Ecuador Debt

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Dear Dr. Gonzalez:

I apologize for the delay in sending you this information on Ecuador's external debt, but the data was more difficult to obtain than I previously thought.

Ecuador is considered by the World Bank to be a lower-middle income country that is severely indebted. The only debt I address in this letter is public or publicly guaranteed debt. This includes external obligations of Ecuador's national government, its political subdivisions, autonomous public bodies and external obligations of private debtors that are guaranteed for repayment by a public entity. (Debt for which private organizations are liable is insignificant compared to Government liabilities.) Public and publicly guaranteed debt is owed to both private and official creditors.

Private creditors include:

- Holders of bonds that are either publicly issued or privately placed. (According to the World Bank, Ecuador does not have outstanding external debt in the form of bonds.)

- Commercial banks: loans from private banks and other private financial institutions.

- Other private: credits from manufacturers, exporters, and other suppliers of goods, and bank credits covered by a guarantee of an export agency.

At the end of 1990, Ecuador owed private creditors $7.362 billion, which included $6.835 billion owed commercial banks (of which $1.541 billion is interest arrears) and $.527 billion owed other private groups. At the end of 1991, Ecuador owed commercial banks about $6.4 billion. Figures are not yet available for other private creditors.

Ecuador's debt to official creditors includes:

- Multilateral loans that came from international organizations such as the World Bank, regional development banks and the International Monetary Fund ("IMF").

- Bilateral loans that came from governments, their agencies, autonomous bodies and export credit agencies. At the end of 1990, Ecuador owed $2.448 billion in multilateral debt and $2.052 billion in bilateral debt. At the end of 1991, Ecuador's bilateral debt was still over $2 billion. The figures are not yet available for

the multilateral debt, but it is probably still near $2.5 billion.

Negotiations for resolving Ecuador's bilateral debt are conducted with the Paris Club, which consists of the world's 17 richest lending nations. In January 1992, the Paris Club and Ecuador negotiated a rescheduling of $340 million of its bilateral debt. Also in January the IMF approved a standby multilateral credit of $105 million for 1992 because Ecuador paid $65 million to the bank advisory committee (the London Club), which is an ad hoc committee of commercial bank creditors. (Negotiations for resolving Ecuador's commercial bank debt are generally conducted with the London Club, but I believe such negotiations may be conducted with individual banks.) The London Club has had difficulties negotiating a Brady plan with the present Ecuadorian government -- long periods of silence punctuated with dramatic exits by Ecuadorian officials, and at least one disinformation campaign about an imminent buy back that the commercial banks did not believe. The London Club sees no chance of negotiating a Brady plan before the election but hopes the new administration "sees more value in coming to reasonable terms with the financial community".

Naturally what is reasonable for the commercial banks may not be reasonable for Ecuador. The following lists some of the methods that can be used to help resolve Ecuador's external commercial debt problem. Each method is aimed at either increasing Ecuador's access to U.S. dollars, transforming debt denominated in dollars to

sucres or refinancing, rescheduling or buying back old debt. In addition, a possible strategy that is reasonable for Ecuador will be presented.

One of the most noteworthy features of the commercial bank debt reduction operations for developing countries has been the variety of techniques used to address debt burdens: encouragement of foreign investment, debt for equity swaps, export commodity linked financing, debt for nature swaps, interest rate reduction bonds, collateralized bonds, open market and negotiated buy backs, including the Brady initiative. There is also a variety of funding sources for these operations: World Bank, IMF, Inter-American Development Bank and bilateral creditors, in particular Japan.

1. Direct Foreign Investment

Encouragement of direct foreign investment into Ecuador will increase economic growth and attract foreign currency which in turn can be used to buy back or service some of Ecuador's external debt. In addition, Ecuador's access to foreign technology in management expertise and markets will increase. The key to encouraging direct foreign investment is to remove obstacles to potential foreign investors, such as restrictive regulatory regimes. Mexico, for instance, over hauled its regulatory framework for foreign investment in the mid-1980's. In 1991 foreign investment, including repatriated flight capital, has roughly doubled since 1989.

Thailand in 1987 simply changed the implementation procedures

of its legal framework for foreign investment. It streamlined the numerous administrative rules, guidelines and standards into a more systematic framework that is now administered by a <u>single</u> government bureau, which is directly under the authority of the prime minister. Foreign investors save much time and effort because they can now complete the application procedures in one department. Rules on the provision of incentives and the imposition of restrictions for foreign investors were also clarified.

