LESSONS FROM ECUADOR (AND SOME NEIGHBOURS)

“We Have Been Here Before”

London, 20 February 2012

Thank you very much for this invitation and, above all, thanks to the organizers – the CAF and the University of London – for organizing this seminar in the first place. It is important that they have done so, because – to the best of my knowledge – this is only the second such seminar, i.e., on “lessons” from other parts of the world, organized in Europe – and both were called by non-euro area entities. The other such conference was last October in Madrid, convened by two essentially non-EU organizations – the IDB and the IberoAmerican General Secretariat, run by Enrique Iglesias, and here we are today thanks to the CAF and the University of London.

The fact that it did not occur to any Eurozone entity to do the same is telling – it is an indication of what has and is going wrong with the management of the eurozone crisis. That is, the very fact that European policymakers, in a truly misplaced sense of pride, have over and again *refused* to look at lessons from elsewhere – be it from Latin America, Asia, or from the IMF’s own decades-long experience in crisis management and resolution. This eurocentric attitude prevailed from the very start, with the obstinate refusal to turn to the IMF at the outset of the Greek crisis, and it has persisted throughout. It has entailed a very costly “learning-by-doing” process (illustrated by the PSI saga) and it also risks leading to a flawed design of the European Stability Mechanism (ESM), the eurozone’s future permanent crisis financing mechanism, where there has been hardly any (if indeed any) input from outside.

The point is that Europe simply does not seem to recognize that “we have been here before” – the heading of my intervention.

The phases of crisis management

A lot has already been said about the Latin American experiences, especially the “large” cases of Mexico and Brazil under Brady, and the Argentinian episode/saga. I will thus look mainly at other cases, including some smaller countries, some of which also more recent in time.

A helpful way to consider cases that are very diverse amongst themselves is that of placing them in a continuous spectrum of the different phases of "debt crises and debt rescues" – the subject of our conference.

These phases can be seen to range from precautionary, crisis-averting arrangements (where Brazil, Colombia and Mexico all offer relevant experiences at different times), to – once the debt crisis bursts – voluntary debt exchanges that take place pre-emptively, before an actual default (such as Uruguay in 2003), going through to unilateral defaults (that can be more or less aggressive), with Argentina and Ecuador providing the most significant examples. I was asked to cover Ecuador in particular, and will thus dwell on it a little longer.

1. *The Early Phase: Crisis Prevention and Precautionary Arrangements*

A common characteristic of all the more successful adjustment programs, in Latin America and elsewhere, has been that of early intervention. As put by Alfonso Prat-Gray, ex-Governor of Argentina's central bank, in an FT article:

"*One thing we have learned from our region's experience is that piecemeal, time-buying strategies always end up in a messier outcome – and almost always in the messiest possible one."*

Europe's approach to date has indeed relied essentially on a "piecemeal, time-buying strategy" – epitomized in what has now become a hackneyed phrase for the EU's handling of the crisis: "kicking the can down the road."

In contrast, let us briefly review **a few cases of successful preventive action in Latin America**.

The first is **Colombia's use of so-called enhanced surveillance procedures** with the IMF. In the mid-1980s, Colombia asked the Fund (1) to certify that its own, internally designed adjustment program was strong enough to qualify for Fund financial support, if requested; (2) to monitor and evaluate progress exactly as if a stand-by arrangement were in place; and (3) to release both the staff report and the Executive Board's evaluation to its creditors. In other words, the authorities sought to have the Fund's "seal of approval" even in the absence of a formal Fund loan. Thanks to this approach, Colombia was able to maintain its access to international bank credits, obtaining both rollovers and new money, and to avoid a debt rescheduling, all the while not borrowing from the Fund (and escaping the related stigma), thus setting itself apart from its less virtuous neighbors.

There is here a first lesson: **the usefulness of procedures that can provide markets with positive, confidence-inducing signals that can avert the need for actual official financing**. A similar set-up could for example be conceived, either under EU or IMF procedures, for euro area countries where financing may not (as yet) be needed, but where confidence could be strengthened by positive assessments under periodic monitoring reports. To be specific, it could, for example, have been a formula for the quarterly monitoring requested by the G-20 for Italy in early November 2011, when the Berlusconi government was still in office. The advent and reform action of the Monti government has (hopefully) rendered the need for such tight monitoring moot in the case of Italy at this point, but it may arise anew or elsewhere.

