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PRIVATIZATION AND THE DEBT PROBLEM IN ECUADOR

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Purpose and Scope of Report: This report is based on interviews with 16 prominent bankers and businessmen in Quito and Guayaquil between July 7 and July 14, 1986. (In addition, interviews with Citicorp, Bankers Trust and the World Bank were held in New York and Washington two weeks before arriving in Ecuador.) The purpose of the interviews was to explore three questions:

1) In the opinion of the private sector what specific enterprises, owned or controlled by agents of the Ecuadorean government, seem suitable for sale to the private sector? Are there opportunities for direct foreign investment in such transfers?

2) What are the major obstacles to privatization?

3) Where is the money to come from to finance such transfers?

Part I of the report presents some answers to these questions. While a list of respondents is attached to the report, the interviews were conducted on the basis of confidentiality. In most cases, accordingly, specific respondents are not identified.

The interviews were conducted in the context of a serious recession caused in part by the fall in oil prices and in part by Ecuador's huge debt overhang (estimated at $8.-billion and requiring annual service payments of about $900-million, or a sum equal to more than one half Ecuador's current export earnings). The interviews convinced the consultant that the prospects for privatization in Ecuador are rather poor given the current financial situation. In fact the prospect is that the government is likely to aquire more assets from bankruptcies in the private sector than it will be willing or able to sell to the private sector. While Part I of the report suggests some ways in which AID might nonetheless persue a useful privatization program, Part II suggests a few talking points for AID in the on-going policy dialogue with the Ecuadorean government about ways and means of restoring growth in the private sector.

The interviews were conducted by the consultant in the company of Sr. Rodrigo Lopez of the AID Mission, who acted both as interpreter and as participant in the interviews. While for convenience the editorial "we" is used in the report, Sr. Lopez is innocent of all errors in reporting and is not necessarily in accord with all conclusions.

Part I: PRIVATIZATION

> The executive branch supervised a number of autonomous agencies concerned with social and economic operations...By 1970 these numbered about 1,400. Theoretically subordinate to the executive branch, these agencies were not responsive to control by the cabinet or by the legislature. (President) Velasco Ibarra (in his fifth term) had reduced their number by 700 between 1970 and 1972, and one of the goals of the military government was to further reduce the number...."
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> "Area Handbook for Ecuador", published in 1973 by the Foreign Area Studies branch of American University, Washington, D.C.

While it is not clear what kinds of enterprises were covered by the 1,400 "autonomous agencies" the authors of the "Area Handbook for Ecuador" referred to, the above quotation illustrates a fact endemic to social and economic life in Ecuador: particular interests use the mantel of national, provincial and local government to "own" and operate a wide variety of economic organizations without the presence of any effective central control.

No respondent would even hazard a guess as to the number of state-owned or operated enterprises that actually exist in Ecuador today. One asserted that the armed forces alone owned $S14-billion (a bit less than $U.S.100-million) in corporate assets. The Ecuadorean army owns Ecuatoriana Airlines (though the present government has installed its own civilian manager); the Air Force appears to own another airline; and the Navy owns a shipping line. And that is only the beginning. Except for the possibility of engineering a joint-venture in Ecuatoriana, very much needed to improve and expand the airline's cargo-carrying capacity, no respondent believed that the armed forces would be willing to sell any of their assets, even if buyers could be found. The armed forces are a fourth branch of government in Ecuador with considerable public support; their corporate activies are an integral part of the retirement system of the officer corps. But to keep the matter in perspective these holdings amount to only some 2% of Ecuador's GDP.

The only other quantitative measure of government participation in Ecuadorean enterprises available to the consultant was a list, supplied by the AID Mission, of corporations in which the CFN has an interest. The list included 34 "empresas en operacion" with a net positive cash flow equivalent to $2.6-million as of the end of 1984. CFN's average holding in these 34 empressas was 18.53 % , but rose to 66% in ten agro-industries and 40% in three cement companies. The list also included 7 empresas "en promotion" (including two more cement companies) and four "en liquidation". The total capital, public and private, in these 45 enterprises as of 1984 was the equivalent of $US 140-million.

