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To: Members of the Executive Board

From: The Secretary

Subject: Argentina - Staff Report for the 1981 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1981 Article IV consultation with Argentina. A draft decision appears on pages 19 and 20.

This subject has been tentatively scheduled for discussion on Wednesday, December 16, 1981.

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ARGENTINA

Staff Report for the 1981 Article IV Consultation

Prepared by the Western Hemisphere Department

(In consultation with the Exchange and Trade, Research, Legal, and Treasurer's Departments)

Approved by E. Walter Robichek and Manuel Guitian

December 1, 1981

I. Introduction

The 1981 Article IV consultation discussions with Argentina were conducted in Buenos Aires in the period August 27-September 16, 1981. The representatives of Argentina in these discussions included the Ministers of Economy, Treasury, and Finance; Agriculture and Livestock; Commerce and Maritime Interests; Industry and Mines; Labor, and Public Works and Services; the President and senior officials of the Central Bank; and the presidents or chief executive officers of the largest public enterprises. The staff representatives were C. Brachet (Head-WHD), M. Blejer (RES), L. Perez (ETR), H. Puentes (EXR), J. Sundgren (WHD), and Ms. Snell (WHD) as secretary. Mr. Iarezza, Executive Director for Argentina, participated in the first and last weeks of discussions.

II. Background to the Discussions

The Government which took office in April 1976 was faced with acute financial imbalances and declining output. In its five years in office, it endeavored to steer the economy on to a path of sustainable recovery and financial stability. The results of these efforts were inconclusive and severe imbalances began to surface again in mid-1980. Following the installation of a new administration on April 1, 1981, efforts to adjust the economy were renewed from the second quarter of this year.

The immediate objectives of the strategy framed in mid-1976 were to redress the balance of payments situation and to rein in an inflation then running at an annual rate of 800 per cent. For these purposes, the authorities sought an early and radical reduction of the public sector deficit, reduced subsidies and other causes of distortions in relative prices, moved toward a unified and flexible exchange rate regime, eliminated exchange restrictions, and liberalized the financial system.

In the period through the end of 1978, marked progress was made in strengthening the balance of payments. A sharp turnaround in the current account and sizable official capital inflows raised net official international reserves from a negative US$0.6 billion at the end of March 1976 to a positive US$5 billion at the end of 1978. However, after some initial progress, control over aggregate demand tended to weaken, and pressures on resources remained substantial. Inflation hovered around 170 per cent a year in both 1977 and 1978. Domestic output recovered in 1977 from the 1975-76 downturn, but this gain was partially erased by a recession in 1978.

These uneven results prompted the authorities to alter fundamentally their strategy toward the end of 1978. Priority henceforth was to be given to curbing inflation, primarily through the opening of the goods and capital markets to foreign competition and abandonment of the crawling peg in favor of the announcement of exchange rate changes several months in advance. The new strategy also involved a gradual reduction of import tariffs; the preannouncement of public sector tariff and minimum wage adjustments; the curtailment of the public sector's borrowing needs; and the setting of targets for monetary expansion of domestic origin.

As it turned out, the planned reduction in the borrowing requirements of the public sector failed to materialize, with the deficit remaining at almost 7 per cent of GDP in 1979 and widening in 1980. As a consequence, the external public debt rose sharply between 1978 and 1980, to an estimated US$14-1/2 billion, and pressures on domestic resources remained strong. Meanwhile, the reduction in exchange rate risk entailed in the preannouncement of exchange rate changes, together with the large interest rate differential in favor of Argentina, triggered sizable private capital inflows, especially in 1979. These inflows allowed the domestic commercial banks to expand credit to the private sector very strongly and, in the process, several financial institutions overextended themselves. This prompted Central Bank intervention of a number of institutions beginning in March 1980. Confidence dwindled; there was a run on bank deposits and very large capital flight. The Central Bank was forced to honor existing government guarantees of bank deposits (and to extend the scope of this guarantee scheme), and eventually introduced a special rediscount line to assist banks facing deposit withdrawals, which resulted in a sharp expansion of Central Bank credit in 1980.

In these circumstances, the moderation of domestic demand pressures fell well short of official forecasts; hence, the sharp deceleration of currency depreciation implicit in the announced exchange rate schedule proved to have been overly ambitious and resulted in a marked real appreciation of the peso. This appreciation, together with the reduction of external protection and steadily rising real domestic interest rates, caused growing difficulties for industries engaged in the production of tradeables. Agriculture faced an additional problem in that adverse weather conditions resulted in generally poor crops. The strong rebound of real GDP growth in 1979 therefore was shortlived, and was followed by increasing sluggishness in economic activity in 1980 and early 1981.

But, in contrast with the previous three years, demand was diverted increasingly into imports, reflecting the reduction of protection and, as time passed, the appreciation of the peso. The current account of the balance of payments shifted from a surplus in 1977-78 to a deficit equivalent to 3-1/2 per cent of GDP in 1980. Despite heavy official foreign borrowing, the accumulation of international reserves slowed down toward the latter part of 1979, and was followed by a loss of US$5 billion over the 15-month period ending March 1981 as high domestic interest rates failed to stem the capital flight triggered by the threat of bank failures and growing uncertainty about the viability of the announced exchange rate schedule.

Confidence also was affected adversely by the length of the transition from the outgoing to the incoming Administration (from October 1980 to March 1981), which tended to compound expectations of a possible large devaluation of the peso once the new administration was installed. These expectations were reinforced by the outgoing Administration's handling of exchange rate policy--when it departed from the announced schedule in October and December 1980, and again in February 1981.

III. Argentine Economic Policies and Prospects

The authorities who took office in April 1981 were faced with a difficult task. Signs of a recession were mounting in industry, construction, and commerce; confidence in the financial system remained low as several banks continued in precarious conditions; and the public sector deficit once more was turning critical. In view of the real appreciation of the peso, prospects were for a large current account balance of payments deficit. The outlook was for an even larger overall deficit, because of continued capital flight, limited official capital inflows, and amortization payments on the external debt (public and private) amounting to just about one half of the total debt outstanding at the end of 1980. The net official international reserves were still at a comfortable level--about four months of 1981 imports at the rate then projected--but they were declining rapidly and were less than one half those of six months earlier.

1. The April-June 1981 adjustment measures

The new administration assigned first priority to redressing the balance of payments and to setting the stage for a progressive revival of the economy. On April 2, 1981, the peso was devalued--in terms of U.S. cents per peso--by about 23 per cent, and by a further 7 per cent over the course of the following two months, as the authorities resumed the crawling peg policy abandoned in late 1978. In the area of public finances, the deficits of the Treasury and of the overall public sector were to be held to within the limits set by the original budget; taxes on certain exports were introduced on a temporary basis, and some excise taxes and customs duties were raised, to help ensure adherence to these targets. The authorities also announced that public sector tariffs would be adjusted monthly through the end of 1981. On the spending side, all categories of expenditures other than salaries were to be frozen at their budgeted levels--a measure that was expected to result in an 8-1/2 per cent reduction in real terms in public sector outlays. At the same time, in an attempt to provide relief to the private sector, the Central Bank established a special rediscount facility for debt consolidation in industry and agriculture.

There was some reflow of funds to Argentina in the immediate aftermath of these measures, with the net international reserves of the Central Bank recovering by US$1-1/2 billion in the subsequent three weeks. But the tide turned again in late April, and the Central Bank lost US$1 billion through the end of May. The announced fiscal measures were judged insufficient to ensure adherence to the original budget, while the exchange rate adjustment was viewed as falling short of that needed to restore competitiveness to domestic industries. Another major devaluation, therefore, came to be widely expected.

The run on the peso continued in May, reaching US$350 million on May 29 alone. The foreign exchange market eventually had to be closed and, on June 2, the peso was devalued by another 23 per cent. Although no formal exchange controls were established, administrative procedures for sales of foreign exchange were tightened somewhat. At the same time, it was announced that, subject to certain conditions, firms with foreign debts contracted during January 1-May 29, 1981 would be compensated for the increased peso cost of their foreign liabilities resulting from the devaluation. 1/

Not even these measures succeeded in calming the situation, with capital flight resuming after a few days and confidence falling to a low ebb. The combination of a 53 per cent cumulative exchange rate depreciation since the beginning of the year, of a new round of wage adjustments in June-July and of sharply accelerating inflation rendered the original nominal fiscal targets increasingly unrealistic. Domestic interest rates skyrocketed to over 15 per cent a month, adding to the recessionary trends and to rising unemployment.

On June 22, 1981 the foreign exchange market was split. In the commercial market, which covers most trade and certain capital transactions, the peso would continue to be depreciated daily and about in line with domestic inflation. In the financial market, which covers all other transactions, the peso in principle would float freely. The splitting of the exchange market was accompanied by a shortening of the maximum period for surrender of export earnings, and by a lengthening to 180 days of the minimum delay for import payments through the commercial exchange market. (This latter measure subsequently was rescinded for certain imports, including all those from the LAIA area; and it was announced that it would be eliminated altogether in early 1982.)

1/ For a description of the devaluation compensation mechanism, see Section IV, subsection 1, in the accompanying report on recent economic developments.

2. External policies and the strategy for economic recovery

There was some instability in the financial market in the weeks which followed the splitting of the exchange system, but from mid-August exchange market developments became more orderly. The financial rate settled in the range of $a 7,300-7,600 per U.S. dollar, with a slight tendency toward appreciation being counteracted by moderate intervention on the part of the state-owned Banco de la Nacion. The authorities felt encouraged by this relative calm, viewing it as an indication that capital flight had been stemmed, and possibly even reversed.

Meanwhile, the commercial exchange rate was being depreciated about in line with domestic inflation, and since August, slightly ahead of the increase in consumer prices. Concern was with Argentina's international competitiveness and particularly with the promotion of exports, on which the authorities counted heavily to pull Argentina out of the recession. The commercial exchange rate was $a 5,807 per U.S. dollar at the end of September 1981, representing a 191 per cent peso depreciation (in terms of pesos per U.S. dollar) since the beginning of the year, compared with an 87 per cent increase in consumer prices in the same period. But the authorities recognized the costs of the dual exchange market in terms of resource allocation and confidence--there was much smuggling across the borders and under/overinvoicing had become widespread. Accordingly, their intention was to strive for a unified rate before long, although the reunification procedure had not been decided yet. A progressive shift of transactions from one market to the other was one possibility, and another was a gradual converging of the rates in the two markets. Exchange rate policy after reunification would be dictated by circumstances, the choice being between a managed float and a crawling peg at about the rate of differential inflation between Argentina and the rest of the world.

