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Argentina: 2002 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of Argentina

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Argentina, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 17, 2002,** with the officials of Argentina on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on December 17, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **January 6, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its January 8, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of Argentina.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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ARGENTINA

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with Argentina

Approved by Anoop Singh and G. Russell Kincaid

December 17, 2002

- **2002 Article IV consultation:** Efforts to reach agreement with the Argentine authorities on a program have lasted all of 2002, delaying the Article IV consultations. Given that the last Article IV consultation was concluded in September 2000, it is proposed to proceed with Board discussion of the consultation as soon as possible. This would provide the opportunity for a more extended analysis of the origins of the crisis and the status of policies.

- **Discussions:** Discussions with the authorities have been held on numerous occasions in 2002. Until April, the Argentine team was led by former Minister of Economy Remes-Lenicov and, subsequently, by Minister Lavagna and Secretary Nielsen. Until June 2002, the discussions included central bank Governor Blejer. After Mr. Blejer's resignation, the discussions continued with his successor, Mr. Pignanelli, who resigned in early December 2002. The most recent mission for the consultations was held during December 16–17, 2002 in which the new Governor-Designate, Mr. Prat Gay participated. Mr. Zoccali (OED) participated in all the discussions in Buenos Aires and in Washington.

- **Staff teams:** The staff teams in Washington and Buenos Aires have been alternately led by Anoop Singh and John Thornton and, since September, by John Dodsworth. The teams included, at various times, Messrs. Collyns, Ramos, Ramirez (WHD), Feler and Hviding (PDR), Cubeddu and Petri (FAD), Ms. Weeks-Brown (LEG), and Mr. Roaf (ICM). MAE teams led by Mr. Hoelscher have been closely involved with the dialogue. The resident representatives have been closely involved—Mr. Terrier until September and Mr. Cubeddu subsequently. The staff has collaborated closely with the World Bank and the IDB.

- **Article VIII status:** Argentina is an Article VIII country but imposed successive restrictions on current international transactions during 2002. In the absence of a firm timetable for their elimination, the staff report does not recommend approval of these restrictions.

- **Surveillance issues:** Argentina raises many surveillance issues arising from the magnitude of its economic and financial crisis after several Fund-supported programs. The staff report makes the assessment that the demands of Argentina's convertibility regime required much greater flexibility in domestic policies, especially fiscal consolidation, than was the case during the 1990s. As such, the political resolve that Executive Directors frequently noted in previous consultations and program reviews was needed to sustain the policy framework could not be delivered by the authorities.

- **Arrears:** Argentina fell into arrears to the World Bank in November 2002; these arrears currently amount to US$830 million. Arrears to bilateral and private creditors amount to about US$1.4 billion and US$11.9 billion, respectively.

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I. Introduction

1. **The effort to reach agreement with the Argentine authorities on a Fund-supported program that would begin orderly resolution of Argentina's deep crisis has lasted all of 2002.** Against the backdrop of a turbulent political situation and social upheaval, the aim has been modest: to reach understandings on a short-term stabilization program that would help restore confidence and maintain macroeconomic stability ahead of the Presidential elections now scheduled for April 2003. Such a program could put in place conditions that would allow a newly-elected government to embark on the type of medium-term program that is needed to tackle the deep structural problems that confront Argentina in the wake of crisis.

2. **The negotiations for such a short-term program continue**. There have been a total of 22 staff missions to Argentina in 2002, and numerous discussions with the authorities in Washington. While progress has been made toward defining critical policy elements for 2003, a recurrent problem has been the delays in securing the necessary political consensus for an orderly program. Also, with much weakened institutions, and low ownership for many parts of the program, policies have been successively adopted without prior consultation and often against the advice of Fund staff. Nonetheless, discussions are continuing with the aim of narrowing remaining differences and finalizing an economic program that could be supported by the Fund.

3. **Because of the crisis, the focus has been on finalizing a program, and the Article IV consultation with Argentina has been substantially delayed.** The last Article IV consultation with Argentina was concluded on September 15, 2000. Under the new decision on consultation cycles for program countries, the Article IV consultation with Argentina should have been completed by June 15, 2002. Thus, it is already overdue by six months. From the perspective of surveillance policies, and although the negotiations toward a program continue, the staff proposes that there should be no further delay in conducting the Article IV consultations.[1] The 2002 Article IV consultation allows the staff to offer a longer perspective on the origins of the crisis, provide a detailed update of recent developments, and discuss the status of economic policies for 2003 and for the medium-term.

4. **Last Article IV consultation:** Executive Directors were concerned in September 2000 that the demands of the convertibility regime and the resumption of sustainable growth required much greater flexibility in domestic policies and credible fiscal consolidation, particularly at the level of the provincial governments. These concerns were repeated at the time of the Fourth Review Under the Stand-By Arrangement and Request for Augmentation of the Arrangement, which was completed on September 7, 2001. On that occasion,

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[1] Indeed, as agreed by Executive Directors (SUR/02/42), Article IV consultations in program countries are most useful before a program is negotiated, when a program has moved off-track, or between two programs. This has clear relevance for Argentina.

Executive Directors noted the need for stronger political resolve to sustain the fiscal adjustment and implement the necessary reforms. Directors stressed there was limited time for the authorities to re-establish credibility with the financial markets so as to be able to roll over relatively large debt payments that were falling due. Soon after that Review, Argentina entered into a vicious cycle of falling confidence, capital flight, economic crisis, and widespread social distress.

II. Background and Recent Developments

A. The Origins of the Crisis

The severe economic and financial crisis that engulfed Argentina at the end of 2001 has its roots in a long history of failed attempts to establish credibility for economic policies. These failures, most conspicuously the disorderly exit from the decade-long currency board arrangement, reflected fundamental political economy factors and institutional weaknesses.[2]

5. **Domestic and external factors combined to bring about the loss of confidence in Argentina that triggered the debt default and the crisis.** Among the external factors, perhaps the most important were the sharp appreciation of the real exchange rate in the late 1990s, and the reduced appetite of foreign investors for emerging market debt. As capital inflows eased sharply, Argentina faced a sudden and significant increase in the marginal cost of borrowing that weakened the prospects for economic growth and debt rollovers.

6. **However, a complex set of domestic economic and political factors were the main driving force toward the crisis.** Of particular importance were:

- **Fiscal performance:** A poor record of fiscal performance (including large off-budget expenditures), particularly at the provincial level, gave rise to a continuous increase in public debt.
- **Domestic structural rigidities:** Failure to address rigidities in the economy, especially in the labor market, prevented adjustment to an appreciating real exchange rate in the context of the currency board arrangement.
- **Credibility:** A fundamental lack of credibility in the national currency perpetuated a high level of dollarization that increased vulnerability by exposing banks to increased creditor risk and through currency mismatches in companies and the public sector.
- **Imbalance between trade and capital integration:** Argentina's low trade share contrasted sharply with an open capital account, increasing vulnerability to sudden reversals of capital flows.

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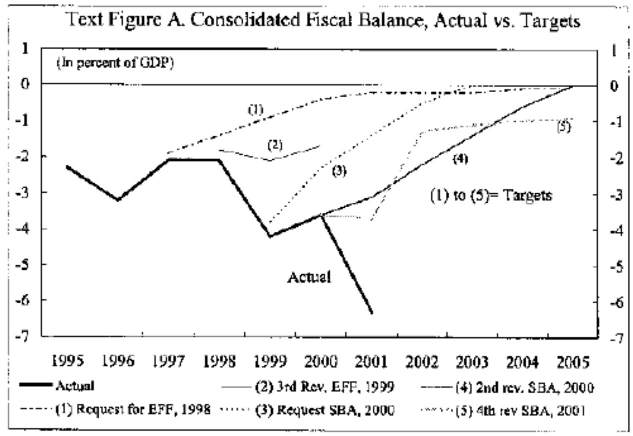
[2] The events leading up to the current crisis in Argentina are discussed in more detail in the forthcoming Selected Issues paper.

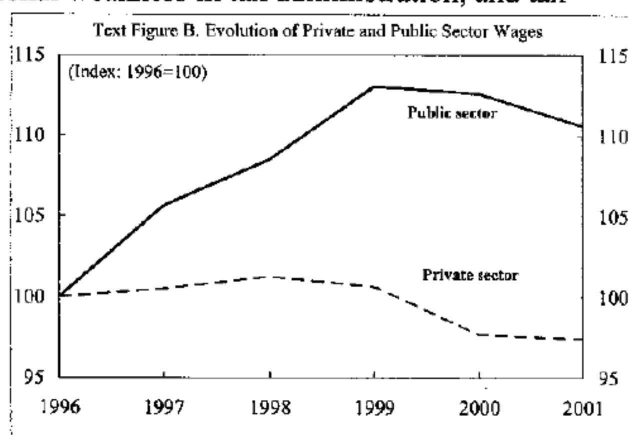
- **Political consensus:** The absence of the necessary political cohesion meant that bold decisions to redirect economic policies were not taken or could not be sustained.

7. **The role of fiscal policy was central.** Persistent cash deficits and 'off-budget' debt creating expenditures added annually to a mainly dollar-denominated public debt (Box 1). Even in the years of high growth following the reforms of the early 1990s, the fiscal effort was insufficient to produce healthy primary surpluses at either the federal or provincial level of government (Text Figure A). These fiscal problems were the product of vested interests and resistance to fiscal reforms, especially in the provinces:

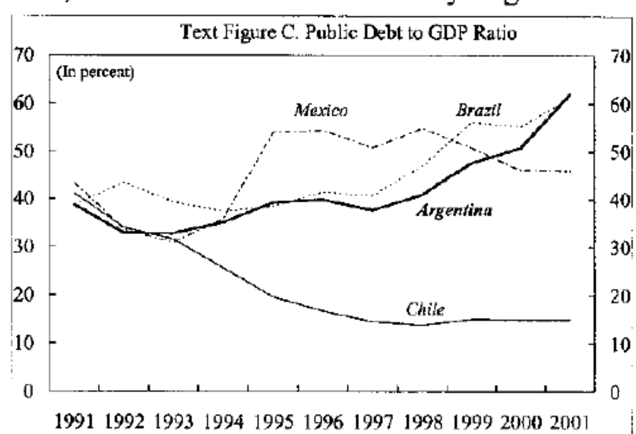


- On the revenue side, there was clear institutional weakness in tax administration, and tax compliance was undermined by the series of tax amnesties that were announced almost annually throughout the 1990s (Box 2).

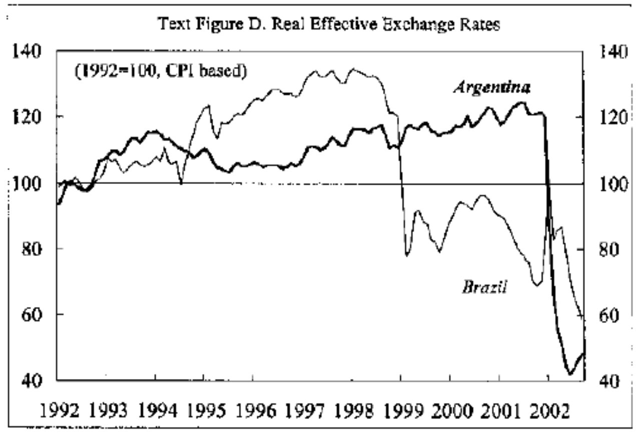
- On the expenditure side, numerous plans to reform intergovernmental relations and enhance fiscal responsibility at the provincial level were fiercely resisted. Increases in the public sector wage bill worsened fiscal solvency (Box 3 and Text Figure B).



8. **The pre-crisis public debt/GDP ratio did not appear remarkable by international standards** (Text Figure C). However, the debt burden was relatively large compared to the government's ability to raise revenues, and to exports; the debt ratio was also biased downward by the overvalued exchange rate. The sustainability of public debt accumulated during the 1990s depended on maintaining healthy growth, strengthening fiscal adjustment, and ensuring access to international capital. In the event, none of these conditions came to apply. Fund surveillance and program conditionality frequently gave the benefit of the doubt to the authorities and, in hindsight, should have taken a firmer position on policies critical to sustainability.



9. **Growth was another key casualty.** The prolonged recession that preceded the crisis reflected both falling confidence and a lack of flexibility in the economy that was incompatible with the currency peg. The steady real appreciation of the *peso*, partly reflecting the strong U.S. dollar and the depreciation of the Brazilian *real* after 1999, could not be accommodated in an orderly fashion given structural rigidities in the labor market and fiscal policy (Text Figure D). Eventually, the brunt of the adjustment fell on domestic prices and employment, placing the economy on a deflationary path and making it difficult to get the political support to re-orient economic policies either toward the necessary structural reforms or for an orderly exit from the currency board.



10. **High dollarization of the economy meant that any exit from the convertibility plan would be very costly and disruptive.** This resulted in a high degree of reluctance on the part of successive governments to consider orderly approaches to another exchange rate regime. Fund surveillance, which left the choice of the exchange rate arrangement to the authorities, called for greater economic flexibility and credible fiscal consolidation but, in the end, there was little domestic ownership of the supporting policies to sustain the currency board. Not only fiscal solvency, but also the solvency of the financial system—which was judged to be among the strongest in Latin America in terms of compliance with prudential norms and high capitalization—was tied to the currency peg. However, the banking system was heavily exposed to credit risk in the event of a devaluation, as a result of making U.S. dollar-denominated loans to clients whose earnings were denominated mainly in *pesos*.[3] At a more general level, the dominance of the nontradable sector and the consequent narrow export base were fundamentally at odds with a liberalized capital account, and a high reliance on dollar-denominated borrowing.[4]

B. The Events Leading up to the Crisis

The immediate period leading to the crisis was characterized by further economic decline, sharp deterioration in the public finances and financing sources, and a worsening of banks'

[3] By way of example, mortgage loans denominated in U.S. dollars accounted for about 80 percent of mortgages outstanding by end-2001. Also, substantial dollar debt was accumulated by the privatized utilities despite their income streams being in pesos.

[4] Other structural weaknesses, such as a poor environment for innovation; weak anti-monopoly policy; low levels of education in math and science; and widespread corruption are cited by several agencies, including the Political Services Group, Transparency International, and the World Competitiveness Report of the World Economic Forum.

financial condition. Policy measures in 2001 avoided addressing fundamental issues and steadily undermined confidence further

11. **In 2001, the economy entered the third consecutive year of negative growth.** After a cumulative decline of 4¼ percent in 1999–2000, real GDP fell by 4½ percent in 2001 (Text Table A, Table 1, and Figure 1). The fall was reflected in significant declines in consumption and, especially, in private investment. The protracted economic recession, high real interest rates, the sharp decline in bank credit to the private sector, and the real exchange rate overvaluation sharply increased unemployment to almost 19 percent and produced price deflation, with a cumulative drop of 2–3 percent in consumer and wholesale prices from end-1999. Spreads on sovereign bonds rose from about 800 basis points in early 2001 to over 4,000 basis points by year end, and market access fell sharply.

Text Table A: Key Macroeconomic Developments, 1999-2002

	1999	2000	2001	Est. 2002
Real GDP growth (in percent)	-3.4	-0.8	-4.4	-11.0
Inflation (e.o.p., in percent)	-1.8	-0.7	-1.5	41.9
Consolidated public sector primary balance				
(In percent of GDP)	-0.7	0.4	-1.4	0.0
Current account				
(In billions of U.S. dollars)	-11.9	-8.9	-4.6	8.8
(In percent of GDP)	-4.2	-3.1	-1.7	8.1
Net international reserves				
(In billions of U.S. dollars)	22.8	21.9	0.4	-4.3

12. **The public finances deteriorated sharply.** The consolidated public sector deficit rose to 6¼ percent of GDP in 2001, reflecting a fall in tax revenue as a result of the weak economy, higher primary spending, and a sharp increase in interest payments (Tables 2–4). The fiscal deterioration was marked in both the federal and provincial finances. As orderly financing sources closed, both the federal government and a number of provinces began the issuance of quasi-monies to finance expenditures (Box 4).

13. **The financial condition of banks began to deteriorate,** reflecting the deepening recession, higher interest rates, and the easing of prudential safeguards. Increasing fears of devaluation and possible confiscation of deposits triggered a gradual outflow of deposits through mid year, which gathered momentum during the second half of 2001. By November, *peso* deposits had declined by well over a third, while dollar deposits had fallen by 10 percent (Text Figure E, Figure 2, and

Text Figure E. Evolution of Private Deposits During 2001

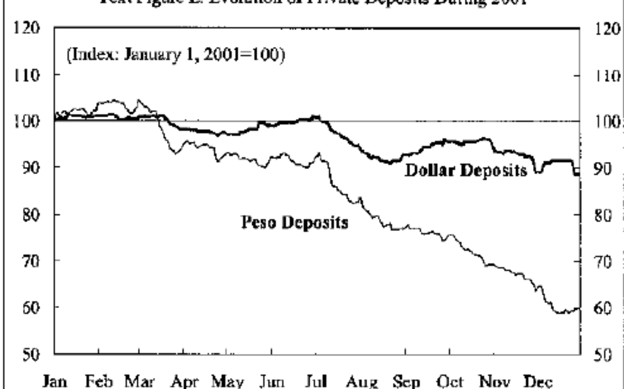


Table 5). At the same time, the government increasingly utilized the banks to finance the fiscal deficit, thereby reducing their liquidity and increasing their vulnerability.[5]

14. **Policy measures successively introduced during 2001 lacked direction and credibility and confirmed fears about impending crisis.** Thus, policies tended to heighten uncertainty by calling into question the viability of the currency peg, weakening central bank autonomy, and failing to reverse the deterioration in public finances.

- **In April, the authorities introduced restrictive measures to overcome the currency overvaluation**, including an import tax and a concurrent export subsidy, while also announcing the eventual re-pegging of the *peso* to the dollar and the *euro* (in equal weights) once the *euro* reached parity with the dollar.
- **In May, a series of competitiveness plans was introduced.** These aimed at improving profitability in the sectors most affected by the recession. Common elements to the plans were tax exemptions (which varied by industry) and allowing employers' social security contributions to be credited against VAT payments. The plans greatly complicated tax administration and reduced tax revenues, and were mostly suspended later in the year. However, by then, they had become heavily politicized, and those that were allowed to remain reflected vested interests rather than any economic rationale.
- **In June, the central bank charter was modified.** The changes allowed greater room for liquidity injections, severely undermining the currency-backing rule under the Convertibility Law. Subsequently, the Governor was dismissed, raising fears that institutions were greatly at risk.
- **In July, the government announced a "zero deficit" rule.** This involved across-the-board cuts in primary spending (excluding low wage and pension earners). The rule lacked consensus and was never fully implemented, in part because of delays in reaching an agreement with the provinces on a revised revenue sharing system.
- **In early September, the Stand-By Arrangement with the Fund was augmented.** Augmentation was based, in part, on commitments to further fiscal correction and structural reforms. However, the political will was weak and commitments were not fulfilled. Implementation was again a casualty.
- **By November, in the context of increasing expectations of sovereign default, spreads had risen to 4,000 basis points.** At that time, the authorities announced a "voluntary" two-phase approach to debt restructuring. The first phase, aimed mainly at domestic

[5] In April, the government used moral suasion to place a large tranche of bonds with domestic banks, allowing them, in turn, to meet an increased portion of their liquidity reserve requirements with government bonds.

banks and pension funds was completed in December 2001 and involved about 34 percent of the stock of debt.[6] The second phase has not been undertaken.

C. Crisis Management

Full crisis was triggered at the end of 2001, when depositors began large scale withdrawals from the banking system and the peso came under severe pressure. Amid a chaotic political situation and rising social unrest, economic policies evolved in a haphazard fashion that exacerbated the crisis.

15. **A sharp acceleration of deposit withdrawals at end-November led the government to impose a partial freeze on deposits.**[7] This measure severely affected confidence and contributed later to a serious "monetary overhang" (Box 5). As exchange market pressures led to higher interest rates and reserve losses under the currency board arrangement (Figure 3), the central bank resorted to a wide net of foreign exchange controls. After the declaration of a number of bank and foreign exchange trading holidays, social unrest became violent and forced President de la Rua from office on December 20. There followed a period of political turmoil in which three presidents came and left office until President Duhalde was finally sworn in on January 3, 2002.

16. **The initial response to the crisis failed to stabilize the economy, and introduced policies that would prolong and complicate the crisis resolution process.** Following President Saá's declaration of a moratorium on all public debt service (except to the IFIs and that associated with the first phase of the debt exchange), President Duhalde abandoned the currency board arrangement on January 3, 2002, in favor of a short-lived and costly dual exchange rate regime.[8] To stem deposit withdrawals, time deposits were frozen and then

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[6] Phase one involved the exchange of (i) US$42 billion of federal bonds (mainly held by domestic banks and pension funds) for new domestic loans with lower interest rates and longer maturities; these loans were *pesoized* in March 2002; and (ii) US$16 billion of provincial peso and dollar denominated debt for new long-term federal government bonds, denominated in *pesos*.

[7] The restrictions capped monthly deposit withdrawals at US$1,000. Accompanying measures included: (i) a comprehensive ban on all payments and transfers abroad, except those related to trade and those explicitly authorized by the central bank; (ii) reserve requirements on increases in bank deposits to prevent deposit "flight-to-quality"; and (iii) limits on financial transactions which imparted a reduction in total bank deposits (e.g., checks, debit cards, credit cards, other bank transfers).

[8] With an official rate of Arg$1.4 per U.S. dollar for most trade transactions (with the exception of luxury imports), transactions related to trade finance, and public sector transactions; remaining transactions were at a market rate.

reprogrammed over five years. Comprehensive export surrender requirements were introduced and exchange controls, which had been eliminated in the free market of the dual exchange rate regime, were reinstated when the market was unified on February 11, 2002. To dampen inflation , the prices of the privatized utilities (gas, electricity, telephones, and water)—that had previously been contractually set in U.S. dollars and indexed to U.S. inflation—were frozen indefinitely, breaking the underlying contracts.

17. **The crisis saw a severe loss of legal certainty.** In late January, the Congress took action to protect debtors by radically amending the corporate insolvency law to the extreme detriment of creditors' rights. In addition, populist statements and actions by the political class tended to rest blame for the crisis on the banking community. In this environment, there resulted a harassment of bankers under the provisions of a defunct military-era Economic Subversion Law, which quickly became indicative of legal uncertainty and weak institutions in Argentina.

18. **Bank solvency was successively affected by direct government intervention in bank balance sheets.** Already damaged by deposit withdrawals and increasingly impaired assets, banks were hit further by the asymmetric *pesoization* of their assets and liabilities that was imposed by the government.[9] To compensate banks for the capital losses associated with the different rates of *pesoization*, the government eventually announced the issuance of government bonds amounting to about US$9 billion. Bank solvency was again adversely affected by the asymmetric price indexation of bank balance sheets forced by the government in May 2002. In addition, throughout the year, banks have been severely affected by large and continuing withdrawals of term deposits under court-ordered injunctions (*amparos*). These *amparos* required banks to pay-out previously U.S. dollar denominated time deposits at the prevailing market exchange rate (rather than the Arg$1.40 rate per U.S. dollar at which they were *pesoized* and indexed).[10] Governance issues played a large role as individual judges made rulings on the *amparos*.

19. **In an environment of regulatory forbearance, most banks managed to continue to operate and only a few banks were intervened**. However, the *ad hoc* approach to dealing with troubled banks, which included the differential treatment of shareholders and

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[9] Assets and liabilities were *pesoized* asymmetrically on February 4, 2002, with conversion rates of Arg$1=US$1 for loans to the private sector, and Arg$1.4=US$1 for loans to the public sector and for U.S. dollar deposits.

[10] The court injunctions intensified the deposit outflow, with about US$2½ billion of deposits released during January-October 2002.

depositors, and the unequal provision of central bank liquidity support, particularly to public banks, exacerbated the crisis of confidence in the banking system.[11]

D. Economic Developments during 2002

The collapse of economic activity was accompanied by a prolonged loss of monetary control and a quick rise in inflation that worsened poverty levels considerably. From mid-year, a "quasi-stability" was established principally based on binding foreign currency controls, continued deposit restrictions, and frozen utility prices.

20. **Output collapsed in the first six months of 2002**. Over this period real GDP fell by 13 percent extending the recession to the fourth straight year, and making Argentina's economic decline one of the largest experienced by any crisis country. The fall in economic activity was reflected in large declines of both consumption and investment, which only now appear to be bottoming out. The unemployment rate is estimated to have increased further to about 23 percent in October 2002, and there was a large increase in the number of people living in poverty (Box 6). The price deflation of earlier years was reversed in 2002 following the sharp depreciation of the *peso*. Monthly inflation peaked in April at 10½ percent and 19.9 percent for consumer and wholesale prices, respectively, but slowed sharply from mid-2002.

21. **Deposit withdrawals through the *amparos* continued through the year.** Initially, this necessitated large-scale liquidity support to banks that could not be sterilized by the central bank given its limited instruments. The flow of central bank credit to banks was equivalent to about 6 percent of GDP in the 12 months to July 2002. During the second half of the year, however, despite continuing *amparo*-related outflows of about US$300 million per month, overall deposits have stabilized and begun to expand (Text Table B). Interest rates, which were raised to 100 percent in March, have gradually been lowered, though bank intermediation has been severely limited. Bank lending to the private sector fell by about 50 percent in the 24 months to December 2002.[12]

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[11] For example, during the first half of 2002, one large local bank was provided significant liquidity and shareholders rights were suspended; one foreign bank and two domestic banks were intervened and subsequently sold to local banks; three foreign banks were taken over and managed by a public bank, and another was merged with its local subsidiary; and one domestic bank was supported in its recapitalization. These banks accounted for about 12 percent of banking system deposits.

[12] Data on nonperforming loans are not yet available as banks have not reported balance sheets since December 2001.

Text Table B. The Change in Private Sector Deposits and *Amparos*, 2002

(in Arg$ millions)	Q1	Q2	Q3	Oct-Nov
Private Sector Deposits	-9,364	-9,891	1,434	1,699
Amparos 1/	-1,136	-3,448	-2,853	-2,010

1/ Deposits released as a result of court-ordered injunctions.

22. **The fiscal position improved on a cash basis.** At the federal government level, the improvement reflected a revised revenue sharing agreement with the provinces (that allowed a sharp decline in federal transfers in real terms), the impact of inflation on revenues, tight control of primary spending (especially wages), and sharply reduced cash interest payments. Even then, the shifts in the fiscal balances were relatively small. During January–September 2002, the primary balance improved by about a ½ percentage point of GDP (to ¼ percent of GDP), and the overall deficit narrowed by 2 percentage points of GDP (to 2 percent of GDP) compared to the same period in 2001. The impact on provincial finances of declining tax revenues was aggravated by the reduction in revenue sharing transfers from the federal government; in the absence of financing, the provinces introduced nominal cuts in primary spending, including on wages, and continued with quasi-money issues. Even with significant interest savings following the phase one debt exchange, the primary and overall balances of the provinces remained in deficit—they are estimated to have narrowed to about ½ percent of GDP and 1¼ percent of GDP, respectively, in 2002.

23. **The cash fiscal position conceals the extent of the underlying deterioration in the public finances**. In 2002, there were large expenditures not captured in the cash balance, including: the issuance of Arg$36 billion of bonds in connection with the banking crisis and additional bonds issued in recognition of other obligations incurred; interest capitalization of Arg$26.4 billion associated with the phase one debt exchange and the indexation of government bonds; and interest arrears on phase two debt. A comprehensive measure would bring the augmented primary and overall deficits of the consolidated public sector in 2002 to 11¼ percent and 25¼ percent of GDP, respectively.[13] Further recapitalization of the banking system—to compensate for asymmetric indexation and capital losses from the *amparos*—also has accrued during 2002, but would be reflected in the augmented balance of 2003.

24. **The public debt-to-GDP ratio more than doubled to about 119 percent in the two years to June 2002** (Table 6). This increase reflected the impact of exchange rate depreciation on foreign currency debt, the issuance of new debt mainly in connection with the banking crisis, and the accumulation of arrears. Since the declaration of the partial debt

[13] Fiscal management has also become increasingly more complicated because of the greater proportion of federal taxes paid with federal and provincial *quasi-monies* (Box 4) and defaulted federal bonds, not all of which could be used to make agreed transfers to the provinces.

default, the government has remained current on its obligations to the Fund and to holders of sovereign debt restructured in December 2001, and on public debt instruments issued since that date. However, it has accumulated arrears of US$11.9 billion to private sector creditors, and US$830 million and US$1.4 billion to the World Bank and bilateral creditors, respectively (Table 7).

25. **Financing difficulties and the collapse of economic activity shifted the external current account from a deficit of US$4.6 billion in 2001 to a surplus of about US$9 billion in 2002** (Table 8). Imports are estimated to have fallen by 55 percent (in U.S. dollar terms) in 2002 and exports were flat, reflecting the crisis in the corporate sector (particularly the lack of working capital), weak demand in neighboring countries, and the imposition of export taxes in April 2002. Private net capital outflows in 2001–02 are estimated at about US$38 billion. Gross international reserves fell by US$20 billion to US$8.9 billion in the 18 months to July 2002; in the second half of 2002, the central bank has been able to make net purchases of about US$2 billion, bringing gross international reserves back to about US$10 billion.[14]

III. Policy Discussions: Macroeconomic Policies

A. Overview

26. **Discussions with the authorities since early 2002 have focused on overcoming initial policy reversals and putting in place a stabilization program that could set the stage for an elected government to undertake much-needed structural reforms.** Progress toward this goal was slow for a number of reasons. There have been difficulties in developing a broad political consensus for the program and, against a background of successive slippages and reversals, securing adequate assurances of implementation.[15] Thus, policy measures (often against the advice of Fund staff) have been initiated either by the executive or congress, and there have also been a number of judicial decisions inconsistent with parts of the program; together, these events have created uncertainties, reduced coherence, and delayed resolution of the crisis. Also, it has not helped that the executive and the central bank have generally not been equal partners in the evolution of policies, reinforcing concerns of central bank independence, and frequently straining relations between the Ministry of Economy and the central bank.

[14] The ability of the central bank to make net purchases in the foreign exchange market in recent months also reflected the surplus in the exchange market resulting from the collapse of imports and the cessation of payments on public debt.

[15] A chronology of key developments in 2001–02 is given in Annex I.

27. **The discussions have passed through a number of phases (and with different counterparts) but the main elements of a program have been identified from the early stages**. In particular, agreement has been sought on:

- **Fiscal framework:** A fiscal framework that explicitly incorporates commitments from the provincial governments and establishes clear progress toward a primary surplus path compatible with debt sustainability over the medium term.

- **Monetary control:** A credible strategy to regain monetary control, including a well-defined process to address deposit restrictions and deal with a monetary overhang.

- **Banking system:** A strategy to restore the soundness of the banking system, while maintaining its traditional private sector orientation.

- **Exchange controls and pricing policies:** Gradual liberalization of foreign exchange restrictions, and development of a new regulatory framework for the utility companies that would allow the freeze on their tariffs to be lifted.

- **Legal reforms, investment climate, and external debt:** Sustaining core reforms to improve legal certainty (including for the insolvency framework) and initiate an orderly process of renegotiation to regularize debt arrears with private creditors and allow corporate restructuring to begin.

- **Social safety net:** Strengthening the social safety net (in close collaboration with the World Bank and the IDB) to address the rising social dimensions of the crisis.

28. **There has been gradual progress toward reaching understandings in many of these policy areas.** In some areas, implementation has begun or is planned in the near future, but in others there are longstanding issues that still need to be resolved—such as developing a firm monetary anchor, finalizing measures to close the fiscal and external financing gaps in 2003, and adopting an agreed approach to privatized utility pricing and the related regulatory framework. In addition, aspects of the insolvency framework and creditor rights remain to be clarified.

29. **Given the difficulties in developing a policy track record, concerns regarding ownership and assurances of implementation have risen.**

- **Continuing concerns about legal certainty**, as evidenced by court decisions inconsistent with the thrust of parts of the program, and by the long awaited Supreme Court ruling on the legality of the *pesoization* of bank assets and liabilities—that would be fundamental to the design of the program.

- **The limited consensus within congress for many elements of the program**, as evidenced by frequent initiatives that have been inconsistent with the policy dialogue, such as maintaining a consistent approach to creditor rights.

- **The continuing influence of vested interests on economic policy**, as reflected by the successive difficulties in eliminating the remaining competitiveness plans.

- **The continuing lack of prior consultation with the staff** on announced policy decisions, the most recent examples being the elimination of the *corralito*, the approach to the frozen time deposits, and the reductions in VAT and corporate income tax rates.

30. **To mitigate these concerns, safeguards have been sought to ensure that an agreed economic program would be implemented.** Such safeguards could take the form of concrete and time-bound indications of political consensus for the main elements of the program under discussion and strong prior actions. In regard to the first of these safeguards, a step forward was taken with the November 18 political declaration signed by the President, most provincial governors, and congressional leaders. However, this declaration has not been supported by the main candidates for the Presidential election. An early test will be the timely passage of the 2003 budget and its supporting measures and tax reforms.

31. **It is difficult to project macroeconomic developments for 2003.** This will depend upon the nature and timing of the final agreement on a sustainable economic program. Nevertheless, given the very large contraction of the economy that has already taken place (more than 20 percent since 1998), and recent indications that the decline may be bottoming out, it should be possible to secure a modest recovery in 2003. Such a recovery will, likely, initially be based on a rise in private consumption. Investment will remain constrained because of delayed corporate restructuring and continuing financing problems. With some recovery in imports, the contribution from net exports is expected to be broadly neutral in 2003. The inflation rate has declined recently to a very low monthly rate, but sustaining this will be difficult in light of price increases already in the pipeline or in prospect (from utility prices), and uncertainties regarding the resolution of the monetary overhang and future exchange rate developments. Even in the context of a tight monetary policy, 12–month inflation would likely remain at about 35 percent by the end of next year.

B. Fiscal Policy

The discussions focused on the feasible adjustment of the primary balance of the consolidated public sector given the severe weakness of the economy and lack of financing; strengthening the social safety net to address the social dimensions of the crisis; incorporating fully the provincial governments into the adjustment effort; and making a start on fiscal structural reforms needed to put the public finances on a path toward sustainability.

32. **At the level of the federal government, the authorities have targeted a (cash) primary surplus of 2.1 percent of GDP in 2003.** This objective formed the basis of the 2003 budget submitted to congress on September 13, 2002, and the staff assessed this objective to be the minimum effort that should be made given sustainability concerns. This compares with the likely outturn of small (0.5 percent of GDP) primary surplus in 2002. However, the recent revisions to the underlying macroeconomic framework for 2003, and the performance of tax revenues risked putting the 2003 fiscal objective already beyond reach.

Consequently, the authorities have submitted to congress additional measures that would maintain the 2003 fiscal objective. These measures are mainly on the spending side. In particular, it has been proposed that a contingency fund of Arg$3½ billion (0.8 percent of GDP) will not be used until a mid-2003 review determines that the primary target is on track, and additional small cuts would be made to other budgeted primary spending (0.1 percent of GDP). Among revenue measures, the specific fuel tax would be converted to an ad-valorem basis with a very small net revenue impact (under 0.04 percent of GDP). In total, revenues are still projected to decline by a further 0.7 percent of GDP, but this would be more than compensated by a 2½ percentage point of GDP reduction in primary expenditures. To achieve the primary spending target, there would be strict limits on wages and pensions.

33. **The staff has made the point that federal spending restraint is probably reaching its limit and the emphasis needs to shift to developing a more robust tax base.** Argentina's (consolidated) tax revenue at about 15 percent of GDP is relatively low, well below—for example—that of Brazil whose tax ratio is more than twice as large. In this context, the staff has long urged taking concrete measures to raise tax compliance, strengthen administration, and improve governance. Initial measures in this direction (developed with Fund technical assistance) focus on intensifying the tax audit program, bringing medium-size tax payers into the system for controlling compliance, and eliminating tax cross-crediting schemes. Steps are also in train to improve fiscal governance and sustainability, although these will require the support of the congress. Thus, key prior actions in this area have been eliminating remaining competitiveness plans that allow credits against VAT payments for the agriculture, transportation and the media sectors, and approving legislation that would prohibit future tax amnesties by the executive (this has been completed on December 10, 2002).

34. **The government has reached agreement with the World Bank on the key *Heads of Household* program, that is the main component of the strengthened safety net.** However, this program had a difficult start. Early concerns over its governance took several months to resolve with the World Bank. Eligibility requirements under the program have now been tightened to ensure that key benchmarks of governance and design are met: (i) that at least 80 percent of beneficiaries meet the eligibility requirements; and (ii) that at least two-thirds of beneficiaries participate in eligible work activities. The World Bank is expected to renew its commitment of financial support for the program once Argentina clears its arrears to the Bank. In addition to this program, the government is reallocating expenditures toward emergency and high priority health and education programs, partly with the help of the IDB.

35. **The authorities agree that orderly provincial government adjustment is a major test for a credible macroeconomic framework.** Commitments of provincial governments are underpinned by: (i) the federal-provincial pact on temporary revenue sharing arrangements, signed in February 2002 and ratified after long delays, which abolished the minimum floor on transfers to the provinces and aims at eliminating provincial fiscal deficits by 2003; and (ii) a second round of *bilateral agreements* with the federal government covering 2003 that still needs to be ratified (Box 7). The adjustment at the provincial level

would be achieved through a combination of spending controls, administrative reforms, reporting requirements and penalties for noncompliance. However, there remain uncertainties whether the provinces will be able to eliminate their fiscal deficits in 2003 as originally committed in the February pact. The authorities expect that, as a minimum effort, the provinces should still achieve a primary surplus of about 0.4 percent of GDP in 2003, after a deficit of about ½ percentage point of GDP in 2002.

36. **On the basis of the policies under discussion, the cash primary balance of the consolidated public sector would improve by 2½ percentage points of GDP in 2003.** This would bring the cumulative adjustment since 2001 to 4 percent of GDP. The authorities have pointed out that this is a significant fiscal adjustment (particularly if measured on a cyclically adjusted basis) in a relatively short period when output declined sharply. The staff agrees that this effort has helped avert the threat of high inflation in 2002, particularly since the government has lost virtually all sources of noninflationary finance. However, the staff has pointed out that the sustainability of this adjustment will remain at risk as long as the tax base is not broadened and pressures continue for wage adjustments. In addition, assessments of the fiscal stance on a cash basis risk yielding incomplete conclusions. The government has had to resort to large debt-creating expenditures that, when taken into account, will imply a much smaller 'augmented' primary surplus of ½ percent of GDP in 2003 and a much larger augmented overall deficit of 12½ percent of GDP in 2003.[16]

37. **The current fiscal projections for 2003 yield a consolidated cash net financing gap of at least US$18 billion** (Text Table C)—reflecting the federal government and the provinces. There are still uncertainties about this financing gap. In addition, the authorities have also stated their desire that external financing be secured to retire the entire stock of quasi-monies, which would add about a further US$1.7 billion to the fiscal gap. Meeting this financing need under a possible program is discussed in paragraph 50 below.

Text Table C. Projected Fiscal Financing Gap, 2003
(In billions of U.S. dollars)

A. Sources of funds	**2.7**
Primary surplus of federal government	2.7
B. Uses of funds	**20.8**
Provincial financing needs 1/	1.4
Interest on federal debt	3.3
Amortization of federal debt	15.0
Payments of federal taxes with defaulted public bonds	0.4
Other	0.7
C. Net financing need (A-B)	**-18.1**

1/ Includes redemption of quasi-monies issued in 2002 to the limit of the agreed deficit for the provinces.

[16] The augmented balances reflect the inclusion of bonds issued: to compensate the banking sector for the asymmetric indexation of its balance sheet; the reinstatement of the 13 percent cut in wages and salaries implemented in July 2001; the capitalization of interest; and interest arrears on public debt.

