

EBS/85/148
Supplement 1

CONFIDENTIAL

July 22, 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 describing the economic measures that were taken subsequent to the submission of the June 11, 1985 letter on economic policy (EBS/85/148, 6/11/85). The new letter, in combination with the June 11, 1985 letter, sets 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.

Mr. Stuart (ext. 8602) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

July 22, 1985

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

Dear Mr. de Larosière:

1. Our letter of June 11, 1985 described a set of policies to bring the stabilization plan initiated in late 1984 back on track. These policies included a major adjustment in the public finances and continuing efforts to reduce the balance of payments deficit and to normalize external trade and payments mechanisms. The Government was concerned, however, that the magnitude of the imbalances in the Argentine economy might make it very difficult to carry a gradual anti-inflation strategy to a successful conclusion because such an approach was likely to lead to an extended period of high real interest rates and weak economic activity. The Government decided, therefore, to strengthen the anti-inflationary effort, and in mid-June it adopted additional measures, namely a monetary reform and a wage-price freeze, aimed at facilitating the elimination of indexation and turning around the expectation that high rates of inflation would persist. To limit the risk that the freeze might cause disruptions in the economy and to produce a drastic abatement of inflationary expectations, fiscal and monetary policies were geared to ensuring that the public sector deficit can be covered by external financing consistent with the program and that, for the time being, the Central Bank essentially need not expand its total domestic credit operations on a net basis. The commitments set out in our letter of June 11, 1985 continue to reflect the policies of the Government except as modified by this letter.

2. On June 15, the Government introduced a new currency unit, the austral, equivalent to 1,000 pesos argentinos. Existing peso currency holdings and demand deposits in the financial system were converted into australes on terms designed so as not to include any confiscation element. To avoid large windfall profits and losses for creditors and debtors while respecting existing contracts denominated in pesos, term deposits and other contractual obligations were allowed to run to maturity; at that time, the peso amounts are to be converted into australes at a pre-established rate that takes account of the average inflation adjustment component of interest rates prevailing immediately before the reform. In fact, the value of the peso in terms of the austral is being adjusted downward on a daily basis in accordance with a schedule which thus far has been set through the end of July 1985, at which time the austral will be worth 1,478 pesos.

3. Since early this year, wages in both the public and private sector have been adjusted each month by 90 percent of the increase in the consumer price index in the preceding month. Under this arrangement, the Government decreed a general increase in wages of 22.6 percent for June. Following this adjustment, wages and salaries, as well as other

direct or indirect forms of labor compensation, are to remain frozen as needed to break the previous pattern of wage-price indexation and to help consolidate expectations of price stability.

4. All prices in the economy were frozen as of the zero hour of June 13. The Government has been examining the implications deriving from the fact that the price freeze caught specific sectors or individual firms at different stages of the process of price adjustment, and intends to manage the freeze with sufficient flexibility to ensure that shortages do not occur. In any event, the Government is convinced that the freeze cannot be maintained for an extended period without impairing the working of the economy. It is thus committed to limiting the duration of the freeze to the minimum period needed to break wage-price indexation and to moving toward a system in which prices will be determined in the market. The Government also is convinced that to prevent the re-emergence of inflation, the lifting of the wage-price freeze will have to be implemented in an environment in which fiscal and monetary policies are consistent with price stability.

5. In accordance with the principle that the public sector deficit must be brought down to a level that can be covered with available foreign financing, it has been decided that the cash deficit of the nonfinancial public sector plus the losses of the Central Bank will not exceed the equivalent of 2 1/2 percent of GDP in the second half of 1985 and will decline further in the first quarter of 1986. This objective is broadly consistent with the fiscal plan on a cash basis described in the letter of June 11, 1985 (including expenditure cuts not specified at that time), when allowance is made for the decline in domestic interest costs resulting from the sharp reduction in inflationary expectations induced by the new program. The staff of the Ministry of Economy and the Central Bank have reviewed the fiscal projections in the light of these adjustments; on the basis of this review, we are satisfied that the combined deficit of the public sector will not exceed the equivalent of 2 percent and 3 percent of GDP in the third and fourth quarters of 1985, respectively. A little more than one half of the projected deficit for the second half of 1985 results from the operations of the nonfinancial public sector, with the remainder representing Central Bank losses (Table 1).

