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MODELING PERUVIAN DEBT RESCHEDULING IN THE 1980S

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ABSTRACT

International debt rescheduling is a strategic game in which the stakes are the wealth and power of banks and nations. Yet, there is little research on debt negotiations that systematically combines economic and political variables. The domestic political economy of adjustment has received far more attention than the international political economy of debt rescheduling. This paper uses a model based on economic and political factors to examine Peruvian debt rescheduling in the 1980s.¹

The Peruvian case highlights difficulties facing small countries in the international financial system; it also provides a different perspective on rescheduling than the more common focus on large countries such as Brazil and Mexico. Moreover, Peru was one of the first countries in Latin America to develop extensive ties with private commercial banks.² In 1954 Peru became the first country to sign an IMF-designed standby agreement.³ In August 1983, President Fernando Belaúnde Terry began a quiet moratorium on the debt, while carefully maintaining the front of a compliant debtor by negotiating with the banks and promising orthodox adjustment. Belaúnde's successor, President Alan García Pérez, condemned the IMF as a "modern system of imperialism." In an unprecedented move, García suspended payments to the IMF and unilaterally declared that Peru would pay commercial banks no more than ten percent of export earnings. García was clear: "We will not deal with the IMF", he said; "We will fight the banks. They are our enemies."⁴ By 1990 Peru was the world's "worst" debtor: it owed \$950 million to the IMF, roughly half the Fund's total bad debts.

What can the Peruvian case, particularly the initiatives of the Belaúnde and García administrations, tell us about the politics of international debt rescheduling? Why have the costs borne by Peru and its lenders in on-going rounds of debt rescheduling varied? Under what conditions do countries comply with IMF orthodoxy or attempt to unilaterally shift the costs of debt rescheduling onto the banks? These questions are addressed in the following three sections of this paper by: (a) presenting a model of international debt rescheduling that draws on economic and political variables;⁵ and (b) applying this model to explain the bargaining and actors' efforts to alter their bargaining position during the years 1982-1990. In concluding, we assess the value of the theoretical model for the analysis of debt rescheduling more generally.

I. MODELLING DEBT RESCHEDULING

Our focus in examining Peruvian debt rescheduling is on the degree to which banks make lending concessions and Peru agrees to undertake adjustment. We do not attempt to model why Peru found itself deep in debt or the intricate domestic politics underlying Peruvian adjustment choices -- topics that have been written about extensively. In focusing on debt rescheduling, we could use a host of approaches to examine international bargaining, ranging from case studies to highly sophisticated and elaborate formal models. In this paper, we choose a middle course: we utilize a relatively simple game theoretic model that permits us to illuminate interesting connections among political and economic variables in an empirical context. Our decision to use a game theoretic rather than a decision-theoretic model is based on the need to consider strategic interaction between Peru and its bankers: the choices that each actor makes clearly affects the calculations of the other.

The Rescheduling Game

We turn now to a model to help predict how much debtors will be willing to adjust their economy and the degree to which lenders are likely to make concessions.⁶ We begin by specifying a generic game between debtors and lenders and then show how we might derive payoffs representing the actors' valuation for policy combinations of lending concessions and economic adjustment.

FIGURE 1: A GENERIC DEBT RESCHEDULING GAME

| | | LENDERS | |
|--------|--|---|--|
| | | High Concessions & Retaliatory Sequence (HC...) | Low Concessions & Retaliatory Sequence (LC...) |
| DEBTOR | High Adjustment & Retaliatory Sequence (HA...) | Major symmetrical rescheduling agreement | Highly asymmetrical outcome favoring lenders |
| | Low Adjustment & Retaliatory Sequence (LA...) | Highly asymmetrical outcome favoring debtors | No accord |

This normal form game depicts possible choices for a debtor and lender and the outcomes that result from their moves.⁷ For ease of presentation, we show only two strategies for each actor:

high or low adjustment for debtors and further possible retaliatory moves; high or low concessions for lenders and possible retaliation by them. In the empirical analysis, we will consider intermediate strategies of medium adjustment and concessions as well. The outcomes resulting from these combinations of strategies are reflected in the cells of the game.

To predict what debtors and bankers are likely to do in a debt rescheduling game, we need to specify the payoffs that result from different combinations of policy choices. Rather than simply postulating that all debt games are of a particular form, say a Prisoners' Dilemma or a game of Chicken, we deductively specify actors valuations for different outcomes based on different political and economic variables that are likely to affect their calculations. Consider first the following **basic** goals. Debtors' leaders will wish to: (1) avoid their country's bankruptcy; (2) avoid politically disruptive economic policies (austerity policies); and (3) maintain long-run access to lending and to markets to buy and sell goods and services. Lenders in a crisis want to: (1) minimize the commitment of additional funds; (2) avoid write-offs by pressing debtors to pursue economic adjustment so that they will maintain debt servicing; and (3) avoid retaliation and maintain good relations with debtors. Both debtors and lenders must, of course, decide how to emphasize each of the goals in making policy choices. We expect debtors in general would like to receive the highest lending concessions possible while making little or no adjustment of their own. Similarly, lenders hope to secure a commitment from debtors for the maximum amount of adjustment (consistent with their interest in ensuring debt servicing) while making the fewest lending concessions. However, we also postulate that debtors and lenders would be interested in maintaining good relations with their counterparts in light of possible retaliation. We can specify a simple function to model these competing considerations.

The Utility Equations for the Debt Game

Let L , A , G , and H represent, respectively, lending concessions, domestic adjustment, and debtors' and lenders' concern about retaliation. The payoffs for the debtor and lenders can be obtained by calculating the values of $U_{(Debtor)}$ and $U_{(Lender)}$, the utilities of the debtor and lenders, respectively, for different policy combinations of adjustment and loan concessions.

FIGURE 2: UTILITY EQUATIONS

(3.0)

(3.2)

where a, b, c are the weights assigned to the three goals by a debtor and x, y, z are those assigned to their goals by lenders and all weights are greater than zero.

Before examining how we should decide what weights to use in these equations, we first consider how the utility functions work.

A debtor's utility for a particular policy combination of adjustment and lending concessions is equal to the algebraic sum of the weighing of three goals: the benefits of loan concessions, L , the costs of adjustment, A , and the value of concern for maintaining good relations, G . Similarly, lenders' utility for different policy combinations will be equal to the sum of the weighted utilities for three goals: the benefits of a debtor agreeing to adjust, A , the cost of providing loan concessions, L , and the value of maintaining overall relations, H .

The terms G and H can be interpreted as terms that represent actors' fear of retaliation by their counterparts as a result of their actions in the debt game. For example, if banks are worried that rescheduling negotiations might get linked to security or other "games" on which they might be weaker, they will avoid playing too aggressively to prevent such linkages. These points can be illustrated by considering the numerical values assigned to the different options and the resulting utility calculations.

$L = 3$ for high lending concessions
= 2 for medium lending concessions
= 1 for low lending concessions

$A = 3$ for high degree of adjustment
= 2 for medium degree of adjustment
= 1 for low degree of adjustment

In light of the assigned values, the values for retaliatory concern will range as follows:

G ranges from 2 (when A is 3 and L is 1) to $-2/3$
(when A is 1 and L is 3),
 H ranges from 2 (when L is 3 and A is 1) to $-2/3$
(when L is 1 and A is 3).

As an example, let us evaluate a policy choice by a debtor of (HC..., HA...) (high concessions and possible retaliation; high adjustment and possible retaliation) versus (HC..., LA...) (high concessions and possible retaliation; low adjustment and possible retaliation) and assume for simplicity that the values of a, b and c are 1 (that is, each of their goals is equally weighted). Then we have:

This illustrates the simple idea that with weights of 1 each for a, b, and c, the debtors will prefer (HC..., LA...) (with a value of $1 \frac{1}{3}$) to (HC..., HA.....) (which only has a value of 0).

Weighting Actors' Goals

We next examine how actors are likely to weight their basic goals in different situations. We consider three variables drawn from the political science and economics literature that capture what we feel are the most significant effects on actors' calculations: an actors' overall power position; issue specific power; and the strength of their domestic coalitions.⁸

With respect to overall capabilities, we examine issues such as trade, political stability, immigration, security concerns, and so on. For example, debtors unable to do without trade may be more reluctant to take precipitous actions for fear of retaliation. Regarding issue-area strength or weakness, we focus on actors' resources directly connected to the debt rescheduling area.

With respect to domestic considerations, debtors' leaders will never be anxious to incur adjustment costs. In some cases, however, depending on their coalitional stability, the political cost they will be forced to bear will be lower. Debtor countries' negotiators must consider whether an agreement to pursue economic adjustment (to increase prices, lower wages, etc., as the IMF might demand) will lead to domestic turmoil. One way to predict whether adjustment will lead to political chaos is to measure the debtors' coalitional stability. Finally, for lenders, we judge the extent to which they have a stable coalition, rather than focusing on their internal stability.

To gauge the effects of different constraints on actors' goals, we identify the various individual situations based on domestic and international factors by dichotomizing the values of the three factors of overall capabilities, debt resources, and domestic coalitional strength as follows:

FIGURE 3: INDIVIDUAL SITUATIONS (IS)

| | | COALITIONAL STABILITY? | |
|---|--|-----------------------------------|-----------------------------------|
| | | Yes | No |
| | Issue strength, Overall weakness | Individual Situation (IS) 1 | Individual Situation (IS) 2 |
| ISSUE AND OVERALL CAPABILITIES | Issue weakness, Overall strength | Individual Situation (IS) 3 | Individual Situation (IS) 4 |
| | Issue strength, Overall Strength | Individual Situation (IS) 5 | Individual Situation (IS) 6 |
| | Issue weakness, Overall weakness | Individual Situation (IS) 7 | Individual Situation (IS) 8 |

The above eight individual situations refer to combinations of the values of the three variables. How are actors likely to weight their goals in different individual situations? To deduce the weights, we consider both the independent effect of each of the three factors of coalitions, debt resources, and overall capabilities, and the possibility that they may have an interactive effect in influencing actors' preferences. Although the detailed arguments for the rationale behind the values specified in the charts in Appendix 2 can be found elsewhere,⁹ we present some examples here. For examples, we can hypothesize that in general, the greater the coalitional stability of debtors' governments (focusing on incumbency expectations and the ability to control opposition), the lower the costs associated with adjustment policies. Higher debt-related capabilities should also lead to a decreased need for additional lending concessions on the debtors' part. And finally, greater overall capabilities will decrease debtors' concern with potential retaliatory actions.

