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*ECUADOR'S BRADY BOND DEFAULT: BACKGROUND
AND IMPLICATIONS*

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Updated February 1, 2000

Abstract. On September 30, 1999 Ecuador became the first country to default on its Brady bonds. The Brady Plan was inaugurated in March 1989 to address the lingering Latin American debt crisis by reducing country debt and repackaging the remainder into various types of bonds that could be sold in the securities markets. Ecuador is seeking to restructure its external debt, negotiating with private-sector investors for debt rescheduling and with the IMF for a \$400 million stand-by arrangement. Although the amount of Ecuador's Brady bond default is small, it is precedent setting, with broader implications for the international financial community.

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Ecuador's Brady Bond Default: Background and Implications

February 1, 2000

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ABSTRACT

On September 30, 1999 Ecuador, facing an ongoing financial shortfall, became the first country to default on its Brady bonds, which were issued in the 1990s to address the lingering Latin American debt crisis by reducing debt and repackaging the remainder into various types of bonds that could be sold in the securities markets. Ecuador is seeking to restructure its external debt, negotiating with private-sector investors for debt rescheduling and with the IMF for a stand-by arrangement. Although Ecuador's Brady bond default is small, it was precedent setting, with potentially broader implications for the international financial community and certainly a pivotal event contributing to the economic and social crisis that led to the ousting of a sitting president in January 2000. This report provides background on Ecuador's Brady bond default in the broader context of its economic crisis and will be updated as events warrant.

Ecuador's Brady Bond Default: Background and Implications

Summary

Ecuador faces its worst economic crisis since the 1930s, suffering from a deep recession, collapsed currency, and failing banking system. Together, these problems led to huge fiscal deficits and increased external borrowing. The fiscal shortfall took a dramatic turn on September 30, 1999 when Ecuador decided to default on its Brady bonds, effectively cutting off Ecuador from foreign financial resources. This proved to be a pivotal decision, contributing to the escalating social and political strife that resulted in the forced removal of a sitting president in January 2000.

Brady bonds (named for former U.S. Treasury Secretary Nicholas F. Brady) were one answer to the lingering Latin American debt crisis. They combined partial debt forgiveness with a repackaging of the remaining debt into bonds that could then be traded on the securities markets. This met debtor country need for a reduction of debt and debt service, and the commercial banks' goal of removing this debt from their balance sheets without having to write off the entire amount. Ecuador currently has \$6 billion of Brady debt in bonds with varying provisions, some collateralized with U.S. Treasury zero coupon bonds held in escrow.

Citing its large budget deficit, Ecuador gave notice on August 26, 1999 that in an attempt to restructure its external debt, it would use the 30-day grace period provision in its Brady bond agreement to defer a \$98 million payment that had come due. On September 30, 1999, Ecuador missed a \$44.5 million interest payment on a portion of its Brady bonds. One month later, Ecuador defaulted on a \$27 million Eurobond interest payment. The Brady bond default was a calculated move to pay off the non-collateralized debt, with the expectation that investors would be amenable to invoking the collateral clause on the discount bonds to cover the missed interest payment, thereby giving Ecuador more time to restructure its debt portfolio.

With no viable plan to restructure its debt portfolio, investors voted instead to invoke the "acceleration" clause, requiring full payment of the Brady discount bonds. Ecuador has been unable to pay these bonds in full, leaving the two groups at an impasse. For Ecuador, defaulting on its Brady bonds worsened its financial crisis, causing creditors to shun requests for debt rescheduling. This has forced Ecuador into acute budget tightening, which may extend an already deep recession and exacerbate attendant social costs in this very poor country. New lending to Ecuador from either private or official lenders seems unlikely until an officially sanctioned structural adjustment plan is in place.

