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

Richard Segal[1]
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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.

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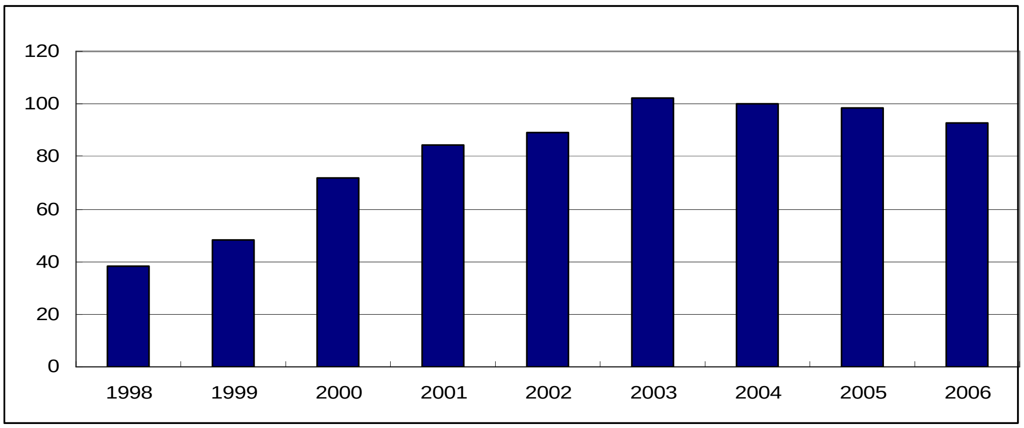
I. Belize: Too Much Debt, Too Quickly

The government of Belize's ultimately-successful debt restructuring was conducted in classic form. By "classic," one can infer that the usual predecessor factors were also in place. These include: the fundamental deterioration that made a restructuring inevitable, the initial defensive reaction by the government and a long period of denial, followed by a swallowing of pride, a rational consultation phase and subsequently a reasonably fair offer to investors, which was widely accepted. One partial distinction from the classics is a historical curiosity. Although sovereigns have been issuing external bonds with Collective Action Clauses (CACs)[2] for several years now, Belize is the first country to actually employ this clause to its advantage.[3]

Figure 1. Belize: Public Debt Surpasses GDP (Public Debt to GDP Ratio, %)



Source: IMF.

The administration of Prime Minister Said Musa publicly admitted external debt was unsustainable in August 2006, but it actually began to tighten fiscal policy in October 2004. During this period, the general government financial deficit contracted from about 8% of GDP to about 3%. Nonetheless, until last summer the government remained in denial about the public debt, which eventually topped 100% of GDP. Of this, domestic debt was an immaterial 12%.

At the time, total external public debt was $934 million. Of this, $571 million was owed to private creditors and $364 million to official creditors. The official bilateral portion

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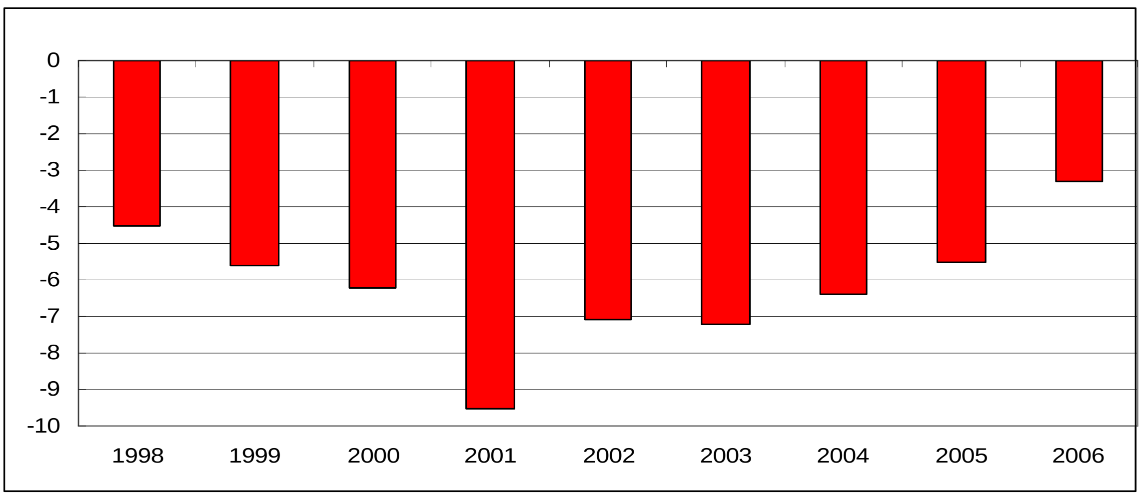
[2] Collective Action Clauses are embedded in most new sovereign bonds issued by emerging market governments. This clause binds minority, or dissident, creditors to the terms of a restructuring, in the event that a supermajority is achieved. Typically this threshold is 75%. The clause is primarily aimed at dissident creditors, but is also effective in addressing creditor non-response for reasons such as lack of awareness and negligence, which is more common in cases where creditor claims are modest. Although CACs could not be introduced into bond contracts retrospectively, over time the majority of sovereign bonds will include this clause. CACs are analogous to the sharing clauses embedded in many syndicated loan agreements.

[3] See "Belize 2015 Notes Amended," Government of Belize, Belmopan, Belize, 5 February 2007.

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)



Source: IMF.

Fourth, the Belize dollar had been pegged at a fixed 2:1 rate against the US dollar since 1976 and modifying economic policies in a way which jeopardized the currency peg was seen as unthinkable. Indeed, officials were long reluctant to negotiate an economic adjustment program with the IMF, for fear that a devaluation and/or commitment to reschedule external debt (in other words, default) would be a condition(s) of support. As a result, the government preferred a “home grown” solution with informal advice and technical assistance from the Fund. Finally, the government fell victim to “just plain denial” that debt was unsustainable because of the emotional, economic and political turmoil that accepting the obvious might produce.