The authorities were satisfied that the exchange rate corrections and the restoration of flexibility to exchange rate management had brought about the desired turnaround in the balance of payments. The trade balance had moved into a surplus from May 1981, following a deficit of US$2.5 billion in 1980 and one of US$520 million in the first quarter of the year; and prospects for the year as a whole were for a trade surplus in excess of US$1 billion. The high interest cost of the external debt nevertheless was expected to leave the current account deficit at over US$2-1/2 billion (about 1-1/2 per cent of GDP), but such a deficit would be barely more than one half of that recorded last year. Capital flows, negative during the first quarter of the year, were expected to turn slightly positive for the year as a whole as net recourse to medium-term Eurofinancing was resumed at a modest pace after an interruption of almost six months, and short-term private capital outflows seemed to have yielded to small-scale repatriation. On these indications, the overall balance of payments deficit was projected at US$2.2 billion, which would represent a surplus of about one half billion dollars in the second half of the year, and an improvement of similar magnitude over 1980.

The sharp turnaround in the trade account in the second half of 1981 and the large trade surplus in prospect for 1982 reflected in part the recession induced drop in import demand and a gradual drawdown of the large inventories of imported goods accumulated before last April. But, the authorities also expected exports to grow strongly in response to the major improvement in the prices of tradeables relative to those of nontradeables.

The immediate beneficiary of the exchange rate correction would be the agricultural and livestock sectors. Although Argentina's grain crop had reached an unprecedented 36 million tons during the 1980/81 crop cycle because of favorable weather in 1980 and strong world demand, indications were that farmers had been encouraged by the exchange rate changes to expand further the planted acreage for the next crop cycle. Barring inclement weather in the next few weeks, production and exports therefore were projected to rise by another 3 to 4 million tons in 1981/82, which would more than compensate for somewhat softer export prices. Exports of manufactures, which had remained about level in nominal terms over the last two years, had begun to show signs of recovery in the second half of 1981; and the authorities were hopeful of large gains in this export category in 1982. To support this export recovery, they recently had liberalized the export prefinancing and financing schemes for promoted exports. Also, there was a possibility that a special export promotion fund could soon be established under the aegis of the Central Bank. Meanwhile, they had expanded the scope of the tax rebate regimes (reembolsos and reintegros) and were considering their replacement by automatic full reimbursement of indirect taxes paid in the production process--at least to the extent permitted by the GATT's Subsidy and Countervailing Duty Code.

The authorities foresaw that imports, which had increased at an average of 66 per cent a year (in U.S. dollar terms) during 1979-80, but were almost certain to decline in 1981, would resume their growth next year as domestic economic activity recovered--although at a rate that would not impose on industries and on the labor market the severe hardships suffered in 1979-80. It was in this context that the authorities wished the suspension from April 2, 1981 of the previous administration's program of import duty reductions to be viewed. They noted that the relative price distortions set in motion by the real appreciation of the peso had greatly compounded the difficulties of a corporate sector already forced to adjust to increased foreign competition by the reduction of protection. The principle of the trade liberalization process was not at issue, they emphasized, but a pause in this process was indicated until such time as this year's exchange rate corrections had worked their way through the economy. There was a consensus on the need to continue improving efficiency in industry and on promoting a strong export sector, but views diverged on the speed at which tariff reductions should be resumed; on whether to move toward a unified import tariff or a graduated one, with retention of special regimes as now existed for the automotive sector; and on the level at which either a unified or the average of a graduated tariff eventually should be established. The Ministry of Industry now was proceeding with further studies and no decision on tariff policy would be taken before the end of the first quarter of 1982, at the earliest.

This year's developments in the capital account of the balance of payments also reflected the special circumstances of 1981, the authorities stressed. They were not concerned with the level of the external debt which, at a projected US$30 billion at the end of December 1981,1/ or 23 per cent of GDP, they considered to be quite manageable. What did concern them was its excessive concentration in short maturity ranges, a result of heavy official short-term borrowing abroad between August 1980 and March 1981 to prop up the official international reserve position, and of extensive private sector reliance on foreign financing in the last two years in consideration of more favorable interest costs than for borrowing in the domestic market. Accordingly, efforts since April had concentrated on lengthening the maturity profile of the external debt.

In the case of private foreign debt, this lengthening had been pursued by extending an exchange guarantee to loans renewed on or after June 2, 1981 for at least 540 days--and since last September, to refinancing loans with maturities of up to three years provided such loans were registered with the Central Bank and the proceeds surrendered at the commercial exchange rate.2/3/ In the case of official foreign debt the maturity transformation had been pursued first by a roll-over of short-term claims and, since mid-August, by tapping again the Eurodollar market for medium-term loans, most of them for debt consolidation purposes. It was the authorities' intention to continue substituting medium- for short-term loans, while also seeking a reduction in spreads.

On the subject of the magnitude of new foreign borrowing over and above debt amortization payments, the authorities noted that it would have to be aligned with the desired deceleration of nominal demand growth. They argued that Argentina tended to generate a high level of domestic savings, and the capital investment required to support an appropriate rate of economic growth in all likelihood would not require significant additions to the real stock of external debt.

1/ US$17 billion public and US$13 billion private, including short term.
2/ For a discussion of the mechanism of these exchange guarantees, see the report on recent economic developments Section IV, subsection 1, and Appendix C.
3/ By September 1981, some US$3 billion of private foreign loans had been brought under this guarantee scheme.

3. Incomes policy

The authorities ascribed part of the difficulties now being experienced by industries to the size of wage adjustments since late 1978. Although Argentina's real income had barely increased during 1979-80, wages had increased sharply in real terms. Despite significant gains in productivity made possible by a pruning of the redundant work force, unit labor costs had risen by an annual average of 144 per cent in peso terms, and by 59 per cent in terms of U.S. dollars. These wage increases not only had resulted in a major loss of competitiveness to the economy but also in an unsustainable redistribution of factor remuneration and the consequent decapitalization of domestic industry; they also had fueled fiscal imbalances. The authorities suggested that the employment effect of these real wage increases had been concealed by a marked increase in self-employment, which implied substantial underemployment.

With the adjustment now underway, the authorities believed a drop in real wages and salaries as well as some increase in open unemployment to be unavoidable. Assuming a 127 per cent December-on-December inflation during 1981, real public sector salaries were expected to decline by 12 to 23 per cent over the course of the year as nominal adjustments were being kept deliberately below the inflation rate. In the private sector, the authorities intended to continue determining the minimum wage (salarios minimos) and the basic contractual wage (salario basico de convenio). These were expected to rise by 114 per cent over the course of 1981 (for a 6 per cent projected decline in real terms). Minimum and basic contractual wages, however, only apply to a small fraction of the work force, and most wages and salaries have been determined by contractual agreement since 1979--with the increases generally exceeding the government-decreed minimum adjustments. Minimum and basic contractual wage adjustments therefore underestimated actual changes in labor remuneration through 1980, while they tended to overstate them in 1981. Actually, independent surveys indicated that average real wages and salaries had declined by some 18 per cent in the first eight months of this year.

No decision had been made yet on incomes policy for 1982. The highest priority was to be given to reducing unemployment, currently estimated at over 5 per cent. Although the authorities hoped that such reduction would follow from the expected revival of the economy, they realized that a return to fuller industrial capacity utilization would not necessarily translate into a marked increase in job creation. In fact, several industries had held onto more workers than they needed because of the expectation that the recession would be of short duration and of the high cost of layoffs. Moreover, the highly competitive conditions under which industry had operated in 1979-80 had resulted in a major trimming of industrial establishments, and the recovery of a leaner and more efficient industrial sector would no longer offer as many employment opportunities as in the past, except by expanding into new areas such as fishing and fish processing. Finally, unemployment now was highest among the self-employed, whose ranks had swollen with the pruning of inefficient industries; and it was this sector which would react most slowly to the resumption of economic growth. Open unemployment thus was unlikely to fall rapidly to the low rate of 2 per cent of the labor force which had prevailed over the last few years.

4. Domestic demand management

The authorities acknowledged that the exchange rate corrections performed since last April would result in a significant acceleration in this year's rate of inflation. Consumer prices had advanced at an average monthly rate of 9 per cent during April-August, up from 5 per cent during the first quarter of the year; wholesale prices had risen even faster, reflecting the higher weight of tradeables in that index. The acceleration of inflation, however, also could be traced to (1) a far more severe deterioration in the public finances than had been anticipated and (2) to a lesser extent, a relaxation of credit restraint in recognition of the private sector's very fragile financial position at the time the new Administration had taken office. Nevertheless, it was hoped that the public sector's borrowing needs could be kept to around 9-1/3 per cent of GDP 1/ and that, with a programed 100 per cent monetary expansion in 1981, domestic inflation could be kept this year to an average of around 105 per cent.

a. Fiscal policy

The authorities recalled that they had assumed office after a first quarter during which fiscal developments had fallen considerably short of budget forecasts--with the overall deficit of the public sector reaching the equivalent of 6 per cent of GDP at an annual rate. 2/ Although the high level of expenditure accounted for part of this deterioration, its principal cause was the slow growth of revenue. The incoming administration had been aware that the budget it had inherited had been based on rather unrealistic assumptions (such as a rate of real income growth of 5 per cent and a 50 per cent average increase in prices), but it had nonetheless decided to abide by it (except for the wage bill) so as to avoid a reopening of discussions about the allocation of expenditure. Moreover, the temporary acceleration of inflation associated with the April 2 exchange rate adjustment was, inter alia, viewed as a means of achieving some real reduction in public spending.

Adherence to the original budget objectives, however, soon had proved beyond reach. The June rounds of exchange rate corrections, with their impact on inflation and interest rates, had called for a thorough

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1/ Equivalent to a deficit of 5.7 per cent of GDP in the Argentine definition. In the definition of the deficit used in Argentina, interest payments deemed to be amortization are treated below the line.

