PN-ABF-398
66761

FINANCIAL MARKETS OVERVIEW; ECUADOR

Bureau for Private Enterprise
U.S. Agency for International Development

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Sponsored by: *Financial Markets Project*
Project Number: 940-2005
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June, 1986

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With regard to priority recommendations to the Ecuadorean Government concerning policy and legal modifications to be made in order to stimulate economic growth and development; I would suggest the following under the categories which were identified:

Capital Markets

1) Commercial interest bearing instruments and loans should be on a floating rate basis factoring in the inflation rate. This will encourage savings and act as a deterrent to flight of capital and encourage its return (see No. 4). Studies will show this will not cause excess liquidity which can always be controlled by varying the reserve requirement deposit at the Central Bank.

2) Lower taxes on corporate dividends from the present total of about 55% to 10 or 15%.

3) Lower the capital gains tax from 50% to 15 or 20%. An analysis of the present revenue derived from dividend and capital gains taxes will show the amount is not considerable and the yield will increase as greater volume will produce more revenue at the lower rates. (The U.S. - I.R.S. has analyses showing the increase in revenues received as a result of lowering the capital gains tax from 27% to 20%).

4) Abolish Article 24 of the Andean Pact which limits foreign investment in local companies to a minority interest. The Presidents of Venezuela and Colombia have already agreed it is desirable to do so. Although returning flight capital of Ecuadoreans will probably come in as Panamanian or other foreign companies, it is better than not coming back at all. Article 24 is an obstacle to this process.

5) Gradually reduce export tax retentions and prior import deposits as well as the advance foreign exchange tax on purchases of exchange. These are regressive measures inhibiting the expansion of foreign trade, encouraging smuggling and encouraging increased imports by government owned companies at the expense of the private sector which is weakened as a result.

6) Enforce collection of income taxes by stiff penalties which will compensate for reductions under No. 4.

Insurance Industry

The insurance industry exerts a minimal influence on savings and investment in general and barely one tenth of the population is covered by life insurance.

Major impediments to growth of the industry consist of a required investment of 55% of insurance company reserves now yielding government bonds with a resulting decapitalization of the companies and profitable operations. Investment of reserves in government bonds should be lowered to 15% and up to 10 of reserves should be permitted to be invested in commercial operations such as venture capital funds with favorable tax treatment. This could be a source of capital for privatization of companies as well as for new ventures.

If Article 24 was modified to allow foreign insurance companies to form joint ventures with local companies, once investment requirements of reserves was reduced, the benefits of transfer of technology would soon become apparent.

Aggressive selling of life insurance policies and new investment techniques would make the industry a thriving one with increased revenues to the government.

Privatization

The Corporacion Financiera Nacional has indicated it plans to place on sale all of the shares it owns in companies in June through the Stock Exchange.

While this is a praise-worthy effort, it would be more effective if an independent audit would first be made of the companies and if an independent appraisal would also be done.

Privatization is a difficult process for a government. The companies which are losing money tend to be over-valued by agencies such as CFN so as not to record a loss after the sale (if the company is sold which is doubtful). The prosperous companies tend to be over-valued as well in order to make up for the annual losses the other companies have suffered. Once the shares are correctly priced the problem is finding buyers who can turn them around.

In this regard, reducing the tax on dividends and inducing the return of flight capital as well revitalizing the insurance industry can open up opportunities for such sales.

It is questionable whether selling control of a company is really feasible through the Stock Exchange. An initial sale is better accomplished through an intermediary such as a bank, broker or financiera as they have customers who might be interested. A private sale leaves more room for negotiation and an intermediary can be most useful.

After a company is sold is the time to have its shares quoted on the Stock Exchange, as a secondary market sale after the measure discussed under the other headings are accomplished. The Brazilian government has greatly stimulated utilization of the Rio and Sao Paulo Stock Exchanges by tax benefits. Under Brazilian law, a company can deduct 15% from its annual income tax and must issue stock for this amount. The stock must be placed in a mutual fund which can only be traded on one of the stock exchanges. Investment banks in Brazil then buy and sell these funds for their investment portfolios.

Venture Capital

A venture capital fund can be successful it if is managed by experienced institutions. A bank with this experience and possibly the IFC and the Inter-American Development Bank's new Inter-American Investment Corporation could by useful partners together with AID. Companies must have independent audits to provide confidence and must be professionally managed. Those exporting at least a portion of their product would have a better chance than those producing purely for the local market as devaluations would provide them with greater cash flows once

export dollars are converted to local currency. A good inter-national bank as manager of a Venture Capital pool could help locate foreign buyers.

Foreign Debt Conversion to Equity

The time seems to be right for this type of activity. Up until a year ago foreign banks were not interested in this possibility but this has changed. In the last ten months Chile has had over 500 million dollars of foreign debt converted to equity. Chilean foreign debt continues to be converted at a rate of 50 million dollars a month. (See separate report on Gallagher y Cia., Santiago, Chile).

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Through the Citibank General Manager, Jim Dean, I met David Gallagher, principal of the above while the latter was visiting Quito.

Gallagher was born and raised in Chile of British parents and is a broker and investment advisor. He formerly head of the Latin American division of Morgan Grenfell, London.

He told me he was responsible for initiating the conversion of part of Chile's external debt to equity which now totals over 500 million dollars and is proceeding at the rate of 50 million dollars a month.

Gallagher began by obtaining an authorization from Chile's Central Bank permitting Bankers Trust Company, New York to convert 100 million dollars and is proceeding at the rate of 50 million dollars a month.

Gallagher began by obtaining an authorization from Chile's Central Bank permitting Bankers Trust Company, New York to convert 100 million dollars of Chilean debt to Chilean equity. They have now converted some 43 million dollars (after 10 months) by buying a Chilean insurance company and a private pension fund. he did a similar operation for the National Commercial Bank of Saudi Arabia.

The conversion was done in stages, first by buying Chilean Central Bank paper denominated in local currency, but with a very low yield and then

exchanging this paper at par for shares of the companies indicated above. The loss of interest is then borne by the Chilean companies which were bought.

Gallagher would like to do a similar operation in Ecuador where his local contact is Mauricio Perez. He travels to Quito from Santiago from time to time.

May 23, 1986

Persons Visited in Quito

May 19 - 23, 1986

1) James Finucane and Kathleen Heffernan,. AID, Quito - repeated visits.

2) Ramiro Crespo, N.A. Stock Exchange Broker.

3) James V. Dean, Vice President - Citibank, N.A.

4) Economist Edgar Cornejo Mencaho, Director Administrativo
Superintendencia de Bancos.

5) Donald S. Green, Principal Consultant - SRI International

6) Jose Correa, Chairman - Cofiec S.A. (two visits)

7) Eduardo Villaguiran, President
Corporacion Financiera Nacional.

8) Economist Teresa Minuche de Mera
Superintendent of Companies.

9) Orlando Llenza, Mission Director - IAD, Quito

10) Ramiro Garzon Abad, Vice President, Citicorp Investment Bank.

11) Victor Bolles, Vice President, Citicorp Capital Markets -0 Unit Head.

12) David Gallagher, Gallagher y Cia.