Belize and Ecuador: Sovereign Debt Restructuring in the New Financial World
or, What a Difference an Isthmus Makes

Richard Segal[1]
February 2007

Two recent liability management episodes – perhaps characterized as "open market" versus "open mouth" – usefully compare and contrast approaches to sovereign debt restructuring. Belize has just completed an exchange which extended the maturity of its external debt, whereas, as this paper went to press, Ecuador's new government of President Correa was still considering all options. This paper summarizes the approach taken by each country, and draws conclusions about the likely financial implications and repercussions for policymakers' reputations. The paper finishes with an analysis of investor relations initiatives and thoughts about debt restructuring trends in general.

[1] Chief Strategist, Argo Capital Management, London. See also disclosure note at end.

Table of Contents

Chapter	Page
I. Belize: Too Much Debt, Too Quickly	3
II. Ecuador: Trying to Drown in Shallow Water	10
III. Investor Relations Efforts: Too Much Ado	17
IV. Summary of Policy Conclusions	19
Bibliography	24

Figures	Page
1. Belize: Public Debt Surpasses GDP	3
2. Belize: Rising Deficits	4
3. Ecuador: External Debt to GDP Ratio	10
4a. Ecuadorean Sovereign Risk relative to the emerging markets universe	12
4b. Ecuadorean Sovereign Risk relative to Ecuador's economic history	12
5. Ecuador's Benchmark Bond Price	13
6. Belize and Ecuador: Comparative Growth Rates	15
7. Number of Defaults or Restructuring Episodes	16
8. Dominican Republic: Sovereign Spread	17
9. Investor Relations and Data Transparency	18
10. Ecuador: Sovereign Spreads	20

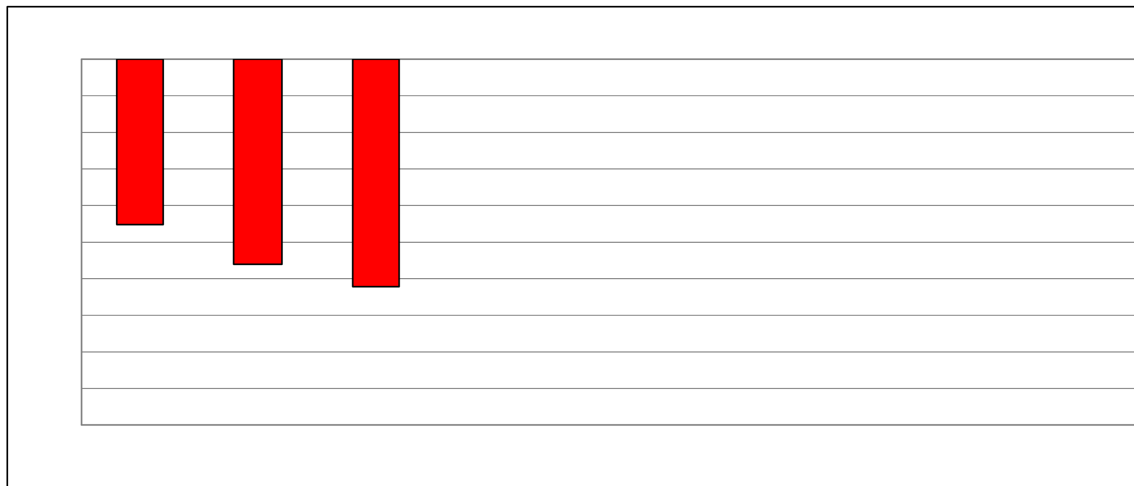
Boxes	Page
1. Comfort Letters vs. Letters of Assessment	8
2. A Rogue by any Other Name	21

Appendix	Page
Belize: Total External Debt by Creditor Category	26

was $162 million (primarily to countries such as Taiwan, ROC and Venezuela), but the Export Credit Agency (or Paris Club) portion, was relatively minor, at about $15 million. See also Appendix, Belize: Debt Stock.

The original state of denial had several root causes. First, at the start of the debt build-up (see Figure 1) the country had little trouble accessing external markets at reasonable rates of interest and this was perceived internally as a sign of strength. However, with global liquidity conditions very accommodating, and international investors favourably disposed toward small dollarized economies, such a perception was misleading. Second, there were few other signs of economic distress. Indeed, inflation remained low, averaging an insignificant 1.8% over the 1996-2005 period, and domestic market-led interest rates were modest. Until the fiscal policy tightening, economic growth had likewise been impressive. Third, the tourism industry continued to boom even as the domestic economy decelerated, with the number of cruise ship passengers accelerating and well-known international marine and air, restaurant and lodging operators expressing keen interest in helping to further develop tourism.