Although Ecuador's Brady bond default is relatively small, it does have potentially broader implications for the precedent it set. The default effectively subordinated Brady debt to other international claims, raising questions in the international debt markets. In addition, Ecuador's inability to come to terms with either public or private international lenders escalated its financial hardship and the political and social turmoil that led to the ousting of a sitting president in January 2000. It is currently unclear how Ecuador will fare under a new administration that faces the same financial impasse and continuing deep economic problems.

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Ecuador's Brady Bond Default: Background and Implications

On January 20, 2000, the armed forces of Ecuador deposed President Jamil Mahuad following widespread political protest against his government led by indigenous groups. A three-man ruling council (junta) handed the government to Vice President Gustavo *Noboa* Bejarano, a decision ratified by Ecuador's congress the following day. The political crisis was firmly rooted in Ecuador's two-year recession, which severely affected all levels of society, including the nation's large, well-organized indigenous community. As Mahuad's economic policy responses became increasingly less credible, social unrest, including seizing of the Congress and Supreme Court buildings, led the armed forces to call for Mahuad to step down.

A critical turning point in Ecuador's deepening financial troubles was President Mahuad's determination on September 30, 1999, to default on a \$44.5 million Brady bond interest payment.¹ This precedent-setting decision followed a month of intensive efforts to reschedule its external debt, including a request to the International Monetary Fund (IMF) for a \$400 million loan (later reduced to \$250 million), as part of a plan to address Ecuador's deteriorating economic and financial situation. Mahuad's gamble was intended to force debt rescheduling, but instead resulted in Ecuador's increasing financial isolation and ultimately a full-blown financial crisis. This report is an update, reevaluating Ecuador's bond default in light of the massive financial and political turmoil that it helped to spark.

Ecuador's Economic Situation

Ecuador faces its worst economic crisis since the 1930s; in 1999, gross domestic product (GDP) fell by 7.5%, unemployment rose to 15.5%, annual inflation reached 60.0%, and the Ecuadoran *sucre* depreciated by over 60% before being pegged to the dollar in January 2000 as the first step taken to "dollarize" the economy (see **Table 1.**) The deep recession was caused first by severely depressed prices for its major export commodities. Oil prices collapsed in 1998-99 and agricultural prices fell as well in large part due to the Asian financial crisis. Ecuador's agricultural sector was also devastated by the effects of an El Nino weather pattern. The decline in export prices caused huge revenue shortfalls for the national government.

On the expenditure side, Ecuador faces the high costs of rebuilding its road network and coastal infrastructure, destroyed in El Nino flooding, and of funding its heavily subsidized gasoline prices. Reducing subsidy costs is recognized as necessary, but has met with resistance by the public at large and the congress. Finally, bailing

¹ On October 25th 1999, Ecuador also defaulted on a \$27 million Eurobond interest payment.

out numerous large failed banks has been the most serious drain on public finances. Audits have exposed a fragile banking system; and although nascent reform is in progress, including a revamp of oversight regulations and deposit insurance guidelines, many banks remain undercapitalized, threatening the system with more defaults as Ecuador's recession deepens and bad loans mount.

Table 1. Ecuador: Selected Economic Indicators

	1995	1996	1997	1998	1999(e)
GDP Growth (%)	2.3	2.0	3.4	0.4	-7.5
Inflation — CPI (%)	22.7	25.6	30.7	43.4	60.0
Unemployment Rate (%)	na	10.4	9.2	12.0	15.5
Fiscal Balance (% of GDP)	-0.9	-2.6	-3.6	-5.6	-4.9
Current Acct Balance (% GDP)	-4.1	0.6	-3.8	-10.8	5.5
Nominal Exchange Rate (ECS/\$)	2,924	3,635	4,428	6,825	25,000
Debt/Exports* (%)	262	249	251	331	317
Avg. price Ecuador oil (\$/barrel)	na	18.0	15.6	9.2	13.4

e = estimate, f = forecast, na = not available, *exports of goods and services

Source: Business Monitor International, Ltd. *Latin American Monitor: Andean Group*, January 2000, p. 11, Standard & Poor's *DRI/World Markets Report: Ecuador*, October 1999, and Banco Central del Ecuador.