38. **The discussions also focused on the measures needed to restore medium-term fiscal sustainability**. The staff took the view that this would require raising the primary balance of the consolidated public sector significantly over the medium term—to the range of 4–5 percent of GDP within the next three years. The authorities are not prepared to commit to surpluses of this magnitude, noting that such large surpluses were unprecedented in Argentina's recent economic history. They have also expressed the view that the present government does not have the mandate to pursue major structural reforms. In response, the staff has pointed out that surpluses of this magnitude would be necessary to anchor credibility in Argentina regaining public-sector solvency, and that there remains considerable scope to bring public wage bills closer to regional comparators (Box 3) and raise tax compliance and collections. The staff has proposed to the authorities that technical work be initiated as soon as possible (with the IMF/World Bank) to prepare supporting reforms and legislation needed to build fiscal sustainability. Such advance work would help the successor government in the following key areas:

- **A comprehensive reform of the tax system** aimed, *inter-alia*, at: (i) a substantial reduction in tax exemptions and preferential tax rates; (ii) a substantial reduction in regional promotion schemes; (iii) broadening the income tax base to include interest and dividend income and the profits of cooperatives and foundations; and (iv) a phased increase in the diesel excise rate to bring it in line with the rate for gasoline.

- **A comprehensive reform of the state** aimed at making the supply of public services more effective and underpinning the containment of expenditure. This would include: (i) a reform of the civil service, at the federal and provincial level; (ii) a reform of the social security system; (iii) a reform of the financing of the health care system of retirees; and (iv) a reform of the social safety net.

- **A reform of intergovernmental relations** that would include: (i) a simplification of the rules related to the primary distribution; and (ii) link the secondary distribution of transfers more closely to the revenue capacity and expenditure needs of each province.

C. Monetary and Exchange System Policy

The discussions on a monetary program have aimed at putting in place a money-based anchor. There remains, however, a high level of uncertainty arising from possible leakages of frozen time deposits. The central bank has limited instruments to counteract large withdrawals from the system.

39. **The main objective of monetary policy is to revive confidence in the peso and eliminate the monetary overhang in an orderly way, averting high inflation.** Thus far, the main focus of monetary and exchange system policy has been to stabilize the floating exchange rate. The authorities are encouraged by the recent stability in the exchange rate and the recovery in reserves, although this has required reliance on very tight exchange controls. Looking ahead, the authorities have agreed that the main focus of monetary policy should shift toward a money-based anchor aimed at controlling the growth of base money (defined

broadly to include provincial monies). In the staff's view, this is appropriate, and alternative approaches will take time to develop. The central bank has been interested in creating the conditions that would lead to the eventual adoption of an inflation targeting regime, but there is general agreement that its enabling conditions would take time to put in place.

40. **The central bank agrees that the monetary base should be held broadly constant until the monetary overhang has been substantially reduced or eliminated.** Subsequently, monetary growth would be tightly controlled in line with the output and price objectives. There is full agreement that the policy framework needs to firmly resist a return to high inflation as a means of resolving the costs of the crisis. Thus, avoiding any monetization of the fiscal deficit is a key plank of the macroeconomic policy framework.

41. **The main difficulty in the discussions on a monetary program has been to secure assurances of its implementation so that there could be a firm monetary anchor.** Deposits released by the *amparos* have continued throughout 2002 (Arg$9.5 billion), although they have recently stayed within the banking system. Risks of future deposit withdrawals remain high from the *amparos* (about Arg$10 billion) and the reprogrammed time deposits to be released in 2003 (about Arg$8 billion).[17] In addition, the recent stability in demand and savings deposits could be vulnerable to shocks now that the restrictions (the *corralito*) has been fully lifted.

42. **The authorities believe that the risks of renewed deposit runs are not large.** In their view, recent increases in deposits and in central bank net purchases of foreign exchange demonstrate that confidence is being rebuilt. They point out that, were deposit leakages to resume, they would raise bank reserve requirements, provide central bank liquidity assistance, conduct open market operations in central bank paper, and sell international reserves.[18] In the staff's view, however, the situation is still fragile and vulnerable to economic or political shocks. The lifting of the *corralito*, which covered mainly transactions balances, does not provide a parallel with balances released from time deposits. In addition, the central bank still lacks sufficient instruments. In particular, the stock of central bank paper is relatively small (about Arg$3½ billion, or 5 percent of total deposits), the market

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[17] Attempts to effectively sterilize the frozen time deposits through voluntary exchanges for bonds have been relatively unsuccessful, and the authorities recently extended further the time period for depositors to make such exchanges.

[18] Previously, the authorities proposed dealing with large deposit withdrawals by introducing legislation to the congress to effectively place the whole banking system in a Chapter XI-type bankruptcy status to give it protection from depositors. In the staff's view, such a contingency plan does not appear to be realistic or defensible—it is not realistic because the introduction of such legislation would likely intensify any run on deposits; and it is not defensible because it would not provide a sound basis to rebuild the banking system.

having been developed only recently. Thus, the staff remains concerned that any significant deposit leakage could quickly result in a loss of monetary control, as occurred in earlier in 2002. To establish a credible monetary anchor, the staff has emphasized that risks to monetary policy from the *amparos* and from the reprogrammed deposits need to be addressed upfront.

43. **The discussions also dealt with the need to phase out quickly the stock of federal and provincial quasi-monies to add credibility to monetary policy and the *peso*.** While the authorities are agreed on the need to redeem quasi-monies, they take the position that the additional *pesos* that would circulate as a result of this operation need to be backed by international reserves to maintain confidence. As such, they have been inclined to request additional foreign financial assistance for this purpose (about US$1½ billion).[19] The staff agrees on the need for caution in proceeding with the redemption of quasi-monies. However, the staff's view is that the redemption of quasi-monies for *pesos* at the prevailing market exchange rate should not be inflationary, given that they had already been in circulation for some time, and were performing the key functions of money.

Foreign exchange restrictions

44. **Several of the measures introduced in 2002 give rise to exchange restrictions subject to the Fund's jurisdiction under Article VIII**:

- The prior authorization requirement for external payments related to interest, profit remittances, dividend payments and reinsurance premiums, which prevents residents from making payments for these current international transactions.

- The prior authorization requirement for foreign exchange sales to nonresidents in excess of US$5,000 a month, which prevents nonresidents from repatriating abroad proceeds from recent current international transactions.

- The prior authorization requirement for external payments of principal on loans obtained before February 11, 2002, which prevents residents from making payments of a "moderate" amount for amortization.

- The freeze on time deposits, which could have captured nonresident deposit accounts holding proceeds of recent current international transactions, thereby restricting the ability of the nonresidents to repatriate these proceeds.

45. **The authorities have justified the restrictions as follows:** they have indicated that they were imposed for balance of payments purposes, that they did not discriminate against

[19] This would be for the pre-2002 stock of quasi-monies. Redemption of quasi-money issuance in 2002 is part of the fiscal framework under negotiation because it reflects delayed orderly financing from the federal government (up to the agreed deficit of the provinces).

Fund members, and that they intend to eliminate them prior to a request for a Stand-By Arrangement being brought to the Executive Board. However, a firm date for elimination has not been proposed and, therefore, the staff does not recommend approval of these restrictions.[20]

46. **The staff has also indicated the importance of setting a timetable for the liberalization of remaining foreign exchange controls**—including the compulsory surrender of export receipts to the central bank. In the staff's view, compulsory export receipt surrender to the central bank is not consistent with increasing the export orientation of the economy and, in light of other experiences, has pointed out that its efficacy is likely to erode over time. The authorities stressed the need to proceed cautiously with the dismantling of controls given the weak balance of payments position. However, they stated that, in the context of a Fund program, a schedule to begin liberalizing the remaining exchange controls introduced in 2001–02, including the compulsory export receipt surrender requirement to the central bank, would be announced. The central bank is in the process of consolidating all existing foreign exchange regulations, clearly specifying the scope and rules of the remaining controls, any exemptions granted, and authorization procedures.

D. Near-Term External Financing Issues

47. **The authorities considered that there were strong signs of a normalization of the balance of payment situation.** They pointed to the recent stability and growth of gross international reserves, the large current account surplus, and a generally more benign situation in the currency market. They envisaged a gradual removal of the export tariffs as the real exchange rate appreciated.

48. **Nevertheless, the authorities had not met their debt service obligations to the World Bank in November.** They explained that gross international reserves were close to the minimum level that they considered essential to maintain market confidence. The authorities emphasized that these arrears would be cleared as the reserve position improved and/or when the discussions towards a Fund supported program had been concluded successfully. The staff has expressed extreme regret at the government's decision to fall into arrears with the World Bank, and has strongly urged the authorities to clear these arrears immediately to ensure the continued financial support of the IFIs, including for crucial social programs. The staff has pointed out that, in the context of the floating exchange rate regime, gross reserves—at about US$10 billion—are relatively high in terms of the usual indicators of financial vulnerability, and that arrears to the IFIs—which would close the only remaining source of financing—would likely undermine recent financial stability.

49. **Regarding Argentina's external situation, the staff is more guarded in its assessment of continuing risks** (Table 9). The staff is concerned about the relatively slow

[20] Arrears (both on interest and principal) on sovereign debt are not subject to Article VIII.

response of exports to the substantial real depreciation of the exchange rate, the delays in restoring a properly functioning banking system, and the likelihood that access by the private sector to external credit would remain limited for some time. In the absence of an orderly adjustment program supported by the international community, risks will remain of further currency outflows from increased dollarization of the economy in response to possible shocks.

50. **Argentina's near-term financing needs are large.** Assuming that net international reserves are maintained at their end–September 2002 level through December 2003, there would be an external financing gap of about US$27½ billion. This includes principal obligations falling due to the IFIs and is before restructuring public debt held by private creditors. The authorities have indicated that the gap would be covered in part by a large temporary accumulation of arrears to private creditors (i.e., before debt restructuring). The remaining external projected financing need corresponds to the fiscal gap of US$18 billion. The authorities believe that this financing need should be fully covered by: (i) the IFIs rolling over debt service obligations due to them (about US$16 billion); (ii) net new IFI financing of about US$1 billion; and (iii) a prospective rescheduling of obligations to bilateral official creditors under the auspices of the Paris Club. This gap excludes any financing to redeem the pre-2002 stock of quasi-monies.

IV. Policy Discussions: Restructuring Issues and Legal Reforms

A. Financial Sector Restructuring

Over recent months, the discussions have progressed toward broad agreement on the main elements of a near-term strategy to begin restoring the soundness of the banking system—an essential priority for recovery. However, its implementation has still to begin.

51. **The development of a strategy to strengthen the banking sector has been hampered by the lack of basic information on banks' financial condition**. Banks did not issue financial statements for most of 2002 because of: (i) uncertainties concerning the compensation for losses resulting from the asymmetric *pesoization* and indexation of their balance sheets, and from court ordered injunctions to release restricted bank deposits; and (ii) delays in issuing necessary prudential and accounting rules which will form the basis of future bank financial statements. As a result, evaluation of the financial condition of the banking system and estimation of the impact of the crisis on bank capital and income has not been possible. These difficulties are now being addressed and banks were expected to submit end-September 2002 financial statements by early December 2002, and end-December 2002 financial statements by February 2003.[21] In addition, banks are expected to prepare detailed

[21] As of December 12, 2002, the revised regulations had not been issued and dates for the submission of the audited quarterly accounts have slipped by about one month.

business plans and cash flow projections for the next 24-month period by end-January 2003. This information should allow the central bank to evaluate the financial condition and the viability of all banks in the system and take necessary corrective steps.

52. **Very preliminary estimates, however, point to high operational losses for banks and a sharp increase in their nonperforming loans.** This increases the urgency of assessing the extent of under-capitalization or insolvency within the banking system. The basic strategy aims at maintaining incentives for the large foreign banks, representing two-thirds of private banking system assets, to remain in Argentina. The strategy anticipates that their shareholders will be willing to restructure and recapitalize their banks over the medium term. International banks have already largely recognized accumulated losses, and their decision to remain in Argentina will depend on a credible macroeconomic program and the implementation of an equitable banking sector restructuring strategy. The strategy also anticipates that smaller private banks will be either recapitalized by their shareholders or resolved through a combination of mergers and asset sales. In the case of bank failure, there would be clear rules for depositors. The public banks will require special attention, as described below.

53. **Thus, the main elements of the banking strategy are as follows:**

- Institutional and legal reforms to clarify the framework for bank resolution.
- Steps to enhance the autonomy of the central bank.
- Revisions to prudential regulations and the lender of last resort framework.
- Strengthened bank diagnostics and resolution.
- Measures to reform the public banks.

54. **The authorities have taken some initial steps to strengthen the institutional and legal framework for bank resolution, including enhancing the autonomy of the central bank**. The central bank has established a bank resolution unit, the *Gerencia de Supervision Especializada* (GSE). The authorities have agreed to submit as soon as possible to congress amendments to the Financial Institutions Law, aimed at strengthening the central bank's powers and authority for bank resolution and giving needed protection for public officials from challenges or compensatory claims against acts performed in a bank restructuring and rehabilitation process. These have been controversial issues in Argentina and it remains to be seen whether there is a clear consensus for strengthening central bank independence. Against this background, early congressional action to approve these amendments will be an important test of implementation capacity.

55. **In parallel, the central bank is finalizing needed revisions to banking regulations that will update the prudential framework**. By February 2003, the central bank has

committed to announce a minimum capital adequacy ratio for a transitional period and a timetable setting out progressive compliance toward full standards of capital adequacy.

56. **The strengthened legal framework aims at addressing the problems of weak private banks in a consistent way.** The framework anticipates that nonviable banks will be promptly suspended and sold (in full or in part) to other viable banks, or liquidated. If a bank is liquidated, depositors will be given the option to subscribe to government bonds or to remain in the bank and receive a *pro rata* portion of the bank's liquidation value. Undercapitalized banks will be required to present an acceptable rehabilitation plan that includes a timetable for gradual recapitalization, or the banks will be suspended and resolved. Adhering to such a consistent framework for bank resolution will be another key test of consensus and implementation capacity.

57. **The staff has given special priority to the risks and problems of the three main public banks.**[22] This is because of their relatively large share—about a third—of banking system liabilities, risks of quasi-fiscal losses, and their large indebtedness to the central bank. A particular difficulty in finalizing a strategy has been to ensure that all the three main public banks are subject to uniform rules of restructuring. This has been controversial because one of the public banks (*Provincia)* falls within the jurisdiction of the province of Buenos Aires. However, the authorities are now confident that all three public banks would be subject to uniform restructuring rules.

58. **The public bank restructuring strategy relies on two core initial measures**: (i) comprehensive due diligence examinations and strategic reviews of the future role of the banks; and (ii) limiting the banks' loss-making activities, strengthening their operations, and strictly limiting further access to central bank financing until a decision is made on their future role. Accordingly, in December 2002, the authorities have committed to issue documents launching the bidding process for international accounting firms to conduct due diligence examinations and for an international management consultant to advise on operational issues and conduct the strategic reviews. This work is expected to be completed by end-March 2003, at which time the government has committed to take decisions on: (i) a time bound action plan to improve operational performance; (ii) strengthening management; and (iii) the future strategic role of the public banks. Implementing the strategy for the restructuring of the public banks is crucial to an orderly implementation of the overall program, but it will be a strong test, again, of the political consensus—against a background of some dissident views that the public banks should be actively used by the government to jump start credit flows and recovery.

59. **The authorities are also considering allowing banks to repay credit from the central bank with government bonds already accounted in their balance sheets.** The

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[22] Banco de la Nación, Banco de la Provincia de Buenos Aires, and Banco de la Ciudad de Buenos Aires.

staff has expressed the view that such a "netting" operation—which would be available to all banks, but would substantially benefit the public banks—should not move ahead of the restructuring strategy. The authorities have explained that the netting would be market based and calibrated in step with the reform strategy—and would thereby have a limited negative impact on the central bank's capital position. A fully specified scheme is to be developed in consultation with the Fund and its implementation of the scheme will not begin until the new prudential regulations discussed above come into full effect. The staff stressed the need for any netting scheme to be available to all banks on a uniform criteria, to preserve liquidity controls, and maintain adequate capitalization of the central bank.

B. Insolvency Law and Corporate Restructuring

60. **During 2002, the congress and the government took various actions to restrict the ability of banks and other creditors to enforce their contractual and statutory rights.**[23] The most extensive of these was a February 2002 emergency law that suspended, for periods ranging from six months to almost two years, a comprehensive range of creditor rights, including the right to obtain judicial and extrajudicial foreclosures outside the insolvency law, and to obtain a declaration of bankruptcy under the insolvency law. Largely to address Fund concerns and after a prolonged period of public controversy—thereby raising issues of ownership—most of these restrictions were finally eliminated in a May 2002 law. A stay on certain kinds of enforcement proceedings that survived the May law was set to expire in August 2002, but was extended by congress for an additional 90 days despite the staff's serious concerns that such an extension would further reduce market confidence in the consistency of the legal process affecting creditors' rights. With the expiration of this stay in November 2002, the government committed that there would be no further involuntary restrictions on creditors' rights. However, after a request by the government (and discussion in Congress about extending the mandatory stay imposed in August), banks agreed in November to a voluntary 75-day stay on enforcement actions. In late November, an Executive decree authorized the courts to impose a stay of 30 days on foreclosure proceedings, during which time the debtor and creditor would be required to attempt to reach a settlement through a court-supervised mediation proceeding.[24] It is expected that further discussions will be held with the authorities on this decree and on the importance of avoiding ad hoc changes in creditors' rights.

61. **The government's efforts are also centered on designing and securing congressional approval of legislation that would encourage out-of-court workouts**—by

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[23] Insolvency law developments in 2002 are discussed in detail in the forthcoming Selected Issues paper.

[24] This decree applies to foreclosures involving individuals and small- and medium-sized enterprises (SMEs). However, the definition of SMEs is quite broad and could cover the vast majority of domestic companies.

providing a framework and incentives for such transactions, and avoiding any use of fiscal resources. While the details are still being worked out, it is anticipated that this legislation will, *inter-alia*, contain provisions aimed at allowing a qualified majority of a debtor's creditors to agree to a stay on certain kinds of enforcement proceedings that could then be made binding on all creditors for a fixed period during out-court-negotiations. The staff has expressed the view that there should not be any mandatory stays in the framework.

62. **The government intends to implement other legal reforms to support corporate restructuring.** This includes a package of definitive insolvency law amendments aimed at ensuring that the insolvency system serves its critical function of supporting out-of-court workouts. In the immediate period ahead, the authorities will also assess whether there are other remaining legal or regulatory obstacles to corporate workouts.

C. Price Controls on the Utility Companies

63. **The approach toward the privatized utility companies remains to be agreed with the authorities.** In the staff's view, the situation regarding utility pricing is unsustainable. Tariff changes (and, therefore, inflation) have been suppressed this year, thereby risking a burst of price pressures when tariffs are eventually liberalized, which could be just as a new government is taking office. The authorities are of the view that only gradual increases in the tariffs of the utilities are feasible in the current circumstances, principally because of the social impact. They have also pointed out that the utility firms generally enjoyed an extended period of high profitability in the past that afforded them the opportunity for appropriately hedging exchange rate risk. Thus, they have recently, in early December, decreed tariff increases averaging 7–9 percent for gas and electricity companies, and have been preparing to announce similar increases for some other utilities. They have also held out the expectation of a further similar increase in March.

64. **The staff believes these tariff increases are too low given the inflation and exchange rate depreciation that have occurred since tariffs were frozen last January**. In any event, the staff is concerned that even the limited proposed increase has since been overruled in the lower courts, underlining the difficulties in assuring implementation in the current environment. Public hearings on tariff increases have also been blocked by the courts, making it difficult to progress toward an agreement on an appropriate regulatory framework for the utilities. The staff proposed a joint IMF/World Bank mission to gather data on the financial situation of utility companies, and to secure an agreed strategy in this area, especially to develop an appropriate regulatory framework that would allow the utility companies to carry forward debt restructuring with their external creditors. However, the authorities are of the view that such a mission should take place only at the time of the first review of a Fund-supported program.

V. Public Debt Restructuring and the Medium-Term Outlook

65. **Public debt restructuring and the medium-term outlook are closely inter-twined.** The staff explained to the authorities the immediate priorities for a program arising from the Fund's policy for lending into arrears. The authorities were of the view that their public debt restructuring efforts were fully in compliance with this policy. They acknowledged that they had been slow to pursue contacts with foreign creditors, but noted that the dialogue had intensified in recent months, including meetings with institutional investors and with German and Italian retail investors, and other bilateral contacts with bondholders. The authorities noted that they had recently issued terms of reference for external debt restructuring advisors, who are expected to be appointed by January 2003.

66. **The staff welcomed these steps, but noted that some institutional bondholders continued to complain about the process.** These complaints centered around the lack of contacts and an unwillingness by the authorities to respond to proposals regarding procedural aspects of the restructuring—and may have contributed to the increase in litigation by retail bondholders. The authorities acknowledged that time pressures had not always allowed them to respond to all approaches made by creditors, and undertook to intensify such contacts. They hoped to conduct further meetings with foreign creditors in coming weeks. However, they were reluctant to make commitments regarding procedural aspects of the restructuring, given expectations that it would be carried out only by the new government.

67. **A very preliminary assessment of the medium-term outlook is presented in Annex II.**[25] The baseline scenario suggests that, even in the presence of a substantial fiscal effort (with sustained primary surpluses well above Argentina's past experience), without significant debt- and debt-service restructuring, the indicators of public debt and debt service would increase and large fiscal and external financing gaps (averaging 12 percent of GDP) would remain over the medium-term. Moreover, these gaps would be very large in relation to obligations falling due on existing debt held by the private sector and bilateral creditors. However, given the highly uncertain economic outlook, any assessment of medium-term fiscal and external sustainability must inevitably be subject to considerable uncertainty and must, therefore, be regarded as highly preliminary. Staff will continue to review the medium-term scenario as the economic situation stabilizes.

VI. Trade Policy

68. **Argentina responded to the crisis with a range of changes in its trade regime.** In a first phase in mid-2001, before the collapse of the convertibility system, it employed a

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[25] Medium-term and sustainability issues are discussed in more detail in Annex II.

combination of import tariffs and export subsidies to try and offset the effects of the appreciating real exchange rate.[26] Similarly, in order to help domestic industries, import tariffs on capital goods were lowered relative to those on consumer goods. In a second phase, after the collapse of the convertibility regime, these earlier measures were reversed and consumer tariffs reduced to alleviate inflationary pressures from the peso depreciation; also, export taxes of up to 20 percent (for farm products) were introduced to raise fiscal revenues. The annual revenue yield from export taxes is estimated to amount to about 2 percent of GDP.

69. **Exports have been slow to respond to the *peso* depreciation.** While this is partly due to financial instability and the collapse of credit, it also reflects the restrictive exchange regime, administrative obstacles, and foreign market access barriers. Apart from the burden imposed by export taxes, exporters have faced a number of onerous exchange restrictions (currency surrender requirements on a tight timetable, and limits on pre-export finance), delays in VAT drawbacks, and a deterioration in public services such as phytosanitary controls. Moreover, competitive exports are concentrated in the agricultural sector, which faces steep tariff barriers, quotas and phytosanitary restrictions (following an outbreak of foot-and-mouth disease in 2001) in Argentina's main export markets. For instance, Argentine beef remains all but banned from the U.S. market, and faces ad valorem equivalent tariffs (AVEs) of almost 180 percent on the EU market; cereals face AVEs of 120 and 58 percent in Japan and the EU, respectively, as well as lower world prices because of advanced country subsidies in this sector.

VII. Safeguards Assessment

70. Under the Fund's safeguards assessment policy, the Central Bank of Argentina is subject to an assessment with respect to the Stand-by Arrangement, which was approved on March 10, 2000 and is scheduled to expire on March 9, 2003. A safeguards assessment of the Central Bank was completed on September 5, 2002. The assessment concluded that substantial risks may exist in the system of internal controls. Staff findings and recommendations will be reported in the staff report for the approval of a possible new arrangement. Implementation of the measures by the Central Bank will be monitored by the staff.

VIII. Staff Appraisal

71. **Since the last consultation in September 2000, there have been far-reaching developments in Argentina that have radically transformed its economic situation.**

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[26] The Fund's trade restrictiveness rating is 5 (this index varies from 0 to 10, with 10 indicating maximum trade restrictiveness with most countries rated between 0 and 5).

Argentina has been subject to a vicious cycle of falling confidence, capital flight, a large depreciation of the *peso*, and collapse of economic activity. The events in Argentina have affected neighboring countries and influenced market perceptions towards the region.

72. **Directors have been kept closely informed of the unfolding events as the staff has tried over a long period to develop with the authorities a sufficiently comprehensive reform package that would arrest the vicious cycle and set the basis for recovery.** However, until now, the staff has not had the opportunity to share with Executive Directors its view of all the factors that have led to Argentina's economic and financial collapse, and the extent to which the deterioration that has taken place could have been contained or avoided. The opportunity of the consultation also allows the staff to present to Executive Directors why it has taken so long for a comprehensive program to be put in place.

73. **Many factors combined to result in the massive loss of confidence that forced Argentina's sovereign default and abandonment of its currency board.** The root macroeconomic cause, in the staff's view, was that the currency board arrangement was not adequately supported by the rest of the policy framework. Inflexibilities in many sectors of the economy could not compensate for the growing real appreciation that was the result of the currency board. In particular, fiscal policy grew progressively inconsistent with the demands of a currency board regime and a sizable public debt was built up during the second half of the 1990s, making Argentina vulnerable to rollover/funding risk. The finances of the provinces of Argentina played a key role in the fiscal deterioration that took place in this period.

74. **Economic causes and factors alone cannot fully explain the extent of Argentina's collapse.** Social, political and institutional weaknesses were also instrumental. The crisis saw a breakdown in many institutions and the loss of legal certainty—the foundation of orderly economic process.

75. **Early government actions and intervention exacerbated the situation.** These took many forms, such as the imposition of the *corralito*, followed by the decision to convert foreign currency denominated assets and liabilities of the financial system into *pesos* at asymmetric exchange rates. Argentine debtors also prevailed upon the Congress to radically tilt the balance in the insolvency law against creditors, thereby jeopardizing any progress toward debt restructuring of the corporate sector. There are important lessons in these actions of Argentina which were taken at the height of the crisis and which have impeded recovery. In particular, they illustrate the problems that arise when there is a lack of political consensus toward resolving a crisis and apportioning its costs in an orderly way.

76. **Against this background, it has taken time to stabilize the economy and put in place an orderly resolution framework.** The challenges have been in at least four main areas. First, giving reassurances about legal certainty. Second, establishing a robust fiscal framework and ensuring that the provincial finances are fully part of it. Third, developing a firm monetary anchor, which has been specially important in light of the monetary overhang. Fourth, developing a framework for restoring a sound financial system.

77. **Progress in all these areas has been halting**. To a large extent, this has reflected the increasingly caretaker nature of the government and the continuing absence of a sufficiently strong political consensus. The stability that has been achieved in the second half of the year is creditable and reflects, in important measure, the fiscal restraint that has been exercised during the year. However, the stability is also reflective of the tight controls that continue to apply on all foreign exchange transactions and on prices for a large section of the economy.

78. **Restoring confidence in legal certainty has been a major challenge for Argentina.** It took the government until the middle of the year to reverse the more harmful provisions of the February emergency law that had curtailed creditor rights and to repeal an economic subversion law that was of significant concern to the investor community. Moreover, even after these changes, steps have continued to be taken that impede the ability of creditors to enforce their contractual rights. It is important that the remaining measures in this area be eliminated and appropriate incentives for voluntary workouts be adopted, so as to facilitate the debt restructuring and increase in the supply of new bank credit, which are needed for sustainable growth.

79. **The fiscal program that is being negotiated is centered on maintaining tight control over primary spending and rebuilding tax administration and a culture of compliance.** Expenditure cuts will be controversial and their implementation will be a key challenge for the authorities. However, they cannot be avoided given the need to make a firm start on restoring fiscal sustainability, as well as the lack of available financing for the public sector. The temporary cuts in the VAT and corporate income tax rates have only added to these difficulties. Recent legislation eliminating the ability of the executive to grant tax amnesties is welcomed.

80. **It will be essential to keep the provincial governments firmly anchored in the adjustment effort.** The authorities need to seek early ratification by provincial legislatures of the *bilateral agreements* that will underpin the 2003 fiscal targets for the provinces. Additional efforts also need to be made to improve the transparency, quality and timeliness of the data reported on the provincial finances to ensure effective monitoring.

81. **A key outstanding issue is how to close the estimated fiscal and external financing gap** that would remain under a program even if the consolidated public sector primary surplus target for 2003 is met. It is likely that the authorities will need to consider further the extent to which additional economies can be achieved. An early start also needs to be made on retiring the stock of quasi-monies, which the staff views as feasible without the additional external financial support requested by the authorities.

82. **The fiscal effort that will be required to sustain the public finances in the medium term is unprecedented in Argentina's recent experience and will require the adoption of major structural reforms in the 2004 budget.** Although only in office for an interim period, the government has an important responsibility in making a start on the necessary reforms by preparing key legislation for a comprehensive reform of the tax system

and a strategy and legislative timetable for a reform of the state and of intergovernmental relations.

83. **The authorities still need to address the risks to the banking system from *amparos* and reprogrammed time deposits to be released in 2003.** This is particularly the case following the lifting of the *corralito,* which has increased the vulnerability of the banking system to shocks. Significant deposit leakage as a result of shocks would quickly lead to a loss of monetary control because of the limited instruments available to the central bank. Uncertainties arise also because of the pending ruling by the Supreme Court on the constitutionality of the *pesoization* of bank deposits. These issues need to be resolved for a credible monetary anchor to be established.

84. **The authorities need to make up for time lost in implementing the banking strategy so to restore depositor confidence fully and limit the fiscal costs of the crisis.** Particular attention should be paid to securing early congressional approval of the legislation to enhance central bank independence and protect public officials carrying out their duties in the bank resolution process. Given the sensitive nature of bank resolution, it is important that it is undertaken in a uniform and transparent manner.

85. **The staff does not recommend approval of the exchange restrictions under Article VIII**. Although they were imposed for balance of payments reasons, and do not discriminate against Fund members, there is still not a firm timetable for their elimination. Nevertheless, the staff welcomes the authorities' intent to liberalize these and other exchange restrictions as soon as possible.

86. **A key concern remains the unsustainable situation regarding utility pricing, which risks putting a large burden on price adjustments in 2003.** It is regrettable that even the recently decreed tariff increases for gas and electricity companies—which staff assessed as too low given the inflation and exchange rate developments this year—have been halted by the courts. Public hearings on tariff increases have also been blocked by the courts, making it difficult to develop an appropriate regulatory framework for the utilities.

87. **Regarding trade policy,** the staff recommends early efforts by the authorities to further liberalize the trade regime, remove the anti-export bias, and leverage regional and multilateral negotiations in order to improve market access for Argentina's products. Recent policies have introduced significant uncertainty for both importers and exporters. Short-term efforts should be focused on reducing administrative obstacles to exports, and phasing out export taxes as the fiscal situation permits. A successful outcome of the WTO negotiations, including in agriculture, would greatly benefit the Argentine economy. In the staff's view, regional agreements are second-best; particularly if they do not cover agriculture and lead to a meaningful reduction in import protection.

88. **The staff welcomes the steps the authorities have taken to initiate contacts with private creditors, and their intention to intensify this dialogue with the assistance of external debt restructuring advisors**. Continuation of progress, particularly with

institutional investors, in this area would provide a basis for determination of compliance with the "good faith" criterion under the Fund's policy for lending into arrears. While it is unlikely that negotiations will commence before a new government is in place, the authorities would be well-served to prepare the ground as fully as possible in the interim, not least to reduce the risk of further litigation against Argentina by bondholders.

89. **The staff has also expressed concern about the ownership and supporting political consensus for the emerging policy framework.** While the November 18 political agreement may be viewed as a step in the right direction, a key challenge will be to ensure that the political consensus can be sustained in the face of populist pressures. There are key tests ahead, such as in congressional approval of the fiscal package and implementing the banking framework.

90. **Even with the best of efforts, Argentina's medium-term outlook appears very difficult.** With the maintenance of a substantial fiscal adjustment effort, the debt ratio would decline over the medium term, but not sufficiently to reach conventional benchmarks for sustainability. At the same time, Argentina's financing needs are relatively large and there are poor prospects for Argentina regaining market access in the near future. While there are obvious difficulties in estimating the magnitude of needed debt reduction in the midst of a severe economic crisis, the authorities need to work closely with the international community and to reach a cooperative solution with private creditors to secure financing and achieve fiscal and external sustainability over the medium term. Finalizing an economic program that could be supported by the international community is an essential first step to putting Argentina on a path to recovery.

Box 1. Growth of Public Debt Under Convertibility

Argentina's gross consolidated government debt doubled as a share of GDP between end-1992 and end-2001, from 31 percent to 62 percent, while rising in absolute terms from nearly US$70 billion to nearly US$170 billion. The table below shows the key contributors to the increase were:

- **Weak primary fiscal effort.** The primary balance effectively played no role in moderating the growth of debt, with the primary balance averaging close to zero.

- **Rising interest payments,** reflecting increasing interest rates and the higher debt stock. The average interest rate on Argentine debt rose gradually through the period, mainly reflecting a rising share of market debt (at the start of the period, official sector and restructured debt, paying below-market interest, made up a very large proportion of the total).

- **Debt recognition, not recorded in expenditures,** which added an annual average of over 1 percent of GDP to the debt. These mainly reflected bond financed expenditures mandated by the judiciary, including compensation payments after the social security reform of the early 1990s and payments to suppliers.

- **Weak economic activity.** In 1993–98, rising nominal GDP reduced the debt-to-GDP ratio by over 2 percentage points a year on average; subsequently, falling GDP pushed the ratio up by nearly 2 percentage points a year.

Argentina: Contributions to Growth of Debt-GDP Ratio, 1992-2001
(In percent of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Averages 1993-98	Averages 1999-2001
Consolidated Government Debt	**30.7**	**30.6**	**33.7**	**36.7**	**39.1**	**37.7**	**40.9**	**47.7**	**50.8**	**62.0**	**36.4**	**53.5**
Contributions to change in debt:												
Total		**-0.1**	**3.2**	**2.9**	**2.4**	**-1.3**	**3.2**	**6.8**	**3.1**	**11.3**	**1.7**	**7.0**
Primary balance		-1.6	-0.2	0.5	1.1	-0.3	-0.6	0.7	-0.4	1.4	-0.2	0.6
Interest payments		1.6	1.7	1.9	2.2	2.5	2.7	3.2	4.1	4.6	2.1	4.0
Privatization receipts		-0.4	-0.4	-0.6	-0.4	-0.6	-0.2	-1.0	-0.1	-0.1	-0.4	-0.4
Debt recognition		3.9	2.8	1.1	1.2	0.8	0.6	1.0	0.9	0.9	1.7	1.0
Other, including valuation changes		0.4	2.2	0.3	0.4	-0.9	1.5	0.4	-1.1	1.1	0.6	0.1
Real GDP growth		-1.7	-2.0	1.0	-2.2	-3.1	-1.6	1.6	0.4	2.7	-1.6	1.6
Inflation (GDP deflator)		-2.1	-1.0	-1.2	0.1	0.2	0.7	0.9	-0.7	0.7	-0.6	0.3

Source: Ministry of Economy, and Fund staff calculations

Box 2. Argentina and Tax Amnesties

- **Argentina's poor tax performance partly reflects weak tax administration and enforcement.** Efforts to improve the efficiency of the system have been hampered by repeated tax amnesties—eleven general amnesties since 1990. These are seen as having created a pervasive belief that taxes can almost always be avoided by waiting until the next amnesty. Hence, staff believes that a credible commitment by government that it will no longer grant amnesties is a prerequisite for any substantive turn-around in tax compliance.

- **Amnesties are attractive to cash-constrained governments because they usually generate some revenue in the short run, though net gains are far less than the gross gains that tend to be quoted by proponents.** The problem is that any amnesty creates the expectation of future amnesties, thereby undermining future compliance, and producing a long-run drain on the budget which outweighs the short-term inflow.

- **Direct indicators of the cost of amnesties are difficult to collect.** However, it is clear that, if Argentina's revenue/GDP ratio is adjusted for changes in tax policy, tax yields have fallen significantly over the 1990s. For instance, revenue as a percent of GDP would have fallen by 2½ percent of GDP between 1996 and 2000 if new taxes had not been introduced in an attempt to stem the losses (this calculation includes revenue loss from the crisis as well as from the decline in compliance). Sectoral compliance rates are also down: the tax administration (AFIP) estimates that the construction industry now pays only one-third of the VAT it should pay, and only 40 percent of its social security obligations. Agriculture is estimated to pay only half of its VAT due, and two-thirds of its social security obligations. Compared to other countries in the region that have had minimal recourse to tax amnesties, these compliance rates are low. For instance, in Chile, the overall compliance rate is estimated to be around 80 percent.

- **Tax amnesties also create other problems for the tax administration besides deterring compliance.** They create additional workflow (to manage the amnesty), divert resources from audit, collection enforcement, and taxpayer services, and undermine court cases (since all delinquent taxpayers have access to the amnesty). These additional inefficiencies are also seen as having contributed to tax collection difficulties in Argentina. Staff compiled estimates of the cost of tax collection in various countries (though these are subject to methodological caveats), and found that Argentina's is the highest. In 2000 (i.e., even before the recent revenue collapse), tax collection cost Argentina 2 percent of total tax revenue, compared with 1½ percent in Mexico, around 1 percent in Bolivia and Ecuador, and ¾ percent in Chile. (Tax collection cost the U.S. 0.4 percent of tax revenue in 1999.)

- **This is the rationale for legislation to preclude the executive from granting further amnesties.** Legislation was recently approved curtailing the power of the executive to grant tax amnesties without support from congress. While this is not as comprehensive as staff had advised (since it does not extend to overdue taxes voluntarily declared by taxpayers), and its success will depend on congressional restraint and the establishment of a track-record over time it is, nonetheless, an important first step toward reestablishing the credibility of tax enforcement.

Box 3. Pre-Crisis Public Sector Wages and Employment

- **Increases in the public sector wage bill have added significant burden on public finances.** The wage bill rose by 1.3 percent of GDP during the four years prior to the crisis with practically all of the increase concentrated in the provinces. A portion of this increase is explained by the education reform in the province of Buenos Aires, which included both significant new hiring of teachers and increases in their remuneration. Overall employment in the provinces rose by 7 percent between 1998 and 2001, while there was a slight decline in the federal employment. By 2001, over 12 percent of the labor force was employed in the public sector. The over reliance on public employment is particularly acute in smaller provinces (e.g., Santa Cruz, La Rioja, Catamarca), where roughly one in five labor force participants is employed in the public sector.

- **The pre-crisis increase in public sector employment and wages occurred against the back drop of growing unemployment, a decline in private sector wages, and some labor reform efforts.** The average public sector wage increased by 7 percent in U.S. dollar terms, with the increase being more pronounced at the provincial government level. Overall, the wage growth in the public sector outpaced the increase in the economy's per-capita income. Public sector employment rose at a faster pace than the increase in the labor force.

Argentina: Public Sector Employment and Wages

	1996/98	1999/01	*Difference*
Wage bill (in percent of GDP)	**8.3**	**9.6**	**1.3**
Federal	2.8	3.0	0.1
Provinces	5.5	6.6	1.1
Employment (in thousands)	**1,730**	**1,803**	**4.2** 1/
Federal	481	462	-4.0
Provinces	1,249	1,341	7.4
Average wage (US$ per year)	**13,831**	**14,804**	**7.0** 1/
Federal	17,024	17,885	5.1
Provinces	12,601	13,741	9.0
Ratio average wage to GDP per capita	**1.7**	**2.0**	**0.3**

1/ Percentage change

- **Public sector employment and wages are difficult to compare across countries, because of definitional differences.** With that caveat, data suggest that Argentina's average public sector wage (compared with per capita income) is not out of line with wages in other middle income countries, or for that matter with European wages – though there is considerable dispersion in the sample. However, public sector employment is much higher than in middle income countries of the sample, though lower than employment in Italy and Portugal.