Similarly stable coalitions will decrease lenders' fear of "free riders." And if lenders are financially secure (that is, they have high debt related capabilities), they are likely to be more aggressive in their demands. Finally, lenders who are weak in overall capabilities will be more concerned about potential retaliation than those who are able to resist coercive efforts by their counterparts in the negotiations.

Examples of Preference Orderings

Based on the weights presented in Appendix 2, for

illustrative purposes, we present some examples of how they can be used to generate payoffs. Consider the following illustration, based on the values that a debtor places on basic goals as well as their weightings:

Debtor Individual Situation: 7

Debtor: Coalition stable, Issue weak, Overall weak

Debtor Weights: Borrowing Need $a=5$, Adjustment Unwillingness $b=1$, Goodwill $c=4$

We can calculate a few examples for debtors' valuation of different possible outcomes.

$$U(\text{debtor}) = aL - bA + c [(A/L)-1]$$

$$\begin{aligned} U(D) \text{ for HC... , LA...} &= 5 * HC - 1 * NA + c * [(A/L)-1] \\ &= 5 * 3 - 1 * 1 + 4 * [(1/3) - 1] \\ &= 11.33 \end{aligned}$$

where HC...= high lending concessions plus possible retaliation and LA = low or no adjustment plus possible retaliation.

$$\begin{aligned} U(D) \text{ for NC... , NA...} &= 5 * NC - 1 * NA + c * [(A/L)-1] \\ &= 5 * 1 - 1 * 1 + 4 * [(1/1)-1] \\ &= 4 \end{aligned}$$

where LC...= no lending concessions and possible retaliation.

These two examples show the most and least preferred policy combinations for a debtor in individual situation number 7. That is, the debtor values the combination of high lending concessions and no adjustment (HC....., LA...) at 11.33 and no lending concessions and no adjustment (LC..., LA...) at 4. In this case, because of the debtor's concern with potential retaliation and relatively high willingness to undertake adjustment, it fears a collapse of the negotiations and would even be willing to undertake adjustment even without lending concessions. What appears counterintuitive in the payoffs from the weights in the calculations based on the utility function, is actually a desirable property. Specifically, the notion that the debtor might be more willing to undertake adjustment even without lending concessions than to simply have no adjustment or loan concessions might seem odd at first glance. The apparent paradox comes in part from the importance assigned by the debtor to fear of retaliation, thus indicating the concern that debtors in a weak overall position who need money -- but who are coalitionally stable -- might have with maintaining good relations with lenders.¹⁰

By combining the payoffs that actors assign to different amounts of lending and adjustment, we can construct 3x3 games (see the next section). In each of these games, we first consider the likely outcome of negotiations as played by the two actors under conditions of perfect information, and focus on the Nash equilibrium of the game as the solution. For ease of presentation, we convert the cardinal values of the payoffs to ordinal rankings in our empirical analysis. We should also keep in mind that intervention by creditor governments (CGs) could push the outcome to one quite different from that which the actors would have negotiated on their own. Some of the relevant calculations that CGs will make in deciding whether or not to intervene will be: (1) the utility they assign to the expected outcome in light of strategic, political, and financial considerations; and (2) the costs of pushing either the debtor or lenders to their preferred outcome. Although we do not formally quantify creditor governments' decisions in this paper, we focus on such considerations in the empirical cases.

II. PERUVIAN DEBT RESCHEDULING

We divide our analysis of Peruvian rescheduling in the 1980s into four periods. In keeping with our theoretical analysis, different periods reflect a change in individual situation for either (or both) Peru and its lenders. Such changes are discussed at the end of each period of negotiations.

The first begins with the bargaining over a jumbo loan in March 1983 and ends in October 1983 when Peru returned to the IMF.

The second period covers the major rescheduling in February 1984 and extends over the remainder of the Belaúnde administration until the inauguration of President García in July 1985. The third period encompasses the announcement of García's "10 percent solution" in July 1985 to the IMF's declaration of the ineligibility of Peru to borrow in August 1986. The final period covers the deadlock between Peru and the banks from August 1986 to the transition of government in 1990.

Period 1: Good Intentions? (March 1983-October 1983)

Although Peru secured an IMF loan in 1982, successful completion of the IMF's austerity measures were hampered by a shortage of loans from the commercial banks in 1983. Negotiations with the banks commenced at the beginning of 1983.

Identifying Individual Situations

We begin by examining actors' bargaining situations to determine the structure of the game between Peru and its creditors during the first period from March to October 1983. The Peruvian government had a stable domestic coalition, but was both issue and overall weak (IS7). The banks, by contrast, were unified and strong overall, but were weak in issue capabilities (IS3).

Peru. The Belaúnde government was stable between 1980 and 1983. It was democratically elected with a broad popular mandate. A majority in Congress was assured by Belaúnde's party's (Acción Popular or AP) alliance with the Partido Popular Cristiano that enabled him to pass important budgets and legislation. The president also controlled political opposition within his coalition (led by Alva Orlandini), whose efforts to build a political challenge to Belaúnde were confined to behind the scenes manoeuvring until the end of this period. The threat of a coup was minimal because the military was reluctant to be drawn back into politics. Belaúnde's government systematically dismantled many of the major reforms of the previous twelve years of military rule with little opposition from either the military or the Congress. At this time, the Shining Path, a Maoist terrorist organization, appeared to be a minor threat that could be contained within the remote province of Ayacucho. Political stability was reflected in the perceptions of the bankers whose risk analysts assured them that Peru could reach 1985 without major political upheavals.

Peru was weak in issue capabilities. Peru used up two thirds of the \$1.28 billion foreign exchange reserves it had at the beginning of 1981 to prepay old debts. This effort proved ill-timed because it coincided with a deterioration of Peru's balance of payments, the onset of the world recession, and the Mexican collapse. By June 1983, net international reserves equalled about \$500 million -- barely worth two months of exports. Peru's issue weakness was further reflected in massive budget deficits (10 percent of GDP), a loss by the government of one third of its tax revenues over 1975, and \$600 million in capital flight.¹¹ As exports shrank, investment fell off, economic activity contracted, and the financial system was thrown into chaos.¹² Prime Minister Fernando Schwab summarized Peru's pessimistic economic prospects for 1983 as resulting from: 1) low prices for Peru's exports, 2) unfavorable trends in financial markets, and 3) continuing disorder in public finance.

In overall terms, Peru was weak. Its GDP contracted by a catastrophic 12 percent in 1983. The deterioration in Peru's terms of trade led to a commercial deficit that severely reduced Peru's ability to generate revenue for debt repayment. International terms of trade declined by 25 percent between 1980 and 1982; \$500 million in exports were lost due to falling mineral prices alone. At the same time, Peru faced a dramatic decline in domestic agricultural production in 1983 due to natural disasters.

Peru desperately needed international bank credits, trade credits, and access to markets for its exports.

Lenders. The bankers had a stable coalition during the rescheduling negotiations with Peru. However, they did not have a unified steering committee to present a common front in the negotiations prior to March 1983. In early 1983, small regional U.S. and Japanese banks began to close down lines of credit to Peru. They were tempted to "take the hit" rather than get drawn into a collapsing economy. Citicorp and Chase Manhattan quickly counseled the Peruvian government to "declare a unilateral moratorium on debt payments so that retreating institutions would be 'locked into' the country's fate."¹³ The government suspended payments from March 7, 1983 until an agreement was reached between the Banco de la Nación -- Peru's financial agent -- and 287 creditor banks led by Citicorp on June 30, 1983.¹⁴ With this action, Peru helped create a stable coalition of bankers in order to guarantee that the banks would not defect from the rescheduling negotiations.

The banks were issue weak: They were concerned about their assets because competition in the 1970s had created a high level of exposure and they were vulnerable to default. Many banks had competed for shares of the Peruvian market because it had not already been captured by the large banks. For example, Wells Fargo used Peru to expand its international portfolio and achieved a high relative exposure.¹⁵ As competition diminished in the 1980s the banks became more concerned about their exposure to risk. They realized they had set aside insufficient reserves to protect their capital base from a potential loss of bad loans. This was especially troublesome in countries like Peru which had heavily "overborrowed"; Peru owed far more than could be repaid by internal savings and investment.

In overall terms the Peruvian debt was small in comparison with Brazil, Argentina, or Mexico. Peru owed the commercial banks only \$5.2 billion in 1982, compared with Brazil's \$56.1 billion, \$22.2 billion owed by Argentina, or Mexico's \$59.0 billion debt.¹⁶

The small size of the Peruvian debt gave banks the flexibility to bear the loss if negotiations failed to resolve in their favor or if Peru ever attempted default.

Creditor Governments and International Organizations. In the early stage of debt negotiations the IMF and the U.S. were particularly concerned about the stability of the international financial system and the potential threat to banks of en masse default by debtors. Although Peru by itself was not a direct threat to the banks, it could set a precedent for other debtors. At the same time, the U.S. was concerned about the consolidation of Peruvian democracy. For their part, Peruvian officials felt that support from the IMF and World Bank would ensure bank involvement. At the beginning of the period analyzed here the IMF remained well-disposed toward Peru.

Actors' Valuations of Possible Outcomes and Game Predictions

Period 1: March to October 1983

| | | LENDER IS 3 | | | | | | |
|--------|--|-------------|---|-------|-----|-------|----------|----------|
| | | HC... | | MC... | | LC... | | |
| DEBTOR | | HA... | 9 | 7 | 5 | 8 | 6 | 9 |
| IS 7 | | MA... | 8 | 4 | 4 | 5 | 2.5 | 6 |
| | | LA... | 7 | 2 | 2.5 | 2 | 1 | 2 |

Note: Nash equilibria in bold face type; expected outcome with intervention underlined.

The game has a structure akin to a called-bluff situation, giving the lender a more advantageous bargaining position. It has one equilibrium, at HA..., LC..., with high adjustment by Peru and few concessions by the banks. Turning to the likely outcome with intervention, given U.S. government and IMF concern about Peru setting a precedent that would undermine the financial system, we might expect the U.S. to encourage the equilibrium outcome of HA..., NC... as this would meet U.S. and IMF goals.

The Negotiations and Actual

Outcome

As expected, Peru demonstrated considerable willingness to adjust its economy. Under the financial leadership of Carlos Rodríguez-Pastor, Peru promised to pursue austerity to secure the IMF's "stamp of approval" in an effort to win agreement with its creditors.¹⁷ From the bankers' perspective, Rodríguez-Pastor was reassuringly more vigorous in applying the stabilization policies.