2/ Four per cent in the Argentine definition. The original budget envisaged a deficit equivalent to 5 per cent of GDP in 1981 (2.9 per cent in the Argentine definition).

review of original assumptions regarding prices, public sector tariffs, wages, and interest costs. Also, there was a continued sharp decline of revenue in real terms, a reflection of the deepening recession and of increasing tax avoidance as rumors spread of the impending adoption of a national tax deferment plan (along the lines of those already implemented by certain provincial governments); such a plan, applicable to national tax liabilities outstanding at the end of March 1981, in fact was approved in mid-September. Moreover, the Treasury had been forced to engage in large transfers to state banks as well as to the rest of the public sector--partly to bail out official provincial banks nearing bankruptcy and partly to provide relief to regional economies judged to have been hit particularly hard by the previous overvaluation of the peso. Because of all these developments the Treasury's financing needs had continued to widen at an accelerating rate, reaching 45 per cent of expenditure in the first seven months of the year; and indications were that because of lags in the adjustment of state enterprises' tariffs and prices through May the financial position of the entire public sector also had deteriorated rapidly.1/

A number of measures had been taken since April-May to arrest these trends, and these had been embodied in a revised draft budget submitted for the consideration of the Legislative Advisory Council (CAL) in September. The revised budget called for a reduction in total public sector expenditure in 1981 to 34-1/3 per cent of GDP, one of more than 2 percentage points. The bulk of this reduction was to affect current government spending, by compressing nonwage expenditure in line with the fiscal plans of April and by reducing real public sector salaries in accordance with the decision to keep wage adjustments below the rate of inflation during August-December. Capital outlays also were to decline slightly in relation to GDP, a reflection of last April's decision to slash the equivalent of some US$1 billion from the original investment budget.

On the revenue side, a decision had been to recoup the losses in real public sector tariffs and prices experienced in the 29 months through May 1981 by adjusting them faster than the rate of domestic inflation through the end of the year. Accordingly, for the year as a whole, public enterprises' savings were projected to recover slightly from their level in 1980, to 2-2/3 per cent of GDP. In contrast, the authorities took the view that the depressed condition of the economy did not allow for any significant tax effort other than improvements in tax administration. In fact, the export taxes introduced in early April, in some cases for a duration of up to 12 to 18 months, already had been eliminated. The attendant revenue loss, together with the

1/ In Argentina, the Treasury accounts for less than 25 per cent of total general government revenue--and 22 per cent of all public sector revenue with the inclusion of the current account surplus of the public enterprises--while, because of its large transfers to the rest of the public sector, it incurs some 60 to 70 per cent of the overall public sector's borrowing requirements.

impact of the recession, the liberal granting of tax rebates to exporters, and the 20-month stretch-out from October of settlement of tax liabilities outstanding at the end of March 1981, in all likelihood would cause this year's total government revenue to fall to 22-1/3 per cent of GDP, 4-1/2 percentage points less than in 1980.

The authorities did not disguise their concern with fiscal prospects for 1981; but they saw it as the unavoidable result of past policies, and one that was not susceptible to corrective action short of imposing intolerable hardships on an economy already undergoing adjustment and experiencing a severe recession. However, they stressed their determination to seek a marked strengthening of the public finances in 1982 and beyond, and to reduce progressively the participation of the state in the economy.

Although work on the 1982 budget did not begin until early October, the intention was to keep the public sector deficit next year to around 5 per cent of GDP 1/ and to less than 3 per cent 2/ in 1983 and 1984. The bulk of the reduction in next year's deficit was predicated on a strong rebound of revenue. The authorities noted that Argentina's tax system relied heavily on transaction and import taxes. The gradual recovery of industrial and commercial activities, as well as the attendant increase in import demand, therefore would automatically yield several percentage points of GDP in additional tax receipts. Also, next year's tax collections would benefit from the settlement of the deferred tax liabilities outstanding on March 31, 1981. In addition, certain measures that would help boost revenue were under consideration or already had been adopted. Tax avoidance was being fought with increased vigor; administration of the value-added tax was being simplified by concentrating controls at the level of wholesalers, who also would act as withholding agents for retail trade--thus obviating the need for controlling some 120,000 retail establishments. Still, other emergency measures also would be kept in reserve should revenue collections fall short of expectations. Finally, public sector tariffs would no longer be allowed to lag behind inflation, unless the state enterprises' operating surpluses could be raised through productivity gains.

In this discussion of fiscal prospects, the staff observed that (i) the tax system had proved to be somewhat inelastic, with collections tending to lag behind prices in periods of accelerating inflation; (ii) the generous extension of tax rebates to exporters might result in some erosion of the tax base; (iii) the extent and speed of the recovery remained uncertain; (iv) there was growing resistance in Argentina to an increase in the tax burden; and (v) expectations were influenced to a high degree by evidence--or lack thereof--of an effort to reduce real public sector spending.

1/ Two per cent of GDP in the Argentine definition.

2/ Equivalent to approximate balance in the Argentine definition.

In response, the authorities noted that they were determined not to allow expenditure, in relation to GDP, to rise above its level in 1981. They said that a consensus had developed in recent months on the need to raise efficiency in public enterprises and to lower the cost of government to the economy by reducing the size of the public sector. Two commissions recently had been set up to review the conditions under which state activities could be auctioned off or farmed out to the private sector. Expectations were that this divestiture program would yield sizable economies in the years to come. The Government also hoped that private equity participation could be brought into firms marked for retention under state control. Finally, the authorities were attaching great importance to securing private sector participation in public investment projects through risk contracts (such as those already in use in the oil industry) or through concession agreements without government guarantee (such as for road or gas pipeline construction).

b. Monetary policy

The authorities remarked that the first half of the year had witnessed a significant acceleration of the income velocity of monetary and quasi-money liabilities to the private sector. Despite a 47 per cent increase in prices in this period, private claims on the financial system had risen by only 19 per cent, reflecting sizable capital flight. Money actually had declined in nominal terms. Central Bank credit expansion, mostly to the public sector (the sharp increase in rediscounts to the banking system of last April had been about offset by progressive upward adjustments in the legal reserve ratio), had been financed by use of its international reserves.

Given the need for major adjustments in relative prices and the fragility of the private sector's financial condition (private debt was mostly at 7 to 30 days and at high positive real rates), the authorities believed it unavoidable that credit policy should be somewhat accommodating in the early stages. In light of these objectives--and in addition to the fiscal incentives detailed earlier--a number of facilities were introduced over the course of April-September to alleviate the financial pressures on the private sector. For this purpose, the Central Bank allocated over $a 1 trillion to the National Development Bank (BANADE) and to the Banco de la Nacion. To capitalize the Mortgage Bank, the Bank's debt with the National Housing Fund (FONAVI) contracted during 1973-75 was cancelled. The emergency US$4 billion Central Bank rediscounting facility introduced last April was supplemented recently with a new seven-year debt consolidation scheme, at partially subsidized interest rates.1/ Special assistance also was granted to agriculture through the establishment, for three years, of a special five-year line of credit (indexed on the value of either

1/ For a description of the mechanism of the consolidation scheme, see Section IV, subsection 2 c., and Appendix C of the accompanying report on recent economic developments.

agricultural or livestock production) in the Banco de la Nacion for lending to farmers who undertook to maintain or expand the planted acreage above the level of 1980/81. It was to ensure parallelism with these local currency consolidation schemes, the authorities explained, that they also had undertaken to compensate for the cost of the devaluation to firms with an open foreign exchange position on June 2, 1981 and to extend exchange guarantees to new private sector foreign borrowing.

Intentions nevertheless were to maintain overall control over money growth and for this purpose the authorities announced in mid-August the details of their monetary program for 1981, as well as their targets for monetary expansion over the next three years. In this respect, the authorities stressed that the change in their approach to exchange rate policy implied a shift in monetary management from one where the Central Bank could control only the supply of domestic credit--as the quantity of money and interest rates interacted freely with the capital account of the balance of payments--to one where the monetary impact of the external sector in principle would be about neutral and where money growth would become the policy variable for regulating aggregate domestic expenditure. On present plans M-2 would grow by about 100 per cent in 1981, which, given the sharp acceleration of velocity in the first half of the year and subsequent deceleration from July, would be consistent with the projected rate of inflation of about 105 per cent. Slightly over one half of this monetary expansion would reflect financing of the public sector deficit and the monetary impact of Central Bank interest payments on certain types of bank reserve deposits (the so-called Interest Equalization Fund). The remainder would be accounted for by bank lending to the private sector which, even after taking account of the effects of the new special facilities, would increase only by some 45 per cent--or less than half as rapidly as money GDP growth.

The target for money growth in 1982 had been set at 66 per cent of the increase in monetary and quasi-monetary liabilities in 1981, and that for 1983 and 1984 at 70 per cent each of this same increase in the preceding year. Attainment of these targets, the authorities said, would be made possible by (i) the planned reduction in the public sector's borrowing requirements from 1982 on; and (ii) the shift from the present largely allocative approach to monetary policy to one concerned primarily with regulating the quantity of money--and indirectly its cost--through reliance on legal reserve requirements and open market operations. It was recognized in this connection that, however much warranted by circumstances, the special assistance schemes introduced in the course of this year had their drawbacks in terms of resource allocation and that their monetary impact would be far from negligible--even though this impact was difficult to quantify _ex ante_ 1/ because it depended on the behavior of domestic prices, domestic and foreign interest rates and exchange rate movements. The authorities,

1/ Except for the consolidation scheme, the cost of which was estimated at about \$a 250 billion a month.

nevertheless, remained confident that the expansion from this source could be accommodated without danger in their monetary program, if they succeeded in adhering to their fiscal targets for 1982-84. They were acutely aware that failure to abide by their fiscal plans either would entail renewed reserve losses or a rate of inflation much higher than planned. In either case, confidence would not recover, and interest rates would remain uncomfortably high, thereby affecting adversely the prospects for robust economic growth in 1982-86.

Finally, the authorities noted that an effective monetary policy required a major strengthening of Argentina's highly fragmented and fragile financial system, where 86 institutions had had to be liquidated since March 1980. Accordingly, measures recently had been adopted to facilitate an increase in these institutions' capital to liability ratio. In addition, the Government had under consideration a project for the "Standardization and Consolidation of Financial Entities" that would remove tax and legal impediments to the merging and restructuring of financial entities, and lower the fiscal and procedural costs of credit operations. In general, the authorities believed that the solution to the problems of banks with large frozen portfolios was either their purchase by foreign institutions or their mergers with stronger local banks. There was also a certain awareness of the incompatibility of the potential monetary expansion involved in honoring the deposit guarantees and/or in extending special assistance to banks threatened with insolvency with the monetary program.

5. Energy policies 1/

Argentina imports (net) the equivalent of about 10 per cent of its oil and natural gas needs. To eliminate this deficit, a major effort is under way to explore and develop untapped hydrocarbon resources, mainly in the extreme south of the country and on its southern continental shelf. Private risk capital has been associated with this effort through exploration and production contracts with the State Oil Company (YPF). Although results have been encouraging, Argentina's commercially recoverable oil reserves are barely equivalent to 13 years of production at current extraction rates. In the best of circumstances, they will fall to about 9 years by the end of the century, assuming approximate balance between domestic production and consumption during 1988-93 and some resumption of imports thereafter.

