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A Post-Keynesian Institutional Analysis**

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Abstract

Ecuador's dollarization was no marginal optimization decision. It was fundamental, dramatic and designed to completely transform central elements of the economy. Since orthodox, a-historical perspectives are inadequate in explaining such significant policy reversals, the paper uses a "post-keynesian institutionalist" explanatory framework (PKI). An Appendix surveys the twenty-year evolution of this effort to combine post-keynesian analysis with institutionalism. The paper's sections critique three orthodox explanations of dollarization, showing why they are unsatisfactory accounts of Ecuador's experience, examines the heterodox literature on exchange rate issues, introduces the PKI concepts used to explain Ecuador's dollarization, considers the actual dollarization process in Ecuador from a PKI perspective, and finally extrapolates from that treatment to the current situation in Ecuador and the likely future course of this dollarized economy.

Keywords: Dollarization, Ecuador, Dollar bloc, Post-keynesian, Institutionalist.

JEL Classification: O1, O5, B25, F31.

I. Introduction

President Jamil Mahuad of Ecuador surprised virtually everyone when he declared that the country would officially dollarize. His January 2000 bombshell sparked a military/indigenous revolt that ousted him by the end of the month. Nonetheless, the policy of destroying the national currency, the sucre, continued under his successor, former Vice-president, Gustavo Noboa. The program soon enjoyed technical and tangible support from the U.S., the IMF, the World Bank and the IDB. By September 2000, even campesinos in remote villages were using the U.S. dollar for transaction purposes. The only remnants of the national currency were the domestic coins (1¢, 5¢, 10¢, 25¢, and 50¢), whose size and shape were virtually identical to the corresponding U.S. coins. The situation paralleled Panama's where balboa coins have supplemented dollars since 1904.

This ninety-six year hiatus in official dollarizations heightens the importance of understanding Ecuador's policy decision. For it could signal that a wave of dollarization will sweep over the domestic Latin American currencies, thereby creating a monetary union based on the dollar. El Salvador's decision in 2001 to encourage dollarization supports such an interpretation, though the absence of later examples provides a counter. Explaining the genesis, performance, and future of dollarization in Ecuador will help understand both the likelihood of widespread dollarization and the factors that will push Latin America in one direction or another.

Ecuador's dollarization was no marginal optimization decision. It was fundamental, dramatic and designed to completely transform central elements of the economy. Since orthodox, a-historical perspectives are inadequate in explaining such significant policy reversals, the paper uses a "post-keynesian institutionalist" explanatory

framework (PKI). The Appendix surveys the twenty-year evolution of this effort to combine post-keynesian analysis with institutionalism. The resulting framework is not the common mathematical deductive one familiar in the discipline. Rather it draws upon concepts from the two traditions to suggest the categories that can be used to understand the complex phenomenon that is dollarization. It is a “pattern model” (Wilber and Harrison, 1978) as required by Ecuador’s wrenching historical experience.

The next section of the paper critiques three orthodox explanations of dollarization, showing why they are unsatisfactory accounts of Ecuador’s experience. Section III then examines the heterodox literature on exchange rate issues as a lead-in to Section IV, which introduces the PKI concepts that will be used to explain Ecuador’s dollarization. The next section builds on this treatment, considering the actual dollarization process in Ecuador from a PKI perspective. Finally, by way of conclusion, the paper extrapolates from that treatment to the current situation in Ecuador and the likely future course of this dollarized economy.

II. Orthodox Explanations of Dollarization in Ecuador

Conventional explanations for why an economy would dollarize generally use one of three approaches. The first draws on the theory of optimal currency areas, OCA’s, which traces its lineage to Mundell (1961). There have been numerous efforts to apply the theory to Latin America and to particular Latin American countries (Panniza, Stein and Talvi 2003; Willett 2002). Karras (2002) found that few western hemisphere countries satisfied the criteria of an optimal currency area with the U.S., the analytical justification for dollarization. The argument for monetary union was strongest in Canada

and Honduras. It was quite weak for Argentina and Mexico, where dollarization had been discussed. It was little better for Ecuador, where dollarization has been undertaken, or Guatemala, which is moving in that direction. Of the dollarizing economies, only El Salvador came close to satisfying the OCA criteria.

The argument that dollarization would improve efficiency and stability can be made for some countries; that is not the case for Ecuador before 2000. The cyclical correlation with the U.S. was low, generally less than .20, and lower than ten other western hemisphere countries (Karras 2002). Add to this the relatively small share of trade between the countries. The U.S. accounted for only 38 percent of Ecuador's exports in 1997, down from 66 percent in 1984 (Dávalos, 1999). OCA proves to be an inadequate explanation for dollarization in Ecuador.

Beckerman (2002) rests his treatment on the "semi-dollarization" of the Ecuadorian economy, i.e. the extensive unofficial dollarization that had resulted in many transactions denominated in dollars. In addition, dollar-denominated banking accounts had increased and dollar assets provided the store of value function the sucre couldn't. His data show that the share of dollars in quasi-money increased from 9.7 percent in 1989 to 34.6 percent in 1998, so this explanation is plausible. The difficulty is that many other semi-dollarized countries have not followed Ecuador's dollarization lead, and the problem of semi-dollarization is not new. Clements and Schwartz (1993) note the high degree of semi-dollarization, or share of foreign currency deposits in broad money, in several Latin American countries. For example, it reached 80 percent in Bolivia in 1991, 48 percent in Argentina, and 60 percent in Peru, none of which have dollarized. Indeed, semi-dollarization appears less extensive in Ecuador in 2000 than during the 1970s and

1980s, when the ill-fated “sucretization” program was undertaken as a counter. So the prevalence of unofficial dollarization was certainly a contributing factor, though a full explanation must be found elsewhere.

