March 19, 2001
Approval: 3/26/01

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 98/103

10:00 a.m., September 23, 1998

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors

A.A. Al-Tuwaijri
T.A. Bernes
R.F. Cippà
B. Esdar
E.R. Grilli
D.Z. Guti

K. Lissakers
J.-C. Milleron

A.S. Shaalan
M.R. Sivaraman
G.F. Taylor
J.J. Toribio

Y. Yoshimura
Zamani, A.G.

A.G. Zoccali

Alternate Executive Directors

A.S. Alosaimi, Temporary
C.X. O'Loghlin
W. Szczuka

A. Giustiniani, Temporary
J.P. de Morais
J.A.K. Munthali, Temporary
O.-P. Lehmussaari
H.F. O'Brien
S. Zádor, Temporary
B.S. Newman
R. Fernandez
M. Daïri
L. Palei, Temporary
J. Shields
M.H. Elhage

O. Kwon
J. Guzmán-Calafell
Y.G. Yakusha
A. Barro Chambrier
H. Ono
C. Harinowo
Zhang F.
Qi J., Temporary
N. Eyzaguirre

R.H. Munzberg, Secretary
A. Linde, Acting Secretary
A. Mountford, Acting Secretary
N.M. Hairfield, Assistant
S. Soromenho-Ramos, Assistant
S.W. Tenney, Assistant

Strengthening the Architecture of International Monetary System; Strengthening Financial Systems; and Orderly Capital Account Liberalization—Draft Reports of Managing Director to Interim Committee

Staff representatives: Boorman, PDR; Mussa, RES; Adams RES

Argentina—Review Under Extended Arrangement

Staff representatives: Ter-Minassian, WHD; Reichman, WHD; Seade, PDR

El Salvador—Request for Stand-By Arrangement

Staff representatives: Jul, WHD; Kincaid, PDR

Also Present
IBRD: I. Bannon, Latin America and Caribbean Regional Office. European I Department: M.C. Deppler, Director; J.R. Artus, Deputy Director. External Relations Department: S.J. Anjaria, Director; M.W. Bell, R.W. Russell. Fiscal Affairs Department: P.S. Heller, Deputy Director; A. Cuevas. Legal Department: W.E. Holder, Deputy General Counsel; R.C. Baban. Monetary and Exchange Affairs Department: M. Guitian, Director; B.J. Laurens, S.C. Sosa, V. Sundararajan. Policy Development and Review Department: J.T. Boorman, Director; T. Leddy, Deputy Director; J. Hicklin, S. Ishii, G.R. Kincaid, K.J. Langdon, Y.A. Metzgen, R.H. Nord, M.L. Parkinson, J. Seade, R.C. Velloso, R. Weber. Research Department: M. Mussa, Economic Counsellor and Director; F.C. Adams, E. Detragiache, P.R. Masson, G.J. Schinasi, A.J. Tweedie. Secretary's Department: S. Bhatia, A. Mountford, B.A. Sarr. Statistics Department: C.S. Carson, Director. Treasurer's Department: D. Williams, Treasurer; H. Flinch, O. Roncesvalles. Western Hemisphere Department: C.M. Loser, Director; M.E. Bonangelino, Deputy Director; T. Ter-Minassian, Deputy Director; P.D. Brenner, L.A.V. Catao, M. Dehesa, J.C. Di Tata, J.R. Franks, F.P. Frantischeck, M. Garza, A.M. Jul, V.A. Mercer-Blackman, S. Morales, T.M. Reichmann. Office of the Managing Director: M. Cross, Personal Assistant; B.V. Christensen, J.A.P. Clément, O.J. Evans, P.J. McClellan. Advisors to Executive Directors: W.F. Abdelati, M. Askari-Rankouhi, J.A. Costa, S.S. Farid, C.M. Gonzalez, E.J.P. Houtman, N. Jadhav, J.M. Jones, M.F. Melhem, H. Mori, S. N'guiamba, H. Ogushi, O. Otazú, A.R. Palmason, E. Rodriguez, M. Sobel, T. Turner-Huggins, F. Zurbrügg. Assistants to Executive Directors: J.A. Akhmetova, Awang G.G., S.A. Bakhache, T. Belay, N.R.F. Blancher, M. Brooke, M. Budington, R. Burgess, J. Chelsky, D. Chen, M.R. Hajian, S. Hinata, J.K. Honeyfield, C. Josz, A. Kapteyn, S.K. Keshava, E. Kornitch, K. Lai, Lu A., A. Lucenti, M.Z. Maatan, D. Merino, W. Merz, K. Ongley, T. Presečan, E.T. Rădulescu, J.N. Santos, C-P. Schollmeier, U.Y. Tilyayev, G. Vigliotti, M. Vismantas, M. Walsh, Wang X., P. Winje, A.G. Yakub.

1. MESSAGE OF CONDOLENCE

The Managing Director took note of the death of Louis Rasminsky, a former Executive Director who had served as chairman of the committee that prepared the final draft of the Fund's Articles of Agreement, and paid tribute to his service to the Fund.

2. STRENGTHENING THE ARCHITECTURE OF INTERNATIONAL MONETARY SYSTEM; STRENGTHENING FINANCIAL SYSTEMS; AND ORDERLY CAPITAL ACCOUNT LIBERALIZATION—DRAFT REPORTS OF MANAGING DIRECTOR TO INTERIM COMMITTEE

The Executive Directors considered the draft reports of the Managing Director to the Interim Committee on strengthening the architecture of the international monetary system (SM/98/231, 9/18/98), and on strengthening financial systems and orderly capital account liberalization (SM/98/233, 9/21/98).