Figure 2. Belize: Rising Deficits (Central Government Fiscal Deficit, % of GDP)



playing a dangerous game, because had it run out of reserves, both a devaluation and a default would have been foregone conclusions. The severity of the situation should not be understated, because the supply of hard currency in the commercial banks was also

already. In addition, in an unusual move, the government chose not to sign up an investment bank to work alongside Houlihan Lokey, although it did hire DF King & Co as information agent.

Most investors readily followed the adage that a bird in the hand is worth two in the bush. That is, a bond with inferior terms which the government has a good chance of servicing is worth more than a bond with superior terms which the government has an unsure chance of servicing. Moreover, officials needn't have nit-picked about the restructuring terms, because, to use another cliché, all comes out in the wash. That is, the majority of institutional investors "mark their positions to market," and the secondary market quickly adjusts to changes in perceptions of creditworthiness. If the restructuring offer had been slightly more generous, it would have been perceived as slightly more onerous, and therefore risky. As a consequence, broadly comparable but different offers would find their values equilibrated in the secondary market with only a short delay.

The government noted that the exchange offer was the result of four months of "intense consultations" with creditors. At the same time, an IMF comfort letter[6] in the name of Managing Director Rodrigo de Rato was noteworthy. In the letter, Mr. de Rato pointed out "commendable strides in correcting serious macroeconomic imbalances," including tax increases, spending cuts and increases in bank reserve requirements. The fiscal measures alone helped the non-interest fiscal balance improve by six percentage points of GDP within two years. The Managing Director cautioned that these measures alone would not be sufficient to restore full macroeconomic balance and alluded to further monetary and fiscal policy tightening, along with structural reforms. Even so, IMF calculations suggested yet more measures – in other words, debt rescheduling – were necessary. With the international official sector prepared to make a financial contribution, it was only natural that the private sector should participate in an "orderly and cooperative debt restructuring." As a parting word to both creditors and the debtor, the Fund warned that there was "little room for slippage" in the policy adjustment program.

Box 1. Comfort Letters vs. Letters of Assessment; the Policy Support Instrument

-

ot(PSI)re frEmrSt0.020hher 0   528.wy Tf -0mrSt0.02 exchSt0r   528.wy Tf -0m.pt

with disagreements at the Executive Board level, or whether the country itself is not willing or able to meet the negotiation conditions.

Indeed, the country may fundamentally disagree that certain conditionality is necessary.

Conclusions:

One can draw several conclusions from Belize's debt restructuring exercise:

1) Denial is the enemy of good economic policy;
2) Countries and cross-border policymakers must look well into the future, both when considering liability management strategy and scenario analysis, and when designing elements of the "international financial architecture;"
3) Coherent fiscal, monetary and structural reform policy must go hand in hand with liability management;
4) Collective Action Clauses are desirable, to the extent they remove incentives for perverse and opportunistic investor behavior;
5) Governments should fully account for contingent liabilities;
6) Constructive and transparent communication will smooth a debt restructuring path, although it is not always essential; and
7) It is never too late to make policy amends, given the increasing flexibility of the international financial markets.

II. Ecuador: Trying to Drown in Shallow Water

The circumstances in Ecuador differ conspicuously with those of Belize. While the government of Belize reluctantly restructured its debt, Ecuador appears intent on rescheduling, even though there is no sizable debt burden. Total external debt is 31% of GDP, and domestic debt another 9%. Nevertheless, former Economy Minister and left-wing candidate Rafael Correa campaigned for the presidency on a platform of debt reduction, stating specifically that much of the external debt was immoral or illegitimate. This posture is not out of the ordinary; opportunistic restructurings have been instigated by this country in the past. However, during the last such opportunistic episode in 1982, the debt-to-GDP ratio was far higher than at present, some 60%.