Another case of early, pre-emptive intervention is that of **Brazil in 2002**, when the IMF committed unprecedented amounts of financing at a time of great market uncertainty. As the October 2002 elections drew closer, the fear of unorthodox economic policies under a Lula government induced both foreign investors and wealthy Brazilians to withdraw their assets from Brazil. To stem these developments, a decision was taken to provide a signal of continuity via a program supported by a bumper credit to Brazil, of $30 billion – far larger than expected to impress investors (an approach, incidentally, suggested by Tim Geithner, who was then on the IMF staff). This was a difficult decision at the time, and many saw it as the Fund taking undue risks. As it turned out, the risks did not materialize, and the experience is since often cited as a model of successful early intervention, via the mobilization (but not the utilization; as Brazil never drew) of considerable firepower.

A second lesson, that emerges from this approach, is that **official financing should be accessible early, pre-emptively, and in sufficiently large amounts,** to function as a firewall that, thanks to its size, remains untested.

This has not been the European approach, where official financing has for a long time been seen as the last resort, an *ultima ratio*, to be provided only once all other options have dried up. This approach is clearly unmindful of the fact that delays are costly for all, ultimately requiring both more financing and sharper adjustment.

It also runs counter to what was, and is, being done at the international level, supported incidentally by the EU Directors in the Fund. There steps were taken in the *opposite* direction of an *ultima ratio* approach. There was, for example, increasing recourse to the Fund’s Emergency Financing Mechanism in order to respond rapidly – for example in Hungary, Latvia and Iceland in late 2008, where arrangements were approved within three and a half to six weeks of the initial indication of interest by the authorities (contrast that with the seven months it has taken to develop Greece's second package, perhaps being at last finalized as we meet). Also, the Fund has been expanding its crisis-prevention toolkit to include early intervention mechanisms, with an enhancement in 2009 of its Flexible Credit Line (FCL) – which is designed to provide insurance against external shocks to countries with strong economic policies. More recently, the IMF also introduced a Precautionary and Liquidity Line designed for similar purposes to meet flexibly the liquidity needs of countries with sound economic fundamentals but with some remaining vulnerabilities. In motivating the facility, IMF staff explicitly referred to "possible global repercussions from the ongoing turmoil in the euro area."

This brings us (after Colombia in the mid-1980s and Brazil in 2002) to **a third example that Latin America offers of successful pre-emptive action to avert crises**, and that Europe would do well to assimilate. Of the three countries that have to date accessed the **Fund's precautionary Flexible Credit Line**, or FCL, two (Mexico and Colombia) are from Latin America (the third being Poland) – all of them without drawing.

Mexico in fact pioneered the FCL in April 2009, and since then has had three successive Flexible Credit Line arrangements (currently with an access equivalent to US$73 billion). Similarly, Colombia was granted a FC line in May 2009, and is now also at its third successive FCL arrangement (for an amount of US$6 billion). The FCL is deemed by these countries' authorities to have added an important layer of protection, sustaining market confidence in uncertain times, by providing a significant buffer against potential tail risks during the severe global crisis of these last few years.

As regards the one European country with an FCL arrangement in place since May 2009 – Poland, in an amount now of some US$30 billion – it today enjoys a spread vis-à-vis German bunds that – at under 300 basis points – is significantly lower than that of either Italy or Spain.

Notwithstanding these positive experiences with precautionary credit lines, Europe took a long time before recognizing their potential, and it was only in July 2011 when – faced with a continued deterioration of the euro crisis – EU leaders shifted from an initial position that circumscribed the EFSF's and future ESM's mandate quite narrowly, extending the mechanisms' range of interventions to include also precautionary lending, as well as the financing of bank recapitalizations, and interventions on both primary and secondary debt markets. Leaving aside the non-trivial point of finding resources for all of these facilities, there is another procedural difficulty, arising from the need to reconcile different decisions taken over time on these funds' range of interventions and related conditionality. One encounters here a typical manifestation of "time inconsistency" – a situation where a decision-maker's preferences change over time in such a way that what is preferred at one point in time is inconsistent with what is preferred at a later point in time.

Let me briefly illustrate. The first basic legal text for the ESM was approved in March 2011 – i.e., before the July decision to extend its range of interventions. To avoid the political complications of a new Treaty and related referenda, it was agreed then that the ESM could be set up by adding a paragraph to Article 136 of the Treaty on the Functioning of the European Union (TFEU), via what is known as the "simplified revision procedure." The wording of this paragraph reads:

"*The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality*."