The final explanation saw dollarization as the only viable means of resolving a currency crisis. Theories of currency crises by now have reached their fourth generation (Velasco 1999). The preferred culprit today is the “sudden stop” in international capital flows, associated with devaluations in emerging markets (Calvo, Izquierdo and Talvi 2002). Regardless of the mechanism they rely on, the models suggest that small economies in a period of free capital movements face daunting tasks in attaining exchange rate stability, mainly because they are unable to maintain credibility in their exchange rate policy. This led to the “bi-polar view” (Fischer 2001) that such countries had only two choices, to float their currencies or to adopt a “hard-peg.” Dollarization is the extreme hard peg. This explanation is inadequate since exchange rate instability has been endemic in Latin America and Ecuador since the 1970s. In addition, there was no significant correlation between the exchange regime and the economic performance of Latin American countries during the 1990s (Frieden and Stein 2001; Wise and Roett 2000). Once again, this explanation for Ecuador’s dollarization is suggestive but inadequate. It may have played a role, particularly before the crisis in Argentina’s hard peg-convertibility in 2001-2003; however it leaves many questions unanswered.

Since these three approaches indicate that there were other Latin American countries that would be more likely to dollarize than Ecuador, and there was no strong rationale for Ecuador to dollarize, it is necessary to approach Ecuador’s dollarization

from a different direction. Let us begin to broaden our inquiry into these questions by examining heterodox treatments of exchange rates.

III. Heterodox Treatments of Exchange Rate Issues

Before examining Ecuador's peculiar choice of exchange rate regime, it will be useful to broaden the range of inquiry by briefly describing two heterodox treatments of exchange rates (Harvey 1999, 2001; Grabel 2001; 2003). Harvey (1999, 200) employed "a Post Keynesian approach to explain the two most salient features of the modern currency market: large and persistent trade imbalances and currency price volatility." The central institutional factor adduced in the explanation was the growth and dominance of portfolio investments in the demand for foreign exchange.¹ He drew on Keynes's treatment of "speculation, or the 'forecasting (of) the psychology of the market'" (204) to suggest that the short term nature of portfolio investment leads to price volatility and "apparently irrational price movements" (205). The powerful impact of exchange rates on asset prices places them at the center of the argument, while changes in exchange rate forecasts generate volatility. According to Harvey (1999, 206), post-keynesians suggest six factors that influence the forecasts: the speculative nature of the currency market; the lack of a true anchor to currency values; the subculture of foreign currency dealers; the particular manner in which people make decisions; the environment of uncertainty in which decisions are made; and bandwagon effects.

Grabel (2001) similarly points to portfolio investment as a central contributor to exchange rate instability. Specifically, she notes that increased portfolio investment, such as occurred during the 1990s, led to both constraints on policy autonomy and more

importantly to increased risk potential. The liquidity of portfolio investment, “coupled with flighty, endogenously determined investor expectations... contributes to investment and macroeconomic instability”(445). Grabel (2003, 319) disaggregated the risk from financial integration into five categories: currency, flight, fragility, contagion, and sovereignty. Instability in any one of these will be reflected in exchange rate instability. The working of the foreign exchange market analyzed by Harvey implies that such instability is endemic in that market.²

Grabel and Harvey (2001) provide useful starting points for the PKI view of exchange rates and of dollarization in Ecuador. Harvey’s concentrates on a critique of neo-classical efforts to explain exchange rate movements as the result of underlying value-free “economic fundamentals.” He and others have deemed the effort a notable failure. His concluding observations (13) provide an excellent context for the remainder of this paper: “It remains a mystery to me why the object of our endeavor cannot simply be to understand how rates are determined *as they are*, without regard for how the answers fit our preconceptions.”³ He continued: “The future is not entirely bleak, though, as there are researchers willing to take on the task of explaining the ‘noneconomic’ behavior of international financial markets...however, the vast majority of scholarly resources in this effort are invested in efforts not directed toward explaining the behavior we observe day-to-day in world currency markets, but to discovering the circumstances under which the Fundamentals as currently defined might finally be relevant.”

To that challenge we now turn. I suggest that the analytical categories of “post-keynesian institutionalism” (PKI) can provide the framework for a more satisfactory treatment of exchange rates and particularly of dollarization in Ecuador. The next section

specifies the analytical constructs that will be used. In addition, the Appendix provides an overview of PKI writing to indicate the varied sources of the concepts.

IV. PKI Analytical Categories

The first use of the PKI term, which I am aware of, was in Wilber and Jameson (1983, Part Three). However, there must be a logical link of the two constituent terms, for the composite has become widely used, though with quite varied meanings. For example, the ASSA meetings in January, 2002, had a session entitled “The Current Relevance of Hyman Minsky’s Post-keynesian Institutionalism.”⁴ I am not aware that Minsky applied the term to his own work, though in one case he pointed out the “affinity between the economics of Keynes and (John R. Commons) the American Institutionalism” (Minsky 1996). In addition, certain of Minsky’s claims about the role of institutions have a familiar ring and describe quite well the broad context we are using to explain Ecuador’s dollarization:

- a. political processes generate and sustain an economy’s structure of intervention and containment;
- b. the effectiveness of an institutional structure is likely to attenuate through time as agents learn how to evade and avoid the constraints and as the incentives to behave well become less powerful;
- c. new institutional structures of containment and intervention are necessary periodically (Ferri and Minsky 1989, 138).

