FOR AGENDA

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CONFIDENTIAL

June 11, 1985

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 the letter from the Argentine authorities setting out the economic policies to be followed in the remainder of the period of the 15-month stand-by arrangement for Argentina granted December 28, 1984. The staff paper describing and analyzing the economic program of Argentina will be circulated in due course.

Att: (1)

June 11, 1985

Mr. Jacques de Larosière
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Larosière,

1. Argentina is facing a deep economic crisis related to both short-term problems and obstacles to growth stemming from low investment and from the heavy burden of interest payments on the foreign debt. Structural rigidities and short-term imbalances have not permitted the country to escape from its long record of economic stagnation and high inflation. Indeed, during the past ten years the annual rate of inflation averaged well over 200 percent, while output remained virtually unchanged. The challenge confronting the Constitutional Government requires firm and decisive action. It is necessary to break the momentum of inflation to restore a growing economy and a lasting improvement in living standards. All the economic and social sectors of the country are asked to contribute to this task, all participating in an equitable manner and in accordance with their means. Achievement of these objectives requires a drastic cutback in the fiscal deficit through a reduction of public spending and the generation of new revenue. Such action would permit a lowering of the inflation tax, which is particularly burdensome on lower income groups. A substantial reduction in the fiscal deficit will facilitate the pursuit of an anti-inflationary monetary policy compatible with an expansion of credit to the private sector at reasonable levels of interest rates. On the external front, the combination of an adequate exchange rate and appropriate institutional arrangements would promote export growth as a means of reconciling economic reactivation and external equilibrium. Increased domestic savings and exports will make it possible to service the external debt at the same time that the economy is recovering. The Government is convinced that this approach is the only one that can help Argentina to reverse the process of economic deterioration of recent years.

2. In September 1984, the Government adopted an economic program which sought a substantial reduction of inflation, a sustainable balance of payments position, and corrective adjustments in relative prices, to lay the basis for sustained growth of output and employment. This program is supported by a stand-by arrangement from the Fund, in an amount of SDR 1,419 million, which runs through March 27, 1986. The program includes, inter alia, a sizable reduction in the fiscal deficit and a tightening of monetary policy, a slowing in the rate of increase of production costs, a liberalization of price controls, a downward adjustment in the real exchange value of the peso, a reduction of restrictions on trade and payments for current international transactions, and the normalization of Argentina's external debt situation.

3. Significant progress in several of the above-mentioned areas was made in the last quarter of 1984. Monetary and credit policy was tightened and interest rates generally became positive in real terms,

there was a sizable real depreciation of the peso, prices charged by public enterprises were raised in real terms, and a beginning was made toward the liberalization of price controls. However, inflation was higher than had been projected, even though it declined significantly in relation to the third quarter, and the peso-denominated performance criteria included in the stand-by arrangement were not observed, though in general by small margins. In contrast, the overall balance of payments position experienced an overperformance of almost US$600 million relative to the targets of the program for the end of 1984.

4. Partly reflecting a buildup of outstanding obligations in the latter part of 1984 and delays in the adjustment of public sector prices, there was a widening in the cash deficit of the public sector in the early months of 1985. At the same time, monetary policy was eased following the run-up of interest rates in the final months of 1984. These changes, together with continuing steps to liberalize price controls, attempts in March-April to correct relative prices, and wage developments, led to an intensification of inflationary pressures. By April 1985 the monthly rate of price increase reached 30 percent, compared with monthly averages of 18 percent in 1984 and 24 percent in the first quarter of 1985. Also, there was a weakening in the balance of payments, owing in part to the decline of grain prices in international markets.

5. Faced with a situation of rapidly accelerating inflation, the Government has decided to give priority to an intensification of its stabilization effort. The aim is first to arrest the momentum of inflation while adjusting relative prices, and then to set the economy on a path of rapidly declining inflation. Key components of this renewed effort are a shift toward monetary restraint in April-May and a fiscal adjustment implemented in stages, assisted by measures to moderate the rate of increase in costs. Also, the objective is to continue to strengthen the country's external position and to implement a phased liberalization of the trade and payments system in the period of the program.

6. As the policy objectives continue to be broadly those contained in the program adopted last September, the Government considers it appropriate to maintain the current stand-by arrangement. Given the escalation of inflation in the past few months, the financial program for the remaining period of the stand-by arrangement is framed on the basis of a rate of inflation for 1985 substantially higher than that projected initially. The program, as revised, remains consistent with a substantial reduction of inflation, and by the end of the first quarter of 1986 the rate of inflation is expected to be down to about 8 percent a month (equivalent to an annual rate of 150 percent), the objective originally set for the end of 1985. At the same time, the revised program calls for a balance of payments performance better than that envisioned earlier.

