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CONFIDENTIAL

January 13, 1987

To: Members of the Executive Board  
From: The Secretary  
Subject: Argentina - Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is a copy of a communication from the Argentine authorities requesting a 15-month stand-by arrangement equivalent to SDR 1,113 million, together with a Memorandum of Understanding on Economic Policy. The staff paper describing and analyzing the financial program of Argentina will be circulated in due course.

Mr. Lachman (ext. 8648) or Mr. Stuart (ext. 8602) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (2)

Buenos Aires,  
January 12, 1987

Mr. Jacques de Larosi re  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431  
U.S.A.

Dear Mr. de Larosi re,

1. The attached Memorandum of Understanding on Economic Policy describes the economic program that the Government of Argentina intends to pursue in the coming 15 months to make further progress in reducing the rate of inflation, strengthen the balance of payments, and maintain the economy on a growth path.

2. In support of this program we request herewith a stand-by arrangement for 15 months from the International Monetary Fund in an amount of SDR 1,113 million. Our request for access to Fund resources in this amount is based on the magnitude of the economic effort that is being undertaken toward the consolidation of low inflation and economic growth, and on the financing needs that Argentina is facing.

3. The Government of Argentina intends to enter into discussions with the international financial community to secure a restructuring of its debt and to obtain new external financing, and attaches great importance to assistance from the Fund in this effort.

4. The Government of Argentina believes that the policies set out in the annexed Memorandum of Understanding on Economic Policy are adequate to achieve the objectives of its program but will take any further measures that may become appropriate 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.

Yours sincerely,

/s/  
\_\_\_\_\_  
Jos  Luis Machinea  
President of the Central Bank  
of the Republic of Argentina

/s/  
\_\_\_\_\_  
Juan V. Sourrouille  
Minister of Economy



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## Memorandum of Understanding on Economic Policy

1. In June 1985 the Government launched a comprehensive plan to correct the imbalances affecting the Argentine economy. This plan represented a major departure from previous efforts at stabilization, and it was based on the premise that sustained economic growth in Argentina could be achieved only if the economic conditions and climate were conducive to a significant improvement in resource allocation and capital formation. The main elements of the plan were a major reduction of the fiscal deficit, an adjustment of monetary policy to a low inflation situation, a wage-price freeze, and a pegging of the exchange rate to the U.S. dollar to bring a sudden stop to inflation. In addition, the program included the adoption of a new currency and a monetary reform to deal with the problem posed by widespread indexation of contracts.

2. The results of the plan were very favorable. The rate of increase in consumer prices came down from an average of 28 percent a month in the second quarter of 1985 to an average of 2 1/2 percent a month from July 1985 to February 1986; over the same period, the rate of increase in wholesale prices fell from 35 percent a month to below 1 percent a month. Moreover, following a drop in output in the third quarter of 1985, a major recovery in industrial activity got underway beginning in the fourth quarter of 1985.

3. Beginning in March 1986, there was a temporary pickup in inflation. This surge could be explained in part by a reduction in beef supplies as the cattle cycle entered the herd rebuilding phase, as well as by seasonal factors. More generally, the circumstances in which the Government made wage and price controls more flexible in the period after March 1986 contributed to the increase in the rate of inflation. Monetary expansion, which initially was in line with the increase in the demand for money, appeared to be permissive. From February to June 1986, consumer prices increased by an average of 4 1/2 percent a month, and they rose by 6.8 percent in July and 8.8 percent in August; wholesale prices rose by 3 percent a month from February to June 1986, and by 5.1 percent in July and 9.4 percent in August.

4. In order to deal with price expectations and regain control over inflation the Government adapted its economic policies in late August. To this effect, the Government announced that public sector prices and controlled prices of industrial goods would be adjusted in line with the officially projected decline in inflation rather than being indexed to past inflation. This was accompanied by a monetary policy consistent with lowering the rate of inflation. In addition, the Government announced that it would aim to avoid a return to wage indexation and to limit wage increases in the remainder of 1986 to 3-4 percent a month as agreed earlier in the year between labor and management. In reflection of these measures there was a progressive deceleration in the rate of inflation, and in December 1986 consumer prices increased by 4.7 percent while wholesale prices rose by 3 percent. From December 1985 to

December 1986 consumer prices rose by 80 percent and wholesale prices went up by less than 60 percent, compared to increases of more than 1,100 percent in both indexes in the 12-month period prior to adoption of the Government's economic program in June 1985. Together with this decline in inflation a significant expansion of the economy took place. It is estimated that in 1986 industrial production increased by around 12 percent and that real GDP went up by about 5 1/2 percent.

