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Peru's Selective Default: A Stain on Its Creditworthiness

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ABSTRACT

In the 1970s, while a leftist military dictatorship ruled Peru, more than 22 million acres of cultivated or grazing farmland – one-third of Peru's total agricultural acreage, or seven-and-a-half times the land area of Connecticut – were expropriated from thousands of large owners as part of a property reform intended to benefit up to 400,000 landless peasant families. The compensation provided to landowners was miserly, however: on average, it was less than one-tenth the then-prevailing market price of water-accessible, cultivated land. Moreover, about 85 percent of total recognized land values were settled not in cash but with long-term Agrarian Debt Bonds, which committed future governments to honor fixed coupons on obligations maturing in 20 to 30 years.

These bonds became worthless during the 1980s, however, because hyperinflation raged and the Peruvian currency lost most of its value. In the wake of the filing of hundreds of lawsuits seeking judicial redress, in 2001 the country's Constitutional Tribunal ruled that the government should resume payment of the land-reform debt after updating its nominal value on an actuarial basis. And yet, successive administrations did not act on this ruling, despite the fact that since the mid-1990s Peru has exhibited vigorous economic growth, significantly strengthened public finances, and substantially improved creditworthiness, such that governments have had more than the necessary ample fiscal resources to redeem the land-reform bonds at their full, original value.

It was not until July 2013 that the Constitutional Tribunal reaffirmed the government's obligation to pay the current value of the agrarian debt and gave it six months to issue a decree-law regulating the procedure for payments on the land-reform bonds. The current (Ollanta Humala) government complied, but it put forth an adjustment formula which does not revalue the bonds correctly and leaves them nearly worthless, thus adding insult to long-standing injury. Evidently, we are now in the presence of a case of blatant unwillingness to pay, one which undermines Peru's claim to be a nation that is creditworthy, investor-friendly, and respectful of the rule of law.

KEYWORDS: Peru, Latin America, default, debt, sovereign, litigation, land reform, credit rating

JEL CODES: D23, E6, F3, F34, F51, F65, H63, K4, N26, Q15

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INTRODUCTION

From 1969 until 1979, while leftist military dictators ruled Peru, more than 22 million acres of cultivated or grazing farmland – one-third of Peru’s total agricultural acreage, or seven-and-a-half times the land area of Connecticut – were expropriated from thousands of large owners as part of a property reform intended to benefit up to 400,000 landless peasant families.¹

The cumulative economic value of the agricultural lands expropriated in the 1970s has recently been estimated to exceed the equivalent of more than \$40 billion.² The land seizures were part of a broader agenda of nationalizations (involving the oil, copper and banking industries), heavy state intervention in labor, agricultural and financial markets, and income-redistributive policies reminiscent of the kind implemented in Venezuela in the past dozen years.³

The then-prevailing Constitution of 1933 contemplated land reforms to promote small and medium-sized farming, but was protective of property rights: Articles 29 and 47 stated that these rights were inviolable, and they could be affected by law in cases of public necessity only after appropriate compensation was paid.⁴

In the event, however, the compensation provided was miserly: while ranchers at least were paid in cash for their herds, recognized land values were very low, based on outdated book values or on tax-related assessments for 1968, and only 15 percent of expropriated land was paid in cash. The average compensation value per acre was less than one-tenth the then-prevailing market price of water-accessible, cultivated land.⁵

¹ The Peruvian experiment privileged about 56 percent of landless families – mostly the families of workers in large estates – and ended up creating a large number of cooperatives which proved largely unsuccessful for a variety of reasons; most were later subdivided into small farms which were likewise uneconomical. See Ministerio de Agricultura y Riego, “El proceso de reforma agraria” available at <http://minagri.gob.pe/portal/objetivos/70-marco-legal/titulacion-agraria-en-el-peru/413-el-proceso-de-reforma-agraria>; José María Caballero and Elena Álvarez, *Aspectos Cuantitativos de la Reforma Agraria, 1969-1979* (Lima: Instituto de Estudios Peruanos, 1980), available at <http://archivo.iep.pe/textos/DDT/aspectoscuantitativos.pdf>; and José Matos Mar and José Manuel Mejía, *La Reforma Agraria en el Perú* (Lima: Instituto de Estudios Peruanos, 1980), available at <http://archivo.iep.pe/textos/DDT/reformaagraria.pdf>.

² Measured as the present value of agricultural production flows from expropriated lands, based on estimated historical cash flows of agricultural production generated by these lands plus the discounted cash flows of projected agricultural production. See Deloitte (Peru), “Comparative Analysis of Supreme Decree #017-2014-EF and #019-2014-EF and Economic Value of Land Expropriated During Peruvian Agrarian Reform,” March 2015, cited in the Brief filed by the Asociación de Bonistas de la Deuda Agraria del Perú (ABDA) with the Constitutional Tribunal, March 16, 2015, p. 5, available at <http://bonosagrarios.pe/wp-content/uploads/2015/03/Peticion-de-ABDA.pdf>.

³ “Government planners [became] convinced of the advantages of a centrally planned and controlled agricultural sector, with directives, credits, inputs, and so on emanating from central authorities to regional offices.” See Colin Harding, “Land Reform and Social Conflict in Peru,” in *The Peruvian Experiment: Continuity and Change Under Military Rule*, ed. by Abraham F. Lowenthal (Princeton, NJ: Princeton Univ. Press, 1975), pp. 252-53.

⁴ See Constitución Política del Perú (March 29, 1933), available at http://www.leyes.congreso.gob.pe/Documentos/constituciones_ordenado/CONSTIT_1933/Cons1933_TEXTO.pdf.

