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February 24, 1988

To: Members of the Executive Board  
From: The Secretary  
Subject: Argentina - Letter on Economic Policy

Attached for consideration by the Executive Directors is a copy of a letter from the Argentine authorities, together with an accompanying memorandum on economic policy, describing their economic objectives for 1988 and the policies intended to attain them. The staff paper describing and analyzing the economic program of Argentina will be circulated shortly.

Att: (1)



Buenos Aires,  
February 24, 1988

Mr. Michel Camdessus  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431  
U.S.A.

Dear Mr. Camdessus:

1. In our letter to you and the accompanying Memorandum on Economic Policy of November 12, 1987 we described our economic policy package of October 14, 1987, which was aimed at keeping the economy on a steady growth path, ensuring a sustained reduction in inflation and strengthening the balance of payments, while at the same time continuing the process of structural reform.

2. The tax measures contained in the October 14, 1987 package were approved with certain modifications in early January. In the attached Memorandum we outline our economic objectives for 1988 and describe the policies intended to attain them. On the basis of this program, we request the completion of the second review of the stand-by arrangement.

3. The Government of Argentina believes that the policies set out in the attached Memorandum are adequate to achieve the objectives of its program but it will take any further measures that may become necessary for this purpose. The Government will consult with the Fund on the adoption of any measures that may be appropriate, in accordance with the Fund's policies on such consultation. Prior to the termination of the present stand-by arrangement, the Government intends to begin discussions on a new arrangement from the Fund.

Yours sincerely,

/s/  
Jose Luis Machinea  
President of the Central Bank  
of the Republic of Argentina

/s/  
Juan V. Sourrouille  
Minister of Economy

## MEMORANDUM ON ECONOMIC POLICY OF THE ARGENTINE GOVERNMENT

1. In our Memorandum on Economic Policy of November 12, 1987 we described our economic policy package of October 14, 1987, which was aimed at keeping the economy on a steady growth path by ensuring a sustained reduction in inflation and a strengthening of the balance of payments, while at the same time continuing the process of structural reform. In the present Memorandum we outline our economic policy objectives for 1988 and describe the policies intended to attain them.
2. The October 14, 1987 package included a set of tax measures, together with a compulsory saving scheme and real adjustments in public enterprise prices, aimed at substantially raising public revenues; a depreciation of the currency aimed at producing a significant adjustment in its real effective level; the introduction of a free exchange market for various service and capital transactions in which the exchange rate was allowed to fluctuate freely; a far-reaching financial reform; and a wage-price freeze. In addition, the Government reiterated its commitment to proceed with structural reforms that would strengthen the finances of the public enterprises, modify the system of revenue sharing between the Federal Government and the provinces, revise petroleum pricing policy, open up activities to the private sector that were previously reserved for the public sector, and promote Argentina's integration into the world economy.
3. It had been anticipated that a timely implementation of the October revenue measures would have allowed for a reduction in the combined deficit of the nonfinancial public sector and the Central Bank from an average of  $6 \frac{2}{3}$  percent of GDP in the first three quarters of 1987 to  $4 \frac{1}{4}$  percent of GDP in the last quarter of the year. In the event, however, congressional approval of the revenue package took place in early January 1988. Moreover, inflation during the last quarter of 1987 was higher than projected, despite a significant reduction observed in December, thereby partially reducing the gains that had been programmed in the real level of public enterprise prices. Thus, notwithstanding a substantial strengthening in the Central Bank's operating position, the combined overall public sector deficit widened to around 8 percent of GDP in the last quarter of 1987. For 1987 as a whole, the combined public sector deficit amounted to 7 percent of GDP as compared with  $4 \frac{1}{2}$  percent of GDP in 1986 (see Table 1).
4. The higher than expected deficit hindered the efforts made to achieve a long-lasting reduction in inflation, and inflation rose in January following the lifting of wage-price controls. Moreover, during the last quarter of 1987 the external accounts remained under pressure and the overall balance of payments recorded a deficit for the year of US\$4 billion compared with a deficit of US\$2 billion in 1986.
5. The basic objective of economic policy for 1988 is to strengthen economic growth through policies aimed at reducing inflation and at

improving the external accounts while at the same time continuing to address the structural problems in the economy. More specifically, policies are to be geared toward achieving a GDP growth rate of 4 percent, scaling down inflation from the current rate to a target of 4 percent a month by year-end and reducing the overall balance of payments deficit to US\$2.5 billion in 1988. In the area of structural reform, in part with the continued financial support of the World Bank, emphasis is to be placed on putting the operations of the public sector on a firmer footing, ensuring better control over central bank rediscount operations, and achieving a broader integration of Argentina into the world economy.

