A BRADY BAIL-IN FOR ECUADOR

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1. A Brady Bail-In for Ecuador

Ecuador's failure to service part of its Brady debt by the end of September 1999 and its missed payment on $500 million in eurobonds in November were precedent-setting events, which conformed to the IMF's desire to incorporate burden sharing into the private bond market. On 30 September 1999, the small Andean nation earned itself the infamous distinction of becoming the first country to default on its Brady bond obligations. Although other countries have restructured their payments in the past none had ever missed one until September. Surprisingly, there was no preemptive emergency assistance package from the international community. In acquiescing to the nation's decision to default on its debts, the International Monetary Fund (IMF) invites questions as to why, after so many high profile bailouts, it allowed one country to fall through the cracks. This situation is particularly curious when one considers the invaluable role Brady bonds have played in helping Emerging Market Economies (EMEs), and Latin American counties in particular, overcome the constant cycle of debt crises that characterized the 1980s. Why would the IMF, the U.S. Treasury, and Group of Seven (G7) industrialized countries risk undermining investors' confidence in this invaluable instrument?

There are several factors which contribute to Ecuador's decision and the international community's ambivalence toward it, but all hinge on the persistent accusations that recent IMF interventions have created an unsustainable condition of "moral hazard" which must be restrained. Pundits claim that the Fund framed Ecuador as a test case of requiring private investors share the burden of debt restructurings and as a precedent-setter for the orderly workout of such difficulties. This maneuver—a defection from the role of the anchor of the Brady bond market to the villain which undermined it—invites much criticism and carries incredible risk, especially a collapse in long-term debt financing to emerging market economies. However, the potential benefits to the global financial system in obliging more responsible financing decisions and in assuring a more systematic approach to debt restructuring offer potential stability to the international financial architecture which—after years of turmoil—would be welcomed by all parties involved.

2. The Brady Solution

When Treasury Secretary Nicholas Brady proposed a new means of overcoming the debt crises that had plagued developing countries during the "lost decade" and restoring the creditworthiness of these heavily indebted countries he understandably faced tremendous skepticism. Since mid-1982 much of Latin America had been suffering through one of the most serious economic crises since the independence movements of the 1820s. At the end of 1987 per capita income was nearly six percent lower than the same figure in 1980 and purchasing power had been declining for a decade. Debt servicing was draining an extraordinary amount of resources from the region, further depressing the struggling economies (Devlin 1989, 2). Numerous proposals for reversing this trend had come and gone with no success. In 1987 James Baker planned a "Program for Sustained Growth (Baker Plan)," which called for $29 billion in new loans to fifteen problem countries of which $20 billion was to come from private banks (ibid). Much of these new loans and forced rollovers were involuntary and even under the best scenarios extended only a short duration of relief.

The new Treasury secretary's approach was radically different. In March 1989 Brady proposed allowing EMEs to securitize their commercial bank loans into longer term sovereign instruments and extending official credit on the condition of promises for structural reforms. Brady realized that the short maturities of financing under previous rescue attempts and work-out arrangements never seemed to give the EMEs enough time to get their economies back on track (Molano 1999). The Brady Plan, on the other hand, has been successful in breaking the cycle of re-negotiations which inevitably became necessary when voluntary external lending and economic growth did not return quickly enough to facilitate debt servicing.

The expansion of the Brady bond market was therefore one of the greatest financial developments of the 1990s. The main tenets of the plan have been IMF mediation, flexibility, and debt reduction rather than provisioning additional credit. In order to qualify for a Brady restructuring a country must establish an IMF approved reform plan and negotiate its Paris Club arrears (ibid). While reaffirming the basic ideals of the Baker plan—a case by case approach involving the implementation of IMF-sponsored reforms and new private and official credits—the new approach advanced a process which sought a long-term solution rather than stop-gap measures. The Brady plan emphasizes principal write-downs and interest reductions more than new credits. Once a country receives the Fund's endorsement it is qualified to exchange its bank loans for a basket of sovereign paper, much of which is partially collateralized by U.S. Treasury Securities. This plan gives investors the freedom to choose options that "best fit their tax, regulatory, and accounting situations, as well as their view on interest rates and the countries' prospects" (Clark 1993). Creditors have the opportunity to decide among par bonds, discount bonds, and new loans. The par bonds or Debt Service Reduction Bonds (DSRBs), are long-term—ten to thirty year—instruments which carry a below market interest rate. Banks could also choose to swap their loans for the discount variety, Debt-Reduction Bonds (DRBs), which are usually issued at a discount to face value of thirty-five percent (Ecuador negotiated a 45% discount) and bear an interest rate of LIBOR+13/16 (Unal et al. 1993). The principal of these Bradys is fully secured by U.S. Zero-Coupon Notes while an additional twelve to eighteen months of interest payments are often backed by AA- or higher rated bonds in an escrow account in New York. Creditors who decline to participate in either Brady option have been required to provision new loans equal to one-quarter of their previous exposure to that country to enable the sovereign debtor to repurchase old loans and make restructuring payments (Molano 1999).