Mr. Bernes made the following statement:

> The two reports being considered today, as well as the report on Bank-Fund collaboration, convey similar messages. It seems to me that some consolidation of these reports might be warranted, particularly if we want them to be read by ministers. For example, the text following Box 3 in the architecture report adds little and repeats the material in the box more verbosely. I suggest that we merge the two papers and expand the section on Bank-Fund collaboration in the financial sector to reflect the summing up of yesterday's discussion. Both reports refer to the lessons learned during the Asian crisis on the risks of large capital inflows. However, neither of the reports mention the fact that maintaining a fixed exchange rate in the face of large capital flows contributed to the deepening of the financial crisis in both Asia and Russia. The issue was raised during our discussions on international capital markets and private sector involvement in the resolution of financial crises. It is evident that a fixed exchange rate provides a level of guarantee that can lead to mispricing of risks and excessive capital inflows. This issue has to be addressed whether or not we believe that a fixed exchange rate may be appropriate for some countries in certain circumstances. I think a reference to this issue is appropriate.
>
> The report on architecture should make it clear at the outset that crises are inevitable, and that the actions proposed are intended to reduce their frequency and severity, rather than to raise a false hope that we can forever avoid crises.
>
> The report refers to collaboration with the international community, but does not elaborate on the work being done by other groups such as the G-22, the G-10, or the International Institute of Finance. Ideally, the report could contain a brief outline of the issues under discussion in the different fora, and how they relate to the Fund's internal discussions. It would also be useful to mention the process through which the results of these efforts might be brought together.
>
> On the issue of private sector involvement, it is essential, particularly if these documents are to be released, to state that close consultation with the private sector would be necessary on many of the proposed measures.

In paragraph 10 of the architecture report, financial policies are listed as one of the Fund's core concerns. This is a very general statement. Core responsibility for financial policies rests with a larger group of bodies, so we should be more specific about the institutions we are talking about. In paragraphs 13 and 14, the comments on transparency should make a distinction between the practices of members and those of the Fund. On transparency by members, there is no mention of the Fund's existing policy on governance. Not only should it be mentioned here, but it should be given some prominence throughout the document where issues of transparency and accountability of policies and data are discussed. Paragraph 19, which covers the reasons for considering a priori market-based mechanisms that can ensure the timely involvement of the private sector, should also mention the issue of moral hazard.

As for the second paper on strengthening financial systems and on capital account convertibility, given that the Board has not moved any closer to a decision on the issue of jurisdiction, I suggest that the text of paragraph 16 not deviate from the most recent Interim Committee communiqué. I would suggest redrafting the last sentence to read, "The Executive Board will return, in light of recent experience, to the issue of an amendment to the Articles of Agreement to make the promotion of orderly capital account liberalization an explicit purpose of the Fund, and to extend the Fund's jurisdiction as needed to the capital account." That is the precise language of the Interim Committee communiqué.

The Chairman pointed out that it had been more convenient for the staff to prepare two separate documents. However, he would favor their consolidation.

Mr. Wijnholds made the following statement:

These are a useful papers, but they may have a somewhat limited impact. They include an appropriate list of issues, but they cover them in the order that the board has discussed them. Yes, we have improved standards; yes, we are working on transparency; and we are considering possible avenues through which enhanced involvement of the private sector may play a greater role. However, we should make a distinction between those issues that are relevant and important over the medium term, and those that are relevant over the short term. Improving standards is not something that we can achieve in the short term. However, involving the private sector in crisis prevention and resolution is a relevant issue right now—we are in the process of shaping our policies and building a body of precedents from the concrete cases confronting us. Unfortunately, the paper does not refer to any of these cases. They might be somewhat difficult to incorporate, but I think that ministers would like to see what we have been doing in the cases of Korea, Indonesia, Russia, or the Ukraine. Perhaps it may be possible to cover these cases in a box or an annex, recognizing that individual countries will be sensitive to the box's specific language. Mr. Fisher could also comment on that experience in introducing the subject to the interim committee. Reading the papers, there seems to be a lack of detail as to the actual role of the Fund at this point. Also, there is no mention of our role as an intermediary between debtors and creditors, and in monitoring. These are important issues of interest to our ministers, who would certainly appreciate an overview. Perhaps we might also cover some of these issues under the section entitled "Next Steps." As we are in a full-fledged crisis, a somewhat more urgent tone might be warranted.

The Chairman noted that there was general agreement on the broad elements of the international financial architecture debate. However, there was less agreement on how to progress specifically from the present state of affairs. Mr. Wijnholds had mentioned the differences between individual countries on the issue of involving the private sector in the prevention and resolution of crises. Despite the fact that it could not offer detailed concrete solutions, the Fund would nevertheless have to find a way of prompting Ministers to provide their reactions and guidance.

Mr. Esdar commented that combining the two papers might be beneficial. He also remarked that the section on private sector involvement appeared somewhat academic. The section should put forward the Fund's views more aggressively, noting that the institution was in the process of exploring different ideas and approaches. It had to be kept in mind that the report would be competing in a highly active intellectual marketplace, in which there was a continual stream of new reports and suggestions on international monetary reform.

Mr. Yoshimura said that he agreed with the comments of Mr. Esdar and Mr. Wijnholds. It was important that the Fund keep at the forefront of the policy debate, and that it not be seen as having been overtaken by events.

Mr. Taylor commented that the Fund should outline its views on some of the more prominent or flamboyant ideas that were currently in circulation. If it failed to do so, the Fund might be perceived as being overly staid or bureaucratic in its approach.

