Dollarization, private banking and financial profitability in Ecuador

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Abstract

This paper aims to analyze the behavior of Ecuadorian private banking during the period 2000-2021, using aggregate information on trends in the banking sector and accounting data for the main banks. Based on a heterodox theoretical-historical approach, we highlight the link between the neoliberal structural reforms, the banking crisis, dollarization and the transformations of the banking sector. The results highlight the fact that the operation of the Ecuadorian banking system under formal dollarization not only recreates well-known elements of former financial fragility but also introduces new variables typical of the 21st-century banking universe that are a source of instability and hinder the financing objectives for the socio-economic development of the country.

Keywords: credit; financial fragility; banking crisis; dollarization.

1. INTRODUCTION

In 2000, after a severe private banking crisis with decisive repercussions on public finances, Ecuador abandoned the sucre as legal tender and formally converted to the dollar. Under the new ultra-rigid monetary exchange system of formal dollarization, the country was immersed in a limited space for sovereign implementation of economic policy. Although the new macroeconomic management conditions of the dollarized country have been the subject of several unorthodox analyses, the same cannot be said of the effects of dollarization on the private banking sector and its relationship with the central bank in this framework. Thus, the main objective of this study is to analyze the behavior of the Ecuadorian private banking sector, especially in the period 2000-2021, using aggregate information on banking sector trends and accounting data, as well as profitability indicators for the main operating banks.

The text is divided into four sections: after this introduction, general theoretical-historical considerations are presented on the Latin American financial sector and the operation of banks in a dollarized setting. The third section provides a more detailed interpretative account of the Ecuadorian banking crisis of the 1990s, which culminated in the dollarization of the country in 2000. This is followed by an analysis of statistics related to the Ecuadorian banking sector over the last two decades. The fourth section presents the final reflections.

2. THEORETICAL-HISTORICAL CONSIDERATIONS ON FINANCE, BANKING AND DOLLARIZATION

In Latin America in the 1990s, the deregulation of the financial sector was reinforced, combined with the popularization of a new macroeconomic arrangement for the implementation of the inflation-targeting regime by the majority of the central banks of the region's countries. These measures resulted in international financial flows being directed to a great extent to Latin American markets, taking advantage of the attractive profitability of government securities and the recent incorporation of large local companies into the Stock Exchange. The massive inflow of foreign funds awakened the interest of local financial intermediaries in partnering with foreign banks. In the case of Ecuador, a rapid internationalization of financial operations was observed, accompanied by the reconfiguration of the national private banking system with a profound generalization of the use of the US dollar as a reference in its operations. According to Correa (2004), from then on, the dynamism of Foreign Direct Investment (FDI) in Latin America was driven by the privatization of public companies and portfolio investment, making the flow of capital input unstable.

Thus, despite the greater external interconnectedness of their financial circuits, an additional problem persisted in the region: unequal access to financing, with large corporations having access to facilitated credit conditions. This is compared to small and medium-sized companies lacking resources originating from formal financial circuits, which reinforces the structural disparity of these economies by deepening the coexistence of a highly leveraged upper corporate pole and a lower one that does not have access to sufficient credit to establish itself competitively (Meireles, 2018). [1]

In this new scenario, the common denominator among Latin American countries is the growing financial fragility, greater liquidity for operations in high-risk instruments, dominance of international capital flows over domestic ones, portfolio over productive investments, unclear regulation of the financial system, increased public and private indebtedness in foreign currency; and a tendency towards balance of payments crises. In addition, the renewed threat of inflation caused several countries to adopt more rigid exchange rate regimes. In the case of Brazil, it was decided to decree a semi-fixed exchange rate, while a fully fixed exchange rate was established in Argentina (López, 2007). In the case of Ecuador, given the inflationary problems derived from the 1999 banking crisis and the selective bailout by the government, the adoption of the dollar as the national currency was chosen.

Upon the formalization of dollarization, a process of physical exchange of paper money needed to be implemented where the Central Bank of Ecuador (BCE) was in charge of supplying the market with US$567.5 million, withdrawing from circulation an amount of ECS$14,187,500 million. In addition, during this transition period, the high cost of transporting banknotes from the United States Federal Reserve (FED) resulted in a severe shortage of dollars in circulation.

In 1999, bank deposits were frozen, and the exchange rate used was ECS$10,530 per dollar. By March 2000, when the regulations for the transformation of deposits in the national financial system into dollars were defined and unfrozen, the official exchange rate was ECS$25,000 per dollar, representing a loss of almost 60% of dollar values for account holders (De la Torre, 2019). Originally denominated in local currency, deposits were translated directly into *xenodollars* electronically, reflecting the new amounts in the account holders' balances. Xenodollars in a formally dollarized economy are "created" dollars -through the money-creating power of local private banks- and do not have the US institutional guarantee (Arauz, 2020). Thus, it is acknowledged that, after formal dollarization, an essential part of the circulation of dollars in Ecuador was "created" by private banks and not by foreign exchange flows, as might be thought.

In this respect, De la Torre (2019) points out that, since dollarization, there has been a growing disparity between the net flow of foreign exchange and the internal liquidity of the Ecuadorian economy due to the phenomenon of "secondary money creation" by banks. This disparity was aggravated by the asymmetric functioning of the payment system based on a hierarchical pyramid of liabilities, which places the entities that issue the most liquid "money", such as the FED, at the top, followed by correspondent mega-banks, then the ECB and the rest of the national banking system. Meanwhile, Ecuadorian households, non-financial companies, and other government agencies are at the bottom of the pyramid (Arauz, 2020).

For his part, Arauz (2020) points out that, based on the pyramid of liabilities, the potential for money creation increases the higher the agent is in the hierarchy and the greater its market share in the denomination of deposits. For this reason, the Ecuadorian banking system is highly attracted to the search for a greater volume of deposits in order to expand its reserves, increase its liquidity and gain even more market power. In this respect, regulating the extent of xenodollar creation in the Ecuadorian economy requires reducing the outflow of reserves and concentrating them in the hands of a few participants.