After their initial successes Brady deals became more attractive to investors, thereby increasing the bargaining power of the debtor countries. Creditors granted greater leniency to the borrower by dropping requirements that countries raise all the collateral, past-due interest (PDI) and rolling-interest guarantees (RIGs) prior to closing the books. In later deals the debtor has been allowed to phase in the RIGs, the PDI has been securitized as well, and the government has determined the proportion of DRBs and DSRBs to be issued. The flexibility of the plan is bolstered by assuring the debtor the possibility of greater debt reduction through swaps for new instruments, debt buybacks at market prices, and debt-for-equity swaps. As part of a deal with major creditor countries the World Bank and the IMF agreed to provision $30 billion to facilitate such programs in exchange for promises of changes in their laws which would facilitate the reduction of EMEs' debt levels (ibid).

The adoption of these instruments first by Mexico in 1989 and subsequently worldwide has proved a catharsis for many struggling EMEs in creating a deep and liquid market for their debts (Dahiya 1997). As of 1995, thirteen countries in Africa, Asia, Latin America, and Eastern

Europe had issued Brady debt of total face value on the order of $154 billion (ibid). By 1999 over twenty countries had availed themselves of the Bradys, which now account for nearly half of *all* developing country bonds (Luce, FT 9/20/1999).

Year-End Share of Fixed-Income Market By Instrument

	1994	1993	1992
Loans	8.8%	13.8%	31.3%
Brady Bonds	60.9%	51.6%	33.8%
Combined Loans and Bradys	69.7%	65.4%	65.1%
Non-Brady Sovereign Bonds	2.8%	4.5%	NA
Corporate Bonds	3.2%	4.5%	NA
Local Instruments (local currency)	13.4%	10.5%	NA
Local Instruments ($ denominated)	3.3%	7.8%	11.7%
Options and Warrants	5.1%	2.9%	2.1%
Short-term Instruments (local currency)	0.3%	NA	NA
Short-term Instruments ($ denominated)	1.7%	1.7%	NA
Unspecified/Other	0.5%	2.7%	21.1%

Source: EMTA 1995

Compared with the Baker plan and its predecessors, the imposition of Brady restructurings has greatly reduced the occurrence of debt reschedulings and involuntary lending. In addition, the long-term cash flow relief and partial insulation from interest rate increases which the DSRBs and DRBs respectively afford, have greatly enhanced many LDCs' access to international capital markets. Brady bonds have thus served as the anchor which secure debtor countries by giving them the flexibility to improve their economic performance and reopen market access. In doing so Bradys play "an indirect but catalytic role in helping countries achieve a positive net cash flow (Clark 1993).

3. IMF and Moral Hazard

During the last fifty years, sovereign bonds have generally been considered sacrosanct, "exempt from any reschedulings and all but invulnerable to default" (Gopinath 1999a). The standard policy during a time of crisis in an LDC has been for bilateral and multilateral donors to intervene in cases of imminent default, provide monetary assistance, and ensure a renegotiation of the debts. Until 1995 this scenario seemed to satisfy most parties. However, the size and rapid succession of bailouts which started with the Mexican peso crisis has changed these sentiments. During the 1995 crisis the privileged standing of institutional bondholders became clear when the

IMF and Exchange Stabilization Fund (ESF) spearheaded a $53 billion package which enabled Mexico, which had only $6 billion in reserves at the time, to retire its $26 billion in *tesobonos*. Milton Friedman maintains that it was the Mexican bailout which “helped fuel the East Asian crisis that erupted two years later” by fostering an environment rife with moral hazard (Friedman, WSJ 10/13/1998). The contagious events which ensnared Thailand, South Korea, Indonesia, Russia, and Brazil resulted in an unprecedented bailout spree which created a “mushroom cloud of moral hazard” that lingers over the international financial system (WSJ 10/4/1999).

According to many critics, the Fund itself fosters this moral hazard by attempting to act as an international lender of last resort, and ultimately subsidizing the excessive borrowing of LDCs and the profits of emerging markets investors (Schwartz 1998). Moral hazard is the situation in which a third party—ultimately domestic or foreign taxpayers—assume the responsibility for another’s mistakes and therefore, by allowing the debtor to escape punishment (i.e. a painful default and the loss of access to international markets), encourage the very risky behavior they purport to prevent. For its part, the Fund argues that since the multilateral loans are almost always repaid, official credits are not major contributor to the problem. Nevertheless, the IMF concedes that the opportunity for moral hazard arises when the anticipation and expectation of multilateral aid encourages governments and corporations of EMEs to borrow more from international investors than is prudent, raising the likelihood and ultimate cost of a bailout (Mussa et al. 1999).