Accordingly, energy diversification and conservation will be given high priority in the years to come with a view to reducing Argentina's dependence on oil from 61 per cent of total domestic energy demand at present to two fifths by the year 2000. One avenue for lessening this dependence will be stepped up production and export of natural gas, which Argentina has in much greater abundance than crude oil. The

1/ Argentina's energy situation and prospects are reviewed in detail in Appendix A of the accompanying report on recent economic developments.

other will be to quadruple power generating capacity to 28,000 MW by the end of the century. To this effect, the energy plan relies heavily on the construction of hydroelectric plants and, to a more limited extent, of nuclear plants.1/ Expectations are that by the end of the century some two thirds of total electricity generation will be from hydraulic sources (compared with about one third in 1980), 10 per cent from nuclear sources (4 per cent at present), and 23 per cent from thermal sources (three fifths in 1980).

Investment requirements in the energy sector are estimated to range from US$110 billion to US$125 billion (in 1980 U.S. dollars) for the next 20 years, about one half of which would be earmarked for the hydropower sector. Total public sector participation, however, would not exceed 65 per cent, which presupposes heavy involvement of private capital.

Domestic energy prices, especially for petroleum derivatives, lagged significantly behind inflation in 1979-80. Since then, some ground has been regained. Prices of petroleum derivatives have been adjusted since July almost twice as rapidly as other public sector tariffs and prices. The authorities intend to continue with this policy which, along with technological improvements and a concerted education drive, should help promote energy conservation.

IV. Post Consultation Developments

The events of the two months since the completion of the consultation discussions, did not yet bear out the authorities' optimism regarding the definitive turnaround in Argentina's balance of payments position. After a period of relative stability in the financial exchange market, the rate started sliding rapidly, reaching close to $a 9,500 per U.S. dollar in early November. Indications are that the Central Bank initially tried to control this slide by intervening in the market, and it lost some US$300 million in the process. The Central Bank subsequently withdrew, but the loss of reserves in the preceding weeks adversely affected expectations and pressures on the financial rate intensified.

It is difficult to explain this sudden weakening of confidence, but it seems to have been related partly to (1) rumors that a large public sector deficit was in the offing for 1982 (following a preliminary round of discussions on next year's budget); (2) uncertainties regarding the size of the fine grain crop because of a prolonged drought in the main wheat growing areas followed by excessive rainfall shortly before harvest time; and (3) an easing of domestic interest rates because of a weakening of private loan demand at the same time that the

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1/ Argentina currently has one nuclear plant in operation. Construction of the second one is well advanced and work has just started on a third one.

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Central Bank was providing substantial financing to the Treasury. As a result of these developments, the spread between the financial and the commercial exchange rates has widened again to over 40 per cent, and plans for an early reunification of the exchange markets may have been set back somewhat. It is also uncertain whether the overall balance of payments improvement in 1981 will be as pronounced as the authorities anticipated last September. On present trends, it would not seem implausible that this year's balance of payments deficit will turn out to be of a magnitude about similar to that recorded in 1980, instead of being reduced by some US$0.5 billion as projected earlier.

At the same time, there are indications that trade policies are deviating increasingly from those pursued until last April. In mid-October the authorities decided to establish import reference prices for certain types of goods and to set import quotas in a few instances. Export tax rebates also were liberalized further for industrial goods.

These renewed balance of payments and exchange rate pressures may also reflect weaker incomes and financial policies than the authorities had planned to follow. Instead of continuing with the 5 per cent monthly wage adjustments planned for the period August-December, public sector wages were raised by 15 per cent in September, which may have a significant fiscal impact, and minimum wages and basic contractual wages in the private sector were adjusted by 25 per cent. Preliminary indications also suggest that tax revenue has continued to lag behind money income growth. Both the Treasury and overall public sector deficits in 1981, therefore, may turn out to be somewhat larger than envisaged in the revised budget.

V. Staff Appraisal and Proposed Decision

Since early 1976, when the economy was plagued by unusually severe imbalances, Argentina has been going through a series of stabilization efforts. The external position was strengthened greatly during 1977-78, but output growth was uneven and inflation, at around 170 per cent a year, remained the highest in the world.

To ensure that domestic price increases would fall gradually into line with those abroad, the adjustment strategy was revised substantially in late 1978. The main instruments of the new policy were the preannouncement of exchange rate changes, to be supported by the progressive opening of the economy to foreign competition and by firm domestic financial policies.

However, failure to bring both public spending and the public sector's borrowing requirement under control, together with heavy Central Bank credit expansion in the wake of the 1980 banking crisis, undermined the new strategy. Inflation, although subsiding from the rates registered in 1976-78, remained high; the real appreciation of the peso contributed to a decline in economic activity; and both the public and the private sectors borrowed heavily abroad on short terms and at increasing cost. The result was that major imbalances reappeared.

The Administration that took office in April 1981 was faced with a very difficult task. Most pressing of all was the need to deal with the external disequilibrium and to set the stage for a gradual revival of the economy. To a good extent, the adjustment of the balance of payments current account has been performed, reflecting the 191 per cent cumulative depreciation of the peso (in terms of pesos per U.S. dollar) during January-September (285 per cent if measured on the financial marrket rate) but also record coarse grain crops and a severe recession in the rest of the economy. Confidence has not been fully restored, however, and the capital account situation remains uncertain.

Developments in other areas also suggest that much remains to be done before Argentina can be deemed to be on the road to recovery and reasonable financial stability. Real GDP is likely to contract by 2 to 3 per cent this year, and inflation is virtually certain to exceed the 100 per cent mark once again. It is clear that Argentina cannot resume sustained growth until the general public is convinced that there exists a firm commitment to implement an appropriate set of adjustment policies and, in particular, to bring about a lasting reduction in the rate of price increases.

The area which requires the Government's most immediate attention is that of public finances. Despite a decline in real spending, the public sector's borrowing needs in 1981 officially are projected at 9-1/3 per cent of GDP 1/ owing to a sharp drop in revenue; and the possibility that the gap will be even higher cannot be ruled out. The authorities are hopeful that this deficit can be narrowed to around 5 per cent in 1982, 2/ on the assumptions that expenditure will remain unchanged in real terms and that there will be a strong rebound in tax collections. The authorities' intention to reduce the size of the public sector and to improve its efficiency are to be welcomed. But the staff would caution against an excessive reliance on an early spontaneous recovery of revenue to pre-1981 levels. The timing and strength of the expected economic recovery remain uncertain, and tax incentives accorded industry may well result in some erosion of the tax base. Also, there is strong resistance in Argentina to any increase in the tax burden, at least as long as this burden rests on as narrow a base as at present. Accordingly, the authorities would be wise to retain some maneuvering room on the expenditure side in the event that tax collections should fall short of expectations; and such maneuvering room is quite unlikely to be available in the absence of a considerable measure of wage restraint in public employment.

The current expansionary stance of monetary policy owes a great deal to the large borrowing requirements of the public sector, and it is to be hoped that the planned reduction of the deficit in 1982 will assist in slowing the rate of money growth. However, the staff would also wish to draw attention to the rather liberal credit stance adopted vis-a-vis the private sector. A certain preoccupation with consolidation of business debts undoubtedly was justified in the prevailing

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1/ Five and three quarters per cent in the Argentine definition.
2/ Two per cent in the Argentine definition.

circumstances, but the staff is inclined to question whether conditions warranted the potentially heavy subsidization involved in certain emergency schemes, including compensation for the June 2, 1981 exchange rate adjustment. Credit expansion to the private sector is likely to remain well below money GDP growth in 1981, but these schemes are likely to have a significant monetary impact beginning in the second half of 1982. If the authorities are to adhere to their monetary targets for the period 1982-84, they may well find it necessary to strive for even greater fiscal restraint than is presently contemplated.

No decision has yet been made on trade policy as it awaits the results of a review of Argentina's future industrial development strategy. Meanwhile, the trade liberalization program launched in late 1978 has been halted and even reversed to some extent when minimum import prices were established for certain goods and import quotas applied to others. The staff urges the authorities not to retrench from the original trade liberalization program lest the ground painfully gained in promoting industrial efficiency and weeding out noncompetitive activities be lost. Indeed, the staff would stress that the adoption of a more flexible exchange rate policy has opened up new maneuvering room for a decisive pursuit of the liberalization process toward its goals of strengthening the competitiveness of domestic industries, promoting the sustained growth of the nontraditional export sector, and assisting in the dampening of inflation. The staff also would want to make the point that appropriate exchange and tariff policies would obviate the need for the present set of fiscal incentives to exports. Aside from being a potential source of distortion in resource allocation, these incentives may contribute to an erosion of the tax base, which Argentina can scarcely afford.

Because of heavy foreign borrowing in late 1980-early 1981, partly to prop up the official international reserve position, the maturity profile of the external debt is patently unsatisfactory. The staff, therefore, agrees with the emphasis the authorities are giving to restructuring the external debt. The staff also would note that approximate maintenance of the ratio of external debt to GDP in a framework of financial stability would be facilitated by effective resolution of the fiscal problem.

Argentina now maintains several restrictions subject to approval under Article VIII, Sections 2 and 3 of the Fund's Articles of Agreement. Multiple currency practices have arisen in respect of the introduction of the dual foreign exchange market, and the permitted exchange of 10 per cent of the receipts from promoted exports at the financial rate.1/ Also, the minimum financing period for most import payments

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1/ The devaluation compensation scheme and the system of exchange guarantees eventually will give rise to other sets of exchange rates in Argentina's exchange system as the loans will be repaid at a rate different from the actual market rate on the date of repayment. This may introduce (depending on the exchange rate at that time) a multiple currency practice subject to approval under Article VIII of the Articles of Agreement.

through the commercial exchange market constitutes an exchange restriction with a discriminatory feature. The staff understands the authorities' decision to split the exchange market in response to the circumstances of late June, but it would wish to emphasize that the maintenance of a dual exchange rate system creates certain instabilities and in the longer run is bound to prove detrimental to resource allocation. The authorities' awareness of the drawbacks of this regime and their intention to reunify the exchange markets--and in the process to remove the other multiple currency practice--as soon as feasible is, therefore, to be welcomed.