As a complement to this post-Keynesian perspective, analyzing such changes in the financial sector and in the role of the monetary authority involves incorporating into the analysis the notions of monetary endogeneity (in which the money supply of an economy is conditioned by the demand for money), of monetary hierarchy, and of the exogenously determined interest rate (playing a redistributive role between the part of national income that is monopolized by the holders of financial securities and the fraction that is divided among the other social participants) (Lavoie, 1992 and 2005). Moreover, following the same approach in which credit is endogenously determined, financial instability is intrinsically linked to liquidity levels and banking activity dynamics (Minsky, 1982 and 1992). [2]

It should be noted that with the introduction of dollarization, the ECB underwent a series of modifications with respect to its role in the economy. Before the Monetary Regime Law reforms and the amendments to the ECB's Statutory By-Laws in 2001, its objectives focused on inflation control and the search for monetary stability. After dollarization, an important part of its activities was diverted towards the granting of emergency credits for private banking. Meanwhile, during the following decades, its objectives were redefined to be mainly oriented towards the provision of means of payment and to try to ensure financial stability by influencing levels of liquidity. In addition, the ECB lost its autonomy when it was subordinated to the Ministry of Economic Policy Coordination (Rosero, 2010).

Furthermore, Ecuador was highly exposed to international fluctuations after the formal dollarization process. Given that part of the monetary base in circulation was also subordinated to foreign trade, it was through this channel that the effects of new foreign financial crises on this country were transmitted. For example, it is estimated that the 2007-2008 crisis generated a contraction of the monetary base (US$844 million between December 2008 and May 2009). To deal with this, the government temporarily relaxed the fiscal austerity policies it had been promoting since the beginning of dollarization and decided to boost credit expansion in the country through new ECB resolutions. This encouraged private banks to repatriate liquid assets held in foreign banks and redirect them into local institutions, the domestic stock market, and the ECB itself (Paredes, 2017).

In short, the main elements to be considered in order to reflect on the specificities of the functioning of the financial sector of a dollarized economy are *a)* the levels of subordination in the process of banking money-credit creation with respect to the FED, *b)* national regulation and the criteria adopted in banking operations, encompassing rationalization after credit dispersion and malleability permitted in terms of denomination currency, location and traceability of deposits; and *c)* the structure of concentration of market power of large banks, changes in their business model and their profitability metrics. Based on an approach that combines these variables, it will be easier to establish the necessary connections to understand how transformations in the sphere of finance -considering the sui generis macroeconomic environment of a peripheral-dollarized country- can trigger the erosion of the banking system and, thus, hinder a development path in which credit serves as an engine of capital accumulation rather than a constant source of instability.

3. FROM THE PRE-DOLLARIZATION ERA TO THE ECUADORIAN PRIVATE BANKING SYSTEM

As of January 9, 2000, Ecuador's formal dollarization was not exclusively the result of an exogenous shock that hit the Andean country. This process occurred in a more specific context of the spread of the neoliberal model, incisive pro-market deregulation and subordinate insertion into financial globalization in the preceding decades. Different authors identify liberalizing reforms, sector deregulation, and massive speculative capital flows as the fundamental causes of the financial instability and successive crises in Latin America (Correa, 1998 and 2009; Girón and Correa, 2007).

Next, we will explore the conjunctural elements that, in conjunction with structural determining factors, unleashed the 1999 crisis and culminated in the abandonment of the sucre as the Ecuadorian currency. Likewise, it seeks to demonstrate the link between elements that allow the ratification of the hypothesis that Ecuadorian dollarization has deeper roots than those identified from the analytical perspective of orthodox currents and that, in an interpretation more akin to heterodoxy, its origin does not have a single cause. Instead, it is explained by a special mixture of endogenous processes - such as financial liberalization and deregulation- with exogenous conjunctural elements of that year -such as the crisis resulting from the El Niño phenomenon, the Asian, Brazilian and Russian financial crises, the sharp fall in oil prices, etc. (Páez, 2004).

Among the most significant events linking both dimensions are Ecuador's foreign debt crisis in 1983, the financial restructuring subsequently implemented; the orthodox-oriented structural reforms implemented as of 1992; the underlying financial fragility that accompanied the liberalization process; the deregulation of the banking sector; the increasing financial dollarization of banking activity; the successive bank crises; the controversial state bailout of some of the failed banks;[3] and, finally, the desperate measure of formally dollarizing the economy to address a severe episode of economic crisis with the threat of hyperinflation in 1999.

> It is worth mentioning that the bailout process for just one bank absorbed more than 1.2 billion dollars from 1998 to 2001 -more than double what the State allocated to healthcare in the same period- [...] the owners of Filanbanco, shortly before handing it over to the State, rescheduled their linked credits, many of them with highly advantageous conditions: zero interest, seven-year terms and one year grace period, a benefit that increased in the case of operations in sucres, which vanished due to the massive devaluation experienced by the national currency between the end of 1998 and January 2000 (Acosta, 2006, pp. 214-215). 214-215).

In the 1990s, a large body of literature emerged in Latin America, presenting both the advantages and disadvantages of fixed exchange rates for controlling inflationary processes. On the one hand, there are those who defended formal dollarization as an essential exchange rate policy to guarantee price level control, eliminate the risk of future exchange rate crises, maintain the lowest interest rate, and deepen economic integration with the US market. On the other hand, there were economists who, since the debate on handling the 1999 crisis, were against such a measure precisely because they understood that the costs associated with the loss of sovereignty would be too high, exceeding the supposed benefits.

