Remittances

	Millions of US dollars	Percentage of GDP	Growth rate in percent
--	------------------------	-------------------	------------------------

³⁵ From 1985-1990, El Salvador’s net migration rate was -11.3 per 1,000 people. This rate fell to -9.2 during the 1990-1995 period but then surged to -13.8 during the 1995-2000 period (UN Data <http://data.un.org/Data.aspx?d=PopDiv&f=variableID%3A85>).

1989	203	4.1	4.8
1990	321.9	6.3	58.6
1991	517.6	8.8	60.8
1992	685.3	10.4	32.4
1993	790.6	11.4	15.4
1994	964.3	11.9	22
1995	1061.3	11.2	10.1
1996	1086.6	10.4	2.4
1997	1199.5	10.7	10.4
1998	1338.3	11.3	11.6
1999	1374	11	2.6
2000	1750.7	13.2	27.4

Sources: Stanley and Schmitt 2001

Table 2: Domestic Bank Assets by Country

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
Millions real 1996 US\$					
1960	555	628	368	117	--
1970	663	818	789	446	--
1980	3,281	1,513	2,239	1,012	--
1990	1,175	1,138	1,048	867	--
2000	3,730	5,518	3,864	2,019	1,245
Real annualized growth rate					
1960-70	1.8	2.7	7.9	14.3	--
1970-80	17.3	6.3	11	8.5	--
1980-90	-9.8	-2.8	-7.3	-1.5	--
1990-00	12.2	17.1	13.9	8.8	--

Sources: Stanley and Schmitt 2001

Notes: Figure for Nicaragua for 2000 refers to 1999.

The large scale of remittances flowing into the country also contributed to anti-export bias, as it placed upward pressure on the colón. When Cristiani originally floated the colón in 1989, it had depreciated but, as remittances grew, the trend reversed and the colón began to appreciate

(FUSADES interview³⁶, Vidal interview³⁷). In 1993, the government shifted to a managed float³⁸ in an effort to maintain a stable exchange rate at approximately 8.75 colones to the US dollar, where it stayed from 1992 until dollarization in 2001. The pegged colón was a boon to the financial sector, which thrived in the context of relatively low inflation and an overvalued currency, but hurt Salvadoran exports by making them more expensive in the global market.

Thus, the financial and agricultural sectors quickly became locked in a zero-sum game-- and the financial sector was winning. The finance sector soon became a driving force of the economy. Between 1994 and 2001, its Economic Activity Index averaged 259.16 compared to the overall economy's average of 163.12; meanwhile agriculture had the lowest private sector Index, with an average score of just 115.27 (Banco Central de Reserva de El Salvador). And whereas agriculture had been El Salvador's largest economic sector in 1980, accounting for 27.7%³⁹ of the economy, by 1999 it accounted for just 10.5 percent. At the same time, financial services increased from 7.8% of the economy in 1980 to 16.1% in 1999 (See Table 4).

Table 3. El Salvador GDP by Economic Sector (% of nominal GDP)

	1970	1980	1990	1999
Agriculture	28.3	27.7	11.2	10.5
Manufacturing	23.4	19.8	23.3	29.5
Electricity, gas, water	1.5	1.9	1.9	2.1
Construction	2.8	4.1	2.6	4.4
Services	48.3	52.5	65.5	57.4
Transport, storage, comms	5	3.5	4.6	8.1
Commerce	21.2	24.1	34.6	19.1
FIRE (Finance, Insurance, Real Estate)	5.9	7.8	8	16.1

Sources: Stanley and Schmitt 2001

³⁶ FUSADES staff member, interview by author, San Salvador, El Salvador, April 12, 2010.

³⁷ Juan Hector Vidal, interview by author, San Salvador, El Salvador, April 22, 2010.

³⁸ A managed, or "dirty" float occurs when the monetary authority intervenes actively in the foreign exchange market without specifying or pre-committing to a preannounced path for the exchange rate. Intervention may be direct (sterilized and non-sterilized) or indirect through changes in interest rates, etc. (Yagci 2001).

³⁹ Measured as percentage of nominal GDP.

With the reorganization of the Salvadoran economy came a reorganization of the country's economic elites. Through the privatization of the banking sector, economic elites who were able, bought up the newly reorganized banks for cut rate prices and used these institutions to anchor the development of powerful economic groups, such as Grupo Cuscatlán, Grupo Banagrícola, Grupo Banco Salvadoreño (today BanItsmo), Grupo Banco de Comercio (today Scotiabank), Grupo AGRISAL, Grupo Poma/Salaverría Prieto, Grupo De Sola, and Grupo Hill/ Llach Hill. Of these groups, Grupo Cuscatlán (Alfredo Cristiani's group), Grupo Banagrícola, Grupo Banco Salvadoreño, Grupo Banco de Comercio, and Grupo Poma/Salaverría became among the most powerful. As the names of Grupo Cuscatlán (Banco Cuscatlán), Grupo Banagrícola (Banco Agrícola), Grupo Banco Salvadoreño, and Grupo Banco de Comercio suggest, each of these were founded primarily as financial groups. However, all of the major economic groups have anchored themselves around banking and finance to some degree. For example, Grupo AGRISAL is linked to Banco de America Central (Credomatic) and Banco Uno, Grupo Poma/Salaverría Prieto is linked to Scotiabank as is Grupo Llach/Hill, and Grupo De Sola was linked to AIG.⁴⁰

As in Ecuador, El Salvador's most powerful economic groups are primarily family empires, with each group's investors dominated by four or five families (See Appendix 2). However, we do see an integration of family capital amongst economic groups through investments, partnerships, and marriage. In a very real sense, these groups have consolidated themselves to become El Salvador's new economic oligarchy. As Arias (2005) notes:

“The privatization of the banking sector has been one of the most important mechanisms for the integration of capital, as such, around these banks we find a grouping of firms dedicated to various activities.... There is a greater relation between family groups not

⁴⁰ For a discussion of the evolution of El Salvador's economic groups, see Equipo de Maiz's *Los Más Ricos de El Salvador* and Goita's "El Otoño de Neoliberalismo."

only due to their family ties but also through their alliance of capital.” (Arias 2005:20, this author’s translation).

To this end, even amongst those groups whose capital is not centrally linked to the finance sector there is a strong connection to finance capital through their investments in other groups. For example, Hill, Llach, De Sola, and Salavarría are all investors in the financial conglomerate, Grupo Cuscatlán.

Throughout the 1990s, El Salvador’s banking sector pursued a strategy of expansion into the provision of complimentary financial services, including non-banking financial services, such as consumer credit cards, insurance, leasing, factoring, brokerages, portfolio administration, and foreign exchange trading (Lemus 2000). And, in 1996, the sector won a coveted victory with the privatization of pension fund administration for public employees. However, while Economic Power Groups revolved around banking, they did not limit themselves to finance but invested their capital in other profitable sectors, including industry, real estate development, services (restaurants, transportation, electricity) and, above all, import and distribution. Families, such as Síman (Grupo Banco Salvadoreño), Poma (Scotiabank and AIG), Zablah-Touché (Grupo Banco Salvadoreño), Cristiani (Grupo Cuscatlán), and Murray Meza (Grupo Cuscatlán, Grupo AGRISAL) are heavily involved in the importation and distribution of goods ranging from automobiles to medicine.

“And they are one and the same, the heads of the banks.... Alfredo Cristiani who was the owner of Banco Cuscatlán, a man of more than 40 companies... exporter of rice, corn, beans, vegetables, meat, games, even wafers for the church—everything. [Cristiani is] an importer of inputs through two companies: UNIFERSA and Cristiani Burkard that has now been sold to Monsanto.... Toys, importer of sports equipment... a tremendous importer! Síman, the department store owner—importer of all kinds of clothing! All are vehicle importers. So, people who were coffee growers... in 10 years they are big importers” (Villalona interview).

“The central axis of accumulation is linked to finance and other activities not necessarily linked to agriculture. Agriculture can be marginally linked to accumulation but what they

did, mainly in the time of the ARENA governments, was to disarticulate agriculture so much that it no longer had control of the land and agriculture was no longer important; what was more important was commercial industry but more [important were] commerce, services, financial services and maquila. They got in to everything.... They financed companies connected to [their financial conglomerates]. And with that capital, during the 90s and 2000s, they diversified into a large number of highly profitable activities” (Goitia interview⁴¹).

Thus, it is difficult to separate El Salvador’s import sector from its financial sector, as capital among the two are closely integrated. It is also important to note that the import sector’s power grew tremendously alongside that of the financial sector, as reflected in El Salvador’s persistent trade deficit (See Table 5).⁴²

Table 4. External Sector 1991-1999 (in millions of US dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Trade Balance	-792	-1,059	-1,113	-1,326	-1,677	-1,433	-1,318	-1,527	-1585	-2,007

Source: Central Reserve Bank of El Salvador

III. CALDERÓN SOL: FIRST ATTEMPT AT DOLLARIZATION

As in the case of Ecuador, El Salvador’s dollarization scheme was not an entirely new proposal.

In fact, the country first broached the subject as early as 1995, when President Calderón Sol’s administration, guided by a group of finance-oriented economists, proposed dollarization as the central component of the country’s new economic plan. The proposal was short lived; it faced strong opposition from both the export and, most importantly, the banking sector. In many ways, the Calderón Sol administration was ahead of its time: it foresaw the tremendous advantages

dollarization would create for the financial sector; however, the country’s banks were still

⁴¹ Alfonso Goitia is a Salvadoran economist who has researched El Salvador’s Economic Power Groups. At the time of this interview, Goitia was an advisor with the Ministry of Planning under FMLN-elected, President Mauricio Funes.

⁴² Between 1991 and 2000, El Salvador’s trade deficit averaged 1.2% of GDP. Between 2001-2010 (post-dollarization), the trade deficit averaged 3.0% of GDP (calculations based of Central Reserve Bank of El Salvador statistics).

primarily focused on the domestic credit sector and saw no reason to jeopardize their high profit yields.

The Second ARENA Administration

In March 1994, nearly two years after the signing of the Peace Accords that ended the country's 12-year civil war, El Salvador held its first truly free and open elections. For the first time, the FMLN were allowed to run candidates for President, the Legislative Assembly and local offices against the incumbent rightwing ARENA and traditional parties. ARENA firmly won leadership, winning the Presidency and 45% of the Legislative Assembly. However, much to the Right's dismay, the FMLN mobilized a significant minority, capturing 24% of the Legislative Assembly (Political Database of the Americas 1999a) and nearly 32% of the vote in the Presidential runoff between its candidate, Ruben Zamora, and ARENA's Armando Calderón Sol (Political Database of the Americas 1999b).

Thus, when the newly elected President Calderón Sol took office in June 1994, his ascent was bittersweet. Not only did he now face new formidable political opposition in the form of the FMLN, he faced an economy whose boom was on the precipice of bust: the post-war consumption-driven boom was beginning to show signs of slowing. In an effort to get ahead of the looming bust cycle, Calderón Sol put together a team, coordinated by Claudio de Rosa, a Chilean-born economist serving as an advisor within the Ministry of Planning, to devise a plan to

combat the economy's slowing growth. The group, consisting of advisors from the Ministries of Treasury, Economy, and the Central Bank and economist Manuel Hinds, who had recently returned from his tenure with the World Bank, discussed proposals for stimulating the economy⁴³. Despite the growth of El Salvador's financial sector, the private sector continued to face high interest rates and restricted access to credit, particularly long-term credit. Seeing this as a major obstacle to growth, Hinds, with the support of De Rosa, proposed dollarization as a solution:

“We had an economy that still had strong rates of inflation in that period and we were reducing it. Interest rates were very high and we thought that the real problem was the interest rate and long-term credit: there was no long-term credit. It is the same problem in all of Latin America: if you are going to take out a 20-year loan, that's four Presidents! And those four Presidents can carry out any type of craziness. So, you are going to give your money to be loaned out to someone and the president does something, inflation rates go up, and you go to hell because you have lost your savings like in Argentina and all over Latin America. So, with dollarization we purchased certainty that people could, number one, lower interest rates and, number two, make long-term loans.”⁴⁴

Like his predecessor, Calderón Sol sought to deepen the country's commitment to financially led neoliberalism. This alignment was reflected in the government's five point plan for economic transformation that included 1) monetary reform centered on dollarization of the economy 2) privatization of telecommunications, electricity distribution, and the pension system, 3) financial opening to stimulate more competitors within the banking sector, 4) tributary reform to increase State resources, and 5) further trade liberalization and the development of new markets for

⁴³ Claudio de Rosa, interview by author, San Salvador, El Salvador, April 23, 2010.

⁴⁴ Manuel Enrique Hinds, interview by author, San Salvador, El Salvador, April 21, 2010.

export (Calderón Sol 2002, Hinds interview).

But when a headline appeared in early 1995 in one of the top Salvadoran papers that the government was planning to dollarize, it sent shockwaves through the country. The export sector vocally opposed the measure from the start, as it had been advocating for devaluation, claiming that the Salvadoran colón was already becoming too overvalued. As a FUSADES⁴⁵ representative noted, “there was no consensus in the debate, there was no agreement. From the side of the manufacturers and exporters...they were not in favor, above all, because this eliminated the possibility of any devaluation.”

However, the most powerful opposition came from the financial sector, which saw dollarization as a threat to profits gained from exchanging the massive quantities of dollars that flowed into the country in the form of remittances. In an interview with the online newspaper ElFaro.net in 2008, President Calderón spoke of the opposition he faced from the banking sector:

“... I faced strong opposition from the business sector, very strong opposition.... [I]t was because of their interests that they did not want it, bank profits, and how much a bank made, just think about how much a bank made on the exchange of currency. If it takes five cents to sell it and five cents when they sell it back.... It was 120 or 140 million colones back then!” (Arauz, Vaquerano, Murcia, and Luna 2008).

The banking sector also feared that dollarization would create pressures to lower interest rate spreads, a large source of profits for the sector at the time (Hinds interview).

⁴⁵ FUSADES, The Salvadoran Foundation for Economic and Social Development, is a Salvadoran think tank founded in 1984 with funds from US AID (US AID: http://pdf.usaid.gov/pdf_docs/PDABM867.pdf).

“The banks were totally against it because their spread was quite high....They had more than a 10-point spread! *That* they were going to defend until the death. And, in addition, there was another business, [currency] exchange that was worth a ton....When you added it up, it was \$200 million per year that they had in revenue. They opposed it to the death, before. At that time, as it was, we made the proposal and the decision not to continue; that was like two or three weeks later” (Hinds interview).

Finally, El Salvador did not have sufficient dollar reserves to buy back the colones in circulation without a devaluation, which the administration opposed. Calderón Sol was already at loggerheads with the non-finance business sector over a proposed increase in the Value Added Tax and faced opposition from the export sector on further reductions of import tariffs. At the same time, divisions between economic factions within the ARENA party were coming to a head. As a political party strongly tied to El Salvador’s business sector, struggles between sectors were reflected in internal divisions over the future of the party. ARENA’s founders, largely connected to the coffee sector, were infuriated by the direction of the party, which they felt was being hijacked by “mercantilist” elements that were using ARENA to implement policies beneficial only to these groups, at the expense of the productive sectors. The “Mercantilist” faction was epitomized by Alfredo Cristiani and the financial sector (Martinez Peñate 2000, Zamora 1998, Villalona Interview, Moreno 1997). To this end, opponents, under the leadership of Antonio Cornejo Arango, accused the “Mercantilist”-aligned Calderón Sol government of “punishing the productive sector for the benefit of financial speculation” (Martinez Peñate

2000)⁴⁶. As a new president presiding over a divided party, Calderón Sol felt he lacked the political capital to invest in dollarization (Calderón Sol 2003). Given the political opposition and lack of resources at the time, the government removed dollarization from its official agenda and, instead, replaced the dirty float with a legal peg to maintain the colón at the going rate of 8.75 colones to the US dollar.

Nevertheless, members of the Calderón Sol administration, led by Manuel Hinds, who by then had become Minister of the Treasury, did not give up on the idea. Throughout the remaining four years of the Calderón Sol government they worked to create the conditions for the country's eventual dollarization, including building up the technical capacity for implementation. As Claudio de Rosa acknowledged:

“...but in that moment we did not have sufficient reserves for a transaction that would allow us, speaking in non-economic terms, to buy back all of the colones. So, in the following years we worked to prepare the conditions: to reduce the fiscal deficit, reduce inflation, and have sufficient reserves to purchase all of the colones” (Portillo 2007).

Thus, during the coming years, the administration carefully built up international reserves to allow for a dollarization at the rate of 8.75 colones to one US dollar.

IV. THE FLORES ADMINISTRATION: DOLLARIZATION SUCCEEDS

Just five years after Calderón Sol's attempt to dollarize El Salvador failed, the next president,

⁴⁶ The mounting tension between the “Mercantilistas” and the Arango-led “Maneques,” erupted publicly in 1996, when the Maneques unsuccessfully attempted gain entry into ARENA's national leadership board, COENA.

Francisco Flores (also from the ARENA party), was able to pass and implement dollarization nearly overnight. Unlike Calderón Sol, Flores had the implicit (and later explicit) support of the financial sector in moving forward with his plan. Flores also leveraged heightened polarization within El Salvador's business community over the future of its economic model and growing fears over the FMLN's increasing political power. This section describes El Salvador's rapid dollarization process. The following section explores how changes in El Salvador's economy and political landscape during the latter half of the 1990s contributed to changes in how El Salvador's most powerful economic groups viewed dollarization.

Adoption of Dollarization: the “*Madrugón*”

Prior to his Presidency (1999-2004), Francisco Flores was a relative unknown within the ARENA political structure and the country. Although he managed to climb his way to the position of Legislative Assembly President during the Calderón Sol administration, Flores had maintained a relatively low profile within the party; his views on critical economic issues were unclear, a point that may have helped him secure the nomination from a party sharply divided over its economic platform. Even in his inaugural speech, Flores was cryptic concerning his position on monetary policy, which had become the indicator of an administration's economic orientation: export-based or finance-based. During the traditional June 1 speech, Flores ambiguously declared that his administration intended to “anchor the exchange-rate regime in the

legal system so that it cannot be manipulated.” It was one sentence in a long speech but it acknowledged the escalating anxieties and struggles among economic groups over the future of El Salvador’s economy. Flores’ words signaled his consideration of three options: complete exchange-rate flexibility, convertibility, or dollarization. Without giving more detail, the new President allowed each sector to interpret the statement as it wished or feared.

Salvadorans often describe the Law of Monetary Integration (LIM, by its Spanish acronym), the law that legalized dollarization, as the “*madrugón*⁴⁷,” referring to the secretive and sudden manner in which it was passed: Salvadorans went to bed with the colón and woke up with the dollar. In many respects, this analysis is accurate. On November 22, 2000, with what seemed like little warning, President Flores announced to the country that he was putting forth a bill to legalize dollarization. Despite vocal opposition from the FMLN, the bill was passed on November 30, 2000 with little debate within the Legislative Assembly by a simple majority made up of ARENA and another Rightwing party, the PCN, to be implemented on January 1, 2001.

Nevertheless, the lead up to Flores’ sudden announcement involved months of analysis and planning that involved the Central Reserve Bank, Treasury Department, external consultants and consultation with the IMF and the United States, all of which were conducted under the highest degree of secrecy. Flores managed this secrecy by keeping his plans hidden, even from those

⁴⁷ A *madrugón* refers to the act of getting up at the break of dawn.

who were conducting the analysis.

“No one suspected. *Nobody!* It was an operation. I thought that [in El Salvador] it was impossible to keep anything secret but it was kept. Nobody realized. [Flores] didn’t even tell his cabinet. His Minister of Economy found out the day he sent out the law. Since I was so closely associated with dollarization the president did not even want me to come there because people were going to ask, ‘What is Hinds working on there?’ and they would think, or they could think, ‘They are working on dollarization.’ One day, we were at the Presidential House, it was around 2pm and they told me to leave before 2:30pm because people from ANEP were coming at around 3pm. We were running behind and the people from ANEP arrived early and we were meeting in a very small salon, and in the salon next door was ANEP. So I was told, ‘you cannot leave because the people from ANEP are next door.’ So, I stayed until 10pm in that room with Manuel Melendez, who was in charge of communications” (Hinds interview).

“I was in ABANSA.⁴⁸ Francisco Flores, Paco, was the president. I was working very closely with, and advising in some matters, the Ministry of Finance on budget, concepts, and expenditures—never interfering in the revenues area—and we had no reforms in those days so there was not a conflict of interest. I was an external advisor for a while to Juan Jose Daboub, who at the [moment] is Executive Director of the World Bank. I’m with him and the President and, sometimes, Rafael Barraza. We met sometimes once a month.... And the second or third meeting that we had with the President he asked me about exchange policy. And I say, ‘Well, we can go from this to that, [a currency board], and I am not going to tell you about dollarization because that is something I am sure you are not willing to [do].’ ‘Who told you that? Tell me about it.’ And I went to talk with him two or three more times and when I met with him: ‘tell me about this, what would happen if... and try to give me good arguments, Claudio.... Could you come and bring me some examples, [do] a little research for me?’.... I was working, providing him information, not knowing that he had already [made] his preliminary decision on going with dollarization and I didn’t know that I was working for him—giving arguments, giving answers. So, he was preparing himself. But at the same time, Rafael Barraza, the President of the Central Bank, was working and preparing all of the concepts with the same scheme: ‘Tell me about this... How would you do this? How will you settle the balances?’ And he also had Manuel Enrique Hinds working in a another arena, going to the IMF and going to the World Bank and we were each working alone, not knowing what the other knew” (De Rosa interview).

Once Flores made the decision to dollarize, it became a matter of political strategy of when to

⁴⁸ Asociación Bancaria Salvadoreña, El Salvador's private banking association. Its members included El Salvador's largest banks. At the time, Claudio de Rosa was ABANSA's Executive Director.

announce it and how to push for its passage. Flores had learned from the events that took place in 1995 that opening up discussion of dollarization to the general public would give opponents greater opportunity to mobilize the public against the idea: the longer the timeline for passage of the law and implementation, the greater the window the possibility for reversal (De Rosa interview, Quintanilla Schmidt interview⁴⁹). Similarly, a longer timeline could engender speculation against the colón in the run-up to dollarization, making the transition more difficult. Thus, timing of the bill's announcement and Flores' ability to ensure quick passage was critical.

Commenting on the influence of Calderón Sol's experience on Flores' strategy, Flores'

Vice President, Carlos Quintanilla Schmidt explained:

“... [what happened to Calderón Sol] was a precedent for President Flores keeping his decision very secretive. It was November when he announced dollarization. He sent the bill, the Law of Monetary Integration, to the Assembly and it was there maybe two or three weeks before it was approved on December 20. It was a very rapid process even though it complied with all of the required steps by law.... In the end it was approved in December to go into effect the first of January 2001” (Quintanilla Schmidt interview).

According to participants in the process, Flores made his final decision in favor of dollarization in September/October 1999 and had determined that November would be the most strategic time to announce a bill that could be quickly passed and implemented by the New Year. Manuel Hinds and Rafael Barraza, President of the Central Reserve Bank, were tasked with drawing up a bill that could be presented to the Legislative Assembly within approximately four to six weeks

⁴⁹ Carlos Quintanilla Schmidt, interview by author, San Salvador, El Salvador, April 16, 2010.

and quickly passed. As Hinds recalls:

“...[Flores] said to me, ‘Create a law to dollarize the country and it has to be done within a month’ because he saw a political opportunity. He thought that, in that moment, he had together all of the votes from Legislators that he would need to pass the bill. This was at the end of September 2000” (Hinds interview).

The result was the LIM, a chimera of bimonetarism and complete dollarization. Technically, the LIM maintained the status of the colón as legal currency; however, the LIM also prohibited the Central Reserve Bank from printing new colones and mandated that banks turn over colones to the Central Reserve Bank so that they were removed from circulation. By allowing the colón to remain as a legal currency, the LIM circumvented the constitutionally mandated process for changing the country’s currency regime, which required a supermajority in two consecutive Legislative Assemblies. Instead, the Flores administration argued publicly that the LIM would simply allow Salvadorans to operate in the currency of their choice: the colón or the US dollar.