Accordingly, the following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Argentina's exchange measures subject to Article VIII, Sections 2 and 3 in the light of the 1981 Article IV consultation with Argentina conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Argentina maintains multiple currency practices and a restriction on payments and transfers for current international transactions. The Fund notes the temporary character of the dual exchange market, and welcomes the authorities' intention to achieve a reunification of the exchange market and to remove the other multiple currency practice as soon as feasible. The Fund urges the authorities to eliminate the exchange restriction, arising from the imposition of a minimum delay for certain import payments, which involves a discriminatory feature, at the earliest possible date. In the circumstances of Argentina,

the Fund grants approval of the multiple currency practices maintained by Argentina as described in SM/81/-- until December 31, 1982, or the completion of the 1982 Article IV Consultation with Argentina, whichever is earlier.

Fund Relations with Argentina

Date of membership:	September 1956.
Status:	Article VIII.
Quota:	SDR 802.5 million.

Fund holdings of Argentine pesos:

As of October 31, 1981	Millions of SDRs	Per Cent of Quota
Total currency holdings	563.4	70.2
Holdings from outstanding purchases	None	None

Special Drawing Rights Department (as of October 31, 1981):	Holdings (347.1 million) are 109.0 per cent of net cumulative allocation of SDR 318.4 million.
Transactions with the Fund:	Argentina has had nine stand-by arrangements, the last of which expired on September 15, 1978. Argentina made no purchase under that arrangement.
Direct distribution of profits from gold sales (July 1, 1976-July 31, 1980):	US$69.9 million.
Gold distribution:	376,565 fine ounces in four distributions.
Exchange rate:	Until June 21, 1981 Argentina maintained a unified exchange market. On June 22, 1981 Argentina established a dual exchange market consisting of a commercial market for trade and certain debt transactions at a rate set by the authorities, and a financial market for other transactions at a freely fluctuating rate. The exchange rates in terms of $a per U.S. dollar on September 30, 1981 were $a 5,807 in the commercial market (single rate) and $a 7,620 (buying) and $a 7,670 (selling) in the financial market.
Last consultation (Article IV):	Discussions May 19-30, 1980, consultation completed by the Executive Board on September 16, 1980 (SM/80/173 of 7/16/80 and SM/80/185 of 7/25/80).

Argentina--Basic Data

Area and population	
Area (continental)	2,792,000 sq. kilometers
Population (mid-1980)	27.1 million
Annual rate of population increase (1976-80)	1.3 per cent
GNP at market prices (1980)	SDR 116,976 million
GNP per capita (1980 est.)	SDR 3,813
Origin of GDP (1980)	(per cent)
Agriculture	12.7
Manufacturing	24.8
Construction	7.8
Transport and communications	10.9
Commerce	14.1
Other	29.7
Ratios to GDP (1980)	
Exports of goods and services	7.8
Imports of goods and services	10.9
General government revenues	26.9
General government expenditures	31.5
External public debt (end of year)	10.2
Saving	18.3
Investment	21.2
Money and quasi-money (end of year)	32.3

Annual changes in selected economic indicators	1978	1979	1980	Proj. 1981
		(per cent)		
Real GDP per capita	-4.7	5.8	-0.2	-4.0
Real GDP	-3.4	7.1	1.0	-3.0
GDP at current prices	156.3	174.5	97.5	104.3
Domestic expenditures (at current prices)	156.1	184.9	101.9	97.8
Investment	128.0	158.6	112.7	84.6
Consumption	165.2	191.3	99.7	101.3
GDP deflator	164.5	156.3	95.5	110.6
Wholesale prices (annual averages)	145.9	149.3	63.8	122.6
Consumer prices (annual averages)	175.5	159.5	100.8	104.5
General government revenues	182.0	161.5	117.3	69.8
General government expenditures	186.7	155.1	119.8	93.2
Money and quasi-money	183.8	190.2	90.8	93.4
Money	169.2	140.9	97.6	...
Quasi-money	189.8	208.9	88.8	...
Net domestic financial assets 1/	160.4	182.6	106.9	91.1
Credit to public sector (net) 1/	11.8	14.0	15.9	34.0
Credit to private sector 1/	123.2	144.0	81.6	46.7
Merchandise exports (f.o.b., in U.S. dollars)	13.2	22.0	2.8	24.1
Merchandise imports (c.i.f., in U.S. dollars)	-7.9	74.8	56.7	-15.8

General government finances	1978	1979	1980	Proj. 1981
	(billions of Argentine pesos)			
Revenues	13,352	34,922	75,873	128,827
Expenditures	15,863	40,466	88,940	171,792
Overall deficit (-)	-2,511	-5,544	-13,067	-42,965
External financing (net)	242	436	2,782	4,224
Internal financing (net)	2,269	5,108	10,285	38,741
Balance of payments	(millions of U.S. dollars)			
Merchandise exports, f.o.b.	6,400	7,810	8,028	9,960
Merchandise imports, c.i.f.	-3,834	-6,700	-10,500	-8,845
Investment income (net)	-681	-920	-1,502	-3,215
Other services and transfers (net)	-51	-726	-716	-479
Balance on current and transfer accounts	1,834	-536	-4,690	-2,579
Official capital (net)	1,294	1,082	2,816	3,903
Financial sector (net)	561	2,237	1,424	-635
Private capital (net)2/	-443	1,586	-2,360	-2,987
Allocation of SDRs	--	73	73	70
Change in net official reserves (increase -)	-3,246	-4,442	2,737	2,228

International reserve position	September 30 1980	Dec. 31 1980	September 30 1981
	(millions of SDRs)		
Central Bank (gross)	6,596.0	5,438.8	3,530.3
Central Bank (net)	6,547.1	5,258.3	3,419.2
Central Bank and Treasury (net)	6,459.8	5,183.0	3,400.8

1/ In relation to the financial system's stock of money and quasi-money at the beginning of the period. Excludes contra-entry of SDR allocations.

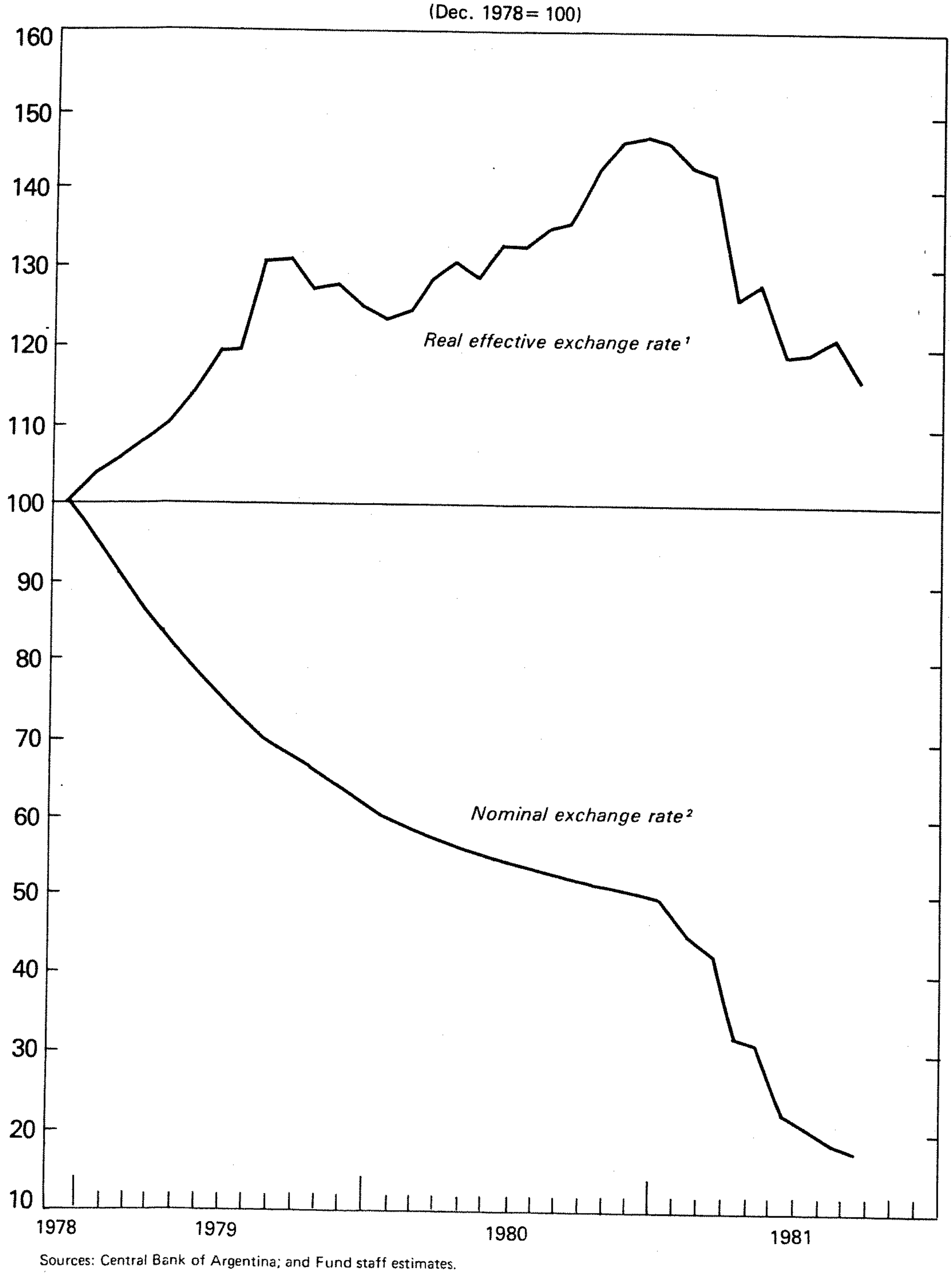
2/ Includes valuation adjustments and errors and omissions.

CHART 1

ARGENTINA

EXCHANGE RATE INDICES

(Dec. 1978= 100)



Sources: Central Bank of Argentina; and Fund staff estimates.

[1] Based on monthly averages of the nominal exchange rate adjusted by price and exchange rate movements in Argentina's major trading partners; after June 22, 1981 the exchange rate of the commercial market was used. Increase in the index value represents an appreciation of the peso in real terms.