7. A marked reduction of inflation will require a slowing in the pace of increase in costs, including nominal wages. The Government, however, is convinced of the need to ensure that the burden of the adjustment effort does not fall disproportionately on certain groups of the population, and in particular it is its intention to provide a measure of protection for real wages. To this end, the rate of increase of wages decreed by the Government each month will be 90 percent of the rate of increase of consumer prices in the preceding month. The Government believes that this wage policy, together with the monetary and fiscal policies described in this letter, is consistent with a marked decline of inflation.

8. The generalized system of price controls in place last September, when the stand-by program was framed, has been gradually liberalized. Starting in November 1984 the Government entered into agreements with major firms or producers in key sectors to allow them to adjust their prices upward over a period of time by more than current inflation to make up for the effect of previous price controls; this process originally was not expected to be completed for all sectors and firms before July 1985 but recently was accelerated and has been completed ahead of schedule. Moreover, the Government already has eliminated most maximum prices that applied to mass-consumption items. For the time being, large firms continue to be required to justify price increases for selected products on the basis of cost developments, but government authorization is not needed before price increases can be put into effect.

9. In the Memorandum of Understanding on Economic Policy of September 1984, it was stated that if inflation was to be curbed the deficit of the public sector would have to be reduced drastically from the high levels that had been recorded in recent years. It also was stated that in order to create the conditions for an eventual recovery of private investment, the fiscal improvement would be sought mainly through a reduction of expenditure. A major effort in this respect was undertaken last year, and public sector cash expenditure (including spending by the public enterprises net of revenue) declined to 30 1/2 percent of GDP in 1984 from almost 33 percent of GDP in 1983. Public sector revenue (excluding receipts by the public enterprises) increased slightly to nearly 22 percent of GDP in 1984, and the cash deficit of the nonfinancial public sector declined from more than 11 percent of GDP in 1983 to just above 8 1/2 percent of GDP in 1984.

10. To an extent, the reduction in the cash deficit of the nonfinancial public sector in 1984 may overstate the improvement in the public finances, as the reduction in cash spending reflected in part postponement of purchases and delays in payments rather than actual cuts in programs. In the National Administration, there were substantial cutbacks in capital outlays and in purchases of goods and nonpersonnel services. However, the limits established on treasury transfers to the public enterprises and the provinces, which were an important component of the program of spending restraint, did not lead to the expected

cutback of spending by these segments of the public sector, as there was an increase in their floating debt and a buildup in unpaid bills. In addition, at the end of 1984 there were delays in the payment of public sector wages, including in the National Administration. Partly because of reductions in the backlog of unpaid obligations, the cash deficit of the nonfinancial public sector increased--counter to the usual seasonal pattern--to more than 9 percent of GDP in the first quarter of 1985.

11. In an effort to strengthen the fiscal position in 1985, and particularly in the second half of the year, in recent weeks the Government has re-examined the budget that had been submitted to the Congress early in the year and is about to introduce a revised budget proposal incorporating reductions in budgetary credits of the order of 12 percent in relation to the original proposal. Including the effect of these reductions and several measures to raise revenue (described below), the deficit of the nonfinancial public sector on a budget basis is estimated to decline from 12 3/4 percent of GDP in 1984 to less than 6 percent of GDP in 1985. Relative to GDP, expenditure would decline from 34 1/2 percent to less than 31 percent from 1984 to 1985, while revenue would increase from less than 22 percent of GDP to nearly 25 percent.

12. Consistent with the fiscal estimates on a budget basis just mentioned and the effects of additional measures taken in recent weeks (in particular, real increases in prices charged by public enterprises), the cash deficit of the nonfinancial public sector would decline from about 8 1/2 percent of GDP in 1984 to less than 4 percent of GDP in 1985. On a semiannual basis, the decline would be from about 8 percent of GDP in the second half of 1984 to less than 2 percent of GDP in the second half of 1985. Cash expenditure would decline from 30 1/4 percent of GDP in the second half of 1984 to 27 3/4 percent of GDP in the second half of 1985. The decline in expenditure is more marked if adjustment is made for salary and other payments deferred from the second half of 1984 into 1985 and for the effect of the employer social security contribution introduced in October 1984. The Government is taking steps to ensure that the effort to restrain cash spending is reflected fully in cuts in actual expenditure and not merely in a postponement of payments. Also, the fiscal plan includes a substantial increase in public sector revenue in the second half of 1985. Achievement of this objective requires in part legislation that already has been introduced or is expected to be submitted shortly to the National Congress; to the extent that these legislative proposals were not enacted, the Government would submit alternative legislation or would take administrative action with an equivalent deficit-reducing effect. A summary of the budget and cash operations of the public sector in terms of GDP, including projections for the second half of 1985 and the first quarter of 1986, is presented in Table 1.

13. Wage moderation and a hiring freeze in the public sector are expected to play an important role in the underlying improvement in the public finances. In late May 1985 the Government decreed a freeze on

the filling of vacancies in the National Administration and the public enterprises, with the exception of certain key positions and priority services. It is projected that by the second half of 1985 the wage bill of the National Administration and the public enterprises will be some 15 percent lower than in the second half of 1984 (a reduction equivalent to about 1 percentage point of GDP), allowing for the postponement of wage payments in December 1984 and for the effect of the increase in social security employer contributions in October 1984.