Structural reforms, financial fragility and the banking crisis (1983-2000)

Ecuador's 1983 foreign debt crisis marked the beginning of a new stage in its economic history. The difficulties in managing the foreign debt crisis and the subsequent structural reforms resulted in the rapid collapse of the model that emerged with the diversification of production with a bias towards industrialization, which defined the previous phase. Analyzing the events of the 1990s in Ecuador, linking the 1999 crisis with the financial liberalization measures adopted earlier, contributes to a clearer picture of the context that led to the adoption of the dollar as the national currency and how the new monetary-exchange regime conditioned the Ecuadorian economy.

It is worth mentioning that the diagnosis of the Ecuadorian financial system corresponded to the operating parameters of what, in orthodox terms, was mistakenly defined as a "repressed system" (McKinnon, 1980; Díaz, 1991). This implied a "niche of opportunity" to be explored in Latin America - particularly in small countries- with the liberalization of banking regularization and the expansion of credit availability for the region. According to orthodox literature, financial liberalization was understood as the "necessary remedy" to attract international capital flows and promote "adequate" financing for Latin American economic development. This resulted in the integration into the global financial system being defended as the answer to the chronic constriction of domestic savings capacity. Consequently, the Ecuadorian banking system changed its operating rules during the government of Sixto Durán (1992-1996). In summary, the measures taken were: *a)* resizing or downsizing of public financial institutions;[4] *b)* elimination of public subsidies to credit in order to adapt financial policies to market conditions; and *c)* liberalization of interest rates. Much of this reorientation of the economy was embodied in the 1992 Macroeconomic Stabilization Plan (MSP) (Viteri D., 1998).

Like other stabilization plans, the PME (publicly presented by the national government on September 3, 1992) pursued a fundamental objective: to control inflation. In line with the measures applied in neighboring countries, the way in which inflation would be kept under control was through an incisive recessionary adjustment with wage repression, discouragement of consumption, balanced public accounts, a central bank solely committed to watching over the value of the currency and well-calibrated external accounts. The goal of orthodox adjustment was monetary stability and the consolidation of "good and healthy macroeconomic fundamentals".

Following the financial changes of the PME, a strong monetary devaluation was first implemented - the dollar was now quoted at ECS$2,000 when its previous value was ECS$1,475, and then a fixed exchange rate system was made official. In addition, the issuance of new public bonds backed by up to 15% of the value of the country's exports was authorized. The legally required bank reserve was reduced from 34% to 32% of the value of deposits, and the mandatory 15-point band between deposit and lending interest rates practiced by the banking sector was eliminated, allowing the banking spread to be freely determined (Viteri D., 1998).

With the new General Law for Financial Institutions of May 25, 1994, Ecuador experienced a real credit boom, accompanied by the expansion of activities in the banking sector.[5] The changes introduced by the new legislation include *a)* the facilitation of the entry of foreign capital to operate in the sector, the multiplication of offshore banking and operations of national banks abroad, *b)* simplification of the legal framework of the entities; *c)* the differentiation between banks and finance companies was changed to only allow the former to capture demand deposits, and other technicalities regarding equity requirements; *d)* it made it easier for bankers to offer loans to their own companies -linked loans- and thus expand and diversify their businesses; and *e)* the "modernization" of the form of banking supervision, in which the Banking Supervisory Authority adapted to the trend of "self-regulation" of the sector through prudential measures, which in reality meant the loss of regulation and supervision by the State over this vital economic sector (Acosta, 2006, p. 210; Miño, 2008, p. 210). 210; Miño, 2008, pp. 250-251).

As a result of these changes, there was a breakdown in the country's banking trajectory since "these reforms changed the system of restricted (and relatively controlled) banking into a system of liberalized universal banking, which, in practice, increased the risks in its operations. It also allowed the entry of new banking products in line with the international speculative environment. This banking system channeled massive external resources into the national economy without adopting criteria of productive selectivity and taking the necessary precautions; resources that were taken out of the country as soon as the first symptoms of the crisis appeared" (Acosta, 2006, p. 211).

Another result of the changes in the financial environment was the concentration and centralization of banking capital despite the significant foreignization of banking in other Latin American countries. What was observed with the subordinate insertion of Ecuador into financial globalization was a relatively low degree of direct ownership of banks by foreign groups, with national banking capital prevailing as the leading participant in the local financial system, operating in association with global banking (Girón and Correa, 2007; Meireles, 2015).

The euphoria surrounding the new business opportunities, increased profitability and greater integration with the international financial system would quickly turn into bitter nostalgia. A precedent for this step was the bankruptcy of several institutions with lower contributions in 1994. The yellow signal was only turned on in 1995 when the ECB had to provide loans to the sector, which rose to US$150 million for banks with liquidity problems. The first to go bankrupt was Banco de los Andes and, later, Ecuacorp, which had severe difficulties. In 1996, the ECB was forced to bail out Banco Continental, the country's fifth-largest financial institution.[6]

At the end of that first cycle of bankruptcy with Banco Continental, the red light was activated to indicate something serious in the Ecuadorian banking system. Doubts about the capacity and sustainability of a banking system that insisted on continuing to operate with such a high foreign exchange exposure began to emerge. Some more judicious analysts warned about the systemic risk suffered since the financial opening up and the worrying banking exposure. In that first wave of bankruptcies, the State's action was highly questioned since, by providing aid to these institutions -always leaving very unclear the criteria for determining the amount of support, when and to whom the resources would be channeled- the increasing moral hazard in banking activity was encouraged.[7]

The analysis of the bailout plans for the failing banks led to a double inference: on the one hand, they were characterized as an explicit measure of state intervention, which, at least in official discourse, sought to minimize the "contagion" of the entire banking system in order to maintain the Ecuadorian economy on track -which is clearly in line with the best of Keynesian-oriented economic policy suggestions-. However, the way the bailouts took place was flawed in its overall smoothness, specifically regarding notorious acts of corruption. In short, the mass of resources channeled from the public sector to save the banking system per se is not to be condemned; on the contrary, it is fundamental to minimize the impact of any financial debacle on the real economy. However, given the way in which bank bailouts were executed -beginning with the bailouts of 1996 and culminating with a veritable drain of public resources for this purpose in 1997/1998-, it is impossible not to point out a myriad of mistakes and a veritable stream of cases of "illicit" use of public resources.