The creation of a country mutual fund through an investment banker or brokerage house in an industrial country allows investors in the world's major equity markets to conveniently invest in a country such as Ecuador. The country fund would receive money from investors and its manager would decide what businesses to invest in or bonds to buy in Ecuador. For a country fund to be successfully launched, the country to be invested in should have a well functioning domestic capital market (stock and bond exchanges) and standards on information disclosure and accounting. The International Finance Corporation, part of the World Bank Group, assists in structuring and offering country funds.

Another form of direct foreign investment in developing countries is the ADR, which is a security issued against a deposit of non-U.S. company shares in a trust account. ADRs are then traded on stock exchanges in an industrial country. Recent ADR offerings include the Chilean Telephone Company and Mexico's Telmex

privatization. Telmex hired an investment banker to arrange for the sale of its ADRs in several major industrial country stock markets, including the United States, Japan and England. Over $2.3 billion was raised in 1991 by privatizing Telmex. The Chilean Companea de Telefonos used the same method of privatization and raised $98 million.

A third form of portfolio investment is outright foreign purchase of particular domestic equity shares. Flows to Latin American stock markets in 1991 suggest that this category could form a significant, if volatile, segment of external finance. Typically investors are concerned about adequate settlement procedures as well as information disclosure and accounting standards. Domestic financial market reform has, therefore, the potential to increase considerably this type of flow, since developing country stock markets often offer high returns and considerable diversification potential.

2. Debt-Equity Swaps

In debt swaps, (which are a form of buy backs) the commercial banks exchange a portion of a country's debt in return for an amount of the country's currency which is then used to invest in the country's businesses. Another method is where a country privatizes a national industry and exchanges a part ownership in that industry for part of its debt held by the banks. Debt-equity swaps offer foreign finance, an inflow of foreign technology and access to foreign markets. Argentina has achieved substantial

progress in reducing its external commercial bank debt through debt-equity swaps connected to the privatization of its state telecommunications enterprise (ENTel) and national airline (Aerolineas Argentinas). Argentina obtained waivers from its creditors so as to permit commercial debt to be bought on the secondary market by foreign investors and exchanged for equity stakes in the enterprises. The total amount of commercial debt exchanged (and thus extinguished) in the ENTel offering and for Aerolineas Argentinas was equal to about 15 percent of Argentina's commercial debt.

The United States Bank Security Pacific has gone into the business of switching debt for equity. At first it changed part of its own debt portfolio into an equity venture capital portfolio through debt-equity swaps. Through its New York office, Security Pacific now buys country debt for entrepreneurial investors and speculators at the best prices, trades the debt through several countries at different exchange rates thereby adding value or finds investment opportunities in a country and converts the debt to equity. Security Pacific makes a profit by charging its investors management fees for the entire process. Ecuador might want to explore a potential agreement with Security Pacific, whereby Security Pacific would purchase Ecuador's debt and Ecuador would agree to debt-equity swaps. Of course, whether such an arrangement would benefit Ecuador would depend on the discount at which Ecuador's debt is swapped -- the lower the better as I will explain

shortly.

3. Commodity Linked Financing

Commodity linked financing can aid in reducing a country's external debt, obtaining additional financing and protecting against the fluctuation in commodity prices. The United States Bank, First Interstate and London's Midland Bank have exchanged millions of dollars of Peruvian debt for Peruvian products shipped to the United States. The banks are also trying to find new markets for Peru's products in order to exchange additional debt for Peru's goods, which are sold in the United States and Europe. In order to obtain additional financing, a country can collateralize further borrowing with commodities. This will increase a country's access to foreign loans at better rates than were the loans unsecured. In addition, commodity linked financing (which is used by industrial countries but little used by developing countries because of a lack of familiarity with innovative financing techniques) can protect against steep declines in commodity prices. For example, in late 1990 and during the first half of 1991, Mexico used financial risk management tools to protect its crude oil export earnings (which average about 1.3 million barrels a day) against a price drop. The strategy covered a significant part of its export earnings during this period. Mexico bought put options at different exercise prices, engaged in selling of oil futures, and used short-dated (up to one-year maturity) oil swaps to hedge its oil price risk. Buying put