14. The fiscal position also is expected to improve as a result of tax measures that would yield about 2 1/2 percent of GDP in the second half of 1985. A 10 percent import surcharge adopted for fiscal purposes and a new tax on bank checking transactions, taken together, are estimated to yield the equivalent of a little more than 1/2 percent of GDP, while the increase in the price of petroleum products and electricity marketed by the public enterprises is estimated to yield 0.4 percent of GDP in additional revenue from taxes linked to petroleum and electricity prices. The revenue projection also includes the effect of an increase in the tax on fuels in June that more than offset a reduction in this tax earlier in the year. A forced saving scheme under which individuals and businesses would be required to constitute five-year deposits in an amount calculated as specified proportions of the income, capital, and net worth taxes due in 1984 is projected to yield about 1.4 percent of GDP in the second half of 1985 and 0.7 percent of GDP in 1986; these deposits would be only partially indexed and thus the scheme includes a large tax element.

15. The Government is deeply concerned by the large degree of noncompliance with tax obligations and is fully committed to strengthen tax administration and reduce evasion. It intends to make changes in the organization of the internal tax office and implement a thorough overhaul of its procedures. The Government also will ensure that in the future the State Oil Company transfers fuel tax collections to the Treasury on a current basis, and has provided for the regularization over the next five months of the backlog of the company's unpaid tax obligations accumulated in the period January-April 1985; better tax compliance by the State Oil Company will be made possible by a large increase in fuel prices in May (described below). Moreover, effective June there has been a shortening of the period between accrual and payment of the value-added tax, which will reduce the negative effect of inflation on tax receipts in real terms.

16. In the medium term, tax collections are to be enhanced by various measures included in a tax reform package recently submitted to the National Congress. The package seeks to make the tax structure more equitable, thereby encouraging voluntary compliance, and includes a number of measures aimed at facilitating improvements in tax administration. In particular, it provides for the elimination of many existing exemptions and the closing of tax loopholes, a simplified system of value-added tax collection from small contributors, and a simplification of legal norms and procedures to make them more understandable and to

facilitate legal action against offenders. In this respect, it is proposed that the tax office be allowed access to certain information on transactions through banks and the stock exchange that at present is protected by the bank secrecy laws. The tax package also seeks to enhance investment incentives by reducing corporate tax rates and the value-added tax on specified investment goods.

17. A substantial improvement in the public finances is expected to come from a reduction in the operating losses of the public enterprises. Recently, there have been sizable real increases in the prices charged for goods and services marketed by the enterprises, and the Government intends to maintain the present level of these prices in real terms. On the basis of this policy, and a program of spending restraint, it is expected that the operating losses of the enterprises, which amounted to 2 percent of GDP in the second half of 1984, will be eliminated in the second half of 1985. Largely owing to adjustments implemented in May-June 1985, the effective real level of prices charged by the enterprises (net of taxes) in the second half of this year would exceed, on average, that in the second half of 1984 by 50 percent for liquid fuels, 34 percent for postal services, 26 percent for natural gas, 25 percent for electricity, 20 percent for telephones, and 18 percent for railway and air transportation. The overall increase in real prices between those two periods is estimated at 33 percent, and the value of sales by the enterprises (net of intra-public sector transactions) is projected to rise by the equivalent of 2 percent of GDP. Moreover, spending on goods and nonpersonnel services by the enterprises is to be strictly curtailed. A plan to eliminate the backlog of unpaid bills in the second and third quarters of 1985, which already has been put into effect, is expected to help lower the prices paid by the enterprises for their inputs as well as their domestic interest costs. In summary, the overall cash deficit of the enterprises is expected to fall from almost 4 percent of GDP in the second half of 1984 to around 2 percent of GDP in the second half of 1985.

18. To ensure that the program of spending restraint in the public enterprises is implemented, the Government intends to step up its monitoring of the enterprises on a current basis through the Public Enterprises Comptroller's Office; this task will be facilitated by the requirement established in the 1984 budget that starting in 1985 the budgets of the public enterprises be subject to approval by Presidential decree. The Government also will ensure that its wage policy is implemented in the enterprises through the careful screening of proposed wage increases by the Public Sector Salary Commission. Finally, the Government is to turn over to the enterprises responsibility for the payment of an increasing proportion of the interest on their external debt; this proportion is expected to rise to about 70 percent in 1985 from less than 30 percent in 1984. To ensure compliance with this objective, a mechanism is being implemented under which enterprises will make monthly contributions, in accordance with a pre-established schedule, to an account in the Central Bank to meet foreign interest payments. The extension of this deposit mechanism to other external obligations of the enterprises is under active consideration.