Ecuadorian private banking: echoes of yesterday reverberating today

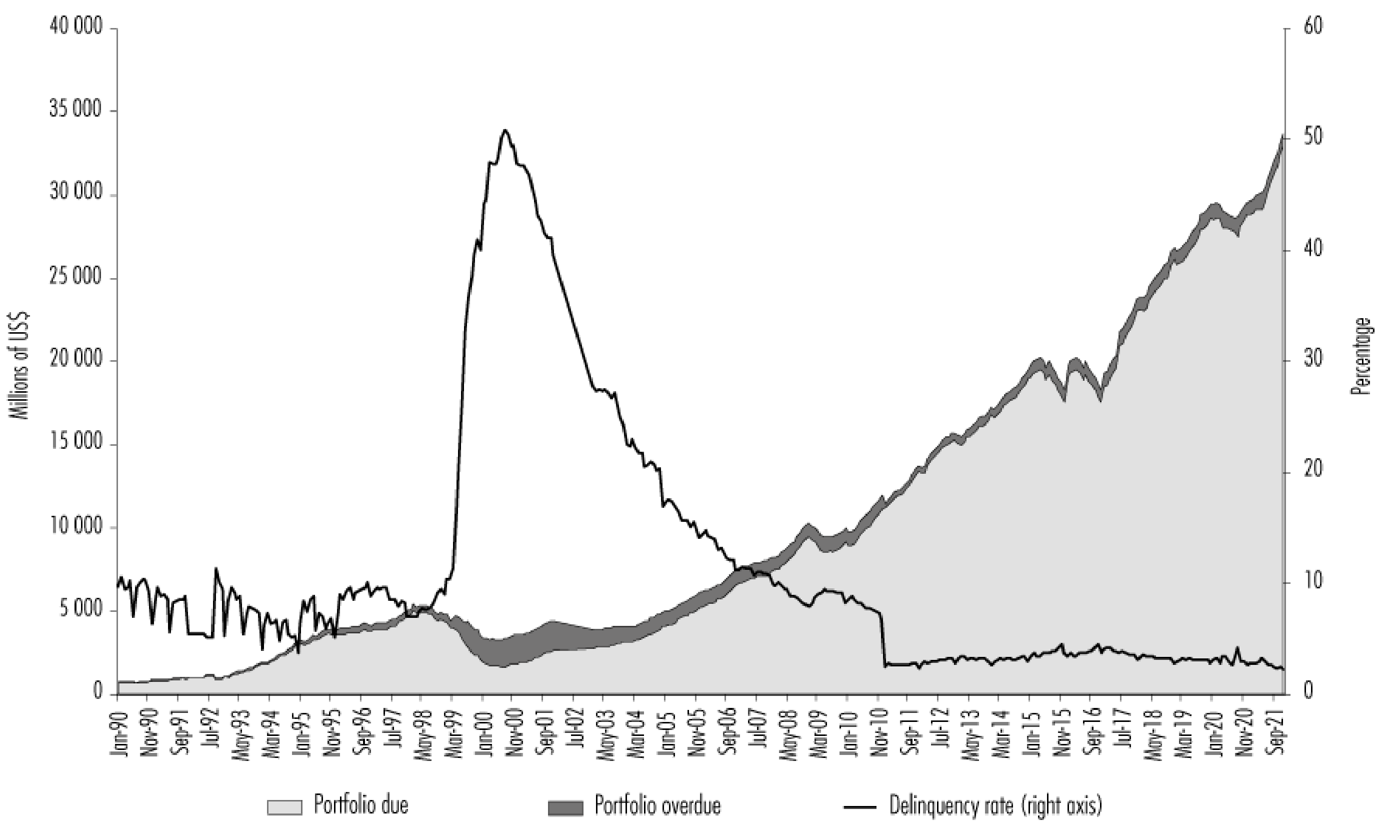
The succession of events behind Ecuador's massive banking difficulties was overwhelming. From the banking crisis, selective bailouts by the public authorities evolved into a fiscal crisis, culminating in the loss of confidence in the value of the sucre and the subsequent "solving" of the monetary crisis by the formal dollarization of the economy. Thus, financial and economic chaos, with almost no remaining institutional order, led to a severe crisis of governability.

When going back to the beginning of the chronology of events of the 1999 crisis, in mid-1998, the Banco de Préstamos -owned by the Peñafiel group, which was also involved in oil commercialization- faced severe liquidity problems and was rescued by the State. Another significant bankruptcy in that year was that of Filanbanco, whose owners -mainly the Isaías family- operated in other sectors of the economy, such as television and radio media; agribusiness linked to sugar, bananas, milk and cattle; mining and oil exploitation; and, at its peak, a professional soccer team, Club Deportivo Filanbanco, with headquarters in Guayaquil.[8] Apart from the major banking institutions mentioned above, other smaller banks also went bankrupt and had their restructuring supervised by the State, such as *a)* Solbanco and Tungurahua in 1998 and *b)* Finagro, Azuay, Occidente, Progreso, Bancomex, Crediticio, Banco Unión, Popular, Previsora and Pacífico, in 1999 (Acosta, 2006).