5. A primary objective of economic policy will be to secure a continuation of the economic expansion observed in 1986 and the Government considers that its program will lead to a rate of growth of about 4 percent in real GDP in 1987. At the same time the Government considers that in order to attain this objective continued efforts to *reduce the rate of inflation are required*. A further aim of policy in 1987 will be an improvement in the balance of payments, notwithstanding that external factors likely will continue to be unfavorable to Argentina. With a view to strengthening the basis for economic growth over the medium term, the Government will deepen structural reforms. These reforms include efforts to increase the efficiency of the public sector, to induce changes in the financial system to make it compatible with an environment of low inflation and sustained growth of investment, and to reduce trade and payments restrictions and wage and price controls. It is expected that many of the structural reforms will be supported by the World Bank.

6. Since mid-1985 there has been a marked reduction in the combined public sector deficit (the cash deficit of the nonfinancial public sector plus the operating losses of the Central Bank), and the deficit declined from almost 11 percent of GDP in 1984 to about 6 1/2 percent of GDP in 1985. The deficit declined further to 3.6 percent of GDP in 1986 (excluding payments equivalent to 0.3 percent of GDP representing interest due on the domestic debt of the State Oil Company capitalized in treasury guaranteed bonds). An important element in the strategy to reduce inflation, improve the balance of payments, and increase savings will be a further reduction in the public sector deficit to 2.5 percent of GDP in 1987. The Administration soon will present to Congress a budget proposal for the National Administration in line with its target for the deficit of the nonfinancial public sector and with lowering inflation in the period from December 1986 to December 1987 to about 40 percent. The operating losses of the Central Bank will be kept to 1.5 percent of GDP in 1987, or about the same as in 1986. According to the Government's plan, the combined deficit would amount to 3.9 percent of GDP in the first half of 1987 and to 1.1 percent of GDP in the second half of the year (Table 1).

7. The reduction in the deficit of the nonfinancial public sector in 1987 will come mainly from an increase in public sector revenue. About 1 percent of GDP in additional revenue is expected from a tax amnesty program to provide for the collection of delinquent taxes. The Administration has submitted the tax amnesty bill to the Congress and approval is expected shortly. Revenues are expected to be increased by

a further 1/2 percent of GDP by the recently decreed increase in social security taxes. Revenues from export taxes are projected to decline by about 1/2 percent of GDP, owing to a sharp reduction in tax rates on agricultural exports, but this would be all but offset by a rise in other taxes. In particular, revenues from the value-added and net worth taxes are projected to rise somewhat, reflecting improvements in tax administration.

8. In 1987, total cash expenditures of the nonfinancial public sector in terms of GDP will amount to 30 percent compared with 29 1/2 percent in 1986. Capital expenditures are projected to increase by around 0.7 percentage points of GDP, while current expenditures will decline somewhat relative to GDP in 1987 despite an increase in government outlays related to a restructuring of the salary scale of the National Administration and a reform of the social security system. A substantial improvement in the operating balances of the public enterprises is expected as a result of recent increases in the real prices charged by these companies as well as of lower external interest rates on average in 1987 relative to 1986; the current operations of the enterprises taken together are expected to be in balance in 1987, after recording losses of close to 0.5 percent of GDP in 1986. Consistent with its targets for cash expenditures, the Administration's budget for 1987 will limit the total outlays of the National Administration on a commitment basis (including transfers to other parts of the public sector) to A 29.7 billion or 24 percent of GDP compared to 24.8 percent of GDP in 1986, and the Government will control budget execution through the application of quarterly limits on commitments. As part of its program of spending restraint, the Government will seek to ensure that the public enterprises do not build up domestic arrears and floating debt to private suppliers; the Government is establishing a system for monitoring the operations of the public enterprises on a timely basis to assure compliance with this regulation.

9. The Government is of the view that in order to attain sustained growth in Argentina the role of the public sector needs to be redefined. While it will not be possible to lower public expenditure in 1987, the Government is introducing structural changes which should streamline the public sector in coming years. These changes include the introduction of a voluntary retirement program designed to reduce employment in the National Administration by 6-7 percent in the next three years; under the terms of this program, employees who voluntarily leave the public service will receive a lump sum payment as well as their regular salary for 6-12 months, and the benefits of this program for public spending will not be felt until 1988. A step to improve the efficiency of the public enterprises was the recent creation of a Board of Directors whose task is to implement the policy decisions adopted by a Joint Committee made up of the Ministers of Public Works and Economy and a specially appointed Chairman of the Board. Also, in early 1986 the Government announced its intention to sell its majority interest in certain public firms, and recently sent to the Congress a draft law that should expedite the sale of these companies.