However, the Musa Administration missed two important signals that trouble lay ahead. First, external debt was being refinanced at increasingly-higher rates and second, the central bank’s official reserves were falling to perilously low levels. The government was 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 limited. The vast amounts of hard currency in the economy were in the pockets of tourists or in offshore zones (including on credit card bills); in other words, they were not widely accessible to the domestic economy. In the event, it took two years for authorities to go from denial to reality.

The government initially blamed its external debt and balance of payments problems on the weather, in the form of twelve tropical storms and hurricanes between 1996 and 2005. On a related note, the Belizean economy registered the second-highest volatility in the Western Hemisphere, after Peru, over the 1980-2006 period, according to IMF calculations. Seen in this light, one can have some sympathy with the plight of Belizean policymakers. However, with the policy reaction it is a far different story.

As well as volatile, the economy was inflexible, in the form of the exchange rate peg. Because most public debt was external, there was no mechanism for inflating some of the debt away. With an average annual inflation-adjusted currency depreciation of 0.7% over the previous decade, the problem was becoming slightly worse over time. A main policy conclusion is that to address economic volatility and policy inflexibility in some areas, policies must be tighter and more flexible in the remaining areas. That is, in order to 1) protect the exchange rate regime, 2) refocus public spending toward hurricane relief and 3) avoid a debt rescheduling, underlying fiscal policy needed to be drastically tightened.

In fact, the reverse happened, in both an above- and below-the-line sense. The major culprit in the latter was the Development Finance Corporation (DFC). Set up as a traditional government agency, it quickly evolved into an opaque lender to favored private sector interests. Credit analysts was rudimentary, record keeping was poor and secondary economic-impact benefits of the DFC's activities were immaterial. Moreover, when the loan book went sour, the government decided to refinance the DFC's balance sheet by borrowing externally, and in a fashion that further reduced its flexibility.[4]

Another policy misfortune was the decision to borrow internationally through a credit-enhanced structure. Investors were attracted to this note because 90% of the principal, in turn $115 million, was insured by a subsidiary of the Zurich Insurance Company, one of the leaders in the field of political risk insurance. Although attractive to investors because of the risk-return tradeoff, and seemingly attractive to Belize because of the sub-market coupons, the deal was costly in the end because of the high premium payments to the insurance company and the high underwriting fees to Bear Stearns, which arranged the deal. Moreover, the insurance policy only benefited the investor, because when external debt became unsustainable, the liability was still owing, only in this case it was to the

[4] The government agreed to "cross defaults" between a $27 million refinancing loan (quasi-government debt in the name of the Belize Mortgage Company) and the direct government debt, which made it impossible to reschedule the quasi-government debt. Even if the DFC's loans were made on the basis of favouritism, there was no economic rationale for effectively providing them a sovereign guarantee, which turned the financial difficulties of a few hundred people into a problem of the entire nation.

Zurich Insurance Company, rather than the original investor. An important lesson learned by Belize is that it is potentially unwise to accept financial advice from an investment bank which stands to gain financially from the advice it provides. This is especially important for a country such as Belize, where financial sophistication is in short supply.

Meanwhile, the government often added sweeteners to debt financings and new borrowings, such as generous put options and ring fencing of privatization proceeds to retire debt, also known as "debt sweeps." This distorted decisionmaking, because, for example, it meant asset sales were conducted on far from their own merits. Nonetheless, given the political complications of privatizing assets and the poor privatization track record, this distortion did not hurt the government's finances appreciably.

Throughout the first half of 2006, the government studied the debt situation with the advisory firm Houlihan Lokey Howard & Zukin, one of the few international firms which specialize in this line of business. This decision marked a departure from previous practice, both because the government was paying directly for financial advice and because this was arguably the first time a comprehensive audit and diagnosis of the public debt had been conducted. Although the government entered the process with an open mind, it was probably sceptical about the merits of a rescheduling. In addition to items mentioned above, ministers were concerned about the reputational issues involved. Indeed, given the strong credit culture in Belize and several other highly-indebted Central American/Caribbean countries (Jamaica being another), debt restructuring can be a bitter pill to swallow.

In January 2006, a leaked document appeared on the Internet, purporting to outline four liability management options, which varied in terms of sustainability, chance of success and ease of implementation. Over the next several months, officials debated these options before settling on the decision to reschedule. In August 2006, therefore, the Ministry of Finance released a statement which confirmed its intentions. This became known as the "impending debt rearrangement" letter. In it, Prime Minister (and Finance Minister) Musa announced that "Servicing of the Belizean external public sector debt stock on its existing terms is no longer a viable option. We must urgently ask the cooperation of our creditors to help put this debt stock on a sustainable financial footing."[5]

The authorities displayed what some might call a lack of insight by inviting creditors to form a single committee, with which the government would officially recognize for the purpose of negotiating on behalf of all creditors. Given the sizable number of external debt instruments outstanding and variety of small, dispersed creditors, contrasting with the broad critical mass that the government demanded, it was unrealistic to expect that a single global creditor committee would spontaneously coalesce in a relatively short period of time (although a regional committee did form). This misstep did not cause any serious damage, but it did delay matters for weeks and it was a small blow to the government's credibility. Moreover, a well-informed debtor would have recognized that a global bondholder committee – if it was going to form – would have formed itself

[5] "Belize Announces Impending Debt Rearrangement," Government of Belize, Belmopan, Belize, 2 August 2006.

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.

The rescheduling may well eventually be judged a success, but it is worth noting that the process took seven months, several weeks longer than originally envisaged. Apart from hiring an experienced advisor, the government did several other things right. Among the first was to adopt a cooperative attitude toward foreign private creditors, and to be fully transparent. Although the government had received financial advice for no direct cost in the past (and had made its own no-outlay decisions), the advice was actually costly, because it helped lead to an unsustainable situation. Meanwhile, officials found out that most international creditors will be understanding, as long as these officials are candid.