⁵ See Caballero and Álvarez, op. cit., p. 64. As per Matos Mar and Mejía, op. cit., p. 180, land values assigned during the reform “do not represent the real value of the assets expropriated, the majority of which were depreciated excessively, despite their having still many years of useful lives.” See also p. 294.

Moreover, the 85 percent of recognized land values that were not remunerated in cash were settled with long-term Agrarian Debt Bonds (*Bonos de la Deuda Agraria*), which committed future governments to honor fixed coupons of 6, 5 or 4 percent per annum on securities maturing in 20, 25 or 30 years, respectively.⁶ The face value of the bonds issued during 1969-79 was approximately 11.4 billion *soles de oro* (the legal tender at the time), the equivalent of \$250 million, or 2½ percent of GDP, on a weighted-average basis.⁷ To put it in context, \$250 million was the mean (and median) of just one year's worth of agricultural exports during the 1969-79 period.⁸

During the 1970s and 1980s, Peru was severely mismanaged by populist military and then civilian regimes, and thus the country experienced violent economic cycles which included hyperinflation and systemic debt, banking and currency crises. Given that the coupons and principal of the Agrarian Debt Bonds were not explicitly protected from the ravages of high inflation and massive currency devaluation, the bonds quickly became worthless. Adding insult to great injury, during the late 1980s the Peruvian authorities started to ignore even their rapidly shrinking debt-service obligations, and they eventually stopped making all payments due on these bonds.

One likely reason why the government ceased to service the bonded debt is that peasant beneficiaries of the land reform were supposed to pay for their plots on an installment plan, but despite the shrinking burden of fixed payments given accelerating inflation and currency devaluation, most did not meet their obligations because of mounting financial difficulties.⁹ In recognition of the problem, in November of 1979, the outgoing military government passed a decree-law forgiving the debt owed by the reform beneficiaries.¹⁰ This undermined the intermediary government bank (Banco Agrario), because it was supposed to use the payments received from reform beneficiaries to meet obligations to those whose land had been expropriated and who had been given Agrarian Debt Bonds in compensation.¹¹

The economy was finally stabilized and constructively reformed during the 1990s, when President Alberto Fujimori was at the helm, and additionally by sensible governments since then. For example, whereas inflation had galloped at a two-digit annual rate during the 1970s, and then at a three- and even four-digit annual rate during the 1980s, it came down rapidly and to single digits

⁶ Caballero and Álvarez, op. cit., Table 8, p. 62.

⁷ To calculate a proper average valuation for the 1969-79 period, it was assumed that bonds were issued in direct proportion to the amount of land expropriated in each year, and then the imputed face-value amounts were converted into US dollars at the average soles-oro/dollar exchange rate prevailing each year. Then the resulting total was compared to the dollar-equivalent annual average GDP figure. Additional bonds were issued in 1982, as mentioned below.

⁸ Calculated from various issues of the Banco Central de Reserva del Perú's Annual Report (1975-1981), available at <http://www.bcrp.gob.pe/publicaciones/memoria-anual.html>.

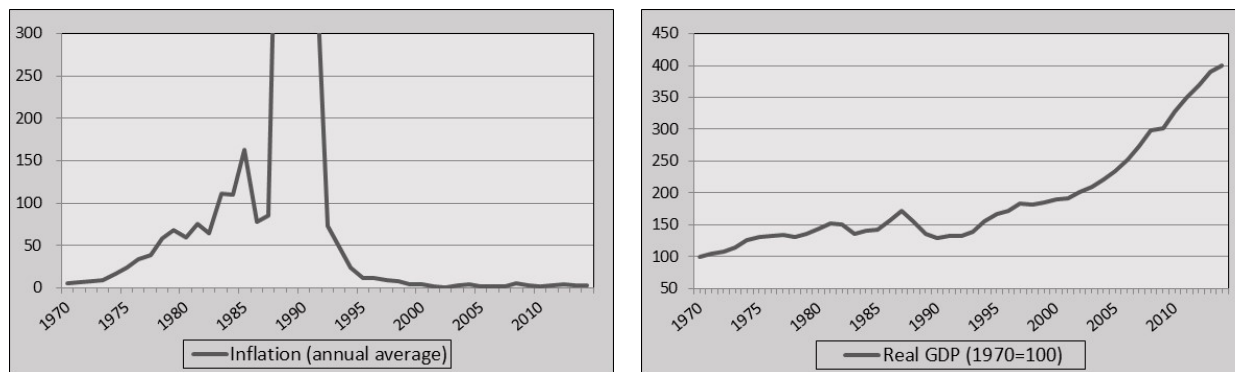
⁹ As reported at the time, "The problems of the new enterprises, often unwieldy and beset by social conflicts, are compounded by the official pricing policy for agricultural produce, as implemented by the state purchasing and marketing agency, EPSA (Empresa Pública de Servicios Agropecuarios). In order to keep prices to the (predominantly urban) consumers low, the prices paid by EPSA to the producers in the reformed and private sectors are uniformly low. This discourages production, and reduces the profits available for reinvestment." See Harding, op. cit., p. 253.

¹⁰ Caballero and Álvarez, op. cit., p. 54 and 71-72.