As economist and the current President of the Salvadoran Central Reserve Bank, Carlos Acevedo, recalls:

“Well, the first is that the law was presented as a type of bimonetarism. It was not going to eliminate the colón. Rather, it was going to continue as legal currency. But there are contradictions: on the one hand, despite saying there is going to be bimonetarism, the power of the Central Bank to emit colones was eliminated. So, how can it be that the colón will continue circulating but the Central Bank can no longer emit colones? That is contradictory. Then, in the government propaganda it said precisely that, because it was bimonetarism, economic agents could use the currency of their choice.... In their discourse they said that I could go to the bank and I could take out money in colones or dollars, whichever currency I want. But in the law there is a clause that says that all of the colones that enter the financial system have to be obligatorily retired. So, I cannot come with dollars and ask for colones, I can go with colones and ask for dollars and the bank is obliged to retire

the colones. So, that is a contradiction in the law around the spirit of bimonetarism: it was a dollarization law.”⁵⁰

Without a majority in the Assembly, Flores had to secure the votes of another political party.

ARENA turned to its ally in the Assembly, the PCN, a small Rightwing party that had a history of making pacts with ARENA around key votes.⁵¹ Traditionally, the PCN’s electoral base was

closely tied to the agricultural sector making it an unlikely ally for such a vote. Nevertheless,

Flores was able to secure the PCN’s support early on. As Flores’ Vice-President, Carlos

Quintanilla Schmidt recalls:

“I believe that when he announced dollarization President Flores had already lobbied the PCN, the other political party from the Right with whom he had a simple majority in Congress. And with the votes of ARENA and the PCN, the Law of Monetary Integration was approved to begin implementation the first of January 2001” (Quintanilla Schmidt interview).

Despite potential differences, recent circumstance gave Flores a powerful bargaining chip in

securing the PCN’s votes. Towards the end of August 2000, one of the PCN’s prominent

legislators, Francisco Merino, was involved in a drunken shoot out with the police, in which he

seriously injured a police officer. Widespread coverage of the event led to an investigation and

⁵⁰ Carlos Acevedo, interview by author, San Salvador, El Salvador, April 19, 2010.

⁵¹ Opposition has long criticized the disproportionate power of the PCN given its small (and shrinking) size within the Legislative Assembly. While ARENA and the PCN have long denied public accusations of pacts between the two to exchange influence for votes on legislation, instances of such pacts have been brought to light. One example was publicized early on in the Flores administration, when it came to light ARENA had made an institutional pact with the PCN to support the candidacy of the PCN’s Francisco Merino to lead the Office of the Controller (Corte de Cuentas), despite serious accusations of corruption on the part of Merino, in return for votes to pass an extension of the Value Added Tax (VAT). In the words of the head of the PNC Legislative Fraction, Ciro Cruz Zepeda: "This is a two-way street and the moment will come when they will need the support of our 10 representatives" (Giralt 1999—Diario de Hoy Jul 1 1999)

calls for Merino's immunity as a legislator to be revoked. Prior to the dollarization proposal ARENA had publicly joined in support of revoking Merino's immunity, a stance which abruptly changed upon passage of the LIM, leading to allegations from the Right and Left that the PCN gave its votes in return for protecting Merino.

“When the Government presented the LIM before the Legislative Assembly, [the Legislative Assembly] was in the process of stripping a legislator of parliamentary immunity, ex vice-president of the Republic, from an opposition Rightwing party. Said legislator had become involved in a shoot-out with the police, injuring an officer, after a night of drunkenness. At least one legislator from the official party, ex-director of the national police, had said publicly that he was going to vote for stripping of immunity. The day of the vote for stripping immunity there were not enough votes; the legislator from the governing party, ex-director of the police, was out of the country. The votes from the party of the legislator in danger were sufficient to achieve the simple majority that passed the LIM two days later” (Glower 2001:162, this author's translation).

“The approval of the law was part of a complex agreement trade between ARENA and PCN [the conservative National Conciliation Party, which held 13 of the 84 seats in the Legislative Assembly] which included an agreement to not revoke the impunity of Francisco Merino, ex-vice-president and current president of the legislative fraction of the PCN, who while intoxicated fired, with intent to kill, at various police officers, gravely wounding a police agent. Whether he would be tried or not depended on whether the Legislative Assembly would revoke his impunity or not. ARENA, who in the beginning supported taking away his impunity, at the last moment said there was not indisputable evidence and voted for Merino's impunity.” (CIS 2000, as quoted in Lucas 2009: 31)

According participants in the process who were interviewed, it was not until the law was publicly announced that Flores began to approach members of the business sector for support (De Rosa interview, Hinds interview, Quintanilla Schmidt interview). However, Flores contacted the financial sector, whose support he knew was instrumental in passing the law, even before his public announcement to ensure its blessing: “[The banks] were who the President feared most.

Everything was basically done in secret because of the banks. Because he thought he could manage the others” (Hinds interview). As soon as Flores had received the blessing of the IMF and the US Treasury Department⁵², he began to personally contact financial sector leaders:

“And when we returned [from the United States], the President called the bankers, first thing, nine in the morning. He called all of the bankers and said ‘I’m going to dollarize. I’m going to present this law, I have the votes and we are going to dollarize and I am doing this because of this, this, and this. I want you to support me.’ And he spoke very well. He said, ‘At first you are going to lose money but you are going to become more competitive.’ And he told them, more or less, what happened. That, ‘you are going to become much more valuable because you are going to be valued in dollars, you are going to become much more efficient, and you cannot stand in the path of the country’s progress.’ And with this, they supported him. He spoke with the banks, he spoke with ANEP, he spoke with various groups; he explained it to them and presented the bill in the Assembly” (Hinds interview).

Unlike the era of Calderón Sol, this time the banking sector gave its blessing. Once Flores publicly announced his intention to submit the LIM for a vote, El Salvador’s bankers’ association, ABANSA, announced its full-fledged support of the measure. By the time dollarization was adopted, 12 of its 16 members supported the measure⁵³. Most importantly, the Presidents of El Salvador’s two biggest banks, Banco Agrícola and Banco Cuscatlán, supported dollarization (Interview with Claudio De Rosa). Archie Baldocchi, ABANSA’s President and

⁵² Before publicly announcing the LIM, the Flores administration sent a delegation, which included Manuel E. Hinds and the President of the Central Reserve Bank of El Salvador, Rafael Barraza, to inform the IMF and the US Treasury of the proposal. According to Hinds, “We were worried about the IMF and the US Treasury because we’re going to use their money. We could have done it because the dollars we had were ours but we wanted the United States to know. In addition, we did not want any reaction of doubt or anything, so that they knew everything and they could say it is good or not good but that we would know how they were going to react.... Then we went to the World Bank and to the [credit] raters, also and we told them all and said that this was all secret. All prepared their statements.” (Hinds interview).

⁵³ This observation was echoed by Quintanilla Schmidt: “I do not believe that the financial sector supported it 100% because I know that there were bankers that disagreed with dollarization and seeing it from their side I understood because they were going to lose a small part of their business. Let’s say I am a bank and was buying dollars... I bought them at 8.70 and sold them at 8.78. There was a banking differential that favored me. So, I think in the financial sector there were those who thought that it should be done immediately and others that were more skeptical. But those that did not like the idea did not create opposition...” (*Quintanilla Schmidt interview*).

President of Banco Agrícola, El Salvador's largest bank, was a dollarization proponent: "Archie [Baldocchi] was in favor before and...helped convince the rest of the bankers" (De Rosa interview).

Indeed, there were strong cues signaling the financial sector's growing support for dollarization in the years leading up to the LIM. This shift in attitude could be seen as early as 1996; that is when Claudio de Rosa, one of the architects of the Calderón Sol dollarization plan, left the Ministry of Planning to become ABANSA's Executive Director. While not as visible as Manuel Hinds, Claudio de Rosa was a known dollarization advocate who continued to campaign for the measure. In 1999, ABANSA hosted Domingo Cavallo, the architect of Argentina's convertibility plan, who made numerous television appearances with De Rosa to discuss the possibilities of convertibility or dollarization in El Salvador (TCS 1999). Not long after, in late 2000, at the suggestion of Archie Baldocchi⁵⁴, ABANSA also hosted former Argentine President and dollarization advocate, Carlos Menem, to speak about his push for dollarization in Argentina as part of the international FELABAN 2000 (the Federation of Latino Banks) conference, which took place that year in El Salvador (De Rosa interview). Similarly, members of the financial sector permeated ARENA's top decision-making body, COENA, which exercised a high level of control over the party, its candidates, and policy initiatives. Since his presidency, Alfredo

⁵⁴ Baldocchi was the President of ABANSA as well as President of Banco Agrícola, one of El Salvador's two most powerful financial institutions. Baldocchi had also been described as a friend and ally of President Francisco Flores (Najaro 2002, *Diario de Hoy* 06/22/2003).

Cristiani and his allies in the financial sector maintained tight control over COENA (Merino 1995, Moreno 1997, Ribera 1996, Martínez Peñate 2000, Miranda 2001). Given the structure of ARENA, it is difficult to imagine that President Flores did not have insight into how dollarization would be perceived by the COENA leadership and, thus, the leadership of the financial sector. According to reports from party insiders, the business leaders that fund and participate in ARENA actively utilize their positions to influence party candidates and policies:

“Four of the nine sources, also agreed that these [donors] are much more active when it is time to name the presidential candidate. ‘The donors normally let people like Fredy [Cristiani] and other leaders administer the party, and they are half waiting to confirm that the presidential candidate is the most convenient,’ says an ex-staff member of the Antonio Saca⁵⁵ administration. ‘During the rest of the year, the only thing they are going to do is propose policies to the president of the party or prevent other [policies] from being implemented. Why do you think the party has done nothing to open the aeronautic market or to reduce the sugar market?’ he questions” (Aragón 2012, this author’s translation).

Why Dollarization Failed under Calderón Sol but Passed under Flores

At the time dollarization was originally proposed by the Calderón Sol administration, early 1995, the banking sector was in the midst of unprecedented growth fueled by the internal market. Between 1992 and 1995, El Salvador experienced an accelerated cycle of growth fueled by consumption and expansion in the availability of credit. Several factors contributed to this consumption and credit boom: euphoria at end of the civil war, greater consumption options due to opening up of the economy, increases in income due to remittances sent from Salvadorans in

⁵⁵ Antonio Saca, of the ARENA party, served as President of El Salvador from 2004-2009 following Francisco Flores. Saca was El Salvador’s fourth consecutive ARENA President.

the US and privatization of the banking sector (Lemus 2000). As noted above, the top banks formed the center of powerful financial groups for which the banks served as the primary source of capital. Their reach extended to nearly every industry in the country, particularly the burgeoning import and service sectors (Goitia 2006, Equipo Maíz, Segovia 2002, Segovia 2004). Between 1993 and 1996, banks maintained high and stable profits, with Returns on Equity (ROE) reaching its height (28.17) in 1995 (see Table 6). With business going so well, there was no reason to place profits in jeopardy for the theoretical promise of greater access to low-priced capital and it certainly was not worth risking the increased presence of foreign banks in the domestic market. Given El Salvador's stable exchange rate and history of low-inflation, the financial sector felt little, if any, pressure to look at drastic measures like dollarization.

However, several important changes would take place to change the views of El Salvador's finance-led major economic groups towards dollarization. Of critical importance was a slowdown in El Salvador's economy in the latter part of the decade that helped push many economic groups to look for profits beyond their borders, not only in the area of finance but also retail and real estate. As El Salvador's consumption boom slowed, the credit boom also came to a halt with dramatic impacts for financial profits. Economic deceleration meant increased defaults on loans. In 1997, banks saw a modest, yet significant decline in profitability but by the following year, banks were barely profitable. As Lemus (2000) notes:

“Bank profitability is similar to the behavior of the real economy, in the sense that

the industry has passed from spectacular growth to a tendency of markedly depressed profitability. The tendency is such that at the end of the nineties the industry averaged on the border of null returns.... Profitability for the majority of banks in 1999 does not achieve even the minimum return that would be obtained on investments in risk-free State bonds” (Lemus 2000:51, this author’s translation).

Similarly, the economic slowdown meant that assets became less productive and banks faced a reduction in interest rate spreads. Given the increased level of arrears and foreclosures in the business sector, pressure increased for banks to lower interest rates. As can be seen in Table 7, between 1995 and 1996, the net spread was over 2.25% but by 2000, it had fallen to under 1%⁵⁶ (Lemus 2000: 44). With the slowing of the Salvadoran economy and profits plummeting, dollarization appeared more palatable than it had in 1995. Lower lending costs associated with dollarization could offset domestic pressures on lower interest rates. As Rodriguez, et al. (2006) demonstrate, the cost reduction in exchanging colones for US dollars alone could save Salvadoran banks between 2.74% and 11.89% in borrowing costs.

Table 5: Private Bank Profitability (excludes FINESPRO, FINCOMER, and CREDISA)

Year	Return on Assets (ROA)	Return on Equity (ROE)
1992	1.35	21.81
1993	1.81	26.64
1994	1.63	25.17
1995	1.71	28.17
1996	1.75	24..71
1997	1.36	18.21
1998	0.32	4.07

⁵⁶ These calculations exclude outcomes from failed banks during this period (FINESPRO, FINCOMER, and CREDISA).

1999	0.64	7.84
2000	0.59	7.04

Source: Lemus 2000:16

Table 6. Net Banking Spreads

	1995	1996	1997	1998	1999	2000 (as of June)
Net Spread	2.28	2.35	1.99	1.37	0.82	0.75

Source: Lemus 2000:16

The steep decline in profitability reinforced the shift in outlook towards the global market. As the local market became exhausted, the financial sector sought to project itself internationally in the hopes of gaining economies of scale (Quisepe-Agnoli and Whisler 2006; Vidal 2009, Herrera 2007, Schmitt and Stanley 2001, Rivas 2005). During the latter half of the 1990s, a number of El Salvador's top economic groups pursued a strategy of alliances with foreign capital and expansion throughout the region and, where feasible beyond the region, through the acquisition of shares of other banks. Banco Agrícola began the trend in 1995 when it opened an office in Panama as an international bank. In 1996, it formed an alliance with the Honduran Banco de la Producción and bought a majority share in Banco Caley Dagnall in Guatemala. (Osorio 2007); Agrícola also opened offices in several major cities in the US. In 1996, Banco Cuscatlán purchased shares of Corporación BFA in Costa Rica and Céntrica Financial Holdings in Guatemala (Osorio 2007). Banco Salvadoreño also began a strategy of setting up offices in the US to service Central American émigrés abroad, particularly in sending money back to their families. By 2001, Banco Agrícola placed first⁵⁷ in the top 100 banks of Central America, Panama, and the Dominican Republic; Banco Cuscatlán placed third on the list,

⁵⁷ In terms of total assets and deposits.

while Banco Salvadoreño placed 7th, and Banco de Comercio placed 11th (Consejo Monetario Centroamericano 2003). Grupo Cuscatlán became one of the three most important financial groups in the region, with a presence in El Salvador, Guatemala, Honduras, and Costa Rica (Osorio 2007) and an eye towards expansion into Panama and the Caribbean around the time of dollarization (Business News Americas 2002).

As mentioned above, due to the interconnection among capital, it is often hard to distinguish retail, import, and other sectors from financiers. For example, Grupo Síman, known for its import and distribution empire, including the well-known department store chain, Almacén Síman, is closely connected to Banco Salvadoreño. Similarly, Grupo Poma/Quiros/Salavarría, known mostly for its interests in real estate development and auto imports, is connected to Scotiabank⁵⁸. These, and other prominent groups, also began pursuing a strategy of regional expansion. During this period, Grupo Síman expanded its department store chain into Nicaragua and Guatemala; at the time of dollarization it had also embarked upon a partnership to found the Unicomer Group, with retail franchises throughout the hemisphere. Meanwhile, Grupo Poma and its partners expanded their real estate and auto interests throughout Central, South, and North America (see Appendix 2 for a more detailed description of holdings of El Salvador's major economic groups).

Unlike previous eras of regionalization, most notably regionalization associated with the formation of the Central American Common Market during the 1960s and 1970s, the period of regionalization begun in the 1990s is intricately linked to strategies of globalization. Whereas the

⁵⁸ Grupo Poma had been connected to the financial institution Ahorromet. However, in 1997, Ahorromet was acquired by Scotiabank, which has been steadily expanding its presence throughout Central America. Scotiabank consolidated its presence in El Salvador in 2005, with its acquisition of Banco de Comercio.

previous era was anchored in a model of regional industrialization during a period of limited free trade and capital mobility, the current phase of regionalization is anchored in just the opposite: it is economic and financial deregulation that have spurred regional expansion. Similarly, the current phase of regionalization sees the region not as simply a foreign market to sell its goods and services but as “the natural space of accumulation” and a platform to expand to other global markets (Segovia 2005).

Throughout the 1990s, the overvalued colón had given Salvadoran banks, real estate, and importers an advantage in the local and external markets. As the major economic groups reached the limits of the Salvadoran economy, they turned their attentions to external markets where dollarization, by offering financial institutions, real estate developers, and importers cheap access to US dollars, would give them a competitive advantage (Quisepe-Agnoli and Whisler 2006, Rivas 2005, Vidal 2009). This was especially true for the financial sector: dollarization would ensure cheap access to dollars that could be loaned abroad at higher interest rates. Throughout the 1990s, Guatemala, Honduras, and Costa Rica sustained real high interest rates⁵⁹ that provided Salvadoran financial institutions with easy opportunities for interest rate arbitrage (Osorio 2007, Schmitt and Stanley 2001) (See Table 8). In this way, dollarization would give Salvadoran-based conglomerates greater access to the US dollars coming in through remittances and greater access

⁵⁹ Real interest rates are interest rates adjusted for inflation to reflect the true cost to borrower and lender. To this end, in the context of high levels of inflation, what may appear to be high nominal rates may actually be quite low or even negative in real terms.

to foreign capital to funnel to its offices abroad.

Table 7. Nominal and real interest rates

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
Nominal interest rates					
1989	29.2	18.5	16	15.4	558
1990	32.6	21.2	23.3	17.1	22
1991	38.9	19.7	34.1	21.9	17.9
1992	28.5	16.4	19.5	21.7	19.3
1993	30	19.4	24.7	22.1	20.2
1994	33	19	22.9	24.7	20.1
1995	36.7	19.1	21.2	27	19.9
1996	26.3	18.6	22.7	29.7	20.7
1997	22.5	16.1	18.6	32.1	21
1998	22.5	15	16.6	30.7	21.6
1999	25.7	15.5	19.5	30.2	22.1
2000	24.9	14	20.9	26.8	21.4
Real Interest Rates					
1989	12.7	0.9	4.6	5.6	-4,212.20
1990	13.5	-2.8	-18	-6.3	-7,463.50
1991	10.2	5.3	0.9	-12.1	-2,927.20
1992	6.7	5.2	9.4	12.9	-4.4
1993	20.2	0.9	12.9	11.3	-0.2
1994	19.5	8.4	12.1	2.9	13.4
1995	13.5	9.1	12.7	-2.5	9
1996	8.8	8.8	11.7	5.9	9.1
1997	9.2	11.6	9.4	11.9	11.8
1998	10.8	12.4	9.6	17	8.6
1999	15.7	14.9	14.6	18.5	10.9
2000	13.9	11.7	14.9	15.8	--

Source: Stanly and Schmitt 2001

As Vidal (2009) observes:

“Due especially to the absence of capital controls mentioned earlier and dollarization, itself, it was thought that El Salvador could become a net exporter of capital to its closest neighbors, using (the business owners’) low cost capital to invest in risky assets and even financial investments that were more profitable than in the country” (p.224, this author’s translation).

The LIM eliminated limits on the contraction of foreign debt, made the concept of the ratio between assets and liabilities more flexible, and eliminated potential losses due to changes in the exchange rate, all of which enabled banks to finance a greater portion of their credit portfolios instead of relying on deposits for capital. Not only was this new strategy cheaper, financial institutions were no longer constrained by the country's low rate of savings (Rodriguez, Guzman, Amaya 2006). The increased capital was especially pivotal in allowing the major financial groups to continue their outward expansion. Thus, it should be no surprise that, upon dollarization, Salvadoran-based financial conglomerates began to increase their loans to businesses abroad.

As economist and President of the Central Reserve Bank of El Salvador, Carlos Acevedo notes:

“From the moment El Salvador dollarized, foreign transactions of banks began to grow in terms foreign liabilities, foreign indebtedness, and foreign assets. We can really see the internationalization or the external expansion of the Salvadoran banks outside of the country; it certainly seems to be easier for them to obtain foreign credit. And their active operations abroad also increased. What seems clear is that the Salvadoran banks took on more foreign debt and placed those resources in other countries: Guatemala, Honduras, Nicaragua, and Costa Rica. It is clear that dollarization made a difference in that realm. There is greater facility and greater access to foreign resources by the banks” (Acevedo interview).

Thus, between December 2000 and December 2006, loans to non-residents increased 5.4 fold from \$65.9 million to \$420.2 million (Osorio 2007). While the figures do not detail to whom these loans were made, it is not difficult to imagine that Salvadoran economic groups took

advantage of lower financing costs to also support their other businesses abroad, particularly the growing international real estate development interests.

Also of timely importance for the passage of dollarization was the continuing push for a change in monetary policy by exporters who sought devaluation. As a UNDP (1999) report noted, El Salvador's monetary policy had become increasingly controversial:

“Maintaining a stable nominal exchange rate and sustaining the exchange rate regime has meant not only systematically intervening in the market to buy up the abundance of dollars but also confronting pressures from sectors that have signaled the need to modify the exchange rate regime and others that have indicated the convenience of devaluing the currency” (UNDP 1999: 57, this author's translation).

Similarly, economist Carlos Acevedo remembers, “All of the studies and the opinions of the exporters said the real exchange-rate was overvalued and, for that reason, the colón had to be devalued” (Acevedo Interview). Indeed, El Salvador's monetary regime had become so divisive among the business sector that in July 2000, ANEP, the umbrella association of private business guilds, decided not to explicitly include any proposals for monetary and exchange-rate policy in its national business agenda (Vidal 2009).⁶⁰

It is estimated that between 1993 and 2000, the real value of the colón rose nearly 25% to 10.83 colones to the dollar (Lazo 2009:8). As calls for monetary reform by prominent economists and leaders of key business groups grew, so did the fears of the finance and import sectors that devaluation could be imminent. The financial sector was particularly vulnerable:

⁶⁰ The year 2000 marked El Salvador's first National Meeting of Private Enterprise (ENADE, by its Spanish acronym), organized by ANEP. The product of each ENADE is a report that details proposals for overall economic and sector-specific measures to implemented by State agencies.

between 1996 and 2000, El Salvador's private foreign debt stocks had increased significantly (see Table 9). While the exact causes of these debt increases are unclear, they were likely related to 1) the finance sector's practice of borrowing money abroad at low rates and loaning it domestically at higher rates of interest (Arias and Sol Perez, Rivas 2005) and 2) to finance the numerous mergers and takeovers within the financial sector that took place during the second half of the decade. Devaluing the colón to its true value would have multiplied the costs associated with repaying their foreign debts and potentially increased the price of future foreign debt due to a perceived increase in currency risk.

Table 8. Foreign Debt Stock of Private Financial Institutions

	Millions of US Dollars
1991	157.4
1992	295.7
1993	424
1994	1251.1
1995	3177
1996	3554.1
1997	4699.1
1998	4519.4
1999	4826.6
2000	3875.1

Source: Central Reserve Bank of El Salvador

However, dollarization would permanently put an end to such a debate and lock in profits for the finance and import sectors, whose continued business model depended on an overvalued colón.

As an editorial in *El Diario de Hoy* read in 1999 when dollarization resurfaced in public

discourse, “The combination of global crisis and an unpleasant Salvadoran economic situation contributed to businessmen and politicians reviving the call for dollarization. The fear? That the colón, in the medium term, is confronting pressure towards devaluation” (Gallegos 1999: 3, this author’s translation).