Exacerbating this problem is the change in the architecture of international markets in the ten years since the introduction of the Brady bond. Before this landmark instrument was introduced large commercial banks were the primary investors in emerging markets. The flexibility and high yields of these new securitized instruments attracted a large number of institutional investors, mutual funds, and hedge funds. These heterogeneous investors have often been exempted from restructuring even while banks and official creditors have repeatedly been forced to roll over their credits. Furthermore, they are less amenable than international commercial banks to suasion by central banks, regulators, and governments to loosening the covenants (Eichengreen 1999). As a result, sovereign bond debt has received “an implicit, though completely unofficial, senior status that helped spark a dramatic spurt in emerging-market bond issuance” which makes the sovereign susceptible to external shocks (Gopinath 1999a).

Critics of this unofficial seniority and concomitant moral hazard argue that such a situation undermines the risk-reward system upon which all private investment is based. Brady bonds manifest attractive yields (rewards) because of the potential (risks) for default. By rendering this possibility infeasible the IMF and the U.S. Treasury may have encouraged mutual funds and hedge funds to invest recklessly in Brady bonds, secure that should problem arise they would be bailed out by the central bank of these LDCs or G7 officials afraid of the contagion a default might incite (Gopinath 1999b).

4. IMF and Burden Sharing

In response to the intense criticism the Fund has endured during the series of crises of the last two years, it has begun to implement a series of reforms. As a solution to the possibility that ever-increasing bailout packages were leading to more frequent and more intense financial panics, G7 countries came up with two key suggestions: improve the transparency of information supplied by EMEs about their policies and practices and attempt to "bail in" as opposed to "bail out" the private sector into debt restructurings (Luce, FT 9/20/99). The first recommendation proved relatively easy to implement; new IMF guidelines strongly encourage member countries to release more information about their financial situation on the IMF's web site, including Public Information Notices following Article IV consultations as well as Letters of Intent (LOIs) and Policy Framework Papers explaining IMF-sponsored programs (IMF 4/28/1999). Applying the second proposal has proved more troublesome.

The idea of sharing the burden (being bailed-in) during a restructuring is anathema to many institutional creditors. Nevertheless, the reform proposal has well-established roots in the Paris Club's 'comparability' principles. The club of official creditor governments require that all external debts, public and private, of EMEs rank pari passu, and therefore be treated on comparable terms (Eichengreen & Portes 1995). The member countries argue that since the proportion of debt held by bond creditors has grown so rapidly in recent years it is no longer logical that creditors be exempted from comparability provisions (Gopinath 1999a). As a result the IMF has published several memos outlining its stance on burden sharing by private investors, including one drafted by Matthew Fisher, chief of the capital accounts division, which asserts, "The apparent halo effect surrounding sovereign bonds is no longer sustainable" (IMF 1998).

That comparability will actually be attempted in the coming months following Ecuador's default hardly comes as a surprise to institutional investors who accuse the Fund of undertaking a "relentless pursuit of the burden sharing agenda" without first consulting those who stand to lose (West LB Investment Review 10/15/1999).

5. The Ecuadorian Situation

Of all Latin American countries, the situation in Ecuador has deteriorated the most during the past years. It has suffered $2.8 billion in El Niño damages, a decline in banana export revenues and, until recently, the depressed price of oil, its leading commodity export (Bustos 1999). Real wages have fallen to the extent that a minimum wage earner secures only one-third of the money needed to cover food expenses for his family (World Press Review 1999). The worst economic crisis in seventy years has been intensified by political chaos. Before Jamil Mahuad was elected in 1998 Ecuador endured the tumultuous and highly corrupt presidencies of Fabian "El Bailarin" Alarcon and Abdala "El Loco" Bucaram, and Sixto Duran Ballen, all since 1996 (North 1999). Since the default and Mahuad's announcement of his intent to dollarize the economy, Mahuad has been overthrown in a peasant uprising supported by certain sectors of the armed forces, surrendering the reigns to his vice-president Gustavo Noboa. Under these conditions of political and economic uncertainty Ecuador's GDP shrank by almost 7.3% in 1999 coinciding with inflation of over sixty percent (Economist 1/13/00).

These effects only compound Ecuador's overwhelming debt burden. A $14.5 billion economy, Ecuador is saddled with $13.3 billion in external debt ($16 billion in overall debt), the highest per capita in Latin America (Business Week 9/13/1999). About $6 billion of this debt is of the Brady variety, including $1.4 billion discounts, $3 billion PDIs, and $1.7 billion par bonds. It's creditors reflect the shift in the international financial architecture in that "banks have been completely eclipsed by private investors" (Gopinath 1999b). Of these debts, fifty-two percent are owed to financial institutions, thirty percent to multilaterals, and eighteen percent to governments of the Paris Club (NotiSur 10/1/1999). The long-delayed fiscal year 2000 budget provisions about fifty-five percent of government revenues or forty percent of exports to debt service (Agence France 10/16/1999). Because the economy had showed no sign of resiliency, it had been widely expected since the summer that a day of reckoning would arise when the country's semiannual coupon payments came due in the fall.