Figure 3. Ecuador: External Debt to GDP Ratio (%)

military dictatorship, and heart from public opinion polls suggesting concurrence that public external debt should be written down or off. Notably absent from his rhetoric is the acknowledgement that Ecuador received a sizable debt reduction during a Brady bond rescheduling, and that the Brady bonds were subsequently restructured on favorable terms. These two restructurings took place under a global microscope and the government made use of international law firms with strong reputations for representing well the interests of debtor nations. If there were chances to challenge the legitimacy of external debt, the time has long since passed.

Finance Minister Patino has suggested that the $650 million international bond issued at the end of 2005 is legitimate in his eyes and this bond will be immune from rescheduling. Although the relative default risk on this individual bond, as determined by secondary market prices, fell sharply after this hint, few investors believe such inter-creditor favoritism will be possible and such tactics would fly in the face of high level recommendations for creditor-debtor relations.[9] Moreover, few observers would accept public opinion polls as input into debt rescheduling negotiations, from a top-down standpoint, in any case. Most people would prefer less, rather than more, debt, given a perfect world. In any event, President Correa need not conduct brinkmanship if he wishes to default. Given the sovereign immunity that Ecuador and most other countries enjoy,[10] he could merely stop repaying the debt, which would leave investors in a poorer state very quickly and also in a poor bargaining position.

Other, more comprehensive, indicators suggest no need for Ecuador to default. According to our proprietary sovereign risk index, for example, economic conditions are deteriorating, but the situation is far from malign. Relative to the projected 2007 median performance of an emerging markets universe of 35 countries, Ecuador scores -1.5, or about -0.15 standard deviations from the median per model component. Relative to Ecuador's own economic performance since 1993, the country is comfortably above the median. The +4.1 projection for 2007 overstates the likely outcome, as well as current conditions, because our forecasts assumed a neutral political environment. This past month's sudden acceleration in capital flight argues that business expectations have made a break with the past, but we still maintain this year's overall economic performance should be comfortable. Disappointing outcomes would reflect, regrettably, self-inflicted policy errors.

---

[9] See "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets," Institute of International Finance, Washington, D.C., September 2006.

[10] Minor exceptions exist where sovereign immunity has been waived as a condition of lending agreements.

Figure 4a. Ecuadorean Sovereign Risk, relative to the emerging markets universe

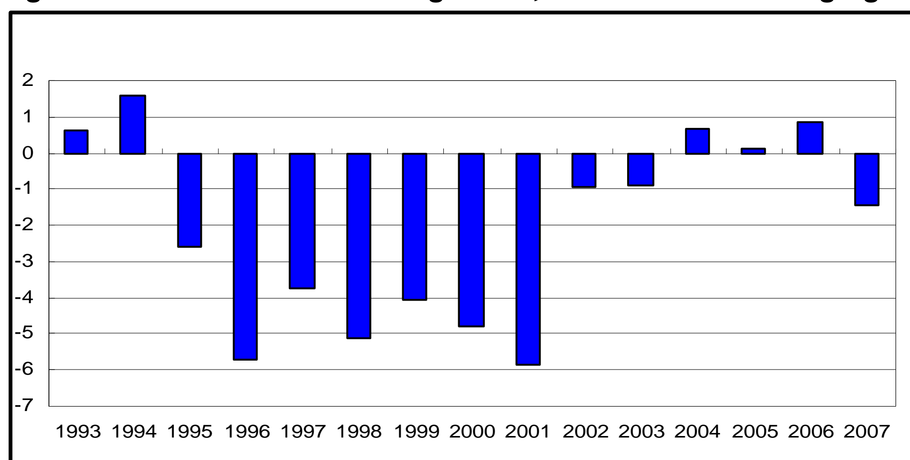
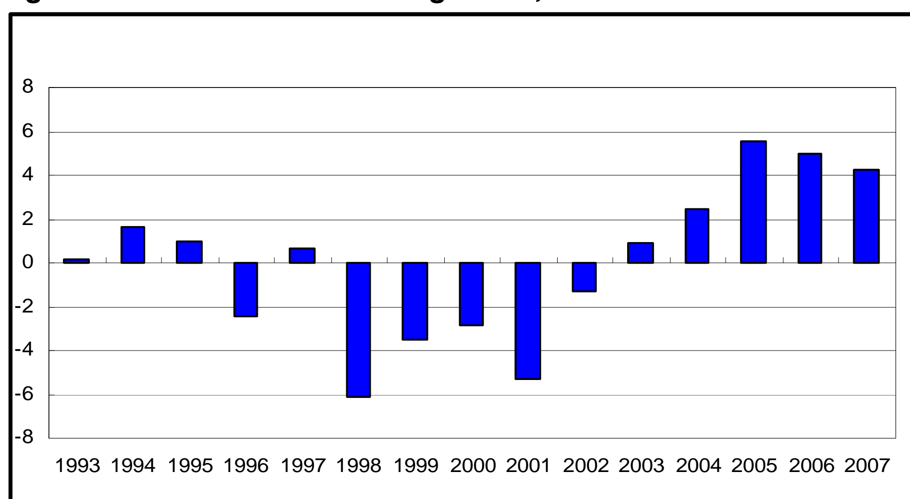