CFN and the Armed Forces are by no means the only state agencies with corporate interests. The Social Secrurity System (IESS), the Ministry of Industry and Commerce, The Ministry of Agriculture, the BFN (national development bank), the National Oil Company (CEPES) were all mentioned in interviews and no doubt the list is even longer. The most consistent theme throughout the interviews was the assertion that nobody really knew the financial profile of any of these enterprises; records simply weren't kept, or if they were, were hidden in some bureaucratic cubby-hole; the interviews were punctuated with general charges of corruption and of a "fast-buck mentality" as one respondent put it. The absence of reliable financial information about these enterprises clearly emerged as a major obstacle to any degree of privatization. Nor was it possible to determine how much of the government's budget is absorbed in subsidies to these enterprises.

A second and related major obstacle to privatization is the difficulty of determining exactly who the effective government owners are and getting even an agreement in principle to consider an offer from the private sector. Take the case of ANDEC, a small company making steel wire and other steel products. One of our respondents had recently served as general manager of ANDEC, placed there by the CFN to bring some order out of a chaotic situation. He claimed he had succeeded and that the company was now well managed and showing a profit. But 80% of the ownership rested with CEPE, the Army and CFN, with one private owner holding the balance. He despaired of getting any agreement among these owners to sell, especially now that the company was profitable.

The CFN, in the opinion of respondents, appears most reluctant to offer profitable enterprises for sale since their profits carry CFN's substantial losses. But unprofitable enterprises ,unless valued realistically (which may mean that the only real asset is the land on which the enterprise rests), will find no buyers. Since CFN officials serve as directors of enterprises in which CFN has a stake, and sometimes earn more as directors than they do as officials, these are some of the key people in determining possibilities for privatization. As will be argued below, this may be the place where AID should concentrate its privatization efforts.

Respondents stressed two other major obstacles to privatization: the state of the economy at present, which will be discussed in Part II of this report, and the problem of disposing of excess labor. The respondents stressed that labor-management relations in Ecuador are really labor-government relations. One respondent's bank was struck last spring; the workers simply occupied the executive officer and locked them out. The strike was resolved, not by collective bargaining between bank management and the work force, but between the work force and the Ministry of Labor. We understand this to be rather typical.

A good example of a state-owned enterprise with a massive labor problem is the sugar company , AZTRA, outside of Guayaquil in which CFN holds a 96% ownership. In 1984 it lost the equivalent of $US 5.4-million and is undoubtedly worse off now. Several respondents cited this, CFN's "worst case", as a large but good example of the difficulties of privatization; selling off AZTRA would involve laying off a thousand or more workers and that is just not in the cards.

Despite these formidable obstacles, we were able to indentify from the interviews eight possible candidates for privatization for which investment capital appears to be available. These eight candidates are set out in Table I:

Table I: Good Prospects for Privatization

	Empresa	Owner	Obstacle	Comment
1)	Adamas Adina (paper)	CFN 18.6% (1984) Balance held private banks.	Valuation	Overcapacity due to collapse Andean market.
2)	National Cement Co.	CFN 47%; Swiss interests 53%	CFN reluctant to sell profitable investment.	Swiss investor likliest buyer
3)	Tezulay (tea grower)	CFN 46%; rest probably Anglo-Ecuadrean tea interests.	Ditto	Financiera Ibroamericana has offered to buy with Anglo Ecuadorian.
4)	Tarabouilla (sugar)	IESS; CFN 17%	Apears sold	Leveraged buy out to local investors.
5)	IPENA (fishing)	Min. Industry & Commerce 100%	Valuation	100 employees plus boat on which Japanese supplier holds a note.
6)	ENSEMILLAS (seed monopoly)	CFN 22.28%; BFN and maybe Min. Ag.	Valuation; Who can decide to	Camera de Agricultura de la Ire

		sell?	Zona has made offer.
7) ENDES (Artificial Insemination)	Min. Ag.?	Valuation	Same interest but no offer yet.
8) Hotel Quito	IESS 40%; Local private 60%.	Labor interest?	Management contract with Intercont-inental up for renewal next year.