10. At present, there is a deficit in the Central Bank that arises from the difference between the interest rates the Central Bank pays on its domestic liabilities (which are related mainly to free interest rates) and the rates charged on rediscounts (which are related mainly to the lagged rate of inflation, exchange rate adjustments, and regulated interest rates), and from interest payments on the Bank's net external debt. With the reduction of monetary expansion beginning in late August 1986 and a rise in free interest rates relative to the rates charged on Central Bank assets, the losses went up from about 1.4 percent of GDP in the first nine months of 1986 to around 2 percent of GDP in the fourth quarter of 1986. It is projected that the Central Bank's losses will decline steadily in the course of 1987, from 2.3 percent of GDP in the first quarter to about 0.9 percent of GDP in the fourth quarter, as free interest rates decline in response to improved expectations about inflation. If it becomes apparent that the variables that affect the operating losses of the Central Bank are developing in a way that would cause higher losses, the Central Bank will manage its interest rates to ensure the attainment of the objectives set out above.

11. Consistent with the objectives of reducing the deficit of the public sector and of limiting public spending, the Government has set limits in australes, presented in Table 2, for the combined deficit of the nonfinancial public sector and the Central Bank, for the cash deficit of the nonfinancial public sector, and for Treasury outlays (excluding interest payments), for the period through June 1987.

12. The Government believes that the attainment of its economic objectives will require a rate of monetary and credit growth in line with the projected decline in inflation. Ceilings have been set for the net domestic assets of the Central Bank through June 1987 (Table 3) that are based on such a pattern of monetary growth. The Government considers that the demand for real money balances will increase as inflation continues to decline during the year and in order to ensure the achievement of the objectives of the program the Government will keep monetary policy under review.

13. The Government is committed to reducing the costs of financial *intermediation in Argentina*. In October 1986, the Central Bank introduced major changes in financial regulations, including a marked reduction in marginal reserve requirements on nonregulated deposits, to enable banks to compete on a sounder footing with the interfirm financial market. In order to consolidate the gains made in this area, the Government considers that it will be necessary to continue making efforts to limit rediscounts and the monetary authorities will seek to lower reserve requirements further in accordance with credit and monetary objectives. In addition, the Central Bank is developing an information system on the repayment schedule of rediscounts and in the near future will be able to outline a medium-term path for credit assistance consistent with the overall monetary plan.

14. An objective of monetary policy in 1987 will be to manage interest rates flexibly so that financial saving is encouraged and credit is allocated efficiently. The share of nonregulated interest rate deposits in total interest bearing deposits increased from 24 percent in June 1985 to 57 percent in October 1986, and it is the intention of the Government to consolidate this trend. At the same time, the Central Bank will set regulated interest rates at realistic levels. With the pickup in inflation beginning in the early part of 1986, regulated deposit rates were negative in real terms from April to October 1986; in mid-October the 30-day regulated deposit rate was increased from 4 1/2 percent a month to 5 1/2 percent, and was positive in real terms in November and December. The Central Bank is committed to ensuring 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 increase in consumer and wholesale prices) by more than 5 percent of the monthly inflation rate (less than 1/4 percentage point at present rates of inflation) and that regulated lending rates will be moderately positive in real terms.

15. In the Government's view, price and wage guidelines have proven to be useful in affecting price expectations. However, they can be used only as a temporary instrument in the effort to reduce and control inflation. As the rate of inflation comes down and inflationary expectations improve, the Government intends to reduce progressively the existing wage and price restraints. In the interim, however, the Government will continue to apply price restraints and guidelines as well as to set upper and lower boundaries for the wage increases to be negotiated between firms and unions in the private sector. For the first quarter of 1987, a range of 7-11 percent has been established for private sector wage settlements and an additional increase of 2 percent can be negotiated at the level of individual firms. Under the system of price controls, only a 9 percent wage increase can be transferred to prices in the first quarter of 1987, and wage settlements above this figure will need to be related to increases in labor productivity. The Administration has submitted to Congress a draft law in order to provide the legal framework for collective bargaining.