Beginning in March 1983, the Peruvian negotiating team sought a new agreement with the banks to obtain more credit.¹⁸ With only \$500 million in international reserves, Peru faced no short-term alternative to large-scale foreign borrowing. Peru had requested an \$800 million jumbo loan from its commercial creditors to avoid a forced rescheduling. Negotiations were opened with the Paris Club of government creditors. Peru also announced a \$400 million cut spending to demonstrate its commitment to the new, IMF-sponsored, austerity program.

Peru's commercial bank creditors stalled during the month of May. The discrepancy between the economic assumptions for 1983 from Peru's financial ministry in early March and those from the IMF disturbed the banks. Still, the IMF urged commercial banks to cooperate with Peru. Rodríguez-Pastor told the banks that unless they cooperated with Peru's request, the IMF would cease to back Peru, and everybody would be "in the soup". This pressure proved effective because IMF withdrawal from the collective bail-out would have jeopardized the over-exposed banks as well as Peru.

In June 1983, new credit was granted and negotiations with commercial banks proclaimed successful. In what amounted to an elaborate recycling of Peruvian debt, the commercial banks, led by Citicorp, agreed to stretch out payments on \$320 million in loans over eight years and to provide \$450 million in new loans. Interest on both portions was at 2.25% over LIBOR or 2% over the U.S. prime rate, at the lender's option.¹⁹ Peru paid all the costs of the rescheduling -- not a trivial sum.²⁰ Two analysts who have examined three periods of debt negotiations between 1965 and 1984 argue that the terms of the agreement "were extremely stiff." They were "equal to the most onerous borrowing conditions recorded" in previous borrowing cycles.²¹

The banks had little incentive to make concessions beyond minor ones necessary to cover a short term liquidity crisis, and Peru had little incentive to default. In 1983 neither the bankers nor Peru recognized the depth of the crisis. As Webb has put it: "Neither bureaucratic procedures nor official mindsets were flexible enough to adapt to such a radical contrast between official views and reality."²² There were almost no concessions by banks because they were mainly concerned with quickly recovering their assets. Moreover, Peru's need for borrowing and willingness to adjust encouraged the conclusion of such a deal.

Although debt rescheduling was regarded as a technical problem, the implementation of austerity measures was a political problem. Despite Belaúnde's best intentions, he had difficulty implementing an austerity program, mainly because of external factors. Notwithstanding the government's efforts, Peru failed to meet the economic targets agreed upon in its IMF program. The fiscal deficit rose to 9% of GNP, rather than the agreed upon 4.2%. The main cause of the growth of the deficit was not excessive expenditure but falling revenue due to a combination of natural disasters, a massive recession and the disappearance of new lines of foreign credit. Proposals to increase taxes were patently unrealistic. Yet, Belaúnde was unable to prevent extravagant arms purchases by the military. Arms spending led the IMF, the World Bank, and the commercial banks to threaten to halt their loans in August. In the same month Belaúnde confronted growing opposition within his party. A fraction within AP tied to Alva Orlandini attempted to have a price freeze imposed, as well as a slow down in the subsidies removal program. The President crushed the parliamentary opposition after Rodríguez-Pastor threatened to resign.

In late October 1983, the Belaúnde government, unable to comply with the original targets, requested a new IMF program, and announced its intention to reschedule its 1984 debt that same month. On October 14, at Peru's request, the IMF relaxed previously set target ceilings on the condition that Peru increase taxes. The IMF immediately offered new, adjusted deficit and domestic credit ceiling targets. A top official of the Banco Central de Reserva del Perú said Peru had no intention of complying with IMF targets, but continued to negotiation with the Fund for more lenient targets because "You spoil the charade if you say it is all fake."²³

The IMF continued to object to "substantial deviations" by Peru from its objectives into December of 1983, and Peru continued to face difficulties in complying with the accord. Peru's failure to reach an agreement with the IMF in December came at a bad time because Rodríguez-Pastor more preoccupied with the 1984 budget in Congress than dealing with the IMF.

Summary and Situational Change. The equilibrium outcome proved to be the one we expected, and was consistent with the stronger position of the lenders in the negotiations. Peru committed itself to undertake high adjustment and the banks refused to make any serious concessions to Peru. We did not anticipate, however, that Peru would face such difficulty in complying with the agreement. The problems it faced, however, seem to have arisen from international problems relating in large part to the recession and the problems induced by the banks unwillingness to be more forthcoming.

Political opposition to Belaúnde's attempts to adhere to IMF austerity dramatically decreased Peru's domestic coalitional stability. In November 1983, Belaúnde's party suffered a humiliating defeat in municipal elections, winning only about 17% of the vote. The victory of the United Left in Lima, and the strong national performance of the left, underscored discontent with Belaúnde's orthodox economic policies.²⁴ Moreover, Belaúnde was forced to declare a state of emergency in rural provinces where the Shining Path was growing. Such unrest caused Belaúnde to waver in his commitment to orthodox rescheduling. Arguing that the IMF was "excessively severe", Belaúnde replaced Finance Minister Rodríguez-Pastor and refused to increase gasoline prices.

Despite such measures, he failed to restore his loss of popular support.

Concern for stability in Peru prompted U.S. Ambassador Jordan to offer Belaúnde a U.S. Treasury/USAID \$60 million loan in an effort to prevent Belaúnde from openly breaking with the banks and the IMF. The major bank steering committees demonstrated new concern for the stability of Peru and a new spirit of flexibility in dealing with Belaúnde. The banks continued disbursing their loans even though Peru had fallen out of compliance with IMF targets. Bank exposure in Peru had increased by 12% since the earlier negotiations, accounting in part for their heightened concern for Peruvian assets.

After a month in Peru checking figures, an IMF evaluating committee left without signing a letter of intent. This lack of confidence in Peru's ability or willingness to lower its public deficit from 10.3% of GDP to under 4% in 1984 stemmed from the fact that Belaúnde's economic policies were rejected and tax collection was virtually impossible. In January 1984, the IMF suspended its standby loan.

The IMF eased performance targets, overlooking Peru's failure to manage its deficit, and drew up a new adjustment package to buy time for further rescheduling in 1984. Peru used this grace period to build up international reserves and strengthen its bargaining position. The Bank Advisory Committee led by Citicorp came through with an emergency rescue operation to lend Peru \$100 million for 90 days as no comprehensive restructuring was expected until the new president assumed power in July 1985.

These shock-induced and policy-promoted situational changes produced a new bargaining context and hence a new negotiating game.

Period 2: Cheating the Banks? (February 1984 - July 1985)

In this period Peru attempted to use its reputation as an honest but hard-pressed player to extract further concessions for the banks. The model suggests an intriguing hypothesis: however, that Peru did not intend to undertake serious economic adjustment.

Although the banks appear to have initially fallen for this ruse, by the second round of negotiations, they had a better understanding of Peru's individual situation and the strategic game in which they found themselves and began to pursue a more confrontational policy as anticipated by the model.

Identifying Individual Situations

Peru. As argued above, Peru's domestic coalition became unstable.

One of the most important conflicts within the government involved Richard Webb, the Director of the Banco Central de Reserva del Perú, and President Belaúnde. Webb insisted on tight monetary policy. Conversations between Webb and Belaúnde illustrate this conflict. Belaúnde claimed,

I was never satisfied with the leadership of Webb. I have expressed this in words and in writing. It [the chair of the Banco Central de Reserva] is a position that has a certain autonomy. Of course, appointed by the president, but it has some autonomy. Naturally, when there are differences of opinion what is done, in the good manners of politics, is that the functionary resigns. This did not happen in the case of Webb.

Webb for his part pointed out that the Banco Central de Reserva refused to release foreign exchange to prevent the government from embarking on a course of excessive spending.²⁵ When asked whether he wanted to renew government spending at the time of the resignation of Rodríguez-Pastor, Belaúnde acknowledged that there were a "series of government projects that were being detained."

These conflicts within the Belaúnde administration prevented implementation of any coherent strategy. Yet this domestic weakness also proved to be a source of issue strength. Javier Abugattas, one of the principal negotiators for Peru, noted that the Bank of the Nation, which negotiates directly with the international banks, did not have hard currency to repay the commercial banks, despite the fact that foreign reserves increased to \$1 billion early in this period. Foreign reserves were controlled by Richard Webb, who opposed using Peru's reserves toward debt servicing. He thus restricted the emission of hard currency in compliance with the IMF limits on the size of the deficit. Refusing to transfer foreign reserves to the Banco de la Nación to pay off the commercial banks, the Banco Central de

Reserva del Perú pitted the IMF against the commercial banks.²⁶

In overall capabilities Peru remained weak. The lethal combination of contraction and inflation continued into 1984. Lastly, Peru's dependence on foreign imports, even food, weakened the possibility of withdrawal from the international systems of trade and finance. In the end, Peru had little alternative to IMF help and accept austerity measures.

Lenders. There is no change in our coding of the banks in this period. The banks had only two options. They could either refuse new loans which eventually would cause them to declare their outstanding loans value-impaired, or provide emergency credit in the hopes that the new government and president would take debt servicing more seriously. In this period, the banks were clearly preoccupied by the big debtors. Peru's relatively small debt allowed the banks to choose between taking an immediate "hit" on interest arrears or to allow Peru to drift along until a new government takes office.

Creditor Governments and International Organizations. Both the U.S. government and the IMF had a limited interest in Peru owing to its relatively small debt compared to the other debtors in the region. The main concern at this time was that lenience toward Peru in terms of rescheduling and emergency aid would provoke resentment and similar demands among other debtors. The principal U.S. interest in Peru concerned democracy and the successful transfer of power from one administration to another at the end of the Belaúnde's term. U.S. interest is apparent from its decision to double military aid to Peru in 1986, making Peru the largest recipient of U.S. aid in South America. The U.S. argued that such extensive military support aimed to ensure the political stability necessary to facilitate a democratic transfer of power. The U.S. however, denied serious strategic interest in Peru, and claimed indifference to the presence of Soviet advisors and influence.

The IMF, on the other hand, wished to ensure that debtors would not get by without making appropriate adjustment. In January, the Fund delayed a standby agreement with Peru for just that reason: to restore its credibility. The IMF was also concerned that a Peruvian default could spur on similar ideas and behavior in other debtor countries from which such a move would be disastrous.