At first glance, the decision to hire expensive advisors may be costly for a small country with budget constraints as it is. However, previous "free" advice from the private sector had failed and the government did not wish to formally accept free advice from the IMF because of the implied strings, along with the stigma, attached. What became apparent is that this would be money well spent, if the Ministry of Finance and Central Bank continued to implement their agreed tightening policies. A comprehensive, sensible debt restructuring can provide a lot of breathing space to an indebted country, but such a rescheduling will likely prove useless without complementary financial policies. In addition, while the government was forced to pay for advice "up front," authorities should in their minds amortize the benefit of the advice over a period of years, effectively the amount of time of the new breathing space. The government has received training in liability management and scenario analysis, which it evidently had not received before, and one should not underestimate the peripheral benefits of this training.

The Belizean government, indeed, became very transparent once it had taken the decision to reschedule, with about a dozen press releases beginning in August 2006. Although it is not clear whether transparency was part of a determined strategy or whether bureaucrats simply decided to publish everything they knew, when they knew, it was refreshing. This was also in sharp contrast to the previous policy of providing public information to external creditors once or twice a year, and then with a distinct lag (not including information provided privately to potential new creditors). The transparency initiative has been mutually beneficial, and creditors hope it will continue, rather than that the debtor will lapse back into old habits now that the crisis has been managed. See also Section 3, Investor Relations Efforts.

In the end, the 18 December 2006 exchange offer was as follows: new bonds would have a final maturity of 2029, compared with existing bonds which originally matured as early as 2012. The bonds would start to amortize in 2019. The new coupons would "step up," starting at 4.25% and eventually rising to 8.5%. For reference, existing Eurobonds had coupons of 9.25%-9.50%. This exchange offer is seemingly costly to creditors, given the longer term and lower coupons. However, the existing Eurobonds were trading at a deep discount, rendering less relevant high coupons on the pre-existing bonds.

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 (PSI) vs. the Stand-by Arrangement (SBA)

The IMF has made much of its transparency initiative, presented in typical style. A transparency analysis should be bi-polar: on the one hand economic research and macroeconomic statistics, on the other the signalling impact of the Fund's decisions. As a clearing house of the former, the IMF stands alone. Country economists and mission chiefs are open to "outreach" from the private financial markets and from civil society, and typically balanced in their comments. Meanwhile, the Financial Soundness Indicators initiative stands out as a groundbreaking statistical effort. However, the General Data Dissemination System (GDDS) has not been as informative as originally hoped.

As for the signalling impact of the Fund's announcements, one has to be "a member of the club" to understand what the institution is saying. Often, the influence of this signalling is overstated. For example, if Stand-by Arrangement negotiations are delayed, it can be difficult for the markets to understand whether this is because of fundamental policy disagreements which should be cumulatively taken as a sell signal, whether the delay is technical and short term in nature, whether it is for political reasons having to do

[6] "Belize – Assessment Letter for the International Financial Community," Rodrigo de Rato, IMF, Washington, D.C., 20 December 2006.

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. During many complicated negotiations, only “time” knows the right answer. The Fund is wary of being too candid, for fear of causing unnecessarily adverse market reactions and with the knowledge that it must be careful with market sensitive information. However, if the IMF wants to send a clear signal to the markets, it has to be prepared to be as candid as necessary.

Meanwhile, certain policy instruments are well understood by those in the know, but confusing to others. The Letter of Assessment for Belize is a case in point. It served the purpose of a comfort letter (though sceptics might also label it a “Bail-In” letter), but it would have been politically complicated to label it a Comfort Letter, because this might have been seen as oversignalling approval of the policy adjustments, particularly with no formal arrangement in place.

In addition, IMF signals can not serve all master and subjects. The Fund recently introduced the PSI at the implicit request of Nigeria and the Paris Club, because the Paris Club can not give its own seals of approval, and Nigeria would never agree to the conditionality associated with an SBA. Without this new instrument, the landmark October 2005 buyback of Paris Club debt would not have been possible. To the markets, though, the launch of the PSI was just the IMF and the Paris Club being quintessentially quaint. If the IMF wants to give its seal of approval, why can’t it just do it? And, why can’t the Paris Club set its own conditionality and write all its own covenants?

The success of the restructuring was further bolstered by a timely statement[7] from creditors based mostly in Trinidad & Tobago. Thirteen creditors, including one from Jamaica, announced they would participate “unanimously” in the debt exchange offer. According to Desmond Edwards of Trinidad & Tobago Unit Trust Corporation, “we find the terms proportional to the need for debt relief and commend the government for maintaining a constructive and transparent dialog.”

The exchange process culminated in a high acceptance ratio of 93% as of the first, preliminary deadline, and 97% as of the second, final deadline. The original offer was scheduled to expire on 26 January 2007, but was extended to allow “late” creditors to participate. Such minor extensions are commonplace during debt reschedulings. In any case, the deal closed quietly and as subsequently planned on 20 February 2007. Implementation of the Collective Action Clause enabled an effective increase in the acceptance rate to 98%, a 1.3 percentage point increase.[8] That is, the government was able to force 1.3% of non-complying or non-responding creditors to accept the terms of the exchange, thanks to the existence of the special clause. See also footnote 2.

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

[8] “Belize Closes Exchange Offer,” Government of Belize, Belmopan, Belize, 20 February 2007.

Conclusions:

