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MEMORANDUM September 11, 2015

To: General Distribution

Subject: **Peru land bonds**

This memorandum is in response to your request for a summary of the issues surrounding an agrarian land bonds issue in Peru.

Background

In 1968, leftist dictator, General Juan Velasco seized power in Peru in a bloodless coup. The following year, Velasco began a chaotic land redistribution program, seizing large farms owned and operated by the Peruvian wealthy class and companies' agricultural holdings and turning them over to worker cooperatives. The chaos surrounding the land seizure program also impacted many middle-class farmers who were not the intended target of the program. It is estimated that some 5,000 farms were seized between 1969 and 1981.

In return for their seized property, an estimated 4,000 landholders were issued government bonds with maturities of as long as 30 years and yielding as much as 6 percent. It was estimated that bonds at the time were worth a total of 17.5 billion soles de oro, Peru's currency at the time.

In 1984, the state-owned Agricultural Bank that serviced the debt closed. The next year, the soles de oro ceased to exist, replaced first by the inti, but after a serious onset of hyperinflation it was eventually replaced by the nuevo sol, Peru's current currency. The value of the land bonds, denominated in a currency no longer in existence became unknown.

Since 1984 various Peruvian governments made half-hearted attempts to deal with the bonds. However, there was, and is, still no official register of who holds the paper. Some former landowners never even picked up their bonds, hoping instead to regain their land. Some of the debt was repaid by Velasco's successors. Some of the original bond-holders sold their bonds at deeply discounted prices to a secondary market of investors. Because of the uncertainty of just how many bonds were outstanding and how they would be valued, it was always unclear how paying the land bonds would affect Peru's budget deficit and credit ratings. Cleaning up a so-called "fiscal skeleton" was seen as a plus, but paying off the bonds would also officially put them on the government's books as debt.

As a result, most of the succeeding Peruvian governments opted not to redeem the bonds due to the uncertain but potential costs to the country's treasury.

In 2001, the nation's Constitutional Court ruled that the debt should be recognized in real terms and the bonds reimbursed. However, succeeding governments since that ruling successively argued that it would be financially unable to pay the bonds without breaking the bank.

In 2006, Peru's Congress approved a project to pay off the bonds, but the bill was vetoed. Another congressional committee started to look at yet another proposal by lawmakers to swap the agricultural bonds for newly issued sovereign bonds but that option fared no better.

In July 2013 the Constitutional Court again ruled that the government must comply with its 2001determination and pay the outstanding debt within a decade at its current value and with interest. It gave the government six months to issue a decree outlining how the bonds would be repaid.

Peru's current President Ollanta Humala, upon taking office, had said his government would comply with any court's future decision. According to a report entitled, "Land-Reform Bondholders' Plight, issued on January 23, 2014, by the USDA Foreign Agriculture Service, the Humala government, in January 2014, issued a decree (Supreme Decree 017-2014-EF) stipulating how the bond repayment plan would work. According to the USDAFAS report, the provisions included:

1. Bondholders would have 5 years to submit their claims which would include a cash-out request.

2. Ministry of Finance would verify the authenticity of the bonds and claims (the Ministry is given up to 2 years to verify).

3. Once the eligibility is established, the government has up to 8 years to pay the bondholders.

4. The government was granted the power to value the bonds cash-out value based on the exchange rate prevailing at the time the bonds were issued. The U.S. Treasury bond interest rate will be used to calculate the bonds' accrued interest.

5. Eligible bondholders can then select a payment method that could include: cash, new government bonds and government-owned land, or tax credits.

6. The priority listing for who gets paid first favors original bondholders or their families. Institutions that are holding bonds as payment for debt or for speculation will be last on the priority list.

Conservative estimates over the years suggested that there are between $1 billion and $3 billion in land reform bonds outstanding. Other estimates say the liability is far larger, between $4.6 billion and $8 billion, or about 4 percent of Peru's gross domestic product. Some say the Constitutional Court's decision could lower the overall value of the bonds well below these estimates. With Peru's economy currently in a slight decline Humala appears to be leaning more toward an option that includes new government bonds and agricultural land, as opposed to cash payouts, as the least costly alternative for Peru. Nevertheless, in the remaining months of his presidency, he does not have to make any final decisions and can pass the process on to Peru's new government next year.

Peru's largest bank, Banco de Cedito de Peru holds some of the bonds as do entities in a secondary market that bought the original bonds from holders at a discounted price, including an American hedge fund, Gramercy, headquartered in Connecticut.

Some of the bondholders, including the institutional holders, are considering suing Peru in international court in order to receive a faster and higher pay out.

In a little over 18 months since the issuance of the decree by the Humala government, it is unclear where the program stands. Technically, there is a five-year period for claims to be filed and verified. There appears to be no information, at least in an English-language version indicating whether any claims have been filed or verified or if any compensation, such as new bonds or land swaps have been approved. Beatriz Merino, a well-respected lawyer and Peru's first woman prime minister, told Reuters in an interview on August 4, 2015 that the time has come for the executive branch to end a 40-year-old controversy regarding the country's infamous land bonds and get the government to finally pay billions of dollars in old debts. However, asked in February 2015, whether he would pay the land bonds, then-

Finance Minister Luis Miguel Castilla said he didn't think this issue was at the top of the agenda at this moment but he did admit that Peru must honor all of its liabilities.

As far as the U.S. government is concerned, it would appear that there has been no historical involvement in the bond issue and while the U.S. today might see the Peruvian government's settlement of the land bonds issue as a factor in perhaps helping to shore up Peru's credit rating, the U.S. has not taken any active role in encouraging a solution or what such a solution should be. It appears the U.S. understands the ruling of the Constitutional Court and how the implementation process initiated by the Humala government will work but it is not planning any activity on behalf of any of the bondholders.

Elections 2016

Peruvians will elect a new president on April 10, 2016. Humala cannot run for a second consecutive term, and his populist Nationalist Party of Peru has suffered strong public backlash over its perceived inability to handle rising crime and a slowing economy. The current field of candidates all appears to be overwhelmingly supportive of foreign investment so to the extent that putting a resolution of the bond issue on a fast track would help Peru's credit rating in case it has to borrow money on the open market, the new president may want to pursue that program. On the other hand, if moving forward on the bonds would cause Peru to incur a significant debt, the economy could suffer more and something like tax increases may be needed, something a new government would probably try to avoid. But even with business-friendly leaders, Peru's economic climate over the next presidential term will be defined not by personalities but by the country's slowing economy. For nearly a decade, Peru enjoyed rapid growth because of a large Chinese construction boom, which was fortified by Peru's iron and copper sectors. But barring major shifts in global mining commodity markets, Peru's economic growth will continue to decline alongside slowing growth in Chinese demand.

None of the presidential candidates thus far including former presidents Alejandro Toledo and Alan Garcia, as well as Keiko Fujimori who came in second to Humala in the last election, or Pedro Kuczynski, a former government minister, have spoken out much if at all on the Humala decree setting the resolution of the land bonds issue in motion. Again, none would oppose the Constitutional Court's demand that a resolution of the bond issue be pursued but given the uncertain state of the economy which the eventual winner of the elections will face, it is unlikely that the land bonds issue will be a campaign issue or a high priority for the early part of the next president's term.