CENTRAL RESERVE BANK OF EL SALVADOR

History and Some Theory

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EL SALVADOR: A BASIC PROFILE

*July 2017 estimate

Population: 6,172,011*

- At least 20% live abroad

Total Area: 21,041 sq km

GDP: 26.8 Billion USD (2016)

- Close to 20% is from remittances

Currency: US Dollar

- Before 2001: Salvadoran Colón

LATIN AMERICAN CONTEXT: EARLY 20TH CENTURY

- International Trade pre-1930s
  - Extensive trading relationship with the US and other Western countries
  - Latin America: Exported raw resources, imported finished goods
  - Economic neoliberalism

- Great Depression hits
  - Exports plummeted
  - Latin American countries couldn’t rely on imports anymore

LATIN AMERICAN CONTEXT: MID CENTURY

- Countries now had to develop their own manufacturing sectors
- Import Substitution Industrialization (ISI)
  - Decrease dependence on US and other developed countries
  - Focus on self-sufficiency
- Shift from free-trade policies to protectionist policies
  - Economic protectionism and political centrism

LATIN AMERICAN CONTEXT: LATE 20TH CENTURY

- 1980s: Hyperinflationary period across region
  - 1990: Region's average inflation rate hit a peak of 438%
- Intervention of the International Monetary Fund (IMF) to remedy the debt crisis
- Abandonment of ISI policies
  - Return to export-oriented neoliberal policies under the direction of the IMF
- 1990s: Sweeping neoliberal reforms
- NAFTA, MERCOSUR

LATIN AMERICAN CONTEXT: LATE 20TH CENTURY

TABLE 15.4 Inflation Rates, 1982–1992

	Inflation (in Percents)		
Country	Average 1982–1987	Average 1987–1992	Highest 1982–1992
Argentina	316	447	4924 (1989)
Bolivia	776	16	8170 (1985)
Brazil	158	851	1862 (1989)
Chile	21	19	27 (1990)
Colombia	21	27	32 (1990)
Mexico	73	48	159 (1987)
Peru	103	733	7650 (1990)
Venezuela	10	40	81 (1989)

High rates of inflation were a common problem of the 1980s.

Source: Edwards, Sebastian, *Crisis and Reform in Latin America*, 1995.

Source: ceasefiremagazine.co.uk

CENTRAL RESERVE BANK OF EL SALVADOR

- Pre-Great Depression background
  - Collapse of the gold-standard throughout Latin America
- Banco Central de Reserva (BCR) established in 1934
  - Part of a wave of Latin American banks established after collapse of gold standard
  - Founded as a private company
- Mission:
  1. Control volume of credit and demand for currency; stability of external value of the colón
  2. Regulate expansion and contraction of credit, strengthen liquidity of commercial banks
  3. Issue currency “in an exclusive manner”

CENTRAL RESERVE BANK OF EL SALVADOR

- Law for the Reorganization of National Banking (1961)
  - The central bank became a state-owned entity
- New objectives:
  1. Development of the national economy
  2. Maintain monetary stability
  3. Preserve international value of the colón
  4. Coordinate monetary policy of the bank with economic policy of the government
- Law for the Creation of the Monetary Board (1973)
  - Concentrated the formulation/direction of financial policy in a new state body
  - The central bank as the sole executor of resolutions

CENTRAL RESERVE BANK OF EL SALVADOR

- Series of further legislation in the early 1980s
  - Nationalization of credit institutions, savings and loan associations: stocks became property of the state
  - Consolidation of the state's administration of monetary, exchange, and credit measures through the Monetary Board.
- Crisis through the remainder of the decade
  - Inadequate economic policy, political/social instability, and destruction of economic infrastructure led to insolvency
  - Financial system was "technically broke" by 1989.

CENTRAL RESERVE BANK OF EL SALVADOR

Source: Google Images

Source: Getty Images

CENTRAL RESERVE BANK OF EL SALVADOR

Source: elsalvador.com

Source: elsalvador.com

CENTRAL RESERVE BANK OF EL SALVADOR

- End of Civil War period
  - Financial System Reform Program: Modernization of the financial system
- Reassignment of the BCR’s role
  - Monetary, credit, and exchange policies redefined
  - Legal and institutional framework adjusted
  - Privatization of institutions
- New legislation in the early-mid 1990s
  - Established the BCR as a public, autonomous institution
  - Re-privatization of the financial system
  - Financial and trade liberalization

CENTRAL RESERVE BANK OF EL SALVADOR

- New, simplified objectives
  1. Protect currency stability
  2. Promote/maintain favorable monetary, exchange, credit, and financial conditions for economic stability
- Trimming down the role of the BCR
  - No longer controlled the assignment of credit
  - No longer responsible for private sector credit
  - More focus on maintaining monetary stability

DOLLARIZATION

- Monetary Integration Act (2000)
  - Established fixed exchange rate between the colon and US dollar
  - Granted legal tender to the dollar
  - Dollar as a means of payment for liabilities
  - Dollar became of the unit of account of the country's financial system
  - Process became effective January 1st, 2001.
- Change in roles of the BCR (again)
  - No longer had the sole right to issue money
  - Could no longer coordinate monetary policy with the government's economic policies