Actors' Valuations of Possible Outcomes and Game Predictions
Period 2: February 1984 To July 1985

LENDER IS 3

| | | HC... | | MC... | | LC... | |
|------|-------|------------|----------|----------|----------|-------------------|-----------------|
| | HA... | 1 | 7 | 2 | 8 | 4 | 9 |
| PERU | MA... | 4 | 4 | 4 | 5 | 6 | 6 |
| IS 2 | LA... | 8.5 | 2 | 7 | 2 | <u>8.5</u> | <u>2</u> |

Note: Nash equilibria in bold face type; expected outcome with intervention underlined.

There are three Nash equilibria in this game: low adjustment by the debtor and the lenders at high, medium, or low concessions. Unlike the previous game, Peru's dominant strategy is now no adjustment. The banks face a difficult situation. No matter what they do, they receive a very low payoff if Peru pursues its dominant strategy of not undertaking adjustment.

In principal, neither the banks nor Peru have any interest in being concessionary as they would both end up worse off. However, Peru had a reputation for being a "cooperative debtor" from the previous round of rescheduling -- albeit a cooperative player with difficulties in implementing its strategy.²⁷ In this period, it appears that the banks were somewhat unsure of the actual game in which they found themselves with Peru. Given their payoff structure, the banks had little to lose by initially playing a more conciliatory strategy in an effort to coax Peru to be more accommodating. With the IMF attempting to ensure that recalcitrant debtors would not be rewarded, however, we might expect the banks to back off and move toward low concessions.

The Negotiations and Actual Outcome

The second period consists of two rounds, the first from February 1984 until about mid-1984 and the second from that time until June 1985. In the first, as we shall see, the banks appeared to be somewhat conciliatory but by the second round, had shifted to a confrontational stance.

Round 1. Following the provisional approval of an IMF adjustment package in January 1984, Peru began negotiations to reschedule \$2.6 billion in old loans with a 12 bank advisory group representing 270 commercial banks. The whole package depended upon prior completion of an IMF agreement. The government agreed to adopt austerity measures in exchange for \$350 million in IMF

loans so Peru could conclude an agreement with commercial banks and government creditors. The agreement was scheduled to be signed in April 1984. Despite domestic opposition to austerity, an agreement with the IMF was ultimately signed. Although Peru pursued orthodox rescheduling on the surface, it began to use its reputation for having difficulties in policy implementation to avoid adjustment. As domestic instability undermined adjustment efforts, the President continued negotiations to avoid a rupture with international creditors. The government's commitment to orthodox adjustment was a bluff. Adjustment was never "convenient."²⁸ Instead, Belaúnde adhered to the IMF agreement long enough to conclude his agreement with the banks in April 1984 and secure about \$130 million in funds from the IMF and banks. The Peruvian government played the orthodox debtor so well that one Peruvian banker suggested it deserved an Oscar.²⁹

The commercial bank agreement technically included no new loans, but it did allow for the renewal of \$880 million in trade credits and the disbursement of the remaining \$200 million in tranches from the previous year's agreement. Peru managed to significantly improve its repayment terms: interest rates were lowered half a percentage point (from 2.25 to 1.75 over Libor); the maturity of 90% of the loans was extended to nine years (in comparison to the eight year maturity on loans rescheduled in 1983); and the grace period was extended from three to five years.³⁰ Payments on the remaining loans were deferred until December 31, 1985. The total amount rescheduled, \$1.045 billion, exceeded bankers' expectations by \$280 million.

The banks made some concessions to Peru in order to help stabilize the government and protect their increasingly damaged and precarious loans. Uncertainty as to Peru's "real" strategy may account for why the banks may have undertaken to provide Peru with some concessions to avoid outright moratorium. Given Peru's economic situation, the bankers tolerated Peru's position as the best alternative to open default. By mid-1984, however, it was clear that Peru could not comply with the terms of debt rescheduling, and emergency aid would be necessary to keep Peru solvent until the election of a new president. The reality of Peru's situation quickly began to dawn on the IMF and the bankers.

Round 2. Predictably, the Belaúnde government failed to impose the negotiated austerity measures. By August 1984, Peru stopped meeting its debt obligations. The IMF suspended its 18-month standby agreement with Peru because the government's deficit continued to exceed the agreed upon target of 4.2% and remained at 9.4%.

Indifferent to Peru's public deficit of 11% of GDP in 1984, Belaúnde spent wildly on his reelection campaign. To finance the deficit, the government used money allocated for repayment to commercial banks. In addition, reports that Peru was secretly

spending millions of dollars in scarce foreign reserves on French Mirage jets annoyed bankers. Peru could not explain to the banks why it had fallen into arrears while the Banco Central de Reserva del Perú amassed over a billion dollars in international reserves.

Belaúnde continued to claim that the Banco Central de Reserva del Perú not only denied him access to these funds but also refused to release the funds destined for his development projects.³¹ These development projects assumed top priority during Belaúnde's last months in office.

Belaúnde criticized the banks for not cooperating; the banks responded by tightening their credit lines, moving more directly to a more confrontational stance as expected from the game structure. Credit available to Peru fell from \$880 million in June to \$310 million in mid-November. From August 1984 through July 1985 the government failed to meet payments on a timely basis.³²

Although Belaúnde could not remember this option being discussed, Webb has confirmed it: "a policy debate within the government had questioned the advisability of an IMF program, citing the standard objections -- the primacy of output recovery, the role of credit as a productive input, and the feedback from devaluation and energy prices to inflation. In the end, these objections were overruled and negotiations with the fund were completed."³³ While this discussion illustrates Peru's increase in issue specific capabilities it ignores the lack of coalitional stability necessary to break from the IMF. According to Webb, "a go-it-alone course would have meant the loss of official and commercial bank loans as well as difficult-to-foresee diplomatic waves during President Belaúnde's last year in office."³⁴

In the final months of office, the Belaúnde team had a difficult time maintaining even the appearance of orthodoxy. The military had spent \$650 million on 20 Mirage jets, perhaps a necessary palliative from the government to prevent potential regime opposition by the military.

By 1985, to avoid a complete break with the bankers, Peru made three "goodwill payments" worth between \$16 and \$52 million which prevented its U.S. regulatory status from falling into the "value-impaired" category. Belaúnde admitted to a delay in loan payments, "but a delay with dialogue; it was not a unilateral moratorium but a negotiated delay." Peruvian debt negotiators acknowledged that the government was merely trying to "keep appearances" in order to "remain part of the game." In the last year in office, "a 'best effort' policy was followed, with the government making ad hoc payments according to its monthly cash position, maintaining an ongoing dialogue with the Fund and other creditors, and taking additional fiscal measures. By maintaining a low profile and, again, keeping-up appearances, Peru gained a considerable measure of de facto acceptance of its inability to pay."³⁵

Strong U.S. support prevented Peruvian loans from becoming value-impaired "for political considerations" -- to avoid antagonizing the next government. The banks rewarded Peru's apparently "conciliatory" gestures by granting a one-month freeze on loans maturing in late 1984. Peruvian Finance Minister Guillermo Garrido Lecca led a mission to Washington. He told creditors that Peru's improved treasury balance was due to increased tax revenues from such unpopular adjustment measures as increased fuel prices. In fact, however, the government was borrowing this money from the state-run Banco de la Nación. Meanwhile, Webb claimed that there were not enough funds for typewriters in the Ministry of Finance. In effect, the banks thought Peru was doing the best it could, but abandoned hope for any real progress from the "lame-duck" government and allowed the country to drift along until a new government was inaugurated in July 1985.

Belaúnde did not intend to adjust in the later part of his administration. Nevertheless, he avoided a major cutoff of credit and labor opposition that would have resulted from further austerity. Belaúnde believed further austerity would make reelection of his party impossible and lead to social unrest that could threaten the democratic transition of government.³⁶ He accomplished the latter: July 1985 marked the first such transfer in nearly half a century.

Summary and Situational Change. In this period, Peru's became domestically unstable and financially strong. According to our model, the resulting game with the banks now made it likely that Peru would follow a strategy of little adjustment, no matter what strategy the bankers followed. In the initial stages of negotiations, it appears that the bankers did not fully recognize the new situation or alternatively, were willing to be concessionary towards Peru in an effort to encourage similar behavior. Soon, however, supported by the IMF, the banks shifted to a much more confrontational strategy and refused any concessions, leading to a deadlock.

With García's election, Peru would once again become stable as in the first period of negotiations. In contrast to the first period, however, the events of the second round, and Peru's economic strategy initially at least made Peru both issue and overall strong. For their part, as a result of U.S. policy, the banks increased their issue strength.

Period 3: García Confronts the Banks (July 1985 - August 1986)

In his inaugural speech, President García unilaterally announced that for a period of twelve months, Peru would dedicate no more than 10 percent of its export earnings to service the medium and long-term public debt.³⁷ Priority would be given to servicing Peru's obligations with multilateral agencies and

creditor governments; the commercial banks would receive no money until January 1986. Peru never normalized relations with the banks. Confrontation with the international financial system led to the declaration that Peru would be "ineligible" for further IMF funds. At the end of the García administration Peru was at risk of outright expulsion from the IMF. President García began with a promising debt initiative, yet by the end of his term Peru was the most financially isolated country in Latin America. Why did García's debt strategy go so badly awry? Our analysis is divided into two periods, the first until August 1986 and the second until 1990.

Identifying Individual Situations

Peru. Between July 1985 and August 1986, García's coalition was stable. Peru's new leader won the presidential elections of July 1985 with a decisive margin of victory. No previous candidate had captured over half the valid votes cast in a presidential election. García had the acquiescence of the military; substantial campaign funds from big business; strong support among workers, the middle sectors and in the provinces; and control over both houses of Congress. He enhanced the cohesion of his coalition by attacking the IMF. The election results repudiated Belaúnde's economic policies; the popularity of "anti-imperialist" rhetoric reflected the dissatisfaction of groups that had seen the erosion of real wages and declining employment opportunities. As García noted, "All successful revolutions require a foreign enemy. The [International Monetary] Fund is my enemy."³⁸

Under García, Peru increased its issue strength. Although faced with \$2.734 billion in debt arrears, of which \$1.924 billion was owed to the commercial banks, the new administration had roughly \$1 billion in reserves. These reserves represented a significant source of issue strength, and they grew to over \$1.5 billion by the end of the year as the result of a positive trade balance, "de-dollarization" of the economy, and the moratorium on the debt. The government's quiet removal of Peru's foreign assets from the U.S. in anticipation of a hardening of relations with the banks further strengthened Peru's issue capabilities. Peru removed a total of \$500 million in gold and \$200 million in silver. The Peruvian government also warned local banks to remove their assets from U.S. banks and place them in safe Swiss and London accounts. In sum, fewer attachable assets in the U.S., and increased gold and silver reserves at home, increased Peru's issue strength.