When examined more closely, the methodological claim embodied in the term is that a theoretical stance from post-keynesian economics can be wedded to an empirical

approach from institutionalism, with the combination offering insights superior to either alone. This resolves the tension noted by Laibman (2001, 279-80): “Institutionalism does not amount to a theoretical alternative, owing to its fundamental commitment against theory. Post-keynesian or ‘structural’ Keynesian theory attempts to carve out a middle ground, but must eventually settle on one side or the other.” The promise of PKI analysis is to draw on post-keynesian theory while being able to assert “Yes, it is important that our theories have a direct correspondence with observable economic reality” (Wilber and Jameson 1983, 151).

Let us turn now to the specific analytical categories that we will use to understand Ecuador’s dollarization more successfully than the orthodox interpretations allow. The alternative PKI framework grows out of a theoretical structure that highlights a different set of factors that determine the outcome of the policy dilemma of the correct exchange rate regime:⁵

- history: Wilber and Jameson (1983, 156-157) find that a focus on “historical time” as opposed to “logical time” is a central differentiating factor between PKI and orthodox analysts. While logical time “takes no account of history and assumes that any point in the past can be reached again in the future,” historical time suggests that the economy is embedded in, and a result of, historical processes that must be included in any analysis. Thus the particular conditions and historical experience of Ecuador will be an important consideration in understanding the decision to dollarize.

- institutional evolution: Hodgson (1994, 223) notes that an evolutionary perspective, tracing to Veblen and before, “provides an alternative to the ‘hard core’ idea of mechanistic maximization under static constraints.” It allows a much richer variety of economic outcomes: non-equilibrium rather than equilibrium, qualitative versus quantitative, structural rather than parametric change, and diverse, non-optimizing outcomes. Thus the particular circumstances of a case come to be central.
- uncertainty: Harvey (1999) and Grabel (2001) make uncertainty, risk, and endogenously determined expectations in international financial markets the central factor in accounting for the instability in those markets that spills over into exchange rate instability. So these markets are not self-regulating and equilibrating but can be a source of financial disruption of the real economy.
- cumulative causation: Eichner (1978) based his analysis on a “systems approach,” which has evolved into the combined analytical and technical structure today termed “system dynamics.” It contributes to PKI analysis an alternative to equilibrium as the characterization of economic processes. Thus, systems are inherently unstable and economic changes are likely to provoke or result from institutional and political changes. The roots of this construct can be traced back to Veblen, Kaldor and Myrdal (Scott 1994).
- power and conflict: Arestis’s (1996) contribution to PKI analysis concentrated on the role of large corporations and labor unions in the

modern economy. This placed issues of power and conflict at the center, in keeping with many earlier analyses, e.g. Adam Smith, David Ricardo, or Karl Marx. The modern treatment of this construct sees power exercised in three main areas, in markets, in social choices, and in personal values. All of these realms are important for understanding Ecuador's dollarization, especially that of social choices. For this was a fundamental social choice.

- the battle of ideas: the classics again provide the roots for this construct, Smith, Ricardo, and Marx. Veblen's work (1899) on "the preconceptions of economic science" was a more recent precursor in the institutionalist tradition, as was his focus on the habits of thought of bankers versus engineers. Hodgson (1989) places these elements at the center of his effort to provide a PKI theoretical framework. In addition to habits as a dominant influence on individual behavior, he suggests that norms have a powerful influence on price behavior.

Let us now examine one particular currency market experience, the volatility and instability in exchange rates in Ecuador in 1999 that led the country to adopt the hard peg of dollarization in 2000. In doing so, we will rely upon these theoretical PKI constructs.

V. A PKI Interpretation of Why Ecuador Dollarized

We will take each of these six constructs in turn and indicate how they can help us understand the dollarization decision in Ecuador.

i. History

The relevant historical context is the international system that dominated Ecuador's domestic economy with the demise of the Bretton Woods system in the 1970s. The fixed exchange rate system with capital controls and jealously guarded national autonomy was replaced by a seeming non-system whose first task was to redirect income to oil producing countries and to recycle the petro-dollars. Ecuador benefited from increased oil prices as a result of its new status as an oil exporter, performing better than much of the rest of Latin American. However, its indebtedness to the international financial community rapidly outran the growth of its oil exports. As a percent of GDP, debt grew from 20 percent in 1973 to its high of 118 percent in 1998 (Jameson 2003, 6). This reflected the relatively low saving rates of Ecuador, and Latin America in general, and the inability to restrict incomes and expenditures to accord with this new international reality. The result was heightened internal political tensions and continuing inability to resolve them. A short-lived military regime failed this task miserably, and traditional political processes and parties became progressively weaker, opening the door to recurrent populist ventures.

By the late 1990s, the absence of any consensus made it extremely difficult to develop coherent economic policy and gave international agencies a central role in economic policy. Coastal interests were arrayed against sierra interests, and populists in both areas challenged traditional powers. The military remained a political arbiter, while indigenous movements grew and found political structures and strategies that increased their role measurably.

This historical process suggests that a decision such as dollarization would not be based on the bloodless rational calculus of costs and benefits implicit in the orthodox analyses. Rather it would grow out of some sort of populist impulse designed to break the political deadlock. Had Ecuador's political-economic system moved in a different direction after 1973, dollarization would have been a very unlikely policy departure.

ii. Institutional Evolution

The post-1973 institutional evolution, in Latin America as well as Ecuador, took place in two spaces, the international and the domestic. From a systemic perspective, this international institutional evolution can best be described as the formation of a "Western hemisphere dollar bloc" that came to dominate the international financial relations of Latin America and that exerted powerful control over domestic economic policy. McKinnon (2001) describes it somewhat differently, as "dollar encroachment in emerging markets," with Latin America notably more encroached upon than Asia. As a whole, he terms the system the "dollar standard." Both renditions of the international institutions suggest the centrality of the relation between the domestic currency and the dollar and between the domestic economy and access to dollar denominated resources. In Latin America, the foreign debt is the key to this relation.

