# Ecuador defaults, and the dominos fall

by Gretchen Small

One year ago, with the world's attention focussed on Russia and Brazil, and on whether or not giant hedge funds would go under, no one gave a thought to the nation of Ecuador, a small country of 12 million people in South America, with a total public foreign debt of just over $16 billion. While this sum is high on a per-capita basis, it is of complete insignificance for a global system flush with $300 trillion in financial paper.

Yet such is the state of the global financial system today, that the functioning of the system itself has been threatened by Ecuadoran President Jamil Mahuad's announcement on Sept. 26, that his government could only pay $50 million out of the $94 million in interest payments due on its Brady bond debt on Sept. 28. A mere $44 million in interest not paid on sovereign bonds has become a worldwide, systemic threat.

On Oct. 1, after a sufficient number of creditors refused to accept Ecuador's offer to pay that $44 million with the collateral behind the bonds, Ecuador was formally declared in default. What precisely this declaration will trigger, remains to be seen. Until Sept. 28, no nation had ever defaulted on their Brady bonds, which are a type of sovereign debt created in 1989-90 under the Bush administration, by writing down, repackaging, and then selling at a discount (some backed by collateral and some without) the sovereign debts upon which nations had already defaulted.

Ecuador's action could trigger a domino effect by other countries who issued Brady Bonds, and in far greater sums. This includes Ibero-America's biggest debtors (e.g., Mexico has $20 billion in Brady bonds outstanding; Brazil, $45 billion; Argentina, $22 billion; and Colombia, $9 billion), as well as other such bankrupt countries as Pakistan, Ukraine, Romania, the Philippines, and Nigeria, among others.

## Chicken games in end times

The Ecuadorian government had forewarned its creditors a month ago that non-payment was possible, when it postponed interest payments for 30 days, a grace period permitted in the contracts. In the end, the government opted for an attempted compromise, despite its desperate financial straits, and announced that it would make a partial payment, and would withhold payment from those bondholders whose bonds were backed by collateral. Those bondholders were urged to collect their interest due from that collateral (U.S. Treasury bills), so that formal default could be avoided. Otherwise, the creditors would have been legally entitled to call in their bonds, seize assets, etc.

But Ecuador could not pay, because it has no money. Its trade has collapsed in the world depression, and when the speculative credit flows that had kept afloat the debts of developing sector nations for the past few years, abruptly ended after the 1997-98 global financial crises, the rollover game came to an end. Over the course of 1999, the government sought to come up with its payments by every wild scheme imaginable, going so far as to seize half the deposits in the national banking system last March, in an attempt to procure some cash with which to pay the foreign creditors. On Sept. 26, President Mahuad was forced to declare his government could not pay. As he told his nation: "Our country only has a future if it manages to reduce the weight of its external debt. This is an immense, undeniable truth."

Ecuador is not the only bankrupt party involved. Equally bankrupt—if not more so—are its bondholders and the International Monetary Fund (IMF). Since 1995, when other governments reached the end of the line as Ecuador now has, in stepped the IMF, organizing the megabillion-dollar bailout packages required to ensure that the foreign creditors of Mexico, South Korea, Indonesia, Russia, Brazil, et al., one by one, were paid.

Now, that game has run its course, too. With not enough liquidity to ensure everyone gets paid in full, and the stakes in Ecuador relatively smaller, the IMF tried to play a chicken game with the country's private creditors on this one. It refused to sign an accord with Ecuador this past August, and demanded the government and its private creditors work out a deal instead, in which every party took some hit.

A sufficient number of bondholders refused to go along, and the IMF's game has just been called. According to London's Gramercy Advisors Llc., a group of about 35% of the bondholders are demanding immediate payment on the Brady bonds principal. Ecuador cannot pay.

All kinds of dicey questions are now raised: Will the creditors retaliate by attempting to seize assets? What will other debtors in similar straits, do? What will be the effect on today's daisy-chain financial system, of the activation of the cross-default clauses written into many contracts? Whose Ecuadoran bond-based derivative deals will go under in some unexpected far-off corner of the world, and what will be the consequences of that, too?

## Regional chain-reaction already under way

The most immediately hysterical reactions, perhaps, are coming from the other governments of Ibero-America, which have tried so hard throughout the 1990s to keep speculative capital flowing into the region, by being the "best boys" at playing by the rules of the IMF system. Peru's Economics Minister Victor Joy Way was one of the first to respond, loudly assuring one and all at the IMF-World Bank annual meetings in Washington, D.C., that Peru is "not going to have a problem in the question of its debts. . . . We do not intend to enter into any renegotiation of the foreign debt. . . . The possibility that it does not fufill its payments on its foreign debts is null."