Cross Country Evidence: Public Sector Employment and Wages 1/ 2/

	Average Wage (% GDP per capita)	Public employment (% of labor force)
Argentina	1.9	12.5
Brazil	...	7.3
Chile	2.0	7.1
Mexico	1.1	4.5
Korea	2.1	8.0
Philippines	3.0	5.2
Turkey	2.1	8.2
South Africa	...	9.2
Italy	1.6	13.6
Portugal	2.0	14.4
Spain	1.7	12.5

Sources: OECD, World Bank and Fund staff estimates.

1/ Includes central and local government, education and health workers and armed forces (except Turkey).
2/ Data for 1996-2000, except for Western Europe 1997-98.

Box 4. The Phenomenon of Quasi-Monies

- **Beginning in July 2001, several provincial governments resorted to the issuance of quasi-monies to settle payment obligations, such as wages, pensions, and purchases of goods and services.** In turn, these quasi-monies can be used to pay provincial tax liabilities, and thus effectively serve as a medium of exchange in the province. Provincial money substitutes have surfaced previously in Argentina during periods of financial distress (e.g., during the *Tequila* crisis of 1995).

- **The federal government also began issuing quasi-money (*lecops*) to meet guaranteed minimum revenue sharing transfers to the provinces agreed under the 2001 federal-provincial pact.** The federal government and central bank have boosted the liquidity of quasi-monies by allowing the *lecops* and the quasi-money issued by the province of Buenos Aires (*patacones*) to be used to settle federal tax obligations, credit card debts, and mortgage obligations. Other provincial governments have gone to the courts to gain broader acceptance of their own quasi-monies, along the lines of that granted to the province of Buenos Aires.

- **Quasi-monies have been issued in 12 out of the 24 provinces and the stock in circulation stands at roughly Arg$7.5 billion.** This is equivalent of about 50 percent of all *peso*-denominated currency in circulation, up from Arg$2.8 billion at end-2001. Over three-quarters of the stock are accounted for by *lecops* and *patacones*, which circulate nationwide.

- **Quasi-money issuance by provincial governments in 2002 amounted to Arg$3.2 billion**—broadly in line with the agreed deficits, and should be compensated by orderly financing as provided in the 2002 bilateral agreements.

- **The main drawback of quasi-monies are:**

➢ **They erode the ability of the central bank to conduct monetary policy** and contribute to the significant *peso* overhang by reducing the demand for *pesos* for transactions purposes. Quasi-monies—which have very different acceptance levels and circulation jurisdictions—exhibit a very high velocity of circulation, reflecting their inferior status to the *peso* in terms of store of value and unit of account.

➢ **They complicate the commitment to fiscal management** and do not alter the budget constraint.

➢ **They contribute to the growth of the informal economy and to tax evasion.** Given restrictions on cash withdrawals from the banking system over most of 2002, quasi-monies were the currency of choice in the informal sector of the economy.

➢ **They have an adverse impact on inter-provincial trade.** With the exception of *patacones*, most of the quasi-monies are not accepted outside the jurisdiction in which they were issued. As such, they generate important trade diversion flows, promoting regional inefficiencies and tending to regionalize provincial economies at the expense of efficiency-enhancing nationwide integration.

Argentina: Quasi-Monies in Circulation, November 2002

	Arg$ million	In monthly wages	Exchange rate (in percent)
Total Quasi-Monies	**7,442**	...	...
Lecops (Federal QMs)	**3,150**	...	95
Provincial QMs	**4,292**	**3.0**	...
1. Buenos Aires	2,583	5.9	95
2. Catamarca	32	1.6	...
3. Chaco	100	2.2	...
4. Cordoba	800	7.6	90
5. Corrientes	206	6.0	42
6. Entre Rios	219	4.2	53
7. Formosa	73	2.4	70
8. Jujuy	6	0.2	...
9. Mendoza	59	1.0	95
10. La Rioja	15	0.5	100
11. San Luis	30	1.6	100
12. Tucuman	168	3.3	...

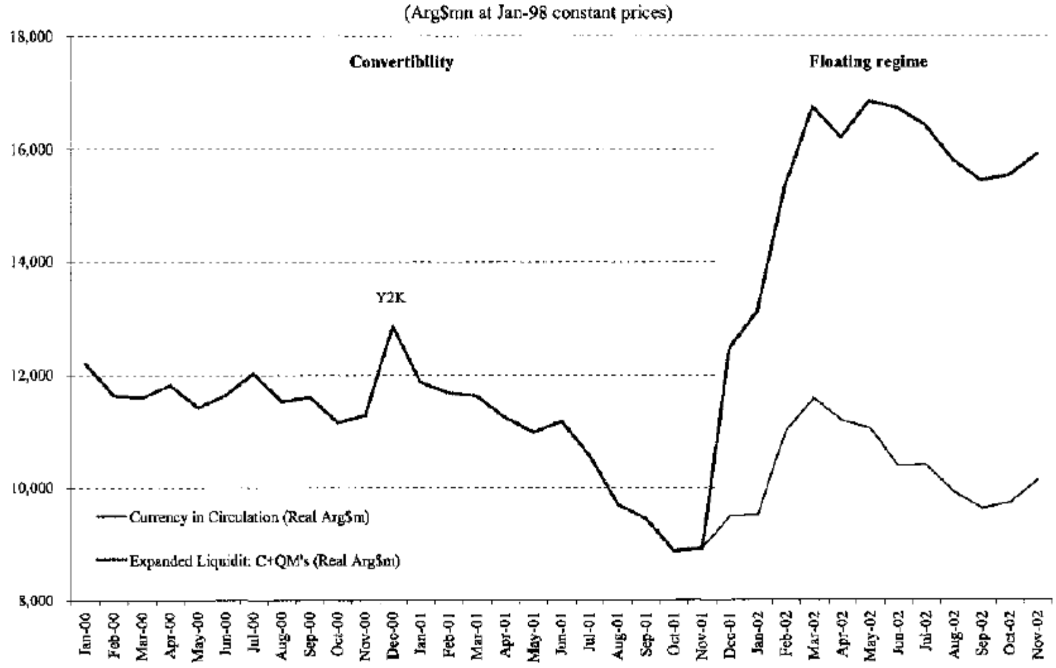
Box 5. The Monetary Overhang

- **Many factors were behind the major collapse in the demand for money in Argentina during November 2001–February 2002:** (i) the change of foreign exchange regime; (ii) the sovereign external debt default; (iii) the *pesoization* of dollar-denominated private contracts at an asymmetric and arbitrarily chosen exchange rate; (iv) growing political instability; (v) the major collapse of real economic activity; and (vi) the accelerated printing of provincial quasi monies.

- **Compounding the drop in the demand for money, and the acceleration of the velocity of circulation, was the rapid growth of the money supply for the first 90 days after the convertibility regime was abandoned.** This was driven chiefly by large-scale rediscounts to the banking system and central bank financing of the budget. Liquidity assistance to the banking system increased form Arg$7.2 billion at end-November 2001 to over Arg$20.6 billion at end -June 2002. Furthermore, dollar denominated deposits—about 75 percent of all private sector deposits—were *pesoized* at 1.4 *pesos* per US$1 and indexed to inflation. This increased the real money supply (M2), at a time when the real demand for money was collapsing, and created a large monetary overhang that was mitigated initially by the restrictions on bank deposits (*corralito* and *corralon*).

- **By late June 2002, Argentina faced a sizeable monetary overhang** (similar to the problems faced by many Eastern European transition economies during early 1990s), reflecting the rapid expansion of currency in circulation and time deposits trapped in the banking system. For instance, currency in circulation plus quasi-monies jumped from 4.8 percent of GDP at the end of 2001, to 7.4 percent at end March 2002, and was still at 6.3 percent of GDP at end-June 2002. In this period, the main instrument available to the central bank to sterilize the excess supply of money was spot sales of foreign exchange, but the magnitude of the money creating flows was such that the central bank achieved only modest sterilization (see chart).

Argentina: Currency in circulation and Expanded Liquidity (C+Quasi-Monies)
(Arg$mn at Jan-98 constant prices)



Box 6. Social Impact of the Crisis and Social Safety Net Programs

The staff has stressed the need to strengthen the social safety net to limit the social consequences of the crisis. Since the start of the economic recession in 1998 through the months leading up to the crisis, there have been large increases in unemployment, poverty and income inequality. By October 2001, roughly two out of every five Argentines lived below the poverty line, and one-fifth of all workers were unemployed. The crisis accelerated the deterioration of an already difficult social situation.

During the first half of 2002:

- **The share of population considered poor grew by roughly 15 percentage points** (more than it had since the start of the recession in 1998), while the number of extreme poor nearly doubled. Currently, more than half of the population live below the poverty line, and close to one-fourth of the population is indigent.
- **Unemployment increased by an additional 3 percentage points to 22 percent,** and employment in the formal sector fell by an additional 5 percentage points (roughly 80,000 formal sector jobs were lost).

Argentina: Social Indicators

	May-98	May-99	May-00	May-01	Oct-01	May-02
Unemployment rate	12.0	12.9	14.5	15.7	18.9	21.9
Population below						
Poverty line	28.6	29.6	31.8	37.0	38.3	53.0
Extreme poverty line	7.9	7.8	9.0	12.8	13.6	24.8
Gini coefficient	0.477	0.465	0.480	0.493	0.505	0.522

Sources: Official Household Survey (EPH), and Fund staff estimates.

To contain the rapid impoverishment of the population and reduce social tensions, the government reallocated resources to a core number of emergency social programs with actions in health, education, nutrition, employment support and community development. Social safety net spending is projected to double as a share of GDP in 2002, to 1.2 percent of GDP, mainly through the expansion of the government's flagship employment support program, the *Heads of Household* program.

- **The *Heads of Household* program pays Arg$150 per month (about US$40) to unemployed heads of household** in exchange for work in community services, small construction projects, or training. The program was established in April and its coverage has grown rapidly.
- **In its initial stages, the program experienced irregularities** in the registrtion of beneficiaries and the organization of work assignments under the program. While there has been substantial progress on both fronts, important challenges remain in the management, supervision, and control of the program.
- **Currently, about 2 million households receive benefits under the government's employment programs**: 1.7 million under the *Heads of Household* program and the remaining 0.3 million under the emergency employment program (PEL), which is a parallel program established to reach out to the unemployed that do not meet all eligibility requirements of the *Heads of Household* program. Roughly half of the poor are estimated to be receiving benefits under these programs.

Argentina: Federal Government Social Emergency Expenditure

(In percent of GDP)

	2001	Proj. 2002	Budget 2003
Direct social assistance and priority programs	**0.6**	**1.2**	**1.3**
Employment and training programs	0.1	0.7	0.8
Priority health and education programs	0.1	0.2	0.2
Pensions to low income elderly	0.3	0.2	0.1
Food assistance and community development	0.1	0.1	0.2

Sources: Ministry of Economy and Fund staff estimates.

Box 7. Federal-Provincial Bilateral Agreements

- **The bilateral agreements signed and ratified in the course of 2002 were designed to introduce a hard budget constraint on the provinces,** through a system of penalties and rewards within the framework of the constitution, and ensure compliance with commitments specified in the February Federal-Provincial Pact. Their basic premise is that the federal government provides orderly financing under the condition that the province reduce its deficit, stops issuing quasi-monies, and reports data on a timely basis. In case of noncompliance, the orderly financing program is held-up, and any net issue of quasi-monies is offset through the withholding of coparticipation transfers. A more detailed description follows:

- **The federal government provides orderly financing to a province** that: (i) commits to reducing the overall deficit by at least 40 percent relative to 2001; (ii) ends the issuance of quasi-monies or other forms of net indebtedness; (iii) submits information on the cash balance, the accrual balance and debt on timely basis to the federal government; and (iv) complies with quarterly deficit targets. The bilaterals allow for the possibility of extending the financing program into 2003, as long as the province meets all of the above conditions.

- **In case of noncompliance, the following penalties have been established**:

➢ If there are delays in the submission of information, the orderly financing would be interrupted, and restored only after the data submission requirements are met.

➢ Should the cash deficit target be exceeded, the orderly financing program would stop, and resume only after corrective measures are taken.

➢ In case of a breach in the accrual deficit target, the implementation of corrective measures would be required in line with a rephasing of the orderly financing program.

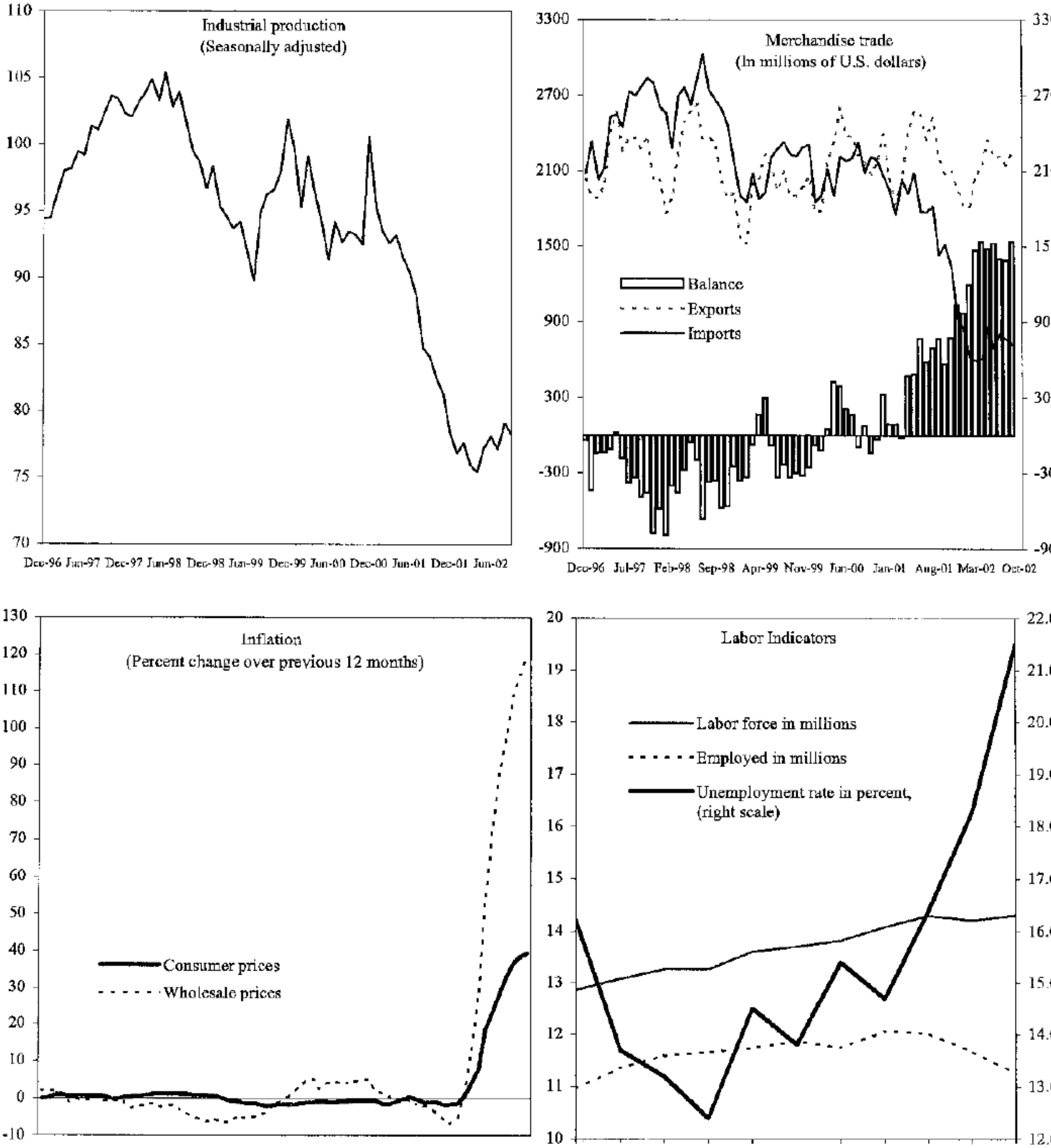
➢ Should arrears at end-2002 be higher-than-targeted, the orderly financing would stop and resume only after corrective measures are taken to reach the 2003 deficit target.

- **The terms of the orderly financing vary depending on the degree of fiscal effort** (see table below). At a minimum, provinces are required to pay a real interest rate (CPI indexed) of at least 2 percent, starting January, 2003; and repay the principal starting January, 2004 in 36 equal monthly installments. Debt service obligations will be automatically deducted from coparticipation transfers.

Deficit Adjustment in 2003	Real Interest Rate
(In percent)	
60 and higher	2
50 to 60	6
40 to 50	8

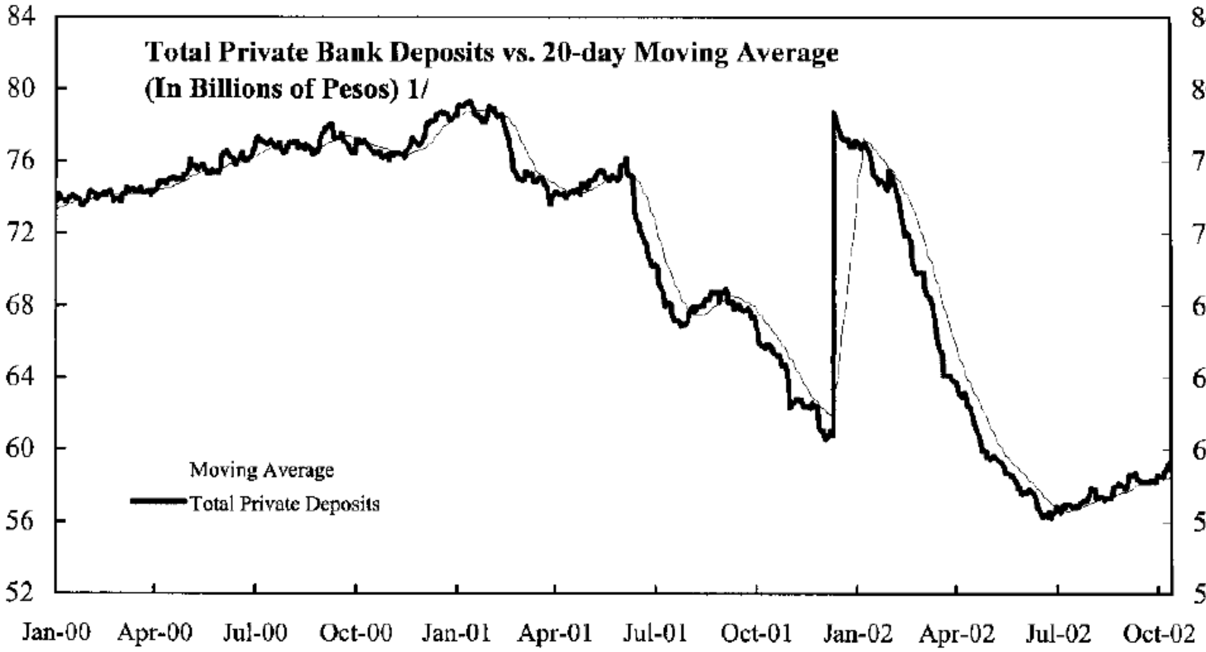
- **The bilateral agreements have been tailored to fit other special circumstances of the provinces.** In provinces with a socially unsustainable stock of expenditure arrears (Chaco, Entre Rios, and Jujuy), orderly financing was provided to help regularize the situation, on the conditions that provinces implement a comprehensive expenditure reduction program.

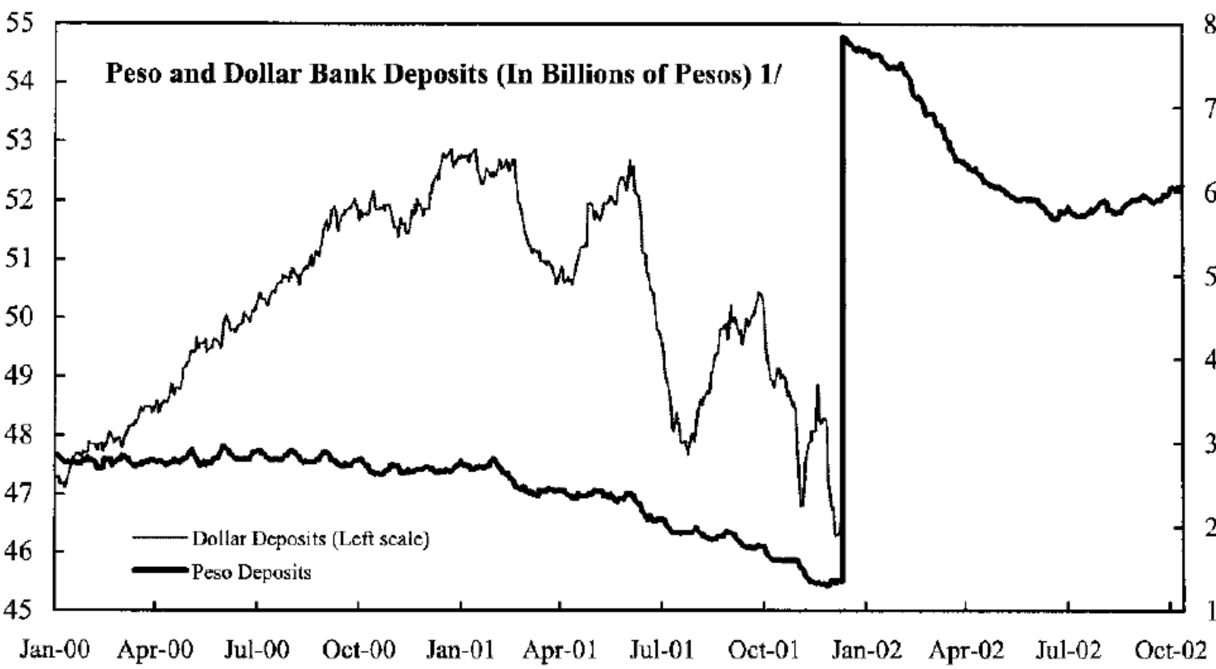
Figure 1. Argentina
Selected Economic Indicators



Sources: Argentine authorities; and Fund staff estimates.

Figure 2. Argentina: Evolution of Deposits

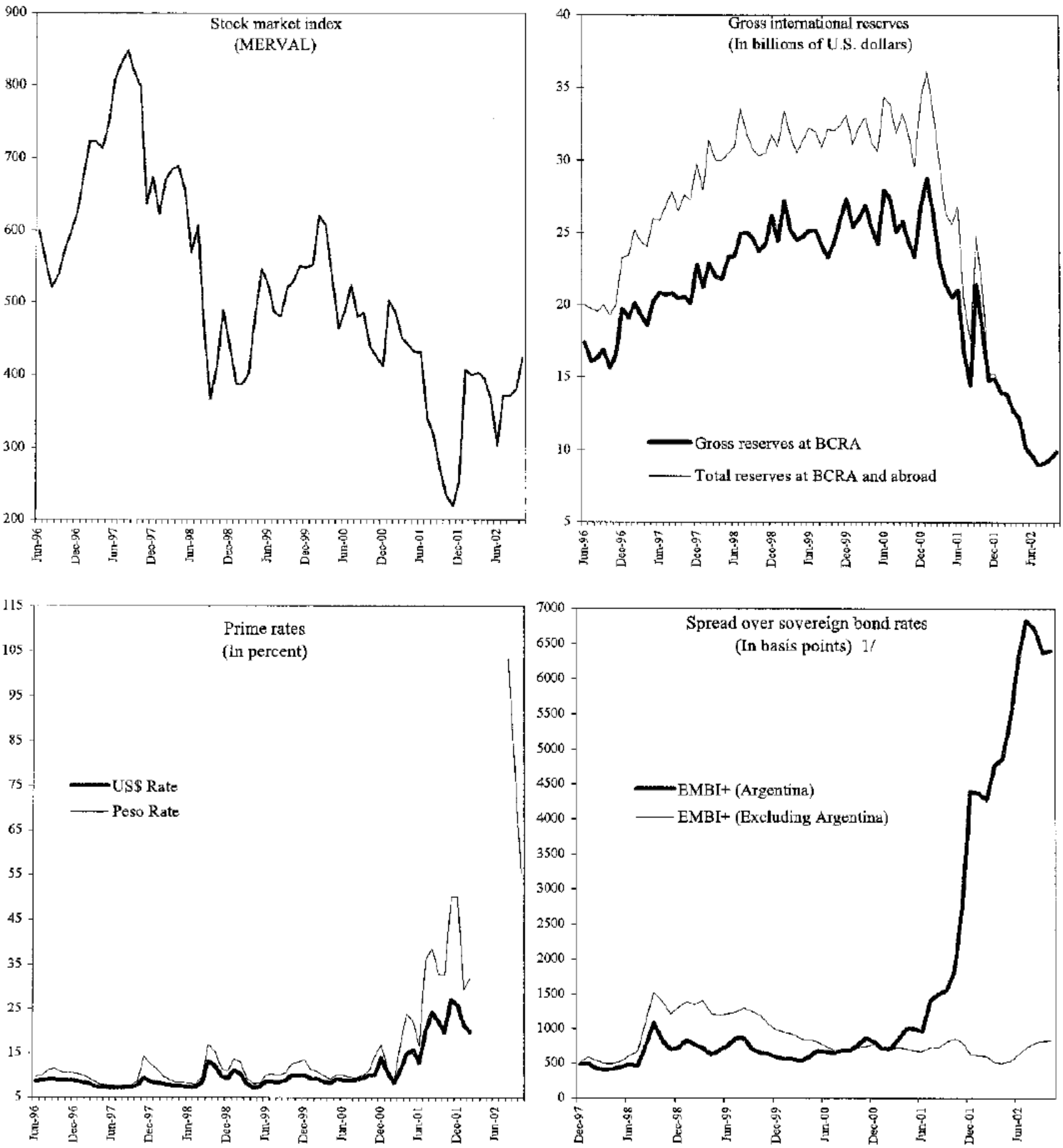




Source: Banco Central de la República Argentina, and staff estimates.

1/ Beginning on January 10, 2002, U.S. dollar deposits converted in pesos at the exchange rate of Arg$1.4.

Figure 3. Argentina: Selected Financial Indicators



Sources: Argentine authorities; J.P. Morgan; and Fund staff estimates.

1/ Data refer to a monthly weighted average stripped spread of major international bonds to U.S. Treasury bonds.

Table 1. Argentina: Selected Economic and Financial Indicators

	1998	1999	2000	2001	Est. 2002	Proj. 2003
(Annual percentage changes; unless otherwise indicated)						
National income and prices						
Real per capita GDP	2.6	-4.6	-1.7	-5.6	-10.8	1.7
GDP at current prices	2.1	-5.2	0.2	-5.5	26.1	45.8
GDP at constant prices	3.8	-3.4	-0.8	-4.4	-11.0	1.7
Consumption	3.1	-2.6	0.2	-4.4	-13.6	1.9
Investment	6.5	-12.6	-6.8	-15.7	-39.0	-0.2
Net exports (contribution to growth)	0.0	1.4	0.3	2.1	6.4	0.2
Exports	9.9	-1.3	2.7	2.7	4.9	8.7
Imports	8.1	-11.3	-0.2	-13.9	-51.9	17.7
GDP deflator	-1.7	-1.8	1.0	-1.1	41.7	43.3
Industrial production (average)	1.6	-6.5	-0.3	-7.6	-12.0	2.5
Consumer prices (average)	0.9	-1.2	-0.9	-1.1	25.9	34.6
Consumer prices (end-of-period)	0.7	-1.8	-0.7	-1.5	41.9	35.0
External sector (in terms of U.S. dollars)						
Exports, f.o.b.	1.0	-12.6	13.2	0.9	0.2	1.6
Imports, c.i.f.	3.1	-18.7	-1.2	-19.5	-55.1	6.4
Export volume	11.6	-0.7	2.8	4.5	4.3	2.9
Import volume	8.7	-13.8	-1.2	-16.8	-55.8	4.4
Terms of trade (deterioration -)	-5.5	-5.9	10.2	-0.6	-1.1	-7.5
Real effective exchange rate						
Average (depreciation -)	3.5	12.4	-0.7	6.0	-57.3	...
Year-end (depreciation -)	0.3	12.6	1.7	2.9	-54.7	...
Money and credit						
Banking system						
Net domestic assets	14.6	4.7	3.3	5.0	...	...
of which: credit to private sector	10.8	-2.1	-3.8	-17.6	-37.5	...
Money (M2)	24.7	-2.4	-2.5	10.7	-9.4	...
Velocity (GDP relative to M2)	8.0	7.6	7.8	8.1	7.8	...
Interest rate (30-day Deposit rate, in percent) 1/	7.6	8.0	8.3	16.2	41.8	...
(In percent of GDP)						
Public sector savings	-0.5	-2.6	-2.2	-4.7	-2.0	-1.7
Federal government cash primary balance	0.9	0.4	0.9	0.1	0.5	2.1
Federal government cash overall balance	-1.3	-2.5	-2.5	-4.4	-9.4	-7.3
Consolidated public sector cash primary balance	0.6	-0.7	0.4	-1.4	0.0	2.6
Consolidated public sector cash overall balance	-2.0	-4.1	-3.6	-6.8	-10.3	-7.5
Gross domestic investment	19.9	18.0	16.2	14.2	10.7	10.9
Gross national savings	15.2	13.8	13.1	12.5	18.8	16.3
Current account deficit	-4.8	-4.2	-3.1	-1.7	8.1	5.3
Public sector external debt (end-of-year)	27.8	29.9	29.7	32.8	83.6	79.7
(In percent of exports of goods and nonfactor services; unless otherwise indicated)						
Public sector debt service	38.0	49.6	54.8	65.7	47.4	69.3
Of which:						
Interest payments	17.5	22.4	21.7	21.0	22.4	23.2
Outstanding use of Fund resources						
(in percent of quota at end-of-period)	251.5	154.1	183.2	525.3	499.8	...
Gross foreign exchange reserves 2/	8.2	10.1	9.8	6.6	8.6	...

Sources: Ministry of Economy; and Fund staff estimates.

1/ Average interest rate on 30- to 59-day time deposits in national currency. The rate is weighted by deposit amounts.
2/ In months of imports of goods and nonfactor services.

Table 2. Argentina: Consolidated Public Sector Operations, 1998-2003

	1998	1999	2000	2001	Est. 2002	Proj. 2003
	(In millions of Arg$)					
Revenue	**71,204**	**68,998**	**70,307**	**63,324**	**68,949**	**95,214**
Total tax revenue	52,018	49,675	51,542	46,930	50,697	73,151
Social security contributions	11,990	10,892	10,684	9,639	9,654	11,708
Other revenues 1/	7,196	8,431	8,081	6,754	8,598	10,355
Noninterest expenditure	**69,456**	**71,075**	**69,077**	**67,179**	**68,812**	**82,553**
Wages	24,916	26,596	27,014	26,577	25,721	30,253
Goods and services	6,492	6,729	5,981	6,104	6,127	7,827
Transfers to the private sector	26,518	27,219	26,795	25,667	28,594	33,244
Other	11,531	10,531	9,287	8,830	8,370	11,229
Primary balance	**1,748**	**-2,076**	**1,230**	**-3,855**	**137**	**12,661**
Interest 2/	7,851	9,655	11,529	14,457	35,080	49,557
Overall balance	**-6,103**	**-11,732**	**-10,298**	**-18,313**	**-34,944**	**-36,896**
Interest capitalization 3/	0	0	0	1,429	26,430	32,300
Overall cash balance	**-6,103**	**-11,732**	**-10,298**	**-16,884**	**-8,514**	**-4,596**
Memorandum items:						
Other debt creating expenditures 4/	1,244	1,861	1,569	1,552	38,100	10,200
of which : bonds issued to assist banks	0	0	0	0	36,000	3,600
Interest arrears	0	0	0	0	12,833	15,200
Augmented primary balance	**504**	**-3,937**	**-338**	**-5,408**	**-37,963**	**2,461**
Augmented overall balance	**-7,347**	**-13,592**	**-11,867**	**-19,865**	**-85,877**	**-62,296**
	(In percent of GDP)					
Revenue	**23.8**	**24.3**	**24.7**	**23.6**	**20.4**	**19.3**
Total tax revenue	17.4	17.5	18.1	17.5	15.0	14.8
Social security contributions	4.0	3.8	3.8	3.6	2.8	2.4
Other revenues 1/	2.4	3.0	2.8	2.5	2.5	2.1
Noninterest expenditure	**23.2**	**25.1**	**24.3**	**25.0**	**20.3**	**16.7**
Wages	8.3	9.4	9.5	9.9	7.6	6.1
Goods and services	2.2	2.4	2.1	2.3	1.8	1.6
Transfers to the private sector	8.9	9.6	9.4	9.6	8.4	6.7
Other	3.9	3.7	3.3	3.3	2.5	2.3
Primary balance	0.6	-0.7	0.4	-1.4	0.0	2.6
Interest 2/	2.6	3.4	4.1	5.4	10.4	10.0
Overall balance	**-2.0**	**-4.1**	**-3.6**	**-6.8**	**-10.3**	**-7.5**
Interest capitalization 3/	0.0	0.0	0.0	0.5	7.8	6.5
Overall cash balance	**-2.0**	**-4.1**	**-3.6**	**-6.3**	**-2.5**	**-0.9**
Memorandum items:						
Other debt creating expenditures 4/	0.4	0.7	0.6	0.6	11.2	2.1
of which : bonds issued to assist banks	0.0	0.0	0.0	0.0	10.6	0.7
Interest arrears	0.0	0.0	0.0	0.0	3.8	3.1
Augmented primary balance	**0.2**	**-1.4**	**-0.1**	**-2.0**	**-11.2**	**0.5**
Augmented overall balance	**-2.5**	**-4.8**	**-4.2**	**-7.4**	**-25.3**	**-12.6**

Sources: Ministry of economy; and Fund staff estimates.

1/ Includes transfers of central bank profits.
2/ In 2002-03, excludes interest due on unrestructured debt (phase two).
3/ Reflects the indexation of government bonds and interest capitalization associated with the phase one debt exchange in 2001.
4/ Includes bonds issued to banks in connection with banking crisis, and the reinstatement of wage and pension cuts implemented in July 2001.

Table 3. Argentina: Federal Government Operations, 1998-2003

	1998	1999	2000	2001	Est. 2002	Proj. 2003
	(In millions of Arg$)					
Revenue	**56,752**	**55,020**	**55,813**	**50,389**	**55,424**	**77,319**
Tax revenue	40,363	38,626	40,672	37,164	40,981	60,316
Social security contributions	11,990	10,892	10,684	9,639	9,654	11,708
Other revenues 1/	4,399	5,503	4,456	3,586	4,789	5,294
Noninterest expenditure	**53,918**	**53,952**	**53,130**	**50,210**	**53,721**	**66,756**
Wages	8,076	8,548	8,440	7,824	7,794	9,995
Goods and services	2,697	2,637	2,268	2,216	2,474	3,624
Transfers to the private sector	23,390	23,847	23,605	22,435	25,383	29,750
Transfers to provincial governments	18,333	17,844	18,041	16,987	17,246	20,895
Other	1,422	1,075	776	748	825	2,493
Primary balance	**2,833**	**1,068**	**2,683**	**179**	**1,703**	**10,562**
Interest 2/	6,661	8,224	9,656	12,021	33,603	46,400
Overall balance	**-3,828**	**-7,156**	**-6,974**	**-11,842**	**-31,900**	**-35,838**
Interest capitalization 3/	0	0	0	1,429	26,430	32,300
Overall cash balance	**-3,828**	**-7,156**	**-6,974**	-10,413	**-5,470**	**-3,538**
Memorandum items:						
Other debt creating expenditures 4/	1,244	1,861	1,569	1,552	38,100	10,200
of which: bonds issued to assist banks	0	0	0	0	36,000	3,600
Interest arrears	0	0	0	0	12,833	15,200
Augmented primary balance	**1,589**	**-793**	**1,114**	-1,373	**-36,397**	**362**
Augmented overall balance	**-5,072**	**-9,017**	**-8,542**	**-13,394**	**-82,833**	**-61,238**
	(In percent of GDP)					
Revenue	**19.0**	**19.4**	**19.6**	**18.8**	**16.4**	**15.7**
Tax revenue	13.5	13.6	14.3	13.8	12.1	12.2
Social security contributions	4.0	3.8	3.8	3.6	2.8	2.4
Other revenues 1/	1.5	1.9	1.6	1.3	1.4	1.1
Noninterest expenditure	**18.0**	**19.0**	**18.7**	**18.7**	**15.9**	**13.5**
Wages	2.7	3.0	3.0	2.9	2.3	2.0
Goods and services	0.9	0.9	0.8	0.8	0.7	0.7
Transfers to the private sector	7.8	8.4	8.3	8.4	7.5	6.0
Transfers to provincial governments	6.1	6.3	6.3	6.3	5.1	4.2
Other	0.5	0.4	0.3	0.3	0.2	0.5
Primary balance	**0.9**	0.4	**0.9**	**0.1**	**0.5**	**2.1**
Interest 2/	2.2	2.9	3.4	4.5	9.9	9.4
Overall balance	**-1.3**	**-2.5**	**-2.5**	**-4.4**	**-9.4**	**-7.3**
Interest capitalization 3/	0.0	0.0	0.0	0.5	7.8	6.5
Overall cash balance	**-1.3**	**-2.5**	**-2.5**	**-3.9**	**-1.6**	**-0.7**
Memorandum items:						
Other debt creating expenditures 4/	0.4	0.7	0.6	0.6	11.2	2.1
Of which: bonds issued to assist banks	0.0	0.0	0.0	0.0	10.6	0.7
Interest arrears	0.0	0.0	0.0	0.0	3.8	3.1
Augmented primary balance	0.5	-0.3	0.4	-0.5	-10.7	0.1
Augmented overall balance	-1.7	-3.2	-3.0	-5.0	-24.4	-12.4

Sources: Ministry of the economy; and Fund staff estimates.

1/ Includes transfers of central bank profits.

2/ In 2002-03, excludes interest due on unrestructured debt (phase two).

3/ Reflects the indexation of government bonds and interest capitalization associated with the phase one debt exchange in 2001.

4/ Includes bonds issued to banks in connection with banking crisis, and the reinstatement of wage and pension cuts implemented in July 2001.

Table 4. Argentina: Provincial Government Operations, 1998-2003

	1998	1999	2000	2001	Est. 2002	Proj. 2003
	(In millions of Arg$)					
Revenue	**32,786**	**31,823**	**32,535**	**29,921**	**30,771**	**38,790**
Own revenue	14,452	13,978	14,494	12,934	13,525	17,895
Taxes	11,655	11,050	10,870	9,766	9,716	12,835
Nontaxes	2,797	2,929	3,624	3,168	3,809	5,060
Transfers from federal government	18,333	17,844	18,041	16,987	17,246	20,895
Primary expenditures 1/	**33,871**	**34,967**	**33,988**	**33,956**	**32,337**	**36,692**
Personnel	16,840	18,048	18,574	18,753	17,927	20,259
Other	17,031	16,919	15,414	15,203	14,410	16,434
Goods and services	3,795	4,092	3,713	3,889	3,653	4,203
Private sector transfers	3,127	3,372	3,190	3,232	3,211	3,494
Transfers to municipalities	4,864	4,794	4,940	4,801	4,611	5,688
Other	5,245	4,661	3,571	3,281	2,934	3,048
Primary balance 2/	**-1,085**	**-3,144**	**-1,453**	**-4,035**	**-1,566**	**2,098**
Interest (cash)	1,190	1,431	1,872	2,437	1,478	3,157
Overall balance 2/	**-2,275**	**-4,576**	**-3,325**	**-6,246**	**-3,044**	**-1,059**
	(In percent of GDP)					
Revenue	**11.0**	**11.2**	**11.4**	**11.1**	**9.1**	**7.9**
Own revenue	4.8	4.9	5.1	4.8	4.0	3.6
Taxes	3.9	3.9	3.8	3.6	2.9	2.6
Nontaxes	0.9	1.0	1.3	1.2	1.1	1.0
Transfers from federal government	6.1	6.3	6.3	6.3	5.1	4.2
Primary expenditures	**11.3**	**12.3**	**12.0**	**12.6**	**9.5**	**7.4**
Personnel	5.6	6.4	6.5	7.0	5.3	4.1
Other	5.7	6.0	5.4	5.7	4.3	3.3
Primary balance 2/	**-0.4**	**-1.1**	**-0.5**	**-1.5**	**-0.5**	**0.4**
Interest (cash)	0.4	0.5	0.7	0.9	0.4	0.6
Overall balance 2/	**-0.8**	**-1.6**	**-1.2**	**-2.4**	**-1.3**	**-0.2**

Sources: Ministry of Economy and Fund staff estimates.