The rules and norms of the dollar bloc were informal and disputed, especially during the 1980s. The power of creditors and their international supporters ensured that default and debt repudiation options never became viable responses for Latin American debtor nations. Then a "Washington Consensus" was finally forged in 1990 that restored capital flows to Latin America. It was the result of modest debt restructuring combined with the Washington Consensus liberalization programs of newly elected governments.

There had been a capital drain during the 1980s when capital flows fell from a high of \$18 billion to only \$3 billion in 1990 and \$5 billion in 1991(IMF 2001). By 1998, the net transfers to Latin America had reached an amazing \$90.5 billion. This was largely because of the rapid growth in foreign direct investment, which reached \$72 billion in 1998 and \$90 billion in 1999. Private non-guaranteed bond placements increased; the highest net inflow was \$13.5 billion in 1993. Commercial bank loans also contributed capital until 1998. Only the public and publicly guaranteed debt constituted a net transfer of resources out of Latin America, as publicly guaranteed loans were repaid. There was a constant drain of resources to pay publicly guaranteed loans, ranging from \$6.7 billion in 1993 to \$21 billion in 1997 and \$24 billion in 2000. So the publicly guaranteed debt flows counterbalanced the private flows, rising in the 1980s as private flows reversed, and then draining capital in the 1990s as private flows increased.

The permissive stance of the international institutional structure, the dollar bloc, encouraged changes in domestic economic institutions. However, domestic financial liberalization, designed to improve the allocation of financial resources, often led to bank failures, thus increasing the fiscal pressure on governments. The first failures in Ecuador were in 1995 and they continued through the rest of the decade. Privatization of state enterprises was an attractor for the foreign capital flows, as were the many raw material concessions that were offered, oil in Ecuador's case. On the other hand, these flows masked the fiscal weakness of central governments, since they were often of such magnitude that they swamped underlying deficits. Fiscal reforms were implemented to address the deficits of the 1980s. As part of this effort, the independence of the Central Bank became one of the guarantors of the credibility of economic policy.

This combination of internationally imposed institutional evolution and domestic institutional change obscured underlying institutional weaknesses. Latin American government revenues became heavily committed to debt repayment, and thus undermined the social safety net. Debt service was 2 percent of GDP in 1988 but rose to 6.5 percent in 1998 and accounted for almost 50 percent of government expenditures by the end of the decade (Dávalos, 1999). In addition, the sale to foreign capital of the major public assets, such as telephones and electricity, provided capital inflows but also changed access to these former public utilities. The denationalized industries became a matter of contention; the ability of government to respond to political and social demands was reduced because of the scarcity of available resources; and the credibility of economic policy-making became an important factor in determining a country's access to the dollar flows of the dollar bloc. This generated the tensions that would arise at the end of the decade and create what ex-President Mahuad has termed the "perfect storm" that blew him from office. The best indicator of this situation is that the total long-term debt owed by Latin America continued to rise rapidly during the decade. The 1989 total of \$377 billion rose to \$673 billion by 2000, increasing almost \$100 billion in 1997 alone. In Ecuador, external debt doubled between 1985 and 1998 to \$16.4 billion (Dávalos, 1999).

iii. Uncertainty

The institutional evolution of the dollar standard in Latin America laid the basis for the process that would lead to dollarization in 2000. Turning to the next construct, as Minsky, Harvey, and Grabel would have us expect, uncertainty and resultant financial instability dominated the end of the decade. Net transfers fell from \$90 billion in 1998 to \$33 billion in 2000. Commercial bank lending led the rout, reversing from an inflow of

\$25 billion in 1998 to a \$5 billion outflow in 2000. Net out transfers on public and publicly guaranteed debt increased from \$235 million in 1998 to \$24 billion in 2000. The gap between new foreign investment and profit remittances fell from \$73 billion in 1999 to \$54 billion in 2000. So on all fronts the willingness of international capital markets to provide saving to Latin America diminished rapidly in the last three years of the decade. In Ecuador, foreign investment fell from an average of \$2 billion per year in the early 1990s to an average of \$1.1 billion by the end of the decade (Dávalos, 1999).

Harvey's claim that institutional changes in international capital markets dominate the movement of exchange rates is certainly correct. However, the particular Latin American and Ecuadorian manifestation of these changes was more complex. The end result was the same: the growth of financial fragility and of financial markets that were hypersensitive to uncertainty and expectational factors. These factors, particularly the post-keynesian uncertainty, were unstable and destabilizing. For most Latin American countries, this manifested itself in unstable foreign exchange rates and recurrent foreign exchange rate collapses. It should be remembered that the roots of this problem were historical, residing in the institutional evolution of the western hemisphere dollar bloc that grew out of the events of the 1970s and that subjected Latin American countries to endemic uncertainty. These three central PKI constructs allow a much clearer understanding of the international context that dominated Ecuador's policy options and provide a basis for understanding Ecuador's dollarization.

iv. Cumulative Causation

Let us turn now to the specific domestic process that led to dollarization in Ecuador. In the first instance, it was a clear case of cumulative causation, where the

international influences interacted with Ecuador's unique political instability. The best starting point is when Abdalá Bucaram of Guayaquil was elected President in 1996 and invited Domingo Cavallo, the architect of Argentina's "convertibility" hard peg program, to provide him with economic advice. Subsequent economic and political instability made Bucaram's December 1996 announcement of an Argentine-style convertibility program, to go into effect in July 1997, appear to be only a desperate attempt to save his regime. He was driven from office in a popular uprising in February 1997; however, the "hard peg" solution had been placed on the table, just as the political process entered a new and unstable phase.