This observation was repeated in interviews with economists and observers of the debate in El Salvador:

“So, how do you resolve this conflict between a group, one that is strong that says to the government, ‘don’t alter the exchange-rate,’ and the other that asks for a mini-devaluation or a maxi-devaluation of 20, 25, or 30%? You resolve it by dollarizing. When the economy is dollarized you can no longer devalue because there is no national currency” (Carlos Villalona interview, this author’s translation).

Dollarization became a solution for the financial sector to insulate itself from the dire effects of devaluation given its high levels of foreign debt. However, it was also a solution to the ongoing struggle over the future of El Salvador’s economic model: without a means of devaluation, dollarization struck a hard blow to the export sector and ensured continuity of a finance-led model of economic development.

Fears of a devalued colón were compounded by anxieties among the entire Rightwing about the increasing political power of the FMLN and the eventuality of an FMLN presidency. Dollarization proponents used the growing anxiety to drive home what they saw as a benefit of dollarization: it would limit the capacity of the socialist-oriented FMLN to control the economy by cutting off monetary and exchange-rate policy: “there was always fear of an FMLN win or

that some populist rightwing government would come to power, too. So, how do you protect yourself from something like that? Dollarize” (Hinds Interview).

By 2000, this fear seemed to be becoming a greater reality. As noted earlier, in its first election in 1994, the FMLN made a strong showing, becoming the country’s second party. Two years later, in 1996, the FMLN made significant strides by winning 27 seats in the Legislative Assembly, just behind ARENA, with 28. ARENA actually lost 11 seats from 1994. The FMLN also made advances on the municipal level, winning 54 municipalities, including the major cities of San Salvador and Santa Ana. The FMLN now represented approximately 45% of the population on the municipal level. Even though it lost the presidency to ARENA’s Francisco Flores in 1999, the FMLN overtook ARENA in the Legislative Assembly that year, gaining a plurality of the seats (31 compared to ARENA’s 29) and gaining control of 78 municipalities: “We knew that the risk [of an FMLN government] was there, number one. Number two, we knew that the longer the dollar was in place, the less possibility there is to revert it.” (Claudio de Rosa interview).

Carlos Quintanilla Schmidt, Vice President under Francisco Flores and member of the ARENA governing board COENA from 1997-1998, recalls the concern about a future populist government and the certainty that the FMLN would, at some point, gain the Presidency:

“The macro economy was, perhaps, one of the biggest achievements carried out by the government once Cristiani put the economy in order. During the period of Calderón Sol and our [administration], the macro economy was very stable.... But what happens if some future government messes up these figures and inflation takes off? A devaluation? We lose investment grade. Then dollarization is going to act as a straitjacket to prevent

crazy things being done that are detrimental to these macroeconomic figures regardless of whether it is a government from the Left or the Right. Of course, I always thought that, at some point, the time will come when we will see an alternation with a Left government but this is going to allow the macroeconomic figures to always remain stable.”
(Quintanilla Schmidt interview)

As the quotes make clear, concern around the future of the FMLN was palpable. ARENA was able to circumvent the FMLN plurality by forming alliances with the PCN, a small Rightwing party, but these alliances often meant negotiating away important roles within the Legislative Assembly and state apparatus. Concerns around the FMLN also coincided with anxieties about the future of the Right in El Salvador and the ARENA party itself. ARENA continued to face internal divisions among its base that would periodically flare up in the full view of the public. Struggles centered on control over the party and continued implementation of a finance-led model of economic development (Towers and Borzutzky 2004, Schmitt and Stanley 2001, Interview with Villalona 2009).

The division had been temporarily addressed during Calderón Sol’s tenure with a reorganization of COENA, the party’s leadership body, to include greater representation of leaders connected to the agro export sector while still under the firm control of Alfredo Cristiani, who epitomized what came to be known derisively as “the Mercantilist” faction, which was closely tied to finance, imports, and services. However, the division between the “Mercantilists” and traditional elites, who often referred to themselves as “Founders,” continued to brew below the surface. ARENA’s poor showing in the 1999 elections became a point of contention for the “Founders,” who charged that ARENA needed to be more representative of its base, which was

code for the agricultural sector. Getting back to party roots became a rallying cry for the group during this period, as they pushed for representation in the ARENA leadership structure.⁶¹ For ARENA, party “roots” would mean not only an overhaul in its political strategy but also its economic strategy, a prospect that the party leadership and financial sector wanted to minimize. To this end, dollarization was a means for the financial sector to protect itself not only from an eventual FMLN government but also from elements within its own political party that sought to reassert their own political and economic power.

V. CONCLUSION:

El Salvador's march towards dollarization clearly demonstrates the complex interaction between financial globalization, sectorial interests, and domestic politics. El Salvador's dollarization in 2001 reflected a complex amalgam of financial globalization and domestic economic and political rivalries over the future of the Salvadoran economic model. Dollarization was both a result of financial globalization as well as a strategy for deepening the finance-led model in El Salvador.

⁶¹ This underlying struggle between “Founders” and “Mercantilists” surfaced in the public arena once more in the Fall of 2001 (post-dollarization), when the “Mercantilist” faction once again demonstrated its control over the party by overhauling COENA and filling its seats with leaders of the top Economic Power Groups, mostly representing finance/import/service sector interest. According to one press report at the time: “ARENA business executive Orlando de Sola said the new COENA showed that divisions in ARENA had hardened. To choose only businessmen for COENA is a reflection of party divisions, he said. ‘This is not a party of common citizens,’ he said, but of merchants, manufacturers, and bankers” (NotiCen 2001). New COENA members included Alberto Murray Meza (President of Grupo AGRISAL), Archie Baldochi (President of Banco Agrícola), Roberto Palomo (connected to Grupo Banco de Comercio), Carlos Araujo Eserski (connected to Grupo Banagrícola), Carlos Boza Delgado (Vice President of Grupo Poma), Ricardo Sagrera (President of the Hilasal). As one angry “Founder” exclaimed, “ARENA has been privatized.” (Miranda 2001)

El Salvador's Civil War laid the foundation for a dramatic shift in economic model throughout the 1990s, beginning with re-privatization of the banking sector in 1992. Influenced by economic theory that placed financial liberalization at the center of economic development as well as the lure of easy profits and access to capital by powerful elites, El Salvador placed banking privatization and financial liberalization at the top of its long reconstruction to-do list. The new bank owners, which included President Cristiani and other economic elites closely linked to the ARENA party leadership, quickly began to impose policies favorable to the burgeoning financial sector. For the remainder of the decade El Salvador followed a finance-led development model built upon the inflow of remittances, a pegged exchange-rate, and low levels of inflation that helped make El Salvador's banking sector one of the most developed in Latin America. Record profits aided the financial sector in consolidating its status as the dominant force in the Salvadoran economic and political sphere. Economically, El Salvador's major economic groups anchored themselves in the financial sector, with investments in other profitable sectors, including industry, services, real estate development and, above all, import.

As El Salvador's domestic economy slowed during the latter part of the 1990s, economic elites looked beyond their country's borders to rebuild profits and initiated a strategy of regional expansion, beginning with the financial sector. El Salvador's most powerful finance-based

economic groups opened offices in Panama, Honduras, Guatemala, and even the US and formed strategic alliances with regional and global financial groups. Later, Salvadoran economic groups also ventured into transnational real estate development projects and expansion of Salvadoran-based retail chains. Dollarization became a cornerstone of transnational expansion by deepening and institutionalizing El Salvador's access to cheap dollars and by removing financial sector dependence on deposits as a base for capital. In the years since dollarization, Salvadoran financial groups have consolidated their regional and international presence, aided in great part, by their ability to export US dollars. Between December 2000 and December 2006, loans to non-residents increased 5.4 fold from \$65.9 million to \$420.2 million (Osorio 2007). During this time, groups like Grupo Cuscatlán, Grupo Banagrícola, Grupo Banco Salvadoreño/Síman, and Grupo Poma/Quiros dramatically increased their financial, retail, and real estate interests throughout the hemisphere, all of which were helped substantially by access to cheap dollars provided through dollarization.

El Salvador's failed initial attempt at dollarization in 1995 and its later success just five years later demonstrates both the role of El Salvador's financial sector in guiding economic policy and financial globalization in shaping this sector's interests. Participants in both Calderón Sol and Flores governments recognized the powerful role of the financial sector in determining the fate of dollarization: without the support of El Salvador's most powerful economic groups (led by the financial sector), any dollarization proposal would meet a dead end. This was

certainly the case during the Calderón Sol administration, when the financial sector doggedly opposed the measure. At the time, the financial sector was focused mainly on the Salvadoran market. Arguments from the Calderón Sol government around lower interest rates and access to cheaper dollars did little to sway the local financial groups in the midst of a booming domestic economy. It was not until these groups sought to project themselves globally towards the end of the decade that their attitudes towards dollarization shifted and the measure was swiftly adopted and implemented.

Domestic political factors also contributed to shifting interest in dollarization by the major economic groups, including growing contestation of the Salvadoran finance-led model by the declining agro export sector and concern over the growing political power of the FMLN. While the political outlooks of the agro export sector and FMLN differed greatly, both threatened the eminence of El Salvador's finance-based model. In addition to shifting economic power, given the tremendous overvaluation of the colón, redefinition of the economic model would likely result in an adjustment to the exchange rate, a move that would prove catastrophic for El Salvador's financial sector, which had become heavily indebted in US dollars. Dollarization killed two birds with one stone: it neutralized growing calls for devaluation and reduced the power of any future government—FMLN or otherwise—in shifting the El

Salvador's economic model by removing its ability to manipulate monetary and exchange-rate policy.

Internal divisions and struggles over power within the ARENA party during this period illustrate the financial sector's tremendous political power and its ability to utilize the ARENA party structure to push forward its preferred policies: financial liberalization, a fixed exchange-rate and, eventually, dollarization. In the political sphere, ARENA united El Salvador's business sector, encompassing traditional elites still tied to the agro export sector as well as economic elites who had expanded into the burgeoning finance, import, and real estate sectors since the Civil War. This coalition of economic interests under one political roof, while politically successful in staving off the rising power of the FMLN, also created intra-party tensions over the party's economic platform and political leadership. Since the rise of Alfredo Cristiani to party leadership in 1989, the Cristiani-aligned group, anchored in the newly privatized financial sector and derisively referred to as "mercantilists" by its traditional elite foes within ARENA, consolidated its power throughout the course of the decade. The complete capture of the ARENA party by this group was most evident in the make-up of successive ARENA governments and its top leadership body, COENA, responsible for choosing party candidates and delineating the party's political platform. To this end, leaders of El Salvador's top economic groups were able to use their political ties and, in some cases, their participation in political and governmental posts, to implement their preferred economic policies and to veto those they opposed.

CH.4: Argentina

I. Introduction:

Argentina was the economy that scholars had in mind when they discussed dollarization, not Ecuador or El Salvador. When, then-President Carlos Menem announced to the world that his government was considering dollarization, it set off a firestorm within the economic policy community. Scholars wrote articles and books on the pros and cons of dollarization and made predictions for which countries dollarization would be the best fit. Academics and pundits alike told of how dollarization would unify the Western Hemisphere, promote the Free Trade Agreement of the Americas, and serve as a bulwark against the rise of the Euro. In light of Menem's public conversation, Senator Connie Mack, Chairman of the Joint Economic Committee (JEC) even held public hearings to help determine what role the US should take vis-à-vis dollarization. For a number of people in the policy community, Argentina seemed a natural candidate for the measure. After all, its economy was already highly dollarized due to the success of the currency board regime (often referred to as Convertibility) adopted in 1991, and Argentines already operated under highly restrictive monetary guidelines; dollarization would simply make Argentina's de facto system de jure. And yet, in just a little over two years after Menem's announcement, in the midst of economic crisis, Argentina abandoned its currency board, de-dollarized and opted for a floating exchange-rate.

The thesis of this study is that official dollarization of sovereign countries is a byproduct of financial globalization but will take hold only in those countries dominated by a globalizing

but locally-based financial sector; the country's most powerful economic agents must be anchored in global finance, with subordinated export and import competing sectors. Power, in this case, is defined not simply by economic power (although it is certainly a necessary component) but also by the political power often found in agents and groups with a long history in the country and deep political ties to political decision-makers; these are often locally-based economic business leaders. The cases studies presented on Ecuador and El Salvador demonstrate how such financial interests can move a country towards dollarization even when, in the case of Ecuador, it simultaneously bankrupts the economy. However, Argentina represents the opposite case, a country that, although poised to do so at the turn of the new millennium, did not dollarize. Rather, the evolution of Argentina's currency board and eventual struggle over dollarization and complete abandonment of a fixed peg represents the triumph of Argentina's export sector over globalized finance.

Argentina set the stage for the struggle over dollarization at the turn of the millennium with the implementation of Convertibility in 1991. Convertibility essentially created a currency board that pegged the Argentine peso at par with the US dollar. The Argentine government embraced financial globalization: capital controls were eliminated (foreign capital did not even have to register investments), Argentines were free to wield US dollars or the peso interchangeably, international banks flooded the country, local and transnational capital formed associations for joint ventures in taking over privatized state enterprises, and financial valorization became a main component of earnings for Argentina's local economic elites.

However, the alliance between local economic groups and transnational capital would prove temporary, as local economic groups sold off their shares in jointly owned privatized companies and shifted investments to the export sector during the latter half of the decade. The dissolution of this alliance, along with the exhaustion of the Convertibility model towards the end of the decade, set the stage for an all-out war over the future of Argentina's monetary regime at the turn of the millennium that pitted a pro-dollarizing coalition, led by a largely foreign globalized financial sector, against a pro-devaluation coalition, backed by local economic groups entrenched in the export sector. While exporters may have been outgunned in terms of financial resources, they did wield much greater local political power as a result of their long history of close ties with dominant political parties and their ability to mobilize political pressure via a campaign to bring back "national production."

This chapter traces the rise and fall of financialization in Argentina and, with it, the rise and fall of Convertibility and the struggle over dollarization that ensued. Section II addresses how the Menem administration utilized globalization, in general, and financial globalization, in particular, to alter the self-interests of local economic groups and even Labor in favor of Convertibility and further financialization. In this way, Menem was able to construct a new broad-based coalition in favor of financialization and currency stability. Section III details the ways in which reforms associated with financial globalization and Convertibility reoriented Argentina's economic system towards financial accumulation even for local actors engaged in nonfinancial industries. Section IV of this chapter shows how shifts in local economic group

investment and exhaustion of financial valorization led to a fissure in the alliance between local and foreign capital that supported financialization and Convertibility for nearly a decade. Section V traces how the breakdown of this alliance resulted in the emergence of two distinct projects--a national production project, anchored in a flexible exchange rate and backed by a coalition of exporters, industrialists, and Labor, and a finance-led development project, anchored in dollarization and led by the foreign-dominated financial and privatized service sectors—and how these opposing projects pressed for supremacy within the national political arena. Section VI covers the ultimate victory of the “nationalist” devaluation project over dollarization and the end of Argentina’s Convertibility regime and Section VII summarizes conclusions.

II. Menem’s Masterful Development of the Convertibility Coalition

Carlos Menem came into office six months early due to an economic crisis that resulted in triple digit inflation, capital flight, and increased rates of indigence. Elected on a populist platform in 1989 and backed by the historical populist legacy and union ties of the Partido Justicialista (popularly known as the Peronists after their former leader, Juan Perón) he represented, Menem quickly abandoned his populist platform upon entering office in favor of free market oriented policies. Menem soon realized that economic stabilization would require him to form a broad and credible coalition that included the support of Argentina’s powerful economic groups⁶²,

⁶² Schvarzer (1995) and Stolovitch (1995) have identified 43 economic groups of local origin in Argentina.

which had the power to destabilize reform efforts through what Argentines refer to as a “financial coup” (golpe de Mercado) but could also convince the international business community that Argentina was a safe place for investment (Starr 1997). However, Argentina’s business sector was heterogeneous. After more than 30 years of following an Import Substitution Industrialization (ISI) model that had subordinated the country’s agricultural sector to the needs of industry, outwardly-oriented agricultural and financial interests were able to reassert themselves during the military overthrow of Peronism during the latter half of the 1970s (Schamis and Bonilla 1999, Santarcángelo and Fal 2010). While the free-market reorientation of the economy definitively ended Argentina’s era of ISI, it did not result in a definitive dominant sector, nor resolve the tensions between the interests of the various business sectors (i.e. inward oriented industrial sectors seeking to prop up internal demand and to reduce the penetration of foreign capital vs. outward oriented export and financial interests seeking economic opening and

However, as Schvarser notes, of these 43, only a dozen or so account for the lion’s share of the top Argentina companies. Kulfas (2001) identifies some of Argentina’s most prominent economic groups include Bunge & Born, Pérez Companc, Techint, Soldati, Bidas, Roggio, Fortabat, Macri, Aluar, ASTRA, Bemberg, Pescarmona, and G&Z. While some of the prominent groups (i.e. Bunge & Borne) have been present in Argentina for more than a century, many of these groups emerged during Argentina’s era of ISI but consolidated their power during the country’s last military dictatorship (1976-1983), when they enjoyed a close relationship with the government that resulted in extremely favorable government contracts. As with Ecuador and El Salvador, Argentina’s economic groups are led by family groups, although some have sold off minority shares to foreign capital. For further discussion on the evolution of Argentina’s local economic groups, see Kulfas 2001, Schvarzer 1995, Schvarzer 1997, and Stolovich 1995.

To this end, I am using Stolovitch’s (1995) definition of an economic group as “an articulated group of companies, among which there is a strong and durable connection that allows for a common policy of which the ultimate goal is to maximize the results of the group, taking advantage of existing synergies and obliging a global logic of accumulation that unifies the process of capital appreciation of each of its constituent companies. The unifying factor and nexus is the strategic communal property and control of the group of companies. A person or group of persons hold the power to adopt key decisions that affect each and every one of the companies as well as the group.” (p.176, note 4, this author’s translation).

reduced labor costs). Despite the relatively subordinated role of the export sector, the need for access to foreign currency in the absence of foreign credit or investment made this sector's support critical. Argentina also faced the outside pressure of creditors it could not pay and the IMF, upon which it depended for credit and credibility among international investors.

Upon taking office, Menem aligned himself with Argentina's most powerful local economic groups⁶³ in their struggle against foreign creditors and the penetration of international capital (Basualdo 2001). Menem's first economic plan, dubbed Plan BB, for Bunge y Born, Argentina's oldest multinational conglomerate from which members of Menem's economic team were plucked, sought to bring the triple-digit inflation rates under control through a combination of typical neoliberal policies, including some economic and financial opening, privatization, cuts in consumer and industrial subsidies, stabilization of the exchange rate after an initial devaluation, and price increases along with a moderate wage increase (Castaneda 1989). Pressured by other local economic groups, the Plan BB did not contemplate any economic reorganization beyond the stabilization of public accounts and providing some relief to the export sector (Basualdo 2001). Despite initial success, the plan soon fell victim to a financial coup undertaken by a small but potent agro-export sector seeking lower export taxes (Treisman 2004: 411).

⁶³ in note 49. From Verbitsky 1991: Barrinuevo said that Menem had received \$8 million from businesses and identified the 4 most important: Bunge and Born (\$700,000), Loma Negra y Perez Companc (\$700,000), Macri (\$600,000), a dozen or so auto companies, Supercentro (\$600,000) and Bidas (\$500,000) (Basualdo 2001: p. 58)

Thus, Menem needed a way by which to make compatible the disparate interests of Argentina's various economic groups and international creditors to form the basis of a credible stabilization coalition. Privatization became the critical component to formation of such a coalition. While foreign creditors and the IMF had been clamoring for a privatization initiative for some time, Argentina's local economic groups, which had benefitted from high-priced government contracts and feared foreign penetration, had historically opposed such measures (Basualdo 2001, Treisman 2004). Menem plied their support for privatization by favoring local groups in public sales, debt cancellations, monopoly protections, and bargain prices on the sale of public industries (Treisman 2004). The privatization process, which began in 1990⁶⁴, was a turning point for the creation of not simply a stabilization coalition but a fixed currency coalition. As Treisman (2004) points out:

“By getting the titans of Argentine business to buy state enterprises, Menem changed their interests, at least temporarily. Such entrepreneurs now needed currency stability in order to sell their shares to foreign investors at a profit. Since many of the privatized firms produced nontradables (telephone calls, airline flights, gas transportation), depreciation would lower the relative price of their output and the implicit dollar value of their assets. An agroexporter whose grain became more competitive when the austral's value fell would, as an investor in a domestic gas distributor, suddenly have a lot to lose from devaluation. Firms accused of speculating against the currency in past crises would now have reason to prefer currency stability” (p. 412)

Privatization also brought together national and international interests through the formation of consortiums that united foreign and domestic capital. For the first time, Local and Foreign

⁶⁴Although the process did not start in earnest until 1991; between 1991 and 1994, the government privatized approximately 90% of all state agencies (IMF 1998: 5).

Capital needed each other: local economic groups had too little economic, financial, and technological capacity to continue excluding foreign investors, while foreign capital needed the local knowledge and greater political influence of local Argentine economic groups (Basualdo 2001).

Menem also neutralized Argentina's once-powerful Labor sector. In addition to exploiting the Peronist's historic alliance with the working and lower-class, Menem was able to neutralize opposition by organized Labor through a combination of punishing those that opposed him and offering benefits to those that supported his regime (Basualdo 2001, Starr 1997, Levitsky, Treisman 2004), including shares in newly privatized companies (Murillo 1997). Clientelist networks developed by the Peronists throughout the 1980s also helped Menem retain support from the working and lower classes in the face of painful structural adjustment (Levitsky 2003, Pastor and Wise 1999).

It is within this context that Argentina, under the leadership of Minister of Economy Domingo Cavallo, passed a package of financial and economic reforms that gave life to what became known as the Convertibility Plan⁶⁵. Convertibility transformed Argentina's Central Bank (BCRA, by its acronym in Spanish) into a currency board by pegging the Argentine peso to the

⁶⁵The Convertibility Plan began with the benchmark Convertibility Law of April 1991, which pegged the Austral at a rate of 10,000 to 1 US dollar, turned the Central Bank of the Republic of Argentina (BCRA, by its Spanish acronym) into a currency board, and then replaced the austral with the peso also at a rate of 10,000 to one in January 1992, placing the peso on par with the US dollar. In September 1992, the Central Bank Charter is reformed to make the BCRA independent and mandate that price stability be its main objective. Finally, in January 1993, the use of dollars for current and checking accounts is authorized.

dollar at a one-to-one ratio, requiring that the newly independent BCRA back all pesos in circulation, removing its power of lender of last resort and prohibiting the financing of public debt.⁶⁶ Pesos could now only be emitted if dollars entered the country. Convertibility also eliminated price indexing and mandated that pesos could be converted into US dollars at any time and could be used interchangeably. Finally, Convertibility meant almost complete elimination of the currency exchange market and the elimination of taxes and other restrictions on securities transactions (Pou 2000, IMF 1998). Reforms also included trade deregulation. In particular, tariff and non-tariff barriers to imports were lifted and import tariffs were dramatically reduced⁶⁷, opening up the economy to global competition. Menem compensated affected sectors with selective compensatory policies. For example, exporters were reimbursed for indirect taxes and certain sectors remained protected, such as automobiles, textiles, and shoes (Bolten 2006, IMF 1998). While reductions on import tariffs hurt the industrial sector, a significant portion of which manufactured intermediate goods, trade reform benefitted the agricultural sector, which had a natural comparative advantage (IMF 1998).

III. The Golden Age of Convertibility: 1992-1994

⁶⁶ In reality, this meant that the BCRA was required to back at least two-thirds of the monetary base with international reserves and up to one-third with dollar-denominated Argentine central government securities evaluated at market prices, with the stipulation that the BCRA's holdings of these securities may not grow more than 10 percent a year (Pou 2000).

⁶⁷ Import tariffs were reduced from an average of 40% in 1989 to approximately 9% by the end of 1991. Tariffs on raw and capital goods were eliminated (IMF 1998).