1/ Expenditures on a commitments basis.

2/ In 2002 the primary and overall deficits on a cash basis would be 0.4 percent of GDP larger due to clearance of arrears.

Table 5. Argentina: Summary Operations of the Financial System, 1998-2003
(In millions of pesos, end of period)

	1998	1999	2000	2001	Est. 2002	Proj. 2003
		I. Central Bank				
Net international reserves	20,807	22,864	21,872	456	-14,972	-15,356
Net domestic assets	5,499	4,647	4,525	17,680	42,408	48,333
Credit public sector 1/	8,744	7,805	8,383	15,742	55,843	...
Credit to the financial sector	1,922	1,856	1,083	10,124	24,446	...
Official capital and surplus and unclassified assets (net)	-5,167	-5,014	-4,940	-8,187	-37,881	...
Monetary liabilities	26,306	27,511	26,398	18,135	27,436	32,977
Currency issued	16,370	16,493	15,054	10,960	16,465	19,758
Government deposits	1,343	935	1,769	367	222	266
Reserve deposits of banks	8,593	10,083	9,575	6,809	10,749	12,953
		II. Banks and Non-Bank Financial Institutions				
Net foreign assets	-5,601	-8,184	-6,622	-9,346	...	...
Net claims on Central Bank	9,545	10,999	10,993	-1,429	...	...
Net domestic assets	63,557	66,567	68,774	70,452	...	...
Credit to public sector (net)	9,976	13,400	18,414	23,747	...	...
Credit to private sector	72,112	70,578	67,910	55,979	36,000	39,240
Capital and reserves	-17,042	-16,905	-17,283	-16,483	...	...
Other	-1,489	-506	-267	7,208	...	...
Private sector deposits	67,501	69,383	73,145	59,677	60,000	69,000
Local currency	28,059	26,445	25,773	15,688	58,800	67,620
Foreign currency	39,442	42,938	47,372	43,989	1,200	1,380
		III. Consolidated Financial System				
Net foreign assets	15,206	14,681	15,251	-8,890	...	...
Net domestic assets	65,791	68,423	70,447	77,640	...	...
Credit to public sector (net)	17,377	20,269	25,028	39,122	...	...
Credit private sector	72,112	70,578	67,910	55,979	36,000	39,240
Net capital, reserves, and other assets	-23,698	-22,425	-22,490	-17,461	...	...
Liabilities to private sector	80,997	83,104	85,698	68,750	74,200	86,040
Currency in circulation	13,496	13,721	12,553	9,073	14,200	17,040
Local currency deposits	28,059	26,445	25,773	15,688	58,800	67,620
Foreign currency deposits	39,442	42,938	47,372	43,989	1,200	1,380
		(In percent of GDP)				
Liabilities to the private sector	25.7	27.4	29.7	29.3	21.1	16.2
Currency in circulation	4.1	4.0	4.1	3.8	3.4	3.2
Peso deposits	9.1	9.1	9.4	8.1	11.0	12.8
Foreign currency deposits	12.4	14.3	16.3	17.4	6.7	0.3
		(In percent)				
Memorandum item:						
Risk-based capital asset ratio (capital over risk-weighted assets) 2/	20.3	21.0	20.1	20.8	...	...
Foreign exchange reserve cover of broad money 2/	42.9	44.4	41.7	32.2	45.9	...
Share of non-performing loans in total loans 3/	10.3	11.5	12.9	12.3	...	...
Share of foreign currency loans in total lending	65.7	66.3	68.7	72.1	...	...
Share of foreign currency deposits in total deposits	54.3	58.5	61.8	76.6	...	...

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

1/ Includes net use of Fund resources.

2/ For 2001, September.

3/ Excludes unrecoverable loans that have been charged-off from assets on balance sheet.

Table 6. Argentina: Debt of the Consolidated Public Sector, 1998-2002

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

	1998	1999	2000	2001	2002 1/
I. Total Public Debt (II + III)	**122,187**	**135,046**	**144,666**	**167,123**	**128,931**
II. Federal Government (a + b)	**112,327**	**122,453**	**128,861**	**144,279**	**114,575**
(a) Medium and long term debt (i + ii)	109,032	118,279	123,753	137,533	107,105
(i) Treasury bills and bonds	77,282	85,697	89,505	57,310	50,996
(ii) Loans	31,750	32,582	34,248	80,223	56,109
Multilaterals	19,167	20,310	21,757	32,357	31,702
IMF	5,420	4,472	5,053	13,952	14,355
World Bank	7,447	8,595	9,050	9,668	8,708
Inter-American Development Bank	6,271	7,207	7,619	8,704	8,606
Other	29	36	35	33	33
Official creditors	7,437	5,939	4,570	4,474	4,397
Paris Club	4,481	3,235	2,375	1,879	1,818
Other bilaterals	2,956	2,704	2,195	2,595	2,579
Banks and other	5,146	6,333	7,921	43,392	20,010
(b) Short term debt (Treasury bills and arrears)	3,295	4,174	5,108	6,746	7,470
III. Provincial Governments 2/	**9,860**	**12,593**	**15,805**	**22,844**	**14,356**
Memorandum items (in percent of GDP)					
Total public debt	40.9	47.7	50.8	62.0	119.0
Federal government	37.6	43.2	45.2	53.5	105.8
Provincial governments	3.3	4.4	5.5	8.5	13.3
Percent of federal government debt in foreign currency	92.0	93.3	96.6	96.9	79.5

Source: Ministry of Economy

1/ Debt as of June 30, 2002

2/ Excluding intragovernmental obligations.

Table 7. Argentina: External Public Sector Arrears, 2002

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

	June	Sept.	Est. Dec.
Official creditors	**797**	**1,409**	**2,527**
Multilateral debt	-	-	874
World Bank	-	-	830
IDB	-	-	44
Bilateral debt	797	1,175	1,419
Paris Club creditors	793	1,171	1,415
Previously rescheduled (PRD)	243	279	440
Nonpreviously rescheduled (NPRD)	550	893	975
Pre cut off 1/	54	204	222
Post cut off	496	688	752
Non-Paris Club creditors	4	4	4
Private creditors	**2,521**	**3,509**	**5,787**
Bonds	2,455	3,403	5,642
Eurobonds	986	1,351	3,010
Other	1,469	2,051	2,632
Commercial bank loans	49	82	103
Others 2/	17	24	42
Total (including late interest)	**3,318**	**4,918**	**8,314**
Of which : late interest 3/	1,385	2,298	3,024

Sources: Ministry of Finance; and Fund staff estimates

1/ Cutoff date: December 10, 1983
2/ Including supplier credits
3/ Excluding interest on arrears

Table 8. Argentina: Summary Balance of Payments, 1998-2003

	1998	1999	2000	2001	Est. 2002	Proj. 2003
	(In millions of U.S. dollars)					
Current account	**-14,270**	**-11,905**	**-8,884**	**-4,567**	**8,810**	**6,454**
Trade account	-4,713	-2,217	1,167	6,348	17,580	17,359
Exports f.o.b.	26,692	23,322	26,412	26,659	26,706	27,073
Of which petroleum (net)	1,716	2,245	3,946	3,731	3,686	3,738
Imports c.i.f.	-31,405	-25,539	-25,245	-20,311	-9,126	-9,714
Services and transfers	-9,557	-9,688	-10,051	-10,915	-8,770	-10,905
Of which : net interest payments	-5,108	-5,855	-5,865	-7,264	-8,606	-8,044
Capital account	**18,139**	**13,943**	**7,920**	**-16,944**	**-21,733**	**-33,775**
Net public sector capital	9,504	10,638	8,107	-2,065	-305	-11,590
Direct investment	4,638	7,756	10,786	3,303	179	-132
Other net private sector capital 1/	3,997	-4,452	-10,973	-18,183	-23,131	-22,053
Overall balance	**3,869**	**2,037**	**-963**	**-21,512**	**-12,922**	**-27,321**
Financing	**-3,869**	**-2,037**	**963**	**21,512**	**12,922**	**27,321**
Net international reserves (increase -)	-3,869	-2,037	963	21,512	4,647	0
Financing gap 2/	0	0	0	0	8,275	27,321
	(In percent of GDP, unless otherwise specified)					
Current account	**-4.8**	**-4.2**	**-3.1**	**-1.7**	**8.1**	**5.3**
Trade account	-1.6	-0.8	0.4	2.4	16.3	14.2
Exports	8.9	8.2	9.3	9.9	24.7	22.1
Of which petroleum (net)	0.6	0.8	1.4	1.4	3.4	3.1
Imports	-10.5	-9.0	-8.9	-7.5	-8.4	-7.9
Total external debt service ratio 3/	**47.5**	**51.3**	**51.4**	**52.0**	**123.5**	**106.5**
Of which : public sector debt	27.8	29.9	29.7	32.8	83.6	75.1
	(Percent change)					
Exports	1.0	-12.6	13.2	0.9	0.2	1.6
Of which petroleum (net)	-18.8	15.8	67.4	-8.3	-8.1	1.8
Imports	3.1	-18.7	-1.2	-19.5	-55.1	6.4
Memorandum items:						
Net international reserves 4/	22.5	5.8	5.5	0.1	-1.3	-2.6
(in millions of U.S. dollars)	22,844	22,844	21,881	369	-4,278	-4,278
LIBOR (6 months U.S. dollar deposits)	6.1	5.5	6.4	3.8	2.1	3.2

Sources: Ministry of Economy and Fund staff estimates.

1/ Includes errors and omissions

2/ Includes arrear accumulation on private sector debt.

3/ As percentage of exports of goods and nonfactor services

4/ In months of imports of goods and nonfactor services

Table 9. Argentina: Indicators of External Vulnerability, 1998-2002

	1998	1999	2000	2001	2002
(Annual percentage change, unless otherwise indicated)					
Financial indicators					
Broad money (M3*)	10.3	2.3	4.3	-23.1	7.5
Private sector credit	10.8	-2.1	-3.8	-17.6	-37.5
Interbank call rate (percent) 1/	6.8	7.0	8.1	22.6	46.4
Interbank call rate (real) (percent)	6.1	8.3	9.1	23.9	16.2
External indicators					
Exports volume	11.6	-0.7	2.8	4.5	4.3
Imports volume	8.7	-13.8	-1.2	-16.8	-55.8
Terms of trade	-5.5	-5.9	10.2	-0.6	-1.1
REER appreciation (+) (12 month basis) 2/	0.3	12.6	1.7	2.9	-57.3
(In percent of GDP, unless otherwise indicated)					
Current account balance	-4.8	-4.2	-3.1	-1.7	8.1
Capital and financial account balance	6.1	4.9	2.8	-6.3	-6.4
Of which : Foreign direct investment 3/	1.3	2.8	3.8	1.2	0.2
Public sector debt	40.9	47.7	50.8	62.0	119.0
Of which : External debt	27.8	29.9	29.7	32.8	83.6
Total external debt to exports 4/	457.2	523.5	470.3	458.1	448.1
External interest payments to exports 4/	33.3	40.8	39.7	39.5	41.4
External amortization payments to exports 4/	43.0	59.9	65.4	70.1	61.1
(In billions of U.S. dollars, unless otherwise indicated)					
Central bank short-term foreign liabilities 5/	5.4	4.5	25.1	14.5	13.9
Short-term foreign assets of the financial sector 6/	6.4	6.7	8.0	1.0	...
Short-term foreign liabilities of the financial sector	12.0	14.9	14.7	10.3	...
Gross foreign exchange reserves 7/	31.7	33.1	34.2	15.2	9.9
In months of imports of goods and nonfactor services	12.2	14.3	13.2	6.0	4.0
In percent of short-term external debt (original maturity)	147.6	168.3	157.1	80.1	95.5
In percent of short-term external debt (residual maturity)	83.3	82.7	79.2	40.9	29.0
In percent of liabilities to private sector	39.2	39.8	39.9	22.2	13.3
Financial market indicators					
Stock market index (MERVAL) (percentage change) 8/	-37.4	28.0	-24.3	-29.1	75.0
Foreign currency debt rating 9/			B1	Ca	Ca
Spread of benchmark bonds (basis points, end of period) 10/	705	548	773	4,372	6,370

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

1/ Interbank call rate, up to 15 days. For 2002, January-September.

2/ Based on 1996 trade weights. Increase means appreciation. For 2002, September.

3/ In 1999, net of the effect of the YPF sale to Repsol (i.e., US$10.8 billion).

4/ In percent of exports of goods and nonfactor services. Interest payments includes accrued interest on arrears for 2002.

5/ Debt outstanding to the Fund.

6/ Includes cash in US$ and liquidity requirement held abroad.

7/ Held at the central bank and liquidity requirements held abroad.

8/ Latest observation in 2001, August 17.

9/ On July 13, 2001, Moody's downgraded the sovereign foreign-currency long-term rating from B3 to Caa1, on Oct. 12, 2001 from Caa1 to Caa3, and on Dec. 21, 2001 from Caa3 to Ca.

10/ Emerging markets bond index spread (EMBI+ Argentina). For 2002, December 6.

Chronology of Key Developments 2001–02

A. 2001

December 1: Facing a substantial run on deposits, the government introduced wide-ranging controls on banking and foreign exchange transactions, including a weekly Arg$250 cash withdrawal limit on sight accounts.

December 10: The BCRA imposes a 98 percent reserve requirement on deposit increases after December 1, 2001; aimed at limiting flight to quality within the system.

December 13: Phase one of the government debt exchange was completed.

December 19: State of emergency is declared to stop protests against Minister Cavallo's economic policies. The lower house of Congress repeals the special legislative powers granted to Cavallo.

December 20: President de la Rúa and Minister Cavallo resign after days of riots and protests that leave over 20 demonstrators dead. A banking holiday is declared for December 21, extended through December 26. Moody's lowers Argentina ratings to Ca from Caa3.

December 23: Rodriguez Saá is named interim President; announces the default on external debt and calls Presidential elections within 60 days.

December 30: President Saá resigns after his emergency policies are rejected by the Peronist governors.

B. 2002

January 3: Senator Duhalde is sworn-in as President with a mandate to conclude the remaining period of the de la Rúa presidency; President Duhalde announces the end of convertibility, and the introduction of a dual foreign exchange regime.

January 24: Utility tariffs are frozen indefinitely.

January 30: Emergency law curtailing creditors' rights is approved by Congress (law became effective on February 14).

February 4: The government decrees the unification of the exchange rate regime and the asymmetric pesoization of bank balance sheets (assets at Arg$1/US$1, and liabilities at Arg$1.4/US$1).

February 11: The foreign exchange market opens for the first time under a unified regime; the peso depreciates to Arg$1.8 to the dollar.

February 27: The federal government and the provincial governors reach agreement on a temporary revenue sharing arrangement that abolishes the minimum floor on transfers to the provinces in exchange for: (i) the broadening of the coparticipation base to include the financial transactions tax; and (ii) better terms for their debt servicing. The provinces commit to reduce fiscal deficits by 60 percent in 2002 and to achieve balance in 2003.

March 5: Export taxes of 10 percent and 5 percent are imposed on primary products and process agricultural and industrial products, respectively.

March 8: The pesoization of government debt under Argentine law is decreed.

March 13: A voluntary bond swap (Swap I) is decreed authorizing the exchange of reprogrammed time deposits for government bonds. The decree also authorized issuance of bonds to banks in compensation for the asymmetric pesoization of their balance sheets.

March 25: The peso reaches a peak of Arg$4 per dollar. To contain the depreciation of the currency, the authorities intervene heavily in the foreign exchange market (US$800 million in March), tighten the access to central bank liquidity assistance (a matching dollar from the parent being now requested as a condition for assistance to foreign banks), and introduce a variety of exchange regulations affecting banks, foreign exchange bureaus, and exporters. Thirteen new regulations are issued on March 25 alone, bringing the total for the month of March to about 50.

April 9: Export taxes on agricultural primary products were increased to 20–23½ percent.

April 19: The central bank suspends for 30 days Scotiabank Quilmes. A bank holiday is declared until Congress approves a solution to the problem of judicial injunctions (*amparos*) releasing bank deposits. The authorities begin working on a plan (the so-called *BONEX II* plan) to convert reprogrammed time deposits into government bonds.

April 20: Economy Minister Remes Lenicov presents to congress the *BONEX II* plan; the draft law is rejected and Minister Remes resigns.

April 23: President Duhalde reaches agreement with provincial governors on a 14-point Federal-Provincial Pact.

April 25: Congress approves the *Ley Tapón* to ease pressure from the *amparos*. The law modifies court procedures, and states that depositors can only access funds once the judicial process is over; in the meantime funds are deposited in an escrow account.

April 26: Dr. Roberto Lavagna, former ambassador to the EU, is confirmed as the new Minister of Economy.

May 3: The central bank approves the capitalization and liquidity plan for *Banco Galicia*.

May 6: Exceptions to price indexation for certain types of bank loans and residential leases are decreed. Exempted loans will be adjusted, beginning October 1, 2002, by a wage index (CVS).

May 6: The Federal Congress approves the February Federal-Provincial Pact.

May 15: Congress approves law that reverses the most harmful provisions of the January emergency law and makes limited improvements to the insolvency law.

May 20: The central bank intervenes *Crédit Agricole*'s Argentine subsidiaries, *Banco Bisel*, *Banco Suquia*, and *Banco de Entre Ríos*. The banks will be administered by *Banco de la Nación*.

May 30: The Economic Subversion Law is repealed.

May 31: In order to tighten the control over the sale of export receipts, the central bank announced that dollar export revenues in excess of US$1 million will have be sold directly to the central bank.

May 31: Province of Buenos Aires and Federal government sign full-fledged text of Bilateral Agreement. Agreement on the Annexes (quarterly fiscal targets and calendar for disbursement) is reached in June.

June 1: President Duhalde signs the *Options Plan* on reprogrammed deposits, a revised version of former Minister Remes' *BONEX II* Plan, giving depositors the option to exchange deposits into bonds.

June 12: Senate approves draft law limiting foreign ownership in the media to 30 percent of capital.

June 18: The minimum level of export proceeds that should be surrendered to the central bank lowered from US$1 million to US$500,000.

June 21: Central Bank President Mario Blejer resigns.

June 25: Central bank Vice-President Aldo Pignanelli appointed central bank president.

June 26: A second level court ruled the *Ley Tapón* unconstitutional.

June 26: Two demonstrators shot dead by the police; worst riots since December 2001.

July 2: Representatives of trade unions and businesses agreed to raise private sector wages by Arg$100 a month effective July 1; and the monthly minimum wage is raised from Arg$250 to Arg$350.

July 2: President Duhalde moves the presidential election forward to March 2003, from September 2003.

July 9: In response to a class action suit lodged by the country's ombudsman on behalf of all depositors, a federal court declared the deposit freeze and pesoization unconstitutional.

July 19: *Banca Nazionale del Lavoro* (BNL) announces that it will gradually withdraw from Argentina.

July 24: The government issued a decree suspending court ordered withdrawals of frozen bank deposits for 120 business days.

July 25: The decree suspending deposit withdrawals obtained through court orders is declared partially unconstitutional by a federal judge.

July 26: Following a demand by the national ombudsman a judge rules unconstitutional the government decree suspending lawsuits on December's bank curbs for 120 business days.

July 29: A panel of monetary policy experts made public several proposals to resolve the country's financial crisis including a monetary policy anchor, an independent central bank, the ending of peso printing deficit-financing, and an end to the use of quasi-currencies by the provinces. The report calls for a floating exchange rate and urges Argentina to stop using international reserves to support the peso.

August 9: Central bank director and Superintendent of Banks Felipe Murolo resigned.

August 15: Congress approves a bill extending for 90 days (through mid-November 2002) the provision that suspends certain kinds of creditor-initiated nonbankruptcy law enforcement actions. Congress also approves a bill extending for 60 days (through end-September 2002) the application of price indexation to loans.

August 22: The Supreme Court declares unconstitutional the 13 percent salary cut for federal government workers and pensioners, implemented from July 2001.

August 23: A federal court declares the open primary elections (where all registered voters can participate) planned for November unconstitutional.

August 26: The government postpones to December 15 (from end-November) the date set for the primaries for presidential elections in order to allow more time to re-write voting rules.

August 26: The government issues a resolution to allow the issuance of bank-compensation bonds for the asymmetric pesoization.

August 28: A federal court establishes that parent banks should be fully responsible for the liabilities of subsidiaries in Argentina.

September 3: The government introduces new exchange controls in an attempt to boost international reserves and defend the peso: (i) the limit for exporters' foreign exchange surrender to the central bank is reduced from US$500,000 to US$200,000; (ii) the minimum maturity of external debt contracted by private nonfinancial entities is set to 90 days; (3) exchange bureaus are required to deposit with the central bank foreign exchange holdings exceeding US$1.5 million on a daily basis; and (4) the net dollar positions held by exchange dealers operating on behalf of the central bank are reduced by an average 40 percent.

September 5: The federal administrative dispute chamber, an appellate court, rules that the decrees establishing the *corralito* and pesoization, were unconstitutional. The ruling applies to only one case, but opens the door for further similar rulings.

September 9: Further tightening of foreign exchange controls: prior authorization from the central bank for dollar purchases exceeding US$100,000 for portfolio and other financial investments abroad, as well as for the purchase of foreign banknotes.

September 13: The Federal Court of Appeals declared the *corralit*o, pesoization, and the 120 days suspension of executions against the *corralito,* unconstitutional; the decision allows depositors to claim their deposits in court immediately. The 2003 budget was submitted to Congress.

September 17: The government issued a decree that extends the negotiation period for utility tariffs for another 120 days with the possibility of a further 60 days extension.

September 20: The government launched a second swap of bonds for frozen deposits and announced the easing of restrictions on frozen time-deposits of up to Arg$7,000.

October 31: The monthly cash withdrawal limit on the *corralito* raised to Arg$2,000 from Arg$1,200.

November 11: After discussions with the government, the banks announced a voluntary 75 day stay on foreclosures.

November 14: The government did not fully meet an $809 million World Bank debt payment; only $79.2 million in interest was paid.

November 14: President Duhalde signed a decree lowering the VAT rate by 2 percentage points to 19 percent for two months.

November 15: A lower court suspended the public hearings designed to grant a tariff increase to the privatized utility companies.

November 18: President Duhalde signed a 12-point agreement with provincial governors and some key legislators over the new election timetable and the government's economic policies.

November 21: The Senate approved President Eduardo Duhalde's plans for delaying the presidential election by a month to April. The first round of presidential elections is scheduled to be held on April 27, 2003 and will be followed by a second round on May 10, if necessary.

November 22: The government announced that it will lift the remaining *corralito* restrictions on sight accounts effective December 2. Term deposits (the *corralón*) remain frozen.

November 22: Minister Lavagna submitted a draft decree to President Duhalde lifting the tariff rates on electricity and natural gas. On average, electricity rates will rise 9.0 percent and natural gas 7.2 percent.

November 27: Executive decree issued authorizing court imposed stay on foreclosures for 30 business days, during which time mediation is required.

December 9: The resignation of Central Bank President Pignanelli is accepted by President Duhalde.

December 10: President Duhalde appointed Mr. Alfonso Prat Gay to be central bank president. Legislation eliminating the ability of the executive to grant tax amnesties becomes effective.

December 11: A court order reversed the decreed increases in electricity and gas tariffs.

MEDIUM-TERM EXTERNAL AND FISCAL SUSTAINABILITY

This Appendix examines Argentina's external and public debt medium-term sustainability under alternative scenarios. Any such assessment conducted in the midst of a major economic crisis will inevitably be subject to considerable uncertainty. In particular, there could be wide margins of error around the likely path of economic recovery; the path of the real exchange rate in the aftermath of the collapse of the currency board arrangement; and the ultimate cost of cleaning up the banking system. The evolution of key external parameters—notably international interest rates—will also affect the assessments of sustainability.

The scenarios suggest that the ratios of public and external debt would not decline sufficiently to reach conventional benchmarks for sustainability without: (i) a major break with past experience in terms of economic performance—particularly with respect to the primary fiscal balance; and (ii) substantial debt- and debt-service restructuring.

A. Macroeconomic Framework and Key Assumptions for Baseline

The baseline scenario presented below is based on the following set of assumptions:

The macroeconomic framework includes: (i) real GDP growth recovery from around *minus* 11 percent in 2002 to an average of 3½ percent a year in the medium term; (ii) inflation falling to 5 percent a year by 2007; and (iii) a modest appreciation of the real exchange rate in 2003, with this rate held constant thereafter.

The fiscal program assumes: (i) the implementation of major structural fiscal reforms (tax reform; reform of the state; and reform of the revenue sharing relation with the provinces) consistent with achieving a primary surplus for the consolidated public sector of 4½–5 percent from 2005; (ii) full debt service is maintained on IFI obligations, instruments issued in the phase one debt exchange completed in December 2001, on other domestic debt instruments issued in 2002, and on debt projected to be issued in the future; (iii) the banking crisis requires the issuance of additional bank recapitalization bonds of about 5 percent of GDP; (iv) no access to new market borrowing; and (v) IFI project lending of US$1 billion a year in the medium term. *No assumption is made regarding further public debt restructuring*, with resulting financing gaps reflected in arrears, on which interest accumulates at a rate of 10 percent in U.S. dollars.

The balance of payments projections are based on: (i) WEO assumptions on world growth and developments in commodity and export market prices; (ii) a gradual reversion of import and export to GDP ratios towards their levels of the late 1990s; and (iii) an annual NIR accumulation of US$1.5 billion on average to build up a prudential reserve cushion.

B. Medium-Term Scenarios

The baseline

On the fiscal side, the baseline (before debt restructuring) would yield large annual financing gaps between budgetary gross financing requirements and identified financing sources (Annex Table 1). These gaps would remain at close to US$20 billion (11 percent of GDP) a year; and would also be very large in relation to obligations due on existing debt held by private sector and bilateral creditors. At the end of the projection period, the ratio of public debt to GDP would still be over 110 percent and public debt service (including interest on arrears) would be about 64 percent of fiscal revenues.

In the balance of payments, the assumed export and import growth is consistent with the constant real exchange rate and a recovery of imports as the domestic demand picks up over the projection period; before debt restructuring, factor income increasingly reflects accrued interest on public sector arrears (Annex Table 2). As a consequence, the external current account balance is expected to swing from a large surplus to a small deficit of 1–2 percent in the outer years. If, however, the public sector were to reach agreement on a substantial debt restructuring, this would reduce the net interest bill and thus the current account deficit. Public debt service at the end of the period would amount to 71 percent of exports of goods and nonfactor services. The external financing gaps are somewhat smaller than the fiscal gaps, reflecting projected financing shortfalls in regard of domestic obligations as well as external obligations.

These levels of debt and debt service indicate a serious sustainability problem. The debt-to-GDP ratio, notwithstanding its relative stability over the medium term, is at a much higher level than would normally be considered sustainable for a country in Argentina's position. More importantly, the very large financing gaps identified throughout the medium term are far beyond Argentina's capacity to raise resources.

Sensitivity analysis

Given the considerable uncertainty in these projections, a number of standard alternative scenarios were estimated to test the robustness of the baseline (Annex Table 3). The scenarios are: (i) setting the macroeconomic variables for the projection period at their historical averages (1991–2001); (ii) a series of two-year macroeconomic shocks resulting from higher interest rates, a weaker economic recovery, lower inflation, a weaker fiscal effort, and a combination of all of these factors; (iii) a 30 percent depreciation of the real exchange rate; (iv) a steady appreciation of the real exchange rate of 5 percent a year; and (v) a 10 percent of GDP increase in the debt stock. The results suggest the following:

- Setting macroeconomic assumptions at their historical averages results in a debt-GDP ratio that rises to over 200 percent of GDP by 2010, and financing gaps averaging nearly US$30 billion over 2004–10.

- The debt ratios and the financing gaps are highly sensitive to all types of adverse macroeconomic shock, with the debt indicators quickly reaching even higher levels.

- A steady real appreciation of the real exchange rate would reduce the debt-to-GDP ratio over the medium term, but very large financing gaps would remain throughout the projection period.

While the above scenarios are clearly subject to considerable uncertainty when projected from the depth of an economic crisis, they suggest that in order to reach a more sustainable external and fiscal position, Argentina is very likely to need significant debt restructuring, possibly including the further restructuring of phase one debt, which would have adverse implications for the solvency of the banking system.

Table 1. Argentina: Medium-Term Consolidated Government Fiscal Sustainability Baseline Scenario, before Further Debt Restructuring

	2003	2004	2005	2006	2007	2008	2009	2010
(In billions of U.S. dollars unless stated)								
A. Financing needs	**35.0**	**24.4**	**27.9**	**25.7**	**26.2**	**27.6**	**28.9**	**28.7**
Identified debt service 1/	29.9	19.2	20.8	16.7	15.5	15.1	14.5	12.4
Official	17.2	5.4	5.7	3.6	2.9	2.8	2.3	2.2
Existing debt held by private creditors	12.6	13.4	14.5	12.5	11.9	11.6	11.0	9.0
Already restructured/newly issued	1.6	2.1	6.3	6.6	6.2	6.3	6.8	6.0
Phase 1 debt 2/	0.6	0.7	2.8	3.2	3.2	3.6	4.3	3.5
Deposit conversion bonds	0.4	0.5	1.2	1.1	1.0	1.0	0.9	0.9
Bank compensation bonds	0.5	0.9	2.3	2.3	2.0	1.7	1.6	1.6
To be restructured (Phase 2)	11.0	11.3	8.2	5.9	5.7	5.3	4.2	3.0
Future debt held by private creditors 3/	0.1	0.4	0.6	0.6	0.6	0.7	1.2	1.2
Other obligations	2.4	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Interest on stock of arrears 4/	2.7	4.9	6.8	8.7	10.4	12.2	14.1	16.0
B. Financing sources	**3.1**	**5.7**	**6.9**	**7.3**	**7.7**	**8.1**	**8.6**	**9.0**
Primary balance	3.1	5.7	6.9	7.3	7.7	8.1	8.6	9.0
C. Financing gap (=A-B)	**31.9**	**18.6**	**20.9**	**18.4**	**18.5**	**19.5**	**20.4**	**19.7**
in percent of: GDP	26.1	13.0	13.5	11.3	10.8	10.8	10.7	9.8
D. Consolidated government debt 5/	**160**	**170**	**177**	**186**	**195**	**205**	**216**	**228**
in percent of: GDP	131	119	115	115	114	114	114	113

Source: Fund staff estimates

1/ Principal plus interest, cash basis.
2/ Net of Phase One loans returned in deposit and Cobertura bond conversion schemes.
3/ Includes service on additional bank recapitalization bonds, and debt issued in recognition of government obligations.
4/ Assuming financing gaps are filled by arrears, which accumulate interest at a rate of 10 percent in U.S. dollars.
5/ Including arrears.

Table 2. Argentina: Medium-Term Balance of Payment Projection, 2002-10 (Baseline)

	2003	2004	2005-07	2008-10
(In billions of U.S. dollars)				
Current account	**5.3**	**4.1**	**2.3**	**0.9**
Trade account	14.2	10.7	9.3	9.5
Exports f.o.b.	22.1	18.1	17.8	19.7
Imports c.i.f.	-7.9	-7.4	-8.6	-10.2
Non-factor services and transfers	-0.6	-0.6	-0.8	-1.4
Factor services	-6.6	-4.7	-3.7	-3.4
Of which accured interest on arrears	-0.7	-0.9	-2.1	-3.2
Capital account	**-27.6**	**-11.2**	**-6.5**	**-5.7**
Net public sector capital	-9.5	-6.9	-2.8	-1.4
Other net private sector capital 1/	-18.0	-4.4	-3.7	-4.3
Overall balance	**-22.3**	**-13.6**	**10.7**	**8.4**
Net international reserves (increase -)	0.0	-2.0	-2.1	-1.0
Financing gap 2/	**22.3**	**11.6**	**8.6**	**7.4**
(Percent change)				
Exports	1.6	3.8	8.5	9.0
Imports	6.4	17.7	15.1	12.8
Memorandum items:				
Current account balance excluding accrued interest on arrears	11.8	8.7	6.0	4.3
Gross international reserves				
In months of imports of goods and nonfactor services	9.0	7.7	6.4	6.5
Percent of short-term debt 3/	19.4	19.8	20.3	27.3

Sources: Ministry of Economy and Fund staff estimates.

1/ Includes errors and omissions

2/ Includes accrued interest on arrears

Table 3. Argentina: Medium-Term Consolidated Government Fiscal Sustainability Sensitivity Analysis, 2003-10

Cash basis, assuming residual financing gaps are financed by arrears	2003	2004	2005	2006	2007	2008	2009	2010
(in percent of GDP)								
Debt-GDP ratio								
0. Baseline macroeconomic assumptions	**131**	**119**	**115**	**115**	**114**	**114**	**114**	**113**
1. Macroeconomic variables at historic average levels	129	135	145	158	168	179	191	204
Two-year macro shocks								
2a. Real interest rates 2 standard deviations above average	131	119	115	115	114	114	114	114
2b. Real growth 2 standard deviations below average	144	149	145	146	146	147	148	149
2c. GDP deflator inflation 2 standard deviations below average	127	139	158	160	162	164	166	168
2d. Primary surplus 2 standard deviations below average	135	130	126	126	126	126	127	127
2e. Combined shock of 1 standard deviation from average	137	158	173	176	177	180	183	186
3. 30 percent real depreciation from 2003 on	173	158	153	155	156	158	160	162
4. 5 percent per annum real appreciation from 2004 on	131	116	108	104	99	94	89	84
5. 10 percent of GDP increase in debt stock from 2002	143	131	127	127	127	128	128	129
(in billions of U.S. dollars)								
Financing gap								
0. Baseline macroeconomic assumptions	**32**	**19**	**21**	**18**	**19**	**20**	**20**	**20**
1. Macroeconomic variables at historic average levels	35	25	28	27	28	31	33	34
Two-year macro shocks								
2a. Real interest rates 2 standard deviations above average	32	19	21	18	19	20	20	20
2b. Real growth 2 standard deviations below average	32	20	22	20	21	22	23	23
2c. GDP deflator inflation 2 standard deviations below average	32	19	22	20	20	21	22	22
2d. Primary surplus 2 standard deviations below average	38	28	23	20	20	22	23	22
2e. Combined shock of 1 standard deviation from average	36	26	23	21	22	23	24	25
3. 30 percent real depreciation from 2003 on	32	20	22	19	20	21	22	22
4. 5 percent per annum real appreciation from 2004 on	32	18	21	18	18	18	19	17
5. 10 percent of GDP increase in debt stock from 2002	33	20	22	20	20	25	26	26

Source: Fund staff estimates

Notes

Averages and standard deviations are for 1992-2001 period

2a.-2e. Shocks apply to 2003 and 2004, except for GDP deflator which applies to 2004 and 2005 (reflecting the expected carry-over of inflation from 2002 into 2003)

2a. Real interest rates shock applies only to new borrowing from private creditors

Argentina—Fund Relations

(As October 31, 2002)

I. Membership Status: Joined September 20, 1956, Article VIII

A. Financial Relations

II. General Resources Account:	In millions of SDRs	In percent of Quota
Quota	2,117.10	100.0
Fund holdings of currency	12,698.10	599.79

III. SDR Department:	In millions of SDRs	Percent of Allocation
Net cumulative allocation	318.37	100.0
Holdings	27.39	8.60

IV. Outstanding Purchases and Loans:	In millions of SDRs	In percent of Quota
Stand-by arrangements	9,756.31	460.83
Extended Fund arrangements	824.70	38.95

V. Financial Arrangements:

			SDR Millions	
Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
Stand-by	03/10/00	03/09/03	16,936.80	9,756.31
of which SRF	01/12/01	01/11/02	6,086.66	5,874.95
EFF	02/04/98	03/10/00	2,080.00	0.00
Stand-by	04/12/96	01/11/98	720.00	613.00

VI. Projected Obligations to the Fund: (Under the Repurchase Expectation Assumptions) (SDR millions; based on existing use of resources and present holdings of SDRs):

	Forthcoming[1]			
	2003	2004	2005	2006
Principal	7,457.89	2,196.86	765.52	21.35
Charges/interest	366.70	74.40	19.82	6.77
Total	**7,824.59**	**2,271.26**	**785.34**	**28.12**

1 Assumes that Argentina remains current on obligations to the Fund in 2002.

VII. Safeguards Assessments: Under the Fund's safeguards assessment policy, Central Bank of Argentina (CBA) is subject to an assessment with respect to the SBY arrangement, which was approved on March 10, 2000 and is scheduled to expire on March 09, 2003. A safeguards assessment of the CBA was completed on September 05, 2002. The assessment concluded that substantial risks may exist in the system of internal controls. Staff findings and recommendations will be reported in the staff report for the approval of a possible new arrangement. Implementation of the measures by the CBA will be monitored by staff

B. Nonfinancial Relations

VIII. Exchange Rate: On March 27, 1991 a law was passed guaranteeing the full convertibility of the austral under a currency board arrangement and pegging the austral at ₳10,000 per U.S. dollar. On January 1, 1992 the peso was substituted for the austral at a rate of 1 peso per 10,000 australes. On January 10, 2002 the currency board arrangement was abandoned in favor of a dual exchange rate regime with an official rate of Arg$1.4 per U.S. dollar for most trade, trade finance, and public sector transactions; remaining transactions were at a market floating rate. On February 11, 2002 the dual exchange rate regime was abolished and substituted by a managed floating regime with no pre-announced rate of the exchange rate.

The exchange rate arrangement includes several exchange restrictions that are contrary to Argentina's obligations under Article VIII of the Fund Statutes, Section 2 (a). These include the prior authorization requirements granted on a discretionary basis for external transfers related to: (i) interest payments on and moderate amortization of private sector debts agreed before February 11, 2002; (ii) profit remittances and dividend payments; (iii) payments of reinsurance premiums, and (iv) foreign exchange sales to nonresidents in excess of US$5,000 a month.

IX. Last Article IV Consultation: The 2000 Article IV consultation was concluded by the Executive Board on September 15, 2000 (EBM/00/96). Argentina is on the standard 12-month Article IV consultation cycle.

X. Fourth Amendment: Argentina has accepted the Fourth Amendment to the Articles of Agreement.

XI. Technical Assistance, 2002

Missions	**Purpose**	**Time of Delivery**
LEG	Insolvency Law and Other Legal Issues	March 2002
MAE	Bank Restructuring	March 2002
LEG	Insolvency Law and Other Legal Issues	April 2002
MAE	Bank Restructuring	April 2002
MAE	Bank Restructuring	May 2002
MAE	Bank Restructuring	June 2002

MAE	Staff Visit	July 2002
LEG	Safeguards Assessment	July 2002
Missions	**Purpose**	**Time of Delivery**
MAE	Bank Restructuring	August 2002
MAE	Bank Restructuring	September 2002
FAD	Public Expenditure Management	September 2002
LEG	Insolvency Law and Other Legal Issues	November 2002
FAD	Customs Administration	November 2002
MAE	Development of Banking Model	November 2002

XII. Resident Representative: Mr. Terrier was senior resident representative in Buenos Aires during February 2000 to September 2002; Mr. Cubeddu has been the resident representative in Buenos Aires since September 2002.

