

On the Costs and Benefits of Restructuring the Selective Default of the Peruvian Land Debt

*Fiscal and macroeconomic implications of honoring the debt associated
with the land reform bonds*

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About the authors

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Dr. César Peñaranda Castañeda is a former Head of the Economics Research Department at the Central Reserve Bank of Peru and Leading Economist at the board of economic advisors of the Minister of Economy and Finance during the early stages of stabilization and market reforms. Dr. Peñaranda's full credentials are included in Appendix B.

Professor Carlos Adrianzen Cabrera is a former advisor to several Ministers of Economy and Finance and Agriculture; as well as Head of the Research and Statistics Office at the Superintendence of Banking and Insurance. Currently, Professor Adrianzen is the Dean of the School of Economics at the Peruvian University of Applied Sciences. Professor Adrianzen's full credentials are included in Appendix C.

Executive Summary

The Land Reform Bondholders Association ("ABDA") has requested our opinion on whether Peru is capable of honoring the debt associated with the Land Reform Bonds. In our opinion, considering the general improvement of Peru's economic indicators, together with its fiscal stability, repaying the debt associated with the Land Reform Bonds ("Land Debt") would not create a significant economic or fiscal disturbance. On the contrary, this repayment will improve Peruvian fiscal sustainability.

The Land Debt, which we have estimated conservatively at US\$5.1 billion as of December 2014, could be restructured by issuing sovereign debt in the amount of US\$5.1 billion. This would increase the ratio of debt to GDP by only 2.3 %, and would create a fiscal impact of only 0.7% of the general current budget.

Paying the Land Reform Debt would also bring a number of macroeconomic benefits associated with the recovery of the country's financial reputation. One of those benefits is that Peru could eliminate current impediments to improving the sovereign debt rating. That would, for instance, reduce Peru's cost of accessing international financial markets—meaning that Peru could save some US\$18 billion over a 30-year period, at current debt levels.

On the other hand, continuing to drag the Default of the Land Debt will have detrimental consequences for the country's economy, including an increase in the costs and access to international markets and a possible deterioration of the current sovereign debt grade.

Outline of the Report

In Chapter I of this report we describe some of the most relevant facts in the history of the Land Reform Bonds and we attempt to estimate the current value of the debt based on public and official documents.

In Chapter II of this report we identify and describe the current situation and outlook of Peruvian public finances in order to show that the burden of Peru's external public debt has been reduced drastically in recent years.

In Chapter III we weigh the effort required to honor the Land Debt. To this effect, we will project the new public debt service flows under a plan to exchange them for 30-year sovereign bonds, assuming an average cost of financing similar to the current 4.9%, rate that Peru has promised to pay in its last long-term bonds issuance (2014).

In Chapter IV we address the potential consequences of continuing to ignore and not pay the Land Reform Debt, followed by the benefits that Peru may derive if it finally honors this longstanding debt.

I. General facts about the Land Reform

A. Peruvian Land Reform

On June 24, 1969, the Government of Peru enacted Decree Law N° 17716—the Land Reform Act—seeking to transform the country’s land-tenure structure and to replace the *latifundio* and *minifundio*¹ system with a redistribution of rural land.² The Land Reform consisted of a series of expropriations of rural parcels, the ownership of which—formerly owned by both individuals and legal entities—passed to the State and was subsequently distributed among peasants and small farmers organized in cooperatives and agricultural associations.³ Expropriated individuals and companies were entitled to compensation based on an appraisal conducted by the State.⁴

However, instead of paying for the expropriated land at the time it was taken, the State promised to pay over time—with interest—by issuing the bonds (“Land Reform Bonds”). The Land Reform Act made acceptance of the bonds mandatory, so landowners had no choice but to receive them.

In order to implement the expropriations, the Government issued three classes of Land Reform Bonds. Class A bonds (6% annual interest over twenty years); Class B bonds (5% annual interest over twenty-five years); and Class C bonds (4% annual interest over thirty years).⁵ Public information available on the Ministry of Agriculture and Irrigation’s webpage indicates that, between June 1969 and June 1979, more than 9 million hectares of land were expropriated consisting of some 15,826 land lots, benefiting about 370,000 families.⁶

In a 2006 report (the “Congressional Report”) Congress noted that the Ministry of the Economy and Finance made a “net bond placement” equal to “13.285 billion Soles Oro.”⁷ That report says that “payments were made for 10.763 billion Soles Oro of the principal” and that there was an outstanding balance of some 2.5 billion Soles Oro.⁸ Jose M. Caballero indicates that the total amount of the expropriations—slightly over 15 billion Soles Oro—is pretty low, as it reflects “approximately half of the national budget for agricultural loans only in one year: 1977, and just

¹ While the *latifundio* is a general concept—referring to a significant or large-scale extension or cultivation area, often associated with economies of scale or network economies—the *minifundio*, in contrast, involves an agricultural farm of such small size that it is usually difficult to exploit. One of the causes of institutional decline and agricultural competitiveness decline after the Velasco reform was the partition of areas of cultivation through the proliferation of *minifundios*, compounded by a weak establishment of associated property rights.

² Land Reform Act, 1, 2, and 3.

³ *Ibid.*, Articles 56 and 67.

⁴ 1933 Political Constitution of Peru, Article 29.

⁵ Land Reform Act, Article 174.

⁶ <http://www.minag.gob.pe/portal/marco-legal/titulación-y-créditos/titulación-agraria-en-el-perú/el-proceso-de-reforma-agraria>.

⁷ Opinion issued on Draft Laws No. 578/2001-CR, No. 7440/2002-CR, No. 8988/2003-CR, No. 10599/2003-CR, No. 11459/2004-CR, and No. 11971/2004-CR.

⁸ *Ibid.*

20% more than the national investment in irrigation in 1978.”⁹

It is worth noting here that the default in settling this debt—which we shall henceforth refer to as the *Selective Default*—has been systematic. Until recently it reflected the fiscal insolvency of the Peruvian economy between the sixties and the eighties, and from its inception, it reflected a legal framework that was very vague regarding bond repayment.

B. Land Reform Debt and Hyperinflation in Peru

In order to fully understand the Land Reform Debt predicament, it is necessary to take into account the periods of inflation and hyper-inflation that affected Peru's economy. From 1980 to 1985 Peru's inflation rate never dipped below 50%.¹⁰ Between 1988 and 1990, the economic situation continued to worsen, and inflation spun out of control, reaching its high-point in August 1990, when annual inflation reached 12.377%. In that month alone, the existing currency lost 80% of its value. This means that at the end of that month, the same amount of money had the power to buy only 1/5th of the goods and services it could have purchased at the beginning of that month. In the case of bondholders, the value of the debt owed to them—as denominated in Soles Oro—virtually disappeared.

It is also accepted that, in response to the inflation and currency devaluation crisis, Peru changed its currency twice in a span of six years. Peru switched from Sol Oro—the currency in which the bonds were issued—to Inti in 1985.¹¹ In 1991, the State once again changed the official currency from the Inti to the Nuevo Sol.¹² As a result, the nominal equivalent of one Sol de Oro is now equal to 0.000000001—one billionth—of a Nuevo Sol.¹³

⁹ José María Caballero and Elena Alvarez, *Aspectos cuantitativos de la reforma agraria 1969-1979* [Quantitative aspects of land reform], Instituto De Estudios Peruanos, p. 61.