6. In the past few months, the Government has been reviewing the budget proposal that had been submitted to the Congress in January, with a view to making it conform to the objective as regards the reduction in the cash deficit. As was noted in paragraph 11 of the letter of June 11, 1985, in May the Government decided to cut budgetary allocations included in the original budget proposal by about 12 percent, bringing the estimated budgetary deficit in 1985 to less than 6 percent of GDP. The provincial governments are ready to participate in this effort as a means to contributing to the national reconstruction. The final budget proposal incorporates further cuts in spending by the Central Administration and the decentralized agencies. These cuts include additional restraint on expenditure based on earmarked funds,

with the resulting surplus being transferred to the Treasury. Moreover, the operating deficits of the public enterprises have been reduced more than was stated in the letter of June 11, 1985, owing to additional increases in public sector prices immediately prior to the freeze; these increases brought the real level of prices charged by enterprises on average to 36 percent above those prevailing in the second half of 1984. As a result, the enterprises are expected to have an overall cash surplus in the second half of this year, and the Government is considering ways to use these funds as needed to provide relief to the Treasury. Specific measures also have been taken to eliminate the deficit of the social security system, in accordance with the commitment expressed in paragraph 19 of the letter of June 11, 1985. Taking account of these changes, the revised budget that is to be submitted to the Congress shortly will provide for a budgetary deficit of about 4 percent of GDP for 1985 as a whole, or nearly 2 percentage points of GDP less than the deficit included in the letter of June 11, 1985.

7. Allowing for the estimated fiscal operations in the first half of the year and the difference between budget (commitment) and cash transactions, the revised 1985 budget is consistent with deficits in the cash transactions of the nonfinancial public sector of 0.8 percent of GDP in the third quarter and 2 percent of GDP in the fourth. The Government is committed to limiting the deficit to these levels to avoid the need for Central Bank financing and thus to ensure the success of the program. To this effect, prior to the approval of the budget the Government will manage public expenditure policy in a way consistent with the revised budget proposal. After the budget is approved, the Government will take all necessary actions, including the setting of monthly limits on commitments by spending agencies, to make sure that its cash operations conform with the above-mentioned objectives for the deficit. The Government is ready to take any additional measures that may be needed to achieve these objectives, without incurring a buildup of unpaid obligations.

8. In recent weeks, measures have been taken to improve expenditure control in the public sector, particularly in the public enterprises. The Secretariat of Finance has been improving the monitoring of the finances of the enterprises to detect at an early stage any deviations from pre-set financial plans, thereby making it possible to adopt timely corrective action. These procedures are designed to track, inter alia, the evolution of the floating debt and domestic arrears of enterprises with suppliers and contractors, with a view to preventing a new buildup of such obligations following the reduction that has occurred in recent months. Also, a mechanism has just been implemented under which public enterprises will make weekly deposits with the state-owned Banco de la Nación, in accordance with a pre-established schedule, to meet foreign debt service payments. In the case of the state oil company (YPF), a financial arrangement was agreed in May providing for the company's full compliance with the obligation to transfer its fuel tax receipts to the Treasury. In accordance with this arrangement, in June YPF transferred all fuel taxes owed in the month, and is expected to reimburse the

Treasury for the taxes not transferred in the period January-May in five monthly installments of A 16 million each starting in August. To ensure that all agencies of the National Administration and the public enterprises operate within their budgets and comply with existing expenditure containment regulations, a decree was issued early this month establishing strict penalties for officials responsible for failures to implement the agencies' budgets.