ARGENTINA—STATISTICAL ISSUES

The statistical information on basic indicators for surveillance is published in a timely manner and is reliable. Argentina has subscribed to and is in full observance of the Special Data Dissemination Standard (SDDS) and, on the basis of the metadata provided by the authorities and reviewed by IMF staff, it meets the SDDS specifications for the coverage, periodicity, and timeliness of the data, and for the dissemination of advance release calendars. Also Argentina has begun to disseminate a partial version of the template on reserves and international liquidity both on its national web site and to provide the data for a database maintained by the Fund.

A. National Accounts

In June 1999, the Ministry of Economy published and updated series of annual and quarterly national accounts estimates for the period 1993–97 (at current prices and at 1993 constant prices), using a new 1993 benchmark and base year. These series have been carried forward to the most recent periods, although data reported for previous years have not been revised yet and they are still published at constant prices of 1986. The new series have resulted in a significant downward revision of current prices GDP estimates by 8–9 percent.

B. Prices

Consumer prices and producer prices are collected by the National Institute of Statistics (INDEC) and the indices are published monthly in a timely fashion. In December 2000, INDEC released a new CPI index (base 1999) for the Gran Buenos Aires, which replaces the index (base 1988) available since June 1989. The new index introduces an expanded basket (40 percent more items than the old index) and revised weights according to the household expenditure survey for 1996–97.

C. Other Real Sector Data

The National Institute of Statistics has recently published detailed accounts on industrial activity, remuneration and hours worked. Employment surveys are conducted three times a year (May, August and October) and data are published in May and October.

D. Government Finance Statistics

Information on revenue and expenditure of the central government, decentralized agencies, public enterprises and social security system is available on a cash basis with a lag of 1½ –2 months while the data on an accruals basis is available only with a lag of about 3 months. However, data on the provincial public finances are available only on accrual basis and with considerable delays and in summary form. Furthermore, provincial data are revised frequently and have deficiencies in terms of coverage and consistency. Annual time series for the consolidated central government and for provincial governments that are consistent with the 1986 GFS standards are available through 2001 on Argentina's national SDDS website.

E. Monetary Statistics

Monthly data on the central bank, deposit money banks, and the banking survey are published in the Central Bank of the Republic of Argentina's (BCRA) Statistical Bulletin, accessed through the Internet. Data for the central bank are available with a six-week lag, but longer delays may occur, particularly with respect to the audited end-year central bank balance sheet. Complete balance sheet data for deposit money banks are unavailable since December 2001. Data published in *IFS* are based, with few adjustments, on the BCRA Statistical Bulletin.

F. Public Debt

Prior to 1994, data on public sector debt were incomplete and not available on a timely basis. The statistical information has improved both as regards coverage and currentness, and the data are now available on a quarterly basis, but frequent revisions are made to the stock of outstanding debt reflecting the regularization of previously undocumented obligations. Detailed information on public debt is available on Argentina's national SDDS website. A comprehensive report on provincial government debt in 1996 and 1997 was published by the federal government in July 1998.

G. Balance of Payments

In April 1999, the Ministry of Economy published a revised set of balance of payments statistics including annual data for 1992–93 and annual and quarterly data thereafter. The new set incorporates improved data on holdings of foreign financial assets and of direct external debt of the Argentine nonbank private sector. The Ministry of Economy also publishes annual international investment position data for 1991 onwards. Quarterly balance of payments data are published with a two to three-month lag. Monthly trade data are published with a six-week lag. Annual international investment position data are published within six months of the reference period. Balance of payments, trade, and international investment position data are available in the Internet.

The National Directorate of International Accounts (DNCI) of the Ministry of Economy has made significant progress in strengthening Argentina's balance of payments statistics. The DNCI's implementation of a number of guidelines set forth in the fifth edition of the *Balance of Payments Manual (BPM5)*, in particular, has enhanced the coverage of the services components of the current account and both inflows and outflows in the financial account. The authorities have also implemented the recommendations of the 1997 and 1998 balance of payments missions, which resulted in improved estimates on capital flows related to the Argentine nonfinancial private sector's portfolio investment.

ARGENTINA: Core Statistical Indicators
(as of December 12, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	12/5/02	12/5/02	12/5/02	Nov. 02	Nov. 02	12/5/02	Nov. 02	Sep. 02	2nd Qtr 02	Oct. 01	2nd Qtr 02	Jun. 02
Date Received	12/6/02	12/6/02	12/6/02	12/6/02	12/5/02	12/6/02	12/4/02	12/2/02	10/2/02	Nov. 02	Sep. 02	Sep. 02
Frequency of Data	Daily	Daily	Daily	Daily	Daily 1/	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Frequency of Reporting	Daily	Daily	Daily	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Source of Update	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Ministry of Economy	Ministry of Economy	Ministry of Economy	Ministry of Economy	Ministry of Economy	Ministry of Economy
Mode of Reporting	Fax	Fax	Pouch	Fax	Internet	Fax	Fax	Fax	e-mail	Fax	Fax	Pouch
Confidentiality	Unres-Tricted	Unre-stricted	Unres-tricted	Unres-tricted	Unres-tricted	Unres-tricted	Unres-tricted	Unres-tricted	Unres-tricted	Unres-tricted	Unres-tricted	Unres-tricted
Frequency of Publication	Daily	Daily	Daily	Daily	Daily	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly

1/ Survey data.

ARGENTINA: RELATIONS WITH THE WORLD BANK GROUP[1]

1. Bank lending to Argentina as of November 30, 2002 totaled US$17.5 billion (net of cancellations). Thirty seven loans totaling US$4.1 billion remain under execution, with US$1.8 billion undisbursed. The Bank's assistance has been to focus on supporting Government efforts to: (i) enhance social development, including poverty alleviation and human resource development; (ii) improve the performance and institutional capacity of sub-national governments to deliver key social and infrastructure services; and (iii) consolidate structural reforms, including reforms in public finances, labor markets and the financial sector to ensure successful implementation of the assistance program, and enhancing governance through institution building.

2. Out of the 37 ongoing loans, one is a Structural Adjustment Loan (SAL) for US$400 million –of which US$200 remain undisbursed—approved in August, 2001 as part of the joint IFI' support to Argentina as the country began to slip deeper into the crisis at the end of 2000. In addition, 3 of the 37 ongoing loans are Provincial Reform Loans (PRLs) totaling US$703 million –of which US$421 remain undisbursed. These loans, approved between September, 2000 and July, 2001, are part of a continuing effort to assist selected provinces –in this case Catamarca, Córdoba and Santa Fe–willing and able to undertake structural reforms in key social sectors (education, health, social protection), fiscal policies and financial management. These operations complement the adjustment operations, addressing many of the same concerns such as social equity and systemic changes in health and education and on basic economic management. The remaining tranche releases for both the SAL and the PRLs are subject to a sound macroeconomic environment, as well as other specific conditionality in each case.

3. Following the worsening of the crisis in December 2001, the Bank responded to the social emergency by reallocating about US$250 million of the existing portfolio for health, education and social protection.

4. During November 2002, the Bank carried out a joint Portfolio Review with the Government of Argentina, aimed at assessing performance during CY02, identifying prospects for the coming year and actions needed to ensure that the Bank's portfolio in Argentina contributes effectively to the country's development objectives in the short and medium-term. Among of the main conclusions of the Joint Portfolio Review is the fact that, subject to adequate budgetary allocations, potential disbursements out of the existing Bank's portfolio in Argentina could range between US$500–600 million in CY03

5. On November 14, 2002 Argentina announced it would be making only a partial payment on their October 15 obligation to the World Bank. As of that date, no new loans can be presented to the Board of Directors, and Argentina looses its eligibility for reductions of interest charges falling due over the next six months. Out of a payment obligation of

[1] Prepared by the staff of the World Bank.

US$805 million, Argentina made a US$79.2 million interest payment. On November 29, 2002 Argentina became 45 days overdue in its debt service payments to the Bank, and as of that date no replenishments or initial deposits to special accounts can be made. Moreover, on December 9, 2002 the Bank will notify co-financiers, namely Japan Bank for International Cooperation (JBIC) and Inter-American Development Bank (IDB) on the impending suspension of disbursements. If Argentina is not current on all payments to the Bank by December 13, 2002, the Bank will suspend effective December 14, 2002 the borrower's rights to make withdrawals on all effective and not fully disbursed loans.

6. Among the immediate consequences that the situation described above has involved is the postponement of the presentation to the Board of Directors of an investment loan for US$600 million to finance the Heads of Household Project, in support of the Government's workfare program, originally scheduled for November 19, 2002.

Financial Relations with the World Bank

(In millions of U.S. dollars)

	Commitments (Net of Cancellations)	Disbursements	Undisbursed Amount
I. IBRD Operations (as of November 30, 2002)			
Fully disbursed loans	**12,961.6**	**12,961.6**	**0.0**
Loans in process of disbursement	**4,566.1**	**2,069.6**	**2,408.9**
Agricultural, Fishing and Forestry	86.8	55.0	31.7
Education	732.4	227.2	461.4
Energy and Mining	46.5	31.3	15.1
Finance	251.5	188.0	63.4
Health and other Social Services	905.3	294.6	591.2
Industry and Trade	27.9	16.9	8.5
Law and Justice and Public Admin	991.0	508.8	463.0
Transportation	1,146.1	545.9	598.8
Water, Sanitation and Flood Protection	373.7	196.8	175.8
Others	5.0	5.0	0.1
Policy Based Guarantee	250.0	250.0	0
Total loans and guarantee	**17,527.7**	**15,031.2**	**2,408.9**
Repaid 1/	**6,622.7**		
Outstanding	**8,747.7**		

II. IFC Operations (as of November 30, 2002)

	IFC			
	Loans	Equity	Quasi	Participants
Held	690.5	196.3	208.1	899.6
Disbursed	660.0	139.6	208.1	879.6
Pending commitment	158.0	42.9	15.0	529.5

III. IBRD Loan Transactions

	Actuals (calendar year)						
	1995	1996	1997	1998	1999	2000	2001
Disbursements	941.0	1,076.7	796.9	2,030.6	1,572.9	1,018.8	1,328.8
Repayment	258.6	281.9	299.1	350.2	445.0	538.1	675.5
Net lending	682.4	794.8	497.8	1,680.4	1,127.9	480.7	653.2

Source: World Bank

1/ Includes repayment from third parties

ARGENTINA—RELATIONS WITH THE IDB[1]

Portfolio

1. The Bank's activities had to be adjusted in light of this new economic context, so as to:

    - encompass harsher fiscal constraints;
    - protect social expenditure, deepening the actions undertaken with respect to reformulation of the social portfolio;
    - support development of the productive sectors through loans to the provinces under the new agreement with the federal government and support for small- and medium-sized enterprises (SMEs), particularly export-oriented SMEs, and support a review of the portfolio relating to the productive sectors; and
    - help maintain political reforms.

2. In March 2002, authorization was given to redirect US$694.2 million from low-performing operations of lesser priority in the context of the social and economic crisis now affecting the country to the Argentine government's Social Emergency Plan for social protection and containment programs, particularly food, medicines, and education.

3. In a second stage, work is underway on a proposal to redirect resources from active projects that are unlikely to make progress again soon to initiatives that help revitalize economic activity and improve the competitiveness of the productive sectors. This revitalization package could total US$800 million.

4. Disbursement of the second tranche of two sector loans is pending: the Financial Sector Program in the amount of US$243 million, and the Sector Program to Support the Federal Pact for Growth and Fiscal Discipline in the amount of US$246.7 million. In due course, a proposal will be submitted to the Board of Executive Directors to reformulate the conditionality of these operations to adapt them to the new reality in Argentina.

5. As of December 2, 2002 disbursements for the year totaled US$406.1 million, 72.3 percent of which were for the social sectors.

Operations Program

1. Provided that an agreement is reached with the IMF, an **emergency loan** of US$1.5 billion may be approved to protect social expenditure. This operation would

[1] Prepared by the Staff of the IDB.

be disbursed in two tranches. Additionally, once the new government to be elected in the coming months has taken office, an additional emergency loan in the amount of US$1 billion could be approved, which could serve the social sectors as an instrument for policy dialogue with the new authorities.

2. Additionally, a financial sector loan is being considered for 2003; a loan for a group of comparatively less-developed provinces and direct loans to three provinces (Salta, Río Negro, and San Luis) that would help revitalize economic growth by supporting sectors with greater comparative advantages.

3. The operation relating to the comparatively less-developed provinces includes planning a long-term development strategy at the national and provincial level, with a view to identifying and strengthening sources of economic growth.

4. Moreover, technical cooperation operations are in preparation that aim to improve the competitiveness of small- and medium-sized enterprises and to strengthen the financial sector.

5. The Bank's new strategy for action in Argentina is expected to be approved by the end of 2003.

INTERNATIONAL MONETARY FUND

ARGENTINA

Staff Report for the 2002 Article IV Consultation

Supplementary Information

Prepared by the Western Hemisphere Department
(In consultation with other departments)

Approved by Anoop Singh and G. Russell Kincaid

January 6, 2003

The following information on economic developments and policy implementation has become available since the circulation of the staff report for the 2002 Article IV consultation. There is no change in the staff appraisal.

I. Recent Economic and Market Developments

1. **The economic situation remains broadly as assessed in the staff report**. Poverty indicators remain serious. The recent stability in the banking system continues. The estimated fiscal outcome for 2002 is broadly as anticipated in the staff paper. Base money increased relatively rapidly in the fourth quarter, partly reflecting seasonal factors.

2. **On the poverty and unemployment situation**, the following information has become available for the greater Buenos Aires area:

- The percentage of the population below the poverty line has increased from 49.7 percent in May 2002 to 54 percent in October.

- The official unemployment rate has declined from 21½ percent in May 2002 to about 17.8 percent in October—attributed, however, to the growth in beneficiaries under the employment support programs (mainly, the *heads of household* program).

3. **Inflation turned up slightly in December but market indicators remain stable:**

- Consumer prices rose by 0.2 percent and wholesale prices fell by 0.3 percent in December, bringing the 12-month increases to 41 percent and 118.1 percent, respectively.

- The peso appreciated somewhat (6 percent) in December, to close the year at Arg$3.36 per U.S. dollar. In addition, the central bank gained about US$450 million in reserves during December to end the year with about US$10½ billion in gross international reserves compared with US$9.9 billion projected in the staff report.

- The trade surplus in the first eleven months of 2002 reached US$15.2 billion, against a surplus of US$5.3 billion in 2001 and a projection of US$17.6 billion for 2002, which now looks on the high side.

4. **Regarding the fiscal situation**: tax receipts in 2002 were broadly in line with the projections contained in the staff report. During the year, tax revenues (including social security contributions) are estimated to have grown by 11 percent in nominal terms, implying a drop in the tax-to-GDP ratio to 15 percent.

5. **Base money increased by 29 percent in the fourth quarter**, partly reflecting seasonal factors at the end of the year but also unsterilized foreign exchange purchases by the central bank.

II. Policy Implementation

2003 budget

6. **The 2003 budget was approved by Congress on December 26.** Expenditure measures were approved as anticipated, but there were some differences in the tax package that was approved by Congress. Specifically:

- Congress has eliminated the contingency fund (about Arg$3½ billion) and reduced the expenditure ceiling by Arg$1 billion.

- However, an important subset of measures in the proposed tax package were not approved by Congress: (i) the elimination of remaining competitiveness plans which are crucial also to begin tax reform; (ii) the conversion of the fuel tax to an ad valorem basis; and (iii) proposed reductions in tax deductions applying to exporters. Against this, Congress approved the extension of the financial transactions tax until December 2004, among other changes in some taxes. It is estimated that the net revenue loss could be about Arg$1 billion in 2003 (about 0.3 percent of GDP).

7. **It is likely that, on this basis, a fiscal financing gap will remain in 2003.** A forthcoming mission to discuss a short-term program that could be supported by the Fund will discuss the measures that could still be taken to maintain the consolidated primary surplus target of 2½ percent of GDP for 2003 and to close the financing gap.

Foreign exchange restrictions

8. **The central bank has relaxed some foreign exchange restrictions, effective January 2:**

- The central bank will no longer require that companies seek its approval for all interest and some principal payments to foreign creditors.

- Restrictions on advanced (pre-shipping) payments on imports of capital goods were eased by allowing pre-payments up to 100 percent of value subject to certain "*ex-post*" requirements.

9. **The central bank also relaxed other foreign exchange measures**:

- The prior authorization on foreign exchange sales for portfolio and other financial investments abroad and for the domestic use of foreign banknotes was increased from sales over US$100,000 a month to sales over US$150,000 a month.

- The limit on the overall foreign exchange position of bank and nonbank financial institutions was increased from 5 percent to 6 percent of regulatory capital at end-November 2001.

- The period for surrendering export receipts arising from certain exports was amended by allowing the surrendering of such receipts to be made taking into account the contractual payment terms agreed upon by the importer and exporter.

10. **The forthcoming Fund mission will determine whether the measure with respect to interest and principal payments to foreign creditors eliminates the associated Article VIII restriction.** The other Article VIII restrictions that were summarized in the staff report (paragraph 44) remain in place. In the absence of a timetable for removing the restrictions, the staff continues not to recommend approval of Argentina's Article VIII exchange restrictions.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/88
FOR IMMEDIATE RELEASE
July 25, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Argentina

On January 8, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Argentina.[1]

Background

Since the last Article IV consultation, which was concluded in September 2000, far-reaching developments in Argentina have transformed its economic situation and prospects. A complex set of factors resulted in the massive loss of domestic and foreign confidence that forced Argentina's sovereign default in late 2001, and the abandonment of its decade-long currency board arrangement in early 2002.

At the macroeconomic level, the currency board arrangement was not adequately supported by the rest of the policy framework. Inflexibilities in many sectors of the economy could not compensate for the real appreciation experienced during the 1990s partly reflecting the strong U.S. dollar and the depreciation of the Brazilian *real* after 1999. In particular, fiscal policy grew progressively inconsistent with the demands of the currency board regime and a sizable public debt was built up during the second half of the 1990s. On the external front, reduced appetite of foreign investors for emerging market debt caused a sharp slowdown of capital inflows to Argentina, leading to a sudden and significant increase in the marginal cost of borrowing that weakened the prospects for economic growth and debt rollovers.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Origins of the Crisis

The role of fiscal policy was central to the crisis. Persistent cash deficits and "off-budget" debt-creating expenditures added to a mainly dollar-denominated public debt. Even in the years of high growth following the reforms of the early 1990s, the fiscal effort was insufficient to produce adequate primary surpluses. These fiscal problems were the product of vested interests, and resistance to fiscal reforms in the provinces. The sustainability of the higher public debt ratio depended on maintaining healthy growth, strengthening the fiscal primary balance, and ensuring access to international capital. In the event, none of these conditions came to apply.

The prolonged recession that preceded the crisis reflected both falling confidence and a lack of flexibility in the economy that was incompatible with the currency peg. The steady real appreciation of the peso could not be accommodated in an orderly fashion given structural rigidities in the labor market and fiscal policy. Eventually, the brunt of the adjustment fell on domestic prices and employment, placing the economy on a deflationary path and making it difficult to get the political support to re-orient economic policies.

High dollarization of the economy meant that any exit from the convertibility plan was bound to be very costly and disruptive. As a consequence, successive governments have shown a high degree of reluctance to consider an orderly transition to another exchange rate regime. Not only was fiscal solvency tied to the currency peg, but also that of the financial system. Banks were heavily exposed to losses from a government default and to credit risk in the event of a devaluation, as a result of making U.S. dollar-denominated loans to clients whose earnings were denominated mainly in pesos. At a more general level, the dominance of the nontradable sector and narrow export base were fundamentally at odds with a liberalized capital account, and a high reliance on dollar-denominated borrowing.

Developments in 2001–02

In 2001, the economy entered the third consecutive year of negative growth. After a cumulative decline of 4¼ percent in 1999–2000, real GDP fell by 4½ percent in 2001, and prices continued to decline. In the first nine months of 2002 real GDP is estimated to have fallen by 13 percent (reflecting large declines in consumption and investment), although economic activity appears to have stabilized since then. By October 2002, the unemployment rate is estimated to have risen to about 23 percent and there was a large increase in the number of people living in poverty. The price deflation of earlier years was reversed in 2002 following the sharp depreciation of the peso. Monthly inflation peaked in April at 10½ percent, and slowed sharply from mid-2002.

The public finances deteriorated sharply in 2001, at both the federal and provincial level, with the overall cash deficit of the consolidated public sector increasing by 2¾ percent of GDP to 6¼ percent of GDP. The position improved in 2002, owing mainly to the implementation of a revised revenue-sharing agreement with the provinces and tight control over spending. The cash fiscal position, however, conceals the extent of the underlying deterioration in the public finances, as there were large debt-creating expenditures, such as bond issuance in connection with the banking crisis, and the capitalization of interest payments. A comprehensive measure would bring the augmented primary and overall deficits of the consolidated public sector in 2002 to 11¼ percent and 25¼ percent of GDP, respectively. The public debt-to-GDP ratio is estimated to have risen to 119 percent by June 2002.

Financing difficulties and the collapse of economic activity shifted the external current account from a deficit of about US$4.5 billion in 2001 to a surplus of about US$9 billion in 2002. The adjustment was driven by a sharp contraction in imports, while exports were flat. Private net capital outflows in 2001–02 are estimated at about US$38 billion, while gross international reserves fell by US$20 billion to about US$10 billion. In 2002, external payments arrears reached about US$8.25 billion, including to multilateral and bilateral creditors.

Executive Board Assessment

Executive Directors regretted that, since the last Article IV consultation in September 2000, Argentina has faced an acute economic and social crisis. Argentina's situation has been fundamentally transformed, with the economy contracting and the poverty and unemployment situation deteriorating. A complex set of economic, institutional, and political factors has led to a massive loss of confidence, default on the foreign debt, and abandonment of the decade-long currency board arrangement. Against this background, Directors expressed their conviction that Argentina will need to formulate and implement—with support of the international community—a strongly-owned program of stabilization and wide-ranging reforms to resolve deep-seated institutional, macro-economic and financial problems, restore confidence, and rebuild economic growth and financial sustainability. They expressed the hope that a transitional program, that could build a bridge to such a comprehensive program, could be agreed at an early date. In particular, Directors hoped that the transitional program will include credible commitments in the area of fiscal and monetary policies, actions to strengthen the banking system, and measures to strengthen Argentina's cooperation with the international community and dialogue with the private sector, in ways that will facilitate a workable transition to a comprehensive program.

Directors had a wide-ranging discussion of the crisis that engulfed Argentina at the end of 2001. They were of the view that Argentina's currency board arrangement was ultimately undermined by its lack of support from the domestic policy framework and by unfavorable external circumstances. In particular, a deteriorating fiscal performance (including off-budget expenditures, persistent provincial deficits, and revenue mismatch in the pension reform) resulted in rising public debt, while structural rigidities, including in the labor market, prevented adjustment to an appreciating real exchange rate. Argentina's vulnerability to external shocks was further compounded by the small size and relatively undiversified structure of its export sector relative to the increasing openness of its capital account and reliance on external financing. Some Directors also drew the conclusion that, while the currency board may initially have served Argentina well, it had not been an adequate exchange rate regime choice given the fiscal choices made in Argentina and unfavorable external developments.

More broadly, Directors underscored the critical importance of addressing vulnerabilities before they become severe, and the important role that Fund surveillance and conditionality have to play in focusing early and sufficiently on sustainability issues. They considered that timely action to correct vulnerabilities, which in the case of Argentina would likely have included an orderly exit from the currency board arrangement, might very well have prevented a crisis that—in the absence of strong domestic ownership of policies crucial for sustainability—became inevitable. Some Directors also noted that the Argentina crisis highlights the importance of properly integrating external factors, including regional dimensions, into Fund surveillance. The Executive Board will have further opportunities to come back to these issues in the broader context of the ongoing effort to strengthen surveillance and focus conditionality.

Turning to the authorities' initial response to the crisis, Directors regretted the time it had taken to develop a consistent policy response that would have enabled Argentina to move toward a Fund-supported program during 2002. Initial failure to build a strong political consensus toward resolving the crisis in an orderly and equitable way—admittedly a difficult task given the severity of the situation—had contributed to policy reversals that greatly added to the social cost of the crisis. In particular, Directors noted that early government actions during 2002—such as the decisions to convert banks' foreign currency denominated assets and liabilities into pesos at asymmetric exchange rates, and amendments to the insolvency law that tilted the balance sharply against creditors—had exacerbated the economic situation and impeded recovery.

Directors were nevertheless encouraged by signs of a return to economic stability in the second half of 2002. Following a sharp decline in real GDP, economic activity has stabilized in recent months; inflation has slowed sharply from its April peak; the external position shows some signs of improvement; and the banking system as well as market indicators have been relatively stable. Directors welcomed the fiscal spending restraint that has contributed to achieving this stability, but cautioned that it also reflects controls on foreign exchange transactions and on utility prices. They were concerned that, with fiscal and banking solvency still to be assured, and indications of repressed inflation, stability is still fragile, and needs to be put on a firm footing.

Directors considered that, in building an enduring recovery, reversing rapidly rising poverty trends, and achieving external and fiscal sustainability, Argentina will need to address five major challenges in the context of a sustained medium-term restructuring effort. These are, first, giving reassurances about legal certainty and the political consensus for reforms; second, establishing a robust fiscal framework encompassing the provinces; third, continued progress in resolving the monetary overhang and restoring confidence in the banking system; fourth, undertaking structural reforms to further liberalize the economy and increase trade openness; and fifth, restructuring debt and reestablishing orderly relations with creditors. While a credible program of core measures, including strong fiscal and monetary performance, can facilitate the transition period to a new government, Directors stressed that only full implementation of a comprehensive program, based on strong domestic ownership, can achieve lasting results. In this context, some Directors called for a broad-based public debate to forge the political, economic, and social consensus that will be needed to support the required reforms.

Directors underscored the urgency of restoring legal certainty in Argentina—as a precondition to reviving new credit flows, investment, and growth. They noted that, even after the reversal of earlier measures, creditors continue to face uncertainties about the enforcement of their contractual rights, and urged the authorities to work expeditiously toward improving the investment environment. Directors hoped that market concerns about the continuity of economic policies following the political transition could be quickly addressed, and looked forward to continued actions in the institutional sphere to improve governance and secure the respect for the rule of law.

Directors viewed the restoration of fiscal solvency as a sine qua non of a sustainable economic program, and noted that this task will require a fundamental break with the past involving several dimensions affecting both the federal government and the provinces. In the short run, both levels of government will inevitably need to rely on tight control over primary spending, and Directors saw expenditure restraint as key to achieving the targeted consolidated primary surplus of 2.5 percent of GDP in 2003 and closing the financing gap without monetization. At the same time, it will be important to ensure that social safety net programs are adequately funded and become fully operational.

Going forward, Directors agreed that rebuilding tax administration and a culture of compliance will be essential to raising revenues and attaining the higher primary surpluses that will help sustain the public finances in the medium term. In this context, some Directors noted that Argentina's revenue effort is below several other countries in the region. Directors urged the authorities to plan the needed tax reforms without further delay and build consensus for them, and welcomed recent legislation eliminating the ability of the executive to grant tax amnesties as a key step toward a comprehensive reform of the tax system. They also called for continued efforts to eliminate remaining Competitiveness Plans, and looked forward to the re-instatement of the recently cut VAT rates to their previous levels at the end of the 60-day reduction period.

Directors were strongly of the view that provincial governments need to be firmly anchored in the adjustment effort in order to achieve fiscal sustainability. Work should begin as soon as possible toward a comprehensive reform of intergovernmental relations that would draw upon the lessons from Argentina's poor fiscal performance in the 1990s, and that would be supported by an incentive structure that ensures fiscal discipline and responsibility at all levels of government. In the short run, Directors urged the authorities to seek early ratification by provincial legislatures of the bilateral agreements that would underpin the 2003 fiscal targets for the provinces, and to make additional efforts to improve the transparency, quality, and timeliness of the data reported on the provincial finances to ensure effective monitoring. They also saw as essential for monetary and fiscal discipline that provinces end the issuance of all new quasi monies.

Turning to monetary control issues, Directors considered the consolidation of a credible monetary anchor as crucial to maintaining macroeconomic stability. They commended the central bank's efforts in building its instruments of monetary control, but a number of Directors cautioned about the risks associated with potentially significant leakages related to the *amparos* and the reprogrammed time deposits to be released in 2003. Some other Directors, however, saw this risk as rather low, given the experience thus far and the relatively robust demand for money. Directors welcomed the recent stability and rise of bank deposits and expressed the hope that a credible short-term economic program would reinforce this stabilizing trend. They noted, however, that the pending ruling by the Supreme Court on the constitutionality of the *pesoization* of bank deposits is adding to uncertainties, and underscored the importance of resolving this issue in a manner that does not undermine establishing a credible monetary anchor.

Directors discussed several other steps that would more fully restore depositor confidence, limit the fiscal costs of the crisis, and rebuild a sound banking system—all of which are necessary to promote domestic saving, investment, and growth. They urged the authorities to work in close cooperation with the Fund staff on bank resolution issues and in implementing an orderly strategy to identify and resolve weak banks according to consistent principles. Directors looked forward to early strong efforts to further strengthen confidence in the banking system, which will be key to ensuring lasting economic stability. They also encouraged the authorities to reaffirm their commitment to safeguarding and strengthening central bank independence, and looked forward to early approval of legislation that would protect public officials carrying out their duties in the bank resolution process. Directors welcomed the authorities' efforts to strengthen the central bank's system of internal controls, and encouraged them to stand ready to take further actions as needed in line with the Fund's safeguards assessment.

On structural issues, Directors considered that the greater stability in the economy provides the opportunity to liberalize the exchange controls that had been imposed in 2002 at the height of the crisis, and to initiate wide-ranging reforms necessary to revive investment and growth. They welcomed, in this regard, the steps recently taken, including those announced immediately prior to the Board meeting, to remove most of the remaining Article VIII exchange restrictions and ease export surrender requirements. Directors looked forward to early further steps to liberalize the restrictive compulsory export surrender requirement which would help rebuild confidence.

Most Directors noted with concern that the situation regarding utility pricing could be putting a large burden on price adjustments in 2003, and regretted that the recently decreed tariff increases for gas and electricity companies, as well as the public hearings on tariff increases, have been halted by the courts. Directors underscored the urgency of an early joint IMF/World Bank diagnostic mission to assess the financial situation of the utility companies and develop an appropriate regulatory framework that will secure their financial and operational viability, while ensuring that the social impact of price adjustments is properly taken into account.

Among other structural reforms, Directors saw a need for a renewed emphasis on trade liberalization and diversification, given Argentina's relatively low level of trade integration. They encouraged the authorities to further lower trade barriers, and seek improved market access for Argentina's products in the context of regional and multilateral trade negotiations. In the short-term, efforts should focus on reducing administrative obstacles to exports, and, over time, phasing out export taxes.

Directors underscored that, in order to strengthen Argentina's medium-term outlook, the authorities face the key challenge of restructuring Argentina's public debt in a manner that will help normalize relations with private creditors and begin the process of attracting capital flows back into the country. They welcomed the authorities' recent steps to initiate contacts with private creditors, and their intention to intensify this dialogue with the assistance of external debt restructuring advisors. Directors looked forward to continued progress, particularly with institutional investors, in this area, and urged the authorities to make all necessary efforts toward advancing a constructive dialogue with private creditors on a debt restructuring, consistent with the "good faith" criterion under the Fund's policy for lending into arrears. While noting that significant net payments had been made by Argentina to the international financial institutions in 2002, Directors regretted Argentina's decision to fall into arrears with the World Bank and urged the authorities to eliminate them as soon as possible. This will clear the way for implementation of the Bank's program of social support under the Heads of Household program. Directors urged the authorities to remain current on their obligations to the international financial institutions.

Directors noted that, even with the maintenance of a substantial fiscal adjustment effort, Argentina's medium-term debt outlook appears very difficult. Debt ratios will remain very high and financing needs very large, while prospects for regaining market access will likely improve only gradually. They urged the authorities to work closely with the international community and to strengthen their efforts to reach a cooperative solution with private creditors to secure financing and achieve fiscal and external sustainability over the medium term.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Argentina is also available.

Argentina: Selected Economic Indicators

	1998	1999	2000	2001	Est. 2002
(Annual percentage changes; unless otherwise indicated)					
National income and prices					
Real per capita GDP	2.6	-4.6	-1.7	-5.6	-10.8
GDP at constant prices	3.8	-3.4	-0.8	-4.4	-11.0
Consumption	3.1	-2.6	0.2	-4.4	-13.6
Investment	6.5	-12.6	-6.8	-15.7	-39.0
Net exports (contribution to growth)	0.0	1.4	0.3	2.1	6.4
Industrial production (average)	1.6	-6.5	-0.3	-7.6	-12.0
Consumer prices (average)	0.9	-1.2	-0.9	-1.1	25.9
Consumer prices (end-of-period)	0.7	-1.8	-0.7	-1.5	41.9
External sector (in terms of U.S. dollars)					
Exports, f.o.b.	1.0	-12.6	13.2	0.9	0.2
Imports, c.i.f.	3.1	-18.7	-1.2	-19.5	-55.1
Export volume	11.6	-0.7	2.8	4.5	4.3
Import volume	8.7	-13.8	-1.2	-16.8	-55.8
Terms of trade (deterioration -)	-5.5	-5.9	10.2	-0.6	-1.1
Real effective exchange rate, average (depreciation -)	3.5	12.4	-0.7	6.0	-57.3
Real effective exchange rate, year-end (depreciation -)	0.3	12.6	1.7	2.9	-54.7
Money and credit					
Banking system					
Net domestic assets	14.6	4.7	3.3	5.0	...
Of which: credit to private sector	10.8	-2.1	-3.8	-17.6	-37.5
Money (M2)	24.7	-2.4	-2.5	10.7	-9.4
Velocity (GDP relative to M2)	8.0	7.6	7.8	8.1	7.8
Interest rate (30-day deposit rate, in percent) 1/	7.6	8.0	8.3	16.2	41.8
(In percent of GDP)					
Public sector savings	-0.5	-2.6	-2.2	-4.7	-2.0
Federal government cash primary balance	0.9	0.4	0.9	0.1	0.5
Federal government cash overall balance	-1.3	-2.5	-2.5	-4.4	-9.4
Consolidated public sector cash primary balance	0.6	-0.7	0.4	-1.4	0.0
Consolidated public sector cash overall balance	-2.0	-4.1	-3.6	-6.8	-10.3
Gross domestic investment	19.9	18.0	16.2	14.2	10.7
Gross national savings	15.2	13.8	13.1	12.5	18.8
Current account deficit	-4.8	-4.2	-3.1	-1.7	8.1
Public sector external debt (end-of-year)	27.8	29.9	29.7	32.8	83.6
(In percent of exports of goods and nonfactor services; unless otherwise indicated)					
Public sector debt service	38.0	49.6	54.8	65.7	47.4
Of which: interest payments	17.5	22.4	21.7	21.0	22.4
Outstanding use of Fund resources					
(in percent of quota at end-of-period)	251.5	154.1	183.2	525.3	499.8
Gross foreign exchange reserves 2/	8.2	10.1	9.8	6.6	8.6

Sources: Ministry of Economy; and IMF staff estimates.

1/ Average interest rate on 30- to 59-day time deposits in national currency. The rate is weighted by deposit amounts.

2/ In months of imports of goods and nonfactor services.

Ministerio de Economía
República Argentina

Assessment by the Government of Argentina of the IMF Staff Reports for the 2002 Article IV Consultation with Argentina

January 2003

I. Overview

1. In 2002 Argentina confronted the most acute social and economic crises of the last century. The initial policy responses should be assessed in light of these emergency circumstances. During this difficult period, the vocation of Argentine society to work within the framework of the Constitution to address deep-seated problems emerged with clarity. This gave resilience to the democratic process and is helping to provide a basis for rebuilding consensus on the medium term strategy needed for recovery and growth with social equity. The detailed staff reports prepared for this Article IV Consultation offer a rich description of events leading to the largely anticipated, yet abrupt, end of the fixed exchange rate regime and the subsequent attempts to stabilize social and market conditions by way of heterodox and orthodox measures . The government of Argentina appreciates staff's effort to describe the difficult situation but find the need to dispel potential misunderstandings in the attempt to provide a more balanced representation of events and prospects.

2. The collapse of the currency board arrangement was preceded by sustained fiscal imbalances, a high level of unemployment and under-employment, increasing public indebtedness, financial dollarization and a real overvaluation of the domestic currency. This took place in tandem with adverse external circumstances, including sharp terms of trade losses and the absence of agricultural export gains from the Uruguay Round, back-to-back crisis in Russia and Brazil, the progressive loss of access to market financing, and the strong US dollar. The inexistence of the exchange rate and of monetary policy as tools for adjustment and stabilization in Argentina put the onus on fiscal policy as the main macro-stabilization variable. The late introduction and unconvincing application of the fiscal responsibility law, including in the provinces, served to amplify the pro-cyclical influences, which in the latter period of the fixed exchange rate regime deepened the output contraction, loss of employment and the process of deflation.

3. The increasing sentiment of unsustainability of the Argentine macro-economic policy mix, by external and later domestic market participants, was reflected in the credit crunch that was already affecting economic activity and contributing to a more generalized perception of insolvency in both the private (particularly non-tradable) and public sectors. The break in the external support, that had been made available since the early 90s, including from the Fund, and the lack of an orderly "exit" strategy from the currency board arrangement in the context of Argentina's completely open capital account, gave way to further heavy deposit and reserve losses, limitations to cash withdrawals, violent street demonstrations, the fall of the De la Rua administration, and the selective default on a large portion of the government debt. This rapidly evolving sequence of events led to a multiple banking, currency, fiscal and corporate crises, followed by the intensification of controls on banking and foreign exchange transactions, the inevitable abandonment of the fixed exchange rate regime, the overshooting of the nominal and real exchange rates and the asymmetric pesoification of banks' assets and liabilities. More significantly, this process led to the widespread disruption of contracts, and to social and civil unrest following eight years of high unemployment, four years of recession and an increasing inequality in the

distribution of income. It also triggered a new round of output contraction and the reappearance of inflation, although lower than expected, it came at a time when more than fifty percent of the population was already below the poverty line. In sum, the result was a massive destruction of confidence, economic "value" and national prosperity. Reverting this process in a manner which equitably distributes the losses and restores market confidence is the major challenge that the government of Argentina have been confronting in the run up to the presidential elections scheduled for this year.

4. In this scenario, the balance of risks still confronting the Argentine economy is, not surprisingly, high given the unprecedented economic, social and political disruption which followed the collapse of the convertibility arrangement. At the same time, the government considers that despite its transitional character and the lack of net external financial support, the policy framework it has put in place is fully owned and sufficiently robust not only for lowering social tension, but to lay the basis for renewed hope and for implementation of the structural reform agenda needed for medium term fiscal and external sustainability.

II. **Policy Issues**

5. Before addressing some specific policy issues that have been part of the protracted negotiations on a Fund-supported program, such as the monetary anchor, the financial sector restructuring and the price controls on the privatized utility companies, it is important to clarify the notions expressed in paragraph 2 of the main staff report: The reference is made there both to much weakened institutions and low ownership for many parts of the program and to policies adopted without prior consultation, and often against the advice of the Fund staff. In fact, the government of Argentina attaches full ownership to its program and prides itself on the positive contributions of the economic policy framework in place , commented on in Section III below. As to the internalization of staff's advice, this has always been appreciated and followed in many instances, although not in all respects, which testifies to ownership. The substance of the successive raising of the limits for withdrawal of time deposits and the more recent complete freeing up of the "corralito" has been discussed and agreed previously with staff, except for its timing. More significantly, the basic macroeconomic framework, underpinned by an austere public expenditure policy and a disciplined monetary policy, should not be taken for granted when assessing overall compliance with what is deemed to be the traditional Fund advice. Regarding the delays in securing the necessary political consensus, it should be noted that this is not an uncommon occurrence in Fund programs, particularly in times of crisis, and, more significantly, when democratic institutions are expected to be fully participatory. An important aspect that could have received greater prominence in the staff reports is that, in the end, political consensus is being achieved, as evidenced in Attachments II and III related to the undertakings in the agreements with provincial governors and parliamentary leaders of April and November last year. Passage of the 2003 budget by Congress on December 26, containing important expenditure reduction provisions, are demonstrations consistent with the government of Argentina vocation to close the financing gap and maintain the consolidated primary surplus of 2.5 percent of GDP for the year.