As is apparent, this language sets a high bar for the activation of the ESM (only if "indispensable" to safeguard overall euro area stability), and is tough on the required conditionality (with "*any* required financial assistance... subject to *strict* conditionality"). Indeed, a strict interpretation of this text would seem to rule out precautionary lending, amongst other things. So, despite the widespread emphasis in the present debate on the need for strong firewalls to contain the spread of contagion to countries such as Italy and Spain, the language can be read as barring pre-emptive action by the ESM to ring-fence a member that still has access to private financing and does not as such present a risk to "the stability of the euro area as a whole," nor requires the imposition of "strict" conditionality.

As noted, subsequent to the adoption of this text, in July 2011, the eurogroup decided to significantly expand the range of activities of the EFSF and those of the future ESM. But these expanded activities now needed to be reconciled with the narrow scope of the ESM's initial mandate. This entailed some creative, but ambiguous, drafting in the final version of the ESM Treaty signed in early February 2012. In particular, on conditionality, the final version of the Treaty has tortured language of this sort: "the ESM may provide stability support to an ESM Member subject to *strict* conditionality, *appropriate* to the financial assistance instrument chosen. Such conditionality may range from a macro-economic adjustment program to continuous respect of pre-established eligibility conditions." But "strict" and "appropriate" sit oddly together, and the concept of pre-established eligibility, which is fully reasonable, is generally understood to apply to strong performers, caught up as "innocent by-standers," and thus deserving of low, if any, conditionality.

In this setting, there is a risk that the tension between the general provision allowing creation of the ESM and the specifics laid out subsequently in the ESM Treaty, based on a wider mandate, could induce some Member States, or at least their Constitutional Courts, to invoke a strict interpretation of the TFEU's Article 136 and hinder any intervention beyond direct stability support. Consequently, some key crisis prevention or management tools – that showed themselves to be useful in Latin America – do not appear to be readily available in the ESM's arsenal – or, in any event, their deployment risks being subject to lengthy negotiations or complex legal debate, with associated delays.

2. ***The Debt Restructuring Phase: Pre-Default and Full Default***

So much, then, for the early phases, those of precautionary or preventive approaches to debt crises: Europe seems ill-equipped, both in terms of overall approach and of actual practical procedures.

So, what about approaches for when the debt crisis has *not* been averted, and indeed develops – as so often happens, but so seldom is recognized – into a solvency crisis, requiring debt restructuring? Latin America of course offers ample material on debt restructuring, with the Latin American and Caribbean region having experienced over 25 restructurings in the last 35 years, and about 10 since 2002. Given this wealth of material, I will focus narrowly on the more recent cases of restructuring of *bond* debt – the issue at hand in Greece and potentially elsewhere in the euro area.

Pakistan became the first country in the modern era to restructure sovereign bonds, in 1999, followed by the Ukraine, **Uruguay**, and the Dominican Republic. These cases all made recourse to the **traditional tool of a bond exchange offer**. They did so in a **pre-emptive manner, before an actual default**, and successfully so. Their experience suggests the importance for a debtor country to get ahead of the game and make a constructive offer while its adjustment program is still on track, rather than wait until its hand is forced. By putting generally reasonable offers on the table, these countries managed to have between 90-99 percent of bondholders participating, and within a relatively short time span (the Uruguay 2003 offer was one of the shortest restructuring processes, lasting only three months). The concern about "free riders" was largely contained, and creditor litigation was avoided.

Another feature of these exchanges was the **presence of international support**. Again, in the case of Uruguay in 2003, this came most notably from the

U.S., not only in bringing on board the rest of the G-7, but also more concretely via bridge loans and guarantees. This contrasts markedly with the prevailing Greek-German antagonism. Such “big brother” backing placed debtor countries in an appreciably stronger negotiating position vis-à-vis their private creditors than that enjoyed by Greece today.

At the same time, however, it has to be recognized that **such exchanges are unlikely to yield a significant discount**. These voluntary, pre-default restructurings rarely saw creditors ready to go beyond a “lite” or modest reprofiling of maturities, with little impact on net present value (NPV). Uruguay’s exchange consisted in a five-year lengthening of maturities, with no haircut to principal or change in coupons, and resulted in an average 20% reduction in NPV. This approach is therefore fine where the debt overhang is not too large. It is obviously far too late, and its likely results anyway insufficient, for Greece. To put it bluntly, Greece in 2012 is simply not Uruguay in 2003.