DOLLARIZATION

- Since dollarization, the BCR has shifted its focus onto the following areas:
  - Regulation and monitoring of the financial system
  - International Reserves Administration
  - Payments System and financial services
  - Financial agent of the state
  - Exporters services
  - Statistics, Projections, and Economic and Financial Studies

DOLLARIZATION

- Dollarization limits BCR’s role as lender of last resort and its monetary authority to respond to financial crises
  - However, it can also reduce the likelihood of bank runs due to greater consumer and business confidence in the banking system
- Contrary to other countries that dollarize, El Salvador enjoyed economic stability and low inflation rates before dollarizing.
- Government’s reasons for dollarizing:
  - Lower interest rates, increase foreign investment, improve financial conditions, decrease transaction costs in international trade
  - Protect wages and savings against devaluations
  - Benefit Salvadorans living in the US by making their remittance transfer costs cheaper

HOW CAN WE CONNECT THIS HISTORY TO SOME THEORY?

- Our discussion of El Salvador began with the collapse of the gold standard before the Great Depression and ended with dollarization at the beginning of the 21st century.

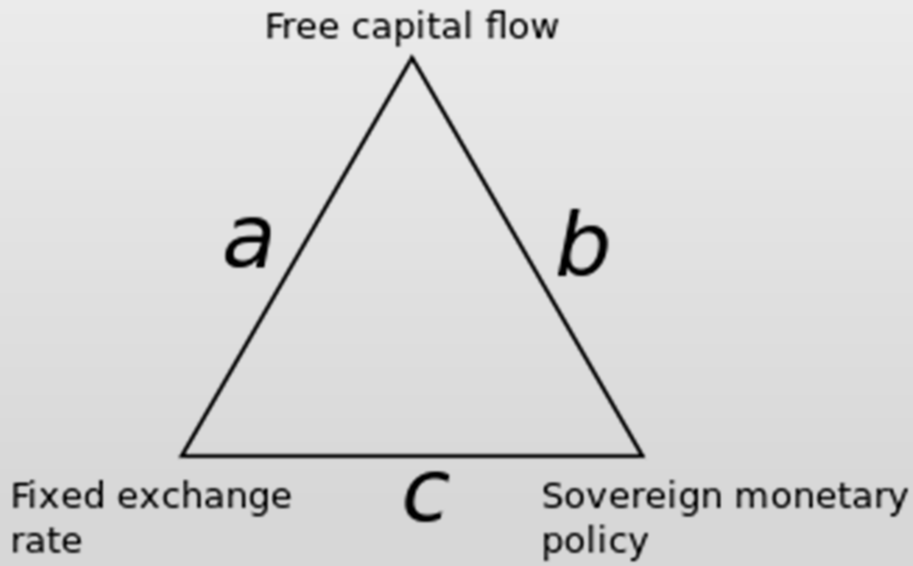
UNCOVERED INTEREST PARITY

- Uncovered Interest Parity condition:

$$r_D = r_F + \frac{E^e_{D/F} - E_{D/F}}{E_{D/F}}$$

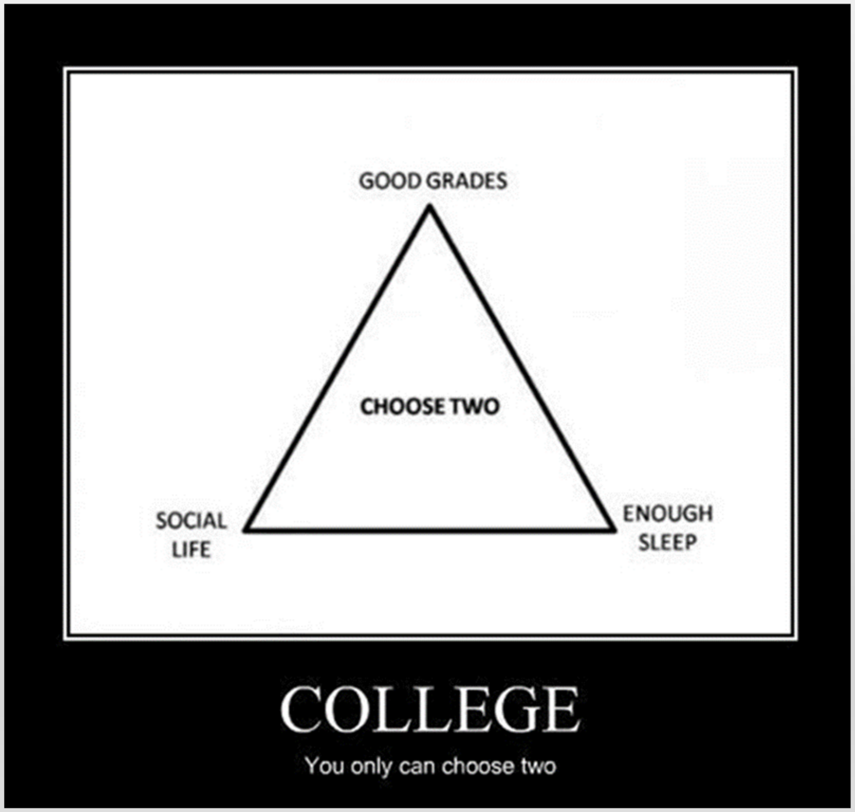
Where D= domestic and F= foreign

A RESULT FROM UIP: THE TRILEMMA



Pick two

LOOK FAMILIAR?



Source: Google Images

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