The government estimates the overall cost to erase the banking sector losses through recapitalization or merger at \$1.5 billion, or over 10% of Ecuador's 1999 GDP of \$13.6 billion.² Private groups place the cost even higher. Ecuador financed the bank failures by issuing currency and the growth in money supply had predictably inflationary effects, which caused the *sucre* to depreciate. In addition to rising inflation, Ecuador's currency also suffered from speculative attacks (capital flight) related to the 1997-98 Asian crisis. The *sucre* was twice devalued in 1998 before being forced to float in February 1999. Ecuador responded by raising interest rates to oppressively high levels to support its currency and to counter inflation, deepening and prolonging the recessionary spiral.

Ecuador's deep recession and dismal fiscal condition increased its foreign indebtedness. Total public foreign debt has grown to \$13.1 billion or 100% of Ecuador's 1999 GDP. The debt service burden stands at 317% of exports of goods and services. The collapsing *sucre* further increased the debt burden, which by most standards has reached an unsustainable level.³ In a desperate move to stabilize the economy, Ecuador currently plans to switch to the dollar as its national currency. Pegging the *sucre* at \$25,000 to the dollar in January 2000 was the initial stage of this

² Business Monitor International, Ltd. *Latin American Monitor: Andean Group*, September 1999, p. 10 and January 2000, p. 11.

³ The average debt/exports ratio for the Highly Indebted Poor Countries (HIPC) that are being considered for broad-based debt relief was 386% in 1998. See: World Bank, *Global Development Finance 1999: Analysis and Summary Tables*, p. 218.

transition, which for many technical reasons may be difficult for Ecuador to achieve given its poor economic condition.⁴

Latin America's Debt Crisis and Brady Bonds

Excessive lending by commercial banks, poor debt management by debtor countries, and dramatic changes in the international economy combined to spawn in 1982 what became known as the Latin American debt crisis. Initial strategies to alleviate the problem involved the imposition of structural adjustment programs on debtor countries and the rescheduling of their debt by increasing lending and lengthening loan maturities (e.g. the Baker Plan). By the late 1980s, however, it had become clear that this approach had served only to compound the problem.

The Brady Plan, named for then-U.S. Secretary of the Treasury Nicholas F. Brady, was unveiled in March 1989 as an alternative to address lingering Latin American indebtedness. The thrust of the Brady Plan was to combine some level of debt forgiveness with a repackaging of the remaining debt into bonds that could then be traded on the securities markets. This met debtor country need for a reduction of debt and debt service, and the commercial banks' goal of removing this debt from their balance sheets without having to write off the entire amount.

The Brady Plan coordinated the roles and responsibilities of debtor countries, international financial institutions (IMF, World Bank), commercial banks, and creditor countries. The debtor countries had to take responsibility for enacting meaningful structural reform, with an emphasis on policies that would reduce huge fiscal deficits and encourage growth. Commercial banks were to respond with debt relief and restructuring on terms favorable to the debtor countries. The IMF and World Bank agreed to allocate funds to help reduce the principal of commercial debt and to finance collateral arrangements, where needed. Finally, creditor governments, which years earlier had come together as an informal group known as the Paris Club, agreed to restructure or reschedule their loans.⁵

The focus of the Brady plan, however, was on reducing sovereign debt to commercial banks and although simple in theory, its actual execution was somewhat complicated. Each debtor country had to negotiate its own deal with the commercial banks through a Bank Advisory Committee (BAC) in coordination with the IMF and the World Bank. The commercial loans were then restructured with some amount of principal written down. The Brady Plan took a "menu approach" to debt relief in which debt instruments were available in combinations that suited each individual country case. An important part of many agreements was the *debt buyback*, in which the countries were allowed to repurchase a portion of their debt at a stated discount.