The Chairman pointed out that every document for the Interim Committee had to be first reviewed and discussed by the Executive Board. In that light, the Interim Committee would generally not hear about any official proposals without first receiving the reaction of the Board. If Directors wished to have the Interim Committee endorse particular reports of other institutions during the forthcoming meeting, it was important to have those reports presented to the Board in the very near future. He invited Directors to remind their authorities of the value of the Board's contributions, in maintaining a constructive interaction between the Fund and other institutions.

Mr. Taylor remarked that the Chairman had raised an important point. However, there were many different proposals that were gaining currency in the international policy debate. For instance, it had been proposed by some that serious consideration should be given to a more extensive use of capital controls. The report to the Interim Committee might mention that the Fund was at least aware of the proposal.

The Chairman agreed that the current debate was wide ranging. Those who suggested that the Fund alter its policy on capital controls would be well-advised to revisit the language of the Hong Kong communiqué, which noted that the Fund could authorize, and even suggest, capital controls in certain circumstances. He said that it should be possible to refer to that language in the text of the report, and perhaps to allude to the current debate. An impressive feature of the current debate on the architecture of the international monetary system was that the ideas coming from official circles, such as the G-10 or G-22, were all somewhat similar to the views expressed by Directors. It would not be too difficult, therefore, to form a broad coalition working toward a common goal.

Mr. Toribio remarked that he had also considered that the draft reports had been somewhat academic. In addition, looking back at the documents presented to the previous spring Interim Committee meeting, it seemed that there had been little progress. If that was the case, the current reports should say so candidly. On the proposal to merge the two reports, he suggested instead that one of the reports be split in two, so that there would be a separate, short report for each of the three items on the agenda.

The Chairman commented that there was not much difference between a single document with three parts, or three documents with one part. As for the apparent lack of progress, the Fund had been extremely busy over the past summer dealing with crises as they developed. Also, the staff had been busy explaining the work of the Fund in various international fora.

Mr. Shaalan added that a third reason for the apparent lack of progress was that the crisis had still been evolving over the course of the past year, so that the Fund had been in the process of learning as events unfolded. As for the reports, he agreed with those that felt the reports were too academic, bland, and indecisive. Perhaps they might be more forthcoming on certain issues, especially those that could be addressed over the short term.

Ms. Lissakers said that she agreed that the draft reports conveyed little sense of urgency, and did not seem to capture the intensity of the international debate. A large number of members, whose policies had been praiseworthy, had been denied access to capital markets. Another segment of the membership had suffered a disturbing decline in their growth and prosperity. The gravity of these concerns did not seem to be reflected in the reports. However, her main concern was that the reports' underlying message seemed to be that the international monetary system only needed some minor modifications. That was not a premise shared by the majority of the Board. Although the external debate had not produced any credible proposals, the reports should at least convey the sense that a basic reconsideration of the system was necessary. It should also note that this reconsideration was already underway within the Fund, and highlight the quality of the internal debate among the staff, management, and the Board.

Many ministers who would be coming to the annual meeting would also have participated in the deliberations of other fora, Ms. Lissakers continued. Therefore, it might be useful and realistic for the report to the Interim Committee to acknowledge the role of these fora in the international debate, and to welcome their contributions.

The Chairman thanked Ms. Lissakers for her comments and suggested that the report on architecture contain an introductory section, placing the report's findings in the proper perspective. That section would highlight the urgent need for change, the work that was being conducted in various quarters, the openness of the Fund to new ideas, and the difficulties involved in arriving at credible, concrete solutions.

Mr. Zamani said that he shared Ms. Lissakers's sentiments. On one hand, the Board had stressed the importance of reform at the country level, to help ensure that individual countries would be better prepared to deal with future crises. On the other hand, the integrity of the international monetary system itself needed to be considered. In the Board's discussion of the *World Economic Outlook*, some Directors had raised the issue of the hedge funds' role in recent events. Though the Fund had found no evidence that hedge funds had contributed significantly to the crisis, there were nevertheless many commentators who believed otherwise. In addition to hedge funds, there were also commercial banks, merchant banks, and other players to be considered. The report had not said anything on how to ensure that the financial markets regulated themselves in a manner consistent with the overall integrity of the system.

He also agreed with Mr. Taylor's comments on the possible inclusion of a section on exchange controls.

The Chairman pointed out that the issue of exchange controls was considered in paragraph 27 of the report on strengthening the architecture of the international monetary system. The report noted that it would be worth revisiting countries' experience with such controls to determine the circumstances under which they were effective. On the issue of the disorderly operation of world financial markets, the Board's concerns would be addressed in the strategy on standards and codes of good conduct. The promotion of appropriate standards seemed to the global community's preferred response to potential market disorder, and the main point of contact for the Fund on this issue was the International Organization of Securities Commissions (IOSCO).

The Fund had already expressed its view on the limited role of hedge funds, though it had not yet determined their role in the propagation of contagion, the Chairman continued. Although the report to the Interim Committee might mention the hedge fund issue in more detail, perhaps reiterating the call for increased reporting of hedge fund positions, it was not productive to reopen discussions that had already been concluded. It should be kept in mind, however, that the Fund was still in the process of learning how to make the international financial market as orderly as most domestic markets.

Mr. Eyzaguirre said that, while he agreed with the impressions of other Directors, he was not overly surprised that the reports had not contained as many concrete proposals as expected. Deliberations on the international financial architecture, and the events of the crisis itself, were ongoing. The report, therefore, should state candidly that the current debate was still very fluid, and that the ideas contained within the report were the best that could be provided at that point.