6. The Government remains committed to its objective of achieving a substantial improvement in the public finances. In this process, the Government already has adopted measures that would reduce the combined operational deficit of the nonfinancial public sector and the Central Bank from 6.8 percent of GDP in 1987 to 2.9 percent of GDP in 1988 (Table 1). On this basis, including net monetary correction the overall deficit of the combined public sector would be reduced from 7.1 percent of GDP in 1987 to 2.7 percent of GDP in 1988. This reduction in the public sector deficit would be the consequence of the increase in revenues resulting from the implementation of the October 1987 package. At the same time, a major effort will be made to constrain public expenditures, in particular those of the public enterprises.

7. The revenue package approved in January 1988, together with the increases in the import surcharge and in the price of cigarettes implemented last October, are projected to yield about 5 percentage points of GDP in additional revenues in 1988. As described below, certain revenues from the package are to be earmarked for financing social security expenditures, while income from petroleum sales previously accrued to the Treasury in the form of taxes is to be channeled to the state petroleum enterprise (YPF) and other public enterprises.

8. The principal measures of the October package as finally approved include: (a) an increase in the tax rate on checking transactions and the prohibition of the multiple endorsements of checks estimated to yield an additional 1.4 percent of GDP in revenues; (b) a special tax on gasoline, natural gas, other petroleum products, and telephone services estimated to raise 1.6 percent of GDP in 1988 and to be earmarked in its entirety to increase the minimum level of social security pensions, to cancel back obligations to beneficiaries of the social security system, and to eliminate the need for treasury transfers to the system; (c) an increase in the import surcharge from 10 percent to 15 percent aimed at raising 0.4 percent of GDP in additional revenues; (d) an increase in excise taxes on tobacco products estimated to produce revenue equivalent to 0.5 percent of GDP for the year; and (e) certain changes to the income tax laws expected to yield 0.2 percent of GDP. Moreover, a compulsory saving scheme for 1988 and 1989 projected to yield 0.8 percent of GDP in each year was enacted in January while a number of

important changes were introduced in the area of tax administration that should improve tax collections. These latter changes include increased penalties and interest charges for overdue tax payments, a broadening of the definition of taxes subject to withholding at source, and provisions allowing government purchasing agents to withhold all value-added taxes from payments to state suppliers and make the corresponding transfers directly to the Treasury.

9. The October revenue package already started to have an effect in the fourth quarter of last year with the increase in the import surcharge and the excise taxes on tobacco products. In mid-February, gasoline prices were raised by 32 percent over and above the general increase in tariffs, as a result of the application of the special tax referred to above. This special tax also provides for a similar increase in telephone rates and a 20 percent increase in the price of natural gas and other petroleum products, that will be applied starting in March. Also in March the increase in tax rates on checks will become effective. The remaining measures of the October package approved by the Congress are to come into effect in the second quarter of 1988.

10. In addition to the recently approved revenue package, important structural changes are being made in the public finances that are intended to define clearly the relationship between the Central Administration on the one hand and the provinces, the public enterprises, and the social security system on the other. These changes aim at predetermining the sources of revenues and transfers to which these latter entities are entitled and then requiring these entities to manage their finances without any further recourse to budget transfers from the Treasury. To this end, Congress recently enacted a revenue-sharing law with the provinces that is to replace the former ad hoc system of revenue sharing. Under this new law, all taxes, other than those on foreign trade and specifically earmarked taxes, are to be distributed in the ratio of 42.3 percent to the Central Administration, 56.7 percent to the provinces, and 1.0 percent to create a special fund to finance provinces encountering special difficulties. Beyond this sharing in revenues, no further budget transfers are to be made to the provinces.