The Convertibility regime ushered in a period of economic growth and unprecedented monetary stability, a relief for the vast majority of Argentines still traumatized by the recent memories of hyperinflation at the end of the 1980s. Between 1991 and 1994 Argentina's GDP grew by an annual rate of 7.7% due, in part, to a domestic consumption boom driven by confidence in Argentina's victory over inflation. The era resulted in widespread support of the Convertibility regime; as Castiglioni (1996) comments, "convertibility and price stability became synonymous for many Argentines" (6).

Sharing the Spoils: Local and International Capital Alliances

Menem's strategy for privatization led to an unprecedented alliance between local economic groups, foreign companies, and transnational banks, which came together to buy up Argentina's privatized public companies at cut-rate prices (Basualdo 2001, Kulfas 2001). The privatization effort led groups that had historically been adversaries to become partners of necessity: local economic groups needed the economic, financial, and technological resources of the transnational corporations, while transnational capital needed not only the local groups' knowledge of the local market but their capacity to define certain aspects of state policy (Basualdo 2001).

Between 1990 and 1994, Argentina privatized more than 30 public companies.

Everything was for sale: from telephone companies to airlines to horse racing stadia (Teubal 2004). Privatized companies provided particularly lucrative opportunities, as they operated under

oligopolistic or monopolistic conditions with little or no government regulation (Kulfas 2001). This period also marked the beginning of an era of precipitous deindustrialization (See Table 1). Some of Argentina's largest industrial groups (i.e. Bunge and Born, Techinct, etc.) shifted their investments out of industry and into the lucrative provision of newly privatized services. The manufacturing sector was also crippled by increasing competition from imports in a liberalized economy and appreciation of the peso since Convertibility (Kulfas 2001, Pastor and Wise 1999).

Table 1. Share of GDP by Selected Sectors

Year	Finance	Agriculture	Manufacturing	Electricity, Gas & Water	Transportation, Storage & Communications
1991	3.8	5.8	16.5	1.8	6.5
1992	4.7	5.4	16.8	1.8	6.8
1993	5.1	5.1	16.3	1.8	6.6
1994	6	5.2	15.9	1.9	6.9
1995	6.1	5.6	15.2	2.1	7.2
1996	6.6	5.3	15.3	2.1	7.3
1997	7.1	4.9	15.5	2.1	7.5
1998	8.4	5.1	15.2	2.2	7.9
1999	8.8	5.5	14.5	2.3	8
2000	9	5.4	14	2.5	8.2
2001	8.3	5.7	13.6	2.6	8.2
2002	7.1	6.3	13.6	2.9	8.5

Elaborated by this author based on BCRA data

Rebirth of the Financial Sector:

After several years of economic instability that gave rise to crushing inflation, the rigid Convertibility Plan helped revive Argentina’s financial sector, which had been crippled by domestic and international lack of confidence in the Argentine currency. In addition to codifying the exchange rate regime into law, Convertibility also committed Argentina to financial globalization through full liberalization of interest rates, tax exemptions for interest on deposits, and the complete liberalization of capital flows—even registration requirements on foreign capital were removed (O’Connell 2005), making Argentina one of the most financially liberalized countries in the world. As a result, international capital poured into the country looking for investment and the country became quickly “dollarized” (See Tables 2 and 3).

Table 2. Private Sector Credit (in millions of Aug. 1999 pesos)

Year	Private Sector Loans in Domestic Currency	Private Sector Loans in Foreign Currency	Total
Dec-90	\$7,188.00	\$684.00	\$7,872.00
Dec-91	\$13,180.00	\$9,573.00	\$22,753.00
Dec-92	\$19,055.00	\$15,933.00	\$34,988.00
Dec-93	\$21,766.00	\$21,477.00	\$43,244.00
Dec-94	\$23,931.00	\$28,282.00	\$52,212.00
Dec-95	\$21,819.00	\$29,686.00	\$51,506.00
Dec-96	\$21,980.00	\$32,958.00	\$54,939.00
Dec-97	\$24,745.00	\$39,489.00	\$64,234.00
Dec-98	\$27,420.00	\$44,786.00	\$72,206.00
Aug-99	\$26,917.00	\$43,637.00	\$70,554.00
Source ABA 1999: 9			

Table 3: Percentage of Private Sector Loans in Domestic and Foreign Currency

Year	% Private Sector Loans in Domestic Currency	% Private Sector Loans in Foreign Currency
Dec-90	91.30%	8.70%
Dec-91	57.90%	42.10%
Dec-92	54.50%	45.50%
Dec-93	50.30%	49.70%
Dec-94	45.80%	54.20%
Dec-95	42.40%	57.60%
Dec-96	40.00%	60.00%
Dec-97	38.50%	61.50%
Dec-98	38.00%	62.00%
Aug-99	38.20%	61.80%

Source: Calculations Based on ABA 1999: 9

Convertibility helped to quickly remonetize the economy: M3⁶⁸ as a proportion of GDP increased from just 9.9% in 1991 to 21.8% in 1994. By 1999, the M3 to GDP ratio reached 32.6% (Burdisso et, al. 2001:3). The immediate macroeconomic stability generated by Convertibility along with the stringent policies put in place to support the regime also paved the way for Argentina's signing of the Brady Plan in 1992, which allowed Argentina access foreign credit once again (Basualdo 2001). As a result, there was a dramatic increase in bank loans, from

⁶⁸ M3 is comprised of the total amount of domestic currency in circulation, as well as domestic and foreign demand deposits, savings deposits and time deposits.

20.5 billion pesos (1999 pesos) in December 1990 to 67.4 billion pesos (1999 pesos) in December 1995. By August 1999, the total amount of loans reached 96 billion pesos, with the private sector accounting for nearly 75% of that total (ABA1999: 8-9).

Beyond growth of the financial sector inside of Argentina, as evidenced by rises in accounts, branches, and efficiency gains⁶⁹ it was the finance sector's role in funneling money out of the country that helped give rise to its dominance during the period of convertibility. As Basualdo (2001, 2002), Basualdo et al (2007), Kulfas and Schorr (2003) and Kulfas (2000) have shown, Argentina's economy quickly came to be centered on what Basualdo dubbed "financial valorization" by which economic groups (and their members!) profited by contracting low-interest external debt and depositing it into local Argentine bank accounts, which paid out higher rates of interest. After letting these financial assets appreciate, these groups moved their financial assets abroad once more (Basualdo 2007). Thus, a large portion of the profits accruing to the top companies in Argentina came not from their productive activities but rather from practicing financial arbitrage with financial assets that were eventually sent abroad once more.

The practice of financial valorization was not completely new; it had flowered for a period during the late 1970s under the military dictatorship which, under the leadership of Minister of Economy Martínez de Hoz, with the support of the IMF, undertook the first

⁶⁹ Between 1994 and 1999, banks were able to reduce their administrative costs as a portion of assets from 7.7% to 4.8%. Likewise average assets per bank employee increased from 730,000 pesos to 1,500,000 pesos (ABA 1999: 26). While the number of private banks decreased from 134 in 1991 to 75 in 2000, the total number of private bank branches increased from 2,345 to 2,862 during that same period, from an average of 18 branches per bank to 38 branches per bank. Similarly, between December 1990 and December 1994, the total number of bank accounts (time deposits + savings accounts+ current accounts) increased from 7,878,633 to 9,111,886 and up to 18,346,902 by December 1999 (ABA Memoria 2001).

liberalization overhaul of the financial sector with the 1977 Deposit Decentralization Law and the Financial Entity Law (Morongiu 2007, Santarcángelo and Fal 2010). According to Santarcángelo and Fal (2010)

The reform involved a radical change in the conditions of accumulation of capital in the country by modifying the four fundamental tenets upon which the economic system operated: nationalization of deposits, interest rates controlled by the BCRA, the amount of minimum capital and control over private foreign debt.” (15).

To this end, the financial reform allowed banks to accept deposits on their own behalf (under the Peron administration banks had to deposit all funds into the BCRA), liberalized interest rates, reduced barriers to opening financial institutions and branches, extended the coverage of the BCRA’s deposit guarantee, redefined the concept of legal and physical personhood with respect to financial activities and economic groups, and replaced the regime of financial entity specialization with one of universality (Santarcangelo and Fal 2010)

Martinez de Hoz also implemented a crawling peg⁷⁰, popularly known as the “tablita,” in an effort to reduce inflation. The administration assumed that liberalizing interest rates within the context of contractive monetary policy and economic opening would lead to positive real interest rates and stimulate savings (Santarcángelo and Fal 2010). True to the culture of finance that was gaining traction within the developed world throughout the decade, financial sector development was pivotal to economic

⁷⁰ A Crawling Peg is a system of exchange rate adjustment in which a currency with a fixed exchange rate is allowed to fluctuate within a band of rates. The par value of the stated currency is also adjusted frequently due to market factors such as inflation. This gradual shift of the currency's par value is done as an alternative to a sudden and significant devaluation of the currency.

<http://www.investopedia.com/terms/c/crawlingpeg.asp#ixzz1wP5BhajW>

development and a strong financial sector depended on savings, which, in turn, required positive interest rates and a stable currency (Morongiu 2007).

While the financial reforms did not achieve the stated goal of promoting national industry and economic development,⁷¹ the policies did lead to a strengthened private banking sector (Morongiu 2007). Between 1975 and 1981, the financial sector increased 34% while the industrial sector decreased 17% (Santarcangelo and Fal 2010: 35). An influx of new banks and an extended state deposit guarantee set the stage for a competitive bidding war for deposits, leading to high interest rates on deposits, which would then be recouped through even higher interest rates on loans. Thus, began a vicious cycle of financial speculation: the high cost of loans together with the high yield for deposits made it more profitable to direct productive investments towards financial speculation. Local and international capital flooded the financial system. As Santarcángelo and Fal (2010) explain:

“The most simple maneuver consisted of taking out foreign loans and interest rates that were lower than local interest rates, deposit them in the country—which paid higher interest rates—to later take that money abroad, which served as collateral for contracting new loans” (29).

⁷¹ Financial reforms resulted in a first wave of Argentine deindustrialization (Cooney 2007). Deindustrialization was no accidental byproduct of these reforms but one of its very aims. To this end, the regime followed economic policies broadly in line with previous governments of the armed forces: it was pro-agriculture, anti-labor and suspicious of industrialists who had been allied with the Peronists. The military saw ISI as the root of political and economic crisis and sought to uproot everything associated with it through economic policy that attacked the manufacturing sector on three different fronts: **open trade, currency appreciation, and high interest rates. As a result, Argentina’s** agrarian and financial groups recovered their former centrality (Schamis & Bonilla 1999).

As a result, public and private foreign debt exploded in Argentina, when increased US interest rates and severe economic recession conspired to lead to economic collapse. Similar to Ecuador's "sucretization," Argentina's Military Junta responded in 1982 by nationalizing approximately \$14 billion of foreign private debt (Santarcangelo and Fal 2010: 34). The government also responded by reversing some of the financial reforms that helped lead to the crisis, including re-regulation of interest rates.

Convertibility and its accompanying economic reforms liberalized capital flows and interest rates once again and to an even further extent than Martínez de Hoz' reforms during the late 1970s. Once again, the stated goal was to enable foreign investment and the repatriation of Argentine capital, which was achieved, to some degree, through the privatization program. However, as in the late 1970s, Argentina's efforts at financial integration together with international economic conditions converged to encourage the revival of financial valorization. Argentina's emphasis on financial liberalization and inflation control in combination with low international interest rates encouraged capital flows into Argentina once more only to be sent back abroad once they appreciated in value.

The model of financial valorization did not contribute to overall economic development but it did reorient the short-term interests of the business elite and support the profits of the financial sector, which channeled funds in and out of the country. For example, Citibank, el Banco Republica (UFCO), and the economic group Wertheim joined together to create CEI (Citicorp Equity Investments, Inc, which would later rename itself CEI Holdings, S.A.).

Originally coming together to hold equity in Argentina's newly privatized telecommunications sector, CEI soon began channeling funds abroad for wealthy Argentines looking to engage in financial valorization and tax evasion (Basualdo 2002, Zlotogwiazda and Balaguer 2003). As a result, the financial sector's share of the GDP steadily increased, from 3.1% in 1990 to 6.1% in 1995 and it would continue to increase throughout the decade as the model deepened. By 2000, the financial sector accounted for 9% of the Argentine economy (BRCA).

Large non-finance companies profited heavily from financial valorization. Basualdo et al. (2007) demonstrate that financial valorization and foreign private debt were concentrated among a small group of large companies: just 55 firms accounted for 60% of the growing private foreign debt during the 1990s and 90% of firms with foreign debt were among Argentina's top 200 companies. Local conglomerates and Associations (mixed foreign and domestic capital) were the most active in this model (Basualdo, et. al. 2007: 212). Evidence gathered by the Special Investigative Commission on Capital Flight of the Chamber of National Deputies in 2001 sheds some light on the process, showing a high level of overlap among the economic groups and firms that contracted foreign debt throughout the 1990s and those that fueled the outflow of capital in 2001. More than 70% of the entities responsible for the capital outflow were companies pertaining to Argentina's top 200 businesses: 42% were large export firms and 26% were privatized public services (Basualdo, et. al. 2007: 213-214, Calcagno 2005). These firms shuttled almost \$14.4 billion abroad (Basualdo, et. al. 2007: 213-214).

With the country's non-financial business leadership earning the lion's share of its profits through financial valorization, local economic power groups formed an alliance with the financial sector in support of a globalized financial regime, the lynchpin of which was Convertibility. Not only did Convertibility support international capital flows through its liberalization of capital controls, exchange-rate guarantee, and the interchangeability of the peso and the dollar but Convertibility also meant relatively high local interest rates, which were the life blood of financial valorization. To this end, financialization came to dominate Argentina's economy during the 1990s, as the financial and non-financial sectors sought to encourage access to cheap international capital by any means necessary.

IV. Menem's Second Term and the Deterioration of the Convertibility Coalition

On May 14, 1995, Menem was elected to a second term in office with nearly 50% of the popular vote. However, if Menem's first term in office was the golden age of Convertibility, then his second term in office might be characterized as the oxidized age of Convertibility. The latter half of the 1990s saw another drastic reorientation of Argentina's economy and the consequent collapse of the "stabilization" coalition that installed Convertibility, as Argentine conglomerates (and some European conglomerates with a long history in Argentina) systematically shifted their investments from domestic-oriented industry and privatized services to agro-export. While the Convertibility Regime maintained popularity among the public and most big business leaders throughout the 1990s, the social and economic shifts that took place during the middle of the

decade laid the foundation for a future coalitional realignment that inflicted its end amidst domestic economic crisis at the turn of the century.

Several global financial crises during the latter half of the 1990s, including the Mexican Peso crisis in 1994, the Asian and Russian Crises in 1997 and 1998, and the devaluation of the Brazilian real in 1999, put tremendous stress on the Convertibility regime due to spiking interest rates, reduced access to credit, and increased price competition. By 1999, Argentina was in desperate crisis: official levels of unemployment had grown from 6% in 1991 to nearly 14% in 1999 with another 14% of the population underemployed. These numbers would only get worse; as the economy contracted during the first years of the new millennium, unemployment reached a high of more than 20%, with another 20% of economically active Argentines underemployed. According to official statistics, more than 50% of the population lived in poverty and more than 25% of the population met the government's definition of indigence (Cooney 2007: 24).

The economic crisis set the stage for a showdown over the country's future economic model and pitted former national and foreign business allies against each other. As Argentina's Convertibility regime became economically and politically unsustainable, two rival projects emerged: dollarization, supported by the financial sector and foreign investors with fixed assets, and devaluation, supported by the predominantly nationally based exporters and industrial sectors. The eventual victory of the devaluationist project over dollarization demonstrates the critical role of local economic power groups in the context of these struggles. As in Ecuador and El Salvador, Argentina's financial sector was ascendant and globalized, thanks in no small part

to Convertibility. For a large part of the 1990s, the needs of the financial sector dominated as economic power groups utilized financial valorization for large profit. However, unlike Ecuador and El Salvador, Argentina's economic power groups were not anchored in the financial sector. Instead, Argentina's business elite shifted their investments throughout the second half of the decade into the export sector while the country's financial sector came to be dominated by transnational financial conglomerates. Consequently, when financial valorization--supported by Convertibility--was no longer profitable, local economic groups closed-ranks to support their primary interests in export and, thus, monetary flexibility.

Disarticulation of the "Business Community"

The mid 1990s saw the dissolution of the "business community" formed during the advent of Convertibility, as local and international capital diverged. Local economic groups that bought up privatized companies in association with international companies sold off much of these assets to their foreign partners for significant profit (Basualdo 2001, Basualdo 2002, Kulfas 2001, Starr 1997, Ortiz and Schorr 2007). Within the context of increased liberalization and an increasingly overvalued exchange rate that favored imports⁷², a number of Argentina's most powerful economic groups also sold off their investments in the local industrial sector. In the face of overwhelming foreign competition seeking market share, many economic groups determined that

⁷² Among scholars on the subject, there is little debate that Convertibility's hard peg to the US dollar led to overvaluation of the peso to the benefit of imports. According to studies by Pastor and Wise (1999), although the Argentine peso was modestly undervalued at the time of Convertibility, it "**crossed a 25% appreciation threshold (above the equilibrium rate) less than two years later**" (485).

it was most strategic to sell their local brands to transnational corporations instead of fighting what many saw as a losing battle (Gaggero 2008, Schvarzer 1997). As Kulfas (2001b) observed:

In a context in which economic reactivation, exchange-rate overvaluation, and asymmetric conditions in access to credit converged with interest by foreign investors in entering (or re-entering) the Argentine economy and the possibility for local business owners to sell their firms (in many cases with obsolete and mortgaged technology but with brands well-positioned in the market and oiled chains of distribution) they were able to make significant profits in dollars (52).

Between 1992 and 1999, 916 mergers and acquisitions took place for a total of \$55.3 billion. Of these mergers and acquisitions, nearly 75% occurred between 1997 and 1999; of the \$55.3 billion spent, foreign acquisition of local companies accounted for approximately \$30.25 billion (54.7%) (Kulfas 2001b: 27). These sums amounted to tremendous profits for local economic groups, due to the undervalued price of their initial investments in privatizing sectors, the profitability of the companies sold, and the overvalued peso (Schvarser 1997, Kulfas 2001b). For example, groups like Techinct, Grupo Perez Companc, and Soldati earned an average of 405% profit on their initial investment from the sale of their shares in Argentina's privatized telephone companies (Kulfas 2001b: 33)

The local business elite invested a large portion of the proceeds from these sales in liquid financial assets abroad⁷³ and redirected the rest towards investment in sectors that were protected

⁷³ While it is difficult to ascertain exactly how much money was sent abroad due to Argentina's very liberal capital regime and high levels of evasion and corruption, the following sheds some light on the quantities. Argentina's largest local economic groups (Arcor, Astra, Bemberg, Bidas, Bunge & Born, Clarin, Fortabat, G&Z, IMPSA, Macri, Mastellone, Perez Companc, Roggio, Soldati, Techint) earned a total \$7.4 billion from the sales of holdings between 1992-1999 but spent just \$3.2 billion on new acquisitions, leaving approximately \$4.2 billion in liquid assets (Kulfas 2001b: 63).

or where Argentina enjoyed natural comparative advantage and profit yields were higher, particularly the agricultural sector (Basualdo 2001, Basualdo 2002, Kulfas, Gaggero 2008). Bunge and Born restructured their investments with the assistance of international consulting firms, like McKinsey, which advised them to de-diversify their investments and begin a process of vertical integration in the food sector while Macri, sold off much of its investments in the auto-industry and increased its investments in the agricultural sector. Between 1994 and 1998, Garovaglio y Zorraquín Group (now G&Z), transformed itself into an agro-industrial holding company. As G&Z Executive Director Federico Zorraquín, explained in 1998:

“We knew that we were not in any shape to compete with the big international players that were coming to Argentina and we preferred to shift towards other businesses where the group has competitive advantages. We returned to the countryside because it is a sector in which Argentina offers important competitive advantages. We also believe that it is easier for a local group to manage the business” (Gaggero 2008: 12).

Despite the increasingly overvalued exchange-rate, the agricultural sector was booming, due not only to its natural comparative advantage but to an international commodity boom, reduced local wages, and new opportunities opened up through the creation of the common market between Argentina, Brazil, Uruguay, and Paraguay—Mercosur—negotiated in 1991. As a result, the value of exports increased throughout the decade, from \$12.4 billion in 1992 to \$26.3 billion in 2000 (INDEC/BCRA).

During this time, the financial sector also underwent significant changes with transnational conglomerates coming to dominate the sector. This shift began with the advent of the Mexican debt crisis, dubbed the Tequila Crisis, which resulted in two waves of

internationalization and concentration of the country's financial sector. The first wave was due directly to the crisis itself, as troubled national banks either merged with or were acquired by stronger international banks (Burdisso, et al. 2001). The second wave was the result of financial reform passed to strengthen the sector in response to weaknesses exposed by the crisis, including increases in capital requirements and facilitation of the entry of international banks⁷⁴. Beginning in 1996, a wave of large international banks entered the Argentine financial sector. New stringent regulations and high priced offers pushed many local banks to sell to their foreign competitors (García 2002, Nahuel Oddone and Granato, Burdisso, et. al 2001 AND), including some of Argentina's most powerful locally-based financial groups, such as Banco Roberts, Banco Rio⁷⁵, and Banco Francés. Between 1994 and 1999, the total number of financial institutions decreased from 205 to 122 (Nahuel Oddone and Granato). Overall, 39 banks (73% of total bank assets) were foreign owned by the end of 2000 (O'Connell 2005:301). Of the 10 largest banks (accounting for 70% of private banking assets), eight were foreign owned, and the other two were partially foreign-owned (García 2002:256).

⁷⁴ Capital requirements were raised to 11.5%, much higher than Basel Committee on Banking Supervision's recommendation of 8%. Reserves on checking deposits were raised to 43% and reserves on savings were raised to 3% (Pou 2000).

⁷⁵ Grupo Roberts sold its holdings in Banco Roberts, Máxima AFJP (pension fund), Docthos, La Buenos Aires Seguros (insurance), La Buenos Aires-New York Life (life insurance) y Alpargatas (textile manufacturing) to Hong Kong & Shanghai Banking Corporation (HSBC) for approximately \$650 million in May 1997 (El Clarín, Martínez 1997). That same month Grupo Perez Companac, sold off its holdings in Banco Rio de la Plata to the Spanish financial conglomerate Banco Santander for approximately \$700 million (Rivera 1997, Schvarser 1997), consolidating its investments in Argentina's energy sector and agro-export (Bianchi 2000, Kulfas 2001).

Table 4. Market Share by Type of Institutions (%) - December 2000				
Type of Institutions	Deposits	Loans	Assets	Employees
Public-National	15.2	13.7	11.3	15.8
Public-Provincial/Municipal	17.9	15.5	14.6	23.1
Total Public Banks	33.2	29.2	25.9	38.9
Private-National	16.3	18.7	18.4	16.6
Private-Foreign	48.0	48.0	52.6	38.3
Cooperatives	2.1	1.8	1.6	3.6
Total Private Banks	66.4	68.5	72.6	58.5
Total Banks	99.5	97.7	98.5	97.4
Financial Corporations and Lending Institutions	0.5	2.3	1.5	2.6
Total Financial System	100	100	100	100

Source: ABA 2000: 19

As Argentina's most powerful local actors shifted more of their investments into agro export and offshore-dollarized financial assets, their interests in maintaining a hard-peg exchange rate regime weakened. The most powerful economic groups continued to support convertibility through the end of the 1990s due to the arbitrage that high local interest rates facilitated but such interests were circumstantial not intrinsic. As long as groups could exploit Argentina's natural comparative advantages within the context of high international commodity prices and had access to foreign capital within the context of comparatively low international interest rates, influential groups like Bunge and Borne supported the finance-led development and with it,

Convertibility. However, once these favorable circumstances changed, so too would support for the finance-led model. Despite the power and international orientation of the financial sector in Argentina and the logic of financial valorization that pervaded the economy, unlike Ecuador and El Salvador, local economic groups were not anchored in the financial sector. In fact, the process of financial valorization eventually supported local economic group interest in devaluation, as the value of their dollarized financial assets held abroad would be increased by a local devaluation.