As for the issue of standards, there seemed to have been little consideration of the incentives needed to induce member countries to take the necessary steps, Mr. Eyzaguirre continued. In fact, many of the relevant standards had been widely accepted as appropriate, but some countries had proven reluctant to adopt them. Greater thought needed to be given to the practical aspects of implementation. The report stated that improved standards would allow for better-informed decision making and a more efficient allocation of resources. However, little consideration had been given to the possibility that decision makers might not behave as expected, and there had been no mention of steps that could be taken to ensure that they acted appropriately. The ex ante measures outlined in Box 3 of the report were somewhat weak, and from the tone of the report, they did not seem to be very promising. Also, the concrete proposals of the Willard Group had not been discussed. The report, at one point, stated that measures to discourage excessive reliance on short-term financing were essential. However, the recommended measures did not seem adequate for that task, and the report later seemed to reverse its position by stating that the effectiveness of market-based controls on short-term capital inflows was questionable.

The report might expand more on the role of the Fund, Mr. Eyzaguirre commented. The section on the institution's role was limited to the Fund's policy of lending into arrears, and did not mention any of the issues associated with the expanded scale of financial flows and the dangers of contagion. It was unclear from the report whether Directors felt the need for any change in the activities or resources of the Fund. Further, the report made no reference to the issue of international cooperation and coordination. Following the recent G-7 communiqué, it was increasingly apparent that economic policy needed to be drafted with specific consideration given to global macroeconomic and financial interdependence.

The Director of the Policy Development and Review Department commented that, outside the Fund, the key official forum on strengthening the international financial architecture was the G-22 "Willard Group," including its three subgroups on transparency, strengthening financial systems, and involvement of the private sector. In addition, the Institute for International Finance (IIF) had convened a number of working groups, and there had also been a variety of academic seminars organized by bodies such as the Brookings Institution. The Fund had participated in all those fora. As for the private sector involvement issue, there seemed to be a diverse range of views. When that topic had been discussed recently by the Board, the staff had presented a list of possible ideas, including embedding call options within interbank credit lines, and changing capital adequacy requirements on interbank lending. Those suggestions had received very little attention from Directors, and there had been almost no discussion on the specifics of such mechanisms. Similarly, in other fora outside the Fund, there was little agreement on measures that might be introduced in the interbank market. The Chairman of the Federal Reserve had put forward a number of constructive ideas, but they had not been taken up by the international community either. There was also a strong difference of opinion on the efficacy of the swap and credit lines to Mexico and Argentina. As for suggestions on possible modification to bond contracts, there was a general sense that majority rules and sharing clauses might help ensure more orderly debt workout. However, recent statements by the U.S. Securities and Exchange Commission had cast doubt on whether a requirement making such contracts mandatory could be enforced within the United States.

There had even been disagreement within the Board on relatively mundane issues such as the modalities and fora for contact between the Fund and the private sector, the Director continued. Some members considered that the IIF was an appropriate point of contact, while others felt that this would introduce an unwarranted level of bias. There was a similar lack of agreement within the Board on the potential use of Article VIII, 2 (b) to allow a stay of litigation in the event of a moratorium on payments.

Within the transparency subgroup of the G-22 Willard Group, in the euro currency standing committee, and within the G-10, there had been a debate on the appropriate standard for reporting on reserves, the Director noted. Within the Fund, the Board had agreed on the standard proposed by the staff, which was for weekly reporting with one-week lags. At the time of the Board discussion, the staff had understood that this standard was the general consensus of the other official fora. Unfortunately, that was not the case—the G-10 had not reached an agreement, and the G-22 subgroup on transparency was still debating the issue. It was likely that the reports from those fora, rather than providing concrete proposals, would instead outline the various issues and call for further progress. In that case, the task of gathering all those disparate reports, including from bodies such as the IIF, and of determining a feasible proposal, would probably fall to the Fund Executive Board. However, that would be some time in the future.

Mr. Esdar said that he agreed with the idea of an introductory section. That section would put the report in context, noting the recent difficulties faced by many countries, and also that markets had been very volatile and that there had been questions raised as to whether they were working efficiently. The section should also point out that the Board was actively discussing many of the proposals that had emerged from the policy debate. It should make clear that there was no simple solution, but that there were certain areas where strengthened policy was necessary, such as data standards and banking regulation.

As for the issue of private sector involvement, although there might not be widespread agreement on the measures that should be adopted, the tone of the staff report was still unduly pessimistic, Mr. Esdar remarked. The report listed a number of proposals in Box 3, only to stress the disadvantages of each one. The overall impression, therefore, was that the Fund had investigated all possible avenues, and had found that nothing was feasible. He suggested that the section be revised to make clear that there were still many promising ideas under consideration.

Mr. Giustiniani commented that it appeared that the current discussions had not produced any clear agreement. It was therefore important that the Interim Committee discuss the various proposals and provide guidance on the best way forward. Therefore, the report should be structured in such a way as to prompt a clear response from the Committee. It seemed that the Board had reached agreement on some elements of a proposal, including improved standards, increased transparency, and more effective surveillance. Those features were probably important pillars of an improved financial architecture. However, the international debate seemed to suggest that extra elements might be needed, such as capital controls or an international lender of last resort. The various aspects of these added issues needed to be presented to the Interim Committee, which should then be encouraged to take the lead in suggesting practical proposals for implementation.