The one empressa on this list that appears about to be "privatized", Tarabouilia, suggests that the social security system may be the most willing to disinvest. In this case IESS offered a slow note to local investors, Financiera Ibroamericana we believe, who wish to join with a Venezuelan partner in the manufacture of ethynol from sugar. The assets transferred include a sugar mill and some land. The peasants who used to grow the sugar cane apparently stopped doing that some time ago in the face of a very low price for cane. The new owners therefore apparently have not inherited a labor problem.

IESS apparently is required to hold a large portion of its funds in government securities with yields below market rates. This makes "privatizaztion" with IESS financial participation a relatively attractive proposition. A test may be the Hotel Quito in which IESS has a 40% interest. The labor union is represented on the board of the hotel and the management contract is to be renewed (with Intercontinental we assume) next year. We were unable to identify any potential borrowers, but this would seem on its face to be a good prospect.

Another test case will be whether the Camara de Agricultura de la Ier Zona"s offer to buy Ensemillas from CFN and BFN will be seriously considered. The empresa has been "losing money by the millions" we were told. Considering the strategic importance of seed suppliers in agricultural development, this case should be monitored most closely by AID.

The list in Table I obviously does not reflect an effective demand for privatization in strict economic terms. Rather it reflects a few particular situations; one company name is on the list simply because the wife of one of our respondents happened to have been named recently financial manager by the controlling government owner with the specific assignment of producing a reliable financial profile of the organization. None of the other respondents had ever heard of the company!

No financial organization appears on the list, but there was considerable discussion in the interviews both of capital markets and of La Provisatora, a national bank that the government took over in the face of rampant fraud and has now recapitalized into the largest bank in Ecuador. One respondent asserted confidently that if the current economic situation should ease, a consortium of three or four Ecuadorian banks would come forward to purchase La Provisatora in part by selling shares on the local market. Several respondents asserted that a market for bank shares did exist, while at the same time rejecting out of hand the suggestion that the state-owned telephone company, INETEL, might ease its burdens by selling its shares. The telephone company is obviously providing very poor service while recieving a substantial government subsidy. Yet no respondent believed that privatization was at all possible for political reasons. Nor did any think that selling telephone shares was possible.This would seem to be a situation where the World Bank is the logical institution to take an initiative (see Part II).

Two respondents explained that selling bank shares was possible, while selling telephone shares was not, because in Ecuadorean eyes bank shares represent "power". We were told that the shares of only eight to ten Ecuadorian enterprises were traded on the stock exchanges of Guayaquil and Quito and most shares traded were bank shares. (There is also a lively trade in tax rebate certificates--CATs--which is reported daily in the press.) CFN holds a 77% interest (1984) in the Guayaquil exchange and a 33% interest in the Quito exchange, but again no respondent thought these were cases for privatization. Seats on the exchanges, we were told, are valued at $S10-million and more apiece, but nobody is really willing to sell at any price. The exchanges, it appears, are more like clubs whose members derive prestige more than trading opportunities.

<u>A Role for AID?</u> CFN would seem to be the most important point of contact for AID when it comes to promoting privatization. Auditing assistance in the fixing of fair valuations for empreseas in which CFN has an interest is a recognized need and we understand AID is already conducting discussions looking to the provision of AID assistance in this matter. This effort could be extended to include the provision of broader management assistance which is obviously needed across the boards. A good case could be made for encouraging CFN to become the source of management assistance (foreign and local) for a broad range of corporate activities in Ecuador.

But this will require some delicate diplomacy. Our respondents were clearly confused over AID's interest in privatization. There was general agreement at the level of philosophy, but AID's specific interests were not clear. The term "privatization" is in danger of being regarded as a Gringo cliche, if, in fact, that is not already so. It is in danger of creating suspicions more than co-operation. We tried to fend off this threat by concentrating our questions on the subjects of valuation and managemewnt assistance. This seems to us to be a better tactic than a program of exhortation or prescription under the banner of "privatization".