⁴ The dollarization issue is a controversial and complicated technical issue. For the implications, see: CRS Report RS20105, *If Argentina Decides to Use the U.S. Dollar, What Does It Mean for both Countries?*, by Gail E. Makinen.

⁵ The World Bank. Appendix III: The Evolution of Commercial Bank Debt Restructuring. World Bank Tables, 1992-93. Volume 1, Analysis and Summary Tables. Washington, D.C. 1993. p. 89.

This provided immediate debt reduction. The remaining options involved debt restructuring in which commercial loans were paid off with newly issued bonds. There were three basic categories of bond used to refinance loan principal:⁶

- 1) *Discount Bond Exchanges* — commercial bank loans were exchanged for bonds at a stated discount, with bonds issued at a market interest rate (goal — debt reduction). Discount bonds had a 30-year term and grace period with a “bullet” payment, meaning that interest is paid periodically (e.g. quarterly), with a single principal payment at maturity;
- 2) *Par Bond Exchanges* — loans were exchanged at face (par) value for bonds carrying lower interest rates than the original loans (goal — debt service reduction). Pars were 30-year bullet bonds like discount bonds, but the interest rate rather than the principal was reduced;
- 3) *Conversion Bonds* — loans were exchanged at face value for bonds issued at market interest rates and banks were required to provide new money to maintain liquidity in debtor countries (goal — continued debt payment without reduction; used to cover claims of usually smaller banks unable or unwilling to take any debt writeoffs.)

Special arrangements were made for countries that had excessive interest arrears. At the time of closing on the Brady deal, interest arrears were converted into bonds with tighter provisions than those applied to rescheduled principal, including:

- 1) *Past Due Interest Bonds (PDIs)* — interest arrears were combined into a single bond issue sold at a market interest rate. They had a 20-year term and 10-year grace period (no payment for 10 years;) and,
- 2) *Interest Equalization (IE) Bonds* — similar to PDIs, but with a 10-year term and no grace period. Issued to ensure that at least some minimal payment on capitalized past-due interest was made from the outset of the Brady deal.

Collateral Provisions

A key Brady provision involves the use of collateral to back some of the bonds. Specifically, those bonds that involved debt forgiveness and had long (30 year) grace periods and maturities, basically the discount and par exchange bonds, were partially collateralized, often with funds loaned by the IMF. This was required for bonds issued in currencies other than the U.S. dollar.⁷ *Principal* on the discount and par bonds was collateralized by the debtor country purchasing U.S. Treasury zero coupon

⁶ The World Bank. World Debt Tables, 1994-95. Volume 1, Analysis and Summary Tables. Washington, D.C., 1994. pp. 27-29 and Institute of International Finance, (IIF) Inc. Economic Report: Ecuador, 1999, p. 11.

⁷ The World Bank, World Bank Debt Tables, 1992-93, p. 90.

bonds, which are held in escrow at the Federal Reserve Bank of New York.⁸ Collateral on *interest* payments works in a similar fashion. The difference is that the debtor country deposited the equivalent of 12-18 months of interest into an interest-bearing account (or purchased U.S. Treasury bills) at the Federal Reserve Bank of New York. **Significantly**, *the U.S. government's facilitation of Brady deals by issuing Treasury debt in this manner does not carry any explicit or implicit guarantee of the Brady bonds themselves.*

Theoretically, in case of a default, creditors would be able to access the collateral, which they would then be able to hold or trade like any other security. Default provisions are technical, but in general, once a default occurs, creditors meet through the Bank Advisory Committee to vote on their collective response. They have the option to do nothing, vote to release the collateral, or vote to “accelerate” payment of the bonds. This third alternative would require immediate repayment of the full debt to the creditors. At least 25% of bondholders must vote to invoke either the collateral or acceleration clauses.