The Chairman noted that ministers could not be presented with issues that had not first been discussed by the Board. For example, while the Interim Committee might reiterate the sentiments expressed during the Hong Kong meeting, they should not be asked to provide details on the circumstances under which exchange controls should be introduced, as the Board had not yet discussed the issue in depth. Such a discussion, drawing on the experiences and lessons of the Fund's members, might be scheduled for some date after the Interim Committee meeting, but would be premature at present.

Mr. Giustiniani commented that he was not suggesting that the Interim Committee provide that level of detail, though some Ministers would be able to draw on their own experiences. Instead, given that the international community seemed to be expecting a signal of the Fund's policy conclusions, he was simply suggesting that ministers should be given an opportunity to react to some of the proposals currently in circulation, and to provide some guidance.

Mr. Sivaraman expressed concern at the impression that the recent debates had not drawn any conclusions, and that the Board had not achieved anything over the past few months. There were areas in which the Board had come to a specific agreement—such as on the need for members to follow the Basle Committee principles on banking supervision, and the need for fiscal transparency. He suggested that those areas receive a more direct focus in the report to the Interim Committee.

Mr. Fernández said that he agreed the report should be more dynamic, and that it include an opening background section along the lines suggested by Ms. Lissakers and Mr. Esdar. However, he expressed surprise at the comments of those Directors who felt that the report did not contain a sufficient number of concrete proposals. That lack of proposals accurately reflected the current state of the Board, as there were relatively few issues on which the Board had agreed. Although the report might have highlighted the areas of agreement, and adopted a more dynamic tone, it was not able to present concrete proposals on issues such as the establishment of creditor councils or the amendment of Article VIII, 2 (b). The Board simply had not agreed on those issues. In the absence of such agreement, a report listing the pros and cons of various items, though appearing somewhat academic, was probably inevitable. The appropriate course, therefore, was to structure the report so as to prompt ministers to give their opinions and provide leadership.

Mr. Shields supported the suggestion for an introductory section that reviewed recent events and lessons learned, and made clear that the Board was aware of the urgency of the situation. The section should also mention the efforts of other fora, and their conclusions. As for the main body of the report, the Board was obliged to be more forthright. For instance, many of the issues included in Box 3 were unpopular with Directors, and were perhaps judged to be unfeasible. Although the opinions of Directors might still be swayed, it was important to convey the current feeling of the Board. There were also other items that had been discussed without any definite conclusion. In those cases, the Board should state candidly that there were issues that needed to be discussed further. As for the issue of capital controls, the report would have to be careful to express the reservations and concerns of some Directors as to the circumstances where they might be appropriate. However, such controls had been discussed by the Board, and the results of those discussions should be included in the Board's report to the Interim Committee. The report might also include a clearer treatment of the interaction between exchange rate policy and crises.

Ms. Lissakers noted that much had happened since the Hong Kong meeting, so that ministers' views on issues such as exchange controls might have changed. The report did not convey the sense that there had been significant developments over the past year, and that the Fund was taking steps to respond with force and ingenuity. The Board should list clearly those proposals that had met with its approval, and should ask for guidance on those issues where there was still disagreement.

Mr. Eyzaguirre remarked that, in an international policy context, the proposals contained in the report would be read at a critical time, so the language of the report would have to be chosen with care. As for some of the more unorthodox solutions that had been suggested, such as capital controls, it was important to distinguish between relatively well-accepted measures such as prudential regulations aimed at discouraging excessive short-term capital flows, and other measures such as exchange rate controls and payments moratoria. He stressed that he did not support controls on capital outflows, owing to possible contagion implications. In his view, the report's treatment of such measures should be worded more strongly.

Mr. Yoshimura commented that the discussions within the Fund and other fora had taken place against the backdrop of dramatic events in Asia and Russia. It was important that the international discussion be expedited, and that the report to the Interim Committee convey a greater sense of urgency. As for the issue of capital controls, although his chair's position was well known, he nevertheless recommended that the issue be included in the report, as the question of capital controls was once again at the forefront in international policy circles.

The Chairman said that he agreed with the need for a sense of urgency. However, on the issue of capital controls, it had to be kept in mind that, although a couple of members had introduced such measures, the other 180 members had adhered to the principles outlined at the

Hong Kong Meeting. That reflected well on the maturity of the membership. Also, in any treatment of capital controls, the potential advantages needed to be outlined alongside the potential risks—not only of the measures themselves, but also the risk that they might detract from efforts to improve a country's financial system. From his experience, financial controls worked well for six weeks at best, but then the underlying problems made themselves known.

Mr. Esdar pointed out that the report's language on exchange controls and capital market liberalization was much more cautious than the Fund's previous statements.The issue warranted further discussion, as the Fund needed to determine why some countries, such as China, had been more successful than others. However, careful wording was necessary. The Fund needed to avoid giving the impression that the institution was prepared to rethink its entire approach just because a couple of members had introduced capital controls.

The Chairman remarked that any discussion of China should focus on the actual country, rather than the virtual China invented by academic commentators. Those two models were somewhat different.

Mr. Daïri said that he agreed that the report should faithfully reflect the state of discussions within the Board. If the report had seemed somewhat vague and academic, perhaps that was because the Board's discussions themselves had been indecisive and lacking in focus. He suggested that the report to the Interim Committee, while mentioning the ongoing international debates that had not been specifically addressed by the Board, should nevertheless stick closely to the Board's discussions.

The suggestions by Mr. Wijnholds and Mr. Esdar that the section on private sector involvement should give greater emphasis to the Board's efforts in that area, also had merit, Mr. Daïri continued. On the issue of capital controls, the report seemed to have placed too much emphasis on capital inflows, rather than outflows. He suggested that the report be reviewed to ensure that it maintained an appropriate balance.