This caution gains weight from the fact that several respondents (most notably IBM) were at pains to impress us that "privatization is not the problem....It won't play a role in easing Ecuador"s present economic pains". In answer to the direct question, 'Do you think CFN will acquire more assets from failing enterprises in the private sector in the next three to five years than it will sell to the private sector from its portfolio?" most respondents replied in the affirmative. In fact, only one replied in the negative. Some respondents thought that La Provisatora would also aquire more bad loans from private banks than it would sell good loans to them. The immediate problem is the debt overhang, coupled with falling oil prices.

Part II: Debts and Equities

"Nobody wants a dollar debt." We heard that observation again and again in the interviews. As a result of the "sucretization" of foreign debt it appears that the biggest game in town is trying to out-fox, or second guess the Central Bank's manipulation of a multiple-exchange rate system. One respondent, a young, U.S. educated banker , simply brushed all our questions aside with the assertion that the establishment of a floating exchange rate for all transactions was the only possible salvation for the Ecuadorean economy.

Such questions lie far outside the terms of reference of this report. At the same time, the prospects for privatization clearly depend on the prospects for the Ecuadorean economy in general. Unless growth can be restored, especially growth in export sales, it is likely that recent gains in private sector activity will be lost. The private sector gained much less than the public sector from the oil boom; it probably lost on balance from the binge of "sovreign" lending by U.S. banks that attended the oil boom. It follows that the immediate problem is to restore some incentive to assume dollar debt on the part of the private sector. It now takes about two months of bureaucratic delays for an Ecuadorean importer to get even 90-day money for an essential import. (One Guayaquil banker told us he tells his best customers in these circumstances to try another method, maybe a foreign bank, if they are really pressed.)

The current policy dialogue between AID and the Ecuadorean government concerns all these matters. Three ideas emerged from our interviews which, while not suggesting programmatic action, do suiggest talking points for AID. One concerns the activiites of commercial banks and the other two the activities of the World Bank. While none suggests an AID program, they do suggests ways in which AID might use its time and influence to help bring about the kinds of changes in private sector attitudes (essentially the restoration of confidence) out of which a more substantial privatization program might grow.

1) A "Baker Company". One of our respondents, a U.S. citizen ,manager in an Ecuadorian enterprise, came up with a suggestion that we were able to discuss usefully with many other respondents. He proposed what he called a "Baker Company", an investment bank established by a group of U.S. money-center banks (perhaps with other international participation) into which a portion of the government's annual debt service payments (perhaps $10-50-million per year) would be placed. These dollars would then be invested in Ecuadorean export industries as equity.

The rationale for this idea is clear, if the mechanics, perhaps, are not. The U.S. banks act together, almost as a cartel when it comes to renegotiating debt with the Ecuadorean Government; afterwards they go their own way and in general that means they go home. Our respondent asked, "Why don't they leave some of their money here?" We think that in the Ecuadorean context the question is a very good one.

The idea emerged from our questions to respondents about their attitudes towards debt-equity swaps. Those who were familiar with the mechanics of the Bankers Trust swap in Chile or the Nisson swap in Mexico felt that the "structures" in Ecuador were not sophisticated enough for these kinds of operations. The Baker Company idea, on the other hand, clearly caught their imaginations. Most thought the Central Bank could be persuaded to offer some guarantees to the new bank as regards repatriation of profits (The Brazil example was cited more than once). Perhaps more difficult would be the problem of "sucretization" of a portion of the equity investments which would be inevitable; could this be controlled in the context of the present program? Most thought that this,too, would be "negotiable." But most thought the real obstacles lay in the headquarters of the U.S. banks rather than in Ecuador.

It was not practicable to explore this idea in depth, especially the related question of retention of dollar earnings by Ecuadorean exporters. But the idea obviously struck a very responsive chord among respondents, a much more responsive chord than the subject of privatization.