As cumulative causation would lead us to expect, this instability generated further instability.⁶ An interim government headed by Fabián Alarcón succeeded Bucaram, but was unable to develop a convincing economic stabilization program. The subsequent elected government of Jamil Mahuad inherited an expectational framework that made its challenges daunting. Instability had spread to the financially fragile banking sector and Mahuad's effort to find new policy approaches, such as taxing financial transactions, led to fractures within his economic team—which led to more instability. In early 1999, the Finance Minister resigned in protest against the implementation of a financial transactions tax; then the independent Central Bank suddenly floated the sucre on February 12; Mahuad's final desperate step was to freeze citizen's access to their bank deposits in March, in the face of financial panic. Any remaining credibility dissipated with this step, closing the door on all moderate economic policy proposals. Cumulative causation dominated the increasingly unsettled landscape.

This spilled over into economic performance. Per capita GDP growth was only 0.4 percent in 1998 and crashed to -7.3 percent in 1999. Inflation began to accelerate to 43 percent and then to 61 percent in 1999. The exchange rate collapsed to 6,825 sucres per dollar at the end of 1998, and then to 20,242 in 1999, devaluations of 54 percent and 197 percent. The rate of investment halved to 12.9 percent of GDP, and unemployment increased from 11.8 to 15.1 percent by the end of 1999. The fiscal accounts were in disarray when the deficit increased from 2.6 percent of GDP to 6.1 percent, falling slightly to 5.9 percent in 1999. Uncollectibles in the banking system rose from 9.6 percent of outstanding loans to 40.4 percent in 1998. The government forced the constitutionally independent Central Bank to finance the deficit as well as a bank rescue program of the ill-conceived deposit guarantee agency. Thus the monetary base increased by 41 percent in 1998 and 174 percent in 1999. There was disintermediation as M2/GDP fell from 32.5 percent to 23.2 percent. The decline would have been far greater, but for the March freeze on bank deposits. Cumulative causation had taken Ecuador into desperate straits, and dollarization was a possible lifeline.

v. Power and Conflict

The next theme was the most value-laden of all, the centrality of power and conflict in determining economic outcomes. One key arena was international, since access to international official resources can often stabilize such difficult situations. The government hoped to stop the chaotic slide by gaining access to \$2 billion in multilateral loans, through the imprimatur of the IMF. Opposition in the congress stifled the required reforms and held up the loans, which led in October 1999 to a unilateral declaration that Ecuador would postpone payment on its Brady bonds and would restructure all of its

debt, except that owed to multilateral institutions. One interesting element of the moratorium was the apparent acquiescence of international agencies, consistent with their abortive efforts to make private lenders bear some of the losses on bad loans. Ecuador may have been used as the guinea pig in this experiment, for the IMF authorized a \$400 million standby loan despite the moratorium. The result, however, was an official default on one class of Brady bonds, meaning Ecuador could no longer renegotiate and restructure portions of its debt and lost access to any other capital flows.

So international power dominated Ecuador's efforts to gain economic space and one observer captured the implications quite clearly: "The bottom line is that Ecuador won't have access to private credit until the foreign debt is restructured... There is no question that the level of economic deterioration is going to increase very, very quickly" (Vogel, 1999). This led President Mahuad to make his desperate dollarization declaration. He had dismissed dollarization only days before; in addition, the policy was opposed by the Central Bank and led to the resignation of the Central Bank President and of the entire cabinet. The Central Bank had characterized dollarization as "rushed, crazy measures" (Notisur, January 14, 2000).

The best indicator of the domestic conflict that led to dollarization was the military/indigenous insurrection that led to Mahuad's ouster at the end of January 2000, after his embrace of dollarization. That was the result of the earlier power conflicts within the government and between the executive and the Congress. Other Latin American countries have on occasion been able to reach social compacts, or their executive has been able to obtain working majorities in their congresses. This has not been the case in Ecuador, where the combination of personalist, populist politics and the strong

coast/sierra conflict make it difficult to gain agreement on any major issues. The statutory ability of Congress to remove ministers, added to the inability of Mahuad to command the loyalty of his own ministers, created a situation where the accepted political-economic decisions were unavailable. This forced him to desperate steps, such as dollarization, in an effort to change the nature of the debate. Despite his success in this dimension, the effort cost him his presidency.

vi. Battle of Ideas

The last PKI element was the “evolution of ideas” or habits of thinking and their influence on economic policy. In the Ecuador case, there was a conscious and concerted effort, with international support, to place dollarization at the center of the policy debate and to develop a “habit of thought” that saw it as the complete solution to the economic problems of the country.⁷ The effort was orchestrated by importers from Guayaquil, led by Joyce de Ginatta, the head of the Chamber of Small Industry.⁸ They produced position papers, hosted international ex-(ponents)erts on dollarization, and even demonstrated in favor of full, official dollarization. International support for dollarization was quite subtle. Neither the U.S. nor the IMF offered public and formal support. Their stance was that it was an internal matter for Ecuador to decide. However, it is certain that dollarization would not have occurred had it not been placed at the center of the thinking on exchange rate regimes by a conscious and concerted effort of powerful interests in Ecuador and abroad. Once the Noboa government decided to press ahead with dollarization, both the U.S. and the IMF provided technical assistance. In addition, the international loans that Ecuador had been seeking were suddenly approved. The standby loan of \$304 million was authorized, providing a gateway to an additional \$2 billion of

multilateral funds and to restructuring of the defaulted bonds (Jameson 2003). So dollarization appealed to the multilateral way of thinking on exchange rates in 2000, dominated at that point by the bi-polar view (Fischer 2001).

