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The Ecuadorian Crisis and the International Financial Architecture

The default on its debts and the dollarisation of Ecuador are both symptoms of a serious political and economic crisis. These events are affecting a small country, and have limited international consequences. However, the insolvency of Ecuador raises fundamental questions for the artisans of the new international financial architecture, questions which differ from those surrounding the Mexican and Asian liquidity crises. Default by a State is not a new phenomenon, but the development of disintermediated finance requires original solutions. How can the activity of private creditors be coordinated? And, how can the burden of adjustment be shared out among private and public creditors? The answers to these questions still run up against the matter of the status of the creditors. The evolution of this status would make it possible both to maintain small countries' access to markets and to prevent "moral hazard" arising for countries which are "systemically important", and which benefit from lender-of-last-resort intervention.

The Monetary Response to a Financial Crisis

The long political crisis which led to the *coup d'etat* by the military last January has clearly highlighted the catastrophic economic situation in which Ecuador finds itself: GDP fell by 7% in 1999, inflation soared to over 50%, and the exchange rate has fallen by 22% since the beginning of the year 2000. This open crisis was sparked most immediately by the collapse of the banking system. In March 1999, a generalised run on banks by depositors was only avoided by the nationalisation of two thirds of the banking system, the freezing of a large share of all deposits and the provisional suspension of all banking activity. Today, preliminary estimates for the resulting capital losses amount to 25% of GDP, which will probably be borne, in the last analysis, by depositors. Indeed, the ability of the State to address the banking crisis actively is strictly limited by its own insolvency, which is reflected by the partial default on foreign debt last September. Cut off from the international capital markets, the State is unable to mobilise domestic savings.

The dollarisation underway since last January has the sole aim of stabilising prices as quickly as possible. The complete conversion into dollars of the money in circulation, of deposits, credits, and of outstanding bills appears as an extension of a currency board, a monetary regime first thought of in 1996. Dollarisation preserves its main characteristics: a fixed exchange rate and the obligation of backing base money with foreign exchange reserves. Monetary policy is thus highly constrained, and lender-of-last-resort interventions are conditioned by the availability of surplus forex reserves. Compared to this already very strict rule, dollarisation prohibits[1] the progressive restoration of an active monetary policy. Barring an agreement with the US Federal Reserve, it also means that Ecuador is losing about 0.3% of GDP in seignorage[2]. In exchange, dollarisation provides enhanced monetary credibility, which should lead to a lower interest rate differential with the United States.

These severe constraints explain why (except for small countries like Hong Kong) the implementation of a currency board and *a fortiori* dollarisation is only justified under exceptional circumstances; after very high inflation or an extreme erosion of monetary functions. Otherwise, the apparent rigor and orthodoxy provided by these monetary regimes help, above all, to mask the absence of

1. See G. Calvo in particular, "On dollarization", University of Maryland, mimeo, April 1999; F. Bergstein, "Dollarization in emerging-market economies...", evidence provided to the US Senate, 22 April 1999. Similarly, the July 1999 reports by the Joint Economic Committee of the US Senate (www.senate.gov/~jec/dollaract.htm).
2. The American authorities have had informal discussions with Argentina and Hong Kong concerning the conditions of total dollarisation of these countries and a redistribution of seignorage receipts. In contrast, they have clearly excluded the possibility of the such a decision leading the United States to adjust its interest rate policy, of banking supervision or of access to the Fed's discount market (CHECK).

a consistent strategy to resolve the internal crisis: Indonesia briefly embarked on this perilous path in 1998, and everything indicates that Ecuador's dollarisation primarily reflects a failure, if not an abdication by its political class.

Managing a Sovereign Default

The default by Ecuador raises a much larger set of international policy issues. For the last six months, the country has failed to pay interest on a share of its Brady bonds, issued in 1994 in exchange for old bank credit stocks which were marked down. Furthermore, serious doubts surround the sustainability of the remaining foreign public debt (other Brady bond issues, a Eurobond issue, multilateral and bilateral credits) as well as domestic debt.