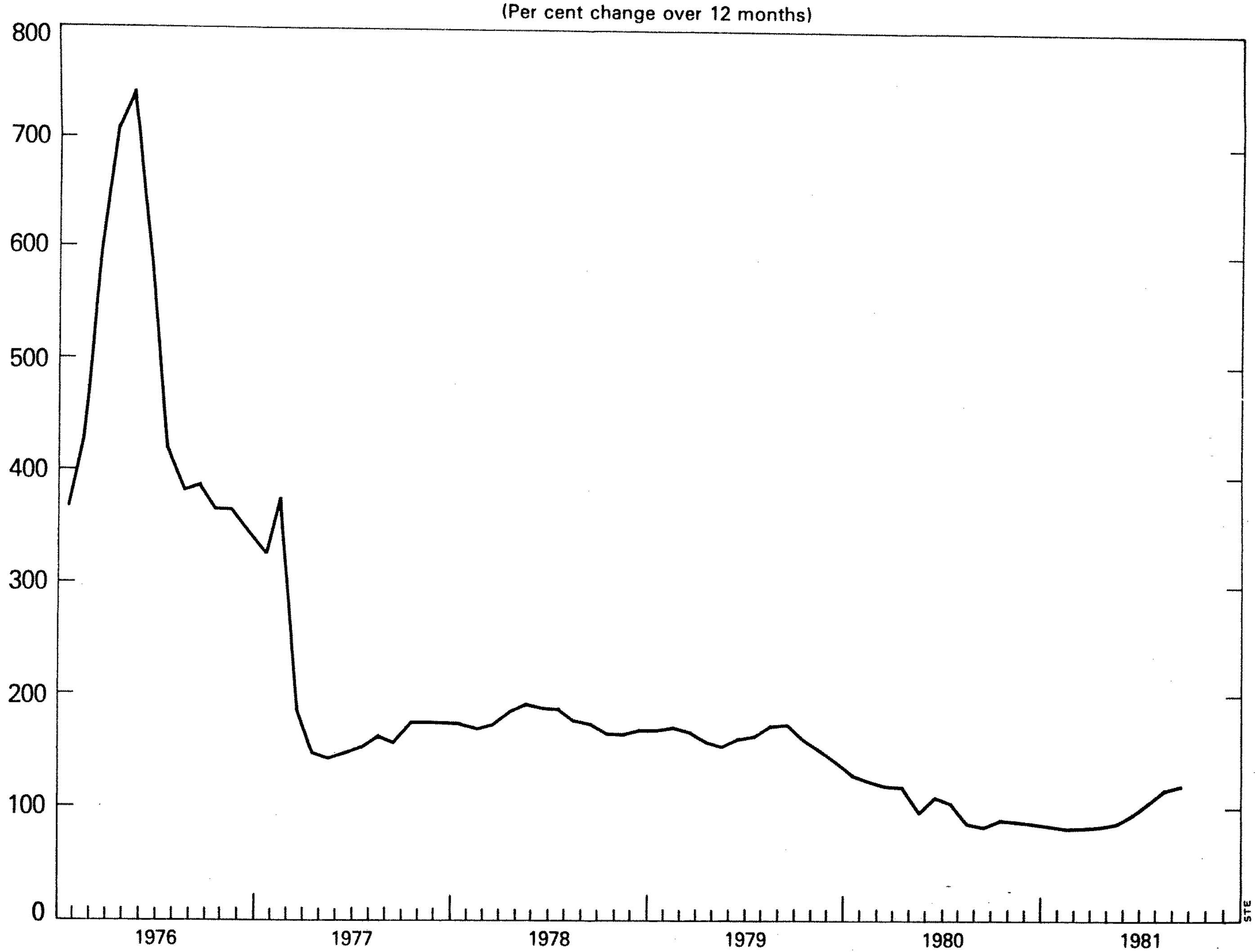
[2] Monthly averages of selling rate of U.S. dollar per peso.

CHART 2

ARGENTINA

CONSUMER PRICES

(Per cent change over 12 months)



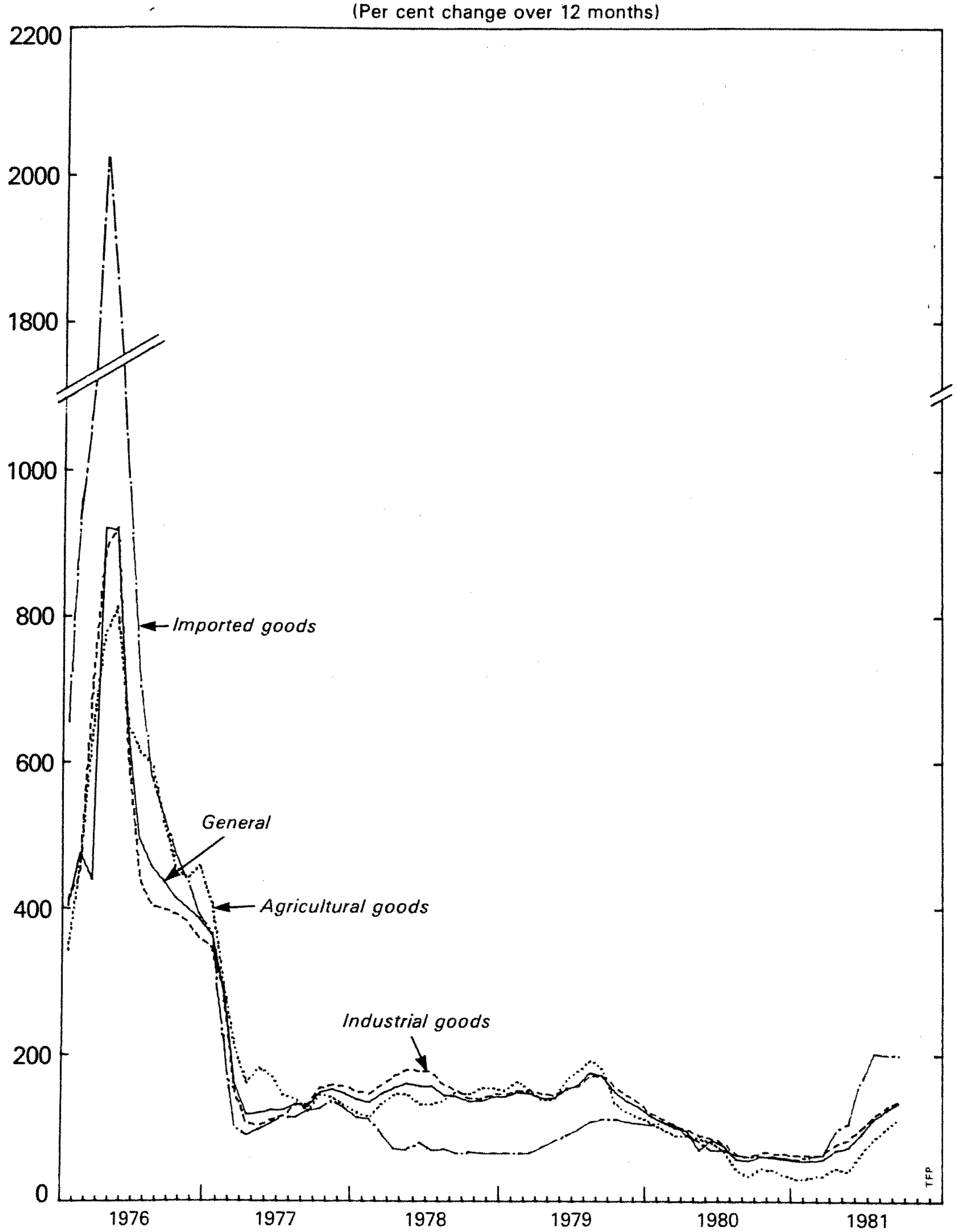
Source: National Statistical Institute.

CHART 3

ARGENTINA

WHOLESALE PRICES

(Per cent change over 12 months)



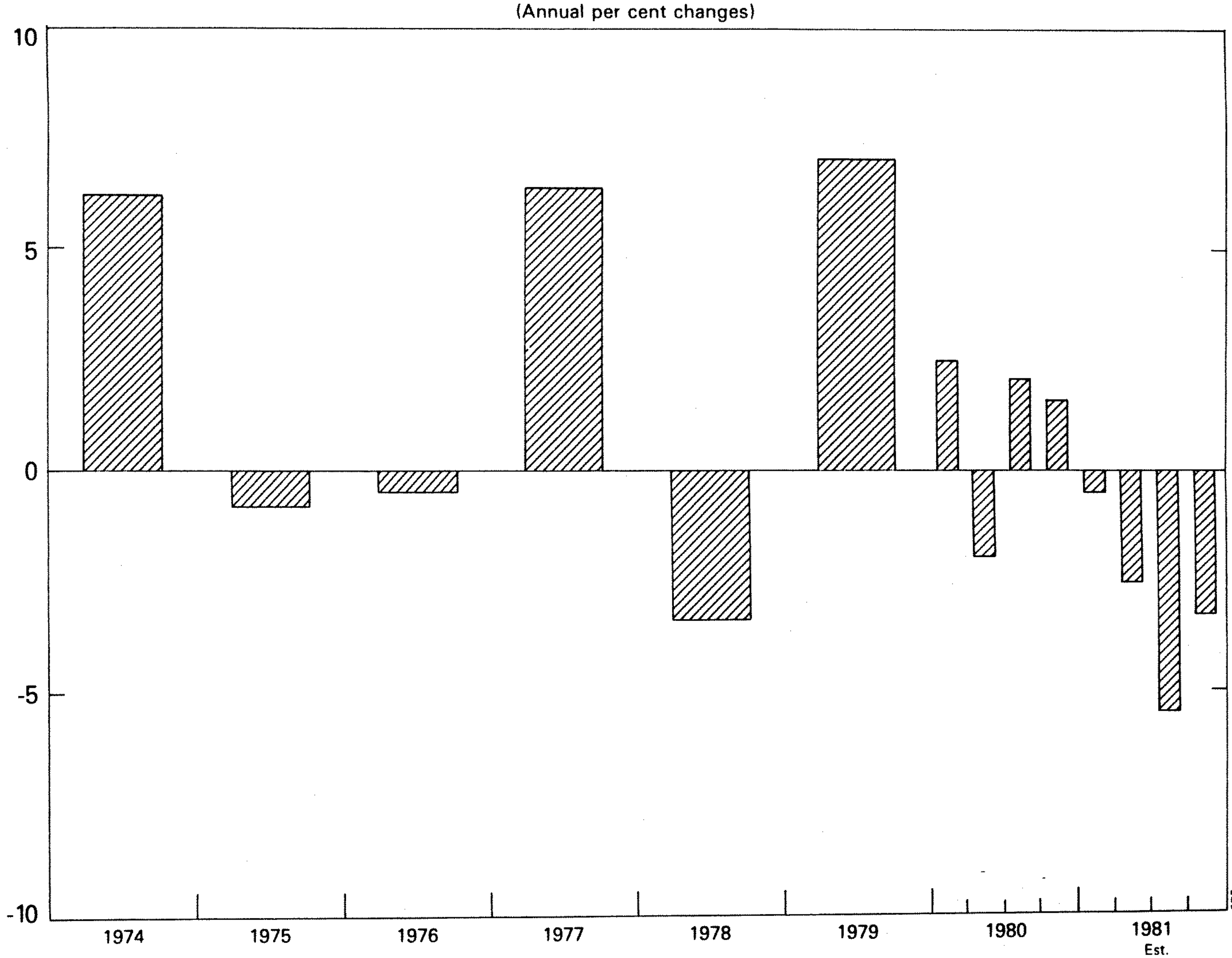
Source: National Statistical Institute

CHART 4

ARGENTINA

REAL GDP AT MARKET PRICES

(Annual per cent changes)