¹⁰ Central Reserve Bank of Peru. Report of December 31, 1985. Annex XII, p. 121: <http://www.bcrp.gob.pe/docs/Publicaciones/Memoria/Memoria-BCRP-1985.pdf>

¹¹ Law No. 24064, Article 1: “As of February 1, 1985, the Inti is hereby established as the unit of currency in Peru (...).” Under this law, one *Inti* was equal to one thousand *Soles Oro*.

¹² Law No. 25295, Article 1: “The ‘*Nuevo Sol*’ is hereby established as the unit of currency in Peru (...).” Under this law, one *Nuevo Sol* is equal to one million *Intis*.

¹³ Central Reserve Bank of Peru. Table of equivalencies: <http://www.bcrp.gob.pe/billetes-y-monedas/unidades-monetarias/tabla-de-equivalencias.html>

C. The Land Reform Selective Default and the Latin American Debt Crisis

Although the *Selective Default* predates the Latin American Debt Crisis, the subsequent deterioration of Peru's external accounts resulted in a macroeconomic scenario that made paying off the Land Reform Debt much less feasible. As such, in late 1980, the ratio of public debt to GDP and external debt service to total exports reached 46.4% and 33.9%, respectively. Beginning in the 1990s, as we will explain below, Peru's fiscal solvency (with an external debt to GDP ratio of approximately 18.4% in the third quarter of 2014) made it possible to consider the debt repayment viable and appropriate.

D. Peruvian Economic Reforms (early 1990's)

In mid-1990, Peru was facing a severe macroeconomic crisis, annual inflation had reached approximately 8.000% and the country's net international reserve position was markedly negative. This macroeconomic crisis required an orthodox adjustment program with defined fiscal and monetary actions (which helped to stabilize prices and exchange rates), accompanied by a set of structural market reforms and privatization processes. A key hallmark of this period was greater respect for private property and the beginning of a financial rehabilitation process that involved paying down a large portion of the accumulated default of the external debt service and breaking through the barriers to eligibility to access multilateral external financing.

E. Current Amount of Land Reform Debt Outstanding

Partly because of these events, the Congressional Report recognized the clear deterioration of the Peruvian currency's value and the need to arrive to a current value of the Land Reform Debt ("Congressional Report").¹⁴ Congress noted that Peru had "acknowledged the debt and promised to pay it" by issuing the Land Reform Bonds, but "as the value of the currency deteriorated," it had become "essential to apply an adjustment factor that, to the extent possible, would allow the value of the confiscated assets to remain constant."¹⁵

The Congressional Report was useful for estimating the current value of the Land Reform Debt. The Congressional Report indicates that 2.52168 billion Soles Oro of principal of Peruvian Land Reform Bond debt remained outstanding as of December 2006. Further, the Congressional Report quantified the adjusted value of the outstanding debt as of July 2006 under the CPI Method as 10,025,618,044 Nuevos Soles.

The equivalent of said sum in US Dollars at the time the Congressional Report was issued was US\$3.455 billion. We are aware of the various methodologies that exist in order to calculate the value of the Land Bond Debt and, in our opinion, the total Land Bond Debt as of December 2014 is approximately S/. 15.251 billion, US\$ 5.1 billion. While this computational method is not suited for determining the current value of debt owed to any particular bondholder, it is a useful way of deriving an estimate of the overall debt for the macroeconomic analysis

¹⁴ Opinion issued on Draft Laws No. 578/2001-CR, No. 7440/2002-CR, No. 8988/2003-CR, No. 10599/2003-CR, No. 11459/2004-CR, and No. 11971/2004-CR.

¹⁵ *Ibid.*

contained in this report.

II. The Peruvian Economy and its Public Finances

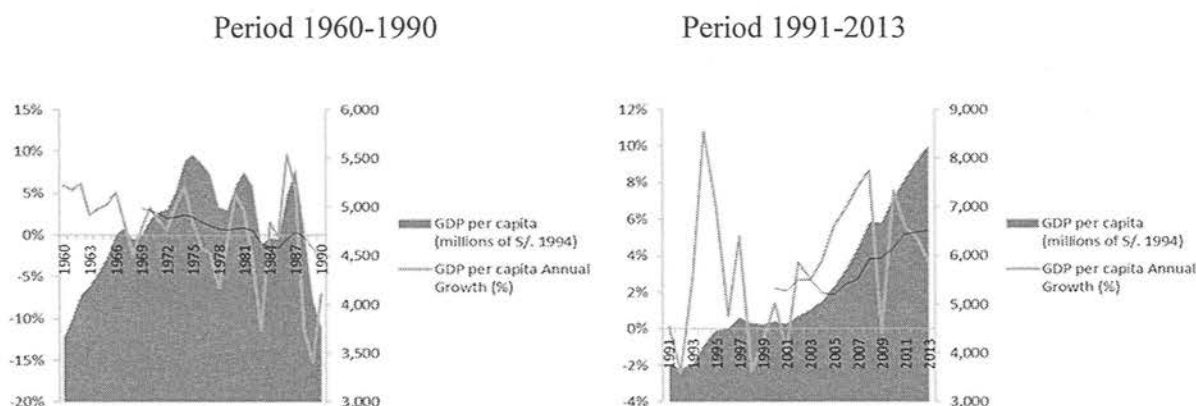
Since the beginning of the nineties, the Peruvian economy has improved significantly. Peru shifted from having an economy in recurring macroeconomic and fiscal deterioration to one with expectant growth profiles and a sound fiscal situation. Comparing the periods from 1960-1992 and 1992-2012 clearly demonstrates the magnitude of said change.

In any approach to a country's fiscal solvency, the importance of its capacity to collect taxes and consistently manage the payment of its obligations is directly tied to its economic growth patterns. Here it is important to note that from the mid-nineties to date, Peru's economic growth has been outstanding, making Peru one of the most dynamic emerging nations on the planet.

A. Strong GDP Growth

This change—from an increasingly insolvent nation (fiscally and with regard to external repayment), to an increasingly solvent one—is reflected first in economic growth patterns, as we can see when comparing the two aforementioned periods.

Figure 1: Basic Indicators of Domestic Economic Growth



Sources: Central Reserve Bank of Peru and Ministry of Economy and Finance

Figure 1 reflects one of the most reliable indicators of a country's payment capacity and fiscal solvency: gross domestic product (GDP) per capita. As we can see, while at the end of 1991 the per capita GDP was approximately 3.5 million *Soles* per capita, at the end of 2012 that same GDP was over 8 million *Soles* per capita. Figures 1 and 2 demonstrate a pattern of economic decline and instability between 1960 and 1992, which contrasts with a phase of sustained recovery with notable levels of growth between 1992 and 2013. As we will see later on, these substantially greater products also generate higher fiscal solvency indicators.

As a consequence, today Peru has a GDP growth that makes it one of the most dynamic emerging nations on the planet. The following figure depicts Peru's GDP as compared to other Latin American countries.