6. A recurrent theme of the policy discussions has been the credibility of the monetary anchor, to which the government assigns great importance given the status of events. There is no basic disagreement with Fund advice on this point, particularly in terms of prioritizing the preservation of macroeconomic stability and avoiding policies which could imply some period of high or hyperinflation. This has been the guiding principle of Minister (of Economy) Lavagna since the beginning of his tenure last May. The difference that emerged with staff relates rather to the instruments envisaged to achieve that goal. In the context of an active Congress and a fully independent Judiciary, the government has opted, paradoxically, for more market-friendly solutions than those advocated by staff to address the problem of pesoification and freezing of bank time deposits for economic, political and legal reasons. The voluntary approach followed by the government, by which depositors were offered a menu of options, was deemed more consistent than the compulsory approach advocated by staff for attaining the objective of rebuilding confidence that is the basis for financial intermediation. In addition, neither the Congress nor the Judiciary were willing to convalidate any measure that entailed yet another generalized infringement of contractual rights.

7. From a purely economic point of view it is important to gauge with some precision the seriousness of the monetary "overhang" problem, which in practice is proving to be less contentious and the demand for money more vigorous than envisaged by staff. The latter became clear with both the recent raising of the limit of withdrawal up to Arg$ 14.000 from the "corralon" (reprogrammed time deposits) and the complete liberalization of the "corralito" (constrained sight deposits) without affecting the foreign exchange market, which instead is showing a persistent strengthening of the domestic currency. The supporting evidence against the uncontrolled monetary overhang concept, in contrast with the conclusion in Box 5 of the main staff report, is further affirmed by the still high level of real interest rates. In this regard, two important theoretical reasons for the sharp increase in the demand for high powered money are the still high liquidity premium, given the monetary events of 2001/02, and a money multiplier, which in the absence of the customary process of secondary money creation by banks, is virtually equal to one. This has allowed for increases in the monetary base without proportionally impacting on the monetary aggregates. The fact remains that the government's voluntary approach for dealing with the so called monetary overhang has produced a substantial reduction in the magnitude of the problem since last May, when this issue was first raised by staff. Notwithstanding the assessment presented in footnote 17, in page 17 of EBS/02/214, reprogrammed time deposits applied to the cancellation of outstanding bank credit, one of the options offered to depositors, exceeded Arg$ 17 billion (almost 5 billion dollars) and contributed to absorbing a significant part of the "overhang" while keeping inflation in check. Thus, while in May of last year payments to be released in 2003 from frozen time deposits were estimated at 130 percent of the monetary base and 57 percent of gross international reserves, in December these had declined to only 23 percent of the base and 17 percent of the stock of reserves. Moreover, as a proportion of unrestricted time deposits, these had declined from 300 percent in May of 2002 to 33 percent last December. The government of Argentina continues to believe that staff's concerns about the effects of the upcoming CEDRO (reprogrammed time deposits) maturities in 2003, are excessive. First, one-off CEDRO installments from the "corralon" have so far resulted in

CEDRO-holders largely remaining within the system. Second, the upcoming maturities represent small monthly liquidity pressures, at least until September 03, well after a newly elected government is sworn in and the prospects of the desired medium-term successor program clarified. Third, the Central Bank is committed to keeping real interest rates at a relatively high level. This is an important reason why CEDRO holders and those resorting to judicial injunctions, "amparos" for that matter have chosen not to exit the system. More broadly, it is difficult to envisage any financial system operating under the assumption that CD maturities will equal CD redemptions. The improving macroeconomic environment in Argentina, buttressed by a Fund supported program, is highly unlikely to result in an exception

8. Another related issue raised by the staff is that the central bank lacks sufficient instruments to conduct open market operations to cope with potentially significant deposit leakages. The assertion was also made that the recent lifting of the "corralito" heightens the vulnerability of the banking system to shocks. While freedom to withdraw funds undoubtedly increases risk, it should also be self-evident that without such freedom no banking system could be expected to operate efficiently. The fact that the stock of central bank paper is relatively small should not be seen in itself as a constraint since the demand remains strong, as shown by the fall in nominal interest rates. This also suggests that there is still a substantial margin for increasing the supply and, therefore, both the effectiveness of this instrument of monetary policy and the credibility of the new nominal anchor in the economy.

9. Another area where the government considers there is general agreement with staff is on the steps to be taken to restructure the financial system, reflected in Section IV. A of the Staff Report. Supplement 1 of EBS/02/214 on the banking system refers in paragraph 47 to public banks as having had a relatively privileged position because of their unlimited access to emergency liquidity. In fact, liquidity assistance was offered initially in a liberal manner to all banks including, to a large extent, to private banks. This has certainly contributed to the high inflation in the period January-April of last year. The new economic authorities that took office last May did not adopt the blanket guarantee of deposits suggested by staff as a matter of policy to avoid moral hazard and the risk of additional excess liquidity injection, as the experience with a resolution of a major domestic private bank in the first half of the year showed. In any event, the lack of explicit reference to the staff suggestion of extending a formal blanket guarantee on deposits contrasts with the explicit mention, in footnote 18 of EBS/02/214, of the possibility of introducing a Chapter XI-type bankruptcy status, proposed by some from the private financial sector and the Judiciary, but soon discarded by the government. With respect to the prospects for the banking system another staff reference that warrants clarification relates to the uncertainty stemming from the compensation to be received by banks for the asymmetric pesoification, "amparos", and the asymmetric indexation of assets and liabilities. In fact, compensation for the most important of those categories, the asymmetric pesoification, has already taken place.

10. Regarding the price of the services offered by the privatized utilities, that were frozen at the beginning of the year, paragraph 16 of the main report notes that this was done to dampen inflation and gain popular support. The latter motive is perceived by the government

of Argentina as distasteful, given that there was no tolerance during the past year for populism. Economic policies were implemented under dramatic circumstances and acute resource constraints, that demanded permanent attention to striking a very fine line among competing goals. As to the former motivation mentioned by staff, in fact, decisions taken since last October were aimed at raising some privatized utility prices in tune with the government's goal of creating an environment which allows these companies to be profitable in order to continue operating in Argentina. Efforts continue to bring in staged price adjustments and to ensure that operating costs are fully covered, while the regulatory framework is in the process of adaptation to the reality of the new nominal anchor in the economy. Profitability, however, should be judged not just in the short run but also over the medium-term given the nature of the concessions. Moreover, it should not be forgotten that these firms enjoyed an extended period of high profitability following privatization supported by monopolic or oligopolic market structure. In addition, prices were indexed to U.S. inflation, which was considerably higher than that in Argentina during most of the 90's. A micro-economic problem that emerged, quite independently from the pricing policy, was the high uncovered leverage in some of these companies. This represents another kind of solvency problem that needs to be addressed through appropriate means and in the context of a well thought-out medium-term regulatory framework rather than merely through price increases that could destabilize expectations. The government welcome a joint World Bank/Fund mission to begin assessing this more encompassing issue, as early as the first review under an eventual Fund supported arrangement.

11. The government of Argentina considers it desirable to clarify that throughout the long period of negotiation, the expectation had been created that some of the net payments made to the IFIs, amounting to some 4.3 billion dollars in 2002, the most critical year of Argentina's modern economic history, would be recovered to support implementation of orderly financing arrangements agreed with the provinces. This was clearly the government's favored option to advance their process of fiscal consolidation. In any event, it considers that even a program of shorter duration than originally envisaged, supported by the international community, with no new money from the Fund, could have a significant impact in terms of domestic expectations, in helping to normalize Argentina's payments situation with the World Bank and the IDB, and to start the long process of debt negotiation with private external creditors. Thus, the government has indicated its full ownership with even a transitional program and its utmost commitment to make it work. The recent intensification of dialogue with international bondholders of Argentine debt and the expected appointment of an external financial advisor, following the recently closed international bidding process, are encouraging steps.

III. Argentina's Emergence from the Crises

12. After the devaluation cum default, the government of Argentina was confronted with the urgent need to achieve rapid stabilization on three interrelated planes. The first was to quell the social consequences associated with the sudden reappearance of inflation and the sharp relative price change in favor of the tradable sector, given the cumulative social and institutional erosion of an unprecedented four years of recession. In this regard, a social

safety net was put in place, revolving principally around subsistence support to unemployed heads of households given the sharp rise in the levels of poverty, indigence and unemployment and underemployment. This program, initiated last May, reaches some 1.7 million people and has been financed with owned budgetary resources.

13. The second objective was to reestablish a more predictable political environment given the succession of transitional administrations and the resulting governance vacuum. The stated goal of the Duhalde Administration to manage an orderly transition during a shortened mandate until new presidential elections are held, was reaffirmed last week by the congressional approval and promulgation of the law that establishes early presidential elections in late April of this year and the transfer of power next May 25.

14. The third and no less relevant goal was to contain the risk of very high inflation, restore the payments system, to stabilize output and to begin the process of rebuilding confidence in the banking system and effective tools for monetary policy. In this regard, the second quarter of 2002 presented signs of a break in the prevailing depressive sentiment. Prudent financial management and selective administrative controls contributed to stabilizing the nominal exchange rate overshooting and to the low and declining devaluation pass-through that became manifest after May and, particularly, in the fourth quarter of the year, when the cumulative change in the CPI slowed to 1 percent. The price stability and more orderly financial market conditions of recent months has clearly contributed to the restoration of social peace, notwithstanding the intensity of the shock and the difficulties of apportioning its costs. Recent employment numbers also show some improvement, reflected in the net creation of formal employment in the four major urban centers for two consecutive months. What is also encouraging is that firming of business expectations and recent polls indicating that over 85 percent of those participating intend to as a minimum maintain labor rosters while a majority harbored intentions of increasing labor demand.

15. More specifically on the economic front, the deceleration of output contraction in the second quarter received a boost from the improvement in domestic monetary and financial conditions. Fiscal policy austerity and the government's attempt to nurture confidence by avoiding resort to further compulsory measures following the earlier deposit freeze and the asymmetric pesoification of bank assets and liabilities, were key to this turnaround. The monthly industrial production estimator grew by an accumulated 7.3 percent in the period May-November. Average monthly tax collection in the period May-November was some 50 percent higher than in January-April, helped by the initial inflationary spike and the emergency introduction of taxes on exports which had received a massive competitiveness boost from the depreciation of the exchange rate. At the same time, public expenditure was maintained stable in nominal terms, producing a sharp real reduction, of some 30 percent. This represented a notable achievement which few analysts thought likely early in the year amid a protracted economic and political crisis. As a result, the non-financial public sector moved from a large primary deficit in 2001 to a surplus, consistent with the indicative target of 0.5 percent of GDP for the federal government for the year as a whole. This fiscal stance in a year when GDP is projected to contract by some 11 percent in 2002 represents the degree of owned conditionality brought to bear and an auspicious beginning for the needed fiscal consolidation that still lies ahead.

16. As domestic absorption fueled by the credit crunch plummeted, export performance was sustained and the trade balance swung into surplus, reaching some 15.2 billion dollars in the first 11 months of the year. In this regard, central bank support in the foreign exchange market ceased last June, beginning a trend of foreign exchange purchases that has continued since in the context of declining interest rates. The most recent (January 2nd) auction of Central Bank bills placed 119 day instruments at 17.3 percent p.a. with the tenor of central bank paper extended to 271 days. Moreover, despite continued service of Phase 1 restructured debt as well as payments to IFIs of over 4.5 billion dollars in 2002, including to the Fund with which Argentina is fully current, gross international reserves continued to grow in December by over 500 million dollars and central bank purchases of foreign exchange continued since, to avoid excessive appreciation of the exchange rate. Restrictions on Article VIII transactions have been lifted and the government stands ready to agree expeditiously to a timetable for removing remaining foreign exchange restrictions. As significantly given the concerns over effective monetary control, liquidity conditions in the banking system have started to normalize. Banks stopped requesting central bank rediscounts. The net drain of deposits from the banking system stopped in July despite the "amparos" and the increase in deposits has continued notwithstanding the freeing up of the "corralito" at the beginning of December 2002. This has allowed banks not only to affirm their liquidity but to attenuate the consequences of the massive credit crunch, and in so doing help to revert the deterioration in the quality of bank assets. Lastly, the flight of private capital, which accompanied the process of loss of confidence has diminished since June.

17. Finally, since charts included in the staff report cover different end dates not fully reflecting all available information, a Ministry of Economy representation of the evolution of main indicators is included with the aim of contributing to the assessment of the progress made on the basis of the economic policy framework in place. It may be worthwhile to keep in mind the differences. (See Attachment I)

IV. **Conclusion**

18. These results clearly need to be nurtured, given the prevailing uncertainties but they are not circumstantial. They prove ownership in an outward-oriented stabilization policy that attempts to give due weight to poverty alleviation and social equity in exceptionally constraining circumstances. The government of Argentina seeks to bring to closure the negotiations with the Fund on a program that the international community could support. It is its firm conviction that this framework offers the best prospects for continued cooperation. The government of Argentina remains committed to working with Fund management and staff on a short-term program that can help advance an orderly domestic transition while laying the basis for the structural reforms needed to normalize Argentina's financial relations and restore the potential for growth and social equity that are essential for medium-term fiscal and external sustainability. The government hopes that the enormous efforts made to reach agreement under adequate safeguards will bear fruit as soon as possible thereby helping to provide confidence at a time of utmost crisis and to correct maladjustments in Argentina's balance of payments without resorting to measures that further destroy national

or international prosperity. The government remains fully committed to the successful implementation of the agreed undertakings given what is at stake for Argentina and in some significant way for the stability of a region that is experiencing the hazards of globalization. In closing, the government of Argentina wishes to express its appreciation to Management, staff and the Executive Board for permanent policy dialogue to advance a country-specific solution for Argentina's difficulties.

Attachments

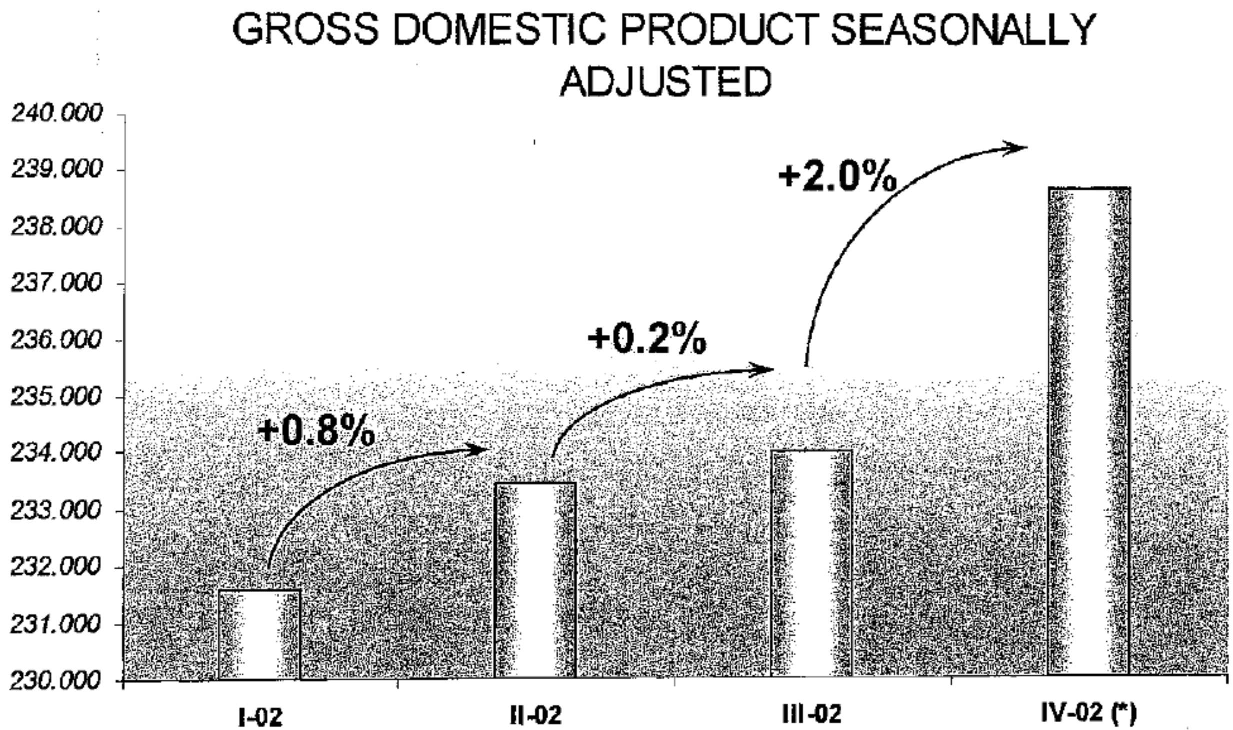
Attachment I

Ministerio de Economía
República Argentina

Argentina
Economic Indicators

Activity

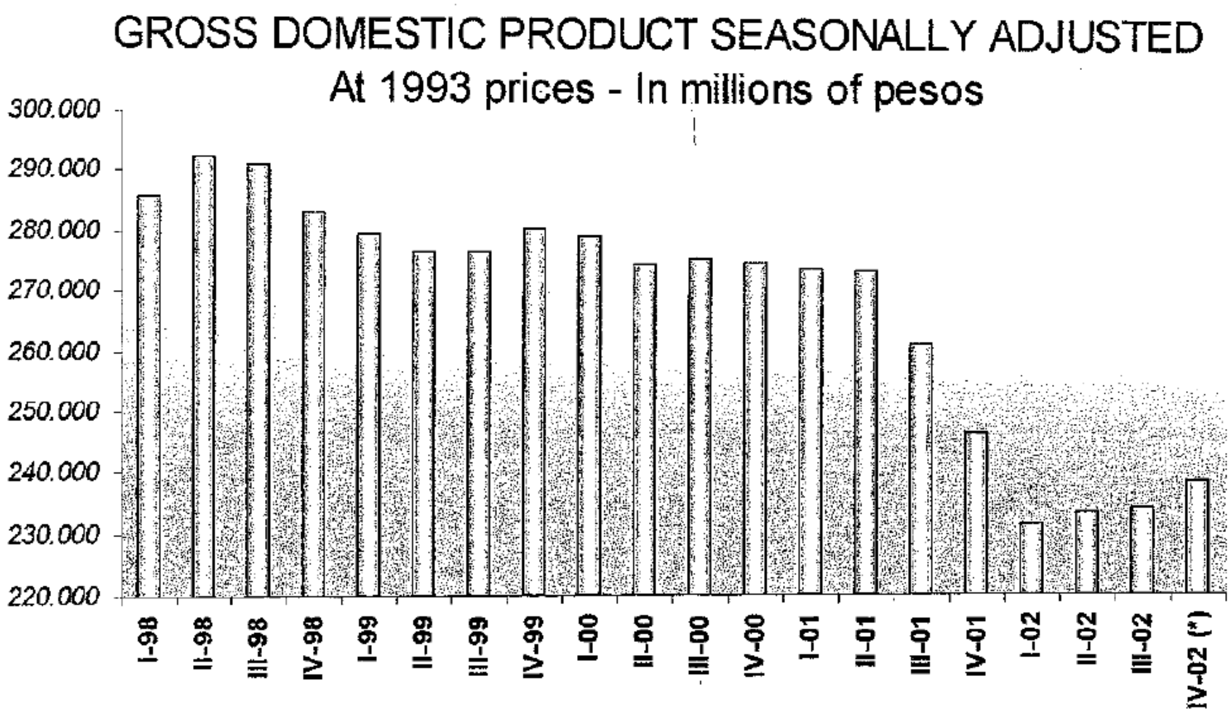
For the first time since 1997, GDP has grown for three consecutive quarters.



(*) Very Preliminar

Activity

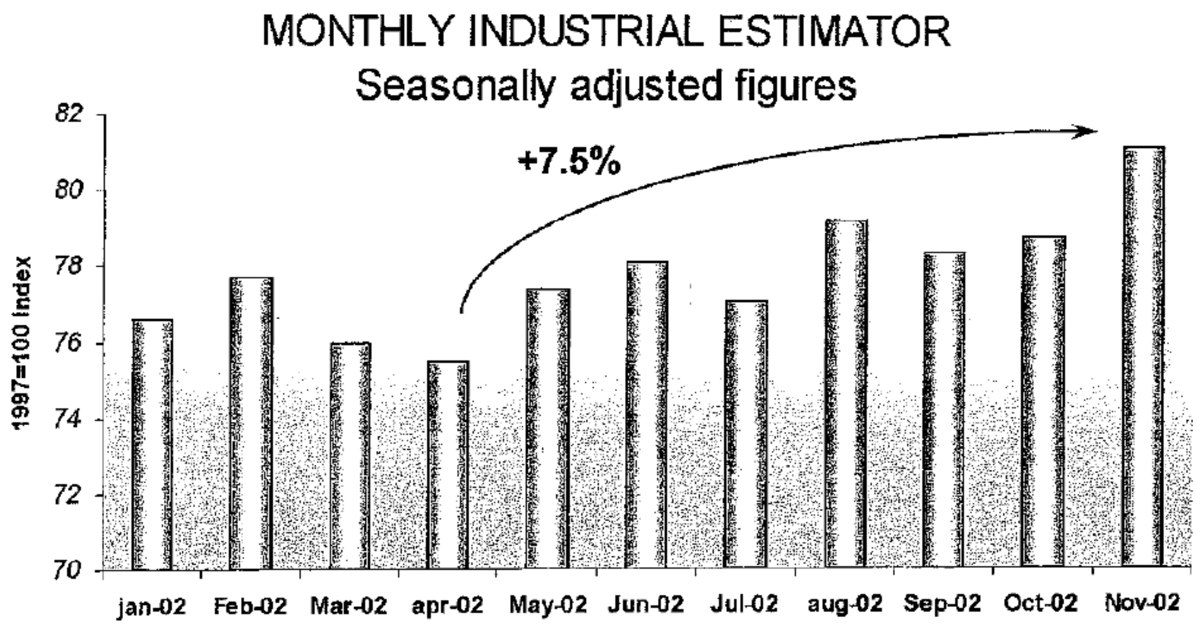
Recovery starts in the second quarter of 2002, after six negative quarters.



(*) Preliminar

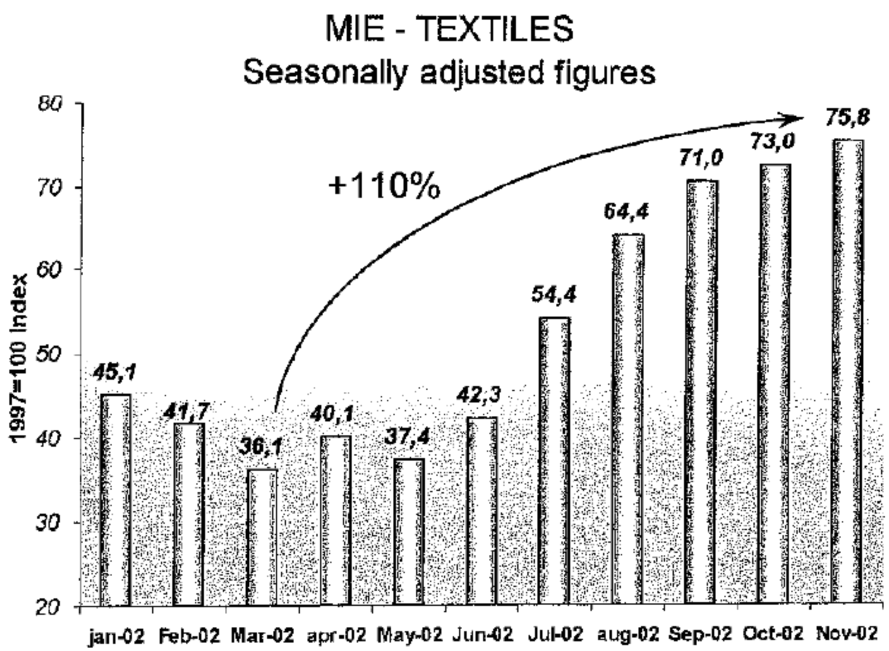
Activity

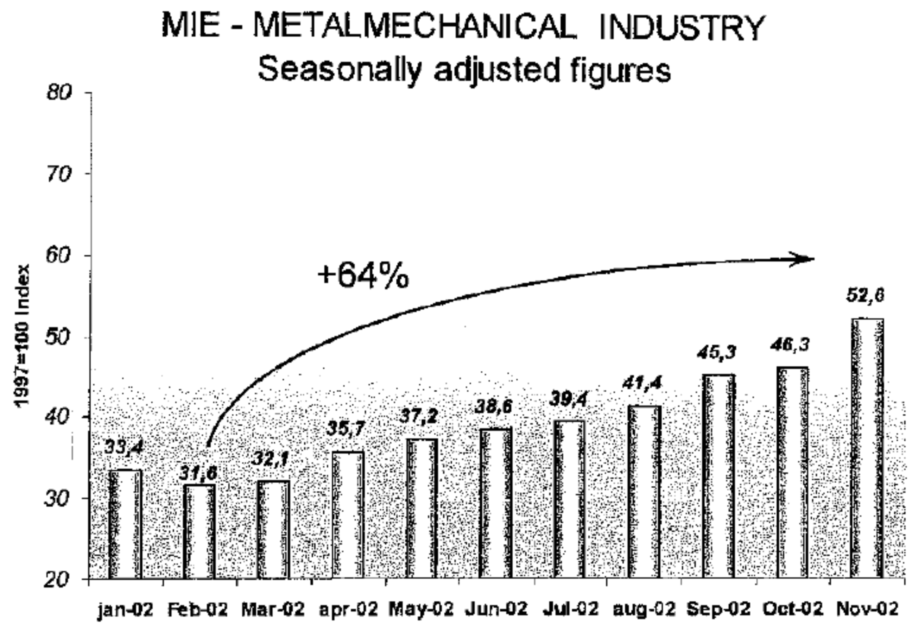
Industrial production accumulated 7.5% growth between April and November 2002



Activity

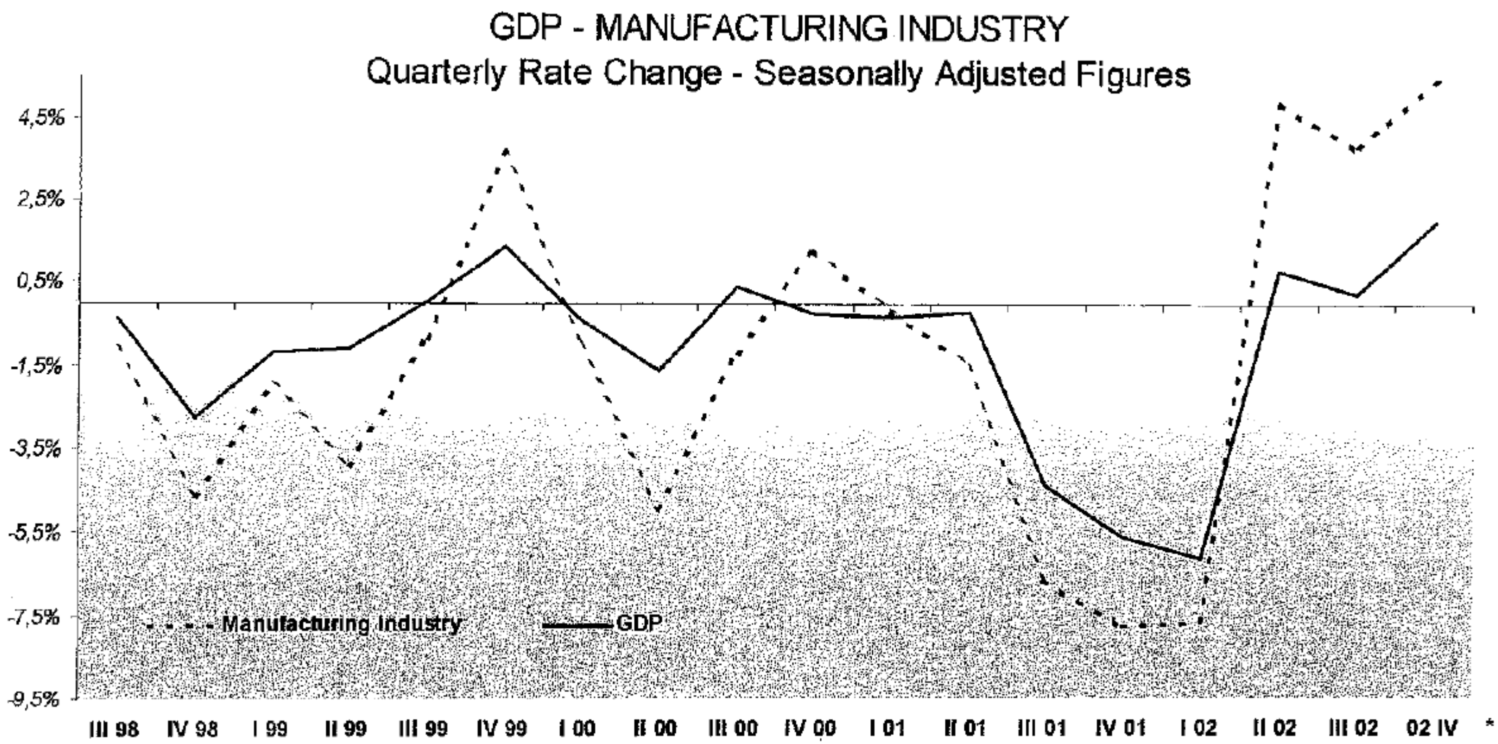
The textiles and metal mechanics industries recovered strongly in 2002.





Activity

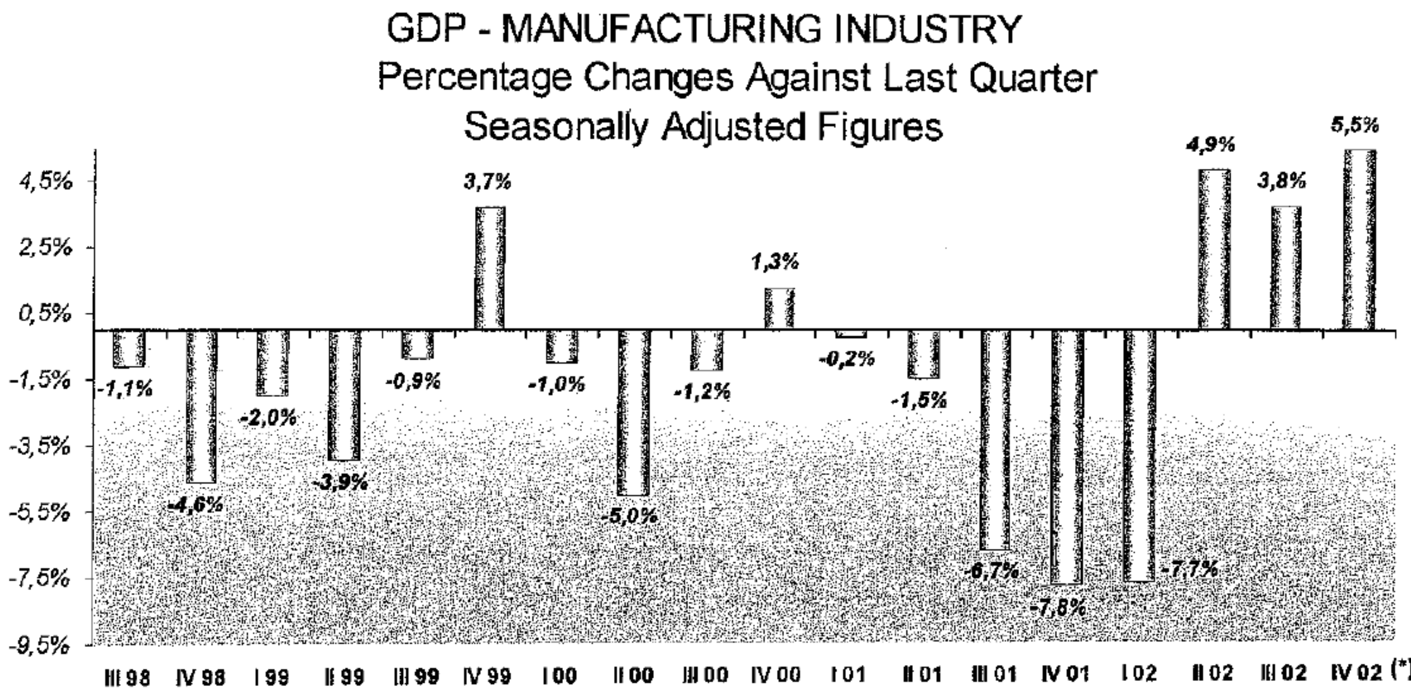
The last three quarters show a positive evolution in Industrial GDP.



(*) Very Preliminar

Activity

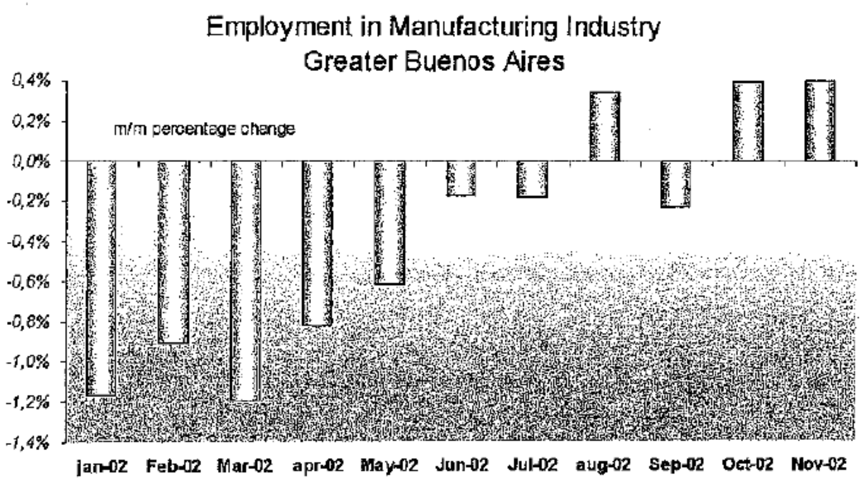
For the first time since 1997, industrial production increased over three consecutive quarters.

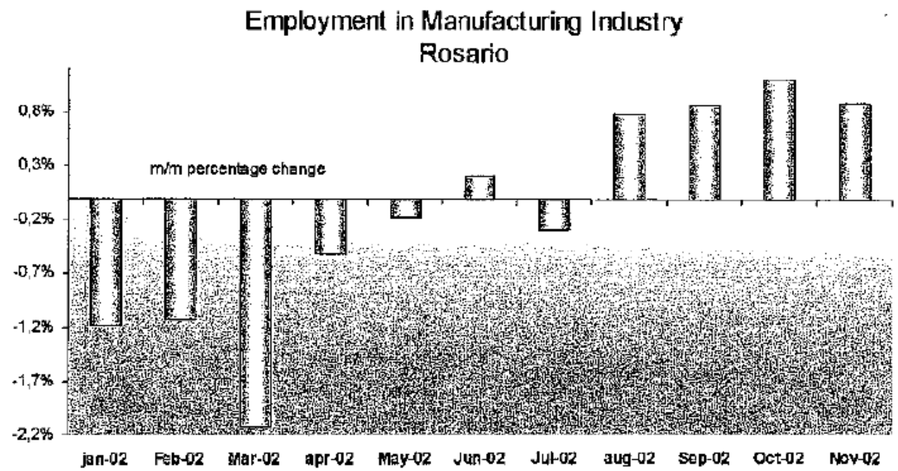


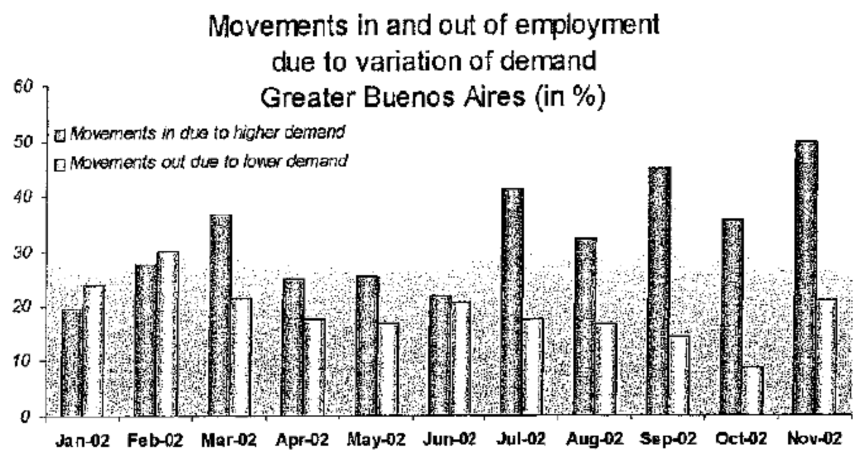
(*) Very Preliminar

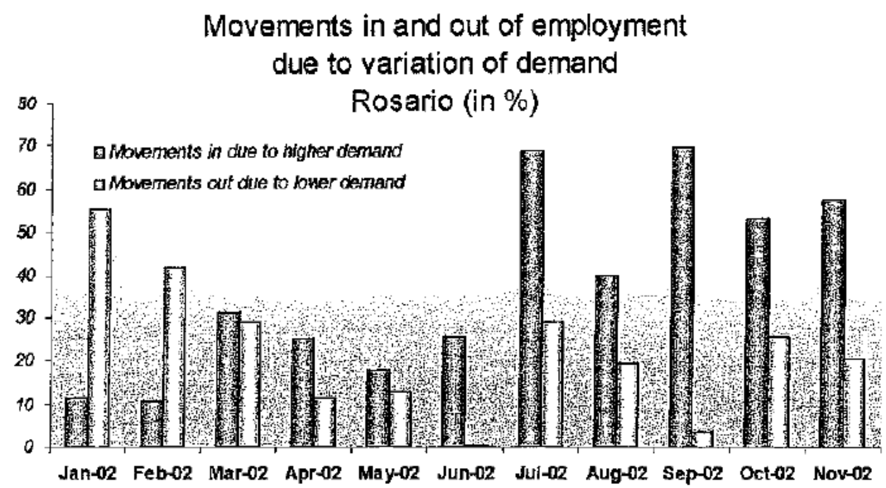
Activity

The employment market is showing signs of improvement.