9. As was explained in paragraph 21 of the letter of June 11, 1985, the Central Bank has a problem of a fiscal nature largely as a result of the assumption in 1982-83 of all public sector debt at virtually no interest and the subsequent increase of such debt stemming from the financing of large fiscal deficits. The losses of the Central Bank are being reduced by the sharp decline in the average nominal cost of its borrowed resources that has resulted from the marked reduction of the inflation premium in interest rates, and the problem gradually will become less acute as the Central Bank halts all new financing to the nonfinancial public sector.

10. Consistent with the fiscal objectives set out in this letter, revised limits in local currency have been established for the combined deficit of the nonfinancial public sector and the Central Bank, the cash deficit of the nonfinancial public sector, and Treasury outlays (excluding interest costs to the Treasury) and are presented in Table 2. Limits for the period of the stand-by arrangement beyond September 1985 will be established on the occasion of the review of the program scheduled for October 1985. That review will provide an opportunity to reassess the adequacy of fiscal policy, particularly into 1986, with a view to taking any additional measures that may be deemed necessary to ensure the success of the program.

11. The elimination of the domestically financed public sector deficit will be the cornerstone of a monetary policy consistent with dealing a decisive blow to inflation, an objective which also will guide credit policy vis-a-vis the private sector. In the early stages of the program, the Central Bank essentially will not extend any credit to the rest of the banking system or the private sector on a net basis. The Central Bank may extend rediscounts for a limited number of purposes, namely export and seasonal crop financing, but these rediscounts would be accommodated largely within the margin provided by the recovery of existing rediscounts. The Central Bank also may need to provide emergency assistance to financial institutions facing liquidity difficulties, or may incur costs in the liquidation of institutions which become insolvent. However, the expansionary effects of such actions would be offset by appropriate measures of absorption so as to avoid any increase in credit on a net basis. In short, to ensure confidence in the internal and external stability of the austral, the Central Bank's operations for the time being essentially will be limited to issuing currency against the purchase of foreign exchange.

12. Consistent with the guidelines described in the previous paragraph, limits for July and September 1985 have been established for the net domestic assets of the Central Bank, defined as the Bank's monetary liabilities (currency issue, banks' sight deposits with the Central Bank, and the Bank's other liabilities to the nonfinancial private sector) minus net international reserves. The limits through September 1985, presented in Table 3, allow for an expansion of credit to the public sector covered by external loans channelled through the Central Bank, largely offset by a seasonal reduction in Central Bank credit to the rest of the economy. The continuing adequacy of the general guidelines for the Central Bank's credit policy described in the preceding paragraph will be examined in the context of the review of the program that is to take place by October 1985, at which time limits on the net domestic assets of the Central Bank will be established for the remainder of the program period.

13. The Central Bank's monetary and credit policies aim at providing an adequate amount of credit to the private sector at reasonable interest rates, subject to the paramount objective of halting inflation. Following the introduction of the wage-price freeze, regulated interest rates were set at 4 percent a month on deposits and 6 percent a month on loans, while the Bank established ceilings on regulated loans, on a bank-by-bank basis, that effectively froze the amount of such lending; the interest rate on the Bank's short-term paper, which is available to both financial institutions and the general public and in effect sets a floor to nonregulated rates, was fixed at 7 percent a month. Nonregulated interest rates initially were well above this level, and there were substantial capital inflows; by the end of June free interest rates were down to around 7 percent a month. Effective July 1 the Central Bank lowered regulated deposit and lending rates to 3 1/2 and 5 percent a month, respectively, and fixed the rate on its short-term paper at 5 1/2 percent. Measures also were taken to permit the expansion of use of instruments with nonregulated interest rates, including the creation of a special margin for transactions at 45 days or more. At the same time, the Government took steps to limit the inflow of short-term capital from abroad to prevent an excessive increase in domestic liquidity, as discussed below. In determining the level of regulated rates the Central Bank will take into consideration movements in nonregulated rates as well as developments in prices and in exchange markets; in any event, the Bank remains committed to avoiding negative real interest rates on regulated deposits and ensuring moderately positive regulated lending rates. The Central Bank also will continue to provide room for the expansion of the nonregulated segment of the financial system, so as to minimize distortions in interest rate determination in that market.