But the reality is otherwise. As *EIR* documented in its study published in its Aug. 27, 1999 issue, "New statistics Show Ibero-American Economies Are In Free Fall," not even the IMF's order that the drug trade be included in Ibero-America's national statistics, can hide the fact that *in the first quarter of 1999, alone,* physical economies across the region had fallen by 15-20%, and the rate of collapse was accelerating, such that what has begun "is a drastic, non-linear free fall, an implosion which will have wide-ranging economic, political, and social consequences."

## Colombia in free fall

Each new phase of collapse generates another. Colombia, whose officials had for months repeated, just as adamantly as Peru's Joy Way now promises Peru will pay, that they would not abandon the trading band system it had adopted to defend its currency, the peso. A major portion of Colombia's trade, however, is carried out with Ecuador, and the value of Ecuador's currency, the sucre, has collapsed, falling 17% in the week before Mahuad's partial payment announcement. On Sept. 26, Colombian authorities announced they were abandoning the trading band, and the peso will henceforth float freely.

The value of the Colombian peso has yet to collapse as rapidly as some feared (it opened on Oct. 1 at 2,020, down from the mid 1990s before the float was adopted), but that is largely because the government jacked interest rates up from 16.5% to 22%, and sold dollar-denominated domestic debt, so-called TES bonds—similar even in name to the infamous *tesobonos* sold by the Salinas government in Mexico which blew out in December 1994.

Despite the official line, inside Colombia it is now assumed that, by the end of this year, Colombia will find itself in Ecuador's situation: unable to pay its debts. Colombia is being ripped apart by a narcoterrorist insurgency, and its economy has ground to a halt. The government statistical agency, DANE, reported recently that Gross Domestic Product dropped by an unprecedented 7.6% in the second quarter of 1999 (and Colombia, at IMF insistence, counts "illicit crops" as part of its GDP). Construction and manufacturing declined by 24% and 17%, respectively, in the same period. Official unemployment now stands at 20%. Bringing the endpoint closer, the IMF ordered Colombia to impose a "real fiscal adjustment," that is, to savagely slash federal, state, and municipal budgets, freeze public-sector wages, and tax broader layers of the population by eliminating most exemptions.

## A Brazilian currency crisis brewing

The competitive devaluations across the region, are accompanied by the collapse of the much-ballyhooed free trade zones. Brazil's devaluation and subsequent free-float of its currency, the real, last January, devastated Argentina, 30% of whose exports go to Brazil. Trade battles between the two neighbors escalated, until they have now, de facto, buried Mercosur, the common market of the south which join Argentina, Brazil, Uruguay, and Paraguay. The *coup de grace* was delivered by Brazil, which announced on Sept. 20 that 400 Argentine dairy, leather, and textile products which up until now had been exported to Brazil under favored Mercosur conditions, would henceforth be taxed. Altogether, these products made up 90% of Argentine exports to Brazil. Alejandro Sampayo, director the Argentine chamber of textile industrialists, FITA, called the decision "more serious than the devaluation of the real last January. . . . This represents a rupture of trade."

Desperate Argentine businessmen and exporters are pressuring the Menem government to abandon its currency board system, and devalue the peso, now pegged in a one-to-one relationship to the dollar.

The "Big One" about to blow out in the region, however, is Brazil—the proud owner of the title of holder of world's largest foreign debt. All the signs of end-game are present here, also, as the government maneuvers to entice in sufficient foreign capital to just meet payments through the end of 1999, a sum estimated by *Gazeta Mercantil* at around $20 billion, for Brazil to meet all its foreign obligations—amortization and interest payments, services, and trade—without a further drop in reserves. The George Soros-run Central Bank is moving rapidly towards a general lifting of all capital controls, its admitted goal. The first step, was the announcement that, beginning Sept. 14, companies involved in oil and natural gas exploration, processing, and transport, as well as generation and transmission of energy, will be permitted to open foreign currency accounts inside Brazil, for any foreign investments or loans that they bring in. The government is projecting that some $50 billion will come in, eventually, under this scheme. The next step, according to the Central Bank's Director of International Affairs, Daniel Gleizer, will be to end all restrictions on profit and dividend remittances abroad. Like Colombia, the Brazilian Central Bank is also resorting to the sale of highly explosive dollar-denominated domestic debt.

Brazilian Central Bank liquid reserves, however, are down to $23 billion, and the IMF accord requires that these reserves not drop below $22 billion. Either Brazil will have to borrow much more abroad—which will be even more difficult after the Ecuadoran default—or the IMF will have to renegotiate its agreement with Brazil. And the worst has yet to hit.