Figure 4b. Ecuadorean Sovereign Risk, relative to Ecuador's economic history



Source: Author's calculations.

Most of its external debt is in the hands of fund managers who follow developments closely and know well its restructuring history, along with other recent restructurings, notably Argentina. Although President Kirchner's negotiating strategy was among the toughest that could have been imagined,[11] investors recognized the weak debt and balance of payments situation, with a debt-to-GDP ratio of about 130% and a currency in free fall. By contrast, we have already established that Ecuador's external debt is modest and it has been operating dollarization successfully since January 2000.

Institutional investors have participated repeatedly – and generally patiently – as the international official community has imposed the policy of Private Sector Involvement when sovereign indebtedness rises above qualitatively-determined unsustainable levels, in a practice known as "bailing in." At the same time, Ecuadorean debt comprises a sufficiently low proportion of investor portfolios such that most would be willing to be

[11] It is less so in retrospect, given the inclusion of "GDP warrants," which have risen more than six-fold in value since they were issued.

new government has many competing priorities, and its top priority is the negotiation with congress over terms of a constitutional referendum. In any event, the markets have become more confident that a draconian restructuring will not be sought. President Correa has also backed away from his threat to declare a moratorium if investors do not accept a reprofiling on his terms.

A few conclusions can be drawn. First, reschedulings which do not emanate from a position of need[13] are destined to provoke considerable market and economic uncertainty, if not fail outright. Should President Correa unilaterally declare a default, business confidence would deteriorate and capital flight would certainly accelerate. As it is, $1 billion left the banking system during January 2007 alone, partly as foreign credit lines were withdrawn. Correa's project is to divert money from debt service, so that he can spend more on health, education and other public services. However, the likely recession

It is easy to sympathize with the plight of the man on the street, whose living standard has

III. Investor Relations Efforts: Too Much Ado About Not Enough

One easy conclusion from the mid-90s Mexican peso crisis, among many, is that investor relations efforts by emerging market economies were inadequate. In response, countries became more transparent, best practices for data releases were published, the IMF set up

this survey. However, South Korea is an infrequent borrower in the international markets and is almost certainly not a default risk for the foreseeable future.

As for Ecuador and Belize, they placed fourth and seventh from bottom in September 2006. Belize will likely move up in the rankings when the next survey is produced, but it is questionable the country will maintain its place over time – as it is questionable that

IV. Summary of Policy Conclusions and Recommendations

To address some of the key policy concerns, it is useful to cite Jack Boorman,[18] at the time special advisor to the Managing Director of the IMF:

> "How does one know when a country's debt is unsustainable and warrants an appeal to a bankruptcy mechanism? How can the incumbent government, and the relevant Ministers and officials, be persuaded to accept that reality and approach creditors for relief? Who gets to decide/vote on a final agreement? How is such an agreement to be made binding on potential holdout creditors? Where should a mechanism for dispute resolution reside? What is the role for the official community, and the IMF in particular, in all of this? And, how can leaders in other countries that may be tempted to appeal for debt relief through such mechanisms when such relief is not warranted be prevented from abusing the system?"

If the questions of inter-creditor equity are being addressed as far as private creditors go, relations between private and official creditors are more complicated. For one, the Paris Club is unnecessarily opaque and informal, and the Comparability Clause is an awkward two-way mirror, at best, and which is difficult to justify.[21] If "possession is 90% of the law," Comparability sits in the other 10%.[22] It is fair and necessary that the private sector bears the brunt of its investment decisions, and has no inherent right to be "bailed out" by international taxpayers, but accounting practices such as marking to market ensure they are automatically "bailed in" without heavy handed action by the official sector. The private sector has been accommodative for the most part when comparability has been requested, but unilateral imposition seems counterintuitive, and this process has also opened back doors for rogue creditors.