Meanwhile, one way to measure the informal dollarization of the country's financial sector and its intrinsic exchange rate risk is the relative share of loans granted and deposits received by banks denominated in foreign currency as a percentage of total deposits and loan portfolio. The discrepancy between the inflow of dollars via deposits and the historical volume of issuing credit contracts in that currency was exorbitant in 1999. By the end of that year, the credit portfolio in foreign currency represented 77% of the total credit operations of banks' assets, while customer deposits registered in hard currency in banks were only 54% of the total (ECB, 2010). In addition to the complications arising from this gap -between the growth in the share of deposits and the portfolio maturing in foreign currency- Ecuadorian private banks had problems with payment defaults and high delinquency levels.[9]

Figure 1 shows the evolution of various indicators of Ecuadorian banks' solvency and liquidity capacity. It is clear how due and overdue portfolios rose dramatically following the reforms in the early 1990s, reaching more than US$5.5 billion in 1997 and 1998. However, both values decreased momentarily after 1999 and remained lower in the first years of official dollarization. It is worth mentioning that, in more recent historical terms, these indicators have shot up sharply since the second half of the 2010s and have continued this trend, reaching over US$33.6 billion by 2021. With respect to the delinquency rate -which is one of the ways of measuring the risk of a group of banking assets and is calculated based on the relative size of the overdue loan portfolio as a proportion of the total portfolio-, it reached an alarming 51% in August 2000, which meant that for every 100 sucres given as loans to the public, only 49 were from operations in which the clients had complied with the payment of amortizations and interest according to the terms of their contracts. If, on the one hand, there was a massive increase in overdue portfolios following the pre-dollarization banking crisis until 2021, on the other hand, the delinquency rate has decreased since 2000, stabilizing at much lower levels between 2011 and 2021.

Figure 1. Private banking: evolution of due and overdue portfolios and delinquency rate (1990-2021)

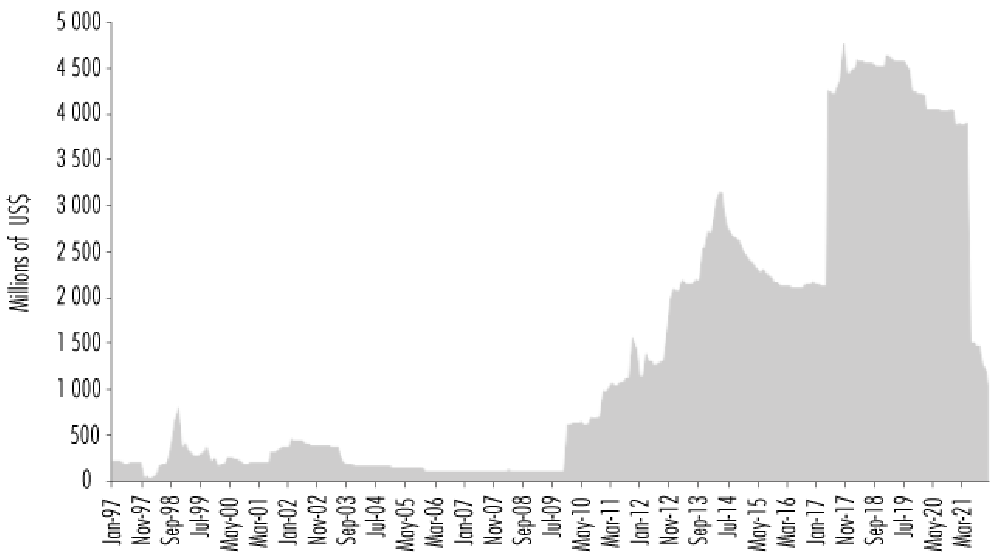


Note: no data for the 2002 annual period.
Source: Compiled by the authors with data from the ECB (2022a).

Faced with the collapse of the banking sector in the second half of the 1990s, an attempt was made to adapt the legal-institutional instruments to respond to the banks in difficulty and the controversial Deposit Guarantee Agency (AGD) was created in December 1998. A huge volume of credit was injected into the system through the bonds issued by the Agency, making it one of the most significant transfers from the State to the private banking sector known up to that time.[10] At the same time, the Law for Economic Reorganization in the Tax and Financial Area was approved, declaring the unlimited and permanent guarantee of deposits and the imposition of a 1% tax on the circulation of capital in order to guarantee the bailout of the owners of the large banks, depositors with the greatest resources and principal debtors of the private banks (Miño, 2008, p. 259). The bailout required a massive transfer of resources from the State for the recapitalization of the private banking sector. It is calculated that, depending on the source of information, the amount of support was between 20 and 30% of the GDP.

In the case of the direct transfer of ECB credits to the banking system through the purchase of securities alone, as shown in Figure 2, the amount of resources exceeded ECS$7 billion in January 1999. The State was monetizing the sector's accumulated losses by financing the bank reorganization through the issuance of liquidity credits -either in the form of direct credits, by purchasing assets or via the issuance of AGD bonds-. The injection of resources was made possible thanks to a substantial increase in the monetary base in sucres, which ended up being decisive in the currency devaluation pressure in 1999.[11]

Figure 2. ECB Loans to the Financial System (1997-2021)



Source: Compiled by the authors with data from the ECB (2022b).

Such was the "addiction" of the banks to resources originating from the State that, by "the year 1999, a significant part of the Ecuadorian financial system was facing solvency problems, so much so that their survival depended exclusively on their levels of liquidity. For this reason, they resorted in increasing numbers and magnitude to the liquidity facilities of the Issuing Institute (the ECB)" (ECB, 2010, p. 39). Since 2009, after the financial crisis that originated in the United States and following the trend of global central banks to promote countercyclical measures with massive security purchase programs, the number of loans issued by the ECB, with the financial system as the destination, soared, stabilizing at US$1,045 million at the end of 2021.