¹¹ The Banco Agrario was finally declared insolvent and shut down in 2008, see Resolución Suprema N° 076-2008-EF, September 26, 2008, available at http://www.cepes.org.pe/apc-aa/archivos-aa/4a15e4303d8c04dde2018292e444138c/RS_076_2008_EF.pdf

after 1996, averaging under 3 percent per annum since then.¹² And while real GDP had grown at an average rate of 3½ percent per year during the 1970s, and then hardly at all during the 1980s, the economy expanded at a pace of 3¼ percent per annum during the 1990s and then 5¼ percent yearly since 2000.¹³ As a result, real GDP has nearly quadrupled since 1990.

FIGURES 1 AND 2: PERU INFLATION AND REAL GDP



Source: Banco Central de Reserva del Perú.

I. SEEKING REDRESS IN PERU

A revised and updated constitutional text came into effect in 1993, and it strengthened property rights in Peru significantly. Under its Article 70, it was specified that any property seizures had to be compensated in cash and, moreover, that the affected owners had the right to challenge in the courts whatever reparation had been decided by a government during the expropriation process.¹⁴

An earlier (1984) reform of the Civil Code had legalized the practice of indexation (Article 1235) and provided that when “the value of an obligation is to be repaid, it shall be calculated to reflect the value it has at the time of payment, except as otherwise provided by the law or a contract” (Article 1236).¹⁵ Indeed, until the end of 2004, all Peruvian companies had to fully adjust for inflation in their balance sheets for accounting and taxation purposes, except for those authorized to

¹² See Banco Central de Reserva del Perú (hereafter, BCRP), Estadísticas, <https://estadisticas.bcrp.gob.pe/estadisticas/series/anuales/inflacion>.

¹³ See BCRP, Estadísticas, <https://estadisticas.bcrp.gob.pe/estadisticas/series/anuales/pbi-gasto>.

¹⁴ See Constitución Política del Perú (1993), available at <http://www.pcm.gob.pe/wp-content/uploads/2013/09/Constitucion-Politica-del-Peru-1993.pdf>. A constitutional text which had come into effect in 1979, once the military returned to their barracks, already fortified property rights by specifying in its Article 125 that expropriations had to be paid in cash and before they became effective, see Constitución Política del Perú (12 de julio de 1979), available at http://www.leyes.congreso.gob.pe/Documentos/constituciones_ordenado/CONSTIT_1979/Cons1979_TEXTO_CO RREGIDO.pdf.

¹⁵ See Código Civil de Perú, available at <http://www.abogadoperu.com/codigo-civil-peru-1984-abogado-ley.php>. For useful background, see Felipe Osterling Parodi and Mario Castillo Freyre, *Estudio sobre las Obligaciones Dineras en el Perú* (México, DF: UNAM, 1995), available at http://www.castillofreyre.com/archivos/pdf/publicaciones/catalogo/obligaciones_dineras.pdf.

keep records in foreign currency.¹⁶ The government also started to issue longer-dated bonds indexed to inflation, with maturities of ten (in 2003), twenty (2004) and thirty years (2005).¹⁷ The legalized alternatives of indexation to inflation or to the price of a U.S. dollar, as well as the rights granted by Article 70 in the 1993 constitution, encouraged mistreated land-reform bondholders to seek judicial redress for their enormous losses due to inflation and currency devaluation.

And yet, the Fujimori administration took a decidedly hard line when it came to land-reform bondholders during a time (mid-1990s) when it was constructively engaged with all other creditors (mainly international, official and private), on which Peru had been in default since 1983-84. These efforts paved the way for Peru's normalization of international financial relations, following the curing of protracted defaults to the IMF (1985-1993) and World Bank (1989-1992), the Paris Club of official creditors (who provided debt relief in 1991, 1993 and 1996), and foreign commercial banks which granted debt forgiveness under the aegis of the Brady Plan (1997).¹⁸ In the midst of that encouraging period of normalization, however, the national legislature passed, and President Fujimori signed, a law (#26597) specifically denying the application of Civil Code Article 1236 to the Agrarian Debt Bonds.¹⁹

Such discriminatory legislation was soon challenged in the courts, however, via a petition lodged in December 1996 on behalf of agrarian bondholders with Peru's Constitutional Tribunal. It alleged that Law #26597 affected the valuation criteria and payment for expropriated lands in blatant violation of the Civil Code and the 1993 Constitution. While the high court was considering the petition, rather than compromising, the legislature twice joined forces with the Fujimori administration to curb the rights of creditors to collect judicial awards against the government.²⁰

Then, three years later, practically on the eve of the Constitutional Tribunal's ruling, the government finally backtracked by passing an emergency decree (#088-2000) recognizing the land-reform debt. It offered to convert any original bonds still outstanding into U.S. dollars at the official exchange rate in effect on their issue date, applying to the result an interest rate of 7½ percent per annum. The downside was that the old bonds thus revalued would have to be swapped for new, 30-year obligations paying zero interest.²¹

¹⁶ See Estudio Echecopar-Baker & McKenzie, *Doing Business in Peru: 2014*, p. 25, available at http://www.bakermckenzie.com/files/Publication/bef43867-252f-465b-abc6-10d4edd5d078/Presentation/PublicationAttachment/0ba32590-7ee8-4c58-85ab-58fd5c20759f/bk_peru_db_mar14.pdf.

¹⁷ See Allison Holland and Christian Mulder, "Can Indexed Debt Absolve Original Sin? The Role of Inflation-indexed Debt in Developing Local Currency Markets," in *Financial Dollarization: The Policy Agenda*, ed. by Adrián Armas, Eduardo Levy Yeyati, and Alain Ize (Washington: IMF, 2006), p. 247.