Ecuador's External Debt and Brady Default

Ecuador's public external debt amounts to \$13.3 billion, as seen in **Table 2**. Nearly \$6 billion or 44% of the total is in the form of Brady bonds. The second largest single category is debt owed to the international financial institutions followed by Paris Club debt (government-to-government), which also has been in arrears since 1996, Eurobonds⁹, and other debt. Of the Brady debt, past due interest is the largest portion (46%). Par and discount bonds, the two bond types incorporating debt relief, together amount to \$3.1 billion or 53% of Brady debt. The discount bonds were issued at a 45% discount on the face value of its debt, meaning that nearly half of this portion of Ecuador's commercial bank debt was written off. Average annual cost for Ecuador to service the Brady debt through 2003 is \$370 million.¹⁰

Citing its large budget deficit, Ecuador gave notice on August 26, 1999 that in an attempt to restructure its external debt, it would use the 30-day grace period provision in its Brady bond agreement to defer a \$98 million payment that had come due. On September 30, 1999, Ecuador missed a \$44.5 million interest payment on its discount Brady bonds, but paid off interest due on its PDIs.¹¹ This appeared to be a calculated move to pay off non-collateralized debt, with the expectation that investors (e.g. bond mutual funds) would be amenable to invoking the collateral clause on the discount bonds to cover the missed interest payment, thereby buying

⁸ A zero coupon bond is sold at a discount to its face value, having no regular interest payment, but paying the full face value of the bond at maturity.

⁹ Eurobonds are long-term debt instruments denominated in a currency other than that of the country in which the instrument is issued.

¹⁰ Institute of International Finance, Inc. Economic Report: Ecuador, 1999, p. 11. Ecuador's 1994 Brady deal was one of the last and involved a higher than the more usual 35% discount on the debt.

¹¹ One month later, Ecuador also missed a \$27 million interest payment on its Eurobonds.

more time for Ecuador to restructure its debt portfolio. Up against an unsustainable debt situation with no viable plan to restructure its debt portfolio, Ecuador instead faced an irate creditor group. Almost immediately, creditors voted to invoke the acceleration clause rather than permit collateral to be drawn to cover the missed interest payment. Ecuador, however, has been unable to pay in full the \$1.4 billion discount bonds being called, leaving the two groups at an impasse.¹²

Table 2. Structure of Ecuador's Public External Debt
(\$ billion)

Creditor	Face Value of Debt	Percent of Total External Debt
Brady Bonds:	5.9	44%
Discount	(1.4)	
Par	(1.7)	
Past Due Interest (PDI)	(2.7)	
Interest Equalization (IE)	(0.1)	
IFI*	3.6	27%
Paris Club	1.0	8%
Eurobonds	0.5	4%
Other	2.3	17%
Total	13.3	100%

*IFI = International Financial Institutions (World Bank, IMF, Inter-American Development Bank)
Source: Institute of International Finance, Inc. *Economic Report: Ecuador*, 1999, p. 11 and Banco Central del Ecuador, as of September 30, 1999.

Creditors moved forcefully against Ecuador for various reasons. First, there is insufficient collateral to cover a large or ongoing default. Second, drawing on the collateral is considered a poor precedent, effectively allowing it to be used as an additional source of revolving credit at the whim of debtor countries. Third, the Bradys already represent debt forgiveness, so private creditors argue that they have already met their obligations for debt relief. In return for debt forgiveness, it was generally understood that Brady bonds would be treated as “senior debt,” payable by countries in advance of other debt should financial trouble arise.¹³ Fourth, debt restructuring is not viewed as feasible until a major economic reform program is in place that can address Ecuador's massive fiscal shortfall.

Negotiated Solutions and the IMF's (Non)Response

Oil prices have recovered and agricultural production has improved, but Ecuador's financial situation remains dire, and a major reason for the continued social unrest that led to the deposing of President Mahuad. Most analyses of Ecuador's

¹² In addition, the rest of Ecuador's Brady portfolio and its Eurobonds have “cross default clauses,” making them all subject to immediate call if bondholders so choose.