11. In regard to the public enterprises, since the beginning of February the Treasury has relinquished to YPF and other enterprises all revenues collected from the sale of petroleum products. This decision implies a realignment of domestic crude oil prices to world levels and will have major consequences for the petroleum sector. In addition, the Treasury will assume interest payments on the external debt of these enterprises. In return, the budget will establish that state enterprises would be required to live strictly within their allocated resources. Under the new system for managing the public enterprises, the Directorate of State Enterprises together with the Ministry of Public Works will have greater flexibility in setting public tariffs. Pricing policy is to be managed with a view to ensuring that the costs of the enterprises can be covered without further recourse to the budget

and on average it is intended that public tariffs be maintained in real terms at their December 1987 levels.

12. In October 1987, the Government reiterated its commitment to redefine the role of the public sector and to open up certain activities to the private sector. Since then, a demonopolization decree was issued establishing the principle that no area of the economy is to be closed to private sector participation. In this respect, the domestic airline (Austral) was privatized and plans to develop a private telephone network in the financial district of Buenos Aires were approved. In the petroleum sector, the objective of domestic self-sufficiency is to be fostered not only by the realignment of producer prices of crude oil to world levels, but also by encouraging private sector participation in the exploration and drilling of oil. YPF is already developing new contracts with private companies in order to induce an increase in their crude oil production from fields owned by the state petroleum enterprise. Steps have been taken to deregulate the petrochemical sector and the Government intends to sell the public share in certain petrochemical enterprises. Finally, the Government has announced the sale of up to 40 percent of the state international airline (Aerolíneas Argentinas) to a foreign airline which will hold the management of the company.

13. Efforts are also under way to restructure those enterprises that will remain in the public domain. A principal measure in this regard has been the recent strengthening of the Directorate of Public Enterprises, which is to operate more fully as a holding company running public enterprises on a managerial basis, with a view to eliminating the need for budgetary transfers. Specific measures being considered to render these enterprises more efficient, include: (i) an improvement in procurement practices; (ii) a reduction in the widespread evasion of fares and charges for services such as rail transport, electricity, and water; (iii) the renegotiation of labor contracts to eliminate clauses that adversely affect productivity; and (iv) the introduction of modern management and control systems.

14. The elimination in October 1987 of the interest rate subsidies on the Central Bank's rediscount operations linked to regulated rates improved significantly the Central Bank's results in the last quarter of 1987. The effects of these measures will further improve the quasi-fiscal results of the Central Bank's domestic operations in 1988. However, the impact of the increase in the interest payments on the Central Bank's external debt will partially offset that improvement.

15. Beginning in 1986, with the placement of bonds by the state petroleum enterprise, the nonfinancial public sector has relied on the issue of interest-bearing instruments to finance its deficit. Since early 1987 these debt instruments have been placed on a voluntary basis. This has given rise to real interest payments, which are included in the operational deficit of the nonfinancial public sector as described above. In addition, with the pickup of inflation in the past

year, nominal interest payments on the domestic public debt have included a large element of monetary correction. At the same time that the Government has financed part of its deficits through the placement of public bonds with the private sector, the Central Bank has developed a net asset position on which it earns nominal interest that includes a monetary correction element. The net monetary correction for the Government and the Central Bank is estimated to imply net expenditure of 0.3 percent of GDP in 1987, and it is projected that there will be net income from monetary correction of 0.2 percent of GDP in 1988.

16. Consistent with the objectives of reducing the deficit of the combined public sector referred to in paragraph 6 above and of limiting public spending, the Government has set limits in australes for the overall deficit of the nonfinancial public sector and the Central Bank, the combined operational deficit of the nonfinancial public sector and the Central Bank, and for treasury outlays (excluding interest payments) for the first two quarters of 1988. These limits are presented in Table 2.

17. The Government believes that monetary policy will need to be consistent with the objectives for reducing inflation and for strengthening the balance of payments. For that reason, the Central Bank's monetary program for February was premised on a 7 percent increase in narrow money and it is the Government's intention to progressively scale down the rate of growth of narrow money to 4 percent a month by the last quarter of 1988. Consistent with this objective and with the balance of payments target, limits have been set on the net domestic assets of the Central Bank for the first two quarters of 1988 (Table 3). In implementing monetary and credit policy in the period ahead, it will be valuable to use several indicators including the spread between the official exchange rate and the rate quoted on the free market.