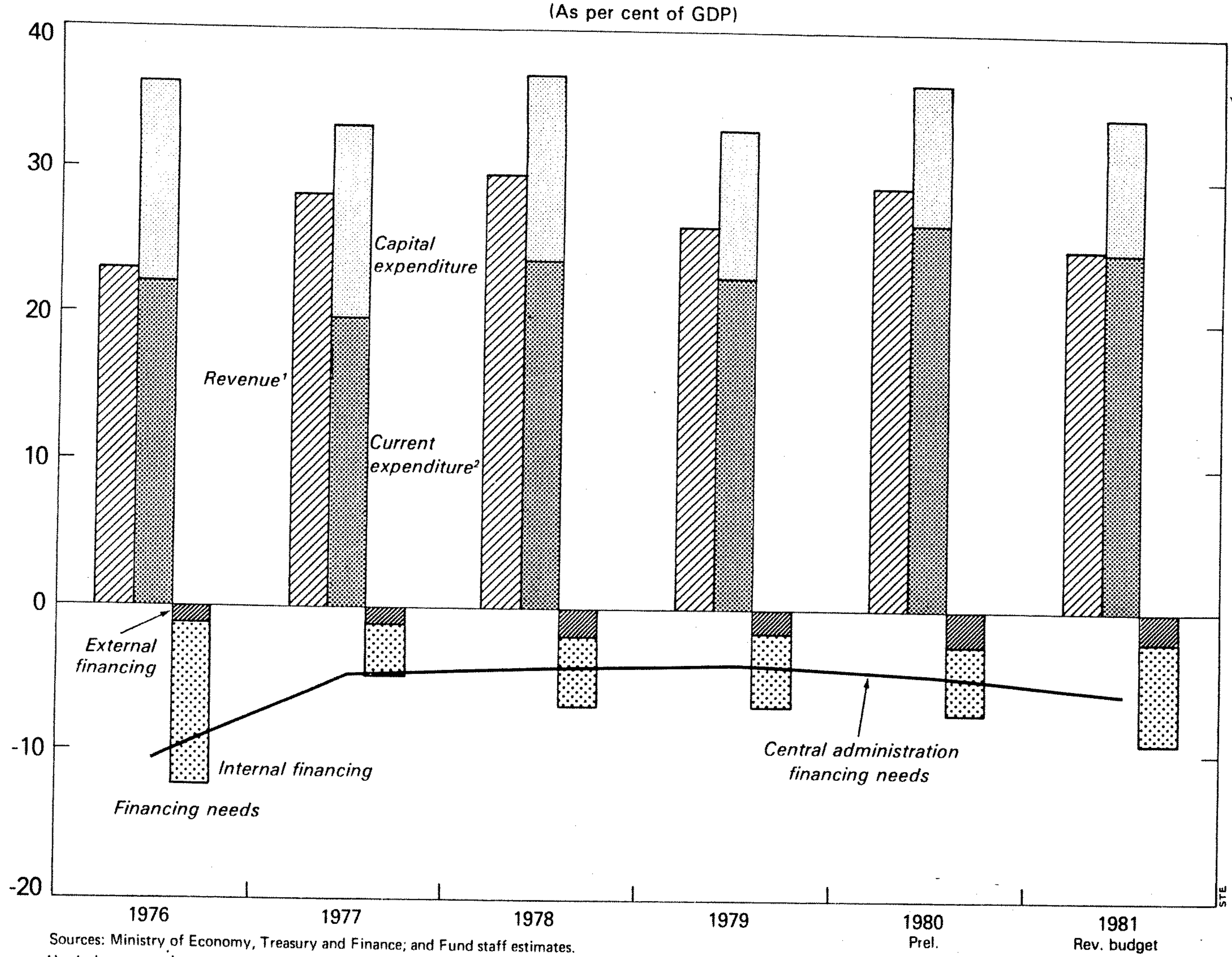
Sources: Central Bank of Argentina; and Fund staff estimates.

CHART 5

ARGENTINA

PUBLIC SECTOR OPERATIONS

(As per cent of GDP)



Sources: Ministry of Economy, Treasury and Finance; and Fund staff estimates.

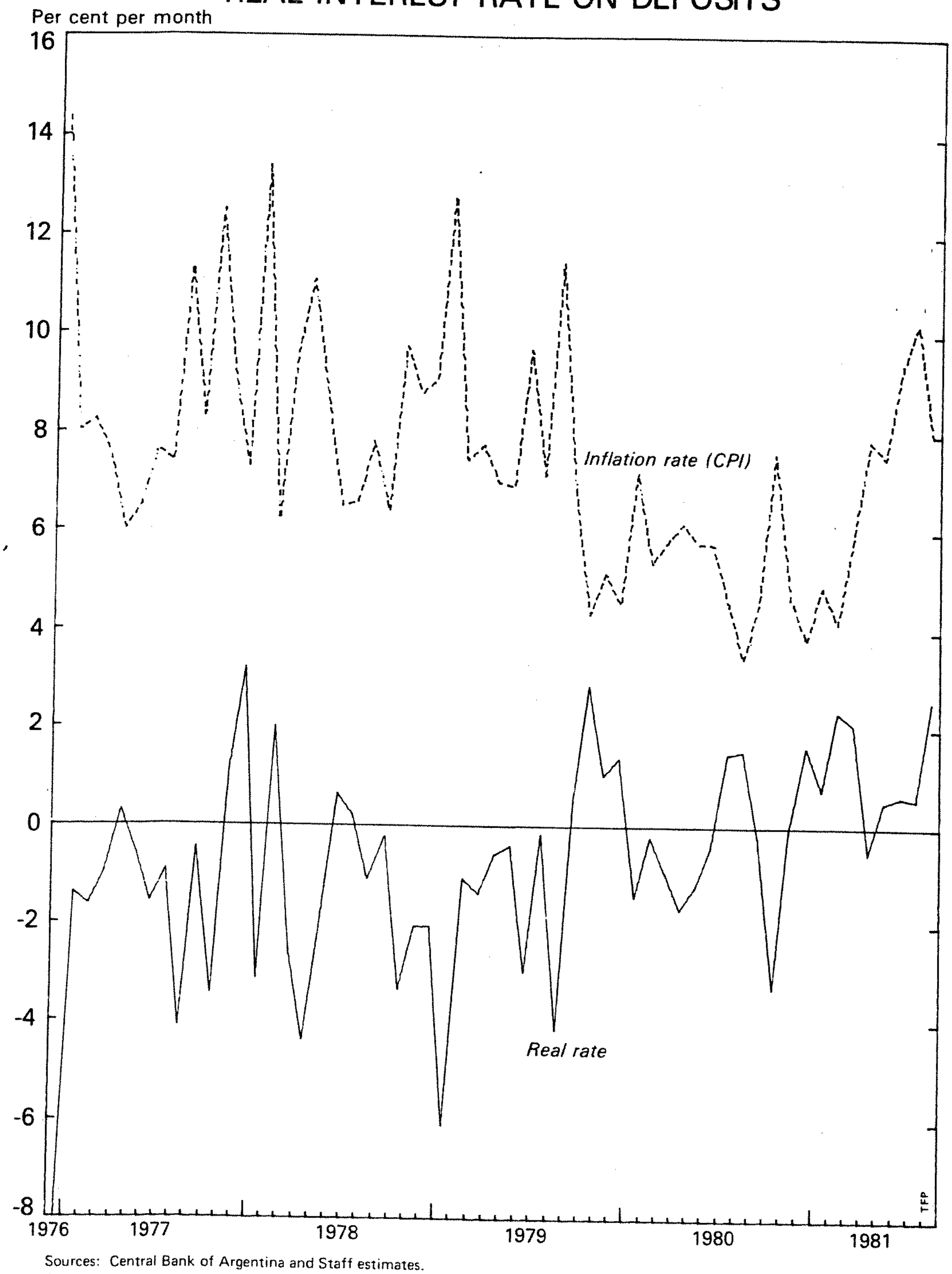
[1] Includes general government revenue and current account surplus of state enterprises.

[2] Includes interest treated as amortization in the Argentine presentation of public sector operations.

CHART 6

ARGENTINA

REAL INTEREST RATE ON DEPOSITS[1]