options guarantees a minimum price, and oil futures contracts and swaps guarantee the seller and the buyer a specified price at some future date. By using these contracts, Mexico effectively insured some minimum price of its main export over the near future. In addition, Mexico established a special contingency fund to protect against a decline in oil prices. Mexico's overall strategy was to ensure that it received at least $17 a barrel, the price used as the basis for its 1991 budget. As explained by the finance ministry, participation in the futures markets reassured investors that, regardless of oil price movements, the economic program and the budget would be sustained. The strategy was quite successful for Mexico since oil prices fell significantly in early 1991. Not only did Mexico achieve more certainty ex ante about its oil earnings, but also it profited ex post as the gains from having ensured a minimum price exceeded the initial costs of buying the put options. There are numerous experts in risk management here in New York City who could put together a hedging plan tailored for Ecuador's exports.

4. Bond Collateralization

New capital can be raised by Ecuador at reasonable rates by collateralizing bonds and then selling them in the bond markets. The security backing for these bonds can include receivables, bank accounts, real estate and any other assets of a public or private Ecuadorian entity. The Mexican private copper company, Mexicana de Cobre, raised $165 million in 1991 through a five year loan secured

by copper export receivables and hedged by copper swaps. Mexico and Venezuela issued more that $2.4 billion in 1990 international bonds, denominated in U.S. dollars and deutsche marks and sold in the Euromarkets. These bonds were issued by public and private organizations that collateralized their bonds with telephone or credit card receivables.

5. Debt for Nature Swaps

Under debt for nature swaps, Ecuador can encourage environmental organizations throughout the world to purchase some of its debt at a deep discount from commercial banks by simply agreeing to convert a portion of the face amount of the purchased debt into long term local currency bonds held by Ecuador's environmental groups. The average purchase price has been 30 percent and the average redemption price has been 85 percent, but these rates are negotiable or can be controlled. The interest on the bonds, paid in sucres, would be used by Ecuador's environmental groups to finance a variety of conservation projects. When the bonds mature, the principal can become an endowment fund for Ecuador's environmental groups. By issuing bonds rather than cash, Ecuador reduces the threat of inflationary impacts. The specific steps of a debt for nature swap follow:

The first step in a swap is to obtain approval in principle from the debtor country -- specifically, from the government, the central bank, and a private conservation organization that will receive the funds and manage the conservation program. The host

country must decide what exchange rate to apply in converting debt into local currency, what conditions of payment to use in exchange for the debt, and whom to designate or accept as a local agent to control the funds and dispense the proceeds. The conservation program is agreed on based on local priorities; it may include site-specific projects or a list of general conservation activities (e.g., training of park managers) to be undertaken when the local agent deems them appropriate.

Next, the debt to be acquired must be identified. Potential swappers must shop for debt notes that are of the right denomination, are acceptable to the debtor country government and have an acceptable maturation schedule. If the debt is not donated, it must be purchased -- itself a technically complex transaction -- at an acceptable discount. Once obtained, the debt must be converted into a local currency instrument by the host government's central bank, in the manner specified in the agreement. Finally, the conservation program may begin.

A twist on these type of swaps is that Ecuador might provide an environmental group the funds with which to purchase its debt from commercial banks. This would prevent a run up in the market price or negotiated price for Ecuador's debt because the banks would be unaware that Ecuador was providing the funding as a means to buyback its debt. Furthermore, commercial banks in the developing countries benefit not just from the sale of debt that may never be paid but the positive public relations of preserving

the environment and changing the trend of developing countries sacrificing their natural resource base just to meet short sighted economic needs. The importance of such public relations to the banks is illustrated by Bank of America's recent announcement it would donate $6 million to fund debt for nature swaps in Latin America. In addition, the Inter-American Development Bank has allocated $400 million to a program to lend money to its member countries for the purchase of commercial debt which will then be used for selected environmental projects the way debt for nature swaps are used.

6. Interest Rate Reduction Bonds

Interest arrears, which Ecuador has in the amount of $1.541 billion to commercial banks, could be refinanced by Ecuador paying a percentage, say 25%, in cash and exchanging the remaining percentage for bonds. The bonds would be dollar denominated with a 10 year maturity and a 3 year grace period. They would carry a below market interest rate (rates in the U.S. are already at a 20 year low) for the first three years and a market rate afterward or a variable market rate with a cap and floor (that predetermines the upper and lower rate bounds). Any variation of the percentages, rates and maturity would depend on what can be negotiated and whether it is beneficial to Ecuador.