¹⁸ See Udaibir S. Das, Michael G. Papaioannou and Christoph Trebesch, "Sovereign Debt Restructurings 1950-2010: Literature Survey, Data, and Stylized Facts," *IMF Working Paper No. 12/203*, August 2012, and Manuel Monteagudo, "Peru's Experience in Sovereign Debt Management and Litigation: Some Lessons for the Legal Approach to Sovereign Indebtedness," *Law and Contemporary Problems*, Fall 2010, pp. 201-14.

¹⁹ See Ley N° 26597 (April 24, 1996), available at <http://docs.peru.justia.com/federales/leyes/26597-apr-22-1996.pdf>.

²⁰ Two laws were passed to this effect: N° 26599 of April 22, 1996, available at <http://docs.peru.justia.com/federales/leyes/26599-apr-22-1996.pdf>, and N° 26756 of March 7, 1997, available at <http://docs.peru.justia.com/federales/leyes/26756-mar-7-1997.pdf>.

²¹ See Decreto de Urgencia N° 088-2000, October 9, 2000, available at <http://bonosagrarios.pe/wp-content/uploads/2015/03/Decreto-de-Urgencia-088-2000.pdf>.

In essence, the government was offering to exchange a compulsory, interest-bearing loan to the government with an original maturity of from 20 to 30 years into a compulsory, interest-free loan for an extra 30 years. In the event, the legality of this decree would likewise be challenged, and in an August 2004 ruling, the Constitutional Tribunal would deem it to be an optional, but by no means mandatory, solution for agrarian bondholders.²²

In March 2001, the Constitutional Tribunal announced its decision on Law #26597, ruling unconstitutional the government's 1996 attempt to keep the Agrarian Debt Bonds from being adjusted in accordance with the valuation principles enshrined in Article 1236 of the Civil Code and Article 70 of the 1993 Constitution.²³ This landmark decision was a huge victory for creditor rights in Peru, and subsequently it was twice validated by Peru's Supreme Court, in 2006 and again in 2010, in rulings concluding that bonds must be adjusted and paid at their full, original value.²⁴

Regrettably, neither of President Fujimori's elected successors, Alejandro Toledo (2001-2006) and Alan García (2006-2011), took steps to address the default on Agrarian Debt Bonds by restoring their value through indexation to intervening inflation or currency devaluation, and by restarting debt-service payments. And yet, during their administrations, Peru exhibited vigorous economic growth, significantly strengthened public finances, and substantially improved creditworthiness, such that they were comfortably positioned to finally cure the default on land-reform debt.

For example, the non-financial public sector posted shrinking deficits during the first half of the 2000s, and then mostly surpluses during 2006-2011 and beyond.²⁵ The ratio of public-sector debt to GDP shrunk from around 50 percent in the early 2000s to the vicinity of 20 percent by 2011 and thereafter.²⁶ The country's official international reserves skyrocketed from \$9 billion at the start of 2000 to nearly \$50 billion by the end of 2011 – and then climbed further to above \$60 billion.²⁷

²² See Sentencia del Tribunal Constitucional (Case N° 0009-2004-AI/TC), August 2, 2004, available at <http://www.tc.gob.pe/jurisprudencia/2005/00009-2004-AI.html>.

²³ See Sentencia del Tribunal Constitucional, March 15, 2001, available at <http://www.tc.gob.pe/jurisprudencia/2001/00022-1996-AI.html>.

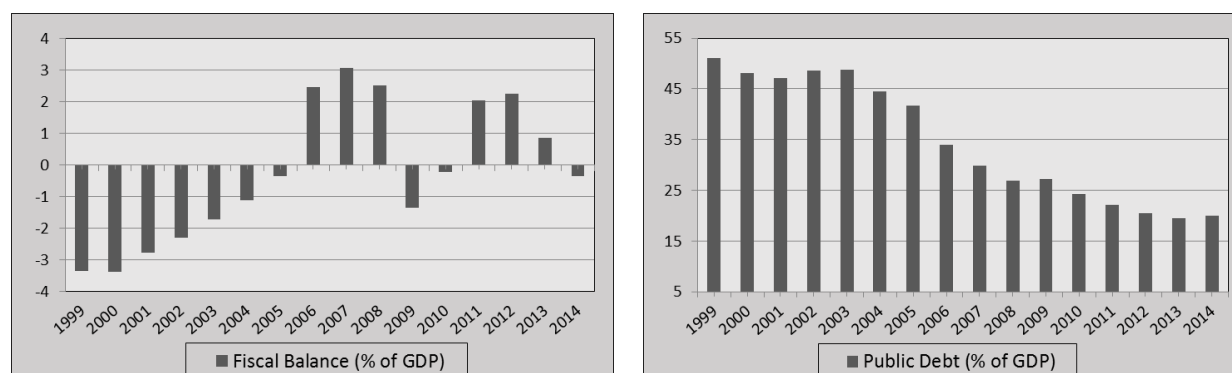
²⁴ See Corte Suprema Casación N° 1002-2005-ICA, July 12, 2006, and Casación N° 1958-2009-LIMA, January 26, 2010.

²⁵ See BCRP, Estadísticas, <https://estadisticas.bcrp.gob.pe/estadisticas/series/anuales/resultado-economico>.

²⁶ Ibid., <https://estadisticas.bcrp.gob.pe/estadisticas/series/anuales/deuda-publica>.

²⁷ Ibid., <https://estadisticas.bcrp.gob.pe/estadisticas/series/anuales/reservas-internacionales>.

FIGURES 3 AND 4: PERU FISCAL BALANCES AND PUBLIC DEBT



Source: Banco Central de Reserva del Perú.