Activity

Between May and October 2002, 861.000 persons were incorporated to labor market

Employment Evolution between May and October 2002

Total Urban Population

New Jobs: 861.000 persons (+7.9%)

530.000 from Head of Household Programme

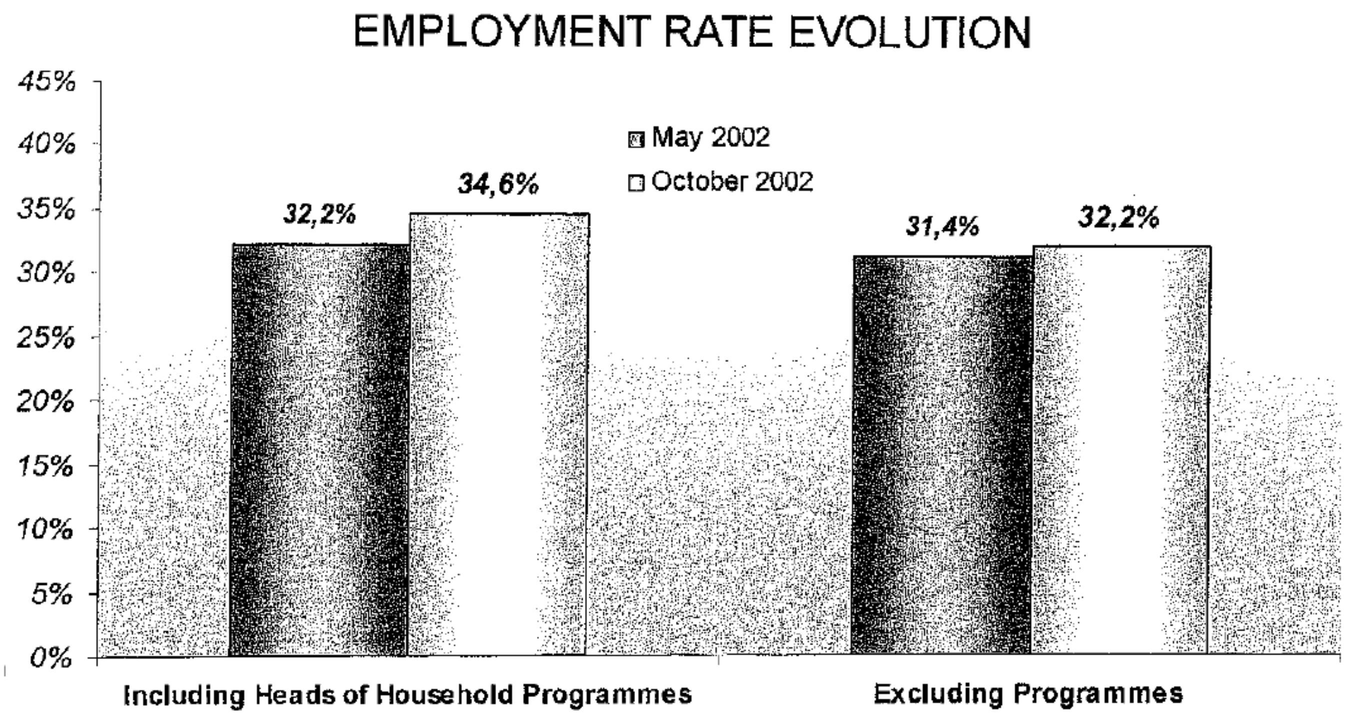
331.000 from the Labor Market (+3.1%)

Decrease in Unemployment 457.000 persons (-15.4%)

Increase in Economically Active Population 404.000 persons (+2.9%)

Activity

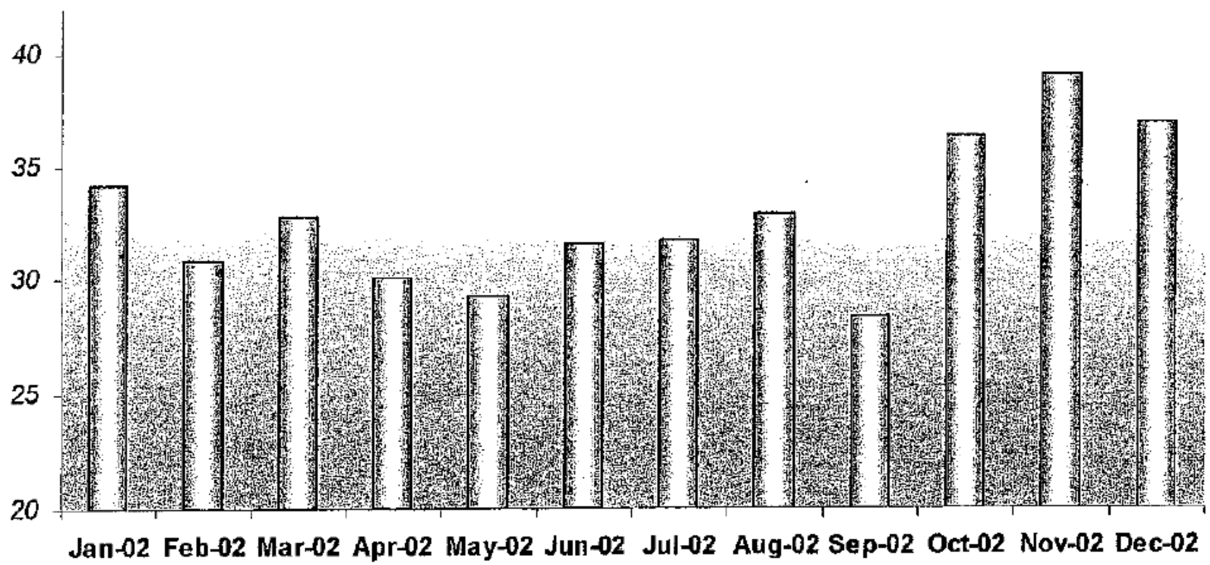
Employment rate recovered again.



Activity

In the last three months, consumer confidence reached a higher level.

CONSUMER CONFIDENCE INDEX
Balance between positive and negative answers



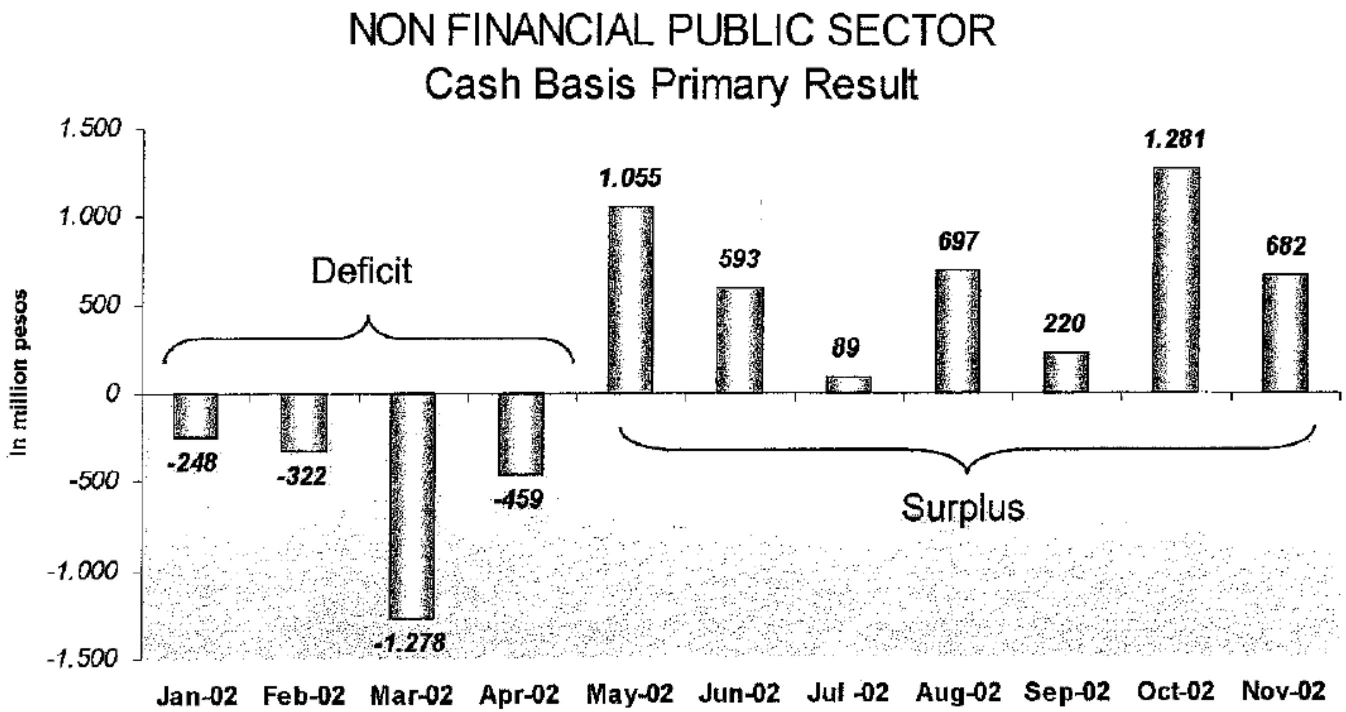
Index = 50 * {p-n+1}

p: positive answers ; n: negative answers

Source: Torcuato Di Tella University

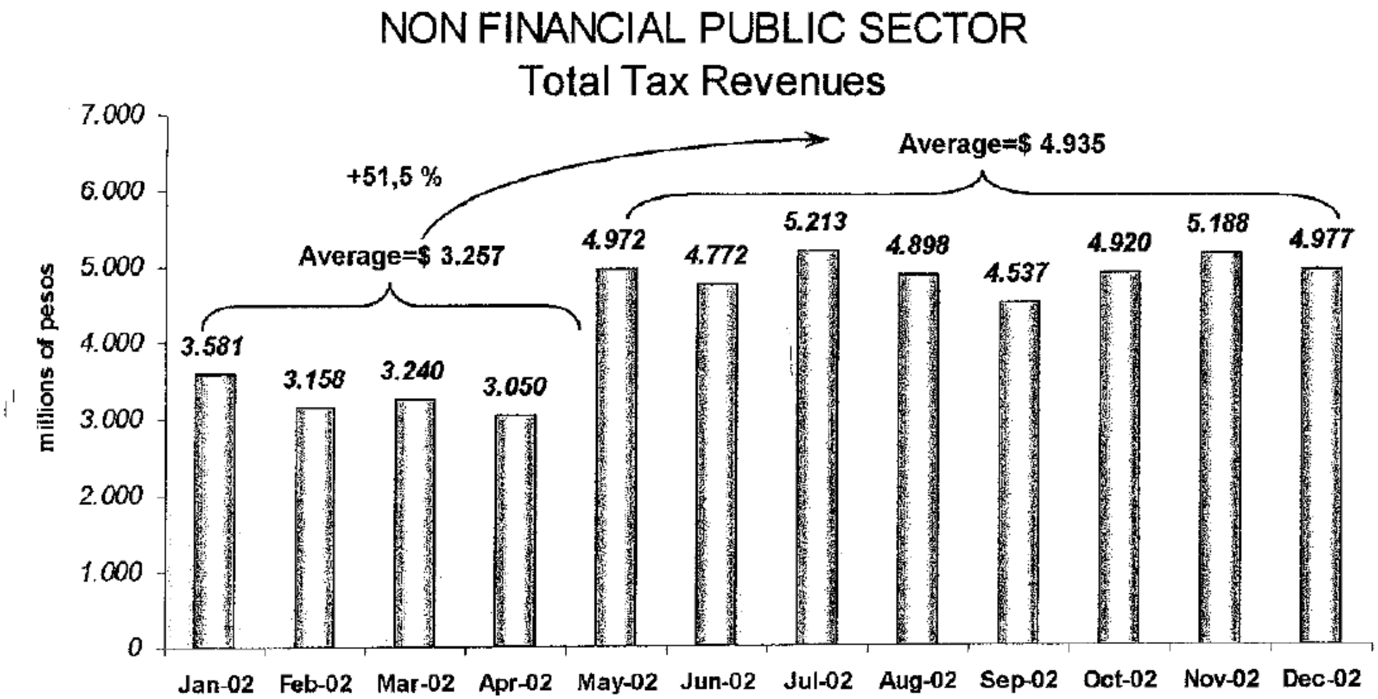
Fiscal Sector

Seven consecutive months of primary surplus since May 2002.



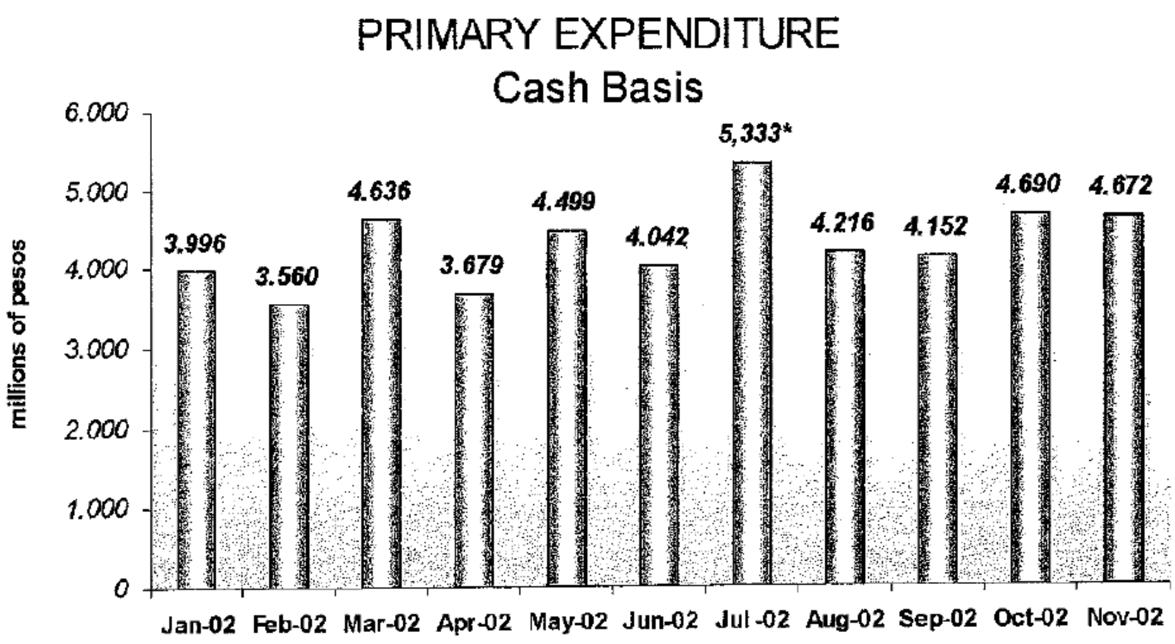
Fiscal Sector

Average monthly tax collection in May-December is 50% higher than in January-April.



Fiscal Sector

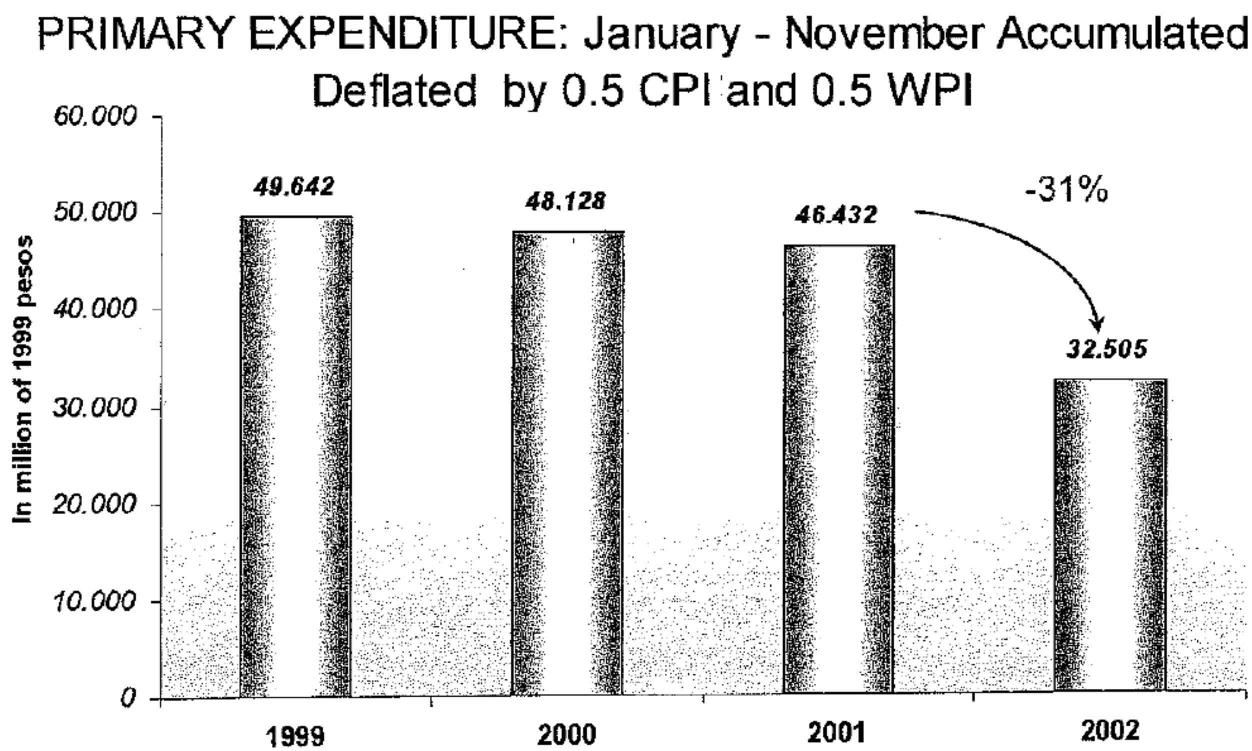
During 2002, public spending remained stable in nominal terms.



(*) Includes complementary semi – anual salary

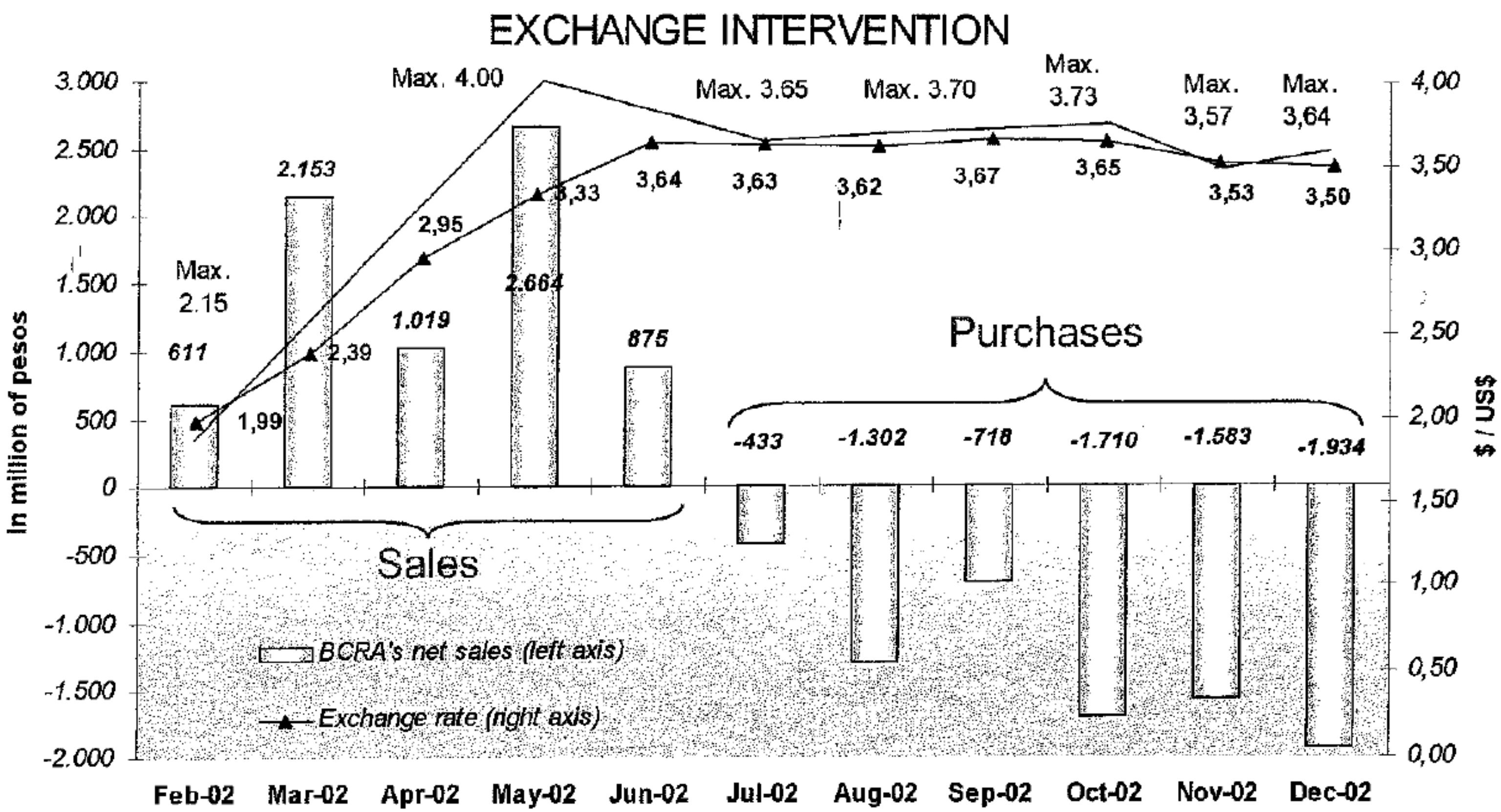
Fiscal Sector

In real terms, spending in 2002 experienced a sharp reduction.



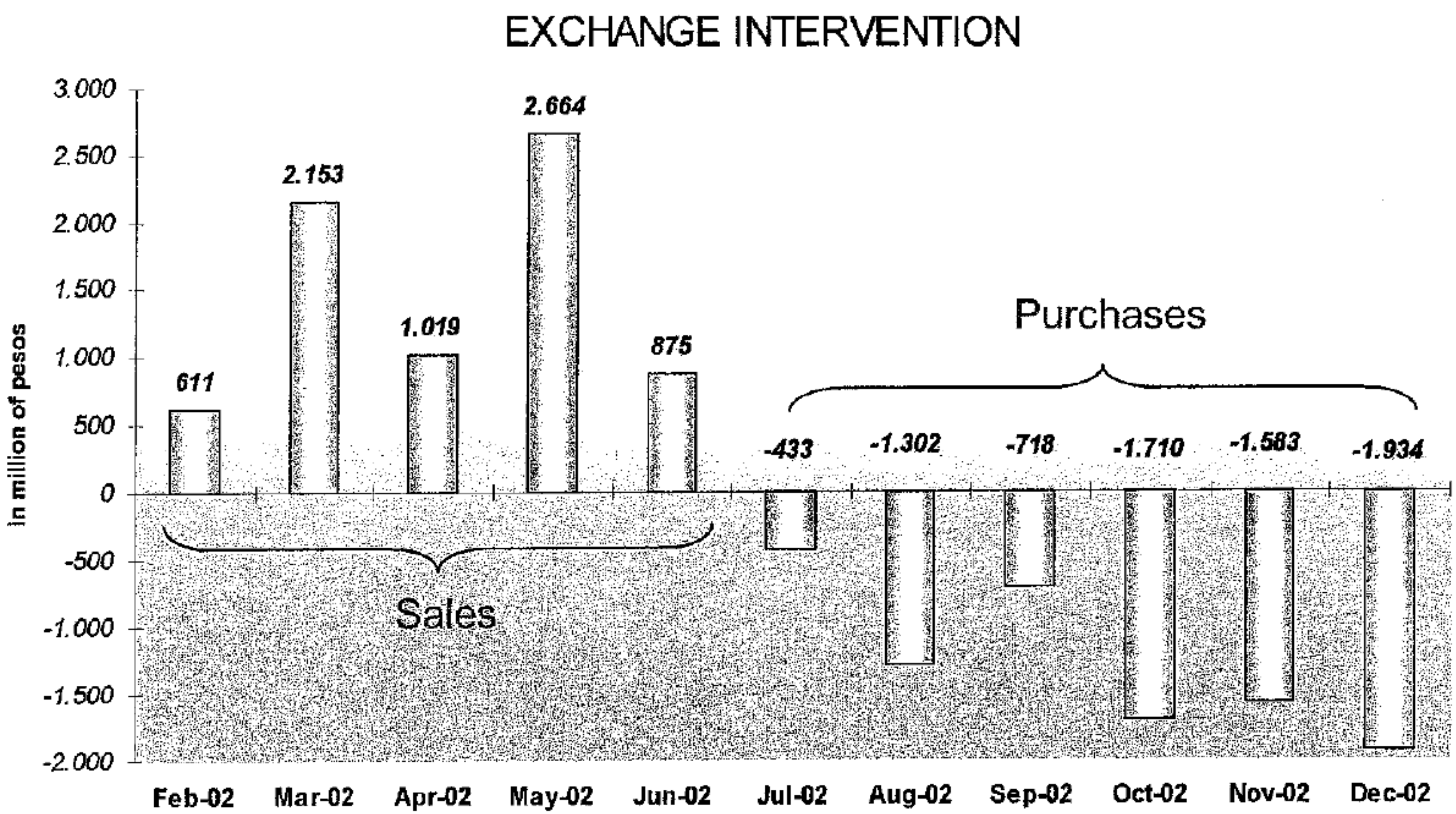
Financial Sector

As regards the exchange market, the exchange rate of the US dollar has remained stable for the last six months.



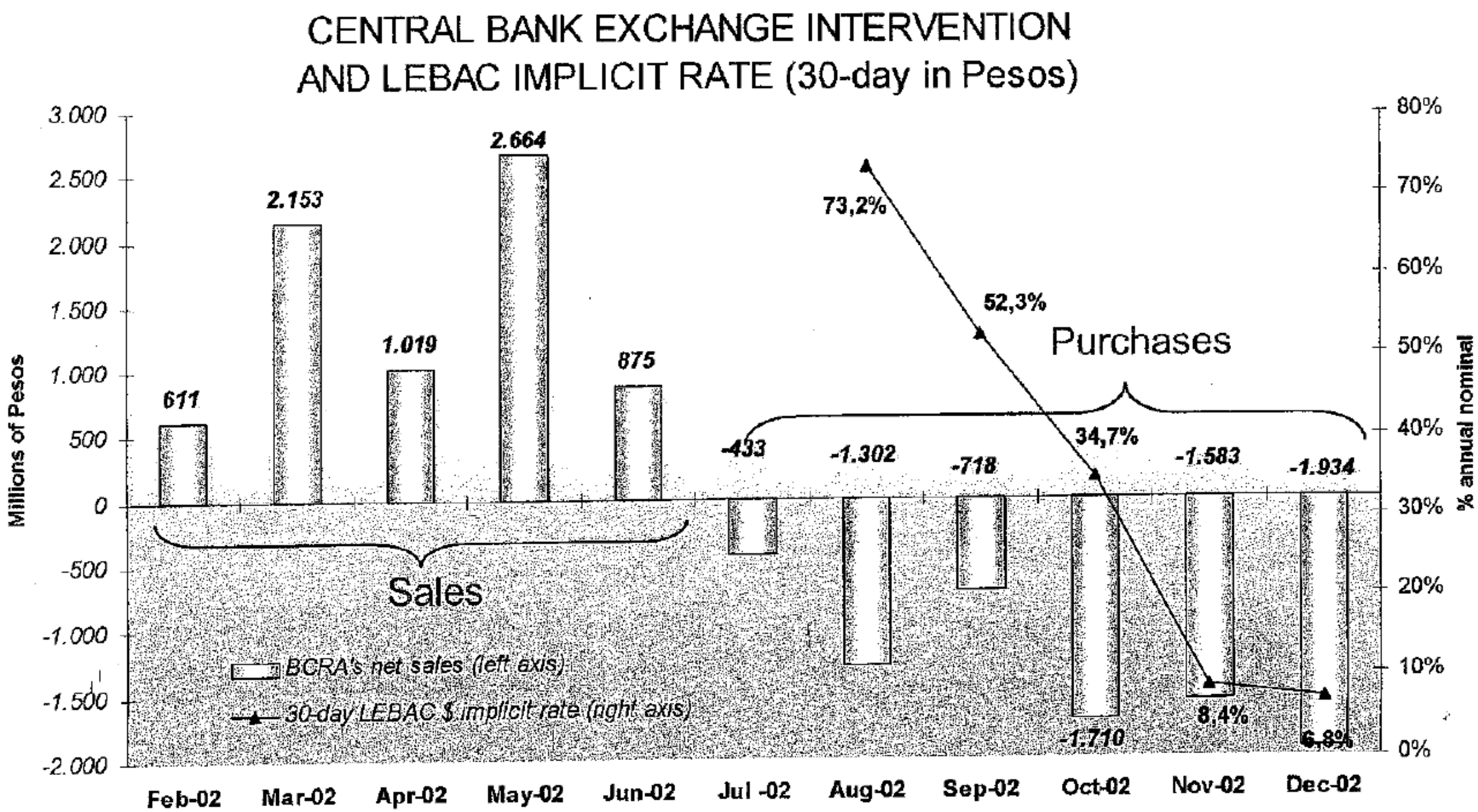
Financial Sector

Central Bank accumulated foreign currency during the last six months, through intervention in the foreign exchange market.



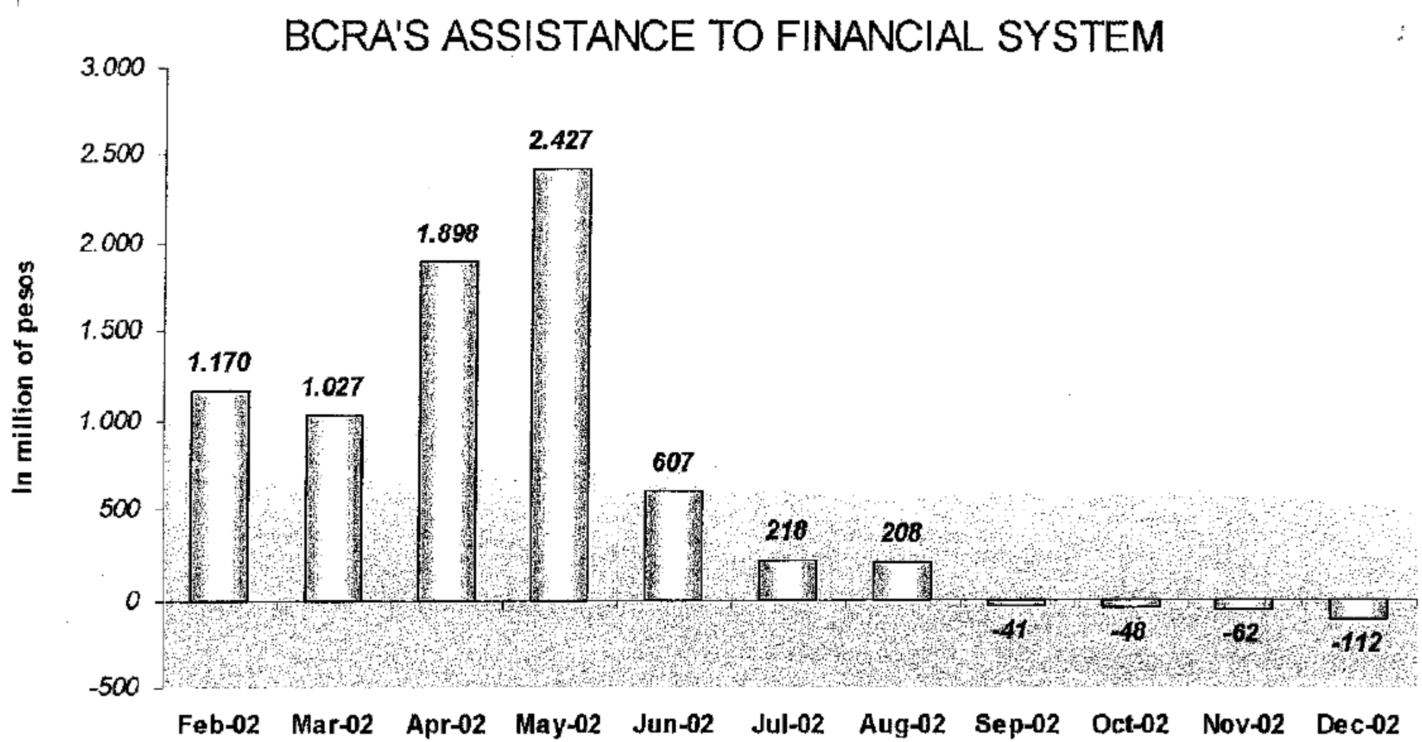
Financial Sector

Following stabilization of the foreign exchange market, reserves accumulate in a context of diminishing interest rates.



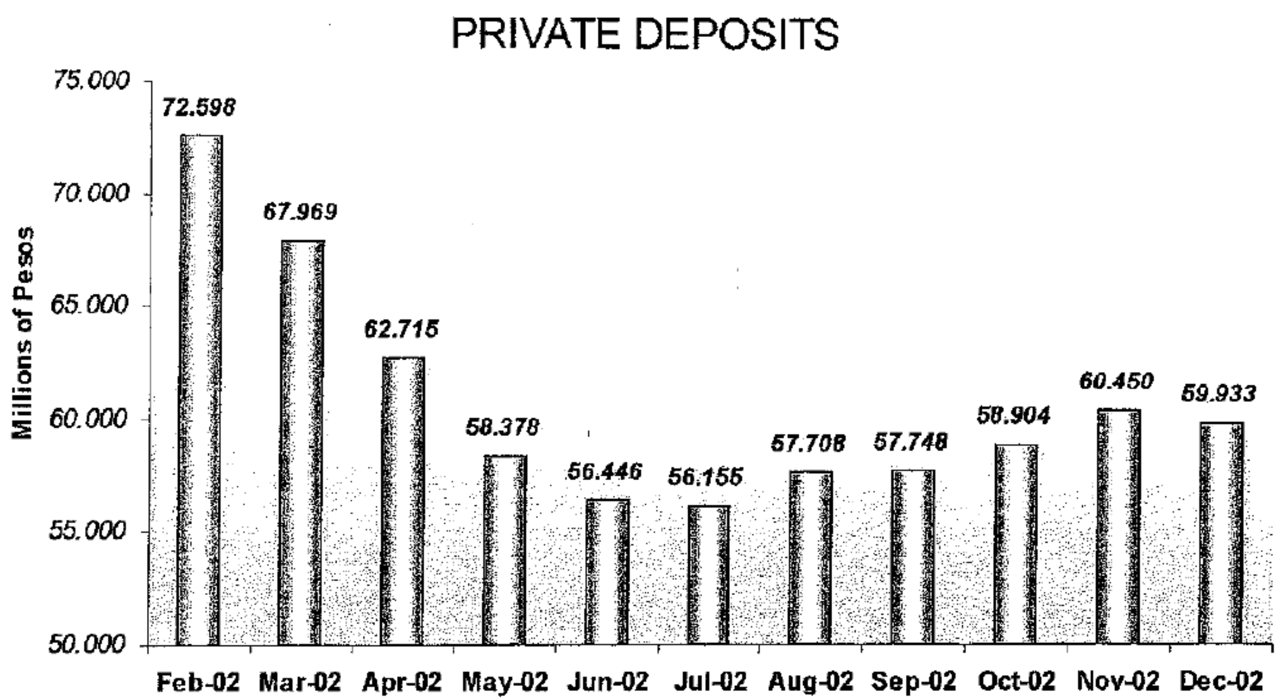
Financial Sector

Financial system normalization: for the last four months, financial institutions have not requested BCRA (Argentine Central Bank) assistance.



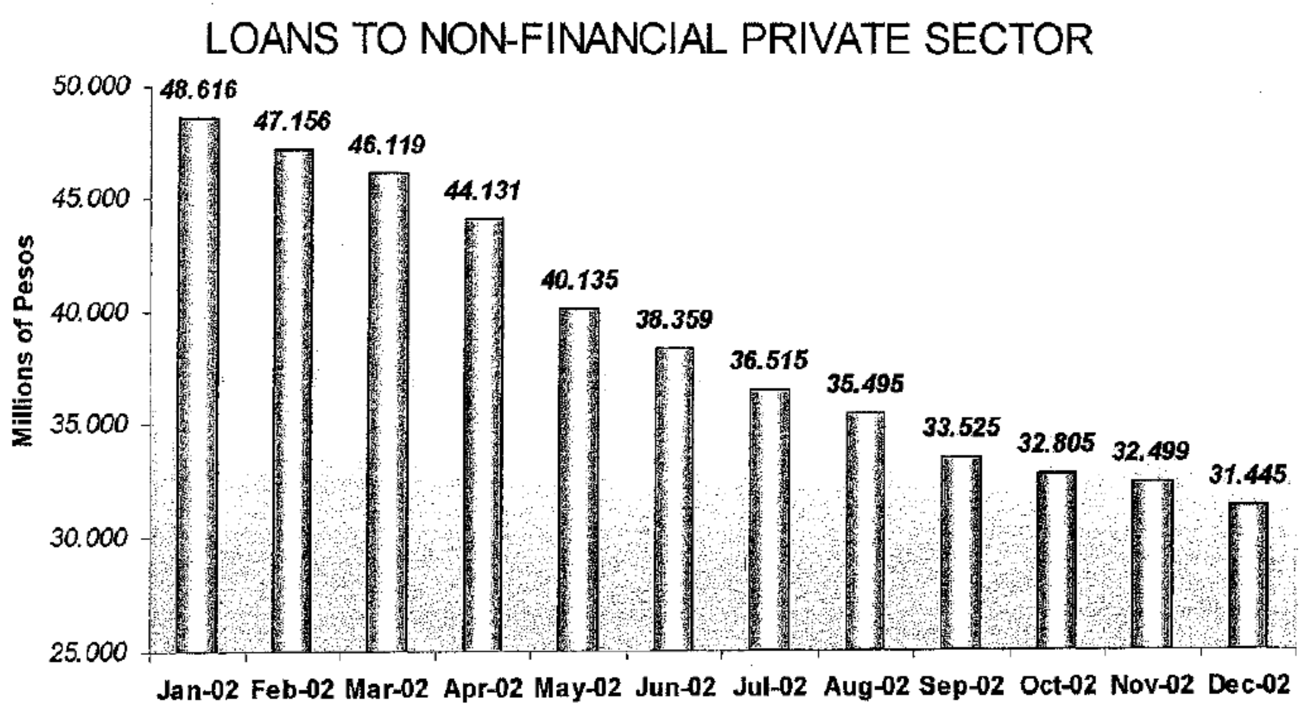
Financial Sector

The drainage of deposits stopped in July, and the trend has remained positive since then.



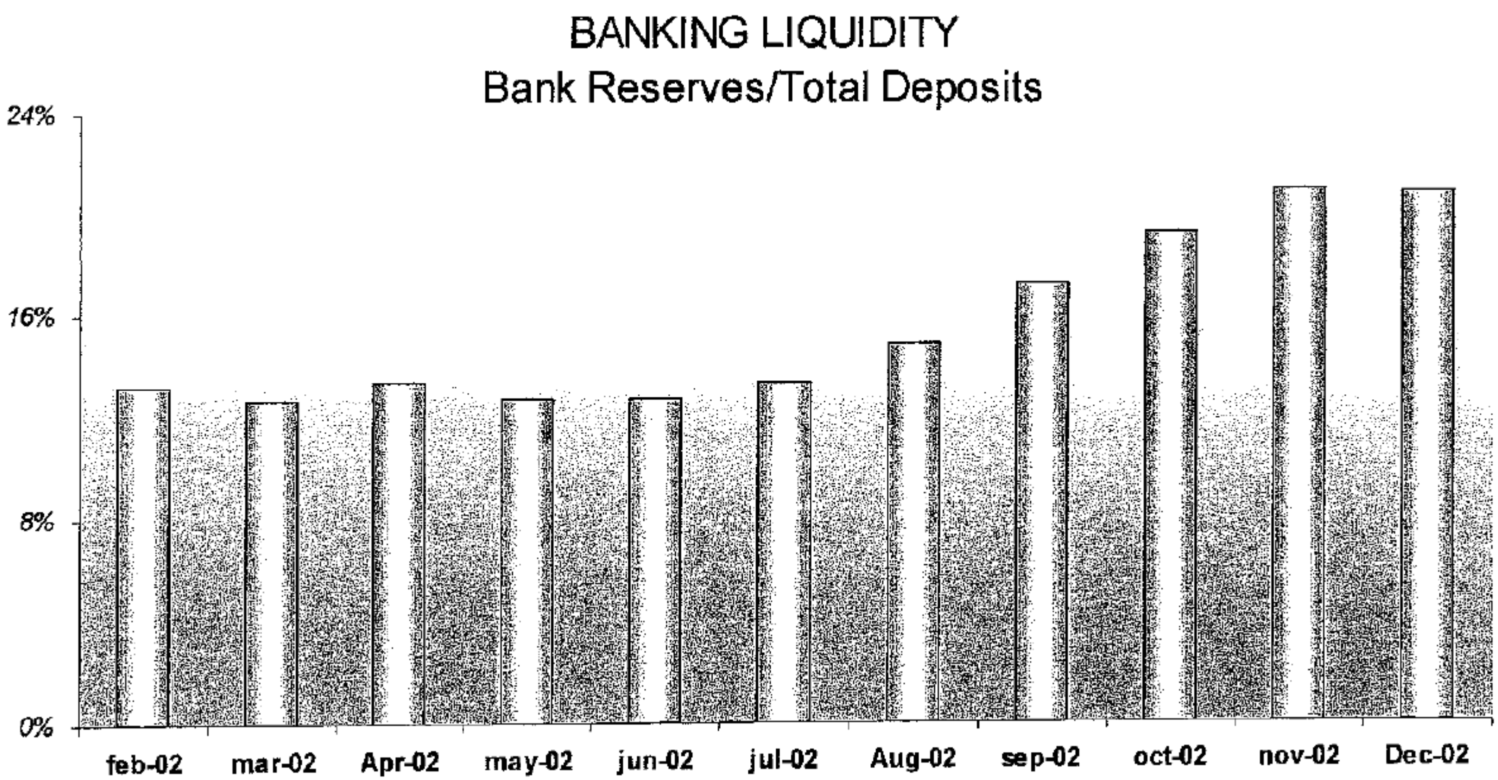
Financial Sector

The credit crunch process vis a vis the private nonfinancial sector attenuated.