The treatment of the Fund's role in promoting the adoption of standards gave the impression that the institution was a de-facto ratings agency, Mr. Daïri commented. That was not a role the Fund should welcome. Further, placing the institution at the center of the financial sector's assessment of individual country loans ran the risk of damaging the spirit of cooperation between the Fund and its members. The reports also did not seem to pay sufficient attention to the issue of technical assistance—that issue, however, had featured prominently in the Board's discussions of international standards. Finally, the Board had discussed at length the issue of ensuring adequate transparency and supervision in the major financial centers. He suggested that the report mention that discussion.

Mr. Taylor commented that, as the Board seemed to prefer the inclusion of an overarching introductory section, he would prefer that such a section be relatively short. That section might also make the point that the global situation was evolving rapidly, and so the Fund might not yet fully understand all the relevant dynamic and causal factors.

As for the section on standards and transparency, one striking feature was that the private sector did not seem to be taking full advantage of the information that was currently available, and was not actively demanding more, Mr. Taylor continued. The report should acknowledge that fact and should raise the issue of the need for appropriate incentives—that would perhaps include a discussion of implied government guarantees and fixed exchange rates. Secondly, the report might note that the ultimate users of a particular standard should be actively involved in its development. Finally, the report should place greater emphasis on the importance of transparency beyond the preparation of official financial reports.

The report had discussed at length the need to strengthen Fund surveillance, and to ensure that its policy advice was appropriate, Mr. Taylor noted. However, the Fund sometimes faced a dilemma in that its advice was not always accepted. In that light, the Fund might need to be more persuasive, as the currently available measures, such as Public Information Notices, were somewhat detached. Perhaps, in the course of surveillance, the Fund should seek to understand how to influence policy debates in countries with different administrative and political systems. And then, if the Fund was not able to persuade a country to pursue a particular course of action, the fundamental question arose as to whether the Fund should still remain engaged. Rather than wasting its scarce resources on a country that would not follow the Fund's advice, it might be better to instead spend those resources on other countries who faced potential contagion. That was a difficult issue, but over the past 15 months, the Fund might have done better to place greater emphasis on saving the neighbors of particular members, rather than trying to save those members from themselves. As an aside, the staff report referred to a Board paper on Fund-supported programs during the Asian crisis. The staff might want to amend that reference, as that meeting had been postponed and had not yet taken place.

The issue of direct intervention and exchange controls was difficult, and the task of the staff in drafting the section on that issue must have been daunting, Mr. Taylor remarked. However, the report needed to carefully and clearly delineate the specific circumstances under which such measures might be considered. A key problem facing the international financial system was that a couple of countries had acted unilaterally, prompting concern in the capital markets that more countries might follow. The challenge for the Fund was to ensure that future actions would be brought within a more multilateral process. On the issue of capital controls, it seemed that China's use of such measures had been successful. And on Mr. Bernes's comment on the Fund's jurisdiction, the reference in the report should be left unchanged, otherwise that issue might take up an unwarranted amount of time in the current meeting.

Ms. Lissakers commented that the report's discussion on capital account liberalization needed to be recast to place greater emphasis on the threat of disorderly reversals in the liberalization process. Private market participants were concerned that the rules of the system had changed unpredictably, and that that had contributed to market volatility. The arbitrary, unilateral reversal of capital account liberalization was perhaps one of the most unsettling events faced by international investors, and had considerable potential to disrupt capital flows. Therefore, the reports' discussion needed to focus less on the process of liberalization, and more on the Fund's jurisdiction in the context of capital account openness and the appropriate response to unilateralism.

Mr. Esdar remarked that the Fund had faced considerable criticism over its role in the Asian crisis. While much of that criticism had been unfair, the report should include one or two sentences noting that the Fund was in the process of reviewing its approach during the Asian and Russian crises. Otherwise, the Fund might be blamed for ignoring its critics.

The Chairman said that he agreed with Mr. Esdar's suggestion, but cautioned that the report should not give the impression that the Fund was now condemning its entire reaction to the Asia crisis. While the Fund may have made mistakes, much of the crisis had its roots in the current international financial system—the Asian crisis had shown that the lessons from the crisis in Mexico needed to have been taken even more seriously, and that policy makers needed to accelerate their efforts to reform the international financial architecture.

Mr. Bernes said that, on that issue, he agreed with Mr. Esdar and Mr. Taylor. The Fund needed to show some humility. Both the Fund, as an institution, and the governments it worked with, were fallible. However, the Fund did have proactive procedures for reviewing its successes and mistakes. Perhaps the report might mention the external evaluation of the institution's surveillance function.

The Chairman stated that he agreed with Mr. Bernes's suggestion. He suggested that the staff should now proceed to draft an introductory section that placed the Fund's architecture efforts into perspective, along the lines suggested by Directors. The staff would also redraft the report to better reflect the progress of the Board—outlining more explicitly those issues that had been agreed, and those that required further guidance from the Interim Committee. The redrafted report would then be presented to the Board for further discussion in the near future. He encouraged Directors to contact the staff bilaterally with any further comments or suggestions.

Ms. Lissakers pointed out that Box 3 of the architecture report mentioned a possible amendment of Article VIII, 2 (b), yet it made no mention of the Board's intense debate over the Fund's policy of lending into arrears. The proposed amendment of the Articles did not have the support of many Board members, so she could not support a report to the Interim Committee that gave the impression that the amendment had been endorsed by the Board.