These exceedingly favorable trends were recognized and rewarded by the leading credit-rating agencies. That is why, in terms of its long-term, foreign-currency ratings, Peru went from being considered a BB credit in 2000 (as per Fitch and Standard & Poor's, Ba3 as per Moody's) to an investment-grade credit in 2008/09, and on upwards to a BBB+ rating in recent years (Fitch and Standard & Poor's) – or even higher (A3 as per Moody's). Moreover, the country's long-term, local-currency ratings have been pegged at the high A-/A3 level as per all three of the leading agencies.²⁸

After waiting for over a decade to no avail for justice to be carried out, in October 2011, plaintiffs filed a petition with the Constitutional Tribunal seeking enforcement of its March 2001 decision – the one which had declared Law #26597 unconstitutional and had endorsed the principle that the Agrarian Reform Debt should be adjusted to reflect its fair value.

Twenty-one months later, in July 2013, the Tribunal handed down its ruling. It reaffirmed the government's obligation to pay the current value of the agrarian debt, and gave it six months to issue a decree-law regulating the procedure for the recording, valuation and forms of payment of the land-reform bonds. However, it sided with the government (the Ollanta Humala administration) when it came to how the obligations would be valued. The Ministry of Economy and Finance had argued that Peru could not afford to pay the current value of the land reform debt if it were to be adjusted for intervening domestic inflation, because doing so would impose too heavy a burden on its budget and affect its ability to provide essential services. Therefore, the Tribunal ordered that the adjusted value of the bonds be calculated in an unusual way – by indexing the existing obligations to their equivalents in foreign currency, and then applying an interest rate for U.S. Treasury bonds, in a manner to be defined by the Ministry of Economy and Finance.²⁹

²⁸ See Peru Ministry of Economy and Finance, Credit Ratings, available at http://www.mef.gob.pe/index.php?option=com_content&view=article&id=2892%3Acredit-ratings&catid=429%3Arelations&Itemid=102039&lang=es

²⁹ See Resolución del Tribunal Constitucional, July 16, 2013, available at <http://bonosagrarios.pe/wp-content/uploads/2015/03/TC-Exp.-00022-1996-Resolución-16-de-julio-de-2013.pdf>, especially #25. However, a criminal investigation is now underway as to how this decision was actually reached, because in September 2015 a senior member of the Constitutional Tribunal filed a criminal complaint alleging that an original majority opinion that he signed, and that would have updated the bonds using the extent of cumulative domestic inflation rather than currency devaluation, was doctored using liquid whiteout and falsely transformed into an alleged dissenting opinion. The former

In January 2014, the government issued two decree-laws spelling out its regulations for registering, adjusting and paying the defaulted agrarian debt.³⁰ To the great disappointment of long-suffering bondholders, the regulations (a) demanded that creditors waive their legal rights to pursue redress through the courts in order to be able to register their holdings, leaving them in a vulnerable position; (b) set up a seven-step, discriminatory hierarchy of creditors according to their age, whether they are original or secondary holders, and whether they are individual or institutional holders;³¹ and (c) imposed erroneous indexation formulas that would value the bonds at less than a penny on the dollar of what they are worth under correct formulas – more on this below.

Moreover, the guidelines said nothing about the form of compensation bondholders would ultimately receive after what is likely to be a lengthy process measured in years, leaving it unclear if in the end they would be paid in cash or with a replacement bond – potentially, with a low coupon and a very long maturity. The fact that the decree-laws were silent on this crucial point was rightly taken by land-reform bondholders as an ominous sign. So was the statement in the guidelines that payment “options” will be contingent on the observance of “principles of fiscal equilibrium and financial sustainability, as well as fiscal rules and the multi-year macroeconomic framework.”³² Evidently, the government reserves the right to service its land-reform debt depending on circumstances within and beyond its control.

In March 2015, the Land Reform Bondholders Association (ABDA) filed a motion with the Constitutional Tribunal requesting standing in the land-reform debt matter and judicial review of the government’s formulas for valuing the bonds.³³

Their legal brief explained how the government’s method for converting the original bonds denominated in *soles de oro* into U.S. dollars using a so-called parity exchange rate was “logically, mathematically and equitably indefensible.”³⁴ The government’s formulas calculate the so-called parity exchange rate incorrectly by incorporating a clear algebraic error;³⁵ they use inappropriately the interest rate on one-year U.S. Treasuries, rather than yields on U.S. government bonds of relevant

Court Secretary to the Constitutional Tribunal has since been criminally charged by Lima prosecutors for falsification of court documents with regard to this decision, and a judge has recently denied the Court Secretary’s request to dismiss the action, ruling that the criminal proceeding will continue. See “Juzgarán a ex relator del TC por adulterar fallo sobre bonos,” *La República*, January 7, 2016, available at <http://larepublica.pe/impres/politica/731697-juzgaran-ex-relator-del-tc-por-adulterar-fallo-sobre-bonos>.

³⁰ See Decreto Supremo N° 017-2014-EF, January 18, 2014, available at <http://bonosagrarios.pe/wp-content/uploads/2015/03/Decreto-Supremo-017-2014-EF.pdf>. It was supplemented, for the case of bondholders who had received coupon payments, by Decreto Supremo N° 019-2014-EF, January 22, 2014, available at <http://bonosagrarios.pe/wp-content/uploads/2015/03/Decreto-Supremo-019-2014-EF.pdf>.