16. In May 1986 the Government replaced the price freeze that had been in place since June 1985 by a system of administered prices under which firms were allowed to raise prices when justified by authorized increases in costs. Following the surge of inflation in July and August 1986 the Government began setting guidelines for the increase in prices of most industrial companies, including small firms. Nevertheless, throughout the period since June 1985 price controls have been administered flexibly, and the prices of a number of items including agricultural products and personal services have not been subject to restraints. As a result, no shortages of goods have occurred. The authorities recognize that a greater degree of flexibility is desirable but the relaxation of controls must be implemented in such a way as to avoid an upsurge in inflation. It is the intention of the Government to carry out a selective policy of reducing price regulations for those sectors that already face a high degree of competition.



17. The Government is committed to a policy of strengthening Argentina's balance of payments over the medium term. In order to reconcile this objective with that of sustaining economic growth, primary emphasis is to be placed on policies aimed at promoting exports. To this end, in April 1986 the Government moved to a system of small frequent adjustments in the exchange rate to ensure that Argentina's international competitive position be maintained. Also, over the past several months export taxes have been substantially reduced, an export rebate scheme and a guaranteed real exchange rate for industrial exports with long-term delivery contracts were introduced, and a comprehensive temporary admission program for the export sector has been put in place. The adequacy of the real effective exchange rate will be kept under consideration so as to ensure an appropriate degree of competitiveness and the achievement of the balance of payments objectives of the program.

18. The external current account deficit widened from US\$950 million in 1985 to US\$2,650 million in 1986. Exports dropped sharply owing to a fall in the world prices of Argentina's agricultural exports and the damage to crops inflicted by extensive flooding in November 1985; imports rose strongly reflecting the increase in domestic activity. The combined effect on the trade balance more than offset the decline in interest payments resulting from lower international interest rates. The capital account improved only slightly in 1986, and the overall deficit increased from US\$550 million in 1985 to about US\$2 billion in 1986. Despite the projection of a further decline in agricultural prices on world markets from 1986 to 1987, the Government's economic program, including the measures that have been adopted to boost industrial exports, is expected to result in a reduction of the external current account deficit to US\$ 2.2 billion in 1987. Moreover, the financial policies that are planned are expected to result in continued net capital inflows. On this basis, the Government has targeted an overall balance of payments deficit of US\$ 1.7 billion in 1987. Consistent with this objective, quarterly targets have been established for net international reserves for the period through the end of 1987, as set forth in Table 4.

19. In the latter part of 1986, administrative problems were encountered in the clearing of external payments arrears, including those under the 1985 Paris Club agreement, and at the end of 1986 arrears amounted to US\$500 million. The Government intends to eliminate external payments arrears by June 15, 1987, and is committed to avoid incurring new arrears. Moreover, by June 15, 1987 the Government will issue the decree authorizing the transfer abroad of profits and dividends for operations relating to fiscal years closed after June 30, 1986.

20. In September 1986 the Government introduced a plan under which payments equivalent to 10 to 15 percent of the f.o.b. value of industrial exports are made to exporters, to effect a refund of indirect taxes incurred on average in the production process. The refund of indirect

taxes is a practice common to many countries, and the rebate system adopted by the Government will enable Argentine producers of industrial products to compete more effectively in world markets. The Government considers that signals to exporters coming from Government policies should not be subject to frequent changes and therefore does not intend to change the scope of this program.

21. The proportion of imports included in the automatic licensing regime relative to a base period July 1, 1981 to June 30, 1982 was raised from 58 percent to 63 percent in July 1985, and this proportion was increased to 73 percent in January 1986. It is the intention of the Government to raise this proportion in the period of the requested stand-by arrangement. At present the Government is negotiating with the World Bank a trade policy loan to support a program of trade liberalization. The Government already has included 3,700 import items (out of a total of 11,500 items) in the temporary import regime under which imports of inputs for export production are permitted into the country duty free, and in the first half of 1987 the Government intends to increase the number of items included in this program to 6,000 items. The Government also intends to simplify administrative procedures for exports and imports and to this end has reduced administrative costs by eliminating the requirement of presenting a formal declaration of import need for items subject to automatic licensing. For goods that remain subject to prior study, the authorities plan to shorten significantly the period of review. The measures that the Government will take in the area of commercial policy will be considered on the occasion of the review under the stand-by arrangement that is to take place in the second quarter of 1987.