There is an interesting parallel with Veblen's differentiation between the habits of thought and attitudes of bankers and of producers. He foresaw the triumph of bankers and their habits of thought, just as a financial solution to the real problems of Ecuador was triumphant. He felt this would signal the demise of capitalism. This raises the question of whether the triumph of the financial habit of thought, dollarization, may lead to Ecuador's economic failure in the future, as presaged in the demise of Argentina's overvalued peso in 2002. That experience quickly diminished the appeal of the bi-polar view.

VI. Conclusion and a Look Ahead

The paper has made the case that adopting a PKI view and drawing on PKI concepts allows a clearer understanding of how dollarization became Ecuador's central economic policy. This historical and value sensitive analysis is more satisfactory than the three orthodox economic explanations and allows the observer to locate the factors that drove the decision. The treatment utilized Post-keynesian Institutional theoretical categories: history, institutional evolution, uncertainty, cumulative causation, power/conflict, and the battle of ideas. They were joined with the specific experience of Ecuador, as a member of the dollar bloc, and with the unique domestic political and economic processes of the country. The end result is a more comprehensive and

convincing explanation of how Ecuador came to dollarize than that offered by mainstream economic theory.

Let us now finish the story by briefly using the same constructs to reflect on the experience of dollarization through 2003 and the likely course of Ecuador and dollarization in the near future.

Dollarization and the international support it elicited did succeed in breaking the established downward cumulative causation for a time. Gustavo Noboa finished the presidential period and handed over the government to Col. Lucio Gutierrez, who had led the military side of the insurrection against Jamil Mahuad. Though Noboa was later forced to flee the country because of allegations of corruption, his presidency had provided enough stability to allow renewed growth with declining inflation, improved employment, increased capital flows, and improved fiscal performance.

This did not represent any significant break with the historical context, however. Debt repayment remained the major commitment of the government and the recently elected, left-populist Gutierrez declared himself “best ally of the U.S.” as he attempted to reassure international capital owners (Notisur, March 7, 2003). Indeed, in late 2003 the Foreign Minister assured critics that Ecuador was not becoming involved in the Colombian civil war because “Ecuador’s economy does not permit foreign adventures... We are living from day to day; 42 % of the national budget goes on debt repayments, imagine getting involved in a military adventure—we would not have the money for it” (Latin American Regional Reports: Andean Group, November 4, 2003). So economic performance remains highly dependent on capital inflows. When they slowed in 2003 because the new oil pipeline was finished and the growth of privately held debt

slowed, GDP contracted by 0.5 percent in the first half of the year, with sluggish growth the rest of the year and into 2004. Unemployment increased and the only bright spot was the continued low inflation.

Institutionally, Ecuador remained part of the dollar bloc or the Latin American variant of the dollar standard. Access to dollars was central to economic performance. There were two new elements to this relation. While Gutierrez capitulated to the rules of the bloc, Lula in Brazil and Kirchner in Argentina pressed for changes in some of its elements, e.g. Lula in trade relations and Kirchner in financial/debt relations. Costa Rica's refusal to enter the Central American free trade pact because of U.S. demands for access to its public sector was another indicator of resistance to the existing norms that may over time benefit Ecuador as well as the other countries.

The depreciation of the dollar was a second change. According to ECLAC (2003), Ecuador's was the most overvalued currency, signifying increasing pressure on the current account. The two-year depreciation of the dollar by 40 percent against the euro and 20 percent against the yen implied that the 62 percent of Ecuador's trade that is not with the U.S. could benefit from the change in the dollar's value. The appreciation of the Brazilian and Argentine currencies against the dollar reinforced this positive effect. Thus the dollar's weakness may stabilize Ecuador's role in the dollar bloc as it lessens current account pressures.

The last two PKI categories raise questions about continued dollarization in Ecuador. The tide of the battle of ideas has turned against formal dollarization. The U.S. remains officially neutral, hesitant to take on any formal financial obligations to dollarizing countries. Stanley Fischer's departure from the IMF occurred along with

Argentina's flight from convertibility, and hard pegs no longer appear so appealing.

While McKinnon and Schnabl (2003) have shown the value of a dollar standard among the Asian countries, with China becoming the anchor, a hard peg in one country in one region has disadvantages that have become all too clear in Latin America.

Finally, dollarization did not resolve Ecuador's issues of power and conflict. Gutierrez was elected on a leftist/populist platform, with his main support in the Sierra. When he seemingly reversed course, he broke with his indigenous allies who abandoned the three ministries they had controlled and went into a position of opposition. Gutierrez seemed to be attempting to form an alliance with the traditionally powerful PSC and its long-time leader, León Febrés Cordero. However, allegations of drug support for Gutierrez's electoral effort halted that effort, making his ability to enact any policy initiatives doubtful as 2004 begins. Thus political strife is likely to grow, particularly from the increasingly powerful indigenous movements who remain skeptical of dollarization. That opposition and increased political strife could call dollarization's viability into increasing question over time.

Ex-president Mahuad presented his view of his overthrow and the adoption of the dollar during April 2003 at the Kennedy School of Government in a workshop on "The Difficulties of Leading in a 'Perfect Storm' Scenario." Post-keynesian Institutionalism suggests that recourse to uncontrollable meteorological metaphors underestimates our ability to explain the factors at play at the time of dollarization. While it does not seem likely that another "perfect storm" situation will appear any time soon, the same factors that brought about dollarization are currently relevant in questioning its continued viability. Despite arguments that dollarization is "irreversible," (Noticen 2002, 2) Post-

keynesian Institutionalism suggests that reversing dollarization in Ecuador and other countries is certainly not inconceivable. Indeed, there is reason to think that process is already underway, with Argentina's decision to abandon convertibility's hard peg in 2002 the first step in that complex and conflictive process. I am confident that a post-keynesian institutionalist perspective will be more successful in explaining the future course of dollarization than any of the standard mainstream perspectives.⁹