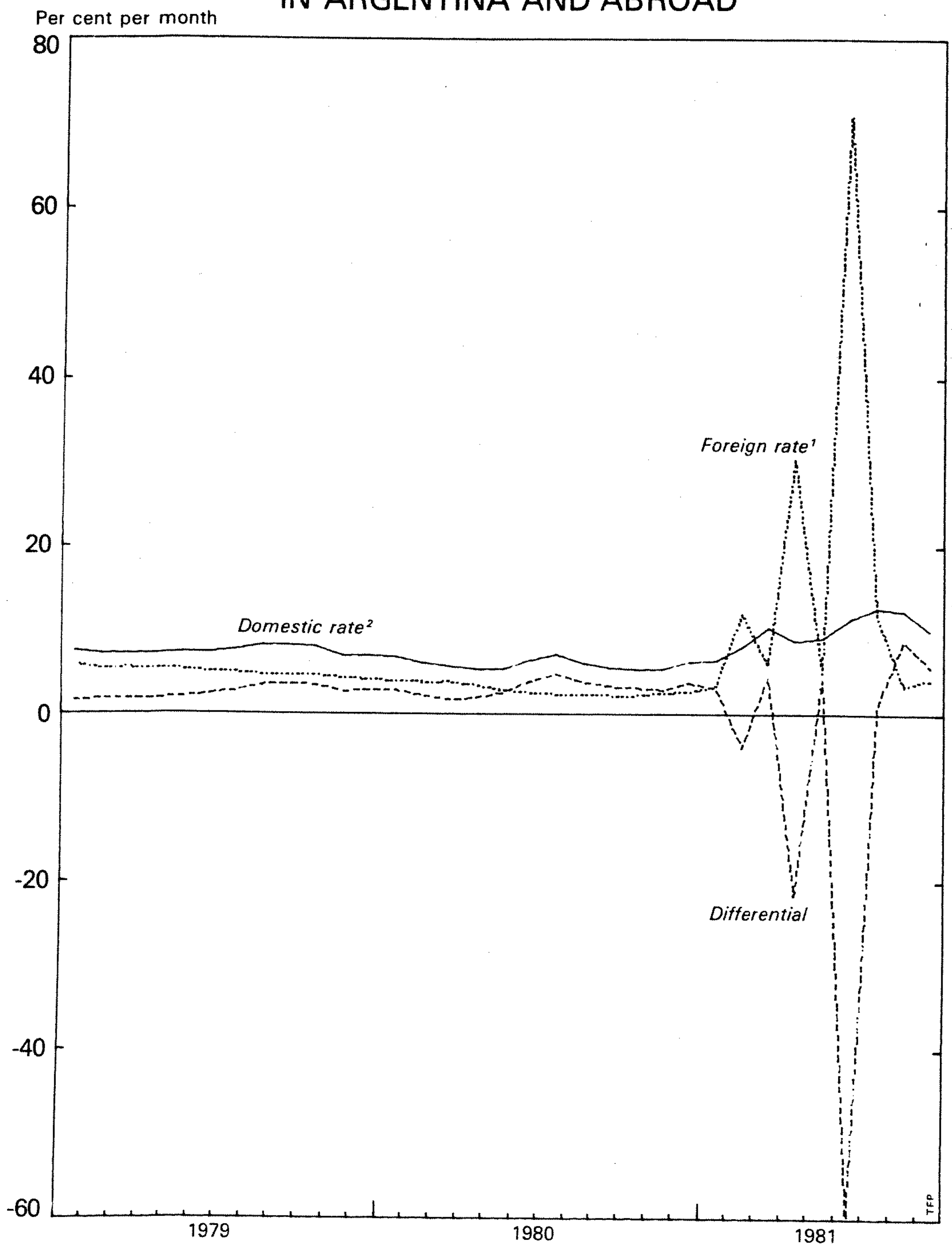
Sources: Central Bank of Argentina and Staff estimates.

[1] 30 days deposit rate deflated by the Consumer Price Index.

CHART 7

ARGENTINA

DIFFERENTIAL BETWEEN INTEREST RATES IN ARGENTINA AND ABROAD



Sources: Central Bank of Argentina, Data Resources Inc., and Staff estimates.

[1]Euromarket 30-day rate, adjusted by exchange rate changes.

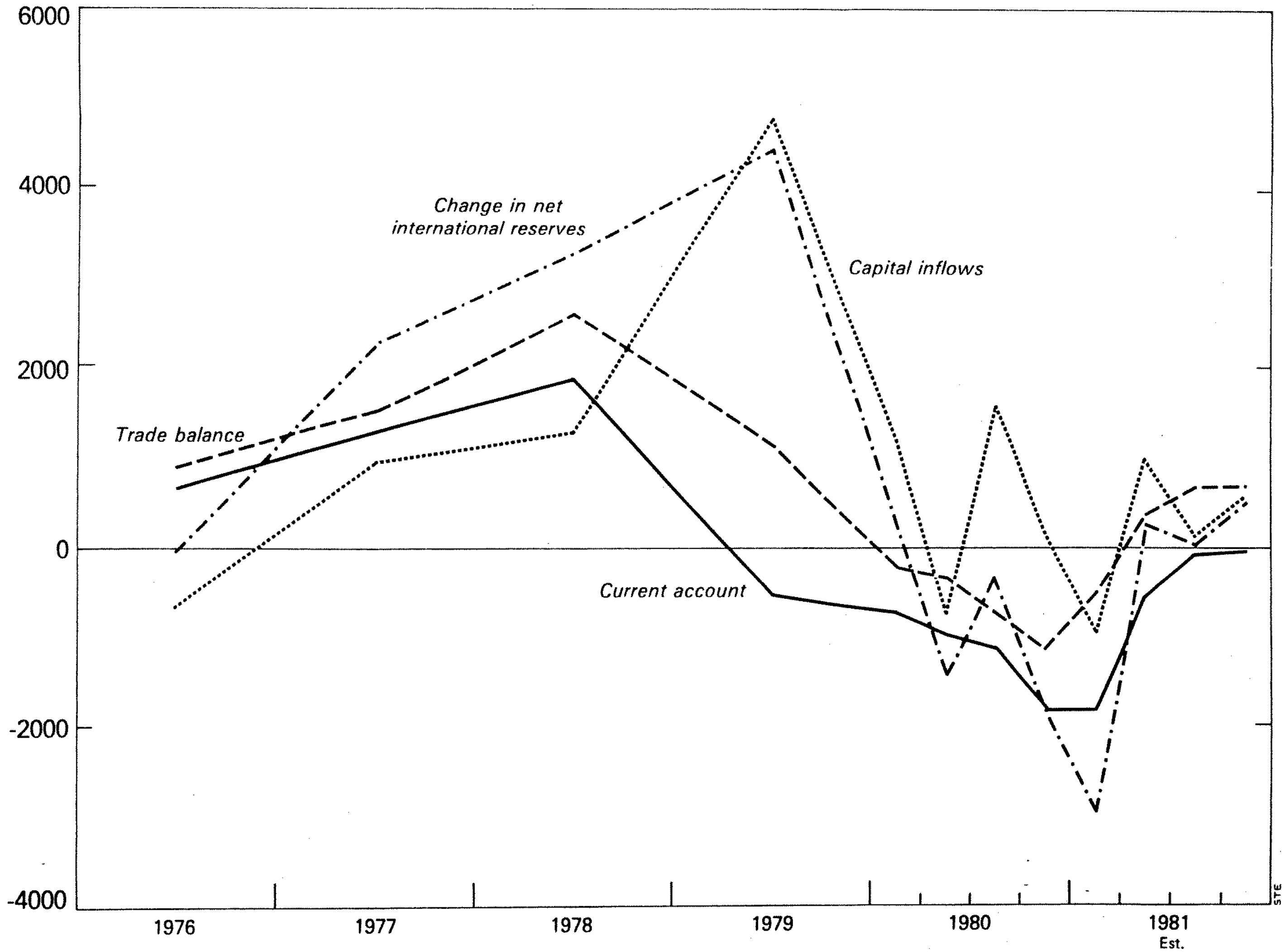
[2]Loan rate-30 day instruments.

CHART 8

ARGENTINA

ARGENTINA'S BALANCE OF PAYMENTS FLOWS

(Millions of US dollars)



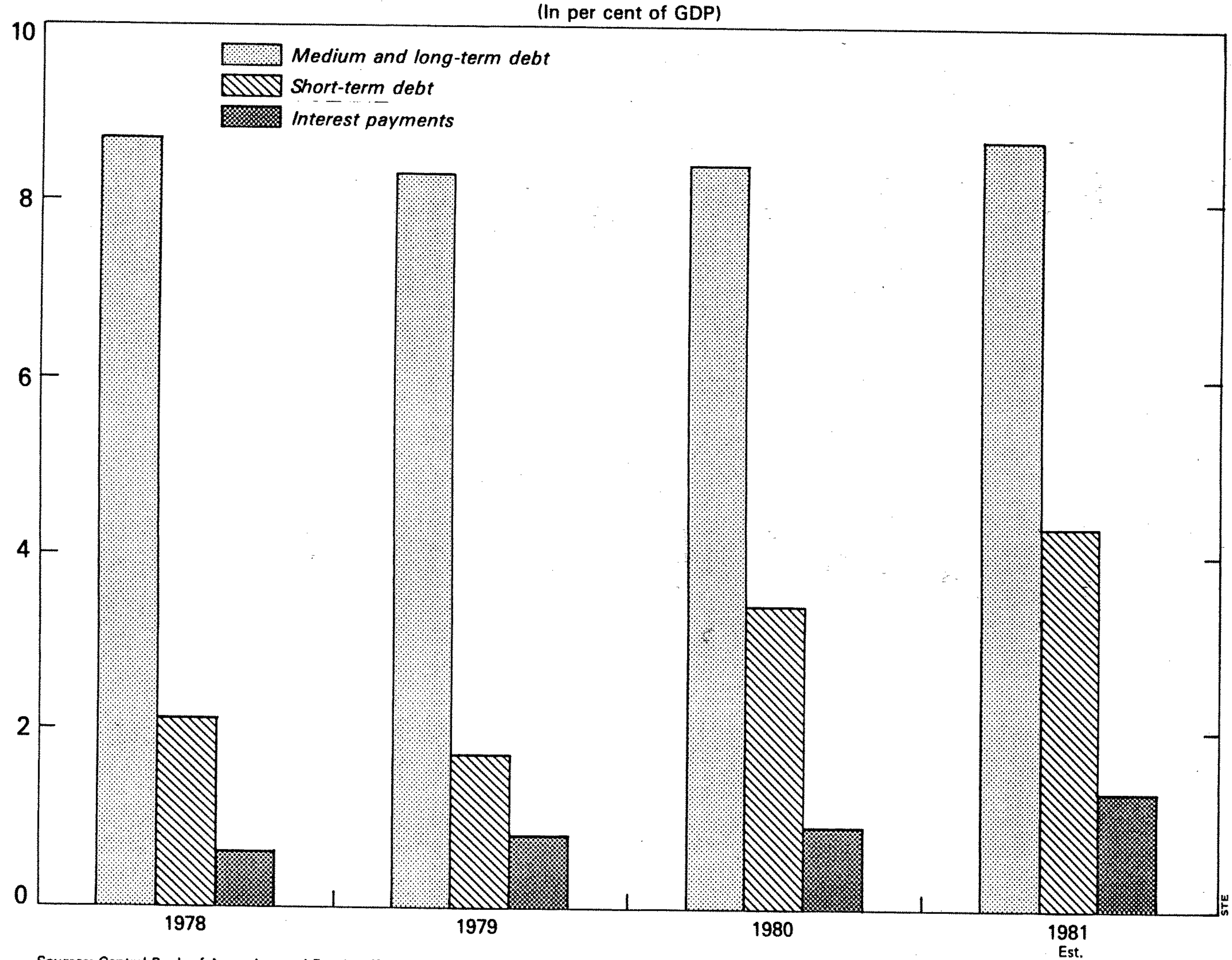
Source: Central Bank of Argentina.

CHART 9

ARGENTINA

EXTERNAL PUBLIC DEBT OUTSTANDING AND INTEREST PAYMENTS

(In per cent of GDP)



Sources: Central Bank of Argentina; and Fund staff estimates.