³¹ Original bondholders aged 65 year or older get first place in the seniority scheme, while institutional bondholders who purchased the bonds in the secondary market (“for speculative purposes”) are relegated to the bottom.

³² Decreto Supremo N° 017-2014-EF, op. cit., Article 17.

³³ The Association consists of more than 340 members that hold agrarian reform bonds, see “Bonistas conforman alianza para cobrar deuda agraria,” *Radio Programas del Perú*, April 21, 2015, available at http://www.rpp.com.pe/2015-04-21-bonistas-conforman-alianza-para-cobrar-deuda-agraria-noticia_789838.html.

³⁴ See Brief filed by the Asociación de Bonistas de la Deuda Agraria del Perú (ABDA), March 16, 2015, p. 29, based on a variety of expert testimony presented, available at <http://bonosagrarios.pe/wp-content/uploads/2015/03/Peticion-de-ABDA.pdf>.

³⁵ *Ibid.*, pp. 49-53. The government’s formula absurdly has an exchange rate on the left-hand side, and a squared exchange rate on the right-hand side, of a key equation.

(namely, long) maturity;³⁶ and convert dollar values back to Peruvian currency (nowadays, the *nuevos soles*) at 2013 exchange rates without further interest accrual thereafter.³⁷

The bondholders backed their appeal with highly credible, technical reports from several leading academic and financial experts, including a detailed study by Deloitte which calculated, among other things, the adjusted, contemporary value of a 20-year, land-reform bond issued in 1975, with a face value of 5,000 *soles de oro* and paying 6 percent per annum, with all of its coupons unclipped, under three potential methods with a final valuation and payment date of 2013.

In the first method, the payout resulting from having the bond adjusted in reflection of the deleterious impact of accumulated inflation through 2013 would be 29,544 *nuevos soles*, or \$9,894. In the second method, the payout resulting from having the bond adjusted in reflection of a correct parity exchange-rate calculation would be 10,218 *nuevos soles*, or \$3,422. Under the third method, as per the government's erroneous formula appearing in the decree-law of January 2014, that bond would be redeemed for just 71.67 *nuevos soles*, or a pathetic \$24. In other words, the government was offering to pay less than one percent of what a dollarization formula with a correct parity exchange rate would imply, or one-tenth of one percent of what an inflation-adjusted calculation – the most common method used in Peru for constant-value calculations – would deliver.³⁸

Unfortunately for the bondholders, the Constitutional Tribunal wasted no time in rejecting their motion. In April 2015, not even a month after it had been filed, the court dismissed their petition explaining that ABDA had not provided persuasive evidence of its proper standing in this case, and that the petition was premature because, notwithstanding the inclusion of detailed formulas in the two decree-laws in question, the actual calculation of the value of the bonds was still to be made by the government.³⁹

However, the court did warn the government that “in no case can the revaluation of the debt result in an outcome which in fact involves the application of a minimalist criterion which damages the bondholders. Therefore, this Court reserves the right to ensure the proper determination of the [valuation of the] debt.”⁴⁰

Essentially, the bondholders were told to turn in their agrarian debt certificates, go through the lengthy and confusing process offered by the government, and if they come out of it feeling maltreated, then they could always come back to the Constitutional Tribunal for a determination on whether or not they were wronged. After some forty years and still counting, seeking redress in Peru if you are a holder of Agrarian Debt Bonds is obviously a case of “Justice delayed is Justice denied.”

³⁶ Ibid., pp. 56-58.

³⁷ Ibid., pp. 58-59. These flaws are in addition to other problems with the regulations, including incorrectly updating the value of bonds with clipped coupons as of the date of the oldest unclipped coupon, rather than the date of issuance, and failing to offer meaningful compensatory interest for past-due interest and principal.

³⁸ Deloitte (Peru), Table 4, p. 16, as cited in the ABDA Brief filed with the Constitutional Tribunal, March 16, 2015, op. cit., p. 40. And as per the government's erroneous formula, a bond whose coupons had been clipped would be entirely worthless.

³⁹ This rush to judgment was an aberration by Peruvian judicial standards. As noted earlier, the petition filed with the Constitutional Tribunal in October 2011 seeking enforcement of its March 2001 ruling took almost two years to be decided.

⁴⁰ See Auto del Tribunal Constitucional (Case N° 0022-1996-PI/TC), April 7, 2015, p. 3, available at <http://www.tc.gob.pe/jurisprudencia/2015/00022-1996-AI%20Resolucion2.pdf>.

II. THE NATURE OF THE PROBLEM

When a legally valid debt goes unpaid for decades, no matter how good are the financial circumstances of the debtor, and notwithstanding how clear are the rulings of the highest judicial authorities, then we are in the presence of a case of unwillingness to pay. And this is why Peru's selective default on its land-reform obligations is a shameful stain on the country's otherwise high creditworthiness.