Mr. Wijnholds suggested that the report highlight some concrete cases where the Fund was working to facilitate the involvement of the private sector. Though the language of the text might be somewhat sensitive, it was an issue that would be of interest to Ministers.

Mr. Zhang commented that capital controls had been one, though not the most important, of the factors that had shielded China from the worst of the Asian crisis. China was still in the process of liberalization, but at a pace and sequencing that the authorities deemed to be appropriate. The precise wording of any reference to China should be chosen carefully. The language of paragraph 6 of the report on strengthening financial systems was appropriate.

The Chairman thanked Mr. Zhang for his comments, as he had conveyed a positive message that would be precisely reflected in the report. The Chinese authorities did not view capital controls to be a key policy instrument, and were liberalizing as rapidly as possible, given the economy's level of development.

Mr. Sivaraman commented that India was in a similar situation, in that capital controls also were not seen by the authorities as a central policy instrument. If the report were to mention India, it should make clear that the authorities did not consider their particular policy measures as capital controls. Instead, they were viewed as part of a regime of strict supervision over the domestic corporate sector's external borrowing. As far as non-residents were concerned, there were no restrictions on the flow of funds. The measures adopted by the Indian authorities were targeted precisely at the type of problem that had been observed in many southeast Asian countries. It also had to be noted that the Indian authorities were in the process of liberalizing, but at a deliberate and controlled pace.

The Chairman confirmed that if the report were to mention either China or India, the Director concerned would be asked to provide the appropriate language.

Mr. Yoshimura remarked that, while it was hoped that unilateral action by members could be avoided, such action was still within the rights of each member. The report should not give the impression that the Fund was condemning the unilateral measures taken by specific members.

The Chairman commented that the issue of condemning a particular country had not arisen. However, unilateral action was contrary to the spirit of the Articles of Agreement. Rather than stand by in silence, therefore, the Fund had to treat such action as serious.

Mr. Shields remarked that there were considerable problems with Box 3 of the architecture report, and suggested that it might be removed. He also agreed that the section on capital controls should allude to the experience of particular countries, but should then go on to discuss the issue in general terms without making an explicit or implicit judgement on those members' actions.

Ms. Lissakers commented that it was possible to comment on unilateralism without condemning any particular country. The report simply needed to state that unilateral action had increased the anxiety of investors, which may have contributed to the markets' volatility. As for the issue of capital controls, while the Fund should highlight its openness to reconsider the issue, the report on strengthening financial systems seemed to go too far in embracing capital and exchange controls. On reading select parts of the text, there might be an impression that the Fund had already endorsed the concept, which was not the case.

The Director of the Research Department and Economic Counsellor remarked that every member of the Fund exercised some guidance over capital flows, particularly on foreign ownership of select industries. In fact, a majority of the Fund's members, though not of the Fund's voting power, had significant capital controls in place. The Articles of Agreement did not give the Fund any jurisdiction to seek the removal of such controls, so the Fund could not simply state that it was opposed to controls in virtually all cases. That would not be coherant with the current state of affairs.

Ms. Lissakers commented that the Economic Counsellor's point highlighted the need to place greater emphasis in the report on the implications of disorderly reversals of capital account liberalization. On the issue of jurisdiction, Article VI, 3 covered controls over capital transfers, and so might warrant greater attention.

Mr. Yoshimura remarked that there had been an extraordinary series of events following the Hong Kong meeting, so the Fund could not say that no reversals of capital account liberalization were appropriate. The issue of whether such reversals were orderly or disorderly was somewhat subjective, and needed to be discussed further.

The Chairman stated that the staff would revise the documents to reflect the suggestions and comments by Directors.

After adjourning at 12:05 p.m., the meeting reconvened at 3:05 p.m.

3. ARGENTINA—REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors considered a staff paper on the first review under the Extended Arrangement for Argentina (EBS/98/160, 9/10/98).

The staff representative from the Western Hemisphere Department made the following statement:

> The following information has become available since the staff report (EBS/98/160) was circulated to the Executive Board. This information does not change the thrust of the staff appraisal.
>
> i. Preliminary national accounts data show that the economy continued to grow strongly in the first half of 1998. The rate of GDP growth for the first quarter, over the corresponding period of last year, was revised upward to 7.2 percent, while second quarter growth is preliminarily estimated at 6.9 percent. Investment remained strong, rising by 23 percent and 13 percent in the first and second quarters, respectively. Available indicators point, however, to a significant slowdown in the third quarter. In particular, industrial production in July–August is estimated to have risen by only 1.2 percent over the same period of last year.
>
> ii. Trade data for July showed a decline of 1.7 percent in exports (over July 1997), while the import bill rose by 11.4 percent. The 12 month trade deficit rose to US$5.7 billion from US$5.4 billion in June.
>
> iii. Through September 18 gross international reserves of the central bank declined marginally from their end-August level, to around US$24.4 billion. Commercial banks' liquidity requirements held abroad edged upwards to US$7.0 billion over the same period. Private sector deposits in the banking system have increased marginally since end-July. The share of dollar-denominated deposits in total bank deposits has risen by about 3 percentage points, to 55 percent.
>
> iv. The continued turbulence in international capital markets has resulted in a sharp increase in both the level and volatility of interest rates. During August and September, interest spreads on sovereign bonds fluctuated widely in the range of 900 to 1500 basis points, compared with just over 400 basis points in the first half of 1998. The interbank rate rose, however, substantially less, to around 9 percent in mid-September, from around 6 percent in midyear. Over the same period, the prime rate on loans denominated in pesos jumped by about 7 percentage points, to 15 percent; similarly, the rate on short-term treasury bills doubled, to 14 percent. The stock market index (MERVAL) has declined by about 40 percent since end-July.
>
> v. On September 9, the lower house of Congress passed the tax reform legislation. The version passed by the deputies, and now being considered by the Senate, narrowed somewhat the scope of the original proposal as it eliminated the proposed increases in excise taxes, and

maintained some of the VAT preferences that were to be terminated. However, by deleting the proposed lowering of duties on capital goods, the project would still allow a reduction of over one third in employers' social security contributions.