However, the massive flight of capital, facilitated by the opening of the capital account contemplated in the financial reforms of 1993 and 1994, led, at the end of 1999, to the Ecuadorian economy entering a vicious circle: monetary issuance-devaluation-inflation. The deterioration of the conditions of the internal variables was compounded by the government's new difficulty in servicing the external debt when, in August 1999, a moratorium was declared on Brady bonds and Eurobonds -which were immediately restructured with the issuance of the contentious and controversial global bonds, subject to the approval and supervision of the International Monetary Fund (IMF) and the US Treasury-, forcing a new round of negotiations with creditors in 2000, after dollarization. Once again, a massive flight of capital contributed to economic and political destabilization.[12]

In short, the sequence of events to connect the dynamics of the private banking sector with Ecuador's formal dollarization are *a)* the liberalizing financial reforms of 1993 and 1994, *b)* the financial dollarization -informal or spontaneous- of the economy, *c)* the fragility stemming from the dollar exposure of the banking-financial system; *d)* specific bank failures; *e)* the generalized banking crisis; *f)* a massive bailout by the government through the monetization of bank debt and the compromise of fiscal capacity as a consequence of such a measure; *g)* the acceleration of inflation and devaluation, which produced a monetary crisis; and *h)* the abandonment of the national currency and the formal dollarization of the economy as the winning proposal for the adjustment and way out of the crisis.

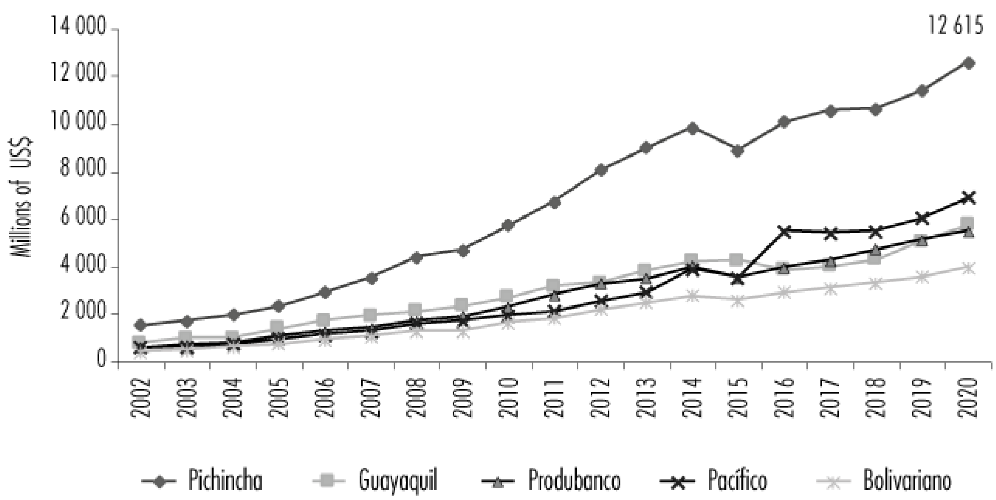
Dollarization, concentration and profitability of the banking sector in Ecuador

The drastic transition from the sucre to the dollar as the national currency led to significant changes in the banking landscape. Initially, for the formal dollarization process to be "successful", it was essential to have a financial system in which the main banks had solid balance sheets. However, during 1999 and 2000, Ecuador's private banks faced the problem of many overdue portfolios combined with an accumulation of high deposit rates and liquidity shortages of such magnitude that a national banking holiday had to be established to stop the massive flight of capital. The system also faced pressure from account holders who, overwhelmed by uncertainty and distrust due to the banking crisis, began an intense process of withdrawing their deposits, causing one of the most voracious bank runs ever experienced in Latin America. At the same time, a persistent lack of liquid reserves and bank assets weakened the financial system and threatened the country's macroeconomic stability.

According to Flores *et al.* (2017), the large banks with more significant political influence managed to overcome occasional adversities because they always "anticipated" adverse moments and promoted measures to " shield" themselves, such as constantly buying dollars, thus reducing financial costs and profiting from dollarization itself. The ease of access to these channels was unevenly distributed among the banks in the system, which led to a tendency to concentrate banking activities in a small group of leading institutions, namely Banco Pichincha, Banco del Pacífico, Banco Guayaquil, Banco de la Producción (Produbanco) and Banco Bolivariano. However, despite the predominance of large banks with national capital in the ranking of the largest institutions, the presence of foreign banks or financial correspondents was notable.[13]

Figure 3 shows the evolution of the assets of the five largest banks - and the changes in their position at the top of the ranking. It is worth noting that, in a straightforward analysis, the increase in the volume of assets is not only due to the power of endogenous creation of xenodollars by the banks but also how it affects other accounting metrics to compute profitability. However, despite the systematic increase in the volume of assets, there is a trend toward a deceleration in asset growth rate, with specific exceptions for specific years; for example, the 55% increase in Banco del Pacífico's assets in 2016.[14] Reinforcing the trend towards a deceleration in the growth rate includes the case of Banco Pichincha, whose rate of asset expansion went from 12% in 2003 to 10% in 2020. [15]

