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Ecuador's poor will restructure emerging market debt

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After weeks of creditor bashing, Ecuador has issued a post-dated promise to honour the $135m due tomorrow on its bonds. But even though the month-old government may pay this time around, a new senior creditor has been seated at the table in the negotiation of troubled sovereign debt. Emerging market investors would do well to reformat old spreadsheets and take heed of a new risk factor: the percentage of the electorate that struggles below the poverty line.

For the first time in the melodrama of Latin American debt – which has seen 20 restructurings in 20 years – a country that clearly has the wherewithal to pay is questioning how much to pay. It was a campaign promise: financial debt to foreign lenders would be subordinated to a social debt to the nation's poor. And where Ecuador leads, a dozen neighbours may follow.

Ecuador's $10bn debt passes a stringent solvency test. At 30 per cent of gross domestic product, the burden is less than half Argentina's 61 per cent or Brazil's 73 per cent. The economy has a current account surplus and is growing at 4.5 per cent a year, the primary budget is in surplus, the banks are solid and the price of oil, the main export, has doubled in three years.

Yet Ecuador is a poor country; almost half the population lives below the nation's minimum standard. The current 6 per cent of GDP dedicated to servicing debt is labelled unaffordable and payments are slated to be chopped in half. President Rafael Correa wants to "pay salaries on time, allot resources to education and health". Lenders get what is left. With a single stroke of the budget pen, senior status bonds were transformed into subordinated debt.

Is this just a speed bump on the path of emerging market sovereign lending, which now totals about $700bn? After all, Ecuador has had eight presidents in the past 10 years and has consumed finance ministers at a rate of two per annum. But Ecuador is not alone. In nine countries in Latin America, the poor – who make up more than 40 per cent of the population – have the numbers to prevail. In the seven elections in the past year, Bolivia, Ecuador, Nicaragua and Venezuela installed populist leaders with socialism in their sights. Peru and even investment-grade Mexico barely retained market-friendly regimes. When economic times get tough, Argentina, Brazil, Panama and Paraguay, where the poor now number 30 per cent, will be at risk. If Ecuador denies its debt without crisis, no leader will ask for sacrifice to pay rich foreigners.

There is a traditional path to debt reduction. First over-borrow, then over-spend until insolvency is inevitable. But Ecuador wants to send a message to the world: the poor take precedence. Governments have the right to prioritise spending. Lenders have a reciprocal right to know their rank in the payments chain before their dollars are handed over.

Those who hold existing bonds have little leverage. The once-powerful International Monetary Fund, which dominated errant sovereign debtors with its store of bail-out funds, is being sidelined as governments pay off their loans to escape its tutelage. Financial markets with short memories welcome back defaulted borrowers, allaying fears of financial isolation. High commodity prices fill central banks with abundant international reserves to outlast financing gaps. Political agendas, not profit, motivate Venezuela, China, and Iran to offer a reservoir of funds without western strictures.

Markets will digest the shock that they are holding junior claims masquerading as first calls on government monies. Borrowers will then be forced to bind the seniority of new issues with constraints written into bonds: collateral held in New York, ceilings on borrowing and spending, interest rates that increase as creditworthiness declines and shorter maturities linked to political cycles. The costs of unwarranted default will be made to exceed the benefits.

Soon, the old simplistic mould of sovereign debt will be broken into pieces that balance risk and return. There will be senior notes bristling with restraints on borrower action, subordinated debt that tolerates hazard and quasi-equities with yields contingent on growth or the prices of oil or soybean exports. As an expanded universe of diverse investors responds, flows to emerging nations will rise, funding costs will fall and cyclical swings will be softened. Markets, not politics, will better the lot of the poor.

The writer is a professor of economics at Carnegie Mellon University. He led the negotiations for ABRA, the largest international creditor in the 2005 Argentine debt restructuring