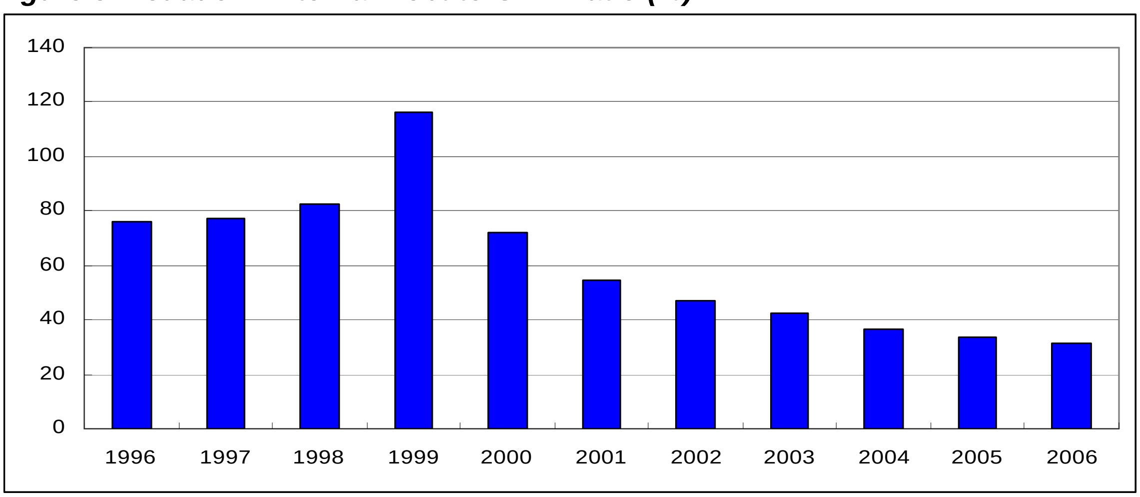
One can draw several conclusions from Belize's debt restructuring exercise:

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 (%)



Source: IMF.
Note: Depending on the year, private external debt has amounted to 15%-20% of GDP.

Though Correa's line of reasoning is often inconsistent, he takes comfort in the knowledge that some of the country's debt was originally contracted during periods of 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

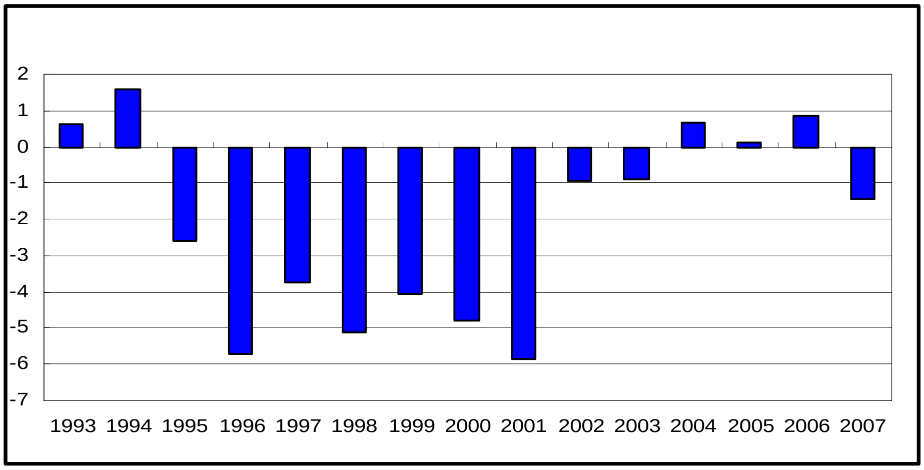
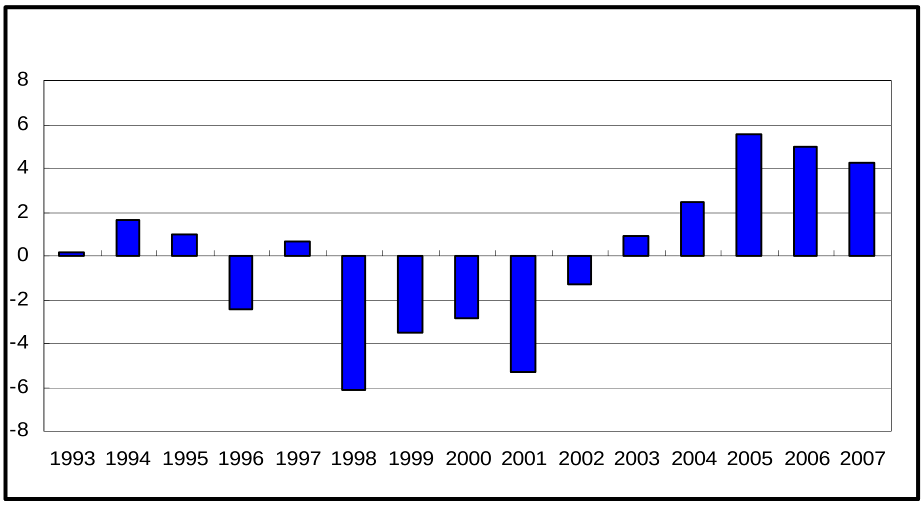


Figure 4b. Ecuadorean Sovereign Risk, relative to Ecuador's economic history



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.

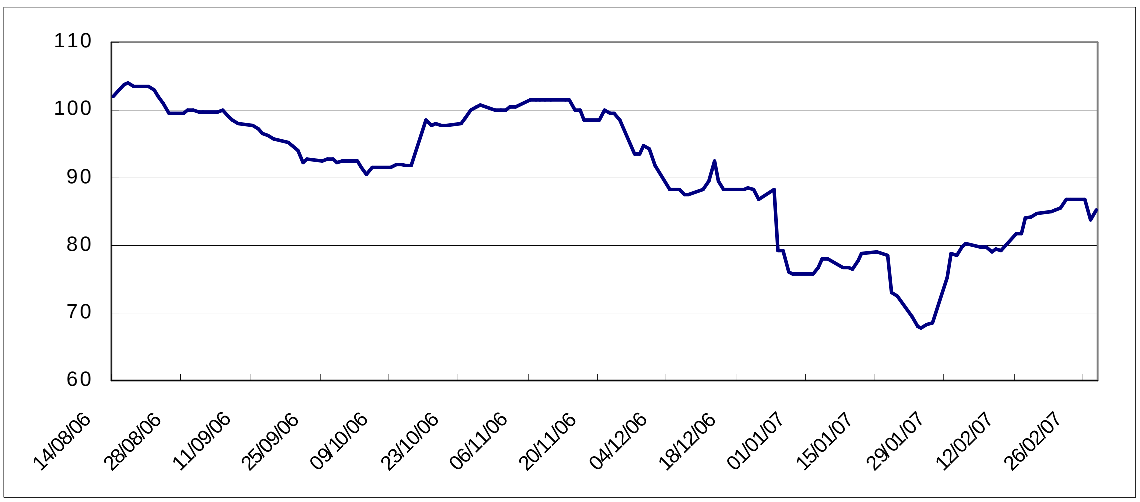
Institutional investors have participated repeatedly – and generally patiently – as the international official community has imposed the policy of Private Sector Involvement when sovereign indebtedness rises above qualitatively-determined unsustainable levels, in a practice known as "bailing in." At 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.

patient and wait for a realistic offer, or litigate, rather than to accept a first low-ball offer. Given this backdrop, few investors give President Correa the benefit of the doubt, and other seasoned observers have been unable to predict a path by which the debt could be rescheduled without significant economic hardship for Ecuador.