19. The public finances had been affected by the elimination of the 15 percent wage bill tax for social security in 1981 and its replacement by direct transfers to the social security system from general tax revenue. As of the fourth quarter of 1984, the drain on general revenues was reduced by one half owing to the restoration of an employer's contribution equivalent to 7 1/2 percent of wages. In recent years the social security system has had a deficit, over and above the transfers just described; this deficit (equivalent to more than 1/2 percent of GDP in 1984) was covered by the Central Bank, either directly or by allowing bank advances to the system to be counted as part of banks' required reserves. The reform of the financial system in April (described below) necessitated a change in the financing arrangements for the social security system, with the Treasury taking over the debt of the system with banks. For the period ahead, the Government is committed to the elimination of the system's deficit. The Government will seek to maintain the consistency of the monthly adjustments in benefits with its wage policy, while ensuring the achievement of the objective as regards the system's finances.

20. As regards the financial arrangements with the provinces, the intention of the Government is to replace the system that expired at the end of 1984, which allowed for direct transfers from the Treasury in addition to the provinces' sharing in most federal taxes, by a system in which federal funding would take the form of revenue sharing. The greater automaticity of the proposed arrangement would be expected to enhance budgetary management in the provinces. It has not yet been possible, however, to implement the new system, and for 1985 it has been decided basically to maintain the previous one. The fiscal plan for the current year has been prepared on the basis of federal funding of the provinces under general revenue sharing and direct transfers, taken together, equivalent to about 4 percent of GDP, a little less than in 1984. However, the large increase in taxes that are partly earmarked for investment purposes under special sharing arrangements implies that the provinces would receive total funding from the National Government about 1/4 percent of GDP higher in 1985 than in the preceding year. The projection of the provincial finances assumes that capital outlays will increase on the basis of higher earmarked transfers, whereas their current expenditure would decline in real terms, which would be consistent with the provinces applying spending policies broadly in line with those instituted in the National Administration.

21. The Central Bank's assumption in 1982 and 1983 of all public sector debt, on which the public sector now pays virtually no interest, transferred to the Bank a sizable imbalance of a fiscal nature, and the problem was compounded by the extension of interest subsidies to the private sector. In the second half of 1984 the operating deficit of the Central Bank rose to an estimated 2 1/2 percent of GDP, and is expected to rise to about 5 percent of GDP in 1985 notwithstanding the virtual elimination of interest subsidies; some 80 percent of these losses correspond to the inflation adjustment component on the resources the Central Bank borrows at market rates to finance the Government. The

losses of the Central Bank, together with the cash deficit of the nonfinancial public sector (described above), would result in a combined public sector deficit of no more than 6.2 percent of GDP in the second half of 1985 and no more than 2.6 percent of GDP in the first quarter of 1986.

22. Consistent with the objectives of reducing the deficit of the public sector and curbing public spending, the Government has set limits in current pesos, presented in Table 2, for the combined deficit of the nonfinancial public sector and the Central Bank; a sublimit on the cash deficit of the nonfinancial public sector; and a limit on treasury outlays (excluding interest payments). Following the normalization of public sector payments to the private sector in recent months, the Government will avoid the incurrence of new domestic arrears and buildup of floating debt, and the limits on the fiscal deficit have been set on this basis. The behavior of domestic arrears and floating debt will be assessed during the October 1985 review of the program to evaluate fiscal policy; this evaluation will be facilitated by the timely establishment of mechanisms to monitor these kinds of debt, both in the National Administration and the public enterprises. In setting the limits on treasury outlays, it has been assumed that there will be no significant changes in the present arrangements regarding the financing of the rest of the public sector; if such arrangements were modified, the effect of the changes would be taken into account in estimating treasury outlays. Changes in outstanding treasury drafts (libramientos impagos) are included in the definition of treasury outlays. The limit on treasury outlays and the inflation adjustment component of interest costs included in the central bank losses and in the nonfinancial public sector deficit will be adjusted as explained in Table 2, if the actual rate of inflation differs from the projected path.

23. The fiscal program just described, in combination with the balance of payments objectives set out below, should make it possible to slow monetary growth without unduly squeezing the private sector. Following a tightening of monetary policy in the latter part of 1984, the rates of growth of the monetary aggregates increased in the early months of 1985, while there was a further reduction in real money balances. The decline in real balances is expected to continue in coming months, and only when the anti-inflation program takes hold and inflationary expectations recede will money holdings show real growth. The growth of M1 (defined as the sum of the monthly averages of currency in circulation and total sight deposits) is estimated to have declined from a seasonally adjusted monthly rate of 22 percent in the period February-April 1985 to about 19 1/2 percent in May and is projected to decline further to 13 1/2 percent by September 1985 and to below 10 percent in the first quarter of 1986. In line with the monetary program for the period May to September 1985 and the balance of payments objectives, limits have been set on the net domestic assets of the Central Bank (defined as currency issue less net foreign assets) through end-September 1985 (Table 3). The limit on the net domestic assets of the Central Bank for the period through March 1986 will be set on the occasion of the review of the program that is scheduled for October 1985, taking into account the behavior of monetary aggregates in the intervening period.