Figure 2: Basic Indicators of Domestic Economic Growth

Real GDP – Forecasts for Latin America 2014-2016



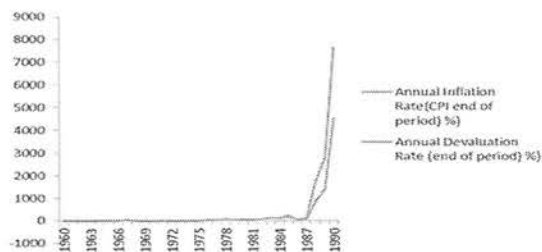
Source: Pro Inversión (Peruvian Private Investment Promotion Agency)

B. Strength of Currency and Foreign Exchange Reserves

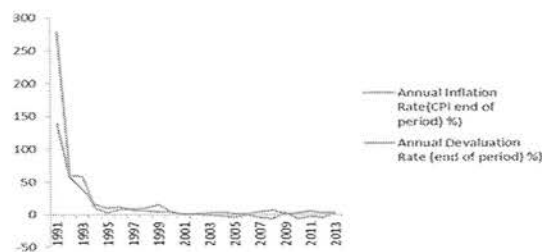
Another key element in determining a country's collection capacity and its ability to service debt such as the Land Debt is inflation. Elevated inflation affects tax collection levels and affects the trends of explicitly or tacitly indexing, as well as passively inflating, expenditure levels and their requirements. This creates a picture that typically feeds back into and deteriorates the nation's fiscal situation.¹⁶

Figure 3: Inflation

Period 1960-1990



Period 1991-2013

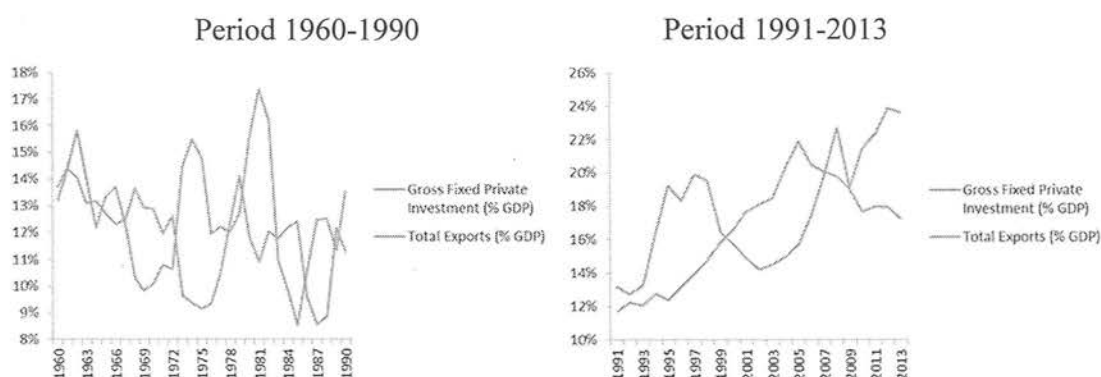


¹⁶ Olivera-Tanzi Effect, due to the constant liquefaction of the tax base. Said effect (also known as the Olivera or OT effect) is the negative temporal relationship between inflation and the collection of tax revenue. Given that inflation hurts business and diminishes consumers' purchasing power, the government's tax revenue falls. The effect has primarily become known due to the research of Julio Olivera at the University of Buenos Aires, and Vito Tanzi, former IMF officer and one of the most respected public sector economists alive.

Figure 3 demonstrates that, beginning in 1988 and until approximately 1991, there were unusually large increases in the Consumer Price Index (CPI) and the nominal exchange rate. However, approximately in 1992 Peru entered into a period of greater stability. This is important because it demonstrates the consistency over time of the country's macroeconomic management. This is crucial when assessing Peru's fiscal solvency. With more stable prices—*ceteris paribus*—the capacity for tax collection and the capacity for public debt service improve.

Another important fact about the aforementioned economic transformation is the connection between private investment and exportation. The following graphs demonstrate how in the last two decades a virtuous circle was created between private investment and exports and how, thanks to this, the capacity for collecting taxes was reestablished, which directly improves debt service capacity.

Figure 4: The Virtuous Circle: Disconnected and Connected



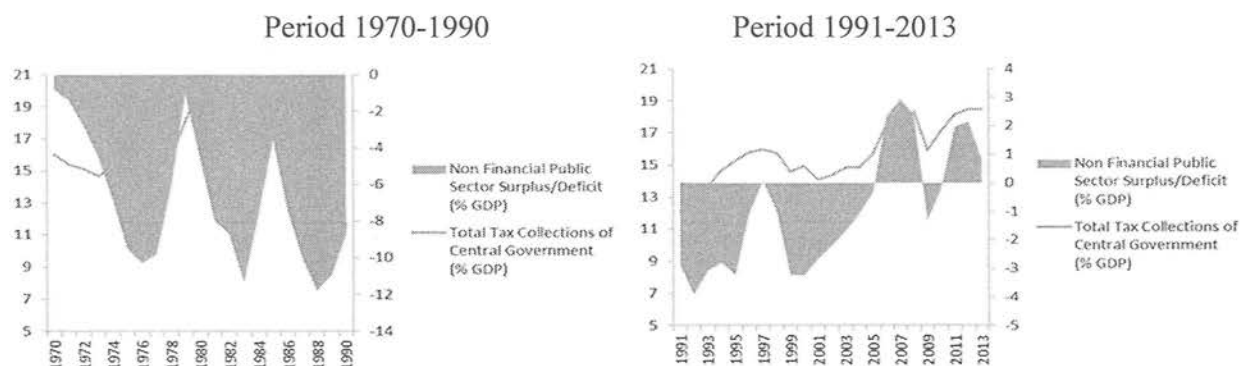
Sources: Central Reserve Bank of Peru and Ministry of Economy and Finance

Figures 5 and 6, presented below, deal with the macroeconomic essence of this report. As you can see, the Peruvian fiscal outlook between 1960 and 1990 demonstrates a clear shift toward extreme fiscal weakness. However, after 1991, there is a significant change for the better.

Thanks to this shift—with a brief interruption in the days of the Lehman Brothers financial crisis—Peru entered a phase of continuous and significant fiscal surpluses, which made it possible to accumulate a significant level of fiscal savings, expressed in the Fiscal Stabilization Fund,¹⁷ which at the end of 2014 was near 4.5 percentage points of the GDP.

¹⁷ This strictly regulated fund was created as a source to deal with contingencies and to be used in the event of a recession scenario (two consecutive quarters of negative growth).

Figure 5: Gaps, Adjustments, and Surpluses



Sources: Central Reserve Bank of Peru and Ministry of Economy and Finance

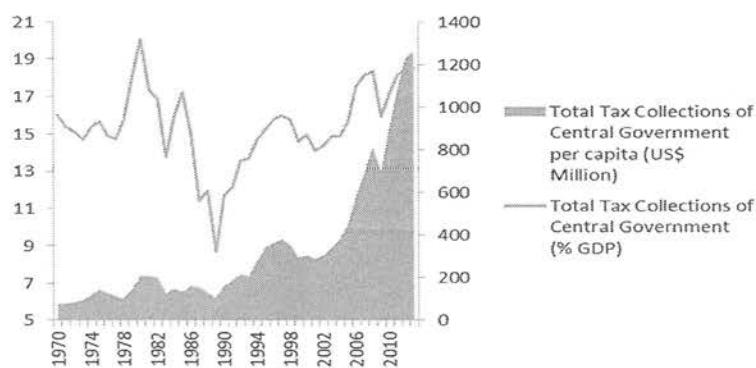
The previous graphs demonstrate that Peru is taking in much more revenue than it was 8 years ago, and has been progressively improving in this area.