¹³ This is referred to as the “principal of implied seniority.”

debt position recognize it as unsustainable and view the Brady default as unavoidable. Although Ecuador has signed a letter of intent with the IMF for a \$400 million stand-by credit (the request subsequently reduced to \$250 million), approval will not be forthcoming until a detailed economic adjustment plan has been accepted including fiscal, tax, and banking reform. So far, Ecuador's Congress has shown little support for such extensive reform.¹⁴

A big part of the adjustment plan will have to be a complete restructuring of Ecuadoran external debt, with an emphasis on arriving at some type of negotiated solution with private creditors. This may take considerable time and effort because renegotiation of a Brady agreement will require 100% of creditors to acquiesce, as they did with the initial agreement in 1994. The current attitude is relatively contentious toward Ecuador because bondholders are foremost concerned with protecting the value of their portfolios, which could suffer if investors lose confidence in Brady bonds as a whole. Creditor incentive to reschedule debt hinges in part on a understanding that the new arrangement increases the probability of repayment. Creditors reluctance to reschedule Ecuador's Brady debt rests on the belief that it is a direct response to previous defaults and theoretically already had "seniority status."

Ecuador is in the difficult position of having no clear and certain access to IMF funds during a time of national financial crisis, hinging any resolution of the crisis on private-sector debt renegotiation. Ecuador cannot pay what it owes, so bondholders will have to come to the negotiating table, but Ecuador is not in a sound bargaining position. The longer the negotiations take, the higher the cost of default may be. Private capital inflows will likely dry up until some new agreement is arranged. To the extent this trend continues, Ecuador's financial condition will deteriorate further. New funds may eventually come, but likely with stricter provisions.

Implications of Default

For Ecuador, default on its Brady bonds likely represents long-term hardship, since it sharply reduces Ecuador's prospects for obtaining new loans. Perhaps the most painful aspect is the immediate need for severe budget tightening, which may extend an already deep recession and exacerbate attendant social costs in this very poor country. The economic repercussions will be unpopular, adding to the political fallout, already visible in the political demonstrations and ousting of President Jamil Mahuad. A political showdown between executive and legislative branches over the depth and timing of deep reform measures may well continue under the new administration of President Noboa, who may have little room to change policy directions given Ecuador's lack of financial options.

New lending to Ecuador from private groups seems an unlikely possibility and negotiations over debt restructuring with a newly-formed creditor committee have

¹⁴ Business Monitor International, Ltd. Latin American Monitor: Andean Group, October 1999, p. 10.

begun, but have not moved ahead significantly.¹⁵ The alternative is to solicit additional financial resources from either the IMF or other official sources, such as Paris Club countries. Without an officially sanctioned structural adjustment plan in place addressing, at a minimum, the large budget deficit, this too is a long-shot.

Although the actual cost to bondholders of Ecuador's default may be relatively small, the default does have potentially broader implications for the developing country debt market. The face value of Ecuador's Brady bonds is \$6 billion, but they trade on the open market at approximately \$0.20 on the dollar, or an actual market value of \$1.2 billion, a tiny portion of emerging market debt. The importance of the default, however, lies in the precedent it sets. To date, no other country has defaulted on its Brady bonds, but Ecuador's restructuring of Bradys could affect trading of this class of asset in the secondary market, if investors thought that this strategy might spread to much larger debtors, such as Brazil or Mexico.

To date, market reactions have been restrained for at least three reasons. First, Ecuador's poor financial condition has been recognized for some time and so the default was no surprise and was already reflected in the lower secondary market value of its Bradys. Second, investors for now appear to be distinguishing between country risks rather than lumping all Brady bonds into a single risk category. Third, the amount of Ecuador's debt is small by global standards. Still, investor decisions to shun Ecuador has left it without the financial resources it needs to help generate an economic recovery, so the decision to give priority to one type of debt over another at this point seems to have worked very poorly for Ecuador.

¹⁵ Private investors formed the Ecuador Creditors Advisory Group, Inc. to act as one official point of contact and Ecuador has created a creditor committee to coordinate negotiations.