22. Exceptional financing will be required in 1987 from official and private creditors in order to finance the projected balance of payments deficit, as well as to provide for a replenishment of the Central Bank's international reserves. The Government intends to negotiate with the Paris Club the rescheduling of all medium- and long-term debt service payments that fell due in 1986 and further maturities. The Government also will seek to reach as soon as possible agreement with its creditor banks on the multiyear rescheduling of maturities that fell due in 1986 and that become due over coming years.

23. Argentina's total external debt, including obligations to the Fund, would increase by about US\$2.7 billion in 1987 to an estimated level of US\$51.5 billion by the end of the year. This would represent an increase of 6 1/2 percent over a two-year period with respect to the level of Argentina's external debt outstanding at the end of 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 through the end of 1987. These limits are presented in Table 5.

24. The Argentine Government considers that the fall in international agricultural prices observed since the beginning of this decade constitutes an element of major concern as it results in a deterioration

in the country's export and growth performance. The effect of the decline in export prices included in the projected balance of payments for 1987 has been taken into account in the request for financing under the compensatory financing facility to be considered jointly with the requested stand-by arrangement. On the basis of recent developments in the spot and future markets for Argentina's agricultural exports, it is not expected that Argentina's export prices in 1987 will deviate significantly from those underlying the balance of payments projection. However, if prices were to fall below those projected in the program, Argentina will request additional resources under the compensatory financing facility. In the review foreseen for June 1987, developments in Argentina's export prices also will be considered in establishing the performance criteria for the rest of the period of the stand-by arrangement.

25. The Argentine authorities consider that sustained growth of output and investment constitutes an essential element of their economic policy, and that such growth is necessary to facilitate the servicing of the external debt. The authorities are of the view that the program that has been adopted will help to achieve the growth that has been projected. However if in June, at the time of the review under the stand-by arrangement, there should be indications that the rate of growth differs significantly from the one projected, actions will be taken, if necessary, to foster productive private and public investment and the need for adjusting the targets for the rest of the program period will be reviewed accordingly. Also, in such circumstances the Government would request advances in the disbursements of approved loans from multilateral development and bilateral sources.

26. Before the end of June 1987, the Government will review with the Fund the progress made in implementing its economic program in order to reach understandings, if necessary, on additional measures to ensure the attainment of the program's objectives. In the context of the review, understandings will be reached on the setting of limits for the remainder of the period of the stand-by arrangement for the variables referred to in paragraphs 11, 12, 18, and 23 above.

Table 1. Argentina: Public Sector Operations

(As percentage of GDP)

	Cash Operations of the Nonfinancial Public Sector			Operating Losses of Central Bank	Combined Deficit
	Revenue	Expenditure	Deficit		
1984	22.9	31.2	-8.3	-2.5	-10.8
1985	27.3	31.4	-4.1	-2.2	-6.3
1986	27.4	29.4	-2.0	-1.6	-3.6
1987	29.0	30.0	-1.0	-1.5	-2.5
<u>1986</u>					
I	26.6	28.9	-2.3	-1.6	-4.9
II	28.4	29.3	-0.9	-1.3	-2.2
III	27.8	28.2	-0.4	-1.3	-1.7
IV	27.0	30.9	-3.9	-2.1	-6.0
<u>1987</u>					
I	26.2	28.1	-1.9	-2.3	-4.2
II	28.6	30.8	-2.2	-1.5	-3.7
III	28.9	28.9	-0.1	-1.5	-1.6
IV	31.6	31.7	-0.1	-0.9	-1.0

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)

Period	Cash Deficit of the Nonfinancial Public Sector	Combined Deficit of the Nonfinancial Public Sector and the Central Bank	Treasury Outlays
January-March 1987	500	1,120	3,570
January-June 1987	1,150	2,220	7,700

Table 3. Argentina: Targets for Change since December 1986  
in the Net Domestic Assets of the Central Bank 1/

(In millions of australes)

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January-March 1987	900
January-June 1987	1,800

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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 projected average exchange rate for each quarter 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. Targets have been set on the basis of estimated M-1 for December 1986, and will be adjusted to allow for the difference between the preliminary and the definitive estimate of M-1, once the definitive estimate is available.

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 1987	-500
January-June 1987	-800
January-September 1987	-1,150
January-December 1987	-1,680

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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 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>	40,500
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/ Data on disbursements of external debt that will be used for the monitoring of external debt developments will originate from a Comprehensive Debt Reporting System.

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.