18. In pursuit of its monetary policy objectives, the Central Bank will aim at substantially reducing the expansion of new rediscounts to the banking system, which in the past have been a major source of monetary expansion. In this regard, the Central Bank is preparing a detailed program for new rediscounts in 1988 according to which new rediscounts shall be less than total repayments of previously extended rediscounts, as compared with the expansion equivalent to almost 2 3/4 percent of GDP in 1987. The details of the rediscount budget will be presented at the time that the National Administration budget for 1988 is submitted to Congress. During 1987 important advances were made toward strengthening the institutional framework that should provide for an improved performance in the period ahead. In particular, efforts are being made to regularize the relation between the Central Bank and those official banks that, in the recent past, obtained credits through overdrafts on their current accounts. Interest subsidies on a high proportion of rediscount lines were reduced as part of the October financial reform. Moreover, after a period of central bank administration of the Mortgage Bank, a new credit policy has been



developed for the Mortgage Bank aimed at limiting central bank financing to the Bank, while at the same time setting the basis for a permanent and stable scheme for financing the Mortgage Bank's operations.

19. Achievement of the monetary objectives of the program will require the careful management of the refinancing of the large amount of domestic government debt that matures beginning in March 1988. The Central Bank is committed to ensuring that this refinancing operation has no monetary impact and already has taken a number of steps with a view toward smoothing the market impact of the refinancing. In particular, it has begun to retire a limited amount of the debt prior to maturity and to arrange for investors to make advance refinancing commitments; in addition, a new type of debt instrument that is indexed to the commercial exchange rate and should be especially attractive to importers is being introduced.

20. Substantial progress has been made in reforming the financial system over the past two years, and since October 1987 interest rate regulations have been eliminated. Within the context of this new institutional framework, monetary policy is to be managed in a manner consistent with the maintenance of interest rates at levels sufficient to encourage domestic financial savings. The monetary authorities are also committed to continue working to improve the efficiency of the financial system in the period ahead. In this regard, the Central Bank has proceeded to liquidate insolvent financial institutions and in recent months has auctioned a number of branches of liquidated banks, has made agreements with commercial banks for the management of the assets of liquidated financial institutions, and has arranged the sale of the largest intervened bank. This policy, together with control over new rediscounts, should allow for a gradual reduction in reserve and investment requirements and for an increased market role in the allocation of credit.

21. Following the wage-price freeze from October 14, 1987 to the end of the year, the extent of wage-price controls has been reduced. In early January, prices of most goods and services were authorized to rise by 4 percent except where higher increases were justified by costs, while maximum prices were set for main consumer goods. In February, a 7 percent general guideline was set for price increases together with a revised list of maximum prices. Since the beginning of the year, a significant range of consumer goods, including food, clothing, and household items, have been freed from controls altogether, while the producer prices of cattle, pork, and grains have also been liberated. In the period immediately ahead, the Government will continue to set price guidelines, but will seek the further liberalization of price controls especially in markets in which prices are competitively determined. The authorities also will work toward reducing regulations and other impediments to competition with a view to the eventual elimination of price controls.

22. As regards wage policy, in December 1987 Congress passed a law re-establishing free collective bargaining. Consequently, the state will no longer play a direct role in setting wage increases in the private sector. However, in accordance with the new law the Government will act to avoid that sectoral agreements between parties adversely affect the consumers' interests. Until negotiations are completed the system of price guidelines will provide a framework for wage increases in the private sector. The Government intends to negotiate with public sector unions wage increases consistent with its inflationary objectives on the basis of guidelines that would avoid indexation and the inclusion of clauses that adversely affect productivity and efficiency in the state enterprises.

23. During 1987, there was a substantial widening in the external current account deficit to US\$4.3 billion while the overall balance of payments registered a deficit of US\$4 billion. These developments mainly reflected the continued deterioration in Argentina's terms of trade and the decline in the volume of grain exports associated with widespread flooding. The Government believes that on the basis of its policy stance and of the expected reversal of a number of the factors that had adversely affected the balance of payments last year, the current account deficit would narrow to US\$3.1 billion in 1988 while the overall deficit would be limited to US\$2.5 billion. In line with these objectives for the year as a whole, targets for the net international reserves of the monetary authorities have been set for March and June 1988 as set forth in Table 4.