Peru was overall strong in the first years of the García administration because the heterodox strategy led to two years of the fastest economic growth in Latin America -- 9.5 percent in 1986, and 7.8 percent in 1987. For a while Peru was able to stimulate rapid growth with the foreign exchange that it was not paying the banks. By August 1987, Peru had been living without fresh bank credit and surviving on trade financing and barter for

approximately two years. Although trade lines decreased to about \$250 million from nearly \$900 million in 1984, the significant increase in reserves fostered the belief in Peru's ability to survive on its own. With industry running far below capacity, Peru faced no immediate need for large quantities of foreign cash for expansion.

Lenders. The bankers coalition remained stable. They increased their issue-strength as a result of actions by U.S. federal banking regulators (the Inter-Agency Country Exposure Review Committee -- ICERC) in October 1985, only a few months after García came to power. This body forced U.S. banks to set aside reserves on their Peruvian loans equal to 15 percent of their total value. This was the first such move against a Latin American debtor and it increased the issue strength of the banks somewhat, leading us to code them as issue medium.

The bankers were overall strong due to the relatively small size of Peru's debt (about \$14 billion in 1985). Moreover, the bankers did not want to set a precedent useful to other larger debtors. Banks were unlikely to make exceptions for yet another problem debtor; and especially not on the terms demanded by Peru.

In sum, banks would be scathed but could ultimately survive a Peruvian default.

Creditor Governments and International Organizations. The main U.S. and IMF's concern resulting from Peru's maverick behavior was its potential to stir up interest in a united regional debtors' cartel. Alone, Peru did not represent a substantial threat. As a promoter of novel approaches to the debt problem -- such as linking debt repayment to export receipts or stopping payments entirely -- Peru was a potential problem for both the IMF and the U.S. government. The Reagan government was unhappy with the "rhetoric" of Peruvian public officials and it stopped military aid as well as USAID disbursements for new projects. The United States also expressed concern about the negotiations between Peru and the U.S.-based oil companies Occidental Petroleum and Belco Petroleum. The latter was expropriated in December 1985.³⁹ Bankers feared being caught in a larger confrontation between Peru and the U.S. "It is very worrying," said one banker, "that there'll be a confrontation, not with the banks directly, but with the U.S. government, or via the oil companies, but the banks will be pulled in."⁴⁰

Actors' Valuations of Possible Outcomes and Game Predictions
Period 3: July 1985 - August 1986

LENDER IS 3/5

| HC... | MC... | LC... |

| | | | | | | | |
|------|-------|-----|-----|-----|---|------------|-------------|
| | HA... | 2.5 | 6.5 | 1 | 8 | 2.5 | 9 |
| PERU | MA... | 6 | 3.5 | 4.5 | 5 | <u>4.5</u> | <u>6.5?</u> |
| IS 5 | LA... | 9 | 1 | 8 | 2 | 7 | 3.5 |

Note: Nash equilibria in bold face type; expected outcome with intervention underlined.

The Nash equilibrium in this game is the lower right-hand cell (7, 3.5), with low or no concessions by the banks and low or no adjustment by Peru. Peru would diminish its payoff as the result of any concessions to the banks. As a result, its strategy is highly uncooperative. In such a game we would expect much posturing and little actual negotiation. The banks are clearly motivated to appeal to creditor governments and the IMF for help in pressuring Peru to adjust. Peruvian policy makers had an equal interest in making alliances against the banks to prevent adjustment measures being foisted upon them. Thus, although we might see some movement toward adjustment by Peru as a result of creditor government pressure, the most likely outcome should be a deadlock.

The Negotiations and Actual Outcome

Under García Peru and the banks never formally agreed to reschedule the debt. Posturing and rhetoric replaced serious negotiation. Although the banks consistently sought to coax Peru into adjusting, they had little real leverage over the new president. García gave them little priority, and in return was unable to extract concessions from them.

At first, President García attempted to assuage the fears of the bankers. He told them he would say some tough things in his inaugural address, but the banks ought not to assume this was a sign of a confrontational approach. In September he praised the bankers for being "prudent and intelligent" in their response to his announcement of the "10 percent solution," which was the idea of the President himself.⁴¹ This strategy would save Peru \$450 million annually, or 2 percent of GDP, which the government argued would be used to reactivate the economy. The revenue generated by the economic recovery would ultimately be used to pay back part of the debt.

At the same time, however, it was clear that the "10 percent solution" would not be viable in the medium-term unless the debt was massively restructured. Prime Minister Luis Alva Castro acknowledged that "the foreign debt problem will not be solved by paying US\$300-350 million a year, which is what 10% of our income from exports will amount to... We must not forget that our debt will increase at a rate of US\$1 billion per year through the accumulation of interests alone." Thus, Peru's proposal was "none other than a common proposal with other Third World countries,

especially those in Latin America, for the handling of the foreign debt."⁴²

Only months after García took office, Peru announced a "unilateral roll-over of interest payments on approximately US \$960 million of short term working capital debt from 16 September 1985 to January 31st of this year (1986)."⁴³ The head of the bankers' steering committee complained that Peru was paying "next to no money" to the commercial banks. They pressed for some interest payments at the very least. In October and November 1985, the bankers' steering committee insistently telexed Peru to request a meeting "as soon as possible" to discuss the debt. The government repeatedly refused to consider such a meeting: "we are preparing our medium term economic program and there is no point in talking before it is ready" said the Vice-Minister of Public Finance, Leonel Figueroa.⁴⁴ Figueroa noted that the "10 percent solution" did not imply no money for the commercial banks. But help from multilateral agencies to "stretch out" Peru's repayment to the banks was being held up by delays in projects already financed.

The pressure on Peru came from creditor governments and the IMF, which were in a better position to break the deadlock than the banks. The threat of having its loans declared "value impaired" by the U.S. government's Inter-Agency Country Exposure Review Committee (ICERC) was something Peruvian government officials did much to downplay. But they were obviously upset about the decision in the end of October by the ICERC to declare Peruvian medium and long-term loans "value impaired." The U.S. banks, collectively holding \$2.5 billion in loans to Peru, had to set aside mandatory reserves of 15 percent of their total exposure. Such a ruling made fresh credit to Peru extremely unlikely. The reaction in Peru was more anti-imperialist rhetoric from García, a decision to keep dollar denominated bank deposits frozen to protect foreign reserves, and a cancellation of the token interest payment demanded by the commercial banks. Informal talks with the commercial banks took place in mid-January 1986, but Peru continued to insist that no formal rescheduling process could begin until the "medium-term" economic plan was prepared. Peru told the banks at that time that the unilateral roll-over of interest payments would be extended.

After Peru rebuffed the bankers, the IMF began to exert pressure on García Peru to adopt a more cooperative strategy -- although with little success. Executive director Jacques de Larosière told Peru to pay \$75 million arrears by April, or face ineligibility for further funds. García's haughty response was: "we will pay when Peru decides to."⁴⁵ The leader of Peru's debt team, deputy economy minister Gustavo Saberbeín said "Paying those arrears would blow our 10% of exports ceiling for servicing the public (medium- and long-term) debt."⁴⁶ Peru expelled the IMF mission in Lima just prior to the deadline, a move designed for domestic consumption, but offered \$33.7 million as a "goodwill

gesture" and received an extension of the deadline until August 1986. Peru agreed to make a proposal on how to payoff its debts to the IMF by August 15. Peru also made a \$15.8 million payment to the U.S. government for USAID and military assistance as a symbol of its "less confrontational" approach. These payments generated an expectation among bankers that they would be next in line.

In March and April, 1986, Peru floated a number of proposals with its creditor banks involving a rescheduling of the debt over an extremely long 25 year period, with 5 years grace and a 3 or 4 percent interest rate. Saberbein, president of Peru's external debt team and deputy economy minister, said Peru was willing to make a "modest but symbolic payment" to demonstrate its willingness to honor commitments to the banks as much as it could.

Such proposals were clearly unrealistic. The bankers had no incentive to listen as long as Peru clearly did not intend to pay.

In his annual speech to Congress in July 28, 1986, García announced that Peru would continue to unilaterally roll-over the principal on short-term working capital debt, service its interest, and default on both the interest and principal of the medium- and long-term debt. The president added that payments on the private debt would also be restricted, increasing the confrontation between Peru and the creditors as well as damaging foreign investments in Peru. He deplored the \$1.3 billion that had left the country in the form of private remittances, profits and royalty payments abroad in the previous year.

The next month Peru defied the IMF. It paid only \$35 million of its \$180 million arrears, with the prime minister saying it was irrelevant whether the Fund declared Peru "ineligible." The IMF promptly declared Peru ineligible, damaging Peru's relationship with the World Bank and the IDB as well. Thus, by August 1986 it was clear that García's debt strategy had failed. The banks had not succumbed to the temptation to make concessions because they had no expectation that Peru would adjust, and the Peruvian government reinforced that perception repeatedly.⁴⁷ On August 16, 1986, García made a speech from the balcony of the government palace saying that Peru would go it alone -- without international creditors.

Summary and Situational Change. As expected, then, Peru and its bankers faced a deadlocked situation, despite significant efforts by the IMF to push it toward adjustment. Moreover, the banks were unwilling to make concessions to Peru and the rhetoric simply increased over time.

From August 1986 until the transition of government in June 1990, Peru entered a period of intense political instability. With negotiations with the banks deadlocked, García found himself facing growing domestic political unrest and financial

difficulties. The first major political blow to García had occurred in June 1986 when a coordinated prison uprising in three jails in Lima resulted in a massacre of several hundred inmates, including the Shining Path members and sympathizers as well as dozens of people not directly involved in the mutiny. Financially and overall as well, Peru's position began to deteriorate, leading to yet another period of unsatisfactory negotiations with increasingly powerful banks.

Period 4: Endgame with the Banks (August 1986 - July 1990)

Faced with a hostile international financial community, García called for a "resistance economy" to face "imperialism" and the "dire days ahead." Trade and short-term working credit was reduced to a trickle and Peru faced increasing isolation. The banks maintained a tough line with Peru. They threatened court action, demanded interest payments, set aside reserves against bad Peruvian loans, and refused to make new loans.

Identifying Individual Situations

Peru. Peru's domestic situation once again became unstable. A major general strike and a police rebellion by 1,000 of the civil guard in Lima in May 1987 underscored massive discontent with the cost of living. The resignation of the Prime Minister Alva Castro, and a cabinet shuffle highlighted major differences within the García administration concerning economic strategy. The government's decision to nationalize the banks fostered strong resistance from the right. Business, intellectuals, and the middle class now coalesced in a new movement called Libertad, catapulting writer Mario Vargas Llosa into the role of opposition to the president. García backed down in the face of a court challenge to the constitutionality of the nationalization, a move that further eroded his support within the APRA party, especially APRA youth.