24. Since the end of March 1985, the Central Bank has implemented a reform of the financial system with the aim of giving the institutional financial market a greater participation in total financial intermediation, relating each entity's lending more directly to its deposit base, and reducing the large cash deficit of the Central Bank and the Central Bank's role in the intermediation process. A feature of the reform has been a reduction in the average reserve requirement on regulated deposits from more than 80 percent to less than 30 percent; the new average results from a reserve requirement of 96 1/2 percent on sight deposits and requirements ranging from 6 to 14 percent on term deposits. The system of reserve requirements in effect until March 1985 entailed the cash payment of interest by the Central Bank on the bulk of deposits in the financial system at the same time that interest income on central bank rediscounts was capitalized, giving rise to a sizable cash imbalance for the Central Bank.

25. In April, banks were required to constitute a frozen deposit (on which interest is accrued rather than paid in cash) to offset the expansionary effects of the reduction in reserve requirements. To the extent that the Central Bank needs to absorb liquidity, it now does so through the placement of compulsory absorption bonds or through the placement of short-term securities with banks or the nonbank private sector. At the beginning of May, as part of the move to tighten policy, absorption bonds were placed with financial institutions in an amount equivalent to 50 percent of the increase in their nonsight regulated deposits after end-March 1985. The short-term bills issued by the Central Bank range in maturity from 7 to 30 days, but banks and individuals have been concentrating their holdings in 7-day bills. To improve the liquidity absorption features of this instrument, the Central Bank recently has taken steps to increase the average maturity of bills by offering higher interest rates on bills of longer maturity; at the end of May, the monthly interest rate ranged from 28 percent for 7-day bills to 32 percent for 30-day bills. In order better to assure that the changes in the holdings of bills are consistent with the monetary program that is set each month, the Central Bank is reviewing the possibility of moving to an auction system for bills.

26. Another feature of the financial reform has been the creation of deposits at nonregulated interest rates with virtually no central bank guarantee. An objective of this measure has been to allow financial institutions to absorb the financial transactions that had developed outside the institutional market since the second half of 1982. Although the new deposits are limited in volume for each institution (in relation to the volume of its regulated deposits and net worth), the overall limits initially were set ample enough to accommodate the previous volume of transactions at freely determined rates (acceptances and swap operations in the financial system and the operations that previously were intermediated outside the institutional system), which as a result of the reform no longer are permitted. The Government is committed to allowing for a continued expansion of the share of financial intermediation at nonregulated interest rates (including indexed transactions)

by adjusting the limits as necessary to ensure that interest rate determination is not distorted and that financial intermediation is not forced outside the organized financial system. In this respect, indicators of conditions in the nonregulated segment of the financial system and in the noninstitutional financial markets will be analyzed on the occasion of the review of the program scheduled to take place by the end of October 1985.

27. The share of deposits at regulated interest rates in total private sector deposits has declined from more than one half in September 1984 and is expected to decline further in coming months. Regulated deposits currently account for more than 40 percent of total private deposits with the financial system and, notwithstanding the financial reforms described above, continue to be the only liquid instrument not subject to limits on the amounts that can be received by financial intermediaries. In the fourth quarter of 1984, the Central Bank broadly achieved its objective of having real interest rates approximately neutral on regulated deposits and moderately positive on regulated loans, but in the first four months of 1985 inflation picked up sharply and on average regulated deposit rates were negative in real terms by about 5 percentage points a month. The Central Bank remains committed to avoiding negative real deposit rates and ensuring moderately positive lending rates in the regulated segment of the market. Regulated rates on both deposits and loans were raised by 4 percentage points in mid-April and by a further 4 percentage points at the beginning of May; in May regulated deposit and lending rates were positive in real terms by 2 and 4 percentage points, respectively. At the beginning of June regulated deposit and lending rates were reduced by 2 percentage points, to 28 percent and 30 percent, respectively, on the basis of the Government's projection of a decline in inflation for the month. Given the difficulty of projecting the rate of price increase at present inflation rates, the program provides that the quarterly averages of monthly interest rates on regulated deposits will not fall short of the quarterly averages of monthly rates of inflation (the average of consumer and wholesale prices) by more than 3 percent (equivalent to about 1/2 percentage point a month at the average monthly rate of inflation projected for the remainder of the program period).

28. The marked decline in financial intermediation in recent years together with a continued increase in the number of bank branches weakened the position of the financial system. Partly because of the the institutional changes described above, the liquidity and solvency problems of many banks were brought to light in April-May, resulting in the liquidation of several institutions, some of which were fairly large. Considerable uncertainty developed in financial markets and there were significant deposit withdrawals from some banks. To safeguard the position of banks that were basically sound and to calm the markets, the Central Bank made available additional rediscount facilities. These facilities did not compromise the monetary program that had been set by the authorities, as the new rediscounts were offset by the placement of absorption bonds and short-term bills.