24. To an important degree, the strengthening in the balance of payments projected for 1988 is to derive from a marked improvement in exports. As noted in the November 1987 Memorandum on Economic Policy, the austral was depreciated substantially last October and since the beginning of 1988 the official exchange rate has been adjusted broadly in line with price increases. At the present time, the external value of the austral in real effective terms is well below its level of mid-1985, immediately following the introduction of the Austral Plan. It is the Government's intention to keep the adequacy of the real effective exchange rate under consideration in order to ensure an appropriate degree of competitiveness and the achievement of the balance of payments objectives of the program.

25. In recent years the Government has introduced a variety of measures to promote exports, including a temporary admission regime and special export programs providing bonuses for incremental exports. During 1987, the competitive position of the export sector was further enhanced by the substantial reduction in export taxes on agricultural products. Moreover, since October 1987 the coverage of the temporary admission regime has been broadened to include domestic suppliers of inputs to exporters, and the system of rebates of indirect taxes was extended to exporters of agro-industrial products.

26. In the first half of 1987, quantitative import restrictions on a wide range of items were eliminated and the scope of the temporary admission scheme was increased. A trade policy and export diversification loan from the World Bank supported this program. Since October 1987, further progress has been made by relaxing quantitative import restrictions in the areas of paper, chemicals, petrochemicals, and steel, which together with deregulation in these areas has strengthened competition in the markets for most basic inputs. The Government will continue eliminating quantitative import restrictions in the context of promoting Argentina's industry and increasing the integration of Argentina's economy with the rest of the world.

27. In 1987, the Government reached agreement on a restructuring of Argentina's external debt to commercial banks and on a new money package of US\$1.95 billion. Agreement also was reached with the Paris Club on a rescheduling of medium- and long-term debt service payments due through mid-1988. Two commercial bank disbursements totaling US\$700 million remain to be made under the 1987 new money package, while cofinancing of World Bank operations has been arranged with bilateral sources. Beyond this, however, substantial additional exceptional financing will be required in 1988 to cover the projected balance of payments deficit. The Government intends to begin soon negotiations with both official and private creditors to obtain new external financing, and it attaches great importance to any assistance the Fund could provide in this effort. The Government also intends to begin negotiations with the Paris Club on the rescheduling of medium- and long-term debt service payments.

28. In October 1987, a free exchange market was created for various nonfinancial services and capital transactions in which the exchange rate is freely determined. By May 15, 1988 the Government intends to take measures permitting the transfer through the free exchange market of profits and dividends related to fiscal years closed after December 31, 1987. As regards external payments arrears, it had earlier been the Government's intention to eliminate arrears by end-March 1988. However, pending the making of external financing arrangements for 1988, this objective is no longer feasible. It remains the intention of the Government to eliminate external arrears as financing arrangements for 1988 are made, and through June 1988 external payments arrears will not exceed US\$1.3 billion.

29. Argentina's external debt at the end of 1987, including obligations to the Fund, is estimated at US\$54.3 billion, with non-U.S. dollar debt valued at end-September 1986 exchange rates. This estimate is based on data from the Central Bank's external debt reporting system for end-September 1986, and takes into account subsequent debt flows that result from balance of payments estimates. Argentina's total external debt is projected to rise by about US\$700 million in the first half of 1988 and consistent with this overall growth in debt, limits have been established through June 1988 for the total and the short-term external debt of the public sector as presented in Table 5.