7. Buy backs: Open Market and Negotiated

There are two major types of buy backs: open market, where purchases are made in the secondary market at whatever price the

market has placed on the debt, and negotiated, where Ecuador or its representatives would negotiate to purchase some of Ecuador's debt from commercial banks. In negotiated buy backs lenders agree to concessions so that a country can effectively repurchase its debt at below-market prices.

The secondary market consists of trading debt securities in over the counter markets, primarily in New York and London. Fourteen (14) commercial and investment banks account for most the trading. Some securities houses are also involved. Investment and commercial bankers are increasingly marketing tradeable claims on developing countries to non-bank investors as high-yielding liquid assets. It is accepted that the substantial majority of transactions are still accounted for by commercial banks wishing to dispose of claims. Trading houses indicate, however, that non-bank institutional investors seeking high yielding assets and capital gains are increasingly active in the market. Such institutions include corporate treasuries, pension funds, and other financial institutions. In 1990, the trading volume was $100 billion, and 20 to 30 insurance companies now trade in the market.

If you or your party gain office, there are a number of securities houses I know of that will be able to purchase Ecuadorian debt in the secondary market (open market buybacks).

The problem with open market buybacks is that unless the market price is sufficiently low, the debtor country would be better off using the money to increase consumption and investment.

If a country already owes five times as much as it is likely to repay in full, then it is unlikely to benefit from buying back its debt in the open market when the debt is selling above 20% of face value. In addition, contrary to popular belief, it is unclear that buybacks (open market or negotiated) stimulate investment; therefore, any premium paid in any buyback may not be offset by additional investments and the economic benefits flowing from such investments. Open market buybacks can benefit a country only if the market price of its debt is very low. This would require the market which is largely the commercial banks to believe that a country only intended to pay back a small portion of its debt and was not going to make any open market buybacks.

Negotiated buybacks have a better chance of keeping the price low enough to benefit a country because the price is negotiated and set by the country and the commercial banks, not predominantly by the commercial banks as in the open market. Depending on the negotiations, the debtor country can benefit by directing its capital to buying off debt rather than to consumption and investment. There is a complicated formula that can determine a range of prices that will benefit the debtor country whether it buybacks debt in the open market or negotiates its buybacks. I know a number of economists, accountants and investment bankers who would be willing to join a team to provide advise for and negotiate the buyback of Ecuadorian debt from commercial banks.

Negotiated buybacks can or cannot use the Brady initiative.

U.S. Treasury Secretary Nicholas Brady introduced the initiative in 1989. Commercial banks would accept a large reduction (so far around 35%) in principal owed them by a debtor country. In return the debtor country would exchange some of its remaining old overdue debt for new debt at a longer term and reduced interest. The new debt (called "Brady" bonds) would be collateralized by U.S. Treasury Zero Coupon bonds and possibly guarantees from the U.S. Export-Import Bank with the interest backed by the World Bank for a period of time. The Brady bonds would trade in the secondary market at a higher price than the old debt. This is a problem for the debtor countries because any attempt to buyback more of their debt either in the open market or negotiated deal will cost them more per unit of debt, although there will be less debt to purchase. In addition, the moment the commercial banks hear of a plan to restructure a developing countries debt they raise the prices at which the debt trades in the open market and the price at which they will negotiate a buyback. At present Ecuador is viewed as a possible Brady participant, which means the price of its debt has risen.

Since Eucador's debt value has already risen in the market, it makes no sense for Ecuador to engage in a Brady or non-Brady negotiated buyback, debt-equity swaps, commodity linked financing or interest rate reduction bonds because Ecuador would be paying out more to retire the same amount of debt (because it is now overvalued). It has been driven up in the market by speculators

betting on a restructuring. (Ecuador could, however, take steps to encourage direct foreign investment and perhaps issue collateralized bonds for new financing but not to restructure old financing. Neither of these two steps involve buying back or swapping assets for Ecuador's overvalued debt). Once the speculators realize Ecuador is not going to further increase the burden on its people by exchanging its assets or money for debt at overvalued prices, they will sell their debt holdings causing the price to drop or simply mark down the value of the debt if no buyers are available at the lower prices.