APPENDIX

In order to provide a necessary background to the core of the paper, this appendix provides a brief survey of the several approaches to Post-keynesian institutionalism, starting from Wilber and Jameson's 1983 treatment.

a. Wilber and Jameson (1983)

They drew on Alfred Eichner (1978) for the central post-keynesian elements. He described the “systems approach” as “the study of how an economic system—defined as the set of social institutions responsible for meeting the material needs of society's members—is able to expand its output over time by producing and distributing a social surplus”(171).¹⁰ This is a pithy representation of the rich theoretical underpinnings of the post-keynesian framework that was being developed at that time. Eichner adds that “the advantage which it offers social scientists is that it can incorporate within its analytical structure (a) purposeful activity, (b) cumulative processes, and (c) the interaction of subsystems, both as part of a larger systems dynamic and in response to feedback from the environment” (171). On the other hand, Wilber and Jameson insisted that a PKI analyst “starts with a given situation and seeks to explain the dynamics of existing structures and institutions...believes that so-called economic ‘laws’ are nothing more than empirical generalizations that are historically specific and must be revised as culture and institutions change” (1983, 152-153). The method, based on institutionalism, accepts that values are part of any argument, which in turn must be holistic, systemic and evolutionary. Historical time-sequential links are also central to understanding. Finally,

they suggested that several theoretical and value-laden constructs were central to PKI analysis, growing out of both sides of the equation: power and conflict, instability and uncertainty, non-rational behavior, and technology.

The remainder of the book operationalized their version of PKI by analyzing the structure and operation of the U.S. economy in the early 1980's, correctly predicting the mediocre performance of the Reagan administration policies. They then examined the existing stagflation and economic crisis, and finally suggested a set of policies for a new social contract that could have addressed the existing economic shortcomings. In actuality, the emphasis was more heavily on the institutional side than the post-keynesian, though this could have in part been a reflection of the nascent nature of post-keynesian analysis at that time.¹¹

b. Alfred Eichner (1985)

Though he didn't use the PKI term, his collection of essays on post-keynesian economics and institutionalism freely asserted that the two frameworks provided the basis for the alternative to orthodox economics. His main concern in the essays was to establish a theoretical basis for post-keynesian economics and so he did not spend a great deal of space on institutionalism. His assertion was that "the alternative body of post-Keynesian (and institutionalist) theory is no less coherent and comprehensive than the orthodox theory, does not run counter to what can be observed in the real world, and avoids positing a supply curve that is independent of demand" (Eichner 1985, 8). His effort at macrodynamic modeling in the same work makes reference to several institutionalist sources. "In a line of reasoning that can be traced back to Veblen...

Mitchell...Duesenberry...and other institutionalists, consumer preferences are seen as being the result of learned social behavior rather than being innate at birth or in some other sense given” (160). Prices are set by institutional factors, in this case the markup over costs. Finally, the nominal wage “depends on the socio-political and other non-economic factors that determine the bargaining strength of workers...This explanation represents a synthesis of the neo-Ricardian arguments of Sraffa...the post-Keynesian theory of income distribution, and the labor market analysis of certain institutionalist economists, such as Dunlop...and Piore...”(172).

Eichner’s theoretical program placed more emphasis on the post-keynesian side of the equation, though his frequent reference to and use of values and institutionalist elements warrants application of the PKI moniker for his work.

c. Geoff Hodgson (1989)

Hodgson was the next author to link the two elements of the PKI framework. He started with a critique of post-keynesian economics because he felt it was losing the theoretical battle with neo-classical economics. Three new theoretical frameworks were investigated to see whether they could fill this vacuum. Sraffa’s long-run framework, Simon’s behavioralism, and Shackle’s non-probabilistic uncertainty were all judged to be inadequate, although they referred back to Keynes and responded to inadequacies in then-current theorizing. In response, Hodgson looked to institutionalism for foundational principles that could more successfully model economic behavior and its implicit values. Among those he suggested were “habits” as a dominant influence on individual behavior; institutions as creators and disseminators of information; norms as influences on price

behavior;¹² the impossibility of perfect competition; cumulative instability; and the evolutionary nature of organizations. He found hints of these categories in Keynes and hoped that they would provide “a theoretical bedrock upon which post-Keynesianism can build its alternative to neoclassicism” (96).

A number of Hodgson’s categories overlap with the earlier sets and continue the effort of providing a coherent set of theoretical terms that can allow a more successful understanding of the economic behavior that we observe.

c. Tony Lawson (1994)

His article specifically attempted to link post-keynesianism with other traditions within economics. In actuality, he concentrated on making the case for a critical realist methodology, arguing that post-keynesianism implicitly utilizes that approach. When he did examine “links between post keynesianism and other contemporary nonorthodox traditions,” he came to institutionalism through the back door of Austrian economics. There have been a number of investigations of the relation of institutionalism and Austrian economics. To link institutionalism, in its Austrian variant, to post-keynesian economics, he quoted two Austrian economists’ claim that “the reader will be hard pressed to find any significant differences between these propositions (in Paul Davidson’s summary of the post-keynesian perspective) and the arguments in our (O’Driscoll and Rizzo) chapter” (141). This seems a far too roundabout route to link institutionalism and post-keynesian economics, though the critical realist reflection on institutionalist methodology is quite suggestive.

d. Philip Arestis (1996)

He stated that “(t)he economic system is not a ‘self-balancing’ but a ‘cumulatively unfolding’ process. This is a view shared by both Keynes and Veblen (and other institutionalists), and provides the basis of the institutionalist tradition within-post-Keynesian economics” (114). With this focus, Arestis correctly highlighted the evolutionary element in institutionalist analysis, along with the view that systems do not tend to equilibrium, especially in the absence of conscious economic policy steps. He gave particular attention to two specific institutions, large corporations and trade unions (118).