As Argentine big business began to feel the pinch of Convertibility, their unyielding support for the monetary regime began to wane. The Asian and Russian Crises led to soaring interest rates on both private and public sector debt (O'Connell 2005), which not only worsened the economic outlook but also reduced the profitability of financial valorization. Argentine export growth began to stagnate along with the Argentine economy. The two main export sectors--agro-industry and low value-added commodities (i.e. petrochemicals, aluminum) showed a tendency towards long-term price decline (Musacchio 2002:16), while the profits of nationally-based economic groups plummeted (See Table 4). To make matters worse, in January 1999, Brazil devalued its currency, the real, by approximately half, seriously weakening the position of Argentine exports with its most important trade partner. As a result, Argentina and Brazil entered into a number of trade disputes that put into question the future of Mercosur. As the economist Guillermo Calvo warned at the time, another Brazilian devaluation could spell the end for Mercosur: "This combination of a fixed exchange rate in Argentina and a floating rate in

Brazil is not good for us” (Hynds 1999). With many of Argentina’s economic groups invested heavily in the future of Mercosur, both as an export market and as an opportunity for direct investment (Kulfas 2001b), the future of Convertibility pitted financial interests (i.e. access to cheap debt, the continuation of financial valorization) against the interests of export and the future of Mercosur (Basualdo 2001, Basualdo 2002, Ortiz and Schorr 2007).

Table 5 :Big Business in Argentina: Exportation of Goods by Principal Economic Activity

1993 – 2003

Principal Activity of Firm	Exportation of Goods								
	1993	1994	1995	1996	1997	1998	1999	2000	2001
	Millions of pesos								
Total	7,382.4	9,453.5	12,691.6	15,170.5	17,304.2	17,501.8	16,062.6	18,729.3	18,676.6
Mines and Quarries	506.0	1,136.2	1,688.4	2,153.1	2,155.4	1,595.1	1,985.7	2,993.5	2,613.5
Manufacturing Industry	6,696.0	8,128.3	10,821.0	12,819.8	14,774.7	15,343.5	13,684.7	15,452.2	15,805.3
Food, Drinks, and Tobacco	3,542.0	4,572.8	5,760.2	7,054.1	7,524.2	7,948.9	7,613.4	7,792.0	7,768.8
Combustibles, Chemicals, and Plastics	1,077.4	1,114.7	1,548.5	1,729.0	1,989.0	2,066.5	2,404.7	3,198.8	3,409.1
Machinery, Equipment, and Vehicles	1,018.4	1,201.4	1,514.0	2,004.0	3,125.6	3,286.9	1,900.4	2,210.7	2,216.9
Other Industry	1,058.2	1,239.5	1,998.4	2,032.7	2,135.9	2,041.2	1,766.2	2,250.7	2,410.5
Other Activities (2)	180.4	189.0	182.2	197.6	374.2	563.2	392.1	283.6	257.8

Source: Instituto Nacional de Estadística y Censos Grandes empresas en la Argentina: exportación de bienes y cantidad de empresas que exportan, por actividad principal de la empresa. Años 1993 – 2003

Table 6. Big Business in Argentina: Number of Companies that Export by Principal Economic Activity

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total	292	318	341	351	350	345	331	340	329
Mines and Quarries	9	16	17	18	21	18	20	21	19
Manufacturing Industry	264	280	292	294	301	294	275	278	274
Food, Drinks, and Tobacco	85	91	100	97	98	98	99	100	95
Combustibles, Chemicals, and Plastics	82	82	86	86	84	82	81	80	81
Machinery, Equipment, and Vehicles	34	38	35	36	41	41	33	35	35
Other Industry	63	69	71	75	78	73	62	63	63
Other Activities (2)	19	22	32	39	28	33	36	41	36

Source: based on data from Instituto Nacional de Estadística y Censos « Grandes empresas en la Argentina: «exportación de bienes y cantidad de empresas que exportan, por actividad principal de la empresa. Años 1993 – 2003 »

Table 7. Big Business in Argentina: Profits of Companies Belonging to Economic Groups: 1993-2001

Type of Economic Group	Profits (Millions of Argentine Pesos)									
	1993	1994	1995	1996	1997	1998	1999	2000	2001	
Total	5,860.50	8,097.70	7,638.10	8,896.30	10,000.50	8,867.60	6,254.10	7,581.60	5,356.30	
Group	3,761.40	5,416.40	5,152.10	5,693.50	6,745.30	5,536.40	3,703.10	4,966.80	3,243.30	
National	1,956.40	2,882.40	1,630.10	1,758.10	1,911.60	755.1	298.4	602.2	399.9	
Foreign	1,805.00	2,534.00	3,522.00	3,935.30	4,833.70	4,781.20	3,404.70	4,364.60	2,843.40	

No Group	2,099.10	2,681.30	2,486.00	3,202.80	3,255.20	3,331.20	2,551.00	2,614.70	2,113.00
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Source: based on data from Instituto Nacional de Estadística y Censos « Grandes empresas en la Argentina: utilidad por actividad principal de la empresa. . Años 1993 – 2004 »

It is around this time that the country's national business leadership began to publicly criticize economic policy and even discuss possible modifications to Convertibility in the future. Roberto Rocca, founder and President of the conglomerate Techint in Argentina, commented during the 1999 presidential campaign:

"The whole world realizes that the [fixed] exchange rate is a problem. This is not the time to touch the exchange rate. But when the next government is consolidated, it would not be inconvenient to be able to calmly announce a fluctuating exchange rate regime, like the Japanese yen fluctuates against the dollar or the mark against the dollar, or the European currencies among themselves, and nothing happens. Brazil could devalue with success because it never had that psychological problem that exists in Argentina but that at some point will be overcome" (Ortiz and Schorr 2007: 4).

Clearly the tide had begun to turn: rising international interest rates undercut the profitability of financial speculation that powered the Argentine economy and the fixed-exchange rate regime was beginning to dampen export profits for Argentina's most powerful economic groups. As a result, local economic groups, which had supported the Convertibility monetary regime that undergirded Argentina's finance-led development model for nearly a decade, abandoned their alliance with the financial sector.

V. WHICH WAY OUT OF CRISIS: DEVALUATION VS. DOLLARIZATION

The De la Rúa Administration

When Fernando De la Rúa took the presidency in December 1999, he faced not only a country plunged into recession but divided as to how to resolve the crisis. Within the ALIANZA⁷⁶ coalition and even within his own party, the UCR, there were disagreements over what approach to take: conservatives within the UCR, including De la Rúa, had wanted to appoint former IMF economist Ricardo Lopez Murphy from the ultra conservative (read: economically liberal) Foundation for Latin American Economic Studies (FIEL, by its acronym in Spanish) as Minister of Economy. Murphy and FIEL were strongly supported by the international financial sector and conglomerates doing business in Argentina. However, De la Rúa was prevented from appointing Lopez Murphy by opposition from within the UCR as well as ALIANZA's junior partner, FREPASO party. Instead, De la Rúa was forced to appoint economist Luis Machinea who had served in the Alfonsín administration⁷⁷ (Hynds 2001 3/16/2001) and was heavily linked to Argentina's local economic groups (Basualdo 2001).

De la Rúa came into power promising a more fair distribution of resources through transparency, honesty, and austerity. If he fulfilled any promises, it was that of austerity. His administration set about a fierce defense of Convertibility, which rested on 1) reducing the fiscal deficit and 2) implementation of regulatory reforms to support the strict requirements of the convertibility regime—above all, this meant further labor reform aimed at flexibilizing the labor force. Although De la Rúa faced opposition to such policies from within the ALIANZA

⁷⁶ ALIANZA represented a coalition of the UCR and the left-of-center FREPASO party.

⁷⁷ Former Argentine President, Raul Alfonsín, served as President of the UCR. The Alfonsín faction of the UCR was tied to local economic groups and a national production platform.

coalition, including the Alfonsín faction of his own UCR party, as well as from the opposition Peronist parties and organized Labor (which organized repeated strikes), the administration was able to push through its policies, even the extremely controversial labor reform⁷⁸. In many ways, De la Rúa's success in this area, despite public unpopularity, makes sense as these policies were backed not only by the IMF, World Bank, and IDB, but the financial sector and the leading economic groups: while the financial sector Deficit reduction through the shrinking of government spending (particularly social spending and further privatization) as well as labor reform had been among the few things these groups could agree on as the crisis progressed. In less than two years De la Rúa implemented seven major spending cuts, many aimed at reducing public employees, pensions, and social spending in areas such as education.

While the De la Rúa administration attempted to appease both the local economic power groups and the financial sector (aligned with foreign conglomerates with millions in recently purchased fixed assets), Argentina's economy continued to worsen. By the end of 2000, public debt reached 45% of GDP, which was unsustainable for Argentina (O'Connell 2005). Rates of unemployment and underemployment skyrocketed up to 18% and 12%, respectively; 52% of the population lived under the poverty level and 15% lived on \$2 or less per day. These statistics

⁷⁸ In May 2000, Congress passed de la Rúa's Labor Reform bill, which included increased the probationary hires for new employees from 30 days to 6 months (up to one year for small businesses), removing the power of unions to negotiate wages and working conditions across an entire industry, and lowered employer contributions to the payroll tax (NotiSur 3/10/2000, 5/19/2000).

eclipsed rates of poverty and unemployment during the hyperinflation that led to adoption of Convertibility⁷⁹ (Heidrich 2002).

National Production vs. Foreign Finance

As the economic crisis unfolded, two blocs began to form around how to exit it: a locally-based “productive” sector coalition led by Argentina’s Industrial Association, the UIA, and backed by Argentina’s largest economic power groups, which advocated for devaluation and a return to a flexible exchange-rate regime; and a coalition among the foreign-owned privatized service sector and the financial sector, also dominated by foreign firms, which advocated further institutionalization of Convertibility in the form of official dollarization (Ortiz and Schorr 2007, Basualdo 2001, Basualdo 2002). Local economic groups whose investments were now concentrated in the export sector, choked by an increasingly overvalued peso and with dollar assets abroad that would multiply in value, advocated for some form of devaluation. However, foreign capital, whose capital was concentrated in the privatized sector, with a tremendous amount of fixed assets and dollar-debts, faced severe losses at the prospect of devaluation, as did the financial sector. While both sectors wielded important political influence, the devaluationist block was able to draw on its historic connections with Argentina’s political parties and mobilize broad-based coalition among Argentines against what it labeled foreign rent-seekers in favor of the nationally-based “productive” sector.

⁷⁹ In 1991, Argentina had an unemployment rate of 7%, and underemployment rate of 5% and 40% of the population lived under the poverty line (Heidrich 2002)

The Resurrection of “National Production”

In September 1999, prior to De la Rúa taking office, the UIA joined with the Argentine Construction Chamber and the Rural Argentine Confederation to form the “Productive Group.” Their short-term goal was to put forth measures that would amount to indirect forms of devaluation to improve foreign competitiveness, such as salary freezes, labor flexibilization, and reductions in employer contributions (Ortiz and Schorr 2007). Their longer-term goal was the formation of a broad front to support the group’s economic project, which put forth the export sector and reinvigoration of Mercosur as the solution to the economic crisis. The group brought together leaders from the industrial, agricultural, and construction sectors. Eventually members of Argentina's social movement--including Labor and the Catholic Church--also joined the Productive Group, whose longer-term goals coincided with their own. While the Productive Group sought out political allies across parties, including within De la Rúa’s own UCR, there was a key connection with the Peronists⁸⁰. This connection helped bridge the divide with Labor, particularly the radical fraction of Argentina’s most powerful union, the CGT, led by Hugo Moyano. By the middle of the year 2000, the Productive Group-CGT (Moyano Faction) alliance

⁸⁰ Towards the end of 2000, Eduardo Duhalde, former Presidential candidate from the Peronist party and governor of Buenos Aires, met with leaders from the UIA, the CGE (General Economic Confederation), the CAME (Argentine Chamber of Medium Business), the SRA (Argentine Rural Society), the CRA (Rural Argentine Confederation), the CARBAP (Confederation of Rural Associations of Buenos Aires and La Pampa), the CAC (Argentine Chamber of Construction), the CONINAGRO (Intercooperative Agricultural Federation), and the FAA (Argentine Agrarian Federation), and suggested that they organize a “multiparty and multisector productive movement” to pressure the de la Rúa government to apply policies favorable to the productive sector (Clarín, 22/12/00), as quoted in Ortiz and Schorr 2007:7).

had agreed that devaluation of the peso would be critical to their economic project (Ortiz and Schorr 2007).

The devaluationist project appealed to Argentina's history of national production and the industrial-worker-state alliance that had supported the golden years of ISI. To this end, they pitted "national production" against financial speculation and foreign interests (Ortiz and Schorr 2007, Basualdo 2001, Noriega). This approach is reflected in the words of Osvaldo Rial, President of the UIA in 2000:

Society, industrialists, agricultural producers, small business, workers, and cultural and religious sectors, we should understand that we will exit the crisis only through a model that stimulates production and the buying power of the people (as quoted in Ortiz and Schorr 2007: 5, this author's translation)

Similarly, in February of 2001, Techint founder, Roberto Rocca, stated, "We should have a national model, that has to be productive, fruit of the productive forces in symbiosis with the political forces of the entire Nation" (as quoted in Basualdo 2001:92, this author's translation).

Argentina's biggest economic groups had an additional reason to finally support devaluation: the liquid financial assets that local economic groups held abroad also meant that local economic groups would profit considerably from devaluation of the peso. As Basualdo (2002) notes:

"... the project linked to local groups and some foreign conglomerates promoted devaluation and the instrumentation of state subsidies for local production. A devaluation of ten points meant that, in dollars, foreign capital would lose approximately the equivalent of what was paid by Repsol for the purchase of the

national oil producer, YPF (nearly \$13 billion). These groups would benefit by a similar amount, keeping in mind that nearly \$120 billion was sent abroad. In addition, it must be emphasized that the economic groups, despite the assets that they sold, continued to have important productive investments in the country, especially in sectors with natural comparative advantages, such as agroindustry and agricultural production. For this reason, being strong exporters, the devaluations that took place since December meant substantial earnings in wealth in dollar terms in the invoicing and profitability of their internal activities (Basualdo 2002: 15, this author's translation).

Thus, Argentina's economic groups stood to gain two-fold from devaluation of the peso: 1) their products would become more competitive in the international market and 2) the expatriated profits earned from financial valorization and the sale of shares in newly privatized companies would increase in proportion to the devaluation; in the aftermath of devaluation, economic groups could repatriate their financial assets and use them to purchase fixed assets at bargain prices.

To defend their interests, economic groups that had formerly supported the finance-led development model embodied in convertibility joined an alliance with the UIA, Labor, and sympathetic political fractions within the dominant parties. In June 2001, a coalition of politicians (including Eduardo Duhalde from the Peronist Party and Raúl Alfonsín of the UCR) and representatives of the industrial and agricultural sectors came together to found the Argentine Productive Movement, which claimed that “to exit this crisis there exists one possible path: **the construction of a national project based in production, work, and the fair distribution of wealth**” (Movimiento Productivo Argentino 2001, this author's translation, emphasis in original). Members of the group took aim at foreign-owned companies they

considered to be against national interests, including a boycott of all companies in Argentina whose capital originated in Spain (Clarín.com 6/24/2001), while political leaders, such as Peronist Eduardo Duhalde, publicly decried the presence of foreign producers to the press:

“Changing the system of ideas that ruled Argentina over the last few years and prioritizing the national interest is indispensable’... [Duhalde] maintained that, in priority order, ‘the first is to awaken the national conscience of Argentines. We must direct all of our energy to caring for our own.... It is shameful that we go to supermarkets in which there are European and North American agricultural products’” (La Nación 10/2/2001 this author’s translation).

The Dollarization Bloc

During Argentina’s crisis, the banks also came together to defend their interests--the model of global financialization that had come to dominate the country--first by trying to defend Convertibility and, later, by championing dollarization. In May of 1999, the Association of Argentine Banks and the Banking Association of Republic of Argentina fused to form the Association of Argentine Banks (ABA, by its acronym in Spanish). The ABA was dominated by the top international banks operating in Argentina⁸¹ and focused heavily on insertion of the Argentine financial system into the global economy.⁸² Unlike most of Argentina’s economy, the

⁸¹ Although its President was Eduardo Escasany of Banco de Galicia one of Argentina’s last large locally-based banks, according to its 2000 Annual Report, at least two-thirds of the ABA’s Board of Directors represented international banks, such as Bank Boston, N.A., Citibank N.A., Morgan Guarantee Trust Co. of New York, HSBC Bank Argentina S.A., Banca Nazionale del Lavoro S.A., BBVA Banco Francés S.A., Bank of America N.A. , Deutsche Bank S.A., ING Bank N.V., Lloyds TSB Bank plc, Scotiabank Quilmes S.A., The Chase Manhattan Bank, Banco Itaú Buen Ayre S.A., Banco Société Générale S.A. (ABA Memoria Anual 2000).

⁸² The themes of both the 2000 and 2001 annual meetings were Argentina in the global economy. The title of the 2000 Annual Meeting was “Argentina in the World: Consolidating Globalization”; the title of the 2001 meeting was “Argentina in the World: Deepening Modernity.” While the 1999 Annual Meeting has no discernible title,

private financial sector continued to be profitable during the first years of the crisis⁸³ and the percentage of the population the sector employed continued to grow through the end of 2000. As a united bloc and a key source of financing for the cash-strapped government, banks strongly influenced the policy agenda (Noriega). Argentina's private banks desperately attempted to maintain, if not consolidate, the reforms that had served them so well throughout the Menem administration, at the core of which was the fixed exchange rate regime codified in Convertibility.

As fears for the continued viability of Convertibility mounted, the financial sector began to pressure for dollarization. Saddled with dollar-denominated debts and large investments in fixed assets that would lose considerable value in the event of devaluation, the banking sector, together with newly privatized companies, mounted a campaign for dollarization. Ex-President Carlos Menem became their spokesperson, campaigning tirelessly for the measure with the support of Central Reserve Bank President, Pedro Pou, and Fernando de Santibañes, former head of Argentine intelligence and a close friend of President De la Rúa (Seman 10/28/2001). According to one banker overseeing Argentine debt at a major New York investment bank, Menem's return was positive, "because he is an element of power that sides with orthodoxy; a base of power

presentations focused heavily on Mercosur as well as European Union and the United States. Discussion at the ABA's first meeting in 1999 included several discussions on the feasibility of monetary integration of Mercosur and included remarks by President Menem advocating that Mercosur adopt the US dollar as a common currency to avoid any fears of devaluation (see <http://www.aba-argentina.com/home.html>).

⁸³ As late as the August 2000, private banks were still earning returns on equity and assets, although these gains largely accrued to the foreign owned private banks, whose average ROE was 3.9 and average ROA was 0.45. Local private banks, on the other hand, had an average ROE of -6.33 and average ROA of -1.33 (ABA Memoria Anual 2000).

demanding dollarization is growing” (Seman 11/26/2001).

Unfortunately for the financial sector, Menem had lost a great deal of popularity among the Argentine public and was losing his once firm grip over the Peronist Party. Shortly after leaving the presidency, Menem was involved in several public corruption scandals and was even arrested on charges of arms trafficking. Although he still held control over the Peronist’s national leadership, his rival, Eduardo Duhalde, controlled the provincial leadership. The Duhalde faction maintained close ties to the Productive Front and Peronist-affiliated unions, including the CGT, and high-ranking members of the faction publicly disputed dollarization as an option. Duhalde, himself, had publicly expressed his apprehension about dollarization during his presidential campaign in 1999.

De la Rúa Attempts to Maintain Political Support

As Argentina’s economy contracted, so too did De la Rúa’s ALIANZA coalition. De la Rúa’s original austerity packages and labor reform, although passed by Congress, placed a great strain on the UCR’s relationship with FREPASO and even divided the UCR, itself. Former Argentine President and UCR party president, Raúl Alfonsín, publicly criticized Convertibility and condemned various austerity measures. Meanwhile, the Peronists, led by Eduardo Duhalde openly opposed a number of measures—such as Labor Reform--and gave only limited support after extensive negotiation. These first reform measures did enjoy support from much of the business community, though, as

they touched on points of general agreement amongst big industry, agriculture, privatized services, and finance. However, this consensus did not last long and De la Rúa's administration increasingly flip-flopped as the discordance over the future of Argentina's economic model and exchange rate regime grew more acute.

Glimpses into the struggle over the future of Argentina's economic model could be seen with the resignation on March 2, 2001 of Economic Minister, Luis Machinea, who cited infighting within ALIANZA as the cause for his departure. De la Rúa appointed Ricardo Lopez Murphy to the post. Lopez Murphy surrounded himself with staff affiliated with FIEL (Hynds 2001 3/16/2001). The appointment was a clear shift to the side of the financial sector, which fiercely supported Lopez Murphy and FIEL (the Foundation for Latin American Economic Research), an ultraliberal Argentine think tank sympathetic to financialization). To show their support for the newly appointed Minister and his policies, finance sector leaders went so far as to accompany Lopez Murphy to his presentation at the annual conference of the Inter-American Development Bank (IDB) in Santiago, Chile. Two weeks after taking the position of Minister of Economy, Lopez Murphy announced his economic proposal to the country. Greatly mirroring the FIEL plan, Lopez Murphy proposed massive cuts to education, including cuts to teacher and professor salaries, funding cuts to schools and universities, and scholarships; reductions to the "Family Salary" for workers with families; cuts to pensions, including those for retirees from the Armed Forces, police, and Security Forces; cuts to the healthcare

ministry and National Social Security Administration (ANSeS); a reduction of 40,000 public positions; cuts in funding to the Provinces; removal of gas subsidies for residents of Patagonia and subsidies to the tobacco sector; increases in the Value Added Tax on cable television, soccer, and movies; privatization of the National Bank's three satellite companies (Pension Fund, Retirement Benefits, and Life Insurance); and further Labor reform (further increases in probationary time for new hires, cuts in unemployment and other benefits, etc.) (El Clarín 3/17/2001). Overall, the plan forecast nearly \$8 billion in savings between 2001 and 2003, nearly 60% of which came from cuts to education (Hynds 2001 3/23/2001).

Although the financial sector welcomed the Lopez Murphy proposal, the Argentine public was enraged; further deep cuts were not welcome and with legislative elections only months away, public political pressure was intense. The Murphy plan also included elements, such as privatization of the National Bank, that were adamantly opposed by portions of the productive front. Just weeks earlier the head of the CRA (Argentine Rural Confederation) responded to the suggestion that Lopez Murphy might propose the privatization of the National Bank by saying, "if they do that, we will declare war" (This author's translation, Bonelli 2001). Several minutes before Lopez Murphy presented his proposal to the nation, three of De la Rúa's cabinet members resigned in protest (Interior Minister, Federico Storani; Education Minister, Hugo Juri; and Social Development Minister, Marcos Makon) and every member of FREPASO resigned from their

government posts. Soon after Lopez Murphy's speech, public protests erupted throughout Buenos Aires and a bomb exploded near the FIEL offices (NotiSur 2001). Lopez Murphy resigned just two days later, replaced by Convertibility's architect, Domingo Cavallo.

According to Noriega:

The failure of López Murphy's drastic plan, even before its implementation, changed the official position. From then on, after the return of Domingo Cavallo to the Ministry of Economy, the government (with the express support of the banking sector) attempted to widen its base of political support, attracting industrial business leaders through credit offered by the state" (this author's translation).

Cavallo's job, as it was under Menem, would be to make compatible the competing interests of Argentina's divergent sectors (Basualdo 2002). Among the first steps Cavallo took was the implementation of a financial transaction tax to help pay for cutting the costs of importers and exporters by 20% (Hynds 2001 6/29/2001; La Nación 3/22/2001). The measure sent the financial sector into a frenzy that could only be stymied by Cavallo's agreement to implement further spending cuts (Basualdo 2002). As the Argentine economy continued to worsen, Cavallo put through a patchwork of new policies meant to appease international investors as well as the Productive Front, including a plan to tie the Argentine peso to a basket of the US dollar and the Euro once the two reached parity, a preferential exchange rate for exporters of 1.08 pesos to one dollar (Hynds 2001 6/29/2001), and further deficit reduction all in an attempt to maintain an economic and political base for Convertibility.