6. The Ecuadorian Test Case

Despite these desperate circumstances the IMF has staunchly refused to cushion this economic disaster until the administration agrees to a reform package. The Fund insists upon the reintroduction of the income tax, an increase in the Value Added Tax (VAT) and the reduction of public spending, before freeing $400 million of IMF money—which would release an additional $850 million in multilateral loans—for which an LOI has been signed (North 1999). According to the U.S. Treasury, Mahuad had been consistently ignoring warnings from multilateral institutions that he could no longer delay these and other "enormously tough political choices" (Sanger, IHT 9/30/1999). [For a more systematic understanding of the how politics in the incomplete democracies of Latin America preclude the passage of necessary reforms, see paper by Laura Panattoni]. Instead of seeking to negotiate with his creditors Mahuad announced on August 25 that he would defer a $96 million interest payment on Ecuador's Brady debts for the duration of the thirty day grace period. The IMF still refused to intervene (the situation compounded by Ecuador's aborted intention to default on only certain classes of its Brady debt), even after cross-acceleration provisions threatened to force all of its $6 billion in Bradys, $500 million Eurobonds, and an unknown sum of corporate debt into technical default.

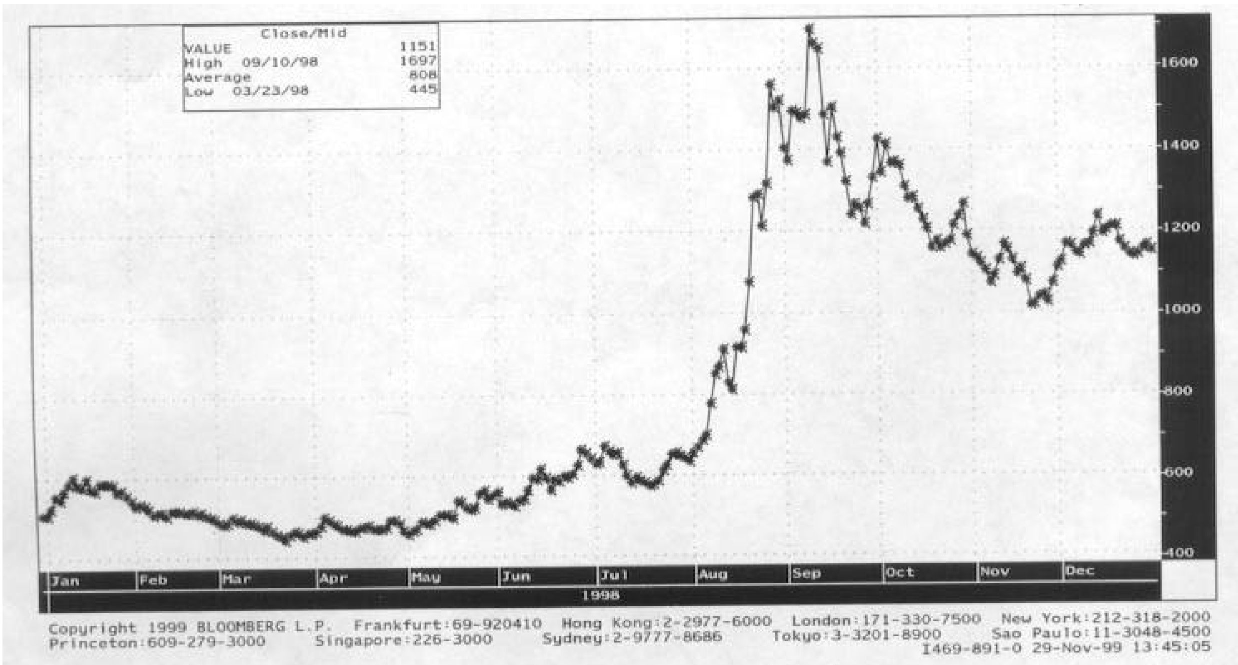
The IMF's insistence that Ecuador first come to a comprehensive debt restructuring agreement with its private creditors before the multilateral package could be released, combined with its interest in setting a bail-in precedent led many in the market to believe that the IMF and the U.S. Treasury had been secretly encouraging Mahuad to default (Gopinath 1999b). The terrible economic situation, the government's unwillingness or inability to comply with IMF-prescribed reforms, its minimal global strategic significance, and the fact that its total debt is too insignificant to incite major turmoil in the global financial system may all have contributed to the Fund's decision. Whether or not the Fund's staunch denial of this rumor is the truth, the Ecuadorian situation serves as a signal to the bond market that the international community will not always intervene. Ironically, this is a calculated attempt to forestall future crises. The Fund's clever switch of allegiance from the anchor of Brady bonds to their saboteur should have tremendously positive long-term implications for the stability of EMEs.