Nonetheless, the price of Ecuador's external debt has gyrated wildly in response to, first, political opinion polls and subsequently, public statements by the president-elect and his finance minister-nominee, Ricardo Patino. If an ounce of prevention is worth a pound of cure, Ecuador has had (at least) two ounces of protection in the form of high oil prices. One interpretation of the market volatility is that the market likewise sees no readily available cure, no less a pound.

Figure 5. Benchmark Bond Price, Ecuador Sovereign Bond Maturing in 2030



Source: Bloomberg.

Notwithstanding Correa's consistently tough stance, Patino has adopted a softer (albeit not soft) tone. Indeed, markets took comfort from another Patino hint – speaking after meeting with advisors from Argentina – that a rescheduling could be attempted along friendly lines, implying the proposed write-off need not be drastic. However, his reasoning has also at times been unpredictable.[12] For example, on 27 January 2007, local newspaper *El Universal* cited his opinion that speculators are driving up country risk as a form of "blackmail," when in fact it is a simple bond market definition that should a country be expected to receive a principal write-off on its external debt, country risk, as conventionally measured, would automatically rise. Rather, the reality is that financial blackmail would occur if speculators forced the market perception of sovereign risk to *decline*, because this would make a restructuring more difficult to pull off.

As the publication deadline approached, the situation remained fluid and the government continued to hint that it would sooner or later attempt to reschedule its debt. However, the

[12] In addition, Patino has floated the trial balloon of repurchasing some of the external debt. However, if the cupboard is bare, as he maintains, there are by definition no resources for a buyback. Meanwhile, it is constitutionally forbidden to raid the central bank for this purpose.

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 that would result from the policies he is promoting would by contrast leave less room for spending on priority areas. It is precisely this paradox with which President Lula began his first term: the financial markets expected an immediate default declaration, but he ended up being more fiscally cautious than his center-right predecessors.

Meanwhile, it would be extraordinarily difficult for Ecuadorean businesses to obtain trade credits if the sovereign defaulted. With the economy becoming increasingly export-oriented, this would be another tough blow to sustain. It therefore stands to reason that a default could threaten Correa's longevity in office and one has to question why he has been so stubborn in promising debt reduction. A final mockery is that a debt exchange offer pegged below market-equivalent prices would meet a low acceptance rate, or below levels which would validate the restructuring in the eyes of the international official community. The resulting disorder would inevitably be inherited by Correa's successor, whether near term or longer term. To paraphrase George F. Kennan, perhaps through his unconventional economic policies, Correa is sowing the seeds of his own destruction.[14]

Several lessons can be drawn by comparing and contrasting the behavior and style of Belizean and Ecuadorean politicians, sitting on opposite sides of the Panama Canal. One has to take note of President Correa's intent and willingness to shake up the establishment, which is entrenched and not necessarily interested in the well-being of the population. General Lucio Gutierrez, a center-right former coup leader, entered the presidential palace in January 2003 with similar intentions, but ended up being stripped of his political rights after less than two and a half years in power. Ecuadorean politics can be unkind to victims of power struggles, especially presidents. Moreover, the economy has performed poorly in recent years, despite encouraging international conditions and bull markets for its exports.

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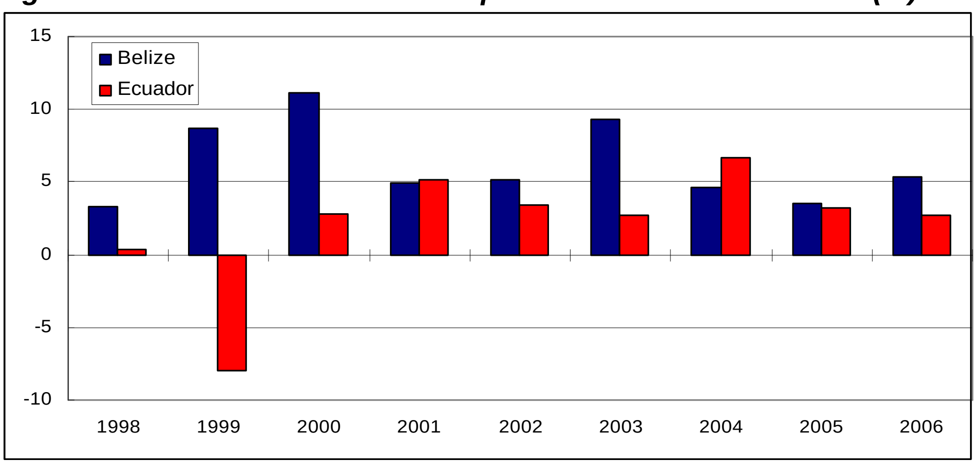
[13] Although the general government financial situation has been reassuring in recent years, it should not go without saying that central government finances have been strained and arrears have accumulated. However, this problem relates to organizational and distributional competencies, rather than the level and sustainability of external debt.

[14] Indeed, on 20 February 2007, President Correa threatened to resign if the outcome of the constitutional overhaul process proved unfavorable to him.

It is easy to sympathize with the plight of the man on the street, whose living standard has stagnated, while neighboring Colombia, Peru and Venezuela fare far better. However, it is misguided to blame Ecuador's problems on its external debt. As outlined in the IMF's Article IV Consultation,[15] "with the political environment highly unsettled, there was no progress on most of the critical issues discussed in the 2004 Article IV consultation. The elimination of the oil stabilization fund and changes to the fiscal responsibility law and pension system have weakened the macroeconomic policy framework. Ecuador should be doing more to take advantage of the favorable external conditions to strengthen the macroeconomic policy framework and advance structural reform."