Specifically, the tax pressure rate (ratio of tax revenue to GDP) has increased steadily by five percentage points, with which the availability of resources to cover non-financing and financing expenses significantly increased.¹⁸

Today we have, then, the highest levels of tax collection per capita (expressed in constant *soles*) and they are continuing to expand, as demonstrated in the figure below.

Figure 6: Tax Revenue
Period 1970-2013

¹⁸ This statement does not take into account the growth in revenue from other sources (fees and contributions) that also finance Peruvian public sector activities which currently represent an additional 6% of tax revenue.



Source: Central Reserve Bank of Peru

So far we have put together a first approximation of the Peruvian fiscal situation and its ability to honor its debt. We recognize a very distinctive environment, much more dynamic and stable than that which for decades characterized and was associated with scenarios of extreme fiscal fragility prior to the nineties. Today, the Peruvian fiscal situation is very different from what it was between 1960 and 1991.

At this point, it is crucial to emphasize the connection between the capacity to generate continuous surpluses and, as a result, accumulate significant fiscal savings (as a buffer against contingencies) and the evolution of the patterns of indebtedness of the Peruvian government, to be described below.

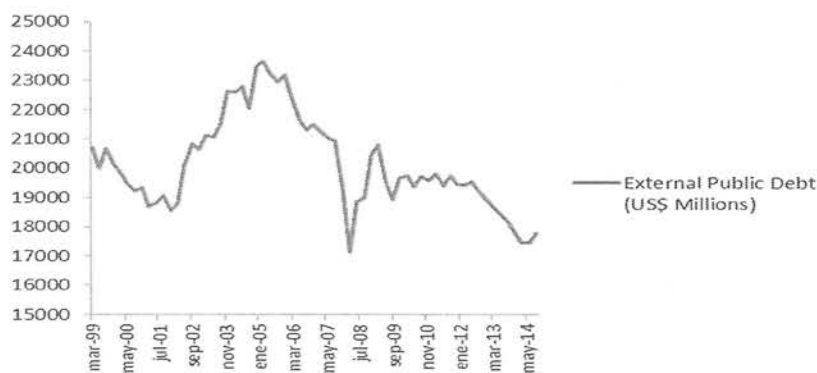
C. Current Debt to GDP Ratio

We will now focus on the details of Peru's national public debt—its scale, composition, and the current levels of service and external indebtedness. According to the Ministry of Economy and Finance, National Public Debt is understood as “the set of outstanding obligations that the Public Sector owes, as of a certain date, to its creditors.” The Ministry explains that it constitutes “a way to obtain financial resources on the part of the state or any public power and it normally takes the form of the issue of securities in local or international markets, and through direct loans from entities such as multilateral organizations, governments, etc.”¹⁹

In particular, we will analyze Peru's national public debt in relation to the GDP. Peru's current debt is only 18.5% of its GDP. This is better than the debt to GDP ratio of many of the world's most stable economies. The debt to GDP ratios of the United States, Germany, and Switzerland, for example, were 101.3%, 76.4%, and 35.4%, respectively, according to the most recent data available. This ratio is also better than many countries in Latin America. For instance, Argentina's debt to GDP ratio is 45.8%, Colombia's is 31.8% and Venezuela's is 49.8%.

Figure 7

¹⁹ Ministry of Economy and Finance, Public Debt, available at http://www.mef.gob.pe/index.php?option=com_content&view=section&id=33&Itemid=100789

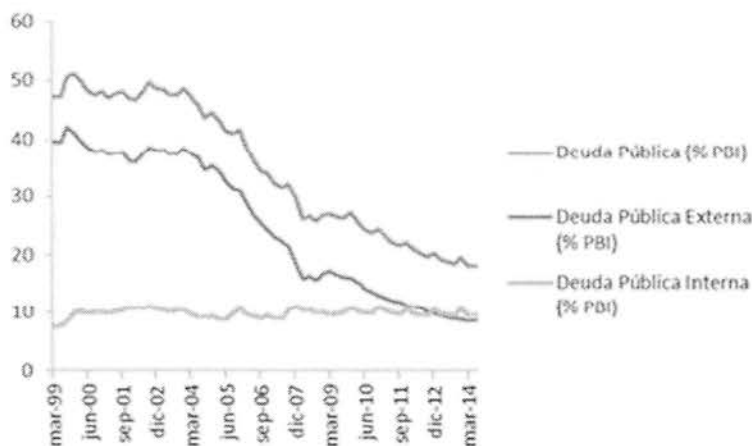


Source: Central Reserve Bank of Peru

The figure above demonstrates that the external public debt has fluctuated over the last 4 years, but with a stable or even declining trend. Currently, after decades of high levels of external indebtedness conditioned the fiscal scope of action for successive governments, this is on a smaller scale than internal debt.

The result of this new structure of Peruvian public financing is less macroeconomic and fiscal fragility in the face of global disturbances that would require exchange rate or internal demand adjustments. It also lowers the risk of a payment crisis by reducing—in relative terms—the weight of the external public debt service.

Figure 8

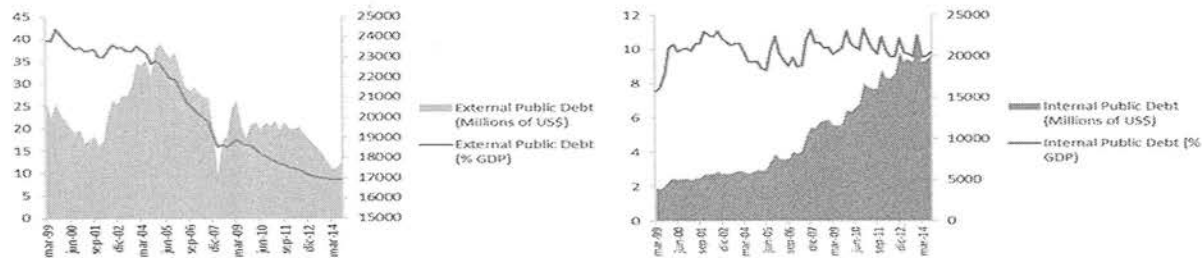


Sources: Central Reserve Bank of Peru & Ministry of Economy and Finance

Figure 8 shows just how the restructuring and reshaping of the Public Debt maturities go hand in hand with the emergence of Internal Debt in local currency owed primarily to local creditors (local pension fund administrators and financial intermediaries). This reduces foreign currency stress during turbulent periods in the exportation or market capital inflows.

The Figure below provides comparative detail of how both the amounts in current U.S. dollars and the percentages of the GDP have shown dissimilar patterns. While the external public debt steadily decreases, the internal public debt grows in a sustained manner as well.