Once prices have dropped, one possible strategy for Ecuador would be to purchase some of its debt, then trading at reasonable and not overvalued prices, by quietly providing environmental groups with the funds for debt for nature swaps. The groups would buy the debt in the open market and exchange the debt for Ecuadorian bonds. In addition, brokers could be used to discreetly purchase Ecuador's debt for Ecuador's account. Afterwards, Ecuador may also want to engage in non-Brady negotiated buy backs, commodity linked financing and debt for equity swaps, since Ecuador probably would still be acquiring more in face value of debt for its assets then when everyone was expecting a Brady buyback. Ecuador could retire the acquired debt or hold on to it and, when economically appropriate, initiate a Brady restructuring, which will cause an increase in value of its debt in the open market. Ecuador then could sell the portion of debt it is holding in the

market for a gain to be used to service some of its existing debt. Professional speculators in the sovereign debt market expect to realize 50% returns when a country does a Brady restructuring.

A corollary affect of Brady debt restructuring is that equity markets in the debtor country generally go up. Prior to restructuring its debt, the government of Ecuador could invest in some of its large businesses. Assuming the market rises following the restructuring, the government could sell its holdings and use the gain to service its debt.

Concerning Ecuador's official bilateral debt, recent actions by the Paris Club are encouraging. In September 1990, the Paris Club adopted greater debt relief for lower middle income countries through extended maturities. Standard maturities were extended from 10 to 15 years with grace periods increased from 5 to 6 years to a maximum of 8 years and for development debts, to 20 years with a maximum grace period of 10 years. Provision also was made for debt conversions on a voluntary bilateral basis, freely for official development assistance ("ODA") debt and within case-by-case limits for non-ODA credits. Through October 1991, eight countries (Congo, El Salvador, Honduras, Jamaica, Morocco, Nigeria, Peru, and the Philippines) had benefited from the new terms, covering consolidated debt of $14 billion. The rescheduling for Peru in September 1991, which covered a consolidated amount of $6.6 billion, was especially noteworthy. The agreement deferred all of the moratorium interest on eligible medium to long-term debt

due during the 15 month consolidation period (from October 1, 1991 to December 31, 1992), contingent on Peru's performance under the IMF's rights accumulation program.

The Paris Club restructurings for Egypt and Poland, which covered an estimated $58 billion of debt, provided for a conditional reduction in the present value of the debt by some 50 percent. In both agreements, creditors can choose one of three options to effect the 50 percent debt forgiveness: reduce the principal, reduce the interest payments, or reduce the interest payments and, in the early years, partially capitalize interest (on which no further interest is charged). Each restructuring is divided into two stages, becoming effective in April 1991 and April 1994 for Poland, and in July 1991 and July 1994 for Egypt. The net present value of debt is reduced cumulatively for Poland by 30 and 50 percent and for Egypt by 15, 30 (at January 1993), and 50 percent, conditional in both cases on agreement on an IMF multiyear or other arrangement. Both agreements provided for graduated payments after the first three years and country-by-country debt swaps.

The goal of the Paris Club treatment of Egypt and Poland is to provide debt reduction sufficient to attain external viability, without the need to carry out further reschedulings. To that end, a number of special features were introduced: debt relief is specified in net present value terms so as to equalize burden sharing between official bilateral creditors; the debt relief is

~~phased and~~ linkage to Fund programs is especially strong; comparable treatment or commercial bank claims is required; the entire stock of eligible debt (including interest arrears) is consolidated at one time; there is an interest holiday (that is, greatly reduced payments) during the first three years for Poland; and non-ODA debt is rescheduled on highly concessional terms.

For some other lower middle income countries, external viability remains a distant prospect. Creditors will therefore need to consider how best to provide concessional support, through debt restructuring if necessary. The G-7 summit in July 1991 signaled its desire to see further progress made toward achieving viability by noting the Paris Club's continued examination of the special situation of some lower middle income countries on a case-by-case basis.

I hope the above is of some use to you. If you have any questions or wish to discuss some of the points made, please feel free to telephone me (212-982-5836). In addition, I will be in Ecuador April 17 to April 25 if you wish to meet.

Very truly yours,

ROY DEN HOLLANDER

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