Arestis was certainly correct that these are central components of institutionalism, though earlier we noted several other elements that are quite compatible with post-keynesian approaches. Consistent with the overall tenor of the article, which provided an excellent survey of the central post-keynesian theoretical claims, he subsumed institutionalism within post-keynesian economics, writing “(t)he inclusion of institutionalism in this way is a distinguishing and novel feature of this current paper” (114). The claim of novelty bears further scrutiny, but Arestis’s effort is important because he attempted to give a coherent theoretical foundation for post-keynesian economics and accepted the importance of institutionalism to this effort. My own view is that he erred by overly privileging post-keynesian theory, the opposite skew from the Wilber and Jameson concentration on institutionalism.

Nonetheless, he distilled a set of theoretical points from joining the two traditions that correlate well with the other treatments we have seen: class, power, distribution of

income and wealth, historical process, uncertainty, expectations, and the role of institutions and their evolution in shaping economic events (114).

d. Mathew Forstater (2001)

His concern, described as “Institutionalist Post Keynesian, is to elaborate on a “methodology of economic policy” in an institutionalist post-keynesian vein. The article elucidates the work of Adolph Lowe, termed instrumental analysis, and of Abba Lerner, termed functional finance. While neither would fit neatly into the PKI canon, their approaches and concerns are quite consistent with post-keynesianism and with institutionalism. To make this point, Forstater shows that Pasinetti’s work can be interpreted through the Lerner-Lowe prism, and that the same approach to contemporary policy issues can facilitate understanding the economy more successfully than “the orthodox view of markets as tending to produce optimal outcomes (1).”

I have found no other more recent efforts to develop the PKI framework. Much more common are surveys that treat post-keynesianism and institutionalism as two different schools of thought among the competing schools. A good example is Prychitko (1998) who has separate sections on “Post-Keynesian Economics for an Uncertain World” and “Beyond the Market: Social and Institutional Economics,” as well as separate bibliographic essays. He describes two intellectual traditions that grow out of two different canons and that operate in two different “discourse communities,” despite their commonality of subject matter and approach. In the treatment of Ecuador, I attempt to use the PKI categories to show that their union can help both traditions in their common

“emphasis on the relevance of economic analysis to real economic problems and the insistence that the objective is ‘to make the world a better place for ordinary men and women, to produce a more just and equitable society’” (Arestis, 114).

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ENDNOTES

¹ In course materials on his web site, Harvey presents variants of what he terms PK/Inst theory.

² Grabel's (2003) other concern is whether interferences with the freedom of the international financial market can counter the instability.

³ Harvey's concerns were reinforced in a recent report on efforts in the NBER Program on International Finance and Macroeconomics by Manzie Chinn (2003). After reporting on numerous empirical studies of exchange rates, he concluded "While the results are not very positive, they do suggest that along some dimensions, structural models have some predictive power...while useful forecasting models remain elusive, the identification of key empirical factors remains a productive, albeit challenging, enterprise" (8).

⁴ Minsky's work lent itself to such a description. Burlamaqui (2000 8) linked his financial fragility analysis with the "evolutionary economics" of Schumpeter. He stated that "either from the 'instability' or from the 'institutional' points of view...we can devise a secure and fertile link, or a set of connecting principles...between evolutionary economics, in its 1942's version, and Post-Keynesian economics...Minsky...is, we suggest, the best access-point to develop that link." I would include Burlamaqui in the later treatment in the Appendix except that he takes his institutionalism from Schumpeter, not generally considered a contributor to institutional economics.

⁵ The survey of PKI works in the Appendix introduces these constructs and provides an overview of how PKI writing has proceeded since 1983.

⁶ The source for the descriptions of these events is various issues of Notisur. The data are taken from statistical publications of the Central Bank of Ecuador. More extensive citations for much of the information are provided in Jameson (2003).

⁷ It was also a debate about the role of the state. Dollarization's limits on discretionary monetary policy and its implication that the Central Bank could be dismantled was one of its appeals. Former Vice-President Alberto Dahik, from his exile in Costa Rica, provided the most telling view of the underlying political pressures for dollarization: "Society needs to understand that this is not a change in the monetary and exchange rate system. It is a reconquest and renewal of ecuadorian society...It is a new order insisting on privatization and elimination of the privileges of bureaucratic sectors" (Pallares 2000).

⁸ See her version of the effort at her website { <http://www.dolarizacionecuador.com/> }; Accessed July 10, 2001. A more detailed treatment is provided in Jameson (2003).

⁹ Studart (2001) provides a post-keynesian analysis of dollarization that is quite consistent with mine. He concludes that it is neither an intellectual fad nor a deep insight. He suggests that the most important factors in its success or failure are the volatility of financial flows and whether institutions, such as the international financial architecture, are adapted to adjust to the current international realities.

¹⁰ Radzicki(2003) uses this same quote to suggest that there are three legs to heterodoxy, post-keynesianism, institutionalism, and System Dynamics.

¹¹ A later and revised version of the book (Wilber and Jameson, 1990) updated the economic and institutional analysis to take us “beyond Reaganomics.” However, its treatment of Post-keynesian Institutionalism remained essentially the same, rather than reflecting further development on the post-keynesian side.

¹² Many of his references are to Daniel Kahneman, the best-known of the “behavioral economics” school and winner of the 2002 Nobel Prize in Economics. That Kahneman et. al. have been claimed by the mainstream rather than by Post-keynesians suggests that Mirowski (2001) is correct: the strength of neo-classical economics is not its reductionism but rather its flexibility and malleability.