Nevertheless, Argentina's economy continued its downward spiral. With minimal

support from the international financial institutions, the state struggled to pay its debts, both to creditors and its employees. As the economy worsened, public pressure for an overhaul to Convertibility grew. Citizens assaulted government officials in the street and provincial government leaders complained that they feared for their own security. Groups of the unemployed and economically marginalized held daily protests that spread throughout the country, shutting down highways, cutting off access to cities, and taking over factories. Union activity also spiked: member participation in union strikes rose from 50% in 1995 to 89% in 2001 (Heidrich 2002: 3). In the face of opposition from the public, the Productive Front, and his own party, De la Rúa continued to defend Convertibility at all costs, this time by supporting Cavallo's Zero Deficit Law, which imposed a zero deficit requirement on Argentina's national government that required steeper cuts to social services and benefits as well as tax increases.

VI. DEATH OF THE DOLLAR

After the October 2001 legislative elections, prospects for Convertibility or dollarization worsened despite De la Rúa and Cavallo's efforts to maintain a viable coalition in favor of a fixed exchange rate. The Peronists swept both houses of Congress. Duhalde was the biggest winner, winning a landslide victory against the UCR's Alfonsín in the race for the seat of National Senator of the Province of Buenos Aires, Congress' most powerful post. With the victory, Duhalde was poised to take over his party's national leadership,

relegating Menem to the sidelines (Terra 10/15/2001; BBC Mundo 10/15/2001) and, with him, hopes for dollarization. In a last-ditch effort, a group of bankers and heads of privatized and foreign firms⁸⁴ put forth a proposal to the government centered on dollarization and a political agreement between De la Rúa and Menem to establish governability. In exchange, these groups offered \$10 billion to strengthen Central Bank reserves (Bonelli 7/12/2001).

However, opposition from within the governing coalition and the newly empowered Duhalde faction within the Peronists made such a deal impossible. Soon after the elections, FREPASO put forth its own economic proposal that foresaw an end to the “exhausted” Convertibility regime. The plan, developed in consultation with the UIA and the more radical elements of the UCR, focused on restructuring the foreign debt and improving the competitiveness of the country’s export sector through reduced export tariffs, increased subsidies and, above all, an “orderly devaluation” (Cufre 2001, Mochkofsky 2001) The Productive Front also put forth an economic plan that was adopted by the Duhalde faction of the Peronist Party, which centered on pesoification (de-dollarization) of the economy and implementation of a floating exchange rate, (Bonelli 12/21/2001).

Allied with the financial sector and privatized services, De la Rúa ignored both

⁸⁴ Supporters included Enrique Ruete Aguirre (HSBC), Emilio Cárdenas (HSBC), Carlos Rohm (Banco General de Negocios), As well as the head of Repsol-YPF-(Spanish Transnational), Ranero Díaz, and Telefonica de Argentina leader, Fernández Prida, (Spanish Transnational) (Bonelli 7/12/2001).

proposals, and even ignored pressure from the international community and International Financial Institutions, which feared that Convertibility's continuation would hasten economic collapse. Soon after the passage of the Zero Deficit Law, the Bush administration conditioned US economic support, in part, on the departure of Cavallo from the government and an orderly exit from the Convertibility regime (Bonelli 12/21/2001).

Similarly, in December 2001, the Vice-President of the IMF publicly stated that, "to solve its underlying problems, Argentina must float its currency" (Bonelli 12/7/2001 this author's translation). Meanwhile, the head of the IDB publicly announced, "If Argentina exits convertibility with a plan for growth, Washington will release \$15 billion to strengthen reserves" (Bonelli 12/21/2001 this author's translation). However, De la Rúa pushed on. His administration continued to tinker with Convertibility at the edges in an attempt to avoid either devaluation or dollarization; although, De la Rúa publicly stated that, if given the choice between the two he would choose the latter (Mochofsky 2001, *Seman* 10/28/2001).

Unfortunately, for many of the Argentine people, the crisis continued to worsen. The depression that had begun in the real sector of the economy finally spread to the financial sector as people rushed to withdraw their money, fearing their accounts would be frozen. To prevent the banks from collapsing, Cavallo imposed strict temporary restrictions on bank accounts. Dubbed, "the Corralito," the Spanish word for little fence

or pen, the package of restrictions prohibited Argentines from withdrawing more than \$1,000 per month (including cashed paychecks) or transferring more than \$1,000 abroad. All other transactions were to be carried out by check, credit card, or debit card (NotiSur 12/14/2001). In response, unions called a national strike and Argentines took to the streets en masse. Violence irrupted throughout the country, as police attempted to suppress the protests, resulting in the death of 26 protesters. On December 19, 2001, in the midst of economic and social chaos, Domingo Cavallo resigned from the position of Minister of Economy. The next day, President De la Rúa also resigned, sending the country into institutional crisis. After three interim presidents in less than two weeks, Eduardo Duhalde was elected interim President by Congress to serve until December 2003.

Duhalde's election as interim President signaled the triumph of the Productive Front over the financial sector and privatized service industries, giving him the political base to remain in office and implement far-reaching economic reform centered on overhaul of the exchange rate regime. At his inauguration, Duhalde clearly signaled his intentions:

"My commitment, as of today, is to end the exhausted model that has added to the desperation of the vast majority of our people in order to lay the foundation for a new model capable of recuperating production, Argentine jobs, the internal market, and to promote a more just distribution of wealth" (Duhalde's inaguaral speech, as quoted in Noriega, this author's translation)

Duhalde followed his comments with the appointment of UIA President, Ignacio de Mendiguren, as Minister of Production. On his third day in office, Duhalde devalued the peso by 30% and de-dollarized basic services,⁸⁵ later stating, “my government will put an end to the alliance between political and financial powers that damaged the country in order to substitute it with an alliance with the productive community” (as quoted in Noriega, this author’s translation). However, Duhalde still had to figure out how to end the “corralito” and de-link the Argentine economy from the US dollar while protecting the savings of Argentines and, perhaps more critically, in a way that would maintain some level of support from the financial sector. Duhalde bridged the gap with the financial sector by allowing banks to liquidate their debts to the detriment of account holders whose funds were frozen during the “corralito.” To this end, bank assets (i.e. loans to be repaid) were reimbursed at a rate of one US dollar to one Argentine peso, while liabilities (i.e. deposits) were to be converted at a rate of one US dollar to 1.4 Argentine pesos. The peso would then be allowed to float. Duhalde also agreed to privatize state banks (Basualdo 2002) and put into place an exchange insurance deal that transferred large portions of the dollar denominated debts onto the state⁸⁶. It was a deal that primarily benefitted local economic groups who reaped double the rewards of devaluation: more competitive exports and higher relative value of dollar-denominated financial assets held.

⁸⁵ Since the implementation of Convertibility and privatization, many utilities had set their prices in dollars. Duhalde imposed “pesoification” of these prices to minimize the pain of devaluation on the Argentine public.

⁸⁶ Although the foreign-owned privatized sector led the call for the exchange-rate insurance, a number of local economic groups took advantage of the deal to liquidate their own debts (Basualdo 2002, Basualdo, et al. 2007). By 2003, the cost of the exchange insurance deal and “compensation” packages had already reached more than \$14 billion (Ortiz and Schorr 2007).

VII. CONCLUSION

Argentina's tumultuous path through Convertibility demonstrates the power struggles inherent in the definition of monetary and, particularly, exchange rate policies. The implementation of Convertibility reflected a period of global investment into Argentina facilitated by international-local associations, which emerged from the country's privatization process. Privatization temporarily changed the interests of local economic groups in favor of monetary and exchange rate stability, since many of the privatized firms they now owned produced nontradables. Depreciation would now mean economic loss: "An agro exporter whose grain became more competitive when the austral's value fell would, as an investor in a domestic gas distributor, suddenly have a lot to lose from devaluation. Firms accused of speculating against the currency in past crises would now have reason to prefer currency stability" (Treisman 2004: 412).

Once implemented, Convertibility ushered in a new era of globally-oriented financialization. With near complete liberalization of capital flows and the interchangeability of the peso and the US dollar, global financial flows quickly became the motor of the Argentine economy. In addition to the pervasiveness of financial valorization, transnational financial institutions flooded the country. As in the cases of Ecuador and El Salvador, globalized finance championed the cause of dollarization as a means of consolidating financialization, which had driven the economy for most of the 1990s. However, unlike the previous cases, Argentina's most powerful economic groups never became entrenched within the global financial sector and, once

the temporary benefits of financial valorization faded, no longer had an inherent interest in maintaining international finance's dominant economic position. Argentina's most powerful economic groups were never completely committed to a dollarized economy or even a hard-peg. To cull together support for Convertibility Menem had to change the short-term economic interests of these groups through privatization and association with foreign capital. This strategy worked well for a while. For nearly a decade, Argentina's economic groups profited under Convertibility: not only did it remove the terrible specter of hyperinflation but its upward pressure on Argentine interest rates and appeal to foreign capital enabled companies to engage in financial valorization. Although Argentina's main economic groups were not anchored in the financial sector, the logic of financial valorization came to dominate their interest calculation, for which a stable currency and low rates of inflation were critical.

However, the combination of external shocks and internal exhaustion of the model made Convertibility much less appealing to local economic power groups, who had retrenched their interests into the export sector during the latter half of the 1990s. Increases in international interest rates and numerous foreign crises cut off their access to foreign credit for valorization and increased the price of their current debt. As private and public debt increased (in part because of the need to maintain liquidity and in part due to the increased cost of servicing debt), foreign investors became even more squeamish about lending money to Argentine companies. Brazil's devaluation worsened the growing recession by flooding the Argentine market with low-cost Brazilian imports while simultaneously making Argentine exports less attractive in the

Brazilian market. Faced with declining export profits and cutoff from the foreign capital that was the life-blood of the financial valorization model, Argentina's economic groups abandoned their strategic alliance with globalized finance and their commitment to a hard-peg exchange rate regime.

Instead, the export sector, embodied in Argentina's economic groups, united with smaller industrialists and organized labor to push for a full-scale change in the economic model, from one centered in global finance to one based on "national production." The Productive Front mobilized both their long-term connections to Argentina's political parties and exploited their status as "national" producers to displace the largely foreign-based financial sector from its seat in power. Despite the financial sector's offers to provide desperately needed cash in exchange for dollarization and his own preference for dollarization over devaluation, De la Rúa was unable to forge a coalition in support of continued monetary stability. De la Rúa's forced resignation and eventual replacement by Eduardo Duhalde signaled the victory of Argentina's export sector over global finance and the end of the fixed exchange-rate regime.

CH. 5: CONCLUSION

As Kirshner notes, today "money leads and the real economy must follow.... [M]oney, once the handmaiden of the modern economy, has become its mistress" (Kirshner 2000:407). For far too long political scientists have left the study of money and its new pivotal role, thanks to financial globalization, in the hands of economists who have concentrated on their economic pros and cons. However, globalization has reconfigured the role and importance of monetary policy in the distribution of economic benefits and with it, its political significance. It is past time that political scientists recognized the dramatic and real impacts of financial globalization on our states, our political structures, our interests, and how all of these coalesce around critical policy choices. Over the past 30 years, movements in favor of and against globalization have penetrated our society. Through a wealth of scholarship, the public has a much greater understanding of how the globalization of trade affects not only the price of goods but also interacts with our social and political institutions, including the strength (or weakness) of Labor, environmental standards, state sovereignty, the quality of state institutions, and particularly, the quality of democracy. However, with this focus on the globalization of trade (aka: the "real" economy), political scientists, have failed to see how financial globalization has restructured the "real" economy and, with it, interest groups, institutions, and the policy landscape.

This dissertation has sought to understand how financial globalization affected local economic interests and to open the black box of the state in order to understand how these interests shaped the policy preferences of sovereign countries in considering dollarization,

arguably the most drastic currency arrangement, due to its high costs to state power and its high cost of reversal. Struggles around dollarization within sovereign countries over the last 15 years clearly illustrate the way in which financial globalization has restructured the real economy as well as the heightened importance of currency policy and its consequent heightened politicization. As this dissertation demonstrates, battles over dollarization were not simply technocratic battles over arcane policy but struggles between fractions of the business community over competing visions of development and insertion into the global economy. These struggles pitted the more “traditional” export-led model, by which trade drives local economic development, against finance-led development, by which international financial flows (sometimes as investment, sometimes as speculation) and the expansion of consumer debt, power growth⁸⁷. In each country, financial globalization contributed to the ascendancy of globally oriented financial sectors that sought to lock-in a finance-led model through continued access to cheap US dollars by removing the specter of devaluation once and for all, a move that would severely damage the position of exporters. As can be expected in such critical battles, both sides mobilized their full economic power and political ties in their bids for supremacy.

Up until now, scholarly attempts to explain dollarization have focused on its theoretical economic “advantages” and “disadvantages”: its impact on lowering interest rates, greater access to credit, the

⁸⁷ A depreciated currency tends to help the tradables sector (exporters and those competing with imports) and adversely affect the financial sector and importers--and visa versa. Currency policy may not only temporarily help or hinder a sector but, if consistent over time, shapes its country's economic development model. An economy that prioritizes its export sector (export-led model) as the driver of economic growth will likely seek to maintain a depreciated currency, while an economy prioritizing finance and maintaining cheap imports (finance-led model) will seek a more appreciated exchange rate.

economic benefits of currency stability versus reductions in seigniorage and the loss of monetary sovereignty. In the case of Ecuador, economists and political scientists, alike, agreed that dollarization was the only option available: it was a sheer act of desperation divorced from social or political considerations other than the desperate need for quick stability. However, these answers fall flat, as they ignore 1) the relationship between local struggles over dollarization and financial globalization, 2) the differential ways in which dollarization impacts various societal groups, creating winners and losers with strong interests in influencing policy adoption, and 3) the ways in which internal political struggles and coalitional alliances impact the outcome of these struggles. Differing monetary regimes create concentrated groups of winners and losers, and where there are winners and losers, actors will work to impose their preferred policies.

Through detailed case studies of two countries where a campaign for dollarization was successful (Ecuador and El Salvador) and one case study of a country where dollarization was defeated (Argentina), this dissertation shows that struggles over dollarization reflect sectoral distributional struggles that are intrinsically related to processes of financial globalization. In many ways, struggles over dollarization can be seen as a byproduct of financial globalization. These struggles are due as much to the role of international capital flows and Eurodollar markets as to the reorganization of local economies in line with an ideology that places globally integrated finance at the vanguard of economic development, leading to the emergence of globally oriented financial sectors across the world. The first section of this chapter will summarize the findings of this study. Section II addresses the implications of this study and addresses how the findings of this study can help scholars to determine which countries are likely to consider dollarization and in predicting the future of dollarization in Ecuador and El Salvador. Section III addresses what, if any, lessons from the struggles around dollarization can be applied to the European

Monetary Union. The final section, Section IV, addresses avenues for future scholarly inquiry related to dollarization.

I. KEY FINDINGS

THE ROLE OF FINANCIAL GLOBALIZATION AND FINANCIALIZATION

Struggles over dollarization are, themselves, a byproduct of financial globalization, the process by which financial institutions and markets become more tightly linked and move closer towards financial integration, creating a tendency toward a worldwide investment environment. This process is typically characterized by the international harmonization of financial regulations (i.e. Basel Accords), the liberalization of local financial markets, and the subsequent free movement of finance capital across borders⁸⁸. As discussed throughout this dissertation, Financial Globalization over the past 30 years has been strongly associated with Finance Led Development, or financialization, whereby capital flows outstrip international trade, and the logic of financial accumulation dominates the economy⁸⁹, on the global and local levels.

The breakdown of Bretton Woods freed the circulation of US dollars (and, by extension, the global economy) from the constraints of a gold standard, allowing dollars to flood the globe while the creation of Eurodollar markets made it economically and politically feasible for sovereign countries to unilaterally dollarize. Eurodollars gave governments access to foreign currency flows free from the constraints of the producing country. Eurodollar markets, free from regulation, permitted the inflow of

⁸⁸ See Gudmundsson 2008, Sergio L. Schmukler, Pablo Zoido, and Marina Halac 2008, Arestis and Basu 2003.

⁸⁹ See Tabb 2012, UNCTAD 2012

private foreign credit, often dollar denominated, to host countries and private citizens throughout the world. Encouraged by the US, International Financial Institutions like the IMF, and economic theories that placed finance at the center of economic growth, policymakers throughout the developing world implemented programs to promote global financial integration to take advantage of these flows. These policies became particularly popular in Latin America in the wake of the US' Brady Plan, which premised debt reduction on financial liberalization.

Throughout the 1990s policy makers in Ecuador, El Salvador, and Argentina enacted large-scale financial reform that focused on deregulating capital flows and interest rates, removing restrictions on foreign currency deposits and credit, the integration of offshore banking, and growing the size and strength of the financial sector through the creation of universal banks and the introduction of new financial instruments (i.e. securities, capital markets, and, in some cases, derivatives). These policies were supposed to increase the role of finance in the local economy with the goal of improving economic efficiency. They were successful in their objective of growing the financial sector and increasing the inflow of foreign capital, if not the overall goal of economic efficiency. The financial sectors in each country grew in size, scope, and profitability, as deregulation and greater access to international capital flows created opportunities to earn windfall profits through speculation on international and domestic interest rates, connected lending, and the expansion of domestic consumer credit markets. However, despite expectations that bigger and more integrated financial sectors would lead to more efficient and productive economies, the opposite was true: the economies of each country shifted their orientations away from production and export towards financial services; financial speculation and wide scale capital export quickly overshadowed all other aspects of the economy. To this end, financialization, characterized by the “dominance of the financial sector in the totality of economic activity such that financial markets

determine the state of the overall economy and financial sector demands dictate nonfinancial company behavior” (Tabb 2012: 20), pervaded each of their economies.

In Ecuador, the financial and commercial sectors profited heavily from access to cheap dollars that were loaned out to the public in the form of consumer credit. With no capital controls and the legalization of foreign money deposits and offshore banking, dollars flowed into Ecuadoran banks. Banks looking to cover their dollar liabilities increased their dollar denominated loans even to those who did not have dollar income. With banks pushing lower-interest dollar-denominated loans to cover liabilities and offering high-interest rates on deposits to attract liquidity, the interests of Ecuador's middle and upper classes became entrenched in these global financial processes. The wealthy as well as the middle class abandoned productive investment to take advantage of deposit interest rate bidding wars, effectively converting themselves into a large rentier class, dependent on financial assets. Even nonfinancial firms became heavily dependent upon the financial sector, as economic groups used their financial firms to fund their other endeavors with low- or no-cost loans and retailers joined with the financial sector to offer lines of consumer credit in the form of store credit cards and medium-term financing.

In El Salvador, mass emigration and privatization of the banking sector helped shift the country's entire economic model from complete dependence upon coffee export to dependence upon the inflow of cheap dollars through remittances and foreign borrowing. These inflows supported the growth of consumer credit and the financial institutions that channeled them. As the domestic credit boom slowed, El Salvador's largest economic groups, all of which were steeped in the financial sector, turned their sights to investing abroad to take advantage of arbitrage opportunities created by their access to cheap dollars, a comparative advantage they sought to consolidate through dollarization. It is important to note

that, in both Ecuador and El Salvador, finance became the cornerstone of each country's largest and most powerful economic groups; every major group during the 1990s either grew out of the financial sector or entered the financial sector in some substantial way, often through direct purchase of financial institutions or significant investments in other groups dominated by financial accumulation. Indeed, the widespread practice of connected lending in both countries meant that these economic groups depended on their financial institutions to support their nonfinancial endeavors, placing finance at the very heart of the economy.

Although Argentina's major economic groups did not revolve around financial institutions, *per se*, finance also drove economic growth in ways similar to that of Ecuador and El Salvador. Drastic financial liberalization and Convertibility came together to create powerful arbitrage opportunities for financial and nonfinancial firms alike. For nearly a decade, Argentine producers earned profits primarily through speculation: they took advantage of an overvalued peso to borrow dollars cheaply from abroad, deposit them into Argentine banks that paid out high interest rates, and then export the profits abroad. The money these companies sent abroad far outstripped local productive investments. Although Argentina's financial sector came to be dominated by transnational conglomerates, not the country's own locally-based economic groups, for most the 1990s, local groups depended on financial transactions to drive profit. Local economic groups supplemented their financial profits by investing in the country's agro-export sector, which enjoyed natural comparative advantages, which cushioned the anti-export bias of an overvalued peso. As a result, local economic groups supported the expansion of the finance-led model favored by the financial sector for most of the decade, support that quickly waned as increases in international interest rates removed arbitrage opportunities and Brazil's own maxi currency devaluation cut into export profits.

DIFFERENTIAL EFFECTS OF DOLLARIZATION ACROSS SECTORS

As governments removed protections from international competition throughout the 1980s and 1990s, the globalization of trade and finance also meant greater vulnerability to currency shifts for all sectors, not only those directly engaged in international exchange, thus escalating tensions between groups over appropriate policy.

Nevertheless, the economic sectors most affected by these shifts have been the financial sector, particularly those integrated into the global financial structure, and exporters. The financial sectors in each country, with their large quantities of dollar-denominated debt and need for low interest rates, feared any currency depreciation, which would result in higher debt burdens and, possibly, inflation. To this end, finance valued currency stability above all else and an overvalued currency that would reduce the cost of foreign credit and assets even further. Meanwhile, exporters (and producers of import-competing goods in Argentina) feared any currency appreciation, which would make their goods less competitive. Thus, while exporters might appreciate currency stability, they had a greater interest in ensuring sufficient exchange rate flexibility to ensure the potential for depreciation or devaluation, something that would be impossible under a regime like dollarization.

If there remains any doubt in the mind of the reader about how these theoretical interests played out in real life, one need only look at the trajectory of each of the economies studied and the reactions of the affected economic sectors. Ecuador's once dominant export sector enjoyed an extended period of currency devaluations that boosted their global competitiveness. As Ecuador's financial sector grew in

power and pushed for greater currency stability, it faced bitter opposition from the export sector, even in the midst of massive inflation. In El Salvador, a fixed currency was associated with the simultaneous decline of the export sector and rise of the finance. As a result, exporters lobbied vociferously for a more flexible exchange rate and publicly derided the financial sector as “mercantilists.” Although Argentina’s agro-export sector enjoyed natural comparative advantages that provided a buffer to an overvalued exchange rate, Brazil’s drastic devaluation removed much of this advantage, resulting in flat or falling profit margins. Once allies of the financial sector, exporters soon became prominent opponents that accused the financial sector of acting as a foreign parasite on Argentina’s national economy.

Workers in each country faced an even more complex set of calculations, as they could potentially suffer real wage decreases from either devaluation or a fixed exchange rate. Devaluation that leads to inflation means a direct reduction in real wages, unless nominal wages are also increased accordingly, something that is rarely done. Within the context of an open economy, where many products are imported, devaluation will have an immediate impact on the cost of living, as the price of foreign goods increases. The cost of devaluation can be even more acute for a middle class with foreign-denominated or indexed home and consumer debt.

On the other hand, barring continuous improvements in productivity, maintenance of currency alignments to prevent overvaluation and sustain competitive prices for tradables would largely rest on wage reductions. To this end, dollarization in Ecuador was accompanied by large-scale economic reform, a critical component of which was making the labor market more flexible. In the midst of Argentina’s Convertibility crisis, President De La Rúa sought to implement labor market reform aimed at reducing labor costs to improve export competitiveness. Although El Salvador did not officially implement labor

market reforms, it has continually exploited countless loopholes and poor enforcement of its laws to accomplish similar ends (Montecinos 2000). As a result, El Salvador's real minimum wage has consistently declined since it pegged its currency in 1994: the 2012 real average wage is just 85% of what it was in the year 2000 (the earliest year for which there is a record) (CEPALSTAT Database). Clearly, for workers in open economies, both flexible and fixed exchange rates pose major risks to their standard of living.