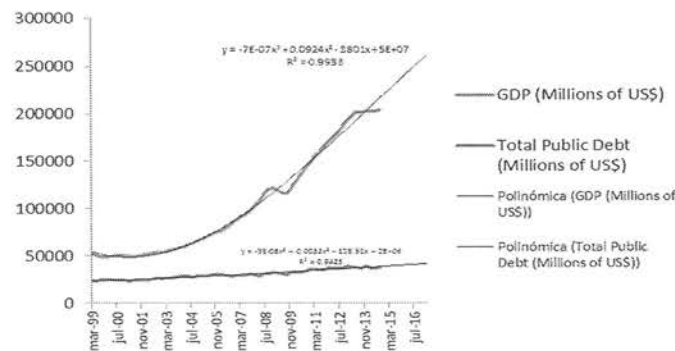
Figure 9: The Two Peruvian Debts: 1999-2014



Sources: Ministry of Economy and Finance and Central Reserve Bank of Peru

The above two figures present a clear path of public debt restructurings implemented consistently—across three successive administrations—over the last fifteen years. Another significant detail in this treatment of the current situation and the country's fiscal outlook means acknowledging another clear fact. The growth and growth trend of Peruvian Public Debt is clearly lower than the growth and growth trend of GDP.

Figure 10



Source: Central Reserve Bank of Peru

D. Investment Grade Debt Rating – Ability to Issue in the Capital Markets

One of the consequences of Peru's strong economy is the ability to issue sovereign debt in the capital markets, as well as the favorable ratings that Peruvian debt has received from the international credit rating agencies.²⁰

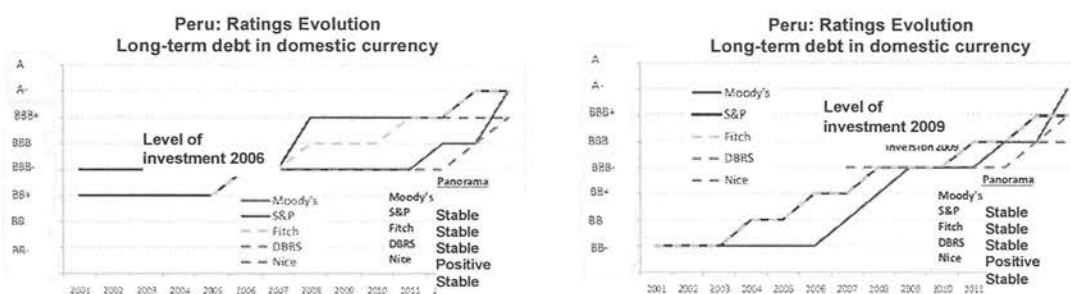
²⁰ See the Technical Appendix on Credit Ratings.

Following a series of severe macroeconomic adjustments, market reforms, and solid evidence of fiscal sustainability for over a decade—and also on the verge of signing the free trade agreement with the United States—in mid-2006 the Peruvian sovereign debt was rated investment grade by Standard & Poors. This event resulted in a very significant change in Peru's practical ability to issue new debt in local and international markets. In practical terms, said change was reflected by many new sovereign debt placements in millions of US dollars under much better conditions (term, interest, etc.).

Standard & Poors credit rating for Peru stands at BBB+. The Peruvian economy outlook remains stable in spite of experiencing a combination of a series of negative shocks, which we consider as temporary, and a lower business confidence. Moody's upgraded Peru's rating to A3 from Baa2; a stable outlook due basically to the expectation of continued strengthening of the government's balance sheet and fiscal framework. Finally, Fitch's credit rating for Peru is BBB due to the same considerations and the domestic banks' solvency.

This means that Peru has gradually evolved, approaching to Chile and becoming one of the strongest economies of the region from a fiscal point of view.

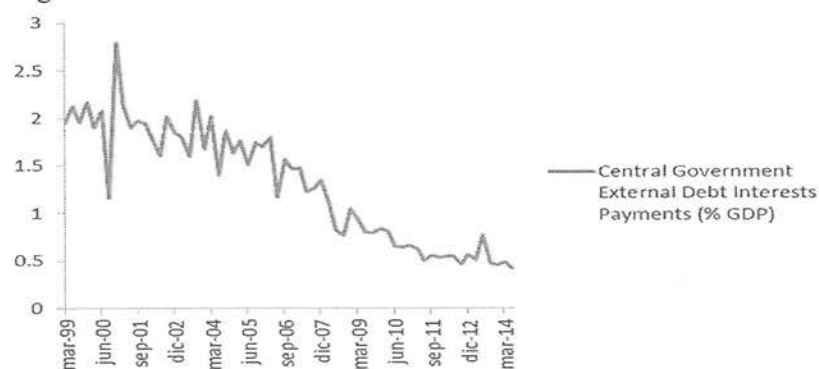
Figure 11: Recent Peruvian Public Debt Ratings



Source: Ministry of Economy and Finance

This significant improvement in Peruvian debt ratings from 2002 to date resulted in a significant and sustained drop in the effective cost of external financing in Peru, leading to a greater capacity for fiscal savings and a visibly improvement of Peru's fiscal solvency.

Figure 12: Reduction of the Cost of Public External Indebtedness



Source: World Bank

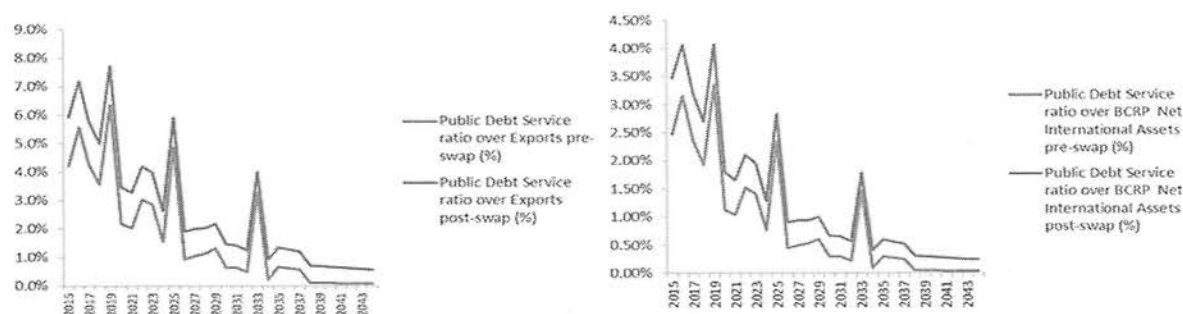
III. Peru has the ability to honor the US\$ 5.1 billion of Land Bond Debt through issuance of new 30-Year Bonds to the Land Reform Bondholders

A. Peru's capacity for external debt repayment has been clearly established.

Given Peru's fiscal soundness and the development of its main indicators of fiscal solvency and sovereign debt rating, its generous capacity for external debt repayment has been clearly established.

As the following two graphics show, the increased service associated with proposed the sovereign bond swap does not involve any significant increase in either the debt service to export ratio or the equivalent to net international reserves. As such it is perfectly manageable for the Peruvian government.

Figure 13



Sources: Self prepared. Gross Figures from the Ministry of Economy and Finance and the Central Reserve Bank of Peru

B. Implementing a repayment plan for the debt associated with the Land Reform Bonds does not imply major fiscal disruption, given the current economic scenario

This capacity means that implementing a repayment plan for the debt associated with the Land

Reform Bonds—through an exchange for new sovereign bonds—does not imply major fiscal disruption, given a passive economic scenario. For the purposes of honoring a debt of approximately \$5.1 billion, we project a bond exchange for each case via an issue of US\$5.1 billion at thirty years, with the current cost of financing of approximately 4.5%.²¹

1. The Debt to GDP ratio will not change significantly

The fiscal impact of issuing US\$ 5.1 billion to be paid over the next 30 years is not significant. *First*, the proposed issuance would increase the debt to GDP ratio by around 2.3%, which gives an overall rate that is still significantly lower than other countries in the region.