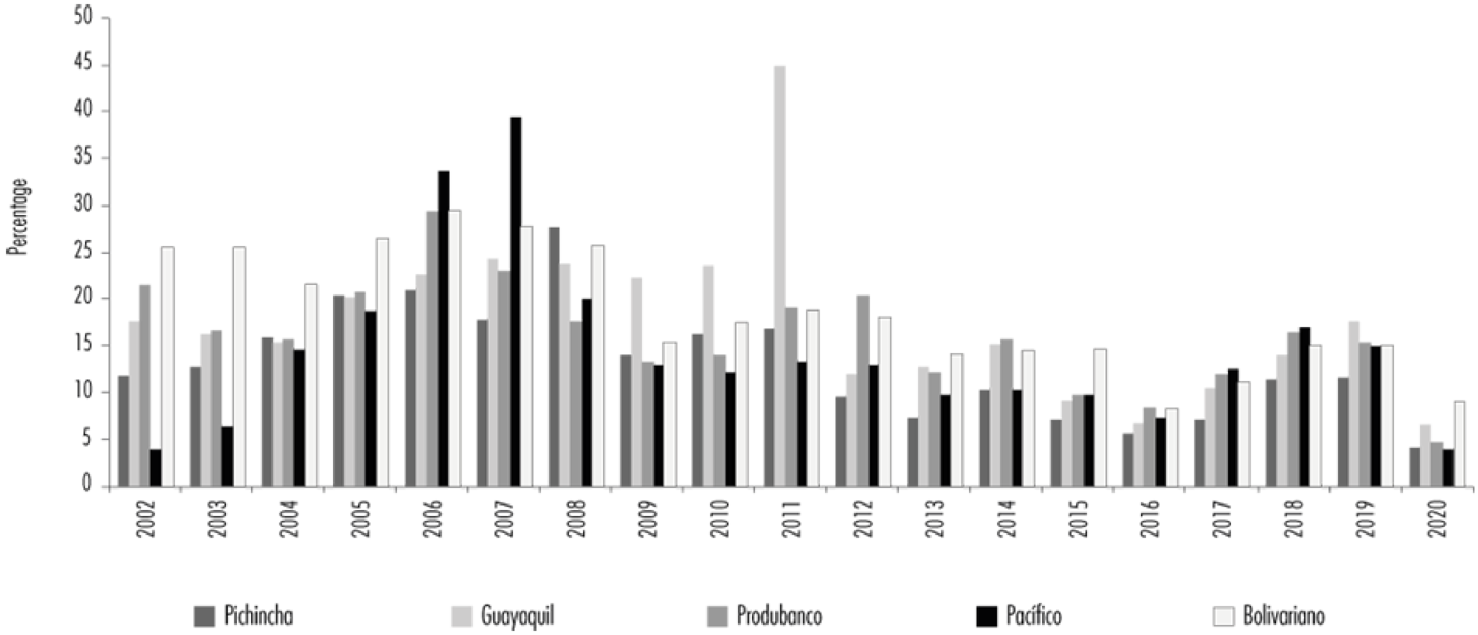
Figure 3. Ecuador: G-5, assets, millions of current dollars (2002-2020)



Source: Compiled by the authors with data from the Banking Supervisory Authority of Ecuador (2022).

Meanwhile, if the evolution of profitability of the same group of banks is analyzed using Return on Equity (ROE) as an indicator -which is the ratio between net profits generated and equity- as shown in Figure 4, a sharp drop can be observed after the international financial crisis of 2007-2008, when capital requirements were increased in banks throughout the world. However, even in the context of lower ROE levels, this metric for some of the large Ecuadorian banks exceeds the average profitability observed for the country's banking sector as a whole. For example, for a particularly problematic year such as 2020, due to the COVID-19 pandemic, while Banco Bolivariano's profitability was 9%, the average ROE for the banking sector in Ecuador was 4.8% (Asobanca, 2020). In addition, an essential source of revenue for banks in Ecuador was "transactional commissions", a group of specific fees for services, such as ATM withdrawals, charged to customers.

Figure 4. Ecuador: G-5, ROE (2002-2020)



Source: Compiled by the authors with data from the Banking Supervisory Authority of Ecuador (2022).

Banks operating in Ecuador also obey trends observed in global banking activity today. For example, following a new business model that favors income obtained from commissions in the administration, management and/or sale/purchase of third-party securities as the primary source of profitability, which is becoming even more important than income related to the asset/liability interest rate differential, i.e., between what the bank collects from loans and what it pays out in favor of savers (Cömert *et al.*, 2016). The same applies to the current existence of renewed tension due to the intensification of competition between large financial groups and a downward trend in profitability due to the increase in bank capital requirements implemented in the post-crisis period of 2007-2008 -whether by regulatory obligation or by voluntary adherence of the participants-, encouraging banks to be more willing to venture into riskier market niches, which result in increased profits.

In short, the heterodox evaluation of banking today gains a lot from examining Ecuadorian banking history intertwined with mapping its links with international capital circuits. This lays the foundations for a type of interpretation that reveals how the actions of private banks can be extremely harmful to the economy as a whole when it enters a trajectory of unscrupulous financial innovation, with doses of excessive speculation, increased exposure in operations susceptible to the ups and downs of the external sector and, now considering more than 20 years of formal dollarization, with the expansion of their assets and profitability determinants anchored in the endogenous expansion of xenodollars.

4. FINAL REFLECTIONS

This analysis sought to review key events in the transformations of the Ecuadorian economy in a historical journey ranging from the foreign debt crisis, through structural reforms of neoliberal orientation, financial liberalization, forms of banking operations, the banking crisis of the late nineties, formal dollarization, and the reconstruction of the current banking landscape in the country.

In a less telegraphic manner, Ecuador was particularly slow to enter the so-called state-led industrialization precisely because of the explosion of the oil boom in the 1970s -a period of exceptional modernization that was extremely short-. In a short time, the development strategy, based on the diversification of the production structure through the strengthening of the fledgling national industry and the strengthening of the domestic market, was replaced by the old and well-known model of outward growth, based on the export of raw materials and categorically dependent on the mood of the external market. The novelty that this form of growth brought was the submission to the growing flow of international financial capital. Previous legislation that allowed the State to regulate the massive inflow of highly volatile resources was reformed until its capacity as a regulatory power was extinguished.

The key event in this process of change in the country's accumulation model was the foreign debt crisis of the 1980s and the measures taken in response to it. Subsequently, in the 1990s, the change in the direction of economic policy was reinforced by the regressive structural reforms carried out by the governments in office. From the in-depth study of the monetary-financial aspects of the trends inaugurated in the 1990s -and the examination of the measures taken by successive governments that completely altered the banking and credit system-, light was shed on the fundamental stylized facts to be understood as offshore operations by the banks operating in national territory, which led to a growing financial fragility with successive bank failures that led to formal dollarization.