As a left-wing politician, Correa would do better to follow the model of President Lula, rather than Chavez or Morales. Rather than confront international investors, the president would be better advised to divert financial resources and pay off as much of the external debt as possible, because this would be the best way of reducing Ecuador's sovereign risk to the greatest extent possible, and ridding himself of the need to interact with portfolio investors, if he finds them so objectionable.

Figure 6. Belize and Ecuador: Comparative GDP Growth Rates (%)



Source: IMF.

Brazil's economy has been performing well, but more to the point, standards of living have been rising beyond that which can be measured by conventional GDP measures. Inflation is modest, real interest rates are historically low and still falling and consumer access to goods and services has never been greater, as the economy becomes more and more efficient. Rather than entering office with default intentions, President Lula has become synonymous with prudent and conservative debt management. Indeed, Brazil has become a model for all emerging economies to follow. This is so much the case that former Vice Finance Minister Murilo Portugal recently joined the IMF as Deputy Managing Director, where one of his areas of responsibility is liability management.

[15] "Ecuador: 2005 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Ecuador," IMF, Washington, D.C., March 2006.

Just as it is no surprise that Ecuador has become the biggest serial defaulter of the past two centuries,[16] with ten, it is also no surprise that Prime Minister Musa did not want to be associated with the first major debt restructuring in his country's history. This perhaps explains why his administration was willing to undertake unconventional financing and refinancing steps in order to avert a default. Away from liability management, Belize is one of the more opaque countries when it comes to economic policy implementation, albeit on a small scale. Even so, the standard of living, as well as GDP performance, is respectable by regional standards. In recent years, the floor on GDP growth has been around 3.5%, well above the ceiling in Ecuador, which has been 3% most years.

Both countries are oil exporters, although of vastly different magnitudes. Ecuador's public sector benefits from oil exports to the tune of $2.5 billion per year, according to 2006 estimates (IMF). By contrast, the figure for Belize is likely to be no higher than $25-30 million per year, starting in 2007 or 2008. There was a long debate in Ecuador about the optimum use of this windfall, once the world price of crude began to skyrocket in 2004, but politicians ultimately decided that oil revenues were too valuable to waste on an item as abstract as foreign debt reduction. By contrast, the first inclination of Belizean authorities is that their modest windfall should be used to improve the country's balance sheet. Once that has been accomplished, they can think about throwing a party.

Figure 7. Number of Defaults or Restructuring Episodes, 1801 to present

Country	**Total Number**
Ecuador	10
Venezuela	9
Mexico	8
Spain	7
Germany	7
Brazil	7
Colombia	7
Liberia	7
Peru	7
Turkey	7
Portugal	5
Argentina	5
Bulgaria	5
Greece	5
Chile	4
Russia	4

Sources: Reinhart, Rogoff and Savastano (2003) and Standard & Poor's *Credit Week*.

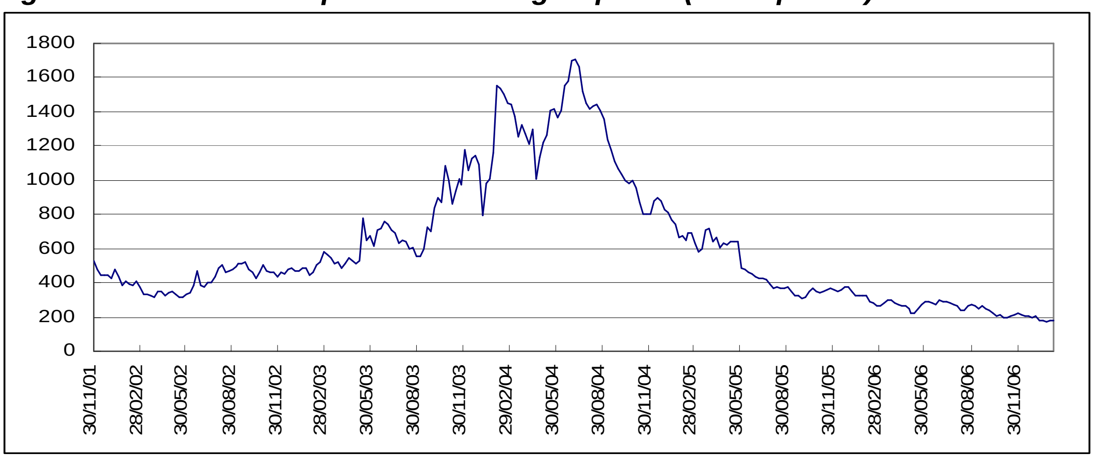
[16] Figures can be found in "Debt Intolerance," Carmen M. Reinhart, Kenneth S. Rogoff and Miguel A. Savastano, NBER Working Paper Series, NBER, Cambridge, Massachusetts, August 2003. In our calculations, we assume President Correa will eventually carry through with his threat to default.

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 the GDDS and emerging market borrowers launched investor relations programs. Mexico became an early bellwether, becoming among the first to adhere to a regular data release calendar, publishing daily banking sector data, and holding quarterly investor conference calls. Many countries soon followed, using Mexico as a model, of course.

The Institute of International Finance (IIF) has been a leader in promoting these programs, regularly publishing best practices and ranking countries[17] in terms of investor relations effectiveness. While such efforts are commendable (and there is no such thing as bad transparency), investors implicitly place little value on them. As an example, the sovereign spread of Dominican Republic bonds (third from bottom in the survey, see Figure 9) was 194 basis points as of 28 February 2007, only slightly above Colombia (175 basis points), which was ranked in the middle of the pack. Meanwhile, two of the riskier countries, Brazil and Turkey, were ranked first and sixth, respectively. In addition, Argentina was once the poster child for data transparency: if Mexico was most famous in the late 1990s for investor relations, Argentina was second. Everyone knows how it treated international investors when push came to shove.