The possible negative impacts of either exchange rate regime for workers often make it difficult for them to identify their self-interests, particularly for those economies that depend heavily on imports. According to Frieden (1991), these cross-cutting pressures often lead workers to support the interests of the sectors through which they are employed. Along these lines, Ecuador's middle class provided a strong base of support for dollarization. The middle class, which was connected mainly to the service sector, was also highly indebted and dependent upon income earned from financial assets. To this end, the Ecuadoran middle class' immediate self-interests were most closely aligned with those of finance capital. Argentine workers, on the other hand opposed dollarization and continuation of a fixed exchange rate. Although the Argentine middle class was also heavily indebted, unlike those in Ecuador, their income was not connected to financial assets and a large portion were employed in sectors negatively affected by Convertibility, such as domestic and export-oriented industry and agriculture. With the De la Rúa administration pushing labor market reform that would reduce the power of workers in an attempt to make Argentine products more competitive, Argentine workers faced a clearer set of immediate self-interests. Dollarization would mean both continued pain for industry and export--the country's major sources of employment--and reduced wages and bargaining power.

THE ROLE OF DOMESTIC POLITICS/COALITIONAL ALLIANCES IN DOLLARIZATION

While dollarization may be intimately tied to financial globalization, financial globalization alone does not determine dollarization: financial globalization is necessary but not sufficient. Over the last 40 years, numerous countries have implemented financial liberalization policies that have integrated their economies into the global financial structure and, yet, only a few have dollarized or openly considered dollarization. Rather local political economy factors play a critical role in how struggles over dollarization will play out. Dollarization will be most likely in countries that have a globally oriented financial sector with strong ties to the national economic and political structure. In the countries where the financial sectors were not only economically dominant but also integrated into the overall economic and political structure, they were successful in their efforts to implement dollarization. In other words, where the financial sector had become a nationally based and dominant elite with close ties to the government and integrated into the national fabric.

In Ecuador and El Salvador, where dollarization was successful, the financial sector became a cornerstone of the economy that extended its reach into almost every economic activity, including importing, retail, real estate, and even export. Financial sector leaders also bought up media outlets, which they could use to attack opponents and promote their own economic and political interests. Similarly, in both countries, the financial sector maintained close and organic relationships with the political sector; that is to say that leaders of the financial sector had historic ties to multiple political parties and actively participated in the political arena not just as contributors, but also as political party operatives, elected representatives, and government officials.

In Ecuador, both the Bucaram and Mahuad administrations were thoroughly penetrated by the financial sector, as reflected in their choices of political advisors and government officials. Bucaram surrounded himself with close friends and campaign contributors tied to the coastal financial and import sectors. For example, Eduardo Azar and Alfredo Addum—both importers—who served as Bucaram’s personal advisers, Roberto Isaías Dassum, President of Ecuador’s largest bank (Filanbanco) and one of its most powerful economic groups (Grupo Isaías), served as Bucaram’s Chief Economic Advisor and his brother-in-law, economist Pablo Concha, also tied to the financial sector, served as his Minister of Finance. The Mahuad administration was even more closely tied to the financial sector, both on the Coast and in the Sierra. Mahuad, himself, had been Deputy Director of Banco de Producción (aka Produbanco), later run by close Democracia Popular (DP) colleague and dollarization supporter, Abelardo Pachano. In addition to appointees and advisors, such as Alvaro Guerrero Ferber (President of the Guayaquil-based Banco La Previsora), Guillermo Lasso (President of Banco de Guayaquil), and Ana Lucia Armijos and Carlos Larreátegui (both former presidents of the Ecuadoran Association of Private Banks), Mahuad also depended upon the financial sector for campaign funds, including a \$3.1 million (US) campaign donation from Fernando Aspiazu, President of the Guayaquil-based Banco de Progreso.

In El Salvador, the whole leadership of the ruling ARENA party was captured by the financial sector, beginning with the Cristiani administration, under whose leadership the banking sector was privatized in the early 1990s. As a result, Cristiani became owner of one of El Salvador’s largest banks (Banco Cuscatlán) and economic groups (Grupo Cuscatlán). The power of the financial sector, however, is most clearly reflected in the composition of COENA, the party’s highest decision-making authority responsible for choosing party candidates and determining its policy platform. Despite efforts by

traditional agro-export elites to reassert power, the Cristiani faction, most closely tied to the financial sector, has remained in firm control of COENA and, thus ARENA, for more than two decades.

The fact that the financial sectors in both countries exercised important political power through their relationships to the political sector did not mean that this power was uncontested. To the contrary, as the struggle over the future of the country's economic model flared, so too did political divisions. Nowhere was this struggle over political supremacy more apparent than in El Salvador where the financial and import sectors had to fight off threats from the increasingly powerful socialist opposition, the FMLN, and from attempts by the traditional agro-export sector to reassert its power within ARENA. In Ecuador, contestation was somewhat more diffuse, given the large number of political parties and general political instability. However, the struggle between the Mahuad Administration and the PSC over implementation of the financial transaction tax signals an attempt by the non-financial sector to assert some level of control over the financial sector; it also demonstrates the contradictions faced by the PSC, as it tried to balance the interests of its two main constituencies, the coastal agro-export and financial sectors. Similarly, Ecuador's history of political instability and populism served as a standing political threat, one that was exercised (albeit shortly) in the coup led by the military and indigenous movement that overthrew President Mahuad, if not dollarization. In addition to the financial sector's economic interests, these political threats were additional incentives to press for dollarization. Dollarization completely removed monetary and exchange-rate policy from the political arena, thus locking in preferred monetary and exchange rate policies no matter who came to power in the future.

In Argentina, on the other hand, the financial sector, although financially powerful, was a relatively new foreign-dominated sector and economically isolated on a domestic level; that is to say, the

financial sector was not integrated into other key Argentine economic sectors as in Ecuador and El Salvador. It also lacked the historical and organic ties of its opponents to the Argentine political system. Aside from financing political candidates, local economic groups, which had become entrenched in the export sector, participated in the political system through corporatist ties, party membership, and government appointments. Once allies of the financial sector, their defection from the pro-currency stability alliance left the largely foreign financial sector politically isolated. In response, the financial sector struggled to raise up its old political ally, Carlos Menem, to power once more. However, the embattled Menem was himself increasingly isolated within the Peronist party and was of little help.

II. IMPLICATIONS OF FINDINGS

First, this study demonstrates that decisions to dollarize (and, in fact, all decisions around monetary and exchange-rate regimes) are inherently political, despite prevailing rhetoric that these decisions are made within a strictly cost-benefit context. For too long political scientists have ignored monetary and exchange rate policies as outside of their purview; when they are taken into consideration at all, any political analysis around the basis of such policies are often limited to the ways in which political leaders manipulate exchange rates to affect electoral outcomes (Alesina 1997, Schamis and Way 2003, Hayek 1991, Desai and Olofsgard 2003). However, the technocratic nature of mainstream debates over policies like dollarization belie the ways that such policies create winners and losers and, therefore, underestimate the political nature of such decisions. The focus within the literature on adding up the costs and the benefits of policy decisions ignores how these costs and benefits are distributed among social and

economic groups. Monetary and exchange rate policies create winners and losers within concentrated sectors (i.e. exporters versus globally oriented finance), giving these sectors a keen interest in influencing policy decisions. Affected groups in all countries actively used all of the tools available to them to promote or oppose dollarization, including lobbying, active participation in political parties and government, coalition formation, and even corruption.

Thus, far from the accepted wisdom that such decisions are made by technocrats and are the outcome of dispassionate economic analysis, we see that the opposite is true: these decisions are made by politicians and are the outcome of highly political struggles. The outcome of these battles depend largely on sectorial alliances (i.e. finance in alliance with import and retail interests in support of dollarization or exporters in alliance with industrialists and organized Labor in opposition) and, even more importantly, the alliances these groups are able to form with various political parties and factions. Where the financial sector not only had economic power but was also integrated into the political sector through historic ties and as a base of political support, as it was in Ecuador and El Salvador, it was successful in its push for dollarization.

In both Ecuador and El Salvador, major financial groups were tightly interwoven with commercial interests (importers, retailers, real estate), either through outright ownership or strategic economic alliance (i.e. consumer credit via financing and/or store credit card deals, etc.). These groups represented some of the most powerful economic interests in each country. Nevertheless, they used their connections to the ruling political parties to push for their preferred

policies. Such pressure was often reflected through the presence of sectorial representatives within political party leadership or governmental administrations, where they could guide policy decisions. As discussed above, President Mahuad in Ecuador filled his administration with representatives from both the Coastal and Sierra banking sector. Although President Flores' cabinet in El Salvador was less obviously infiltrated by the financial sector, he actively sought consultation from persons closely connected to this sector, such as Claudio de la Rosa, Executive Director of the country's banking association. In addition, ARENA's executive committee, COENA, was thoroughly permeated by individuals connected to the financial sector, such as Alfredo Cristiani, Rodrigo Somayoa, and Roberto Murray Meza⁹⁰, to name a few. Business groups also pushed for their preferred policies via more covert means, such as personal ties and corruption. This was nowhere clearer than in Ecuador, where President Mahuad was revealed to have accepted a secret \$3.1 million campaign donation from the President of Banco Progreso, Roberto Azpiazu.

What's more, we see that the specter of future governments whose policies were suspected of being inflationary and/or detrimental to the interests of globally oriented finance and its allies also plays a role in mobilizing support in favor of dollarization. Fearing the election of leaders counter to their interest, the financial sector and its allies sought dollarization in an attempt to lock-in the advantages of a fixed exchange rate no matter who came to power. To this

⁹⁰ Cristiani, Somayoa, and Murray Meza were all connected to Grupo Cuscatlán.

end, the motivation to dollarize was not purely economic but also political in its origins. Ecuador's long history of institutional instability and populism, with its associated periods of devaluation and inflation, provided fodder for those in favor of dollarization. Ecuadoran dollarization supporters did not trust even the rigid institution of Convertibility as a possible solution, as it left the government with a potential window to devalue, as was the eventual case in Argentina.

The specter of the socialist-oriented FMLN gaining the presidency in El Salvador also provided added incentive for dollarization, as the business sector—especially the financial sector--feared that an FMLN government would use monetary and exchange-rate policy to implement policies inimical to its interests, with the byproduct being devaluation and inflation. Thus, dollarization supporters touted the ways in which dollarization would reduce the power of future governments to manipulate economic policy.

Finally, both the Ecuadoran and Salvadoran financial sectors had to contend with the potential reassertion of the agro-export sector within the political arena and its demands for greater exchange-rate flexibility. Such a threat was particularly palpable in Ecuador, where the coastal agricultural sector had dominated until the middle of the decade and remained a powerful economic and political force, particularly through its presence within Ecuador's influential political party, the PSC. Although the agro-export sector in El Salvador had been severely crippled during its Civil War, the Salvadoran financial sector did have to contend with its attempt

to reassert power within the ruling ARENA party, as the "founders" continually attempted to gain greater influence within COENA. As the country's preeminent political party, control of COENA would have meant an essential return to political power for agro-export and inevitable devaluation.

Thus, this dissertation not only places politics firmly at the center of decisions over dollarization but also demonstrates the superficiality of analyses that characterize dollarization (or any monetary policy choice for that matter) as being a country's "only option." The folly of such arguments is most apparent in the case of Ecuador. Despite assertions that President Mahuad had no choice but to dollarize, we see that dollarization was very much a choice, one whose roots went back as early as 1997, with Bucaram's campaign for Argentine-style convertibility. In fact, dollarization was the product of a long line of choices by the Mahuad administration to prop-up and supplicate the financial sector at any cost, rejecting policy alternatives that posed a risk to the sector as a whole, including the option of reinstating capital controls and temporarily nationalizing the banks in response to its unfolding financial crisis.

In essence, the decision of whether to dollarize in all three countries was ultimately a political one. In each case, interest groups—epitomized by the financial and export sectors--fought for their preferred policies within the political arena. Which side ultimately prevailed depended not only on their economic power but the coalitional alliances they could form, economically and politically. In Ecuador and El Salvador, the financial sector was intimately

connected to multiple economic sectors, including importers, retailers, and the media, as well as the major political parties, through which they could exercise political influence.

However, the key role of politics in the struggle for dollarization is best illustrated in the case of Argentina, where the financial sector, despite its superior economic resources, found itself politically isolated once its coalition with the country's major local economic groups collapsed. The financial sector's key political allies, Carlos Menem and Fernando de la Rúa, were, themselves, increasingly marginalized both nationally and within their respective parties (the Peronists and the UCR). Meanwhile, Argentina's key economic groups, entrenched in the agro-export sector, joined forces with industry, Labor, and prominent leaders within the Peronist and UCR parties (including Buenos Aires Governor, Eduardo Duhalde, and UCR National Committee President, Raúl Alfonsín) to oppose dollarization. This broad, nationalist coalition portrayed the pro-dollarization financial sector and its ally, the service sector, as transnational economic parasites that sought only to reap profit at the expense of the overall Argentine economy. The anti-dollarization/anti-convertibility coalition, on the other hand, portrayed itself as being pro-growth, pro-national business, and pro-worker, appealing to the public's memory of the hey-day of Import Substitution Industrialization, when Argentina's middle class boomed.

Second, the findings of this dissertation affirm the new pivotal role of exchange rate policy as the battleground for distributional conflict. Whereas distributional battles had often centered around interest rate policy during the Bretton Woods era, during the era of financial

globalization they center on exchange rate policy. This shift in policy arena has had important implications for class interests. As Frieden (1991, 1994) points out, during the Bretton Woods era, when financial flows were contained and monetary policy operated mainly through the interest rate mechanism, distributional battles fell along the broad lines of debtors versus savers and lenders. In many cases, the working class (as debtors), benefitted from moderate inflation, which reduced the relative size of their debt burden while finance capital and capitalists of various stripes suffered the consequences of reduced value of their investments (unless, of course, said capitalist happened to have a high debt burden that would be eased by inflation). However, extreme financial liberalization has largely neutralized interest rates as a mechanism for monetary policy; monetary policy now mostly operates via exchange rate policy in developing countries. The increased exposure of all economic sectors and classes to foreign currency movements and the shift towards exchange rate policy as the key mechanism for monetary policy manipulation has led to a realignment of interests that are no longer cut across broad class lines but along narrower sectorial lines. The differential distributional effects of exchange rate shifts have become much more acute and more concentrated and, as a result, exchange rate policy has become highly politicized.

Despite theories that exporters, as a sector exposed to cross-national economic flows, will be most interested in monetary stability over flexibility to reduce the uncertainties associated with cross-border trade (Hefeker 1996, Eichengreen and Frieden 1993, Pereg and Steinherr 1989), all three case studies provide evidence to the contrary. Rather, this dissertation supports

the contention that tradables producers (export and import-competing) value the capacity to devalue more than currency stability and, thus, will tend to support more flexible exchange rate arrangements (Frieden 1991, 1994; Frieden and Stein 2001; Hefeker 1996; Schamis and Bonilla 1999) while international investors and importers will prefer an appreciated fixed exchange rate (Frieden 1994, Frieden and Stein 2001). Although, as the case studies also suggest, exporter interest in currency flexibility may be mitigated by the sector's relative competitiveness on the global market. Both the Salvadoran and Ecuadoran export sectors depended heavily on devaluation to improve global competitiveness and, therefore, consistently supported more flexible exchange rate arrangements. However, the Argentine agro-export sector, with its natural comparative advantage, supported a fixed exchange rate until Brazil's own drastic devaluation cut into its competitive edge, at which point support for Convertibility began to wane. In each of the countries studied, not only did the concentrated differential distributional effects of exchange rate policy galvanize intensive political mobilization, pitting the tradables sector against a globalized financial sector, importers, and retailers, but also came to embody the country's very economic growth model: export-led (flexible exchange rate) or finance-led (fixed exchange rate).

The globalization of trade and finance and the shifting importance of exchange rates has also had a direct impact on the interests of the working class, with contradictory tendencies that often capture workers in a catch-22 and make it difficult to identify their medium to longer-term self interests regarding the currency regime. Trade liberalization and greater access to foreign denominated or indexed loans has sharpened the negative impact of devaluation for workers; this

is particularly true for smaller economies heavily dependent on imported consumer goods. As discussed above, in a globalized economy where residents are often much more exposed to imports, devaluation translates to a direct increase in the cost of living and a consequent reduction in real wages. Similarly, greater access to and dependence on consumer loans by workers, often denominated or indexed to harder global currencies, such as the US dollar, also translates into greater devaluation-related suffering. Nevertheless, fixed currency regimes, without sufficient increases in productivity, rely on reduced wages and increased labor flexibility (read reduced worker protections) to stay competitive.

Given these contradictory impacts, Frieden (1991) contends that workers will tend to support the exchange rate regime that most benefits the sector in which they work. This dissertation provides tentative support for Frieden's assertion. This certainly was the case in Argentina, where organized Labor, whose members were employed mainly in industry and exports, supported currency flexibility in an effort to jumpstart job growth. The case of Ecuador, however, provides a more nuanced view, at least for the middle class, which was mired in foreign-denominated debt and dependent upon interest rate speculation for income. With its immediate interests tied to the financial sector, the middle class tended to favor dollarization, regardless of their sectoral allegiances (although a large portion of the middle class was connected to the service sector).

Third, this dissertation demonstrates the critical interaction between global structural economic forces and local political conditions in keeping with Gourevitch's (1978) second image reversed. Financial globalization has drastically changed the internal economic landscape of local economies and, therefore, changed the interests of local actors. Policies that give finance and global financial integration a vanguard role in economic development have led to the emergence of powerful globally oriented financial sectors and have often reoriented economic growth away from production and export towards finance. This was certainly the case in Ecuador, El Salvador, and Argentina, where finance quickly came to drive profit and reoriented economic power from groups engaged in traditional modes of production (agricultural export in Ecuador and El Salvador, export and domestically-oriented industry in Argentina) to those engaged in financial accumulation. In turn, local political variables shaped the way each country inserted itself into the global economy via their exchange rate regime. The capacity of financial sectors to form alliances with other sectors and to integrate themselves into the local political arena was paramount in their ability to impose dollarization in each of the countries studied. Thus, recent struggles over dollarization, although highly dependent upon domestic political conditions, can only be fully understood within the context of global financialization, which reshaped domestic economic and political interests as well as power relationships.

In all the countries studied, governments implemented drastic financial liberalization policies to encourage financial sector growth and local financial integration with the global market. These reforms included deregulation of interest rates, elimination of low-interest

developmental loans or the channeling of these loans through private financial institutions, and reforms to encourage the creation of universal banks and the use of new financial instruments, such as trusts and securities. Most importantly for the financial sector, reforms also centered on near--if not complete--elimination of capital controls, the legalization of foreign currency deposits and deregulation of foreign-currency denominated loans. Adoption of these policies were premised on the belief that integration into the global financial structure would encourage overall economic efficiency and growth, an ideology that had become widely accepted throughout the economic policy community and formed the basis of loan conditions by the IMF, World Bank, US AID and the Brady Plan. Financial liberalization sought to take advantage of the influx of international capital flows that circulated the globe with the growth of Eurodollar markets, the creation of new financial instruments to diversify risk, and advances in technology.

On a local level, greater access to international financial flows and the increased focus on the financial sector as a locus of economic development central to financial globalization increased the importance and power of the financial sector in each country, reshaping the economic structure and the composition of economic elites. In Ecuador and El Salvador, elites with connections to the financial sector surged to economic and political power, dislodging those who remained primarily attached to the traditional agro-export model. Implementation of the finance-led development, by giving companies and consumers greater access to cheaper credit, also increased the power of importers and retailers, who aligned themselves with financial sector.

Local Argentine economic elites initially reaped the benefits of financial sector expansion and also joined economic forces with transnational financial conglomerates to take over privatizing utilities and services. As financial sector opening and reform in line with international standards put greater pressure on the local financial sector, local elites attached to this sector sold off their assets to foreign conglomerates and retrenched their investments in the agro-export sector; so too, did local elites attached to the industrial sector, and those who had formed associations with foreign conglomerates to take over the newly privatized utility and service sectors. Unlike Ecuador and El Salvador, the agro-export sector was able to maintain a competitive edge throughout most of the 1990s due to its natural comparative advantages. Nevertheless, although local economic groups sold off much of their finance and service-related assets, they continued to exploit the finance-led model to engage in interest rate arbitrage. For most of the decade, finance served as the country's main economic driver, far outstripping production and export. Thus, Argentina's path, although more complex, followed a similar pattern of financializing the local economy, although in ways that differed from Ecuador and El Salvador. In fact, as this dissertation shows, these differences help explain why the financial sector in Argentina ultimately lost its fight for dollarization.

Finally, by laying bare the roots of dollarization as a byproduct of financial globalization and financialization, this dissertation disputes assertions that dollarization as a policy alternative is dead (Cohen 2003, Jameson 2003). Rather, the opposite is true: struggles over dollarization, and nature of exchange rate policy in general, will continue to erupt as economies become

increasingly integrated. Increased sensitivity to exchange rate movements caused by globalization (of both trade and finance) and financialization on a global and local level will continue to place pressure on monetary and exchange rate policy as a centerpiece of any economic development model. Exchange rate policy, once a tool among many for controlling economic growth has become a central component in choosing a national path for economic development. In many developing economies, the exchange rate regime has become a proxy for its economic model and, therefore, will continue to be highly contested. As globally oriented financial sectors emerge in developing economies, their quest for a stable and appreciated exchange rate will come into direct conflict with the needs of exporters and local producers for one that is more flexible and depreciated; thus, we will likely see continued eruptions over exchange rate policy and dollarization. Pro-dollarization campaigns will be particularly acute in those countries with ascendant, globally oriented financial sectors, such as has been witnessed in Costa Rica and Iceland over the past several years (Aragón 2008, Ibarra 2010, The New York Times 2008, Taylor 2012).

THE FUTURE OF DOLLARIZATION IN ECUADOR AND EL SALVADOR

One of the key characteristics that make dollarization so attractive for its proponents is its supposed irreversibility. Although de-dollarization would be costly and likely traumatic, nothing is irreversible, not even dollarization. Thus, even after more than a decade of dollarization, there

are still rumors and debates about the possibility and convenience of de-dollarization in Ecuador and El Salvador.

Ecuadoran dollarization proponents faced their greatest challenge to dollarization, to date, in the election of left-leaning economist, Rafael Correa, to the presidency at the end of 2006. Correa had been a vocal critic of dollarization and has continued to express his dislike for the measure. However, the Correa government has repeatedly claimed that it does not intend to touch dollarization due to the high costs of exit. Many of Correa's opponents, on the other hand, attribute his unwillingness to intervene on dollarization's widespread public support. According to the polling firm, Cedatos-Gallup, more than 90% of the population approved of dollarization upon its 10-year anniversary (Pallares 2012). As one Ecuadoran businessman interviewed for this study asserted, "the only thing more popular than President Correa is the dollar" (Interview with Ignacio Perez).

After five years in office, Correa has not attempted to overhaul Ecuador's dollar regime, although his critics assert that high levels of government spending under his administration puts dollarization's future in jeopardy. Should the price of oil and the level of remittances fall, Ecuador would face a fiscal crisis that could lead to de-dollarization (Pallares 2012), similar to the Argentine crisis that led to the abandonment of convertibility. However, dollarization is much harder to exit than convertibility, in which local currency still circulates freely. De-dollarization, would, thus, depend greatly on the strength and character of the financial sector

relative to other sectors, much as dollarization did. In the case of Ecuador, dollarization has consolidated the financial sector, which still forms the cornerstone of the country's top economic groups. Since the 1998-1999 crisis, this sector has not only recovered but is thriving with rates of profitability that surpass those of the pre-crisis period. Steadily increasing levels of consumer credit also indicate that the financial sector's alliance with the importers and retailers will likely remain strong and a formidable foe to those opposed to dollarization.

In El Salvador, too, dollarization has faced the challenge of governmental leadership hostile to the regime. In 2009, El Salvador had its first alternation of power in 20 years with the election of FMLN presidential candidate, Mauricio Funes. Similar to Correa, Funes has continually stated that his administration would not reverse dollarization due to the high costs it would have on the economy. Nevertheless, several FMLN leaders continue to publicly state their opposition to dollarization and the need to reintroduce a national currency to help spur the country out of its continued economic stagnation. According to FMLN Party Coordinator, Medardo González, it is not a question of whether dollarization should be reversed but when (Cáceres 2012, Tejada 2012).