As we know, next to these voluntary operations, Latin America also saw *other* approaches that were essentially **unilateral defaults**. What is in fact interesting to note, in looking at the spectrum from voluntary exchanges to unilateral defaults, is that restructurings are somewhat “bipolar” in this way – either voluntary/friendly or unilateral/aggressive – and that the NPV reductions obtained (based on data from 202 sovereign debt restructurings) show a distribution with very fat tails, with one half of the haircuts either lower than 23% (the pre-emptive restructurings) or higher than 53% (the aggressive ones).

The most notable cases of unilateral defaults in Latin America are Argentina and Ecuador. We have already heard about Argentina from Roberto Frenkel. As to Ecuador, it provides two salient experiences, in 1999 and 2008 – the first of these is of the “less aggressive” variety, and the more recent one definitely more antagonistic.

Ecuador’s 1999 episode had some important “firsts”: it was the first restructuring to cover Brady bonds and Eurobonds governed by New York law (the strictest around), and the first to cover bonds that were included in standard indices of emerging country debt. It was also the first to take place well after initial default – in fact, almost a year after the suspension of payments (in contrast, the cases of Uruguay, as well as Pakistan and Ukraine, took place while the debtors were still current on payments). But one of the more noteworthy, and possibly controversial, aspects of Ecuador’s case was the role of the official community, and notably the IMF. The Fund granted Ecuador a stand-by arrangement in May 2000, when it was already in arrears, and proceeded to implement its “lending into arrears” policy, whereby it gives support to a member provided it is making good faith efforts to reach collaborative agreement with its creditors. Whether this could be said of Ecuador at the time is debatable – but most observers agree that the fact that Ecuador's unilateral default in 1999-2000 was relatively orderly and litigation-free, is attributable to the backing that the official financial community provided the debtor country while it was negotiating.

It took the IMF a long time to develop its "lending into arrears" policy, and it is difficult to envisage the ESM fitting this approach into the straitjacket of the ESM Treaty, but cases could well arise where Europe should be ready to provide supportive backing and some form of "lending into arrears" as a member undertakes good faith negotiations with its private creditors – unless it wishes to perpetuate a situation, observed in the case of Greece, in which private sector creditors hold a program hostage, forcing the public sector to fill the gap until it remains virtually the only creditor.

Finally, just a few words on the **most recent restructuring episode on the part of Ecuador – by now a "serial defaulter" – that of 2008**. It was another landmark case, because it was the first so-called "strategic" default, that is a default not caused by an inability to pay. Ecuadorian President Rafael Correa, who had campaigned on a platform of debt repudiation, appointed an audit commission on the national debt, which in November 2008 came to the conclusion that much the country's $10 billion debt had been 'illegally' acquired by past administrations, and was thus 'illegitimate.' The President accordingly announced that the country would not be paying interest due on some of this debt – despite ample reserves from high oil prices. After expiry of a grace period, Ecuador formally entered into default in mid-December 2008. In April 2009, it launched a cash offer to repurchase some of these bonds. Despite initial skepticism, this offer was in the end highly successful, with a final price (35 cents) close to the initial offer, and with 91% participation.

Actually, it was a spectacular success – I will not go into all the details of why this was so, which included astute timing and aggressive, albeit questionable, repurchases on the secondary market by an intermediary, the Banco del Pacifico. The fact is that, despite its antagonistic nature, the operation was described by Felix Salmon in the FT as "probably the most successful and least fraught debt restructuring in the history of Latin American sovereign defaults."

As to the reputational costs and the availability of external financing, Ecuador has (predictably) not returned to the markets, but China has rushed in: it has lent an estimated $7.25bn to Ecuador – 16 per cent of GDP – some of which is tied to oil exports. And President Correa is still in office, having won re-election comfortably.

At first blush, one would think the Ecuadorian case has little relevance for Europe today, and one would probably be right. Still, one can be a Cassandra – just to evoke Greek mythology – and contemplate the following. As noted, at the center of the Ecuadorian case is the issue of the legitimacy of the defaulted debt. Can we really be sure that, polarized elections – such as potentially those in Greece in April – will not see the advancement of extremist forces that similarly question the legitimacy of debt incurred by previous administrations, or the legality of arrangements that are judged to impinge on Greece's sovereignty? And that there will not be a Greek equivalent of Ecuador's Debt Audit Commission (*Auditoría de la Deuda*), with Greece then proceeding to full-scale default, encouraged also by what are perceived to have been relatively low costs for Ecuador? As one market observer has put it: "As much as we can say Ecuador is an outlier, any country which runs into trouble now has a great blueprint of how to do it." Ecuador has indeed created a precedent.

And on that last non-lesson, let me conclude and thank you all.