In a passive scenario of accumulated external debt and projecting how much the Peruvian economy could realistically grow over the next three decades, this increase would be diluted to statistically marginal amounts.

2. Debt service on new bonds will not impact Peru's general budget

As we have graphically established, the service associated with this Bond exchange—given the official projections from the Ministry of Economy and Finance—would not impact the national budget for a number of reasons. If the prevailing linear trends are sustained, the fiscal effort needed to honor the Land Debt requires approximately 0.7% of the current value (2015) of the Government budget.

It is just as possible that the ratio will steadily decrease over time, in step with the growth of the GDP and tax revenue collection.

3. Restructuring the Selective Default will not result in a ratings downgrade

Given the foregoing, restructuring the Selective Default would result in a marginal ratio in terms of increased public spending in the future as a result of the exchange, and what is more—given the current high demand for Peruvian debt—said exchange could be advantageous and even result in a more favorable sovereign risk classification, along with lower financing costs for the country's external debt over the short and medium term. In the next section, we discuss the benefits associated with the cure described above.

IV. Benefits of Honoring the Land Reform Debt

Honoring the Land Reform Debt will undoubtedly bring a number of benefits to Peru. Conversely, not honoring the debt will affect Peru's economy in various ways, which means that continuing to ignore it does not mean that Peru is not paying a cost.

²¹ This rate is relevant to the local financial system for the period in question because it is the rate of the most recent issue of Peruvian sovereign debt dollar bonds (2014).

In addition to failing to honor the Land Reform Debt for several decades, the Government has attempted to further expropriate bondholders through an absurd valuation methodology contained in two Supreme Decrees that were issued in January of 2014. This is likely to continue dragging the Land Debt, and it is therefore necessary to analyze the consequence of this.

Countries that remain in Default for extended periods not only damage their reputations,²² but also their economies, both by indefinitely damaging their direct foreign investment and portfolio flows in the country and by tightening the conditions of access and restructuring (cost, term, etc.) and negatively and cumulatively affecting the sovereign debt rating. In addition, they must take on the constant and growing foreign legal costs that result from the default in meeting their obligations.

Additionally, carrying a Default over time also has other serious consequences. The first involves its effect on commercial exclusion—and commercial financing—of a market unable to meet its commitments. In an economy that is very sensitive to trade flows on the macroeconomic level, this implies less economic growth and greater local financial stress.

But the second consequence is not less relevant. A Default implies the decline of the institutional base of a country through the weakening of its rule of law and—in this case—the flagrant noncompliance with various resolutions of the Congress of the Republic and the Constitutional Tribunal.

A consequence of this Selective Default and the Supreme Decrees also entail an additional complication in that the World Bank, when constructing its business climate indicators for Peru (*Doing Business*), placed particular interest on the fact that one of the thorniest issues of the Peruvian market is, precisely, its institutional weakness. This fact is also corroborated by the work of the World Economic Forum, which stated in its latest report that the global competitiveness index is going down precisely because of the decline of the institutional pillar.

On the other hand, there are three clear benefits of honoring the Land Debt, which can be summarized as (A) potential credit rating upgrade; (B) reduced borrowing costs and (C) enhanced reputation in the marketplace.

A. Peru's Potential Ratings Upgrade

First, it would help to improve the sovereign debt rating because it will significantly reduce country risk and attract new portfolio and foreign direct investments to Peru. It is very important to notice that these positive effects will materialize over the short and long term.

B. Potential reduction in Borrowing Costs

Second, it will lower Peru's borrowing costs. Borrowing cost is a commonly-used economic term that refers to the financial costs incurred by a sovereign borrower in connection with the

²² Where the cost of rehabilitating exceeds that of restructuring the Default itself.

borrowing of funds (*i.e.*, interests, amortization of discounts or premiums arising on the issue of debt securities.²³ [sic]

To have some idea of how much Peru would save by restructuring the Default studied here, it is necessary to compare the cost of repaying the Land Debt to how it would reduce the total updated value of the Public Debt and total Peruvian Debt. In this direction, the following exercise suggests that the net effect of honoring the Land Debt would be very positive for the country.

Up to this point, we have focused solely on the cost of restructuring a Selective Default. But Defaults also involve other costs. For example, the financing terms—the term, interest rate, etc.—under which a neighbor nation such as Chile has access to external financing are notably lower than those Peru has been receiving in recent years.

A comparison between the interest paid for issuing Chilean and Peruvian sovereign debt shows a costly differential in favor of our neighbors.²⁴

Table One

Comparative Costs of the most recent issues (2014)				
	Annual Interest Rate (%)	Standard & Poors Credit Rating	Maturity in Years	Currency
Peru	5.75	BBB+	10	Nuevo Sol
Chile	3.185	A+	10	US Dollar

Source: Self-prepared

This differential reveals the hidden cost of the Selective Default (expressed as the differential between the Rating Agencies and the external debt costs) carried by our country for more than four decades.

To get a referential idea regarding how much our country would save by restructuring the Default we must compare the cost of paying the Land Debt against how the total adjusted Value of the Public Debt and Peru's total debt would go down, as shown in the following table. We can see that the net effect of compliance with the Constitutional Tribunal's ruling would be very positive for the country.

²³ Here we are using the term borrowing costs as the amount of money paid in interest on a loan or other debt. In other words, it is what one must spend in order to receive money. Source: Farlex Financial Dictionary 2012 Farlex, Inc.

²⁴ Given the fact that Chile and Peru currently have broadly similar country risk ratings, and that the Peruvian inflation rate is close to average for developed countries.

Table Two

Differential saved in the Annual Rate	Total External Debt**	Public Debt
Referential Stock	63,465.00	23,803.00
0.50%	2,991.40	1,121.94
1.00%	5,982.79	2,243.89
1.50%	8,974.19	3,365.83
2.00%	11,965.58	4,487.78
2.50%	14,956.98	5,609.72
3.00%	17,948.37	6,731.67

Source: Self-elaboration

Current value of debt service, 30 years, 10% discount rate

** Public and Private as of September 2014

According to the table, a mere half percentage point reduction of the interest rate (paid annually by issuing a new sovereign debt) would more than cover the cost of compliance with the Constitutional Tribunal's ruling and cure this costly, reputation-damaging, long-standing Default.

If, for example, the Land Debt were equal to US\$5.000 billion, recent empirical evidence suggests that the reduction of the cost of issuing new sovereign debt—expected over the medium term—could approach 3 percentage points. Just getting closer to Chile (the foreseeable 3 percentage point drop at 30 years) would reduce the present value of the Peruvian external debt by nearly US\$18 billion, which would more than compensate for the fiscal effort.

C. An enhanced reputation in the marketplace will attract capital investments

Finally, it would create a better level of confidence among foreign and domestic investors, helping to attract capital investment in a number of ways.

In Peru, restructuring this default would result in the opportunity to attract, among others, institutional investors such as Global Pension Funds which could, for instance, invest in infrastructure projects where, according to the Lima Chamber of Commerce, there was a deficit of investment of some US\$100 billion.