Despite the expected default, the terms of the default announced by the president came as an unwelcome surprise to both the country's IMF advisors and its creditors. Mahuad declared that Ecuador would pay the $51.5 million due on its PDI bonds, but not the $44.5 million interest payment on its discount bonds. These creditors were encouraged to tap the collateral which secures the interest on these bonds (but not the PDIs) to cover the missed payment (Gopinath 1999b). The IMF was disappointed and investors were outraged at this discriminatory two-tiered deal. Even in the unlikely case that this unprecedented proposition were possible, it surely was not acceptable, as far more than the seventy-five percent of bondholders rejected the deal, placing both the PDIs and the discounts into arrears.

7. Risks of the Burden Sharing Experiment

Notwithstanding the curve ball Mahuad threw the international community, the basic goals of the bail-in remain. In attempting to dissolve the "mushroom cloud of moral hazard" the Fund has assumed a tremendous risk. For this reason it was Ecuador, a country besieged by structural problems in addition to severe economic woes and minor global strategic value, that was selected for the experiment. The largest potential pitfall is the occurrence of exactly the opposite of what was intended: instead of preventing crises to produce one. With the precedent of burden sharing set, institutional investors, reluctant to be dragged into a lengthy renegotiation, might withdraw their capital each time a country enters into discussions with the IMF. The resulting crises would be as costly or more to EMEs, since the amount of time required to regain the confidence of investors would surely be longer than is presently the case following a currency run. According to the Institute of International Finance (IIF), a Washington-based group representing three hundred financial institutions worldwide which strenuously oppose the IMF's bail-in rhetoric, burden-sharing will lead to a sharp decline in *private* capital flows to EMEs and the associated rise in cost of financing (Luce, FT 9/20/1999). The IIF argues that explicit burden sharing is unnecessary because these institutional investors are already bailed-in to any renegotiation when the mark-to-market prices of their assets tumble (Tyson 1999). Higher spreads on emerging debt and the evaporation of capital flows would be devastating given the principal role bonds play in emerging market finance.

The risk implied by the IIF's threat is the dissolution of the bond market entirely, and Brady bonds in particular. Since their origination Bradys have come to account for very significant share of emerging markets debt. The Emerging Markets Trading Association (EMTA) calculated in 1995 that over sixty percent of the LDC fixed income market was accounted for by Brady bonds (BradyNet 1996). However, it remains a very sensitive market. Sandeep Dahiya of the Stern School of Business at New York University conducted an in depth study of Brady returns and deviations before and after the peso crisis of 1995. He determined that individual country's Brady bonds traded independently before the crisis and had a risk adjusted return second only to small stocks. Following the peso's collapse in December 1994, the bonds returns moved together as a group, and yielded the lowest returns of any asset class, wiping out almost entirely the gains achieved in the first four years. This indicates that the negative effects of a country-specific event can have widespread, long-lasting effects on the market as a whole (Dahiya 1997). A more recent example of this susceptibility is demonstrated by the effect of Russia's August 1998 devaluation on Brady spreads. Although Russia accounts for only one percent of the world's GDP, the financial disaster there caused Brady spreads to skyrocket from around 650 basis points in early August to 1700 basis points in early September.



Source: Bloomberg LP 1999, JP Morgan EMBI+

This widespread loss of confidence in the security of Brady debt from Russia's surprise default is an event from which the market still has not recovered. Despite steadily declining spreads, developing countries' debts still demonstrate an eleven percent spread over comparable U.S. Treasury bonds, almost double the pre-"Vodka crisis" levels (Bloomberg LP 1999, all spreads data from JP Morgan's EMBI+ index).

Ecuador's situation and the precedent for future bail-ins threatens to have even more enduring consequences. An editorial on BradyNet, a forum for emerging markets investors, indicates that the first-ever Brady default has irreversible implications. Much of the success the instrument has earned has been derived from the expectation that Brady bonds have been so significant in EMEs' recoveries that no country would risk sacrificing this aura by missing a payment. The newly realized vulnerability of the instrument, strips Brady bonds of "any advantage they enjoy over non-collateralized foreign currency bonds" whose records are not nearly as unblemished (BradyNet 8/30/1999). This vulnerability is demonstrated by fact that shortly after the Ecuadorian default Mexican Bradys were trading 550 basis points wider than their globals (Institutional Investor 2/5/00). The result has been that new sovereign issuance among Latin American countries was virtually nonexistent in the second half of the year, as many of these nations focused instead on swapping their existing Brady bonds into new global issues.