Although the government has not released any information on the face-value amount still outstanding of these bonds, in 2005 the congressional Committee on Agrarian Affairs issued a report which made specific mention of an estimate that had been provided by the Ministry of Economy's Directorate of Public Credit at the time: 13.285 billion of these *soles de oro* bonds had been issued; 10.763 billion of redemptions had taken place; therefore, a balance of 2.522 billion was in circulation. The congressional report stated that, depending on the indexation method employed, that balance translated into a figure as low as \$1.2 billion and as high as \$3.1 billion.⁴¹

Given the passage of a decade, by now the updated value of the land-reform debt is surely higher mainly because of the accrued interest, but in minor part also, if translated into U.S. dollars, because the Peruvian currency strengthened over time on an inflation-adjusted basis – about 12 percent versus the U.S. dollar from mid-2005 until mid-2015.⁴²

The range of private estimates can be very wide, however, because of two key unknowns: (a) in which year the land-reform bonds outstanding were issued – it could be as early as 1969 but as late as 1982; and (b) how many coupons were paid, or went unpaid, on the bonds that remain outstanding. For example, one group of expert witnesses (Benavides, Peñaranda and Adrianzen) recently came up with an estimate of \$5.1 billion for the end-2014.⁴³ Standard & Poor's mentions in its September 2015 report on Peru that “the maximum amount estimated by the creditors is \$4 billion.”⁴⁴

Nevertheless, any reasonable estimates made suggest that the proper recognition of Agrarian Debt Bonds still outstanding would put no stress on Peru's extremely healthy public finances. If the land-reform debt turned out to be on the order of \$5 billion, for instance, that would be the

⁴¹ See Comisión Agraria del Congreso, “Dictamen recaído en los Proyectos de ley N° 578/2001-CR, N° 7440/2002-CR, N° 8988/2003-CR, N° 10599/2003-CR, N° 11459/2004-CR, and N° 11971/2004-CR, que propone la “Ley de Seguridad Jurídica para el Saneamiento Físico Legal de predios afectados por el Proceso de Reforma Agraria y la Actualización y Pago de la Deuda Agraria,” May 10, 2005, p. 13, available at <http://bonosagrarios.pe/wp-content/uploads/2015/03/Dictamen-Comisión-Agraria-15-de-mayo-2005.pdf>.

⁴² See BCRP, Estadísticas, Tipo de Cambio Real Bilateral, <https://estadisticas.bcrp.gob.pe/estadisticas/series/mensuales/tipo-de-cambio-real>.

⁴³ See Ismael Benavides, Cesar Penaranda and Carlos Adrianzen, “Sobre los Costos y Beneficios del Saneamiento del Default de la Deuda Agraria Peruana,” February 17, 2015, p. 5, available at http://bonosagrarios.pe/wp-content/uploads/2015/03/Reporte_pericial_de_Benavides.pdf.

⁴⁴ Standard & Poor's, “Supplementary Analysis: Republic of Peru,” September 30, 2015, p. 12, available at http://www.standardandpoors.com/en_US/web/guest/article/-/view/type/HTML/id/1458085.

equivalent of about 2½ percent of Peru's GDP.⁴⁵ If it were to be recognized and added onto the government's balance sheet overnight, the existing stock of public debt would increase from a very low of around 20 percent of GDP to a still very low 22.5 percent of GDP.⁴⁶

As it is, Peru's ratio of public debt to GDP is exactly half the median of developing countries rated Baa1 to Baa3 by Moody's, such that all else being equal, the government could take on even an extra twenty percentage points of GDP in debt (namely, \$40 billion) without necessarily coming under downward rating pressure.⁴⁷

Evidence that the recognition of the true value of the land-reform debt would not adversely impact Peru's creditworthiness is provided by how Standard & Poor's recently described the contingent liability which this defaulted debt represents, in addition to certain other potential government obligations:

*"The eventual payment by the government of agriculture bonds – issued in the 1970s during a land expropriation program – is another contingent liability. The nominal value of these bonds collapsed with the currency change to the nuevo sol. In 2013, the Constitutional Court ruled in favor of bondholders and ordered the government to pay these bonds at their present value. The amount and timing of payment is not known. The maximum amount estimated by the creditors is US\$4 billion (about 2% of GDP). Neither [other potential liabilities] nor the agricultural bonds are significant enough in size compared with the current government debt level to modify the starting limited contingent-liability assessment under our criteria."*⁴⁸

Moody's has also weighed in recently on the potential fiscal implications of recognizing and settling the land-reform bonds outstanding, which represent "an unpaid liability of the government through the end of their tenor":

*"We believe that the effect would be limited and manageable. Peru's gross public debt/GDP ratio of under 23% is significantly below the 'A' category median of 40%, and we expect fiscal deficits below 3% of GDP through 2017. ... Even under a worst-case scenario, ... the liability would represent less than 2.6% of GDP. Spread out over a number of years, the payouts would not materially affect the sovereign's fiscal dynamics or its creditworthiness. Under all scenarios, in addition to cash payments, the government could also exchange the [unpaid bonds] for market instruments."*⁴⁹

To be sure, it would matter to the government's cash flow whether the bonds were paid out all at once in cash or if they were redeemed over a period of several years – and whether they were

⁴⁵ Data for 2014 calculated from BCRP, Estadísticas, available at <https://estadisticas.bcrp.gob.pe/estadisticas/series/anuales/pbi-gasto> and <https://estadisticas.bcrp.gob.pe/estadisticas/series/anuales/tipo-de-cambio-nominal>.

⁴⁶ Data for 2014 calculated from BCRP, Estadísticas, available at <https://estadisticas.bcrp.gob.pe/estadisticas/series/trimestrales/deuda-publica>.

⁴⁷ Data for 2015, see Moody's Investors Service, "Statistical Handbook: Country Credit," May 2015, p. 99.

⁴⁸ Standard & Poor's, op. cit.