14. During the week preceding the wage-price freeze, the Argentine currency was depreciated by nearly 25 percent in nominal terms vis-a-vis the U.S. dollar. Despite the acceleration of prices in the first half of June, the average real exchange value of the currency in that month was about 5 percent lower than in May; at the time of the freezing of

the exchange rate, the exchange value of the austral was about 7 percent below its average for June. With respect to the average of September 1984, there has been a real depreciation of about 30 percent in relation to the U.S. dollar and in relation to the currencies of Argentina's major trading partners. The recent depreciation was accompanied by the introduction of additional taxes on exports ranging from 7 to 10 percent of export value. As a result, average export taxes on principal agricultural products, which were about 19 percent in September 1984 and 18 percent at the beginning of June 1985, rose to 26 percent. At the same time, rebates on nontraditional exports were eliminated and gave way to some degree of taxation on most such exports. Furthermore, a temporary import surcharge equivalent to 10 percent of the value of most imports was established, primarily for fiscal purposes. In announcing the wage-price freeze, the Government also indicated that the practice of daily adjustments in the exchange rate was being discontinued and that the exchange rate vis-a-vis the U.S. dollar would remain unchanged in nominal terms. The adequacy of the exchange rate will be kept under scrutiny, with a view to ensuring achievement of the balance of payments objectives of the program. It also is the intention of the Government to lower both the import surcharge and export taxes as soon as permitted by the evolution of the public finances.

15. As noted above, the measures introduced in mid-June were followed by a sizable capital inflow, much of it in the form of an acceleration of export prefinancing. Because of concern about the effect large purchases of foreign exchange by the Central Bank might have on monetary control and in order to dissuade inflows of volatile capital, at the beginning of July and as an emergency measure the Central Bank shortened the maximum period for which the principal traditional exports can be prefinanced, from 180 days to 30 days; at the same time, the minimum term for nontrade related capital inflows was extended from 180 days to 360 days. The Central Bank has conducted an investigation on the effects on exports of these changes in financing terms, and has just lengthened the maximum period for export prefinancing to 90 days for grains and oilseeds and 120 days for other traditional exports affected by the measure of the beginning of July so as to avoid impairment of normal trade flows.

16. During the month of June, Argentina made payments of interest in arrears to banks in the amount of US\$580 million, using proceeds from a bridge loan of US\$483 million from official sources abroad and the Central Bank's own reserves. The reduction of arrears opened the way to the completion of agreements concerning the refinancing of Argentina's debt to foreign banks due through 1985, the new bank loan for US\$4.2 billion, and the trade maintenance and money market facilities; these agreements are expected to be signed by the end of August, and a first disbursement of US\$2.2 billion of the bank loan would be available in September 1985. On the basis of an updated schedule for the disbursement of the bank loan and other changes in the balance of payments projections (as presented in Table 4), a revised schedule for the elimination of external payments arrears is set out in Table 5. The

strengthening of adjustment policies in mid-June could well result in a more favorable balance of payments performance than was projected in the letter of June 11, 1985; in that case, and in line with the Government's commitment to regularize external payments as quickly as feasible, the process of elimination of arrears would be accelerated. In the meantime, the Central Bank has instituted a scheme under which the austral counterpart of private sector external payments arrears is to be deposited with the Central Bank.

17. At the beginning of July the Central Bank issued regulations regarding the restructuring of private sector loans which mature through end-1985, with or without exchange guarantee. These regulations provide for their refinancing by means of the issuance of central bank notes and government promissory notes with a ten-year maturity, including three years of grace. In addition, provisions were made for the regularization of interest obligations relating to the rescheduled principal amounts.