8. Anticipated Benefits

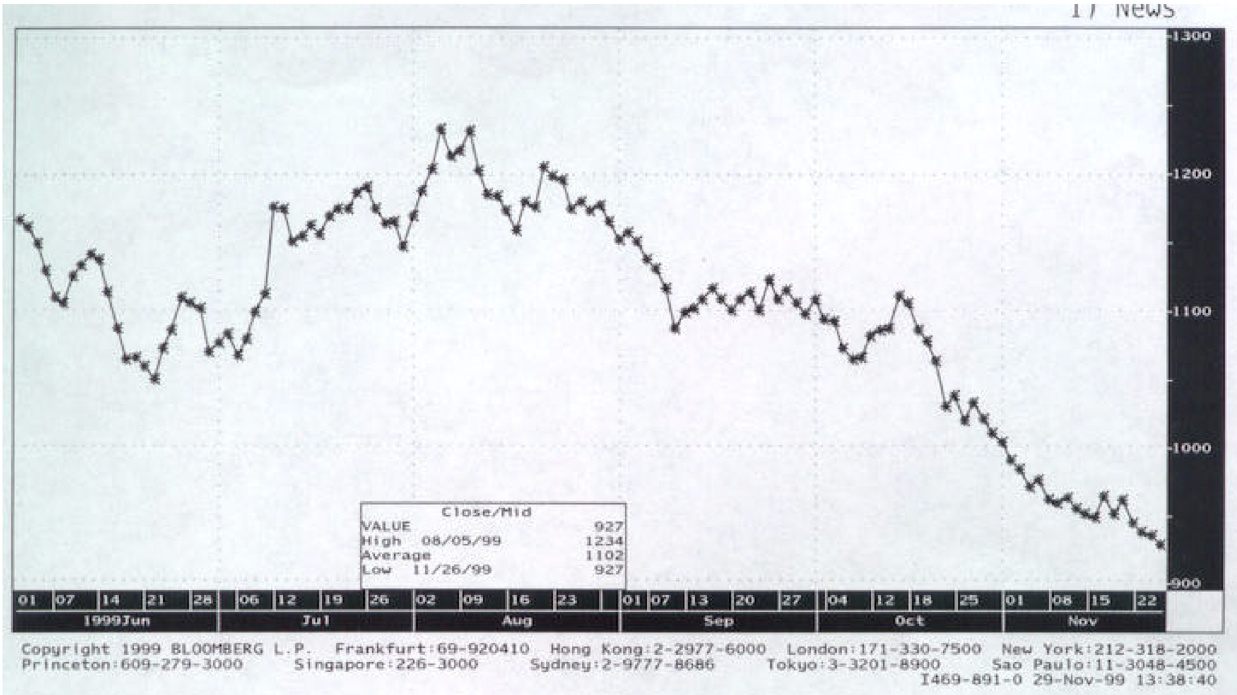
With such potentially disastrous risks, Michael Camdessus and Larry Summers have chosen to explore the bail-in option because it has the potential to yield benefits to the international financial system which outweigh the short-term risks. The benefits all revolve around the premise that prudent borrowing and lending can prevent the outbreak of ever more ruinous financial breakdowns. Precluding such events would greatly increase the stability and durability of the global economy, as “each rescue mission is less successful in restoring confidence than its predecessors, the bailouts inevitably become bigger, more expensive, and more unpopular” with the taxpayers of developing countries (Gopinath 1999a). The primary goals of the burden sharing agenda are to apply comparability to ensure the fair distribution of risk and reward and to overcome the perils of moral hazard. By sending a warning to bond investors that their claims are not de-facto senior to those of commercial bank or official loans, the Fund intends to restrain the imprudent lending of these mutual funds and hedge funds. U.S. Undersecretary for International Affairs Timothy Geithner summarizes his department’s ex ante rationale for not forestalling Ecuador’s collapse: “We want to shape expectations ahead of time to help reduce the risk of crisis” (Gopinath 1999a). Even the risk of less liquidity in the Brady market may serve as an advantage. Higher interest rates at the margin may encourage debtors to be more prudent borrowers themselves.

Perhaps the most interesting and important aspect of the Ecuadorian precedent is that it requires a precedent be set for the orderly work out of sovereign debt among bondholders and the debtor. The Fund is eager to promote an alteration of bond contracts which facilitate a more expeditious renegotiation process. Current provisions, which require unanimity or near unanimity of ninety to ninety-five percent to alter the covenants, make restructuring almost impossible. Restructuring becomes especially difficult when groups of “vulture investors” prepared for litigation buy positions in distressed issues at twenty cents or fewer (in the Ecuadorian case) to the dollar (Eichengreen & Portes 1995, Gopinath 1999b). One alternative being suggested is to substitute the American-style bond contracts which require the unanimous consent of creditors to reschedule with those of British-style Trust Deed bonds which contain provisions for the modification of terms by qualified majorities (IMF 4/15/1999, xi). Additional suggestions involve adopting aspects of London Club provisions such as sharing clauses, requiring any creditor who receives a more favorable settlement than the others to share the payment with other creditors. Other possibilities include the introduction of non-acceleration clauses to allow time for orderly discussions and temporary stays of litigation to avoid attracting the interest of the vulture groups (Eichengreen 1999, Eichengreen & Portes 1995). These provisions are designed to prevent individual bondholders from tying up the debtor and its more flexible creditors in protracted litigation (Gopinath 1999b). Institutional investors counter that these suggestions are hardly feasible: " 'No emerging market will be the first to voluntarily adopt a majority clause on its bond because it would be admitting the possibility of default,' " increasing the spread on such an issue (Luce, FT 9/20/1999). However, since most creditors mark their positions to market daily, if such stipulations avoid a long gridlock and are overseen by the IMF to prevent "asset stripping by debtors," investors would have no reason to shun bonds with these caveats (IMF 4/15/1999, 22). Barry Eichengreen suggests that the IMF indicate that "it is prepared to lend at more attractive interest rates" to countries that issue debt securities with these provisions. "U.S. and U.K. regulators, for their part, could make the admission of international bonds to their markets a function of whether those bonds contain the relevant provisions" (1999). Such maneuvers should help overcome the fears of investors that making it less painful for debtors to restructure would make them more likely to attempt to do so. Ultimately, the goal of burden sharing is to enforce greater prudence on the part of investors and borrowers and to encourage more orderly, less protracted workout procedures. Accomplishing this should preclude the need for G7 countries to intervene in all but the most dire balance of payment situations.