Peru also became issue weak. Public spending quickly used up much of the foreign reserves, creating a serious foreign exchange squeeze. Net reserves fell from about \$1.49 billion in 1985 to under \$0.04 billion by the fourth quarter of 1987. During 1988, net reserves were negative; although they rose to a peak of about \$0.36 million in 1989, they again became negative by 1990.⁴⁸ Throughout 1986-1987 the Peruvian government desperately sought to promote local investment and generate exports earnings. Trade credits became a source of leverage for the bankers over the administration (these credits were unaffected by the "value-impaired" status of loans to Peru). The cash situation of the central government deteriorated so quickly that the government began to sell off gold reserves. When the government took more coercive measures and nationalized the banks, business confidence collapsed. Between 1988-1990 the economy contracted by 23 percent.⁴⁹

Peru became overall weak. Declining oil and mineral prices as well as the anti-export bias of government policies led to a negative commercial balance. Isolated internationally, García received little concrete regional or international support. The President referred to himself as a "solitary gladiator" against the IMF. Although other debtors threatened the banks by arguing "if you do not give us what we want we will behave like this one [Peru],"⁵⁰ both Argentina and Mexico rejected President García's call for a united front among Latin American debtors.

Lenders. During this period, the banks became issue strong. Most banks had written off large parts of their Peruvian loans which increased their issue strength. In October, after Peru was declared ineligible for further loans from the IMF, the banks were ordered by the ICERC to increase provisions against bad loans to 30 percent of total exposure. By 1989, it had ordered the banks to make provisions equivalent to 75 percent. Moreover, no new medium- or long-term loans were made to Peru, a point which enhanced the bankers' overall strength. By 1990 Peru could default with little impact on the banks.

Creditor Governments and International Organizations. As the world's worst debtor, Peru presented a singular problem for the international financial system. It had been declared ineligible for further funding. Yet the strategy of autarchic economic reactivation ultimately led to an unprecedented economic collapse. Under such conditions, a government with the best intentions would have difficulty generating the foreign exchange necessary to clear its arrears with multilateral agencies. Yet no credit would become available from other sources as long as such outstanding obligations made it "ineligible." The outcome of the "deadlock" game seemed to be the possibility of medium- to long-term isolation from the international financial community. Creditor governments and multilateral agencies would be expected to search for solutions to that would make "reintegration" into the international system possible yet punish the failure to comply with demands for adjustment.

Actors' Valuations of Possible Outcomes and Game Predictions

As a result of the changes in both actors' individual situations, the Peru found itself in IS8 and the lenders in IS5, leading to the following game.

Period 4: August 1986 to July 1990

LENDERS IS 5

| | HC... | MC... | LC... |
|--------------|-------|-------|------------|
| PERU IS 8 | 5 2.5 | 2 6 | 1 9 |
| | 8 1 | 5 4.5 | 3 8 |
| | 9 2.5 | 7 4.5 | <u>5 7</u> |

In this game, the ordinal Nash equilibrium is low concessions/low adjustment (the lower right cell **5,7**), predicting a continuing deadlock between Peru and the banks. As compared to before, at the equilibrium outcome, Peru's ordinal payoff has worsened while the banks has increased considerably. Bankers are less concerned about their assets, and thus improve their payoff.

Peru on the other hand is no longer refusing to adjust because it does not need to, but rather because it cannot due to political instability. Thus, we may expect the bargaining posture, rhetoric, and goodwill of the debtor to change, even though the outcome is predicted as the same of the last period. In addition, in this case, we do not expect the IMF or U.S. to have much success in pushing the equilibrium away from a deadlock.

The Negotiations and Actual Outcomes

In this period, efforts to engineer a rapprochement between Peru and the banks were clouded by deep pessimism on both side about the prospect for breaking the deadlock. Over time, the IMF became more active in searching for a way to reintegrate Peru into the international financial community. Peruvian negotiators met with commercial bankers in September and October 1986. It became increasingly evident that García government's was weakening. Forced to increase reserves by 15 to 30 percent to cover their Peru loans, bankers were in no mood to make concessions. They were more aggressive, even reluctant to send a mission to Lima. Peru had to go to New York.

Peruvian negotiators formally proposed a plan that had been floated earlier in the year for a stretch out of the loans for 20 years with a 5 year grace period and interest rates at 3 or 4 percent. They received a flat "no." "We don't even give that to countries which maintain themselves current," said one banker. The bankers claimed they were more than willing to negotiate, but Peru had unilaterally rolled over their loans -- there was not even agreement on whose figures to assign interest rates on the loans.

After failing to reach an agreement on September 26, 1986, the banks issued a statement saying that rescheduling negotiations would resume only after Peru made a "meaningful" effort to pay its \$630 million arrears in interests. Indeed, the banks threatened to dissolve the advisory committee -- formed with Peru's help in a more cooperative round of the bargaining -- and leave the 270 some banks free to try to attach Peruvian assets, including exports, through the courts. Such measures could include embargoes and nuisance suits. "You don't even have to harass the government; just other people dealing with Peru" said the same banker.⁵¹

In response Peru offered to pay the creditor banks at most \$20 million over the next year in order to persuade the banks to send a mission to Peru to study the situation. Peru also offered to pay up to \$140 million in kind. The steering committee rejected the offer as inadequate to justify a mission, and demanded a minimum of \$60 million. Peru certainly could have paid at this time, but there were increasingly troublesome signs of a faltering of the economic recovery.

Despite this dismal situation García appeared eager to reach an agreement with international creditors, pushing a range of exotic schemes to make payments-in-kind. The new policy was to pay in accordance with the "capacity to pay," using methods that did not deplete foreign exchange. In fact, a couple of banks -- the Midland Bank and the First Interstate Bank of California -- accepted these solutions, to the dismay of the banks' advisory committee. With reserves down to \$454 million in October 1987, Peru instructed newly appointed Minister of the Economy Saberbeín, to talk with the World Bank, the Paris Club, and the commercial banks. Government officials also began to speak more favorably about the IMF. But the proposal required even greater concessions from the banks than those already discussed and rejected -- payment was to be made in kind in exchange for the banks accepting 25 year zero-coupon bonds. Public officials soon reversed themselves in response to political pressures. Following public opposition to the devaluation of the Inti in December 1987 and January 1988, García began to backtrack. Meetings with the banks never occurred. It became obvious that World Bank money would come too little and too late to ward off an balance of payments crisis. Rapprochement became, "a fifth-rate consideration" once again. Instead, the government began to sell off the country's gold reserves. Net reserves in February--almost entirely gold and silver--were valued at only between \$400-500 million. Saberbeín insisted that the reserves were "there to be used," and it was "normal" to sell them.⁵²

A stabilization plan in September 1988 involving a massive devaluation of the Inti, and a major increase in prices, especially petroleum, led to riots and looting in Lima's market areas. Annualized inflation in 1988 reached 1,722 percent, up from 115 percent in 1987.⁵³ Bowing to pressure from within his party, President García sent the Minister of the Economy, Abel

Salinas, to mend fences with the IMF. Salinas conferred with IMF executive manager Michel Camdessus, and announced that the IMF would send a mission to Lima. But he denied that Peru had signed a letter of intent. Hopes of obtaining fresh credits quickly evaporated. The Fund sent a team to Lima, but concluded that if Peru did not stick to its apparent intention to normalize relations, it should be expelled. It became clear to the government that the government would get no fresh credit from restoring relations with the Fund because the Fund's contribution would be limited to Peru's quota or the loss of its reserves over the previous year.

Carlos Rivas Dávila, the Minister of the Economy who replaced Salinas after he resigned in November in the wake of a second shock package, had no better luck reestablishing contact with the IMF. Dávila visited Washington in late January 1989 and arranged for Peru to pay a "symbolic" payment. He returned to Lima to discover that García was "unconvinced" by the IMF's position; the president refused to pay even the token \$30 million negotiated by Dávila. Later, the IMF dropped the demand for a symbolic payment. The IMF, according to Dávila, had adopted a new attitude. It would make a \$1 billion bridge loan to cover its arrears with other countries and organizations. Another mission was sent to Peru in April. Observers suggested, however, that far from any serious effort to reschedule Peru's international debt, the IMF only sought to prevent the further deterioration of relations as creditors waited for the change of government in 1990. Aware of this, the president flatly stated he did not expect the IMF to give Peru anything: "it is...nearly impossible for us to obtain [from them] more than we have to pay."⁵⁴

In late August the Fund threatened to expel Peru by declaring the government in "non-compliance" with IMF regulations. This action was not taken, and in October Peru reached an agreement with the IMF in which the Fund agreed to "negotiate the securing of the resources necessary to pay Peru's arrears with multilateral organizations and to negotiate the securing and payment of the resources necessary to support the medium-term programme." Peru would seek to normalize its financial relations with official creditors with the help of the IMF. Peru promised to make a number of small symbolic payments before turning the government over to the next administration in July 1990, which it did with regularity. The agreement with Peru presaged the outcome of negotiations between Peru and the IMF under the new government of Alberto Kenyo Fujimori, who took office in July 1990. Fujimori was given the option of agreeing to the terms of a stand-by loan without receiving new credit. The payoff for compliance would be that the IMF, the World Bank, and the IDB, would provide the moral underwriting of a huge bridge loan by OECD countries to pay for Peru's arrears to multilateral lending organizations. This Strengthened Arrears Strategy would provide no new funds for Peru in the immediate run, but would clear up \$2 billion in obligations

with multilateral agencies, thereby going a long way toward normalizing relations with the international financial community.

If the country defies the IMF, it can have its membership suspended. Clearly this new "cooperative" strategy was aimed at helping countries like Peru that are unable to break the deadlock created by the strategy of playing "bad debtor."

III. EPILOGUE: "REINSERTION" OF PERU UNDER FUJIMORI

In 1990 President Alberto Fujimori began "reinserting" Peru into the international financial system. It was not until February 1993 before Peru cleared arrears with the IMF and World Bank, and thus became eligible for new multilateral loans. Only then did Peru seriously consider mending fences with the commercial banks.

Fujimori's sought to normalize relations with the international financial community. A "Support Group" of creditor nations was formed to help Peru clear arrears with the multilateral institutions. The World Bank allowed Peru to gradually acquire the right to obtain loans. As soon as Peru reached an agreement with the IMF it also renegotiated the public external debt with the Paris Club.