As with private sector bankruptcy within a country, the primary objective in dealing with sovereign default is to coordinate creditors and to avoid the proliferation of bilateral accords, or the unilateral seizure of State assets held abroad (bank accounts, planes, export earnings etc.). Lack of liquidity is usually resolved by extending the average maturity of the debt. For example, at the start of 1998, Korean bank debt reaching maturity during the year was swapped for a Eurobond issue with a one- to three-year maturity, backed by a State guarantee[3]. In contrast, insolvency calls for debt reduction, with the explicit aim of re-establishing a country's solvency and permitting renewed access to international capital markets.

Table 1 - Ecuador's Foreign Debt, end 1999

	Outstanding debt in $bn	Structure in %
Total	15 890	100
as a % of GDP	*101%*	
Public debt	13 370	84
IMF	410	3
Multilateral debt	3 600	23
Bilateral debt	2 450	15
Brady bonds	5 920	37
Other bonds	500	3
Bank loans	490	3
Private debt	2 520	16

Source: Banco Central del Ecuador.

Ecuador's debt default is very different from the external liquidity crises which affected Mexico (1994-95) and even Asia (1997-98), and which were self-fulfilling. The share of short term debt is small and forex reserves are substantial ($1.2 billion). Instead, national tax revenues required to service the public, foreign debt are lacking. The current State insolvency is thus closer to the debt problems of Latin America during the 1980s, which were characterised by strong macroeconomic imbalances. A significant difference, however, is that Ecuador's public foreign debt exists mainly in the form of international bonds, and not bank loans (Table 1). This raises two difficult problems of general importance, which have been identified for several years, though not directly dealt with[4]. How is the insolvency of a sovereign borrower to be managed in a world of financial disintermediation? And, how are the capital losses to be shared out among the various sorts of lenders?

Restructuring International Bonds

During the 1980s, coordination of private creditors was assured in the homogeneous framework of the London Clubs, set up by commercial banks on an *ad hoc* basis, without any specific institutional structure. There were only several dozen actors that were primarily involved at the time, whereas today the number of investors affected by the Ecuadorian default is far more numerous and diversified: investment funds, insurance companies, company treasurers etc. This results in a great diversity of legal situations, investment objectives and accounting constraints, which in turn make it far more difficult for interested parties to be represented. A first step to resolving the problem would be to establish a bondholders' committee, with responsibility for negotiating a settlement with the borrower. However, no set of rules exists for creating such committees, which risk proliferating according to the interests of each category of investors. Thus, a "representative group" has indeed been formed in Ecuador, but its representativeness must be viewed with caution, and its capacity for imposing a possible agreement on all bondholders is fragile.

Another problem raises more fundamental issues: the restructuring of international bonds is far more complex than restructuring bank loans. The legal specifications of all Brady bonds and all other bonds issued under American law require the consent of all investors for them to be modified or exchanged for new securities. Such legal clauses greatly increase the problems of coordination and open up possibilities for "hostage-taking" strategies by marginal investors. They may even lead to litigation against the defaulting country, or against the bondholders' committee that negotiates an agreement, or even against fund managers who may be in breach of their contractual mandate by accepting any such agreement.

3. See J. Sgard, "Contrôler une panique: le won coréen en 1997", *L'Economie Politique*, 2, 2nd quarter 1999.
4. See in particular B. Eichengreen and R. Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors*, CEPR, London, 1995.