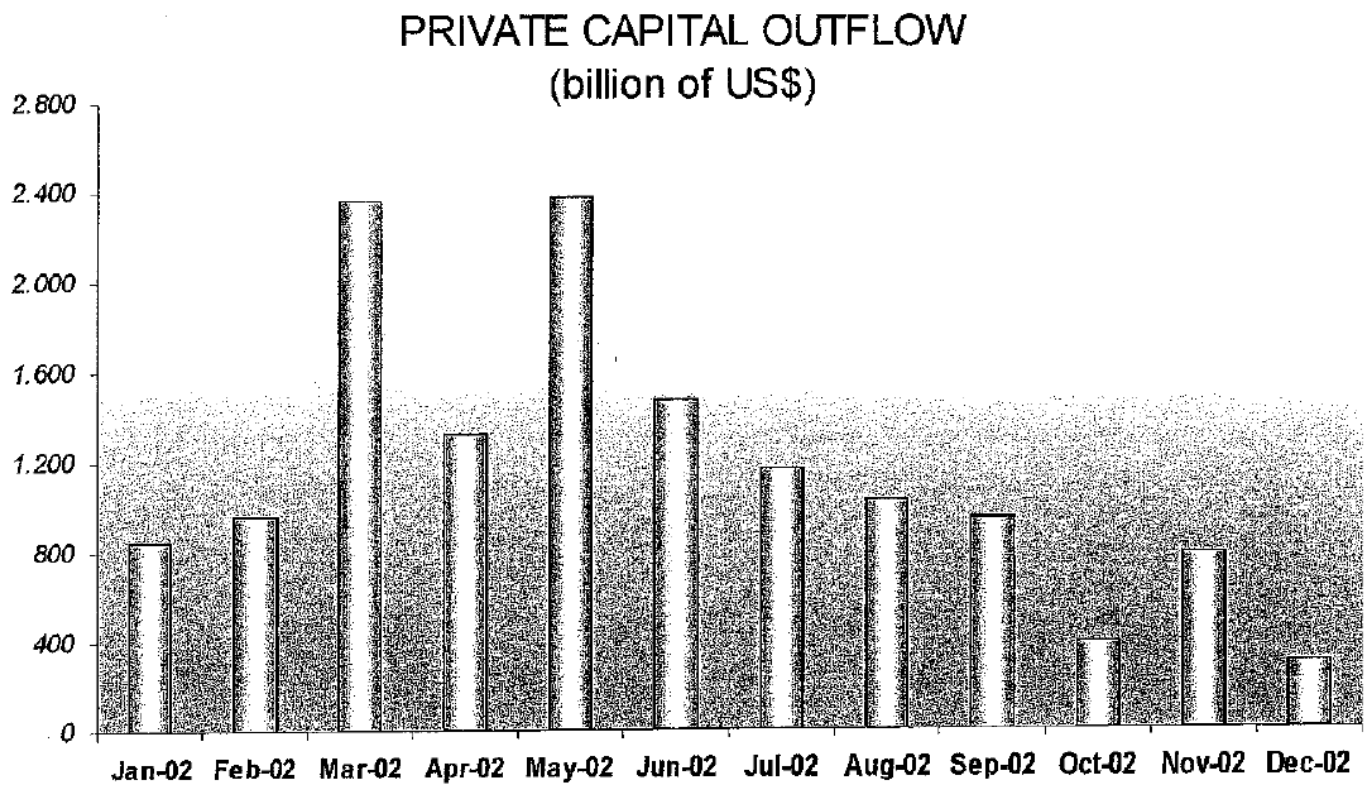
Financial Sector

Banks have been recovering liquidity since late July.



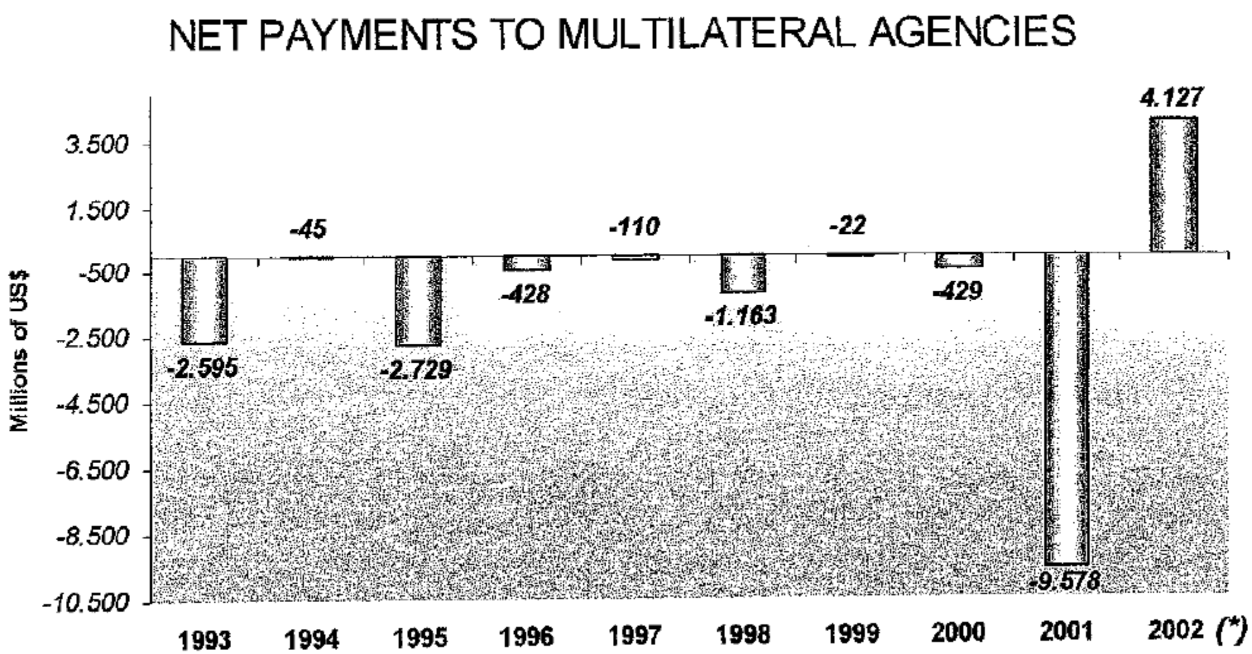
Financial Sector

The flight of private capital has diminished since June 2002.



Financial Sector

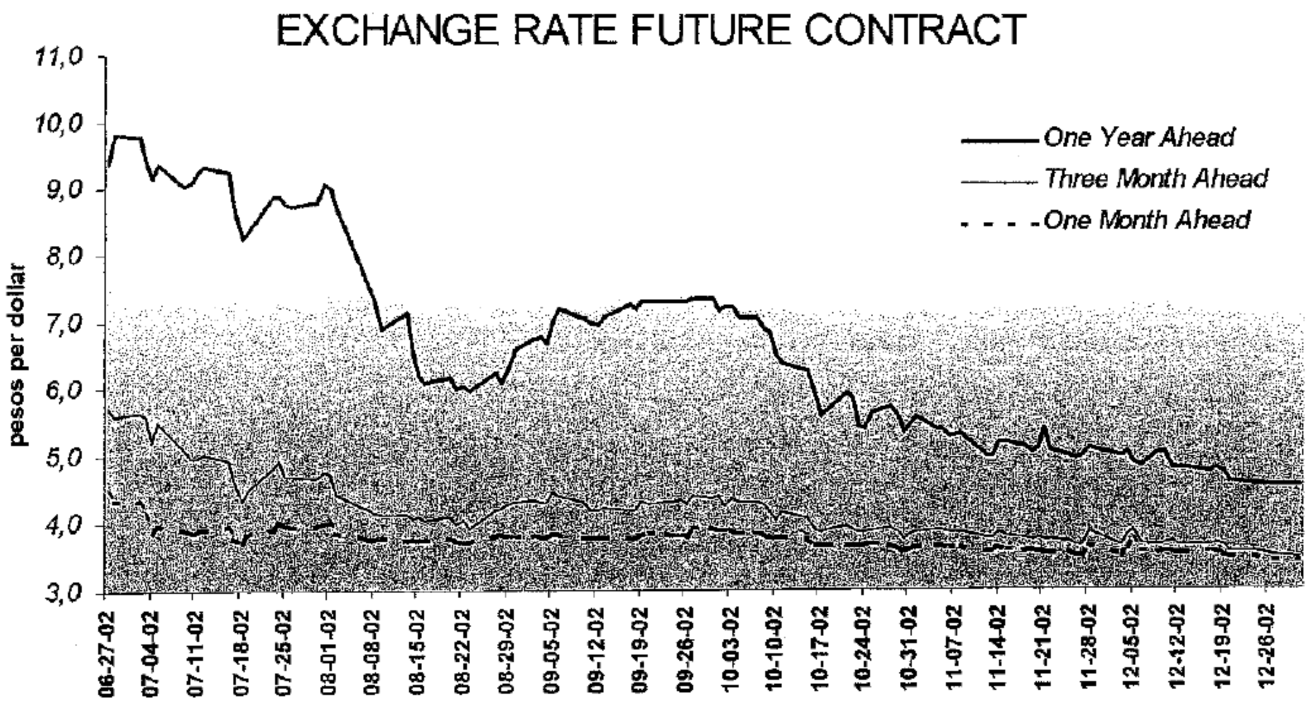
Unlike the case in previous years, in 2002 Argentina made net payments to multilateral lending agencies.



(*) In addition in2002 there were net payments to official creditors [(Banco do Brasil, Club de Paris, I.C.O. (Spain) and J.B.I.C.(Japan) amounting to USD 142 million.

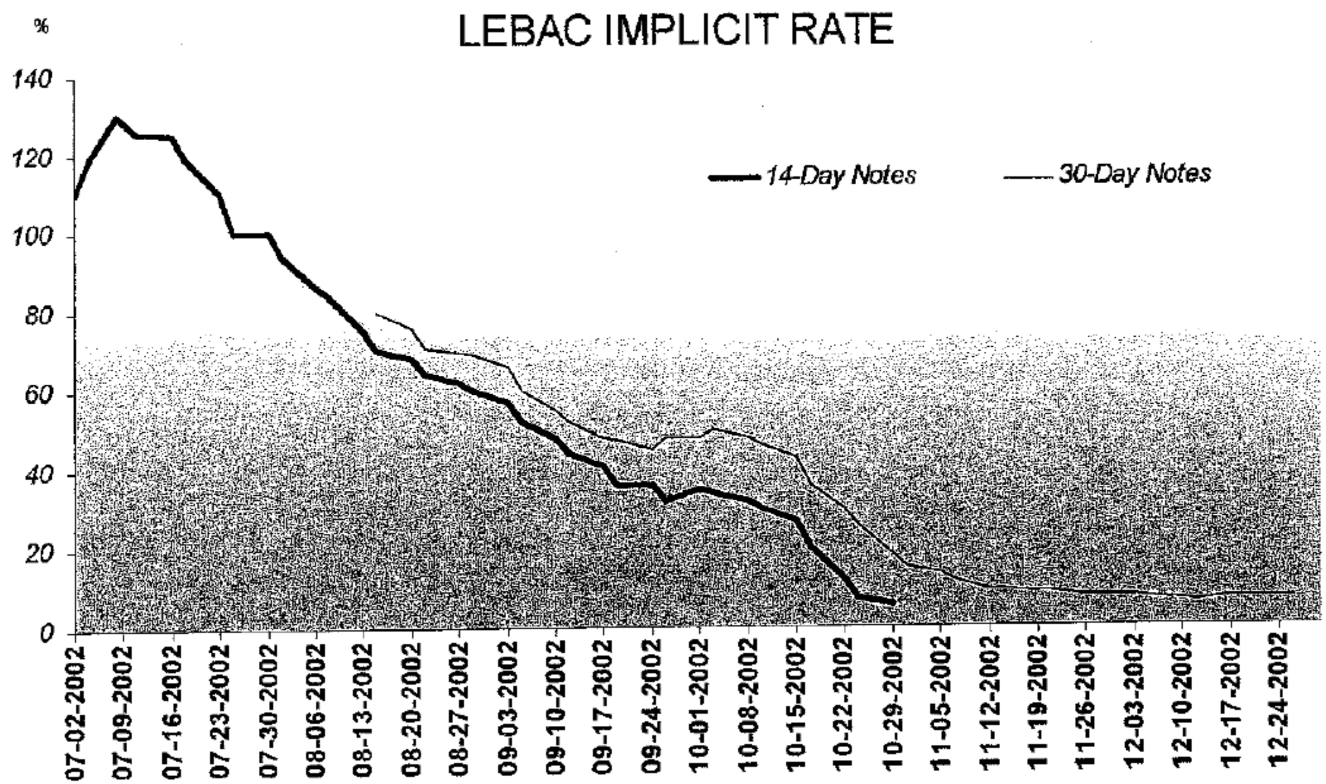
Financial Sector

The improvement in Argentina´s economy led to a sharp reduction in the exchange rate for the US dollar futures market.



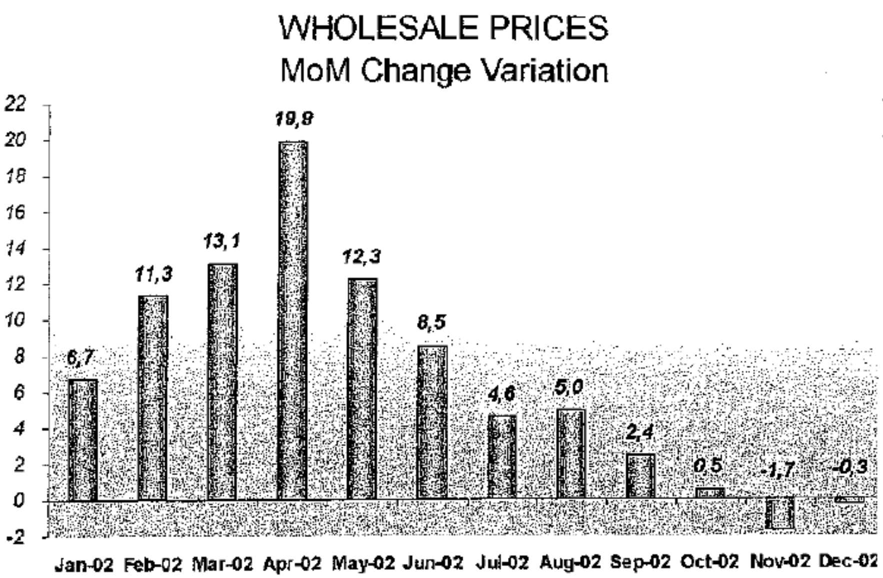
Financial Sector

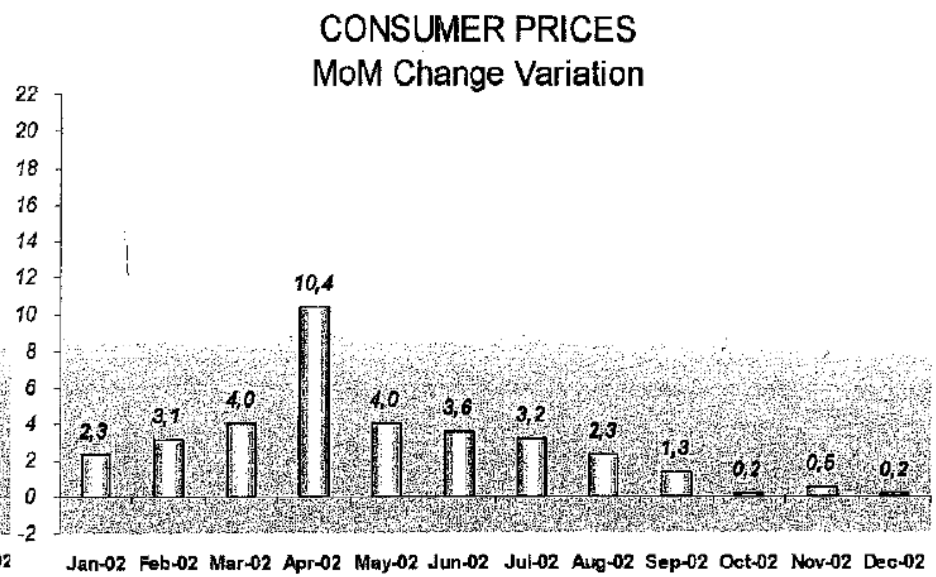
Since July 2002, the cost of BCRA intervention aimed at regulating surplus liquidity has decreased.



Prices

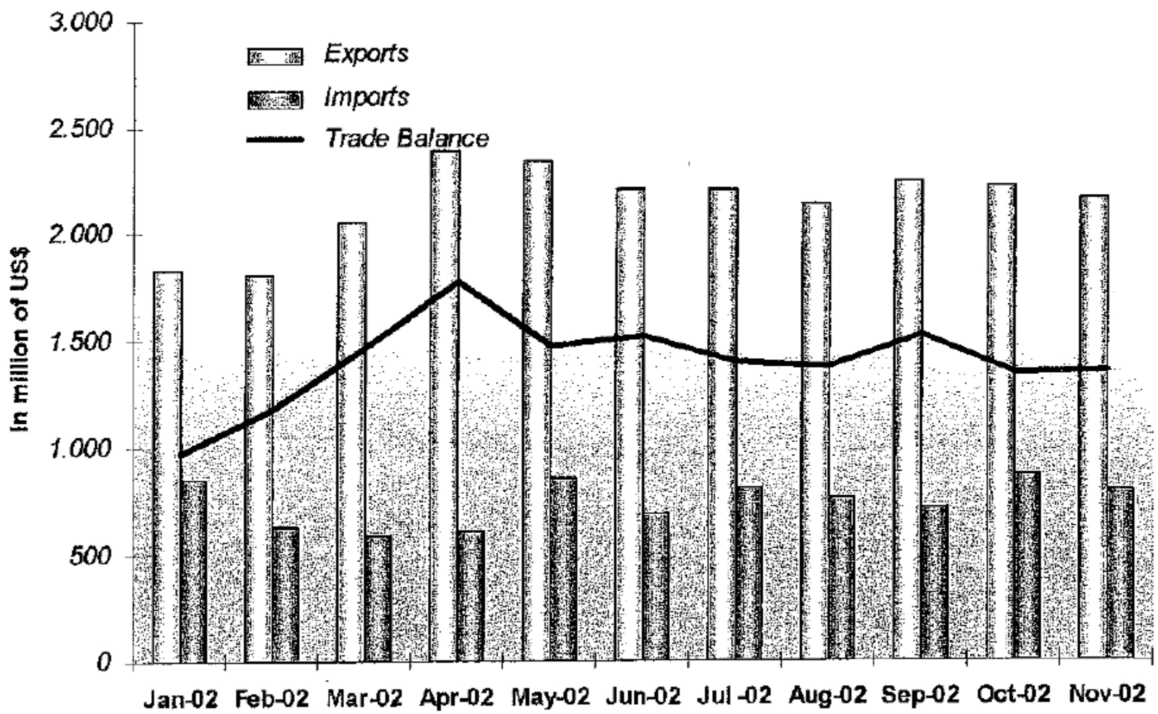
During the last three months, wholesale and retail price variation was less than 1%.





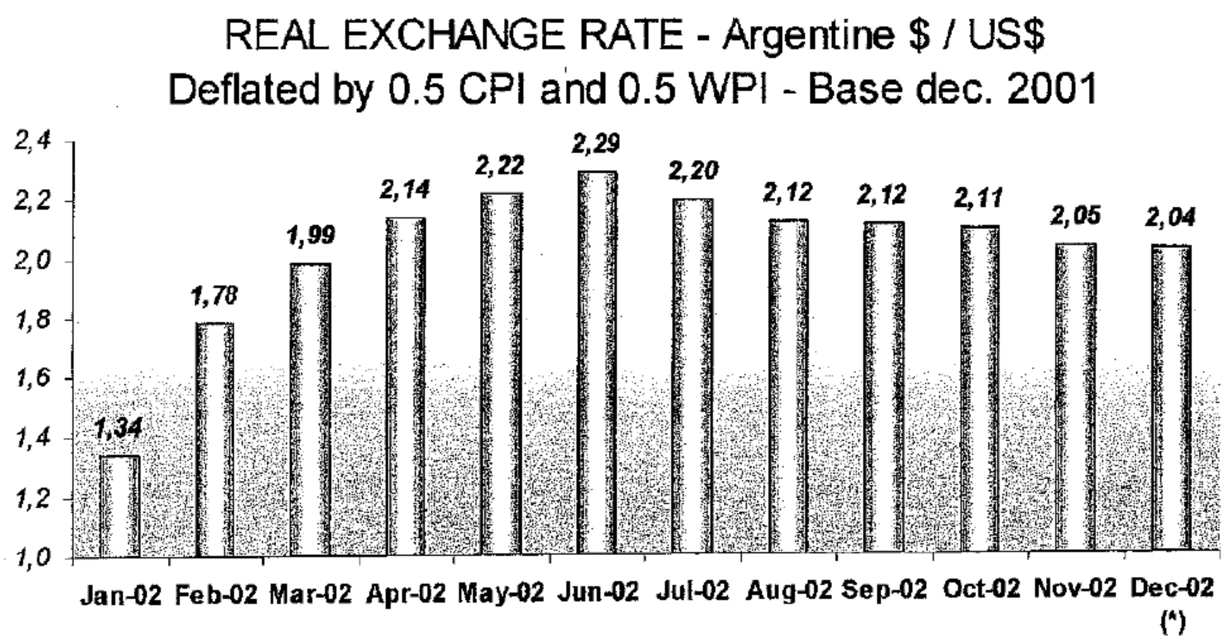
Foreign Trade

The depreciation of the peso led to a significant surplus in Argentina´s trade balance.



Foreign Trade

In 2002, conditions were created for a more realistic exchange rate than the one that existed under Convertibility.

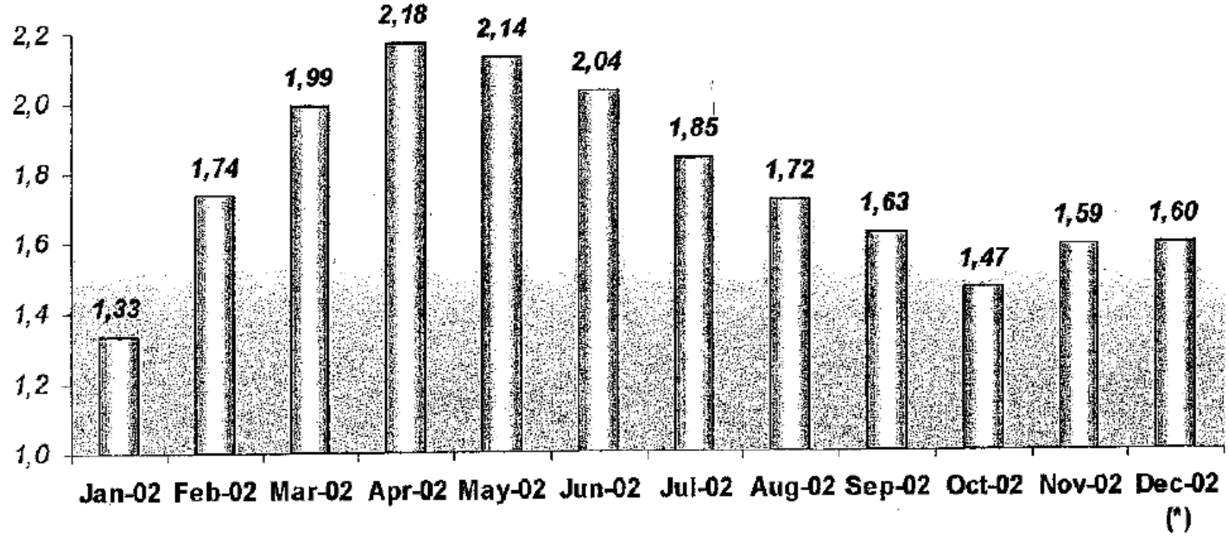


(*) Preliminary figure

Foreign Trade

The exchange rate between the peso and the currency of our trade partner reached more realistic levels.

REAL EXCHANGE RATE - Argentine $ / Brazilian R$
Deflated by 0.5 CPI and 0.5 WPI - Base dec. 2001



(*) Preliminary figure

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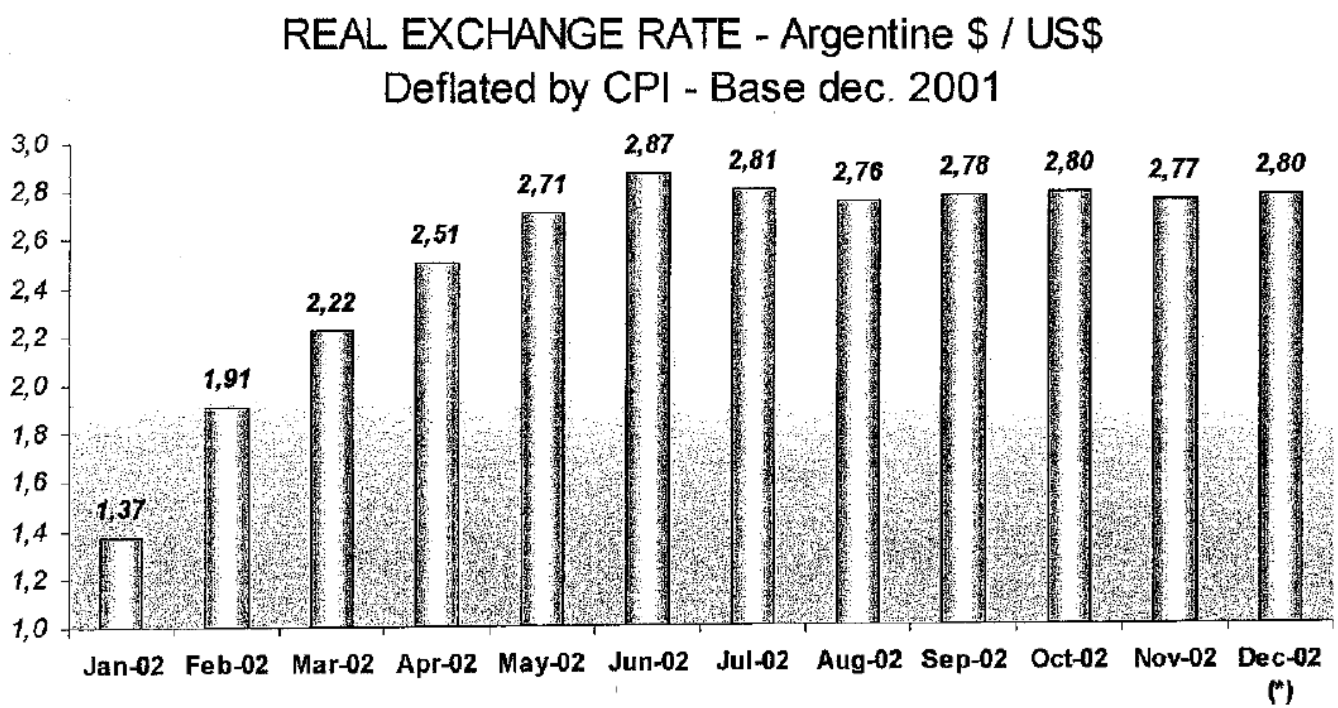
In 2002, conditions were created for a more realistic exchange rate than the one that existed under Convertibility.

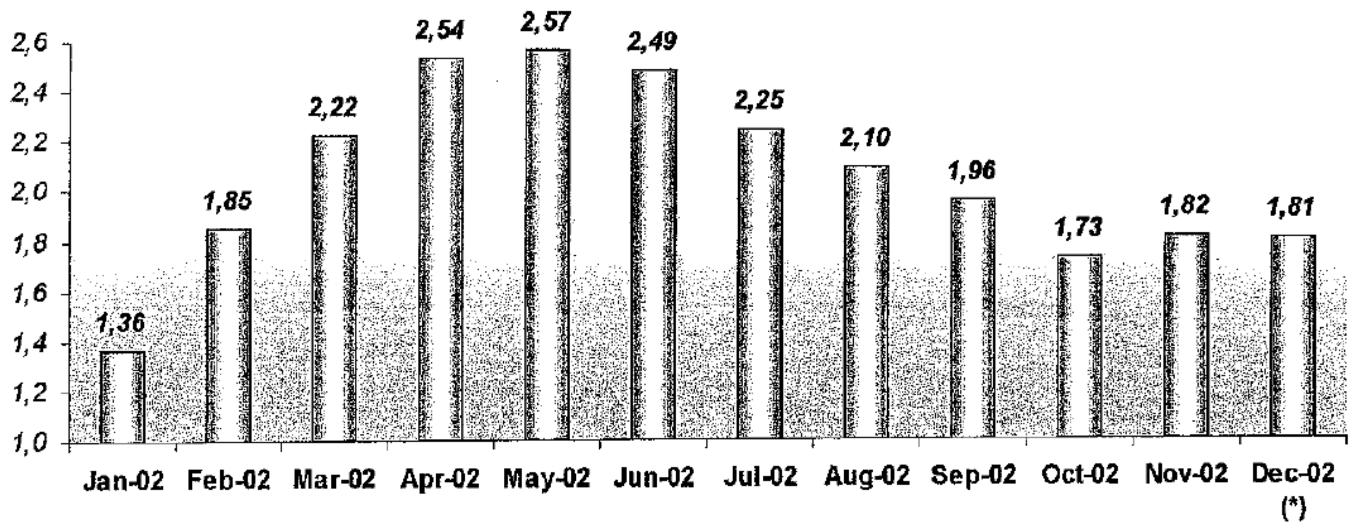


(*) Preliminary figure

Foreign Trade

The exchange rate between the peso and the currency of our trade partner reached more realistic levels.

REAL EXCHANGE RATE - Argentine $ / Brazilian R$
Deflated by CPI - Base dec. 2001



(*) Preliminary figure

ATTACHMENT II
(English translation)

REVIEW OF COMPLIANCE WITH THE FOURTEEN POINTS

TEXT OF THE DOCUMENT SIGNED BY THE GOVERNORS

The Governors of the provinces of Argentina, at a meeting convened by the President of Argentina at the Olivos presidential residence, have agreed as follows:

1. ***To abide by the international agreements entered into by Argentina and to reaffirm their intention to integrate Argentina with the rest of the world***

In keeping with this fundamental point, Argentina has been actively negotiating with Multilateral Lending Agencies, has paid USD 4.3 billion, thereby reducing its net debt to such Agencies, and has launched the negotiation process with external private creditors.

On the trade front, on the other hand, progress has been made towards the opening of specific markets in the European Union and the United States, and Argentina is actively participating in Mercosur negotiations, agreements with Mexico and the continuation of global free trade negotiations with FTAA and the European Union. The country is also actively present in the negotiations launched at the Doha Round.

2. ***To sign within fifteen days the bilateral agreements with the provinces, pursuant to the provisions of the Fiscal Pact entered into.***

In periods longer than anticipated, bilateral agreements to control deficit and the issue of quasi currency have been negotiated, signed and subsequently received legislative ratification. The provinces involved in the Orderly Financing Program account for 95 percent of total provincial deficit.

3. ***To submit to the Argentine Congress within ninety days aDraft Law agreed by consensus on a newFederal Revenue Sharing system.***

This point has not been complied with.

4. ***To encourage fiscal and monetary policies to keep the necessary disciplinee and balances in order to prevent runaway price increases and exchange rate instability.***

The current policies have clearly enabled compliance with these objectives. The wholesale inflation rate went down from 19.9 percent in April to 0.9 percent in October, and in the same period the retail inflation rate went down from 10.4 percent to 0.2 percent. The banks have again been able to attract deposits, are not turning to rediscounting, and the interest rate has fallen from over 120 percent to around 25 percent. The foreign exchange market is stabilized and State intervention has been to purchase foreign currency and increase reserves, which have increased by over USD 1 billion, despite the payments made to Multilateral Agencies.

5. ***To ensure, through appropriate legislation instruments, that depositors have the necessary certainty regarding the situation of their funds, thus ensuring liquidity.***

Part of the recovery in the banking sector has to do with the confidence created by discarding compulsory solutions and focusing on voluntary solutions. Fully unrestricted accounts have been created, 65.5 percent of the total amount in rescheduled deposit accounts has been released .and progress has been made towards releasing demand accounts.

On the other hand, there has been a voluntary swap for government bonds, there is currently a program to swap deposits for government bonds and/or bonds issued by the banks, and the Deposit Certificates (CEDROS) are transparently quoted on the Stock Exchange.

Dollar-denominated bonds are being actively used for purchases linked to the automobile sector. The quota for the first month has already been used and a second quota has been introduced. These instruments are also being widely used to pay bank debts.

Foreign-currency-denominated BODEN bond coupons have been paid within the agreed terms.

6. ***To ensure actions leading to the immediate reestablishment of a solid and reliable financial system***

The voluntary actions referred to above, plus the recapitalization of the system through the issuing of a bond as compensation for the asymmetric pesofication, amounting to 10 billon dollars, have made it possible to achieve this objective.

7. ***To implement a new fiscal responsibility agreement fo the federal, provincial and local administratiom ensuring compliance by means of an implicit system of rewards and punishments.***

The Orderly Financing agreements with the provinces referred to in 2.- are evidence of compliance with this commitment.

8. ***To encourage a comprehensive, modern and simplified tax reform to foster and promote capital investments while preventing evasion, avoidance and smuggling.***

VAT for two months has been reduced from 21 percent to 19 percent as a signal of expectations for a consolidation of the economic recovery under way and the maximum income tax rate for corporations has been reduced from 35 percent to 30 percent in order to take account for a single time of the inflation of early 2002.

Changes have been introduced to agricultural VAT withholdings in order to reduce evasion. We have taken active steps through the AFIP in cases involving amparos (court actions) and similar steps are being implemented in respect of the execution of judgments between individuals. An AFIP-INTI agreement is under way to control commodities exports and major noncompliance cases involving large exporters.

A Draft Budget Bill has been submitted to Argentine Congress, providing for a reduction in the tax burden.

9. ***To encourage the immediate enactment of the Bankruptcy Law.***

A law consistent with international standards has been adopted.

10. ***To encourage the immediate repeal of the Economic Subversion Law.***

The law has been repealed in order to conform to international standards.

11. ***To encourage the repatriation of Argentine capital mainly for productive labor-intensive projects.***

The stabilization, normalization and revival of the Argentine economy, with positive GDP development in the last two quarters (for the first time in over two years), as well as monetary and fiscal responsibility (5 consecutive months of surplus) are the best instrument to enhance the circulation of resources that are currently abroad, or even in Argentina, but outside the system.

12. ***To encourage domestic and foreign investments forexport of manufactured products or efficient import substitution.***

The reactivation referred to above relies on two pillars: replacement of imports with domestic production consistent with the new relative costs and exports. In the case of exports, compliance with this objective will be favored by the financing trusts that are being set up, the automobile agreements with Brazil, Chile and Mexico and the negotiations for the opening of specific markets in the US and the European Union. The growing importance of regional economies in the exporting process should be stressed.

13. ***To ensure effective compliance with the agreed political reform, ensuring the reduction of political and unnecessary bureaucratic expenditure and the modernization of electoral procedures.***

There are projects in this area but it does not seem possible to state that there has been an adequate degree of compliance in this field.

14. ***To ensure a mechanism for allocation of employment plans, turning them into effective employment through the productive sector.***

Having overcome the extreme emergency of the socioeconomic situation through the Program for Unemployed Household Heads, which in conjunction with the medicines and school grants programs, has created a basic social protection network, the phase that has now begun involves linking these programs with job creation.

Olivos, April 24,2002,
(Source: Argentine authorities)

ATTACHMENT III
(English Translation)

POLITICAL, ECONOMIC AND SOCIAL AGREEMENT

The Governors of the provinces of Argentina and the parliamentary leaders of Argentina, at a meeting convened by the President of Argentina at the Olivos presidential residence, have agreed as follows:

1. To maintain and widen the scope of social assistance programs and enhance their implementation in order to fight efficiently against the effects of poverty and indigence.

   To launch an Emergency Plan throughout Argentina, with the participation of federal, provincial and local government agencies, NGOs and community-spirited citizens, aimed at detecting, preventing and attending to the most acute problems of the most unprotected parts of the population.

2. To reaffirm Argentina's intention to integrate with the rest of the world, abide by the international agreements it has entered to and reach agreements with multilateral lending agencies that take account of its national interests.

3. To ensure exchange rate stability, the protection of reserves and inflation control and to encourage, through appropriate measures and instruments, the reactivation of the productive apparatus .

4. To attach high value to reduction of 2 points in the VAT rate seeking to reactivate consumption, and to establish the full absorption of the fiscal cost of this measure by the Federal Government.

5. To encourage consideration by the Argentine parliament of the President's resignation as of May 25,2003, to propose that the general. election of the new President and Vice-president be held on April 27 and the runoff, if required, on May 18, while at the same time seeking the suspension, only €or this time, of all of the terms of Law 25,611, which provides for simultaneous open primaries for President, Vice-president and national legislators during this week.

6. To implement the negotiation of the Provincial Bilateral Agreements on Orderly Financing for the yeas 2003, with the necessary legislative ratification, where necessary, by the end of the first half of February 2003.

The 2002 Orderly Financing Agreement is also ratified.

7. To pass, the Budget Bill for the year 2003, with the tax rules being included in the calculation of resources, restricting the allocation of the AR$3.5 billion items and identifying budgetary execution savings of AR$ l billion, before the end of 2002.

8. To include in the Law referred to in 7. above, the elimination of the "Competitiveness Programs".

9. To amend the Financial Institutions Act, in order to include measures relating to the transfer of bank assets, valuation of assets, judicial banking appointment of receivers in bank under resolution and the elimination of rules involving restrictions on, or discrimination against civil servants responsible for conducting rehabilitation processes, when acting in good faith and within the framework of applicable rules.

   Furthermore, to introduce enhanced protection of the claims of purchasers and administrators of transferred assets.

10. To seek enactment of the bill which has been passed by the Lower House and gives back powers to legislate on tax amnesties to the Argentine Congress.

11. To maintain the current rules governing the operation of the Bankruptcy Law and foreclosure.

    To set up, within the sphere of the Executive Branch, a legal emergency unit for nonbank foreclosures and, for such purpose, to create a special Parliamentary Committee responsible for follow-up.

    The Federal Revenue Administration shall create an information system on such court actions.

    To ratify the Government's agreement with the banking organizations.

12. Consolidate the current rules related to the payment of banking debt with BODEN bonds and reprogramated deposits.

Olivos, November 18,2002
(Source: Argentine authorities)