Ecuador default, Colombia devaluation: renewed debt and currency jitters in Latin America

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President Jamil Mahuad of Ecuador announced Sunday that the South American country would fail to make half the interest payments due September 28 on bonds largely held by New York banks and other big foreign lenders. Ecuadorian officials began meeting this week with a team of creditors led by Chase Manhattan Bank to discuss restructuring the country's private and public debt.

Ecuador is the first Latin American country to default on "Brady bonds," named after the US Treasury Secretary Nicholas Brady, in the Bush administration, who devised them as a stopgap solution to the debt crisis of the 1980s. Much of the unrepayable debts of Latin American countries were transformed into dollar-denominated bonds for which the governments involved deposited collateral in the New York Federal Reserve Bank, in order to prevent an outright debt repudiation which would have shaken the world banking system to its roots.

In the decade since Brady bonds were instituted, none of the issuing countries has been late with a payment, let alone defaulting outright. Ecuador made $46 million in interest payments due September 28, on about half its Brady bond debts, while telling bondholders due another $50 million in interest to seek payment from the collateral on deposit at the New York Fed.

To use funds set aside as collateral for repayment of principal to make interest payments instead requires the consent of one quarter of all of Ecuador's creditors, which has not yet been obtained. If the creditors refuse to give their consent to this procedure, the default will become official. This expedient is only a temporary measure, in any case, since the total amount of collateral, $200 million, is dwarfed by the nearly $6 billion worth of Ecuadorian Brady bonds.

The bond markets have largely discounted an Ecuadorian default, which has been predicted for months. Some of the country's bonds are already trading for as little as 25 cents on the dollar. Besides the Brady bond debt, Ecuador has another $7 billion in foreign debt outstanding, and its total public external debt is more than 90 percent of the country's Gross Domestic Product.

The economy of Ecuador has been ravaged over the past two years by heavy flooding, caused by the El Nino effect, which has devastated agriculture; by the long-term fall in the real price of oil, Ecuador's principal export; and by the refusal of international lending agencies to provide new loans until the government imposes austerity policies, including tax increases and cuts in subsidies for basic necessities, measures which have already provoked political upheaval.

Ecuador's GDP has fallen 7 percent this year, the Ecuadorian currency, the sucre, was devalued, and conditions for the Year 2000 look even worse. Scheduled foreign and domestic debt payments due next year come to $2.3 billion, half the proposed national government budget and more than the country's total $1.7 billion in foreign currency reserves.

President Mahuad is in negotiations for a $400 million IMF loan which would trigger another $1 billion from other lenders, such as the World Bank and the InterAmerican Development Bank. IMF Managing Director Michel Camdessus said the fund wouldn't approve the loan until Ecuador makes “good-faith efforts to reach a collaborative agreement with its creditors” and implements the austerity plan.

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On the same weekend as the Ecuadorian default, neighboring Colombia announced that it would abandon efforts to maintain the value of its currency, the peso, in a fixed band against the dollar, and allow it to float.

The peso was under attack from currency speculators for nearly a month, since the announcement that Chile would abandon its currency band system and float the Chilean escudo. In the last four trading days before the devaluation, the Colombian central bank spent $401 million trying to prop up the peso.

The announcement of the float was delayed until after the government of President Andres Pastrana had negotiated a three-year contingency line of credit with the IMF of between $2 billion and $3 billion. Together with additional lines of credit from the IADB and World Bank, this gives the Colombian regime $6.9 billion to bolster the country's finances.

The announcement of new IMF and World Bank credits staved off a collapse in the peso during the first two days of trading after the currency was floated. The peso dropped 1.1 percent against the dollar, on top of a 20 percent decline since January 1.

Colombia's devaluation could further destabilize the financial position of neighboring Venezuela, which still maintains a currency-band system and has foreign reserves of $14 billion, derived from its extensive oil exports. The new president of Venezuela, former military coup leader Hugo Chavez, has pushed for protectionist measures against cheap imports, especially agricultural products from Colombia, which will be even lower-priced after the devaluation. Colombia is Venezuela's largest trading partner after the United States.

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