29. The Government remains committed to continuing the adjustment in the external accounts that has been underway since 1981. The overall balance of payments improved markedly in 1984, with the deficit declining to US$1 3/4 billion from more than US$2 1/2 billion in 1983. Furthermore, the 1984 overall balance of payments was some US$600 million stronger than had been projected in September 1984. Declines in international interest rates and unexpected inflows of trade finance more than compensated for a balance on goods and nonfactor services some US$340 million weaker than had been projected; trade performance was adversely affected by declines in agricultural commodity prices and lower than expected growth in industrial exports.

30. The medium-term growth strategy of the Government is based in large part on a strong expansion of exports. The Government has chosen a central role for exchange rate policy in recognition that the needed growth in exports requires domestic prices that are sufficiently remunerative to encourage an expansion in production. The peso was depreciated against the U.S. dollar by nearly 20 percent in real terms from end-August to end-November 1984 and its real value relative to the U.S. dollar remained relatively unchanged through March 1985. Taking into account the real appreciation of the U.S. dollar against other currencies, from August 1984 to March 1985 the real effective depreciation of the peso in terms of the currencies of Argentina's major trading partners was 6 percent. Accordingly, and to encourage the growth of exports, the Government has resumed the policy of adjusting the exchange rate by more than the increase in prices. From end-March to end-May the real value of the peso was lowered by 5 percent against the U.S. dollar. It is estimated that since March the real depreciation of the peso against major trading partners has been around 9 percent. The Government intends to conduct exchange rate policy in accordance with the balance of payments objectives of the program. At a minimum, the exchange rate will be adjusted in line with the evolution of domestic prices vis-a-vis international prices. In addition, an export promotion scheme, implemented in February 1985, is intended to foster the growth of nontraditional exports by encouraging the formation of trading companies, removing certain tax impediments to exports, and increasing funding for trade expositions.

31. The Government is committed to reducing gradually the scope of nontariff restrictions on imports in coming months. In September 1984 imports included in the automatic licensing regime represented 63 percent of the total value of imports in the base period July 1, 1981 to June 30, 1982, but by March 1985 the percentage of base period imports eligible for automatic licensing had been reduced to around 58 percent; imports of other goods are either prohibited or are subject to prior consultation. The Government intends to put all imports, except a limited list of luxury goods, on the automatic list by March 1986. As first steps, the proportion of goods eligible for automatic licensing will be raised to not less than 63 percent by July 31, 1985 and not less than 68 percent by September 30, 1985. Concerning further steps, it may be noted that the work of an interministerial commission which

is analyzing the existing tariff structure may lead to adjustments in duty rates to correct anomalies in the tariff structure and to provide some protection for products on which the quantitative restrictions are to be lifted. It is recognized that exchange rate policy needs to be consistent with import liberalization to limit import demand following the removal of quantitative barriers. In addition, in a move aimed primarily at strengthening fiscal revenue, the Government has just introduced a surcharge equal to 10 percent of the value of most imports. Progress in the process of import liberalization will be analyzed on the occasion of the review of the program scheduled for October 1985, at which time understandings will be reached on additional steps to be taken toward the above-mentioned liberalization objectives.

32. In line with the aim of a continuing strengthening of the country's external position, the overall balance of payments deficit has been targeted to narrow from US$1.74 billion in 1984 to US$1.65 billion in 1985. The current account deficit is projected to decline from US$2 1/2 billion in 1984 to US$2 billion in 1985, with about one half this improvement reflecting the sharp reduction in international interest rates since September 1984. Also, following a deterioration in the early months of 1985, the private capital account is expected to strengthen in the second half of 1985 and into 1986. The exchange rate and credit policies described above should encourage capital inflows and, in addition, the Government has taken steps to attract foreign direct investment in the petroleum sector and has established a scheme whereby foreign creditors can convert outstanding loans into capital participation. Targets for net international reserves through December 1985 are set forth in Table 4. The target for end-March 1986 will be agreed on the occasion of the October review of the program.

33. To finance the overall balance of payments deficit and to provide both for the elimination of external payments arrears and a needed increase in the gross reserves of the Central Bank, the Government has been arranging exceptional finance from official and private creditors. The Paris Club Agreed Minutes of January 1985 provide for the rescheduling of US$2.1 billion in service payments on medium- and long-term debt including US$1.4 billion that were in arrears at the end of 1984 and US$0.7 billion that fall due in 1985; bilateral agreements are being finalized with some official creditors and the Government is committed to completing all these agreements as soon as possible. The Government is near agreement with creditor banks on the rescheduling of US$14.5 billion of principal payments that have matured since April 1982 or will mature through December 1985. The Government also is near agreement on new financing of US$4.2 billion from creditor banks and has received assurances from official creditors of US$1 billion in additional trade finance. A substantial portion of this exceptional finance is to be used to repay arrears and other foreign obligations. The disbursement of the new bank financing is to be timed to correspond to the drawings from the Fund under the stand-by arrangement, and the elimination of external arrears has been planned accordingly, as shown in Table 5. External payments arrears are to be eliminated by March 31, 1986 and no

new arrears will be incurred after that date. While arrears are being eliminated, the Government is interested in maintaining an accurate presentation by the private sector of requests for official exchange. To this end, the Government intends to institute a deposit scheme whereby the peso counterpart of external payments arrears will be placed with the Central Bank at the time of payments requests.