Finally, we tracked how dollarization reconfigured the Ecuadorian banking system, highlighting that -in the post-2007-2008 financial crisis context of lower profitability levels- there was an intensification of the oligopolistic dispute among large banks, accompanied by a new round of search for quick ways to obtain profits, which reiterated speculative practices by banks. In other words, the race for higher profits resurrects not only familiar elements of the old financial fragility but also adds new variables typical of the 21st-century banking universe as possible sources of instability -for example, securitization, derivative operations, the expansion of xenodollars, new links with global banking and the respective increase in exposure to international capital fluctuations, the growth of multiple types of crypto-assets, etc.-. In one word, it would seem that the task of encouraging the behavior of the national private banking system to contribute to the objectives of financing productive activity, generating employment and promoting socioeconomic development is still pending in Ecuador instead of serving as a cause for constant concern.

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[1] Regarding unequal access to financing, Vera and Titelman (2013) point out that, in Latin America, 40% of small companies report having a bank loan or line of credit, while for large companies this rises to almost 70%.

[2] Minsky (2008) proposes an analysis of financial instability based on the increase in indebtedness. In his financial instability hypothesis, he shows how the profit expectations of credit-taking companies are related to access to debt operations and their capacity for financial leverage, considering three types of financing patterns: *1)* the "covered", where the resources obtained as a loan security are paid in full from the profits obtained from the company's final activity; *2)* "speculative", where only a fraction of the money paid to creditors is made from non-operational income; and *3)* "ponzi", where both interest payments and debt principal are settled through new loans acquired. The growing trend towards leverage explains the chronic financial fragility with recurrent episodes of crisis (Girón, 2010).

[3] The bailout process of a single bank absorbed "more than 1,200 million dollars from 1998 to 2001 -more than double what the State allocated to healthcare in the same period- [...] the owners of Filanbanco, shortly before handing it over to the State, rescheduled their related credits, many of them with extremely advantageous conditions: zero interest, seven year terms and a one-year grace period, a benefit that increased when dealing with operations in sucres that vanished due to the massive devaluation experienced by the national currency between the end of 1998 and January 2000" (Acosta, 2006, pp. 214-215).

[4] The Banco Nacional de Fomento (BNF), the Banco Ecuatoriano de la Vivienda (BEV), and the Fondo Nacional de Preinversión (FONAPRE) were significantly affected.

[5] This credit boom shows that from "1986 to 1995, 40 new institutions entered the market, including banks, finance companies, financial intermediaries and leasing companies. Since 1991, the number of banks increased from 32 to 40 and the total number of financial institutions from 78 to 103" (Miño, 2008, p. 251).

[6] Fraudulent schemes, bad faith and corruption are just some of the elements that have marked the relationship between public authorities and banks facing liquidity problems. So much so that "the management of the bank (Continental) would be accused by the Banking Supervisory Authority of fictitious capital increases through the triangulation or pyramiding of capital, carried out to conceal the true financial situation of the bank and take advantage of public funds granted by the Central Bank, through the use of liquidity credit quotas" (Miño, 2008, p. 253).

[7] The moral risk in relation to Ecuadorian banking activity was identified with "a new trend: with the danger of other banks failing, depositors have preferred state-controlled banks, under the wise criterion that these are less likely to close. Thus, measured in dollars, from March 31 to August 31, Filanbanco increased deposits by 30% and Continental by 21%, compared to 8.4% on average for privately held banks" (Weekly Analysis, October 11, 1999).

[8] During the state intervention of Filanbanco, an attempt was made to merge it with Banco La Previsora, resulting in a severe impact on the finances of the latter institution due to the absorption of "rotten credits". In addition, Filanbanco definitively closed its operations in 2001, while the brothers Roberto and William Isaías are defendants in several lawsuits in Ecuador and are currently residing in Miami.

[9] The monetary authority also indicates that: "[...] credit in foreign currency granted by the banking system grew rapidly once the financial institutions decided to transfer the high exchange risk to their borrowers, even when the recipients of these resources did not necessarily generate foreign currency, further deteriorating the quality of their assets. Thus, the foreign currency portfolio grew faster than deposits" (ECB, 2010, p. 37).

[10] Regarding the AGD, Acosta states that "this crazy 'invention' was consistent with traditional profit-making practices" (2006, p. 37).

[11] In January 1999, the increase in the last 12 months of the monetary base amounted to 44.2%. However, when comparing the increase in the monetary base from July 1998 to January 1999, it reached 135%, indicating the trajectory of something that became uncontrollable (Weekly Analysis, January 25, 1999).

[12] The flight of capital merited a direct statement by President Mahuad in a speech delivered in Riobamba: "There are Ecuadorians who take their money abroad. Some of those who do so claim that the country is failing: those who decapitalize Ecuador with their actions are hypocritically crying over a problem they have generated" (Análisis Semanal, January 3, 2000).

[13] The combined assets of the three largest banks represented 52.27% of the total assets of the national banking sector in 2020. They were distributed as follows: Banco Pichincha 26.03%, Banco del Pacífico 14.35%, and Banco Guayaquil 11.89% of the market. The best-placed foreign banks in the ranking were Produbanco -in fourth position, with its main shareholder since 2014 being the Central American financial group Promerica-, Diners Club del Ecuador in seventh place, and Citibank in twelfth position (*Revista Gestión*, August 1, 2021). Nevertheless, other smaller foreign private financial institutions, such as ProCredit and FINCA Ecuador, also operate in the system.

[14] Banco del Pacífico's largest shareholder is the state-owned Corporación Financiera Nacional (CFN). After numerous ups and downs in its sale, President Lasso has pushed for it to be completed in 2023. However, despite six international institutions expressing their interest in buying the bank, only one entity submitted an offer that was ultimately rejected (*Revista Gestión*, November 10, 2022).

[15] Regarding the specific situation of Banco Pichincha, a Quiteño entity in operation since 1906, in 2021, it recorded profits double those obtained in 2020, with profits in the order of "US$ 102 million, compared to US$ 50 million the previous year" (*El Comercio*, March 15, 2022).