It will also help improve the climate of legal security in the country, which is one of the most important elements in creating confidence for investors.

In a country like Peru, which is striving to recover and strengthen its judicial institutional framework and promptly comply with its rulings and decisions, the restructuring of this default, respecting a ruling handed down by the Constitutional Tribunal, would set a symbolic precedent. Given the government's continued efforts to establish multilateral investor protection agreements, curing this default would have a very positive impact on Peru's overall reputation in the market.

The continued delay in curing the default of the Land Reform Bonds, not to mention failing to comply with a mandatory order of Peru's highest court, inevitably constitutes a severe obstacle that will negatively affect future Peruvian debt ratings—both public and private—and could even have a negative impact on the country's financial reputation (downgrading Peru's creditworthiness).

V. Conclusion

This report clearly establishes the benefits that would represent to Peru resolving the prevailing Selective Default (that is, the unpaid debt owed to the Land Reform bondholders), both from the perspective of the country's reputation, for the purpose of attracting capital and investment to finance its development, as well as in terms of the concrete benefits of reducing the costs of servicing and obtaining external loans (current and future loans) not just for the Peruvian State, but for the country as a whole.

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Technical Appendix on Credit Ratings

A credit rating agency (CRA, also called a ratings service) is a company that assigns credit ratings, which rate a debtor's ability to pay back debt by making timely interest payments and the likelihood of default. An agency may rate the creditworthiness of issuers of debt obligations, of debt instruments and in some cases, of the servicers of the underlying debt, but not of individual consumers. The debt instruments rated by CRAs include government bonds, corporate bonds, CDs, municipal bonds, preferred stock, and collateralized securities, such as mortgage-backed securities and collateralized debt obligations.

The big three credit rating agencies are Standard & Poor's (S&P), Moody's, and Fitch Group. S&P and Moody's are based in the US, while Fitch is dual-headquartered in New York City and London, and is controlled by the France-based FIMALAC.

The ratings are given to large-scale borrowers, whether companies or governments, and are an indication to buyers of this debt how likely they are to be paid back.

The score card can also affect the amount that companies or governments are charged to borrow money.

If a country is deemed to have suffered a downturn in fortunes and its rating is lowered, investors may demand higher returns to lend to it, as it is judged a riskier bet.

Credit ratings that concern corporations are usually of a corporation's financial instruments, i.e., debt security such as a bond, but corporations themselves are also sometimes rated. Ratings are assigned by credit rating agencies, the largest of which are Standard & Poor's, Moody's and Fitch Ratings.

They use letter designations such as A, B, C for its ratings. Higher grades are intended to represent a lower probability of default.

A standard table of rating taxonomy can be easily stated:

Moody's		S&P		Fitch		Rating Description	
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term		
Aaa	<u>P-1</u>	AAA	<u>A-1+</u>	AAA	<u>F1+</u>	Prime	
Aa1		AA+		AA+		High grade	
Aa2		AA		AA			
Aa3		AA?		AA?			
A1	<u>P-2</u>	A+	<u>A-1</u>	A+	<u>F1</u>	Upper medium grade	
A2		A		A			
A3		A?		A?			
Baa1		BBB+		BBB+		Lower medium grade	
Baa2	<u>P-3</u>	BBB	<u>A-3</u>	BBB	<u>F3</u>		
Baa3		BBB?		BBB?			
Ba1		BB+		BB+		Non-speculative	
Ba2		BB		BB			
Ba3	Not prime	BB?	<u>B</u>	BB?	<u>B</u>		
B1		B+		B+		Highly speculative	
B2		B		B			
B3		B?		B?			
Caa1		CCC+	<u>C</u>	CCC	<u>C</u>	Substantial	
Caa2		CCC				Extremely	
Caa3		CCC?				Default prospect	
Ca		CC					
C		C					
		D	/	DDD	/	In default	

APPENDIX A

EXECUTIVE PROFILE

Name: Ismael A. Benavides

Date of Birth: May 10th, 1945

Education:

- Agricultural Engineer and Agricultural Economist
 - Master in Business Administration, specialized in Finance.
University of California, Berkeley.
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Business Career:

- Over 30 years in Banking and Finance in Peru. Began career in Citibank, most recently Managing Director of INTERBANK, Perú fourth largest bank. Retired in 2007.
- President Peruvian Bankers Association 2005 - 2007
- Presently, Managing Director of Agricola Santa Fe and Empacadora y Procesadora Huamaní a farm and packing house in Pisco, Perú.

Outside Directorships (Presently):

- Ban Bif, Perú fifth largest Bank
- Quimpac – Peru's largest chemical company
- Peruvian Institute of technology (IPTIG)
- Pro Naturaleza (Peru's section of the Nature's Conservancy)

Public Service:

- Minister of Economy and Finance 2010-2011
- Minister of Agriculture 2007-2008
- Minister of Fisheries 1984-1985
- Vice Minister of Finance 1982 – 1983
- Director of the Central Bank of Perú 1983 - 1984

Other Information:

- Married to Patricia Seminario, has 4 daughters.
- Pass Times: Walking, hiking, surfing. Also agricultural investigation and reading.

APPENDIX B



César A. Peñaranda Castañeda

Licentiate in Economics. Master and PhD (ABD) from Cornell University, New York, USA. Currently the Executive Director of the Institute of Economy and Business Development (IEDEP) of the Lima Chamber of Commerce (CCL), Arbitrator for the Center for Conciliation and Arbitration of the CCL and President and Director of various companies in the areas of consulting, services and manufacturing. He writes a monthly opinion column on the editorial page of the Peruvian newspaper *Gestión*.

Has served as Professor at *Universidad del Pacífico*, *Pontificia Universidad Católica del Perú*, University of Lima and ESAN University. Author of three books of Economics published by BID-INTAL (1984), *la Universidad del Pacífico* (1996) and the *Banco del Comercio* and the CCL (2008), the latter entitled *Agenda Económica para el Cambio, crecer con menos pobreza e inequidad* [Economic Agenda for Change, growth with less poverty and inequality]. Additionally, he co-authored three books for IEDEP-CCL (2010, 2011 and 2012) entitled *Creecer con Inclusión* [Growth with Inclusion]; *Perú País del Primer Mundo: ¿Cómo, cuándo?* [Peru, First World Country: How, when?]; and, *Ruta al Primer Mundo: Cuatro Desafíos del Quinquenio 2011-2016* [Path to the First World: Four Challenges for the Five-year Period 2011-2016.] Has published over 60 articles at prestigious Peruvian and international academic institutions.

He was Vice President of the *Banco de Comercio* (2004-2013), Vice President of the Institute for Liberty and Democracy (ILD, 2007-2008), led by the economist Hernando de Soto. President of the Board of Directors and the Executive Committee of the CCL (2006-2008). Member of the Indecopi Market Access Commission, acting as its president during the last year of his membership (2002-2008). Executive Technical Secretary of the Council for International Negotiations (CENI, 2004-2005), acting as the technical spokesperson for the Peruvian private sector in the negotiations for the FTA with the USA. Advisor to the President of the CCL (2001-2004). Advisor to the ILD (2003). Primary Advisor and Lead Advisor to the Peruvian Ministry of Economy and Finance (1991-1992). Consultant for the Government of Bolivia (1987) and Honduras (1996). Head of the Department of Industrial Development of the Andean Community (1972-1982). Head of the Department of Economic Research of the Central Reserve Bank of Peru (1967-1972). As of 1982 has served as an international consultant for the IDB, INTAL, UN, CEPAL, CAN, ALADI, CAF; of the latter he was the Director in 1992.