34. The total external debt, including obligations to the Fund and external arrears, increased by about US$1.8 billion in 1984 to US$47.8 billion, and is expected to rise by another US$2.4 billion in 1985. Consistent with this overall growth in debt, limits have been established for the total and the short-term external debt of the public sector for the remainder of the arrangement, as presented in Table 6.

35. The Government intends to simplify the exchange and trade system and eliminate restrictions to the extent permitted by the availability of foreign exchange. With a view to allocating scarce exchange at a time of severe balance of payments difficulties, in September 1983 external payments and transfers were subjected to prior approval by the Central Bank. It is the intention of the Government, pari passu with the reduction of external payments arrears, to make foreign exchange available for bona fide payments and transfers for current international transactions; with respect to the private sector this will be done on an automatic basis. In pursuing this objective, priority has been attached to private sector import payments; since August 1984 all private sector import payments, other than those expected to be rescheduled, have been on a current basis and foreign exchange is now being, and will continue to be, made available automatically for such payments. On the basis of the expected improvement of the balance of payments and the external financing to be obtained, the Central Bank intends to provide, as soon as possible, foreign exchange for interest payments and for transfers related to nonfinancial services, profits, dividends, and royalties. In the meantime, the cancellation of obligations in respect of profits, dividends, and royalties will continue to be permitted through the delivery of marketable Government of Argentina bonds denominated in U.S. dollars (BONEX). Moreover, the regulations regarding the restructuring of loans with exchange rate guarantees which mature in 1985 will be announced before the end of July 1985.

36. As noted above, in April-May there were significant deposit withdrawals from some banks, including especially large withdrawals of U.S. dollar deposits which are not guaranteed by the Central Bank. As a matter of prudential concern, the Central Bank, on May 17, 1985, froze outstanding dollar deposits in the banking system for 120 days. In doing so, it provided that deposits maturing during the period of the freeze could be converted, at the option of the depositor, into BONEX. The Government believes that a sudden withdrawal of U.S. dollar deposits in present circumstances could compromise the soundness of the financial system, but it intends to take steps as soon as possible to permit holders of frozen deposits to use these resources to make external payments.

37. Before the end of October 1985, the authorities will review with the Fund the progress in implementing their economic program in order to reach understandings, if necessary, on additional measures to ensure achievement of the program's objectives. During the review, stock will be taken of the external financing secured in support of the program and the objectives with regard to the balance of payments, external arrears, external debt, the exchange system, and import policy. Limits for the variables defined in peso terms referred to in paragraphs 22 and 23 will be set for the remainder of the program period; the target for the net international reserves for end-March 1986 also will be set in the review.

Yours sincerely,

/s/
J.J. Alfredo Concepción
President of the Central Bank
of the Republic of Argentina

/s/
Juan Vital Sourrouille
Minister of Economy

Table 1. Argentina: Operations of the Public Sector

(In percent of GDP)

	Nonfinancial Public Sector			Operating Result of the Central Bank	Combined Deficit of the Non-Financial Public Sector and the Central Bank
	Revenue	Spending	Deficit (-)		
			I. Budget Basis		
1983	21.5	36.0	-14.5		
1984	21.8	34.5	-12.7		
1985	24.9	30.8	-5.9		
			II. Cash Basis		
1983	21.5	32.8	-11.3	-1.1	-12.4
1984	21.8	30.4	-8.6	-2.7	-11.3
1985	24.9	28.7	-3.8	-4.5	-8.3
1983					
I	19.4	25.1	-5.7	-0.3	-6.0
II	22.7	29.4	-6.7	-1.4	-8.1
III	23.0	32.1	-9.1	-0.5	-9.6
IV	20.8	36.9	-16.1	-1.4	-17.5
1984					
I	20.1	29.5	-9.4	-3.4	-12.8
II	20.4	30.9	-10.5	-2.2	-12.7
III	21.4	27.8	-6.7	-3.1	-9.8
IV	22.9	31.8	-8.9	-2.3	-11.2
1985					
I	19.4	28.8	-9.4	-2.9	-12.3
II	22.9	30.9	-8.0	-5.6	-13.6
III	25.7	26.7	-1.0	-6.2	-7.2
IV	26.0	28.4	-2.4	-3.2	-5.6
1986					
I	24.8	25.4	-0.6	-2.0	-2.6

Table 2. Argentina: Limits on the Cash Deficit of the Nonfinancial Public Sector, the Combined Deficit of the Nonfinancial Public Sector and the Central Bank, and Treasury Outlays

(In billions of pesos argentinos)