⁴⁹ Moody's Investors Service, "Government of Peru: FAQ on Peru's Bonos de la Deuda Agraria," December 18, 2015, p. 3.

paid out of fiscal reserves or financed through new debt issuance. Still, it is worthy of note that the government's own liquid reserves in domestic currency (*nuevos soles*) have risen steadily to the equivalent (at market exchange rates) of over \$17 billion as of the end of 2015, such that the authorities could literally pay the defaulted bonds overnight, in cash, and still have plenty of funds left over.⁵⁰

It is because Peru's ability to settle and pay the land-reform debt is so very ample that we are in the presence of a case of blatant unwillingness to pay. And this is a troubling realization, indeed, because the government actively markets Peru as a country in which "past mistakes have helped us set up sounder policies," there is a "friendly environment for doing business," and there is a "wide range of investment opportunities" including in farmland and agro-businesses.⁵¹

Moreover, the government does not acknowledge that it is in selected default and that it has been involved in a protracted dispute with its land-reform bond creditors, both domestic and foreign. According to recent prospectuses filed with the U.S. Securities and Exchange Commission in connection with the August 2015 placement of \$1.25 billion of U.S. dollar-denominated Global Bonds due in 2027, and the October 2015 sale of €1.1 billion of euro-denominated Global Bonds due in 2026, "Peru is unaware of any other claims filed against it, in Peru or abroad, for overdue debt payments and Peru is not involved in any disputes with its internal or external creditors."⁵² This is an inaccurate description of reality at hand, as freshly pointed out by a renowned securities-law professor who researched the matter.⁵³

III. IMPLICATIONS

The troubling case of the Agrarian Debt Bonds demonstrates that governments in Peru are fully capable of mistreating legitimate creditors for very long periods of time, and also of ignoring the will and intent of the country's highest courts, thereby undermining the rule of law.⁵⁴ Given what has transpired and current official attitudes in Lima, Peru does not deserve a top credit rating on its sovereign debt.

⁵⁰ Data for December 2015 calculated from BCRP, Estadísticas, Posición de las Cuentas Disponibles Moneda Nacional, available at <https://estadisticas.bcrp.gob.pe/estadisticas/series/mensuales/resultados/P00569FIM/html>, plus Saldo de Bonos Soberanos Moneda Nacional, <https://estadisticas.bcrp.gob.pe/estadisticas/series/mensuales/resultados/P00571FIM/html>.

⁵¹ See Ministry of Economy and Finance, "Peru: Investment Opportunities," March 2014, available at http://www.mef.gob.pe/contenidos/english/presentations/INPERU_NY_march_2014.pdf.

⁵² See Peru Prospectus Supplements (to prospectuses dated August 18, 2015), Debt Record, S-1, available at <http://www.sec.gov/Archives/edgar/data/77694/000119312515294056/d17726d424b5.htm> and <http://www.sec.gov/Archives/edgar/data/77694/000119312515355983/d58194d424b5.htm>, respectively.

⁵³ See John C. Coffee, Jr., "Legal Opinion on disclosures that were set forth in prospectuses filed by the Republic of Peru with the U.S. Securities and Exchange Commission," January 11, 2016, available at http://perubonds.org/wp-content/uploads/resources/coffee_opinion_final_executed.pdf.

⁵⁴ For a moving, first-person investor account, see Antonio Llaveria, "Haunted by a legacy of betrayal, Peruvians still seek justice," *The Hill*, November 12, 2015, available at <http://thehill.com/blogs/congress-blog/foreign-policy/259887-haunted-by-a-legacy-of-betrayal-peruvians-still-seek>.

In recent months, two small but independent rating agencies, HR Ratings and Egan-Jones, have done their own assessments of Peru, and both rightly assigned a D rating to the defaulted land-reform bonds.⁵⁵ In addition, Egan Jones, after taking into consideration this default and other weaknesses in the underlying credit story, also rated Peru a sub-investment-grade, BB credit.⁵⁶

Now that the proverbial writing is on the wall, and before investors and the leading credit-rating agencies catch on and start to cast doubt on Peru's creditworthiness, as well as to forestall a potentially embarrassing international-arbitration claim by jilted creditors under one of Peru's bilateral investment treaties,⁵⁷ it behooves the authorities in Peru to change course and deal promptly and fairly with the land-reform debt.

A nation which seeks to join the Organization for Economic Cooperation and Development (OECD), as Peru aspires to do in the years to come, must demonstrate that it respects creditor rights and the rule of law.⁵⁸ Until it does, the malign neglect of the country's land-reform bondholders will remain a stain on Peru's reputation and creditworthiness.

⁵⁵ "HR Ratings has assigned a rating of HR D (G) to the Peruvian Agrarian Debt Bonds, classes A, B & C, issued by Peru, October 27, 2015, available at http://www.hrratings.com/pdf/Peruvian%20Agrarian%20Debt%20Reform%20Bonds%20Press%20Release_20151027.pdf; and "Egan-Jones Assigns a First-time Rating of "BB" to the Republic of Peru's International Bonds [and a Rating of "D" to Peruvian Land Reform Bonds," November 17, 2015, available at <https://www.egan-jones.com/public/press/egan-jones-rates-peru-bonds.aspx>.

⁵⁶ Ibid.

⁵⁷ See Robin Wigglesworth and Andres Schipani, "Hedge fund pressures Peru to pay back 40-year-old debt," *Financial Times*, available at <http://www.ft.com/cms/s/0/db360686-6ba5-11e5-aca9-d87542bf8673.html#ixzz3nt1bLvQ3>.

⁵⁸ See World Bank, "Peru Exchanges Experiences with Countries on the Road to Joining the Club of Developed Countries," May 7, 2015, available at <http://www.worldbank.org/en/news/feature/2015/05/07/ocde-peru-intercambia-experiencias-con-paises-en-camino-para-entrar-en-el-club-de-los-paises-desarrollados>.