APPENDIX C

Carlos M. Adrianzen Cabrera
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Professional Experience

Dean of the School of Economics, Peruvian University of Applied Sciences, Monterrico, Lima, Peru. July 2010 to date.

President, Economic Opinion Group (GOE), AMCHAM Peru. San Isidro. 2006 to date.

Radio and Television Commentator on Economics. Grupo Radio Programas del Perú, San Isidro. 2013-2014.

Member, Judicial Branch Advisory Board. Chief Justice of the Supreme Court, Peruvian Justice System. Lima, Peru. March 2009-2013.

Board Member, National Commission of Companies and Securities (CONASEV). San Isidro, Lima, Peru. 2010-2011.

Director of the Professional School of Economics and Professor of Macroeconomics, Managerial Economics, and Research Seminar, School of Accounting, Economic and Financial Sciences. San Martín de Porres University, Lima, Peru. July, 2006 through July, 2010.

Primary Researcher in macroeconomics. Instituto del Perú, San Isidro, January, 2008 through July, 2010.

Member of the Special Multi-partisan Commission in charge of Monitoring the International Financial Crisis, Peruvian Congress. Lima, Peru. September, 2009 through July, 2010.

Advisor to the Ministry on various Economic Subjects, Ministry of Agriculture, La Molina, 2008.

Founder and Executive Director. Instituto Acción (Think Tank for Economic, Political, and Financial Research), Lima, Perú. 2005 through February, 2007.

Professor, International Program for the Executive Master in Business Administration at the Université du Québec au Montréal, UQAM. Professor of the Economic Analysis Course. Lima, Peru; Quito, Ecuador & Montreal, Canadá. 2001 to date.

Director of the Degree Program in Economics and Finance and Postgraduate Professor, Peruvian University of Applied Sciences. Surco and San Isidro. 2005-2006.

External Member of the Pro Free Trade Agreement with the United States of America High Level Commission and Academic Sector Representative in Work Groups, Ministry of Foreign Trade and Tourism. San Isidro, Lima, 2004 to date.

External Economic Consultant, AMBEV, Lima, Peru. Economic consulting on free competition 2004-2005.

Dean of the Postgraduate School, San Ignacio de Loyola University (USIL). Professor of Managerial Economics, Economic Policy and Open Macroeconomics. San Isidro, Lima, Peru. 2003-2005 (June).

Executive Director, Latin American Board of Business Schools (Cladea), Lima, Peru. 2000-2004.

Academic Director, Executive MBA Program, San Ignacio de Loyola University (USIL). Full Professor. Areas: Corporate Strategy, National and Managerial Economics, San Isidro, Lima, Peru. 2000-2002.

Dean, School of Economics, Administration and Marketing, and Director of the Degree Program in Economics, San Ignacio de Loyola University Full Professor. Specialization Areas: Macroeconomics, Economic Policy, Corporate Restructuring, Monetary Economics, History of Economic Thought, Managerial Economics, Applied Microeconomics and director of the Research and Thesis Workshop, La Molina, Lima, Peru. 1996-2003.

Vice President, Free Competition Commission, Institute for the Defense of Competition and Intellectual Property (Indecopi), San Borja, Lima, Peru. 1999-2003.

Visiting Professor, Katz School of Business, Pittsburgh University, Pittsburgh, 1997.

Director of Economic Research, Free Market Economy Institute (IELM). External Consulting Coordinator and Member of the Editorial Board, San Isidro, Lima, Peru; 1993-1998.

Lead Economist and Head of the Studies and Statistics Office, Superintendency of Banking and Insurance of Peru (SBS). Lima, Peru, 1994-1995.

Consultant for the SBS-Inter-American Development Bank Program on Financial Reform topics and the development of an institutional and industry risk monitoring unit, Lima, Peru, 1993-1994.

Associate Consultant on various papers and studies prepared for the board of directors of the Corporación Andina de Fomento (CAF). In Lima, Caracas, La Paz, Cochabamba and Bogota, 1993-1996.

Member of the Board of Directors, Reaseguradora Peruana (RP). Lima, Peru, 1992.

Director, Corporación Financiera de Desarrollo (COFIDE). Lima, Peru, 1991-1992.

Economic Advisor to the Minister of Economy and Finance. Economic and Finance aspects. Lima, Peru, 1991-1992.

Professor and Researcher. Department of Economics, Pontifical Catholic University of Peru (PUCP). Specialization Areas: Macroeconomics, Monetary Policy, International Monetary Economics, Stabilization, Monetary Theory and Advanced Economic Theory. Fundo Pando, Lima, Peru, 1984-1990.

Consultant, Consulting for the National Industry Society on the effects of the unorthodox program implemented by the APRA regime in 1986. Lima, Peru, 1987.

Consultant for the World Bank and the Government of the Republic of Zambia, Tariff Reform Commission of Enquiry. Lusaka, Zambia, 1986.

Planning Department Officer, Junta del Acuerdo de Cartagena (JUNAC). Lima, 1984.

Economic Advisor to the Ministry of Economy, Finance and Commerce (and to the Deputy Minister of the Treasury). Lima, Peru, 1984-1985.

Economist, Central Reserve Bank of Peru (BCRP). Economic Studies, Monetary Sector. Lima, 1984. Duties: Assistant Economist in the preparation of the monetary program and other duties.

Graduate Research Assistant for the Center for Latin American Development Studies (CLADS) and the Department of Economics, Boston University, Boston, Massachusetts, 1983.

Credit Officer, Credit Division, Banco de Crédito del Perú (BCP) Lima, Peru, 1981.

Economic Analyst, Department of Economic and Finance Studies. Banco Wiese Ltd. Lima, Peru, 1980.

Research Assistant, OECD Program on the Impact of External Shocks on Less Developed Countries, PUCP Economics Department Program, Fundo Pando, 1979.

Education

Universidad Politécnica de Cataluña, PhD candidate in the Business Administration and Management Doctoral Program, Lima-Barcelona, Spain. 2010-2015

Harvard University, John F. Kennedy School of Government, Senior Executive Fellow, Boston, Massachusetts, 2003.

Université du Québec au Montréal, École des Sciences de la Gestion, Matrise en Administration des Affaires (MBA). 2000.

Pittsburgh University, Katz School of Business, Management Program (MPE), Pittsburgh, Pennsylvania, 1997.

Harvard University, Program on Macroeconomic Policy Management, Harvard Institute for International Development (HIID), Boston, Massachusetts, 1995.

Boston University, Graduate School of Arts and Sciences. Studies in the Doctoral Program in Economics (MA/PhD), Master of Arts in Economics (M.A.), Boston, Massachusetts, 1983.

Pontifical Catholic University of Peru, School of Social Sciences. Bachelor's Degree in Social Sciences with Economics Concentration, Lima, Peru, 1982.

Other Activities

Winner of the Hipólito Unánue Prize in Economics given by the Peruvian Ministry of Economy and Finance, Honorary Professor of the Presidente de la República School and regular columnist for El Comercio Newspaper and radio and TV commentator for various stations.