Period	Cash Deficit of the Nonfinancial Public Sector 1/	Combined Deficit of the Nonfinancial Public Sector and the Central Bank 2/	Treasury Outlays 3/
April-June 1985	775.0	1,315.0	1,060.0
April-July 1985	875.0	1,770.0	1,600.0
April-September 1985	955.0	2,600.0	2,635.0

1/ These limits will be adjusted upward (downward) by $a 1.0 billion for each percentage point that the rise in prices (the simple average of the increase in wholesale and consumer prices) exceeds (is less than) an average of 29 percent a month in the second quarter of 1985. The limit for the period April-July also will be adjusted upward (downward) by $a 0.4 billion for each percentage point that the rise in prices exceeds (is less than) 23 percent in July. The limit for the period April-September 1985 also will be adjusted upward (downward) by $a 2.0 billion for each percentage point that the rise in prices exceeds (is less than) an average of 20.5 percent a month in the third quarter of 1985.

2/ These limits will be adjusted upward (downward) by $a 8.3 billion for each percentage point that the rise in prices exceeds (is less than) an average of 29 percent a month in the second quarter of 1985. The limit for the period April-July 1985 also will be adjusted upward (downward) by $a 6.6 billion for each percentage point that the rise in prices exceeds (is less than) 23 percent in July 1985. The limit for the period April-September 1985 also will be adjusted upward (downward) by $a 22.2 billion for each percentage point that the rise in prices exceeds (is less than) an average of 20.5 percent a month in the third quarter of 1985.

3/ The limit for the period April-June 1985 will be adjusted upward (downward) by $a 5.3 billion for each 1 percent that the average index of prices (the simple average of wholesale and consumer prices with March 1985=100) exceeds (is less than) 171.4 in the second quarter of 1985. The limit for the period April-July 1985 will be adjusted upward (downward) by $a 8 billion for each 1 percent that the average index of prices in the period April-July 1985 exceeds (is less than) 193.9. The limit for the period April-September 1985 will be adjusted upward (downward) by $a 13.2 billion for each 1 percent that the average index of prices for the second and third quarters of 1985 exceeds (is less than) 245.

Table 3. Argentina: Targets for Net Domestic Assets of the Central Bank 1/

(In billions of pesos argentinos)

March 1985	1,573.0
June 1985	1,955.0
July 1985	2,120.0
September 1985	2,380.0

1/ For March 1985, net domestic assets of the Central Bank are defined as average currency issue minus net international reserves of the monetary authorities (as defined in Table 4) valued at the end-December exchange rate of $a 178.66 per U.S. dollar multiplied by a factor of 0.59 (the ratio in May 1985 of currency issue to the monetary base, including absorption bonds). For June, July, and September 1985, net domestic assets are defined as net domestic assets for March 1985 plus the increase since March in average currency issue through each month plus the decline in net international reserves between March and each month, with the decline in net international reserves valued at the rate of exchange at the end of March and April and that projected for the end of June, respectively, multiplied by the factor of 0.59 in each case.

Table 4. Argentina: Targets for Net International Reserves of the Monetary Authorities 1/

(In millions of U.S. dollars, end of period)

1984	
December	-8,263
1985	
March	-9,216
June	-9,220
July	-9,120
September	-9,217
December	-9,913

1/ For measuring balance of payments performance, 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 June 30, 1984 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. The data for December 1984 and March 1985 are presented for purposes of defining the series.

Table 5. Argentina: Limits on Outstanding External Payments Arrears 1/

(In millions of U.S. dollars, end of period)

December 1984	4,162
March 1985	3,543
June 1985	3,400
July 1985	3,600
September 1985	1,600
December 1985	1,100
March 1986	--

1/ For purposes of these limits, external payments arrears are defined to exclude: (a) principal amounts subject to rescheduling under general principles agreed between Argentina and its foreign bank creditors; (b) principal on loans originally covered by swap contracts with the Central Bank; (c) deposits placed with the Central Bank; (d) principal on loans for which the domestic private sector borrower obtained an exchange rate guarantee from the Central Bank in 1981 or 1982; and (e) arrears refinanced in accordance with the Paris Club Agreed Minutes. The data for December 1984 and March 1985 are included for purposes of defining the series. The schedule for the elimination of external payments arrears is based on certain assumptions concerning the disbursement schedule for balance of payments loans. The arrears schedule may need to be revised on the basis of changes in the prospective timing of balance of payments financing actually arranged.

Table 6. Argentina: Limits on the External Debt of the Public Sector During the Program Period

(In millions of U.S. dollars)

Limit on the total outstanding disbursed external debt of the public sector 1/	39,700
Limit on cumulative net disbursements of short-term debt of of the public sector contracted after September 30, 1984 2/	2,500

1/ 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 and the official banks. However, this definition excludes 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, 1983, 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.

2/ Includes cumulated disbursements, net of repayments, of debt with a maturity up to one year, contracted by public sector entities after September 30, 1984, other than obligations classified as reserve liabilities.