Figure 8. Dominican Republic: Sovereign Spread (basis points)



Source: JP Morgan.

Indonesia was voted second most improved by the IIF and placed fifth overall. However, the market for Indonesian sovereign bonds is limited, as most public sector debt is either government-to-government or local-currency denominated. Although the *country* has plenty of foreign debt, it is mostly sub-sovereign, and certain Indonesian companies are well known for treating corporate governance principles with disdain (which therefore reflects poorly on the entire corporate sector). As a result, it would be misleading to read too much into Indonesia's most-improved status. Finally, South Korea ranked second in

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[17] See "Investor Relations: An Approach to Effective Communication and Enhanced Transparency," Institute of International Finance, Washington, D.C., September 2006.

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 this will make a significant difference to investors, over time. It would also be misleading to suggest that Ecuador is viewed as risky because of mediocre investor relations. Too many other economic policies are sub-standard for opacity to be a major factor in deterring portfolio investors from incurring exposure.

Admittedly, it is possible that investors do attach substance to investor relations: with Dominican-quality transparency, Turkey could be viewed even riskier. Then again, there is both a supply and demand side to transparency. The economic and financial situations of most sovereign borrowers are "over-researched" by analysts in New York, London, Hong Kong and so forth. In addition, finance ministers and central bank governors are regular fixtures at seminars organized by leading investment banks coinciding with multilateral development bank annual meetings, as well as at capital-raising roadshows.

Figure 9. Investor Relations and Data Transparency Index (Best Practice = 80)

Country	Sep '06 Score
Brazil	75
Chile	71
Mexico	71
Turkey	70
Peru	68
South Korea	67
Philippines	63
Indonesia	58
Poland	58
Thailand	54
Bulgaria	53
Uruguay	49
Colombia	48
Egypt	43
Venezuela	41
Malaysia	38
Ukraine	33
Ecuador	32
Russia	29
Belize	21
Dominican Republic	15
Vietnam	13
China	11

Source: Institute of International Finance.
Note: 23 of the 32 ranked countries are presented in this table.

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?"

In his speech, Mr. Boorman was debating four workout approaches: the Sovereign Debt Restructuring Mechanism, Collective Action Clauses, the two-stage process proposed by two officials from J.P. Morgan and the then-existing "muddle through" process. Although closely associated with SDRM, Boorman presented the merits and shortfalls of each dispassionately. Now that four-plus years have passed and calmer heads have prevailed, it is a good occasion to reassess the landscape. The SDRM died a quiet death, given insufficient international support. On the one hand, it was counterintuitive that a public sector institution such as the IMF should stand between an official sector debtor and private institutional creditors, without any meaningful legal basis. On the same hand, the IMF was in an obvious conflict of interest situation,[19] because it would in most cases be a creditor to the same debtor nation(s).

On the other, there has always been a role for an independent international arbiter and clearing house of information, whether this would be a standing committee of wise men, a division of the IMF, or a joint multilateral consortium.[20] It is a shame that all the king's men could not see through the fog of debt wars to find this gap in the international financial architecture. At present and for the foreseeable future, "information asymmetries" will be the enemy of quick and painless debt restructurings. However, as pointed out above, it is never too late to make policy amends. In addition, the debate sponsored by the launch of the SDRM proposal galvanized the private sector to do something meaningful, as the muddle through scenario was clearly not sustainable. The J.P. Morgan two-stage proposal, while well meant, was also not practical.

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[18] "Sovereign Debt Restructuring: Where Stands the Debate?" speech by Jack Boorman, presented at a conference cosponsored by the CATO Institute and *The Economist,* New York, 17 October 2002.

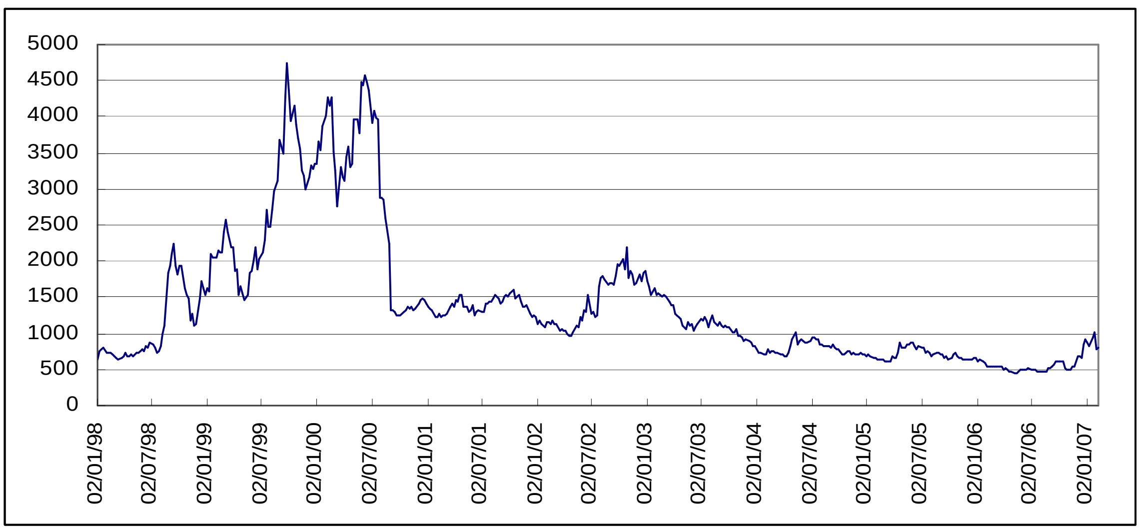
[19] Argentina is an excellent case in point. President Kirchner and his aides consistently and accurately insisted that they had little room for manoeuvre with regard to private foreign creditors because of the substantial sums owed to the IMF, for which no debt relief was possible.

[20] The OECD-BIS-IMF-World Bank joint database on external debt is a good example of multilateral collaboration. However, the database has become less user-friendly over time.