18. The strengthening in the balance of payments and the enhanced confidence in financial markets that followed the economic measures of mid-June made it possible to start unfreezing the U.S. dollar deposits in commercial banks in Argentina that had been frozen on May 17, 1985, ahead of the 120-day period established initially. The Central Bank has just taken measures to permit access to these deposits, subject to a maximum withdrawal limit of US\$1,500 per deposit.

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	21.8	37.4	-15.6		
1984	22.4	34.4	-12.0		
1985	25.1	29.2	-4.1		
II. Cash Basis					
1983	21.7	32.1	-10.4	-1.1	-11.5
1984	22.5	30.7	-8.2	-2.7	-10.9
1985	25.3	28.9	-3.6	-2.4	-6.0
<u>1983</u>					
I	20.4	25.5	-5.1	-0.3	-5.4
II	24.4	30.2	-5.8	-1.4	-7.2
III	22.9	31.4	-8.5	-0.5	-9.0
IV	20.3	35.3	-15.0	-1.4	-16.4
<u>1984</u>					
I	20.5	29.1	-8.6	-3.4	-12.0
II	21.5	31.0	-9.5	-2.2	-11.7
III	21.7	27.6	-5.9	-3.1	-9.0
IV	23.9	32.8	-8.9	-2.3	-11.2
<u>1985</u>					
I	19.1	27.0	-7.9	-2.9	-10.8
II	22.6	30.1	-7.5	-5.6	-13.1
III	26.9	27.7	-0.8	-1.2	-2.0
IV	27.7	29.7	-2.0	-1.0	-3.0
<u>1986</u>					
I	25.4	25.8	-0.4	-0.8	-1.2

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 millions of australes)

	Cash Deficit of the Nonfinancial Public Sector	Combined Deficit of Nonfinancial Public Sector and the Central Bank	Treasury Outlays
July 1985	50.0	100.0	550.0
July-September 1985	105.0	260.0	1,630.0

Table 3. Argentina: Targets for Cumulative Changes since June 1985 in the Net Domestic Assets of the Central Bank 1/

(In millions of australes)

July 1985	500.0 <u>2/</u>
September 1985	800.0 <u>3/</u>

1/ Net domestic assets of the Central Bank are defined as monetary liabilities of the Central Bank minus net international reserves of the monetary authorities (as defined in Table 4) valued at the exchange rate of \$ 0.800 per U.S. dollar. For purposes of this measure, the monetary liabilities of the Central Bank are defined as each month's average broad money (currency in circulation plus all local currency-denominated deposits in the consolidated financial system not including accrued interest, plus central bank paper held by the nonfinancial private sector) times a factor of 0.445. This factor corresponds to the estimated average value in June 1985 of the ratio of the Central Bank's monetary liabilities (currency issue plus deposits of financial intermediaries in the Central Bank plus central bank paper held by the nonfinancial private sector) to broad money. The targets have been set on the basis of estimated monetary liabilities for June 1985 and will be adjusted to allow for the difference between the preliminary and the definitive estimates of monetary liabilities, once the definitive estimate is available.

2/ The increase in the July average reflects the rise in monetary liabilities of the Central bank during the course of June. The limit for July is consistent with the same level of net domestic assets at end-June and at end-July.

3/ The increase in net domestic assets in August and September can be attributed almost completely to onlending by the Central Bank of increases in its foreign liabilities.

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

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

<u>1984</u>	
December	-8,263
<u>1985</u>	
March	-9,204
June	-9,015
July	-9,015
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, and the figure for June 1985 is a preliminary estimate.

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	3,650
September 1985	1,800
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) certificates of deposits placed with the Central Bank in conformity with circulars A-404, A-562, A-576, A-696, and A-697; (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, and the figure for June 1985 is a preliminary estimate.