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MARKET COMMENTARY

Ashmore

# The merits of Ecuador's approach

By Jan Dehn

Ecuador has put forward a plan for dealing with an unprecedented triple shock of lower oil prices, coronavirus and loss of access to financial markets. The shocks are no fault of Ecuador's, but due to loss of access to financing the current Ecuadorian government now finds itself in the painful predicament of not having enough resources to both service debt and look after the health of Ecuadorians.

While default cannot be ruled out, in Ecuador's case there is a better way both for the country and for creditors. Investors can take steps to avoid default by engaging directly with the government and multilateral financial institutions to provide temporary liquidity relief in a market-friendly way. This would ensure that the bonds continue to perform, while at the same time help the country through an unusually severe humanitarian crisis

It is by no means possible to strike such deals with all countries, but it is possible in the case of Ecuador, because the current government has demonstrated very strong willingness to pay. The key ingredient for a deal – desire to honour obligations in full – is therefore in place.

## Ecuador's plan

This week the government of Ecuador put forward a plan for dealing with an ongoing triple shock of sharply lower oil prices, a vicious coronavirus outbreak, and loss of access to markets. The government's plan comprises three distinct elements, namely to utilise and extend the grace period for payment of coupons on sovereign bonds, enter into negotiations with bondholders and bilateral creditors to find a market-friendly resolution that provides temporary liquidity relief, and to strike a new agreement with the International Monetary Fund (IMF).

It has launched a consent solicitation, which is a key first step for the success of the plan – to seek an extension of the grace period for sovereign bond coupons, therefore avoiding a default and winning precious time needed to negotiate with both creditors and the IMF. The consent solicitation carries the distinct feature of including a new IMF staff agreement by a given date as part of its conditionality, thus demonstrating commitment to the plan from both Ecuador and the IMF.

## Ecuador's crisis is no fault of its own

One of the poorest countries in Latin America, Ecuador was this year hit by three major exogenous shocks at the same time. The 60% plunge in oil prices hurt the public finances precisely at a time when the country found itself racked by one of the worst coronavirus outbreaks in Latin America, with a particularly severe humanitarian crisis unfolding in the economic centre of Guayaquil.[1] Political pressure on the current government is rising sharply with new elections scheduled for early next year.

Both the coronavirus outbreak and the oil shock are transitory shocks, so Ecuador ought to borrow to help it through this crisis. Moreover, since Ecuador's debt burden is sustainable this seems the obvious solution. However, the concurrent global financial crisis has widened the spread on Ecuadorian bonds to the point where the country has currently been cut off from access to global finance.

The loss of access to finance is particularly problematic in a low income Dollarised economy, such as Ecuador, which only has very basic domestic financial infrastructure. For example, Ecuador does not have the option to issue bonds in the local market nor can it devalue its currency.

Without access to fresh financing, some people are saying that Ecuador's government now faces a stark choice between taking care of the health of its own people, or servicing debt. However, it is not that black and white. The reality is that a unilateral default would plunge the economy into an even deeper economic crisis, potentially leading to a bank run and the collapse of the dollarisation regime revered by all sectors of society, precisely at a time when Ecuador also faces the worst humanitarian crisis in its modern memory. Fortunately, there is another way that ensures a far better outcome for everyone.

[1] See: https://www.theguardian.com/world/2020/apr/05/ecuadorian-city-creates-helpline-for-removal-of-coronavirus-victims

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## A better way

It would amount to a global market failure if Ecuador – with a sustainable debt burden and strong willingness to pay – was pushed into default solely due to a collapse in market access. This outcome can be avoided provided that the government, bondholders, and multilateral and bilateral lenders work together.

Ecuador's multilateral and bilateral lenders have already shown considerable flexibility towards Ecuador in light of its difficult predicament. Based on the current Ecuadorian government's strong record of compliance with the ongoing programme with the IMF, the Fund will most likely agree to grant Ecuador access to its Rapid Financing Instrument (RFI) soon. The RFI extends grants of quick, low-hurdle financial assistance to member countries facing urgent balance of payments needs, without the need to have a full-fledged programme in place. The IMF is also working with the government on a successor programme (with potentially larger size) to its current Extended Fund Facility (EFF), which provides assistance to countries to deal with structural impediments or slow growth in the context of a weak balance-of-payments position. On the bilateral front, China, the major lender, is refinancing loans to the country and providing new funds.

It is now time for bondholders also to contribute to help a government which is trying to do the right thing. There are countless examples from the world of corporate finance, where companies find themselves in trouble through no fault of their own. In such cases, bondholders always have the option to pursue legal redress, but in most circumstances it is far better for both sides to resolve the issues through friendly re-negotiation in order to provide temporary liquidity relief. Consensual solutions work better because they allow well-run companies to continue to operate and prevent lengthy and potentially costly and acrimonious legal processes. They also allow investors to continue to receive income from their investment and look forward to capital gains once the crisis blows over. This principle can of course also be applied to sovereigns.

## Payers versus defaulters

It is extremely important in the case of sovereigns that bondholders carefully distinguish between 'payers' and 'defaulters'. If a government chooses to default even though it has the means to pay, even in stress situations, given some flexibility, it removes the basis for any agreement. Amicable deals with such governments are unlikely to be made or succeed.

By contrast, the current Ecuadorian government has demonstrated extremely strong willingness to pay. Ecuador just repaid its 2020 bond last week. More impressively, the government has consistently undertaken institutional and fiscal reforms in recent years under its IMF programme. The government of Ecuador is clearly acting in good faith and wants to remain a 'payer', so the basic pre-condition for a deal with bondholders exists.

There are other examples where bondholders and sovereigns have successfully established trust, struck a deal and then proceeded to emerge from crisis in far better shape than if they had gone down the road of confrontation. In the case of Uruguay, bondholders and the government worked closely together to re-profile the country's debt and re-open markets, including Uruguay's local markets, when the country found itself buffeted by severe external shocks. Uruguay was able to emerge from crisis in an orderly fashion with its reputation strongly enhanced. Relations between Uruguay and bondholders have been excellent even since, based in large part on the experience of working together closely and constructively through crisis.

## The merits of Ecuador's approach

Bondholders should now engage constructively with the current Ecuadorian government and official lenders to help manage the government's debt in a market friendly manner. This will be better for Ecuadorians as they go through an unprecedented humanitarian crisis and it will be better for bondholders, who, in exchange for providing flexibility to help the country with its cash flow, continue to have access to a borrower that meets its obligations in full. More importantly, a deal would deepen the trust between Ecuador, multilateral financial institutions and investors, which would make market failures, defaults and humanitarian crises less likely in the future.

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## Contact

**Head office**

**Ashmore Investment Management Limited**
61 Aldwych, London
WC2B 4AE
T: +44 (0)20 3077 6000
@AshmoreEM
www.ashmoregroup.com

**Bogota**
T: +57 1 316 2070

**Dubai**
T: +971 440 195 86

**Dublin**
T: +353 1588 1300

**Jakarta**
T: +6221 2953 9000

**Mumbai**
T: +9122 6269 0000

**New York**
T: +1 212 661 0061

**Riyadh**
T: +966 11 483 9100

**Singapore**
T: +65 6580 8288

**Tokyo**
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