The "reinsertion" of Peru was placed in doubt when Fujimori closed Congress and suspended the constitution on April 5, 1992. After the elections Peru and the IMF reached a new agreement. By February 1993 it had cleared arrears with both the Fund and the Bank, thus becoming eligible for fresh credit from them. In May 1993 Peru again rescheduled its Paris Club debt.

Only after Peru had mended fences with the multilateral agencies and creditor governments did it return to the bankers' steering committee to discuss restructuring the debt and resuming interest payments. Peru was under pressure from at least ten pending lawsuits by the creditors. With interest arrears worth 90 percent of the principal, many bankers hoped for a lucrative settlement. But there were major disagreements over the amount owed. Peru put the number at around 6 billion, but the banks claimed they were owed \$9.5 billion.

At the time of writing, formal negotiations had not yet begun. In informal talks Peru sought to have creditor lawsuits dropped in return for agreeing to resume interest payments and debt-equity swaps. The bankers remained reluctant to make concessions to Peru that would set a precedent for larger debtors. They can be expected to continued to take a hard line. Peru sought a Brady plan operation, involving a substantial debt reduction, based on its continuing inability to pay. As economic analyst Hernan Garrido said: "the government has to concentrate on its proposal, without worrying about what the creditor banks will say because they will have to adjust to what it offers if they want to collect....Peru's strength lies in its weakness, in its low capacity to pay. So President Alberto Fujimori has to present his formula as the only one possible. In such cases, anyone who can ask for much but asks for little is a

IV. SUMMARY AND CONCLUSION

The objective of this paper was threefold. First, we discussed a simple game model that incorporates both political and economic variables for analyzing debt rescheduling. Much modelling of international debt rescheduling -- and international economic relations more generally -- has ignored the importance of political variables. A distinctive feature of the model is that it attempts to formally examine political and economic factors in debt rescheduling.

Second, we sought to integrate this model with careful analysis of a specific case. Our central thrust in using a model to analyze Peruvian debt rescheduling has been to go beyond the abstract specification of a mathematical model to a real-world application. The virtue of this approach to modelling is that it generates clear and testable hypotheses that can be evaluated on the grounds of both logical consistency and empirical utility. Moreover, our intent has been to develop a generalizable analysis of debt rescheduling that can be readily applied to other cases.

Third, we attempted to provide insight into the banks' and Peru's strategies in the 1980s. We argue that despite the generally negative assessments of the Belaúnde government, in international debt negotiations it was not so inadequate. The Belaúnde government avoided the costs of direct confrontation with the banks by assiduously courting international lending institutions, both public and private.

In 1985 and 1986 García made debt payments comparable to those under the Belaúnde administration -- and more than 10 percent of export earnings -- yet Peru's debt was declared "value impaired" and no concessions were extracted from the banks. The Fujimori government that inherited Peru from García found itself with international reserves so low it was unable to make even the symbolic payments on its multilateral debt necessary to recover its credit worthiness among the developed market economies. Although space constraints and the nature of the ongoing negotiations do not allow us to fully investigate this latest period of negotiations, the model predicts that faced with a stable, issue and overall strong group of banks, Peru will either be forced to adjust or will find itself once again locked out of the international financial system.⁵⁶

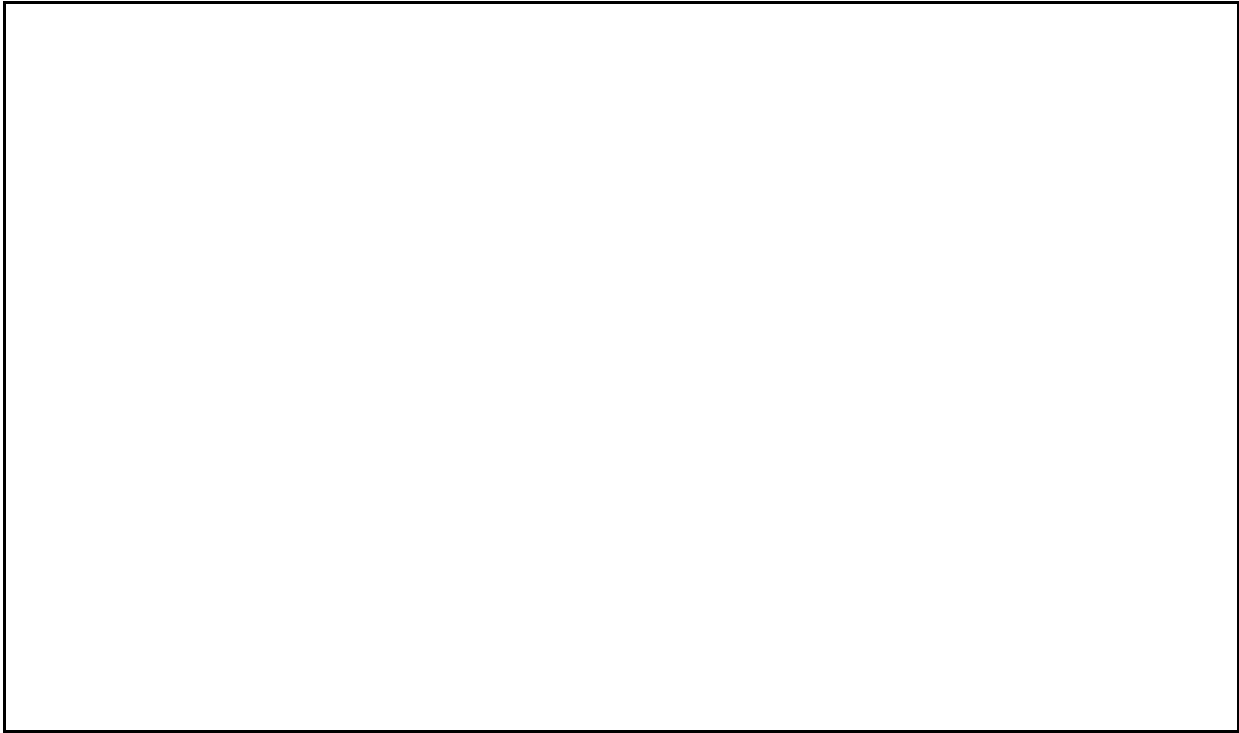
APPENDIX ONE

AN EXTENSIVE FORM GAME TO MODEL DEBT RESCHEDULING

In this paper, we have used a normal form game approach to examine how actors who find themselves in different individual situations are likely to behave. A more explicit (and considerably more complex depiction) that is consistent with this approach is the extensive form game presented in this appendix. Elsewhere, Aggarwal and Dupont⁵⁷ have shown that the normal form and extensive form of a situational theory of payoffs yields nearly identical results in modelling debt rescheduling when modelling games with complete information. We have chosen this approach because of the much greater tractability of the normal form game analysis for empirical analysis. However, some readers may be interested in seeing what the specification of the larger extensive form game would be.

As before, the players are a debtor and a lender. Both players have two initial moves, High or Low Adjustment for the Debtor and High or Low Concessions for the Lender. We explicitly model their first moves simultaneously to more realistically approximate debt rescheduling negotiations. When the debtor and lenders make their first moves, they cannot be certain whether the other will follow through on his commitment. Thus, at least initially, the game appears simultaneous. On the next move, however, the debtor or the lender can choose whether to retaliate or not as depicted in the game tree, followed by a second potential retaliatory move by the other player, with retaliatory moves being of the same type as in the normal form game analysis.

AN EXTENSIVE FORM DEBT RESCHEDULING GAME



Outcomes 1 through 8 reflect payoffs a_D and a_L , b_D and b_L , c_D and c_L , d_D and d_L , e_D and e_L , f_D and f_L , g_D and g_L , and h_D and h_L , respectively, where D refers to the Debtor and L to the Lender. HA..., LA, HC, and LC refer to high adjustment, low adjustment, high concessions, and low concessions, respectively, and R and NR refer to retaliation and not retaliation, respectively.

Once payoffs are specified for the eight outcomes, the game can readily be solved for subgame perfect equilibria. Moreover, the game can be transformed to a four by four normal form game. The normal form games used in this paper are reduced normal form games based on the concept of this larger normal form game with strategy specifications of high or low adjustment and concessions with retaliatory sequences. The payoffs in the reduced normal form games represent continuation payoffs in the extensive form game. That is, the utility equations that we use generate the payoffs at Outcome 1 and Outcome 8. They also produce the subgame perfect equilibria arising from the continuation of the game after the initial HA, LC or LA, HC moves which lead to outcomes 2, 3, and 4 and 6, 7, and 8, respectively.

APPENDIX TWO: WEIGHTS FOR INDIVIDUAL SITUATIONS

WEIGHTS FOR DEBTORS AND LENDERS, INDIVIDUAL SITUATIONS (IS)

a=borrowing need b=unwillingness to adjust c=goodwill

x= unwillingness to make y= need for servicing z=goodwill
loan concessions

where low= 1, low-medium=2, medium=3, medium-high=4, and high=5

COALITIONAL STABILITY ?

| | Yes | | No |
|---------------------------------------|--------------|--|--------------|
| ISSUE AND OVERALL CAPABILITIES | | | |
| ↓ | | | |
| v | | | |
| ===== | | | |
| Issue strength, Overall weakness | IS1 | | IS2 |
| | a: 1 x: 2 | | a: 1 x: 5 |
| | b: 2 y: 1 | | b: 5 y: 1 |
| | c: 4 z: 4 | | c: 3 z: 3 |
| ----- | | | |
| Issue weakness, Overall strength | IS3 | | IS4 |
| | a: 4 x: 1 | | a: 4 x: 5 |
| | b: 1 y: 4 | | b: 5 y: 4 |
| | c: 1 z: 1 | | c: 1 z: 1 |
| ----- | | | |
| Issue strength, Overall strength | IS5 | | IS6 |
| | a: 1 x: 2 | | a: 1 x: 5 |
| | b: 2 y: 1 | | b: 5 y: 1 |
| | c: 1 z: 1 | | c: 1 z: 1 |
| ----- | | | |
| Issue weakness, Overall weakness | IS7 | | IS8 |
| | a: 5 x: 1 | | a: 5 x: 5 |
| | b: 1 y: 5 | | b: 5 y: 5 |
| | c: 4 z: 4 | | c: 3 z: 3 |
| ===== | | | |