The response to the risks of an impasse lies in modifying these contractual clauses, so that any agreement on restructuring becomes imperative when it is supported by, say, 50% or 75% of the bearers. A 1997 report by the G10 put forward such a proposal, and it has been backed by the G7 and the International Monetary Fund (IMF)[5] since then. With the Ecuadorian crisis, however, several spokes persons for the private sector again came out against such a move, basing their views on the fact that it would make default easier and hence more probable. This would ultimately raise the average cost of indebtedness for the emerging economies[6]. However, empirical analysis rules out part of this thesis: for good quality borrowers, bonds written under British law, which include restructuring clauses, have a lower cost than American bonds[7]. More generally, States have regularly gone bankrupt over the last two centuries at least. In a world in which finance is more and more disintermediated (Table 2), this risk must be integrated within the sophisticated legal apparatus that regulates all other aspects of Eurobond issues. Otherwise there is a danger that endless litigation may proliferate, pushing many developing countries out of markets for a long time.

Table 2 - Stocks of sovereign commercial debt* for intermediate income countries

In %	1990	1998
Bank loans	52	41
Bonds	28	52
Non-brady bonds	17	43
Brady bonds	11	9
Other sources	20	7
Total ($ billions)	514	1 258

*External debt in forex, owed to private creditors.

Source: World Bank, Global Development Report.

Sharing the Burden

However, the difficulty of restructuring international bonds is only one aspect of the more general problem of burden sharing among the various categories of creditors - be they banks, or non-banks, private or public, bilateral or multilateral. This theme shifted to the centre of the international debate in 1995, when the IMF, the United States and the G7 bailed out Mexico and allowed private investors to exit the crisis with minimum losses. Since then, and especially since the crisis in the emerging markets in 1997-1998, burden sharing has cropped up regularly as the answer to such moral hazard: the costs of a crisis must also be shared by the private sector.

This principle is at the heart of the new strategy for managing payments crises, which is currently being tested on the Ukraine, and which is based on a twofold conditionality. First, the country must sign an agreement with the IMF, which grants its seal of approval. But loan disbursement is then conditioned by a restructuring of commercial debts (the London Club and bondholders), which guarantees that IMF credits will not be used to finance the exit of private investors. Unilateral public intervention thus acts as a catalyst. It blocks a possible panic by investors and eases the ordered adjustment of debt schedules, without modifying its net process value.

Ecuador's public insolvency, however, is far more menacing, as it also requires a reduction in outstanding debts, i.e. a sharing of losses among creditors. Who is to decide at what rate debt will be reduced: the IMF, the markets, the most-involved creditor, the first party to sign an accord with Ecuador? How is this domestic debt problem, which is never included in international negotiations, but clearly contributes to public insolvency, to be tackled? The private sector has a strong point to make, in recalling that Ecuadorian Brady bonds stem from bank loans that were already cut by 45% in 1994, on the condition that this was a "first and last" debt reduction. Why should this debt now be reduced a second time? Moreover, when most of the Brady programmes were launched, including Ecuador's, public creditors in effect contented themselves with providing some new credits, and unless new legal precedents are set, this situation seems likely to repeat itself: Ecuador is not one of the poorest countries which could benefit from debt reduction; nor is there any talk of the Club of Paris (which brings together bilateral debtors) according Ecuador an exceptional debt reduction, as was the case for Poland and Egypt in 1990.

In the 1980s and up until now, such exceptions in public lending were justified by the low interest rates it carried, or because it could not be substituted by private debt. Such forms of subsidy or public aid are now difficult to justify in the case of Ecuador. On the one hand, from 1990 to 1998, interest payments and net amortisation of bilateral and multilateral debt (IMF loans excluded) constituted a transfer of resources abroad of just a little more than $1billion. The counterpart to this was a fiscal transfer in the order of 0.8% of GDP, on average. On the other hand, the debt write-off included under the

5. See: the Group of Ten and the BIS, ***The resolution of sovereign liquidity crisis***, Basle, 1997; IMF, ***Involving the private sector in forestalling and resolving financial crises***, Washington, 1999.
6. See especially: the Institute of International Finance, ***Involving the private sector in the resolution of financial crises in emerging markets***, Washington, April 1999 (www.iff.org) Emerging Markets Traders' Association, ***Is burden-sharing being pushed too far?***, New York, September 1999 (www.emta.org/section6/index.html).
7. B. Eichengreen and A. Mody, ***"Would collective action clauses raise borrowing costs?"***, NBER Working Paper 7458, January 2000.