Box 2: A Rogue by any Other Name

In the past several weeks, the case of Donegal vs. Zambia has been widely reported in the English financial media, as well as on websites and web logs of debt relief campaigners. These reports suggest that Donegal International, a special purpose vehicle of Debt Advisory International (or DAI for the purpose of this illustration; there is another, better known and unrelated company named DAI which is involved in technical assistance to developing countries), acquired government-to-government loans from Romania to Zambia, with the intention of achieving recovery through litigation. Interest groups have labeled DAI a vulture fund and have widely decried the lawsuit, which has resulted in a British court judgment in its favor. DAI initially requested summary judgment in the amount of about $45 million (the total amount due under the facility, including interest), although the courts have suggested a figure closer to $20 million would be fairer. As has been reported, DAI's original purchase price was a little less than $4 million.

The term "vulture fund" is colloquial, but DAI does not meet the colloquial definition in this instance, because the debt was not purchased with the express purpose of litigation. The facts that the debt was purchased in or about 1998 and that the lawsuits are relatively recent would alone seem to rule out the vulture fund qualification. As quietly pointed out by officials of DAI, the debt was purchased with the intention of achieving a reasonable return through negotiation, and litigation was a final, last resort. An initial objective was to utilize the claim in a debt

amoue s meetmplexcludins orion, ac orenvironry judgmonable

and it likely had little internal capacity for negotiating a cash repayment with African debtors. While it is obvious that G7 countries have no business requesting full repayment of debts from HIPC countries, it is less clear that lower-middle income countries (which Romania was at the time) should be forced to accept HIPC-type debt reductions. Second, the amount that DAI has indicated it would accept, $20-25 million, is approximately $2 million per year for the time in which it has held the debt, before costs and without discounting for the opportunity cost. Such an amount for a country such as Zambia, with

appropriate occasion, because there is no “heat of the moment” to bias opinions. Investors seem to believe that bail-ins are automatic, except when the amounts are insignificant, or when the creditor has a good lawyer and knows where there are assets to attach and ultimately seize.

The IMF’s lending into arrears policy should be reviewed and clarified, if necessary, and an uncomfortably high level of private sector input should be welcomed. Along these lines, opinions emanating from glass towers might better inform the debate than those

Bibliography

Andrade, Carlos and Soto, Alonso, “Ecuador to Pay Debt While Audit Underway,” Reuters News, Quito, Ecuador, 15 February 2007.

Belize Creditor’s Committee, “Press Release (from the Belize Creditor’s Committee) from Trinidad & Tobago,” Port of Spain, Trinidad, 21 December 2006.

Boorman, Jack, “Sovereign Debt Restructuring: Where Stands the Debate?” speech presented at a conference co

International Monetary Fund, “IMF Executive Board Concludes 2006 Article IV Consultation with Belize,” Washington, D.C., 20 October 2006.

Reinhart, Carmen M., Rogoff, Kenneth S., and Savastano, Miguel A., NBER Working Paper Series, NBER, Cambridge, Massachusetts, August 2003.

Valencia, Alexandra, “Ecuador to Start Probe of ‘Illegal’ Debt in March,” Reuters News, Quito, Ecuador, 16 February 2007.

Disclosure note: Among items discussed above, Argo Capital has been active in Argentine sovereign debt and Indonesian corporate debt. It has had no recent investments in sovereign bonds of Belize or Ecuador. An employee of Argo Capital formerly worked for Debt Adml-, Rogoff, Ken t0.7rsC,-0.0

Appendix

Belize: Debt Stock and Debt Service Projections

	Stock (30 Sep 06)	Principal Payments (2007)	Interest payments (2007)
Total Public External Debt	$934.9 mln	$149.0 mln	$66.5 mln
of which:	571.2	117.7	50.7
Direct debt, Bonds	335.4	83.2	36.6
Direct debt, Loans and supplier credits	182.4	19.8	9.3
Indirect debt, Private creditors	53.4	14.6	4.8
Total Official Creditors	$363.7 mln	31.4	15.8
of which:			
Multilateral creditors	201.3	16.1	9.2
Bilateral creditors	162.4	15.3	6.6

Sources: Belize Minister of Finance, Central Bank of Belize.
Note: Figures may not add up due to rounding.