Aside from the present increase in power for the FMLN, El Salvador has also undergone significant structural economic changes that could signal a fracture in the pro-dollarization alliance. Towards the end of 2006 and beginning of 2007, all of El Salvador's major national financial groups, which also the country's three largest banks, sold their financial holdings to

large foreign financial conglomerates for windfall profits. Grupo Banagrícola sold all of its financial holdings to Grupo Bancolombia, Colombia's most powerful financial group, for approximately \$900 million; Grupo Cuscatlán sold its holdings to Citi Group for \$1.51 billion in cash and Citi Group stock (Citigroup also took over Banco Uno one year later); and HSBC bought out the remainder of its holdings in Banco Salvadoreño for \$190.7 million (El Diario de Hoy 2006, Croft 2007, HSBC 2007, Business Wire 2007, Salmerón and Moncada 2006). By 2009, foreign investment accounted for 90% of financial sector assets (Castillo 2009).

However, with the sale of their banks, El Salvador's largest national economic groups lost their access to easy lines of low-cost credit, a fact made worse by the current economic crisis. As a result, these groups have begun to pressure the government to make lines of credit available through State development banks, something that they opposed bitterly when they owned the financial sector (Interview with Goitia). Although these groups still maintain a strong interest in the import and real estate sectors, their shift out of the financial sector, coupled with continued economic stagnation, could lead to the construction of a viable de-dollarization alliance in the medium to long-term.

III. LESSONS FOR UNDERSTANDING THE EUROPEAN MONETARY UNION

As the current crisis in the European Monetary Union (EMU) unfolds, it makes sense to ask what lessons can this study provide in assessing the future of the Euro and which countries will likely

remain, leave, and/or seek entry into the EMU in the future. The basic findings of this dissertation should hold true for EMU member countries. That is, non-reserve currency countries with domestically powerful and globally oriented financial sectors would be most likely to seek entry and to remain in the EMU for the same reasons discussed in this dissertation. Spain and Greece are examples of countries with globally expanding domestic-financial sectors (Spain in Latin American and Greece in Southeastern Europe); thus, it should be of little surprise that, despite the current financial crisis in these countries, Greece and Spain continue to maintain their commitment to the EMU.

However, as noted in this study, continued commitments will depend on several other domestic factors, such as the relationship of the financial sector to the political sector, the ability of the financial sector to form alliances with other key economic and social sectors (i.e. service, commercial, and import sectors), and the relative power of the tradables sector (export and import-competing sectors). While monetary unions, like dollarization, provide a hard fix for member countries, the underlying nature of these regimes differ in important ways that will affect the character of such alliances. The most fundamental difference between dollarization and a monetary union is the nature of the relationship between participant countries and, thus, the degree to which they surrender monetary sovereignty. In both cases, countries entering these regimes sacrifice monetary autonomy, that is, the ability to form *independent* monetary policy based on their individual economic needs. However, countries that dollarize, by unilaterally taking on the currency of another country, also completely surrender any form of monetary

sovereignty: they are unable to influence monetary policy to their own interests. While sovereignty is limited in a monetary union, it is not eliminated by virtue of the joint nature of the regime.

Similarly, depending on the monetary union, members may enjoy certain economic and political benefits that could boost sectoral and social support for membership despite the negative impacts of overvaluation, including side payments to negatively affected sectors (i.e. subsidies and other payments) and economic support. EMU members, in particular, enjoy a range of such benefits, including regional funds, agricultural subsidies, and cohesion funds. The current Eurozone crisis also demonstrates that, although associated with tough austerity measures, smaller member economies do maintain some leverage in obtaining aid, depending on how their exit would affect the entire union. Thus, any prediction of which countries will seek entry into the EMU and which will remain once joined will also depend on the way in which sectors traditionally hurt by fixed and overvalued exchange rates will be compensated by EMU membership.

IV. AVENUES FOR FUTURE INQUIRY

Until recently, the scholarship on monetary and exchange rate policy, overall, and dollarization, in particular, have focused on its technical merits with an assumption that governments adopt such policies based on dispassionate cost-benefit analysis. However, as the case studies in this dissertation show, such policy decisions are permeated by political conflict and are, thus, heavily

affected by domestic political structures. This dissertation sheds light on the ways in which global economic and domestic political structures interact to influence debates over dollarization and its ultimate adoption. However, much remains to be understood about how dollarization, itself, impacts domestic political institutions and, particularly, the quality of democracy. A number of scholars point to the ways in which democracy leads to inflationary monetary policy using two interrelated arguments: 1) that a short-sighted citizenry or special interest groups are able to capture politicians, through democratic institutions, to implement their preferred expansionary monetary policies (Schuler 2003; Drazen 2002; Hinds 2006; Desai, et al. 2003; Hayek 1991) and 2) democratic elections lead politicians to implement short-sighted inflationary policies in the hope of boosting employment, and the economy overall, to garner votes (Bernhard & Leblang 1999; Drazen 2002; Alesina 1992; Schamis & Way 2003). This scholarship is often used to justify the insulation of monetary institutions from governmental influence via the creation of independent central banks (ICBs) (Stiglitz 1998; Drazen 2002) and dollarization (Hinds 2006; Hayek 1991; Drazen 2002; Schuler 2003). There has been some, although limited, discussion of the democratic nature of ICBs (Stiglitz 1998), particularly in relation to the European Central Bank (Aziz 2005; Eijffinger & Haan 1996; Gormley & de Haan 1996; Issing 1999; Verdun 1998). This literature has made recommendations for how to create ICBs in accord with democratic values of representation, accountability, and transparency (Stiglitz 1998; De Haan and Eijffinger 2000; Buiter 1999).

The question remains, though, as to how even more stringent monetary and exchange rate regimes, such as dollarization, affect the quality of democracy within adopting countries. Does removing a major policy area, such as monetary policy, from democratic influence reduce the quality of democracy? How does adoption of dollarization affect the electorate's capacity to implement preferred policies that are not in line with maintaining a dollarized economy (i.e. current account and balance of payment deficits)? How does such a reduction in policy space impact political accountability, representation, and responsiveness?

Similarly, within the context of a global economy, characterized by highly mobile capital flows, is it possible that dollarization may improve the quality of democracy in adopting countries by removing the specter of currency crisis, creating the space for governments to implement a wider range of policies? National policies deemed risky or unwelcome by investors, even if they are widely supported by the national citizenry, often lead to capital flight and speculation. These activities, in turn, result in an unstable currency or even a currency crisis, which encourages leaders either to avoid such policies or face currency and economic crises. Dollarization virtually eliminates the possibility of currency crisis, particularly due to speculation. While investors may certainly punish governments perceived as implementing risky or bad policies in other powerful ways, by minimizing the possibility of currency crisis, might dollarization actually give leaders enough stability to implement policies that might otherwise lead to destabilizing speculation-induced inflation and capital flight? Answering these questions will not only be instructive for countries considering dollarization but also improve our

understanding of democratic institutions and the nature of democracy within a globalized economy fraught with constraints.

APPENDIX

APPENDIX 1. Ecuador's Economic Groups and Activities

Name of Economic Group	Primary Group Members (families)	Key Industries	Region
Grupo Noboa	Alvaro Noboa Ponton Noboa Azin Noboa Ponton	<ul style="list-style-type: none"> · Banana export (Bonita Bananas) · International Investments · Banking (Banco Litoral) · Insurance (Seguros Condor, Harford) 	Guayaquil
Grupo Isiais	Isiais Dassum	Filanbanco (Universal bank) Filancard (credit card) Editora Edimpres (Publishers; puts out newspaper El Hoy & magazines) Television (Gamavisión, TC Televisión, Cable Noticias (CN3)) Ecualeasing, Filanleasing Total of 195 companies (incl. textiles, plastics, real estate, import, electricity, etc.) Grupo Kronfle (Pinguino ice cream, textiles)	Guayaquil
Grupo Egas	Egas Grijalva Egas Larrategui	Grupo Pichincha <ul style="list-style-type: none"> · Universal Banking (Banco Pichincha-Ecuador; Banco de Pichincha-Panama; Banco Financiero del Perú, Banco Pichincha Ltd. Bahamas, Banco Pichincha Miami Agency, Banco de Loja, Banco Rumiñahul) 	Quito

	<p>Egas Sosa</p> <p>Salazar Egas</p>	<ul style="list-style-type: none"> · Finance/Insurance (Seguros del Pichincha, Servicios Financieros Interdín, Casa de Valores Picaval, Administradora de Fondos Fondos Pichincha, Sociedad de Servicios Financieros Amerafin Sistema de autofinanciamiento de vehículos Consorcio del Pichincha Condelpi, Servicios Financieros Credi Fedesarrollo microempresarial, Servicios de financiamiento de vivienda Servicios Financieros Procimag y Financiera Inversora) Grupo Diners <ul style="list-style-type: none"> · Diners Club del Ecuador (credit card) · Tarjetas Optar del Ecuador (credit card) Other Activities <ul style="list-style-type: none"> · Media (Teleamazonas) · Real Estate 	
Grupo Elijuri	Elijuri	<ul style="list-style-type: none"> · Auto (import and assembly, incl. Kia, Hyundai, Yamaha; car sales and repair) · Department Store Chain (Almacenes Juan Elijuri, Las Fragancias; Telecuador) · Import (cosmetics—Max Factor; electronics; ceramics; etc.) · Finance (Banco de Austro, Financiera de Austro, Seguros Unidos, Inversiones Ferrazano, etc.) · Real Estate · In 2008, had 161 companies 	Azuay
Grupo Favorita (Grupo Wright)	Wright	<ul style="list-style-type: none"> · Super Maxi (super market chain) 	Quito

	Duran-Ballen Paz Pachano	<ul style="list-style-type: none"> · Super La Favorita (super market chain) · Mr. Book (Bookstore chain) · Pollo Favorita (food processing) 	
Grupo Paz-Pachano/PROINCO	<p>Abelardo Pachano Bertero (1988-1990: Presidente de la Junta Monetaria y de la Comisión de Renegociación de la Deuda Externa)</p> <p>Rodrigo Paz Delgado (Ran for Pres in 1995 for DP-UDC; former Mayor of Quito)</p> <p>Attia Galante</p> <p>Bueno Villacorte</p> <p>Paz Delgado</p> <p>Paz Rodriguez</p> <p>Pachano Bertero</p> <p>Pachano Estupinan</p>	<p>Grupo Financiero Produccion</p> <p>Produbanco (universal bank/credit cards)</p> <p>Produfondos (investment)</p> <p>Produvalores (investment)</p> <p>Grupo PROINCO (Owned by Grupo Financiero Produccion)</p> <p>Commercial Centers</p> <p>Real Estate</p> <p>Insurance</p>	Quito
Grupo Pinto		<ul style="list-style-type: none"> · Omnibus BB (automotive assembly for domestic market and export) · Textile manufacturing 	Quito
Grupo Lasso-Banco de Guayaquil	Lasso	<p>Universal Banking and credit cards (Banco de Guayaquil)</p> <p>Insurance</p>	Guayaquil

		Portfolio Management/Brokerages Real estate	
Grupo Pacifico		<ul style="list-style-type: none"> · Universal Banking (Banco Pacifico- Ecuador; Banco Pacifico-Panama; Pacific National Bank of Miami) · Credit Cards · Leasing · Insurance <p>Grupo Maspons Shrimping Nestle Dairy Importing Finance (Banco Sociedad General de Credito, Ecuatoriana de Finaciamento) Grupo Tosi Importing</p>	Guayaquil
Grupo Aspiazu	Fernando Aspiazu Seminario Juan José Pons (Costa Trading)	<p>Universal Banking (Banco del Progreso)</p> <p>Electricity (Emelec)</p> <p>Media (Canal 12/SiTv; El Telegrafo-newspaper; El Telegrafo-radio)</p> <p>Banana Export (Costa Trading)</p>	Guayaquil
Grupo Ribaneira-Morisaenz	Ribeneira Morisaenz	<p>Universal Banking (Unibanco, Banco Solidario)</p> <p>Credit Cards and Financial Services (Tarketa Cuota Facil, Sicobra)</p> <p>Automotive (distributes Mitsubishi, Fuso; distributes PayStar, WorkStar, DuraStar trucks and tractors; repair and servicing)</p>	Quito

		Commercial (electronics and appliances sales) Real Estate Information and Technology	
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Sources: Fierro Carrión 1991, Ecuador SRI, Herrera Llive 2007, La Revista Vitzazo 1999, Cooperitva.cl 2008, Diario Hoy 1/21/1999)

Appendix 2: El Salvador's Major Economic Groups (as of 2006)

Name of Group	Principle Families	Top National Investments	Top International Investments
Grupo Cuscatlán Total Firms: 44	<ul style="list-style-type: none"> • Cristiani • Llach • Baldochi Dueñas • Kriete • Murray Meza • Meza • De Sola • Salaverria • Hill 	<p>Finance</p> <ul style="list-style-type: none"> • Inversiones Financieras Cuscatlán (Cuscatlán Financial Investments) • Banco Cuscatlán (Universal Banking) • Grupo Financiero Cuscatlán (Cuscatlán Financial Group) • Tarjetas de Oro (Credit Cards) • Valores Cuscatlán (Investments/Brokerage) • Corfinge (currency trade) • Factoraje Cuscatlán (transport, correspondence delivery, and management of remittances) • SISA -insurance • SISA Vida –insurance • AIG Unión y Desarrollo-insurance • AIG Seguro de Personas- insurance <p>Imports</p> <ul style="list-style-type: none"> • Unifersa y Serte (imports fertilizer) • Droguería Santa Lucía (produces & imports medicine) • Sistemas C&C (imports computer equipment) <p>Agro-Export</p> <ul style="list-style-type: none"> • Montebro • Radex SA de CV (flowers) • EXportadora de Plantas Ornamentales (ornamental plants) • Union de Exportadores y Llach SA de CV (coffee) • Aquacorporación <p>Commerce</p> <ul style="list-style-type: none"> • Cristiani Burkard (sells agricultural inputs) • DIFERSA (fertilizer distribution) • Consejo SA de CV (buys & sells land) • Omnisport: (electronics and sports equipment retail) 	<ul style="list-style-type: none"> • Guatemala: Grupo Paiz (supermarkets, commerce) • Costa Rica: Corporación BFA (finance) • Panama: Corporacion UBCI – Union de Bancos Cuscatlán Internacional (merger with UBC from Costa Rica) • Honduras: Banco Lloyds TSB • Panama: Banco Cuscatlán Panama

		Industrial <ul style="list-style-type: none"> • Droguería Santa Lucía (manufactures & imports medicine) • Plásticos Salvadoreños (plastics manufacture) • Textufile (manufactures thread & cloth) • Imacasa (manufactures agricultural instruments) 	
Grupo Banco Salvadoreño Total Firms=54	<ul style="list-style-type: none"> • Simán Jacir • Simán Siri • Salume • Zablah Touché 	Finance <ul style="list-style-type: none"> • Inversiones Financieras Bancosal (investments) • Banco Salvadoreño (universal banking) • Salvadoreña de Valores (brokerage) • Internacional de Seguros (insurance) • Seguros Universales (insurance) • La Centroamericana (insurance) • Crecer (administration of pension funds) • Corporacion Excelencia (financial Services) -- Siman • Fondo Universal - Zablah Commerce <ul style="list-style-type: none"> • Almacénadora Salvadoreña • Almacenes Simán (department store chain)- Simán • Tropigas El Salvador (gas) --Simán • Comercial SA de CV (beverage distribution) - Salume • Sistemas Comestibles (fast food) • Union de Distribudora Internacional (wholesaler of home goods) - Salume • Unicomer Group (founded in 2000; a joint venture between Grupo Síman and Puerto de Liverpool SAB de CV) (www.unicomer.com) Industrial <ul style="list-style-type: none"> • Cartotecnica Centroamericana (paper products) - Siman • Industrias St. Jacks (clothing manufacturing)- Siman • Jacks Export Corp (clothing export) - Siman • La Fabril de Aceites (vegetable oils, etc.) -Zablah • Café Soluble de El Salvador (food processing) • Bonapetit – (food processing) - Zablah 	<ul style="list-style-type: none"> • Almacen Siman Nicaragua • Almacen Siman Guatemala • Unicomer Group: <ul style="list-style-type: none"> ○ La Curacao retail home furniture chain (Central America and Dominican Republic) ○ Almacenes Tropigas (Central America) ○ Radio Shack (Central America) ○ Unicomer (home appliance/electronics/furniture retail chain in the USA) ○ Courts (Caribbean) ○ Lucky Dollar (Caribbean) ○ Artefacta (home appliance/electronics retail chain in Ecuador) ○ Ocho Tiendas (Costa Rica)
El Grupo Banagrícola Total Firms =36	Baldochi Dueñas Kriete Ávila	Finance Inversiones Financieras Banco Agrícola (investment holding company)	Banco Agrícola S.A. Panama (headquarters) Banco Caley Dagnall (Nicaragua)

	Dueñas	Banco Agrícola Comercial (universal banking)	Banco de la Produccion (Honduras)
	Palomo Déneke	Banco Credomatic (universal banking)	
	Araujo Eserski	Aseguradora Agrícola Comercial (insurance)	
	Schildknecht	Asesuisa (insurance)	
	Pacas Díaz	Asesuisa Vida (life insurance)	
	Cohen	Confía (pension fund administration)	
		Crecer (pension fund administration)	
		Travel & Communications	
		TACA Internacional (airlines)	
		Aeroman (maintains TACA planes)	
		Telecorporacion Salvadoreña (telecommunications)	
		Unión de Telecomunicaciones (telecommunications)	
		Tele VIP (telecommunications)	
		Telefonica Moviles Centroamericana – (information, reservations, and international communication)	
		Industrial	
		Cemento Cessa (cement--only one in El Salvador)	
		Destilería Salvadoreña (alcoholic beverages)	
		Cajas y Bolsas (paper products)	
		CELPAC (wrapping/lamination/printing)	
		Summa Industrial (soap, oils, etc.)	
		Industrias Topaz (cosmetics, clothes)	

		<p>Curtis Industrial (cosmetics, chemical & medicinal products)</p> <p>Agriculture</p> <p>Ingenio Azucarero La Cabaña (sugar production)</p> <p>Prestomar (shrimp & lobster)</p> <p>Union de Exportadores (coffee export)</p>	
Grupo Banco de Comercio - 27 Firms	<p>Belismelis</p> <p>Catani</p> <p>Papini</p> <p>Alvarez</p> <p>Freund</p> <p>Cohen</p> <p>Sol</p> <p>Escalante Sol</p> <p>Quiñónez Sol</p> <p>Palomo</p>	<p>Finance</p> <p>Corporación BanCo/Scotiabank (universal banking)</p> <p>Inversiones Financieras (investments)</p> <p>Banco de Comercio (universal banking)</p> <p>Compañía General de Seguros (insurance)</p> <p>Seguros de Persona (insurance)</p> <p>Industrial</p> <p>Implementos Agrícolas Centroamericanos (agricultural tools)</p> <p>Corporación Industrial Centroamericana (construction materials)</p> <p>Gases Industriales (industrial oxygen and hydrogen)</p> <p>Cemento CESSA (cement—only cement company in El Salvador)</p> <p>Sherwin Williams de Centroamerica (manufactures paints, varnishes, etc.)</p> <p>Imports</p> <p>General Automotriz (automotive)</p> <p>General de Vehículos (automotive)</p>	

Grupo AGRISAL - 41 Firms	Meza Ayau Sol Meza Meza Hill Palomo Quiñonez Meza Alvarez Meza	Finance Banco de America Central (Credomatic) (universal banking) Banco UNO (universal banking) Credomatic de El Salvador (credit cards) Confía (pension fund administration) Corporacion Desarrollo SA (brokerage) Agricola Industrial Salvadoreña (AGRISA) (manages investments for Grupo AGRISAL) --Meza Ayau Inversiones La Estrella (financial corporation)-Meza Ayau Capricornio (financial corporation)-Meza Ayau La Abeja (financial corporation)-Meza Ayau La Arboleda (financial corporation)-Meza Ayau Commercial Radison Plaza Hotel Plaza Mundo (commercial center) Star Motors (Mercedes Benz distributor) Almacenes ADOC (chain of shoe stores)—Palomo Zona Franca de Exportacion El Pedregal (Free Trade Zone) Industrial Cemento CESSA (cement manufacture) Cerveceria La Constancia (brewery) Meza Ayau Industrias Cristal de Centroamerica (purifies water & other beverages)	<ul style="list-style-type: none"> • Banco de America Central part of a network of Banks throughout Central America (Guatemala, Honduras, Costa Rica, Nicaragua) • Allied with South African Breweries (5th Largest beer company in the world)
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		<p>Corcho y Lata (plastics)</p> <p>Agriculture</p> <p>Union de Exportadores (produces and exports coffee)</p> <p>Agroindustrias e Inversiones</p>	
<p>Grupo Poma/Salaverría Prieto/Quiros /Scotiabank - 55 Firms (30 by Familia Poma)</p>	<p>Poma Salaverría Prieto Quiros</p>	<p>Finance</p> <p>Ahorromet (bank)</p> <p>Ahorromet Valores (financial institution)</p> <p>Banco Scotiabank El Salvador (bank)</p> <p>AIG Union y Desarrollo (insurance)-Salaverría Prieto</p> <p>AIG Seguros de Persona (insurance)-Salaverría Prieto</p> <p>CrediQ (automotive financing)-Quiros</p> <p>Commercial/Real Estate</p> <p>Didea (car dealership)</p> <p>Repuestos Didea (car parts)</p> <p>Poma Hermanos (buys & sells real estate)</p> <p>Inversiones Roble (real estate development/construction of commercial centers)</p> <p>MetroCentro (commercial center)</p> <p>Lexus</p> <p>AutoKia</p> <p>AutoFacil</p> <p>Europa Motors (car dealership) Salaverría Prieto</p>	<ul style="list-style-type: none"> • Grupo Q (automotive sales and servicing) in Costa Rica, Guatemala, Honduras, and Nicaragua • CrediQ (automotive financing) in Costa Rica and Honduras • Inversiones Roble (real estate): <ul style="list-style-type: none"> ○ Hotels in Honduras, Guatemala, Nicaragua, Costa Rica, Mexico, the USA ○ Shopping centers in Honduras, Costa Rica, Panama, Nicaragua ○ Part of the IBM building in the USA

		<p>Automax (car dealership)-- Salaverría Prieto</p> <p>Utravel Service (travel agency)--Salaverría Prieto</p> <p>Inversiones Mirosal (real estate)- Salaverría Prieto</p> <p>Corporacion Desarrollo - (commercial real estate)- Salaverría Prieto</p> <p>Saquiuro – (car dealership)-- Quiros</p> <p>Salvaparts (car parts) –Quiros</p> <p>Industry</p> <p>Solaire (produce aluminum products)</p> <p>Unimetal</p> <p>Cemento CESSA (only cement producer in El Salvador)--Salaverría Prieto</p> <p>Zona Franca de Exportacion El Salvador (Free Trade Zone--clothing)</p> <p>Agriculture</p> <p>Quality Grains (processes coffee) --Quiros</p>	
Grupo de Sola 10 Firms	De Sola	<p>Finance:</p> <p>AIG Union y Desarrollo (insurance)</p> <p>AIG Seguro de Personas (personal insurance)</p> <p>Industrial:</p> <p>Fabrica Oliva (manufactures soaps and detergents)</p> <p>Unesola (manufactures food, deodorant, shampoo, etc.)</p> <p>Commercial/Real Estate:</p> <p>Inmobiliaria El Sitio (real estate)</p> <p>Homarca- (buys and sells real estate and personal property)</p> <p>Inversiones Bolivar (real estate development)</p>	

		Agriculture: Union de Exportadores (produces and exports coffee)	
Sources: Asociación Equipo Maíz 2006, Goitia 2006, Grupo Q (www.grupoq.com), Grupo Unicomer (www.unicomer.com),			

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