This left the Collective Action Clause proposal, which was swiftly and universally adopted by the international bond markets. Some are concerned that it is helpful on an individual bond basis, but not necessarily for the entire universe of a country's bonds. In addition, the clauses are enclosed only in recently issued bonds (*ie*, existing bonds were grandfathered). However, it is neither practical nor fair to make non-trivial changes to the legal rights of creditors without their consent. This was a shortfall of other proposals, such as SDRM. Over time, the vast majority of sovereign bonds will include the Collective Action Clause, and international policymakers will be able to sleep soundly.

Meanwhile, it is worth pointing out that the financial markets are concerned about prospective policy actions in Ecuador, but given historical perspective, no particular excitement is in evidence. Although this may sound provocative, President Correa will need to raise the rhetoric a lot more to get the markets to really panic. Its sovereign bonds were perceived to be far riskier in the second half of 2002, or during the last regularly-scheduled presidential election campaign. Lucio Gutierrez had been viewed by the markets as a default-risk candidate, but proved centrist during his brief time in office.

Figure 10. Ecuador: Sovereign Spreads (basis points)



Source: JP Morgan.

A principal benefit of the Collective Action Clause is the disincentive for rogue creditor action. To the extent that such behavior causes debtors to dig in their heels, it creates a more hostile rescheduling environment overall. It is counterintuitive that non-rogue investors should subsidize rogue investors, although New York law (the domicile for most sovereign bonds) "is what it is," and it is sensible that there be reasonable checks and balances on the behavior of both debtors and creditors. Some investor groups have complained about debt renegotiation formats. However, it is the outcome of the negotiation, or exchange offer, rather than the form, which should concern them. In addition, the success or failure can not be predicted in advance. Most relatively recent reschedulings, from Ecuador, Uruguay and the Dominican Republic, to Argentina, have given investors what they deserved – perhaps even more. Iraq may be an exception, but that case stands apart as a political unavoidability.

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-equity swap: the Paris Club has been promoting such swaps with varying degrees of effort for close to ten years. The negotiations made some progress, but were never completed due to the complex internal political environment in Zambia.

Although the figures publicized by interested parties seem striking, a little perspective is in order. First, the amount paid by DAI to Romania is not very relevant, because the debt was purchased at a time when this economy was going through a hard-currency crisis,

[21] Indeed, few sophisticated market participants understand the definition of "comparability," and how it is applied in practice.

[22] The Paris Club's Comparability Clause is arguably incomplete, because new financings are exempted. Logically, comparability suggests new financings should be at subsidized interest rates as long as a Paris Club debt relief treatment is in place.

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 an official reserve stock of \$720 million, as of December 2006, should not be considered onerous. With a population of 11.7 million (according to December 2005 estimates), Zambia is well off by African standards, using hard currency as a yardstick.

Third, given the history of governance in southern Africa, one should not automatically take for granted the history of facts and prognosis provided by the debtor country. Fourth, the Zambian government has been actively marketing its local currency Treasury bills to foreign investors in recent years, and it is counter-intuitive that one type of foreign investor is a friend and another (who in practice could be the same person) is an opportunistic "vulture." Moreover, countries such as Zambia have carte blanche to borrow from middle income countries such as China at non-subsidized rates. Fifth, given that the original trade credit was for the purchase of tractors, the common claim that much HIPC debt relates to goods or services which the creditor knew would be of little value to the debtor, clearly does not apply in this example. It is almost absurd to suggest that a country such as Romania would have been morally obliged to donate tractors to a country such as Zambia in 1979. In sum, and as argued elsewhere in this paper, rogue behavior is to be discouraged, and incentives should be framed accordingly. However, conclusions about individual cases should not be drawn before any analysis is done, particularly when it is not immediately clear who is the bigger rogue.

Please also refer to the disclosure note on page 25.

Accounting practices of the constituent Paris Club members, are, likewise surprisingly opaque and inconsistent. Along these lines, debtor nations are in the habit of automatically approaching the Paris Club first (although not Argentina), and it is also fair to ask whether this quaint practice could benefit from creative destruction. Although different hard currency creditor groups will have different interests, it is worth debating whether all distinct groups should start the debt rescheduling process with a grand meeting, perhaps coordinated by the international wise men introduced above, so that all major creditor groups have the same information. Such a standing committee of wise men would be the enemy of information asymmetries, which can only be beneficial. With this in mind, it is sensible that if one creditor group is dominant, it should lead the process, because to proceed otherwise will be to allow distortions to creep in.

Bail-outs should be discouraged, but not banned. For example, if a bail-out would be of clear benefit to a country, it should go ahead regardless of whether a private investor is taking unfair advantage of moral hazard. Deterrence of moral hazard is to be encouraged, but it can not be the sole basis of operating an international financial system. Meanwhile, the debate about bail-ins, and whether they are desirable, should continue. Now is an 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 from ivory towers. At present, there is little clarity about the extent to which rogue debtor (toward external private creditors) behavior should be allowed to influence the IMF’s broader decision-making process, and whether loud and large voices are supposed to drown out quiet and small voices. It would be helpful if debtor countries would listen to fellow sovereigns when the former acts counterproductively. To paraphrase Mr. Boorman, how might a framework be designed that disincentivizes sovereign debtors from abusing the system?

Finally, the time is ripe for re-evaluating the concept of preferred creditor status. It seems logical that the IMF’s lender-of-last-resort type facilities, at sub-market rates, should be immune from rescheduling except in isolated cases. However, there is no readily understandable legal basis for its status as preferred creditor, regarding some of its other loans. In addition, the World Bank seems to benefit from me-too rights because it is the other Bretton Woods twin. Both institutions may well merit their present status, given their long-standing and generally-beneficial place in the international financial system, but an overdue debate about their status should not be taboo. With the decline in its lending activities, the IMF’s income has fallen sharply. This has prompted a thorough review of its funding base and an airing of the once-unthinkable suggestion that it should charge for some services. If one long-held taboo can be broken, perhaps another can be, too.

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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 Advisory International, which is mentioned in Box 2.

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.