Brady plan represents an equivalent transfer of resources to Ecuador ($1.18 billion), financed mainly by the shareholders of commercial banks. Some may thus conclude that in this specific case the private sector has indirectly contributed to financing the withdrawal of the public creditors[8]. From this point of view, the protected status of public loans, especially those by the Club of Paris, weakens procedures for restoring indebted States' solvency, but it also indirectly weakens calls for burden-sharing.

The Lender-of-Last-Resort and Bankruptcy Procedures

The insolvency of Ecuador raises a number of important questions relating to the new international financial architecture. Since the Mexican crisis, the international debate and various reforms that followed have been dominated by problems of liquidity crises. Confronted with systemic risk, international organisations and the G7 have unilaterally taken the initiative in order to restore market stability, which is viewed as a public good. The aim of these interventions and this strong dualism between private and public actors allow these new forms of intervention to be compared with those of the national lender-of-last-resort.

In contrast, the Ecuadorian crisis reiterates the fact that the insolvency of a sovereign borrower cannot be tackled with a such "vertical" strategy. Indeed, at the national level, market illiquidity and private insolvency are managed by institutions that are complete strangers to each other - the Central Bank and commercial law. Insolvency puts all creditors *de facto* at the same "horizontal" level, in other words it forces them to all sit at the same negotiating table. Within this out-of-market framework, they must find a solution to bankruptcy which is economically effective while respecting the legal status of the various forms of credit. At the international level, one option would be to create a procedure for States similar to that used in cases of national bankruptcy[9]. It would work by taking insolvent States "out of the market", returning them to solvency and hence, after readjustment and restructuring, allowing them to re-access international capital markets. However, it is to be doubted whether such a proposition, taken in its entirety, is feasible, if only due to political difficulties. Yet, this should not prevent pursuing the logic of bankruptcy proceedings, so that the different statuses of creditors do not act as an *a priori* obstacle to coordination among them. A starting point would be to make re-negotiation of private, international bonds easier; another would be to normalise the conditions under which the Paris Club would accept debt write-offs.

Without such change, there is a risk that regular access to markets will in the long run be limited to countries considered "systemically important", and which therefore benefit from the support of an international lender-of-last-resort. This would lead to dangerous distortions. On the one hand, countries in the second zone would face many years of obscure negotiation, in case of insolvency. On the other hand, the absence of a reliable procedure for managing insolvency will likely destabilise any type of international lender-of-last-resort for "systemically important" countries: massive moral hazard may occur regularly. Indeed, from a domestic point of view, a central bank which is incapable of excluding failing private banks from the market rapidly risks blindly bailing out the most powerful and corrupting agents. This happened on a large scale in Thailand and Indonesia in 1997. The same is true internationally, other things being equal. In July 1998 - a little more than one year before the Ecuadorian crisis - $22 billion was accorded to Russia, deemed to be a victim of illiquidity. Three weeks later, a unilateral default on Russian public debt denominated in roubles, and largely borne by international investors, led to a major market shock, massive capital flight and a thorough pillage of forex reserves that had been recently replenished.

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8. In early March 2000, multilateral creditors provided Ecuador with $2 billion, over three years (of which $300 million was provided by the IMF). It may be noted that this sum of money corresponds to expected service payments on bilateral and multilateral debt in 2002 ($2.1 billion), according to World Bank estimates (Global Development Finance, 1999).
9. See in particular, J. Sachs, "Do we need an international lender of last resort?", *Frank Graham Lecture*, Princeton University, April 1995, as well as B. Cohen, "A Global Chapter 11", *Foreign Policy*, 75, 1989.

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