Table 1. Argentina: Public Sector Operations 1/

(In percent of GDP)

	Cash Operations of the Nonfinancial Public Sector			Operating Result of the Central Bank <u>2/</u>	Combined Public Sector		
	Revenue	Expenditure <u>2/</u>	Operational Balance		Operational Balance	Net Monetary Correction <u>3/</u>	Overall Balance
1986	21.6	24.3	-2.7	-1.0	-3.7	-0.6	-4.3
1987 Prel.	20.0	26.1	-6.1	-0.7	-6.8	-0.3	-7.1
1988 Proj.	23.3	25.6	-2.3	-0.6	-2.9	0.2	-2.7
<u>1987</u>							
I	19.8	23.6	-3.8	-1.1	-4.9	-0.7	-5.6
II	21.5	27.9	-6.4	-1.5	-7.9	-0.2	-8.1
III	21.2	25.4	-4.2	-1.5	-5.7	-0.2	-5.9
IV Est.	18.5	26.8	-8.3	0.3	-8.0	-0.1	-8.1
<u>1988 Proj.</u>							
I	19.0	23.9	-4.9	-2.1	-7.0	-0.2	-7.2
II	26.5	26.2	0.3	--	0.3	0.9	1.2
III	23.9	24.4	-0.5	-1.0	-1.5	-0.5	-2.0
IV	22.9	27.2	-4.3	--	-4.3	0.6	-3.7

1/ Operations of the provinces and the Municipality of Buenos Aires that are not supported by budgetary transfers are treated on a net basis, with the deficit of the provinces included as expenditure.

2/ Including only real interest payments and receipts.

3/ Negative sign indicates net expenditure.

Table 2. Limits on the Public Sector Deficit  
and Treasury Outlays

	January-March 1988	January-June 1988
Combined operational deficit of the nonfinancial public sector and the Central Bank	6,000	5,600
Combined overall deficit of the nonfinancial public sector and the Central Bank	6,400	5,300
Treasury outlays	10,600	25,900

Table 3. Argentina: Targets for Change Since December 1987  
in the Net Domestic Assets of the Central Bank 1/

(In millions of australes)

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March 1988	5,100
June 1988	10,000

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1/ The change in the net domestic assets of the Central Bank is defined as the change in M-1 minus the change in net international reserves of the monetary authorities valued at the average exchange rate for the period multiplied by a factor of 0.534 which is the ratio in September 1986 of M-1 to a broad definition of the monetary base (currency issue plus deposits of financial institutions in the Central Bank, investments of financial institutions with the Central Bank related to regulated deposits, and Central Bank paper held by financial institutions and by the nonfinancial private sector). M-1 is measured as the monthly average of the sum of currency in circulation and sight deposits (excluding the Treasury accounts with the Banco de la Nacion and the Unified Fund on a net basis). Net international reserves for each month are the average of the net international reserves at the end of the previous month and the four weekly estimates for the month of net international reserves as defined in Table 4.

Table 4. Argentina: Targets for Change in Net  
International Reserves of the Monetary Authorities

(In millions of U.S. dollars)

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January-March 1988	-1,100
January-June 1988	-1,150

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1/ For measuring balance of payments performance, changes in international reserve assets and liabilities in currencies other than the U.S. dollar will be converted to U.S. dollars at the market exchange rates of December 31, 1986, and gold will be valued at US\$325 per fine troy ounce. The net international reserve targets will be adjusted for any other changes in the value of reserve assets and liabilities that result from factors other than balance of payments flows.

Table 5. Argentina: Limits to the External Debt of the Public Sector During the Remainder of the Program Period 1/

(In millions of U.S. dollars)

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Limit to the total outstanding disbursed external debt of the public sector <u>2/</u>	44,000
Limit to cumulative net disbursements of short-term debt of the public sector contracted after December 31, 1986 <u>3/</u>	1,200

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1/ The stock of debt is to be valued at end-1987 exchange rates.

2/ The definition of total outstanding disbursed external debt of the public sector includes all external obligations of the public sector, including the Central Bank of the Republic of Argentina (BCRA) and the official banks. However, this definition excludes all external indebtedness related to the agreement on COGASCO, bonds and notes issued in lieu of providing foreign exchange to meet principal payments falling due on private sector debt covered by exchange rate guarantees, obligations deriving from the assumption by the public sector of debt of private domestic borrowers after December 31, 1986, and those categories of obligations not subject to the Central Bank's debt registration system as of September 15, 1984. It includes loans covered by swap arrangements undertaken by the Central Bank.

3/ Includes cumulated disbursements, net of repayments, of debt with a maturity up to one year, contracted by public sector entities after December 31, 1986, other than obligations classified as reserve liabilities.