9. Ex-Post Effects

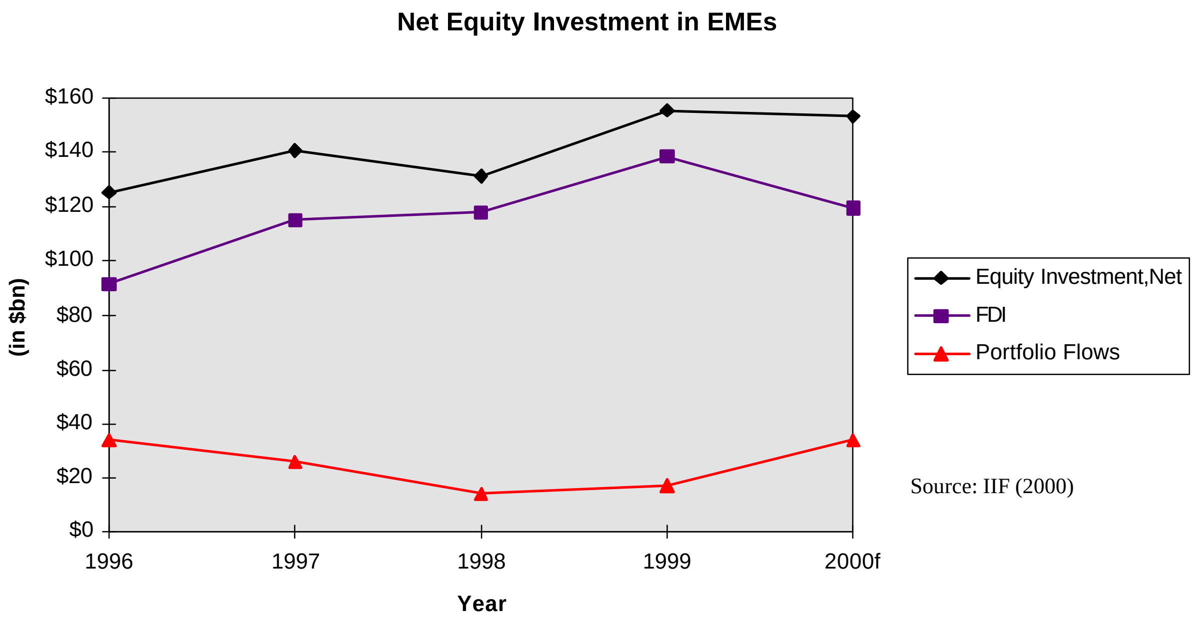
Ecuador's failure to service part of its Brady debt by the end of September and its missed payment on $500 million in eurobonds last month were precedent-setting events, which conformed to the IMF's desire to incorporate burden sharing into the private bond market. However, the events since then have confounded the expectations of all influential parties. At the time of the missed eurobond payment Ecuador's then finance minister, Alfredo Arizaga announced "The country has decided to confront the issue of foreign debt with a global strategy that includes the renegotiation of all components of debt, except that of the multilateral institutions" (Latin Finance 11/10/1999). Nevertheless, at present the troubled country's strategy remains clouded. The bond contracts governing Ecuador's Brady bonds make it virtually impossible to change the terms. With creditors in no mood to be lenient with Ecuador following Mahuad's attempt to treat the distinct classes of bonds differently with a two-tier default, Ecuador will be hard-pressed to get bondholders to agree to swap the non-performing instruments for new bonds. The dollarization plan will further delay any agreement on debt refinancing as the government has no chance of negotiating with its creditors while the uncertainty of the currency change looms.