ENDNOTES

- 1.. This work is part of a larger effort by one of the authors that examines a number of countries both currently and historically. See Vinod K. Aggarwal, "Interpreting the History of Mexico's External Debt Crises," in Barry Eichengreen and Peter Lindert, eds., A Long Run Perspective on the Debt Crisis (Cambridge: MIT University Press, 1989) and Aggarwal, Debt Games: Strategic Interaction in International Debt Rescheduling (New York: Cambridge University Press, forthcoming). For an adaptation of this model to examine U.S.-Mexican trade negotiations, see Maxwell A. Cameron, "North American Trade Negotiations: Liberalization Games Among Asymmetric Players," Working Paper, Norman Paterson School of International Affairs, Carleton University, 1992. Available upon request.
- 2.. Robert Devlin and Enrique de la Piedra "Peru and Its Private Bankers: Scenes from an Unhappy Marriage," in M.S. Wionczek, ed. Politics and Economics of External Debt Crisis: The Latin American Experience (Boulder: Westview Press, 1985), p. 383.
- 3.. Thomas Scheetz, Peru and the International Monetary Fund (Pittsburgh: Pittsburgh University Press, 1986), p. 91.
- 4.. Wall Street Journal, August 30, 1985.
- 5.. For relatively apolitical analysis of debt rescheduling, see Analytical Issues in Debt, edited by Jacob Frenkel, Michael Dooley, and Peter Wicham (Washington D.C.: IMF), 1989. See also Jonathan Eaton and Mark Gersowitz, "Debt with Potential Repudiation: Theoretical and Empirical Analysis," Review of Economic Studies (Edinburgh), Vol. 48 (April 1981), pp. 289-309.
- 6.. Although the decision of creditor governments to intervene in negotiations is also a crucial issue, owing to space limitations we omit that portion of the model. Readers interested in the full model and a more detailed discussion of its elements and rationale should consult Aggarwal, Debt Games. This section draws heavily on this work.
- 7.. As discussed in the appendix 1, this reduced normal form game is consistent with a more complex extensive form game tree. We use a normal form game for simplicity of presentation.
- 8.. These concepts are operationalized at length in Aggarwal (1989) and (forthcoming).
- 9.. See Aggarwal (forthcoming).
- 10.. The payoff structure for the debtor is, in this instance, is one of Harmony; with both players facing such payoffs, the game's equilibrium would be high adjustment and concessions.
- 11.. Richard Webb, "Domestic Crisis and Foreign Debt in Peru," in J.F.J. Toye, ed., Taxation and Economic Development (London: Frank Cass, 1988) pp. 244, 246.
- 12.. The April 15, 1983 collapse of Banco Regional Sur Medio y Callao, the seventh largest private national bank, became the third in a series of bank collapses beginning with the December 1981 state liquidation of Luis Leon Ripp's Banco de la Industria de la Construcción (BIC) and seconded by the liquidation of Banco Commercial (Bancoper), Peru's third largest private commercial bank after the chairman of the board, Luis Bertello was discovered to have indulged in over \$100 million in irrecoverable loans--80% to Bertello's personal investment interests (Latin American Weekly Report [hereafter LAWR, April 15, 1983). These bank collapses and the subsequent increasing state involvement in this sector, illustrated Peru's issue weakness.
- 13.. Devlin & de la Piedra (1985, p. 410). Interview with Javier Abugattas, 17 August 1988. Many small creditors resented being "locked into Peru by their big brothers on the steering committee." LAWR, May 13, 1983.

- 14.. Banco Central de Reservas del Perú, "La Renegociación de la Deuda Externa, 1983-1984: El Caso Peruano," (Lima, 1985) p. 21.
- 15.. Barbara Stallings, Banker to the Third World: U.S. Portfolio Investment in Latin America, 1900-1986 (Berkeley and Los Angeles: University of California Press, 1987, p. 278).
- 16.. Robert Devlin, "Los Procesos de Reprogramación de la Deuda Latinoamericana, 1982-1987: Tendencias y Perspectivas," prepared for a conference on La Economía Mundial y el Latinoamericano, Problemas y Perspectivas, Caracas, Venezuela, May 1987, p. 36.
- 17.. Rodríguez-Pastor, a banker from Wells Fargo and principal negotiator of the Cofide loan for the lenders in 1982, had replaced the previous Minister of Economy and Finance, Manuel Ulloa. Brian Jenson of the Banco Central de Reserva del Perú, who also participated in the negotiations, was a Vice-President in Wells Fargo.
- 18.. Interviews with negotiators Ismael Noya, Lima, 12 August 1988 and Adela Lerner, Lima 17 August 1988.
- 19.. In negotiations concluded later in the year with the Paris Club, an agreement was reached to reschedule over 90% of the principal and interest on Peru's official debt maturing that year, with an advance agreement to consider extending the maturities again in 1984.
- 20.. The two sources used to ascertain the terms of the agreement were: Banco Central de Reservas del Perú (1985) and Devlin (1987). See also LAWR, June 17, 1983.
- 21.. Robert Devlin and Enrique de la Piedra (1985), p. 410.
- 22.. 1988, p. 247.
- 23.. LAWR, October 7, 1983, p. 5.
- 24.. See Carol Wise, "Democratization, Crisis, and the APRA's Modernization Project in Peru," in Barbara Stallings and Robert Kaufman, eds., Debt and Democracy in Latin America. (Boulder: Westview Press, 1989), p. 170.
- 25.. Webb also made this argument in writing: "Fresh money from banks was conditioned on an IMF agreement, and this was ruled out by the size of the deficit. The central bank refused to lend, Additional fiscal measures were ruled out by the government. Starting in August, the shortfall was made up by postponing debt payments". Webb (1988), p. 248.
- 26.. Interview, Lima 17 August 1988.
- 27.. In game theory, players with such problems have been referred to as playing with a "trembling hand" (see R. Selten, "Reexamination of the Perfectness Concept for Equilibrium Points in Extensive Games," International Journal of Game Theory, Vol. 4, Issue 1, 1975, pp. 25-55). We do not formally analyze the implications of this type of actor here.
- 28.. As President Belaúnde put it: "The Monetary Fund was too stringent, and a sovereign country can accept advice or reject it. At one point we more or less arrived at an agreement. But in the second part when the agreement was to be perfected at the end, there we could not reach an agreement because the accord was inconvenient for the country. So, like any sovereign country we can choose not to agree." Interview, Lima, 9 November 1987.
- 29.. LAWR, January 13, 1984.
- 30.. Devlin (1987), p. 44. Peru also won improved terms in its agreement with the Paris Club.
- 31.. This interpretation came from Drago Kistic, Director of Macroconsult. Interview, 12 August 1988.

- 32.. Interestingly, on April 13, 1984, the LAWR had suggested that: "Last week would probably have been ideal, politically, for Belaúnde to have taken Webb at his word (in the sense that Peru has enough reserves to face a break with the IMF) and to have launched Peru on a radically different supply-side oriented populist course. A well-timed editorial in the Wall Street Journal of 3 April ('Opportunity in Peru') along these lines appeared to set the scenes for precisely this option."
- 33.. Webb (1988) p. 247.
- 34.. Webb (1988), p. 247.
- 35.. Webb (1988), p. 248.
- 36.. November 27, 1984. Belaúnde mildly disagreed with this report, saying "a fundamental aim of any government is to survive, this is elemental, it is the first duty of a government. But that was not our first priority. The first priority was to develop the country." Interview, Lima, 9 November 1987.
- 37.. For an overview of the debt policies of the García government see Oscar Ugarteche "El Perú: La deuda y el ajuste heterodoxo con Alan García," in S. Griffith Jones, ed. Deuda Externa, Renegociación y Ajuste en América Latina (Mexico: El Trimestre Económico y Fondo de Cultura Económica, 1988); O. Ugarteche, Inserción y Deuda, Peru, 1985-1990: Un Caso Especial (Lima: FONDAD/DESCO/CEPES, 1991); and Drago Kisić, De la Corresponsabilidad a la Moritoria: El Caso de la Deuda Externa Peruana, 1976-1986 (Lima: Fundación Friedrich Ebert/Centro de Estudios Internacionales, 1987).
- 38.. Los Angeles Times, March 3, 1986.
- 39.. Nicholas Ashelov, "The 1987 Peruvian Bank Job," The Andean Report, October 1988, p. 264.
- 40.. LAWR, 29 November 1985, p. 5.
- 41.. Oscar Ugarteche, author, interview in Lima, 5 August 1988; Guillermo Runciman Saetone, Director General of Public Credit, interview, Lima, Ministry of Finance, 11 August 1988.
- 42.. LAWR, 6 September 1985, p. 7.
- 43.. LAWR, January 17, 1986.
- 44.. LAWR, 11 October 1985, p. 3.
- 45.. LAWR, 21 February 1986, p. 7.
- 46.. LAWR, 21 February 1986, pp. 8-9.
- 47.. It is reported for example that the Peruvian debt team refused to answer telexes from the banks, and at one point even told a banker on the advisory committee that "the check is in the mail"--as if debt payments were disbursed through the notoriously irregular Peruvian postal service! Interview with Adela Lerner, Lima 17 August 1988.
- 48.. Felipe Larraín and Jeffrey D. Sachs, "International Financial Relations," in Carlos E. Paredes and Jeffrey D. Sachs, eds., Peru's Path to Recovery: A plan for economic stabilization and growth (Washington D.C.: The Brookings Institution, 1991, p. 232).
- 49.. The economy contracted by 6.7 percent in 1988; 12.9 percent in 1989; and 2.1 percent in 1990. Cuanto, 3(25) February 1991, p. 33.
- 50.. LAWR, 28 July 1988.
- 51.. LAWR, 25 September 1986, p. 10.
- 52.. LAWR, May 12, 1988, p. 7.
- 53.. Dornbusch, R. and S. Edwards, "La macroeconomía del populismo en la América Latina," El Trimestre Económico, Vol. LVII, No. 1, January-March 1990, p. 158.
- 54.. LAWR, May 4, 1989, p. 3.

55.. Abraham Lama, "Peru: Government sets out to placate its private creditors" Inter Press Service, August 17, 1993.

56.. This prediction is based on the banks in IS5 and Peru in either IS 7 of IS 8.

57.. "Modelling International Debt Rescheduling: Deriving Payoffs and Choosing Game Theoretic Representations," paper to be presented at the American Political Science Association meetings, Chicago, September 1992.

PERIODICALS CONSULTED

Latin American Weekly Report, The New York Times, Los Angeles Times, The Wall Street Journal, Journal of Commerce, The Andean Report, The Economist, Economist Intelligence Unit.