2) Sales of World Bank Loans: By sheer co-incidence one respondent raised a suggestion we had floated in our interviews with banks in New York: why should not the World Bank sell early tranches of its Ecuadorean loans to U.S. banks and take discounted government debt in return, passing some or all of the discount on to the Ecuadorean government? Was not this a fairly simple route to a small measure of debt relief?

We could not test this idea out on the management of the World Bank, but the Bank has rersumed selling portions of loans after many years of neglect on the grounds that it was not profitable business for the World Bank. What would be new would be swapping portions of loans for discounted government debt.

Anybody familiar with the World Bank's balance sheet, as we are, knows that such activity would not in any way weaken the World Bank's standing in the international bond market.

The obstacle to implementing this idea appears to be U.S. bank regulators, who now say that when a bank discounts any portion of a given portfolio, it must discount the whole portfolio. This point, advanced by the respondent from Chase Manhatten Overseas Corp., masks an anomoly: banks can now discount a portion of a portfolio by selling discounted paper to the Libor Bank in London; Ecuadorian government debt now sells at a 40% discount through this channel. (Chase-Manhatten holds a large interest in the Libor Bank.) This anomoly suggests to us that this avenue to modest debt relief is worth pursuing, especially in the Ecuadorian context.

3) Project vs. Structural Adjustment in World Bank Loans: The Baker Plan envisions a bigger role for the World Bank in heavily indebted countries through the medium of "structural adjustment" loans that are disbursed much more rapidly than the Bank"s conventional project loans. We found reason to question the way this new strategy is being carried out in Ecuador. There may well be better ways to achieve rapid disbursement than by piling on another level of international bureaucracy dealing with the two or three top economic officials of the Ecuadorian government. There may be better ways that actually help the private sector in Ecuador directly.

Our respondent from Cofiec gave pertience to this line of questioning. The World Bank recently concluded its fifth industrial sector loan to Ecuador for $125-million. Cofiec has been a co-financier under several of these loans and has many years experience dealing with the World Bank. The recent loan was origianally negotiated for a series of industrical investments totalling $125-million in foreign exchange. Then at the last minute the World Bank witheld $50-million for "structural adjustment"--specifically for trade adjustment assistance to firms that might be injured by trade liberalization policies urged on the government by the Bank and the IMF. It is not at all clear that rapid disbursement, one major feature of structural adjustment lending, will be any greater under actual circumstances than it would have been under the loan as originally negotiated. What is clear is that some loan monies earmarked directly for the private sector, will now go to the

Central Bank instead.

Given the fact that the World Bank is asking nothing under the heading of "structural adjustment" that the IMF is not also asking, it stands to reason that more consideration should be given to the real capital needs of the private sector in Ecuador under World Bank lending.We were not able under this contract to review the actual state of World Bank project lending in Ecuador to determine the real causes of sluggish disbursements. We believe this would be a worthwhile exercise for the AID Mission. If, as we suspect and is broadly true in many, many other countries, the major cause of sluggish disbursements is the failure or inability of the host government to provide local cost finance for these projects, the question should be asked why the World Bank shouldn't make supplementary loans to cover the missing local costs in the present situation? Or to put the question differently, why isn't a policy of fully funded projects a better response to the present situation by the World Bank than a policy of structural adjustment in tandem with , or duplication to the IMF? Would not such a policy stimulate local economic activity directly? And would not the effect on World Bank disbursements approximate that of structural adjustment loans?

On the surface these seem reasonable questions for AID to ask, even under the rubric of privatization. For without resumed economic growth in Ecuador, hopes for private sector investment are certainly not going to be bright.

Footnote: On completion of this report I checked the World Bank to ask the disposition of the $50-million in "trade adjustment assistance" contained in the recent industrial sector loan. "We were double-crossed," said my informant. "They agreed to remove 50 catagories of import quotas; they did that. But then they imposed 170 new quotas, making things worse than they were before." I asume the Bank is not disbursing these monies.