Curiously, despite a lack of progress during the first meetings between Ecuador and its creditors and the IIF's warnings about a possible investor boycott, the potential for a wholesale loss of confidence in Bradys, and the drying up of the market for emerging market debt these dire predictions have not materialized. Somewhat surprisingly, Ecuador's PDIs and discounts rallied from their lows (although the massive currency depreciation preceding the dollarization announcement suppressed Ecuador's Bradys close to their all-time lows) and the defaulter's plight has not triggered the blanket outflows from Bradys and eurobonds that followed the devaluations in Asia and Russia (Latin American Special Studies 10/26/1999). In fact, the steady stream of money flowing into the market from its more "traditional buyside participants (i.e. 'real money' pension and insurance funds) continue to bolster sentiment market-wide, and force players off the sidelines who had expected to coast into year-end with a decent yearly performance already booked" (Daily Latin Market Wrap-up 10/26/1999). Market analysts believe that emerging markets are being further bolstered by worries about U.S. interest rates, the direction of the Dow Jones, and the recovery of oil prices (Latin Finance 11/10/1999). Perhaps more significant is the fact that within weeks of the default, the Philippines, Brazil, and Mexico were are able to successfully swap their Bradys for new debt instruments. As a result of the inflow of this real money and generally improving global economic situation spreads on Brady debt, both Latin American and non-Latin have actually narrowed since the default. Spreads widened through the summer months as it became increasingly clear that the IMF would follow through on its threats and allow Ecuador to test the burden sharing waters; however, since early August spreads have been on an almost unmitigated decline, helped by mounting evidence of a global recovery (Bloomberg LP spreads chart 1999).



Source: Bloomberg LP 1999, JP Morgan EMBI+

Nevertheless, Latin America and Brady bonds are not completely out of the line of fire. Indeed, many large international portfolios remain underweight in Latin American Bradys (Molano 11/3/1999). This is in part because overall investment in emerging markets, despite the recent gains, remains soft. According to the IIF, net private capital flows (direct and portfolio investment) to EMEs in 1999 was $148.7 billion, an insignificant improvement over 1998. Anxieties that IMF actions in pursuit of involuntary burden sharing will lead to further defaults on Bradys will continue to restrain foreign lending. They predict only a slight recovery of fifteen percent in 2000, despite rapidly rebounding fundamentals, leaving overall flows far below the record $335 billion witnessed in 1996 and $266 billion of 1997 (IIF 9/25/1999). Furthermore, due to a slackening in the pace of asset sales the IIF predicts a deceleration in FDI for 2000 and the return of hot money to pre-crises levels (IIF1/24/2000).



10. Conclusion

In capitulating to widespread criticism that its rescue packages have contributed to the need to more frequent, ever larger bailouts the IMF has taken the risky step of incorporating private investors into a debt restructuring. It is a worthwhile effort to reverse the occasion for moral hazard which an unprecedented spree of multilateral bailouts and the de facto seniority of bond claims which these bailouts bestowed. Ecuador was basically set up to serve as the test case; however, it set itself up for this fall. A disastrous economic situation, political hot potato and incompetent leadership, lack of transparency, as well as an inability or unwillingness to undertake structural reforms combined with the heaviest debt burden in the Americas relegated Ecuador to a situation which could not be sustained. It wasn't.

Since the default the situation has become even more uncertain. The entire future of the Brady market is at risk, despite Latin American countries' repeated claims, such as Carlos Massad, president of Chile's central bank, that the Ecuadorian situation "will not be generalized" (Economist 10/9/1999). If, as is hoped, the case serves as a warning to borrowers and lenders alike that foolish behavior will earn them the strict penalty of a more difficult economic resuscitation act and a likely write-down of assets, many crises will be averted. Another compelling benefit is the reformulation of future bond contracts to allow for orderly restructuring should the need truly arise. Clauses enabling the relaxing of covenants under the qualified majority of three-fourths of bondholders would be a positive change. Furthermore, sharing clauses, non-acceleration provisions, and temporary stays of litigation, if required by the IMF of all new issues, would facilitate an orderly discussion among debtors and creditors without the looming threat of litigants.

The Fund hopes that forcing the private sector to negotiate a settlement with Ecuador (and likely write down some of their holdings) will make institutional investors more amenable in the future to accepting a softer solution, i.e. bonds with contracts facilitating an organized restructuring. However, the IMF, the U.S. Treasury appear willing to force future bail-ins should the Ecuadorian test case not be convincing enough. Pakistan and Romania have both complained of being pressured by the Paris Club to restructure their Eurobond debts (Luce, FT 9/20/1999). These cases do not indicate that the Fund is dead set on enforcing burden sharing in all cases; every IMF document to date has been careful to affirm that the Fund stands by its policy of treating each crisis on a "case-by-case" basis and some countries are thought too big and too important to default (Fisher, 1999). However, bail-ins do promise to play a significant role in dealing with LDC debt crises, either as psychological deterrent to reckless lending or in action. Bondholders and debtor governments will have to adapt accordingly or risk being shut out of international capital markets for a long time to come.

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