vi. On September 14, the government sent its 1999 budget proposal to Congress. The budget calls for no increase in federal primary spending, which would thereby decline by 0.8 percentage points in relation to GDP in 1999. The budget projects an increase in federal revenues of 4.3 percent (based on a projected GDP growth of 4.8 percent), but this forecast does not incorporate any revenue increases from the tax reform. The deficit is targeted to decline to Arg$2.65 billion (0.7 percent of GDP), in line with the program target.

Mr. Zoccali made the following statement:

Introduction

After more than a year since the outbreak of the crisis in East-Asia, and a global environment of increasing volatility in financial markets and more manifest deflationary forces, Argentina's macro-economic and structural framework continues to prove its robustness. Without downplaying the consequences impacting, in particular, on emerging market countries, my authorities are convinced that partly as a result of the lessons learned during the "tequila" crisis of 1994/5, the Argentine economy is now better prepared to withstand the turmoil buffeting globalized real and financial markets.

Firm program ownership, rooted in the more than seven year old currency board arrangement (CBA) and widespread structural reforms, that include a radical revamping of the role of the state and one of the most ambitious privatization drives in the world, have resulted in regained fiscal responsibility, virtual price stability and a domestic environment propitious for strong investment and sustainable real GDP growth, averaging 6.1 percent p.a. during the last seven years.

The Fund's support throughout this critical period for Argentina's full reinsertion into the world economy is particularly acknowledged by my authorities. Moreover, they consider the present precautionary EFF Arrangement a centerpiece of their proactive strategy for buttressing market confidence and reducing the vulnerability of the economy in the face of high market volatility and the normal uncertainty associated with a run-up to presidential elections, scheduled for the second half of 1999. This provides the clearest possible signal of commitment to a consistent medium-term policy framework. It should also be noted, however, that all political parties are behind the market-based orientation being pursued despite some attempt at differentiation in areas that do not pose risk to continued macro-economic discipline.

Since staff's report for the first review under the Extended Arrangement for Argentina is well focused and macro-economic policies have been kept strictly in line with the intentions of the program, I will refer only to some developments that my authorities consider worth highlighting in the current circumstances.

Recent Developments and Prospects

Preliminary figures indicate that real GDP growth in the second quarter, on a year over year basis, reached 6.9 percent, following a revised first quarter number of 7.2 percent. This was buoyed by increases in exports and investment of 15.7 and 12.6 percent, respectively. Consumption growth, on the other hand, has been moderating in recent months, reflecting a more cautious attitude of consumers. The widening trade balance through July, to US$ 2.9 billion, is explained primarily by the continued demand for imports of machinery and capital goods and a drop in export prices of some 9 percent during this period. The latter obscured a hefty 13 percent increase in export volume, led by exports of manufactures of industrial origin particularly to Nafta. The current level of Argentina's total foreign trade is now four times that registered in 1990, while the trading pattern already points to a virtuous circle of private investment enhancing productivity and further supply-side responses that ultimately underpin external viability.

Despite this upside potential, the relatively strong fundamentals, the absence of any manifestation of asset/price inflation and Argentina's low level of short-term indebtedness, the country has clearly not been immune from the spill-over effects of the expanding global economic crisis. Interest rates for prime borrowers in the domestic market have doubled in the last month and equity and bond prices weakened mirroring the more generalized sudden change in risk perceptions and unfavorable developments elsewhere. Interbank call rates, on the other hand, have eased somewhat and stand around 9 percent p.a. Consequently, my authorities have scaled back their GDP growth projection for the year as a whole to 5.3 percent. Barring a major prolonged disruption in access to international financial flows, however, they remain heartened by an underlying sentiment of optimism regarding Argentina's medium-term prospects and clear manifestations of lower domestic vulnerability. Suffice it, in this regard, to point to the turnaround of 1.5 percent of GDP in the primary fiscal balance since 1996, to the rise in bank deposits and international liquidity of over US$ 10.2 and 5.2 billion, respectively, since last October, and to the much improved liquidity cover for a more consolidated domestic banking system as a result of restructuring and the increased participation of foreign financial institutions.

In the structural area, staff finds that progress is being made and that most benchmarks for the first review had been met satisfactorily, although progress in labor market reform was seen as disappointing. In this regard, the extent of the structural reforms already adopted with widespread sectoral support to improve the functioning and flexibility of domestic markets should be kept in mind. The most recent labor market legislation contains some important elements. In the first place, it was approved by Congress rather than through presidential decrees, evidencing the willingness of Congress to tackle important issues in a pre-electoral period. Secondly, it is understood by all the parties that the process of labor market reform is by no means concluded. The authorities are advanced in the preparation of complementary legislation to replace the current system of severance payments and eliminate existing special labor statutes. They will also shortly be implementing regulations for a more flexible legislation governing small and medium-sized enterprises (PYMES). Most importantly, the new labor legislation allows for a significant reduction in dismissal costs of between 30 and 40 percent, depending on the length of employment. The principal shortcoming of the new law: the "ultraactividad" clause that extends contracts indefinitely in the absence of agreement on a new contract is not seen by my authorities as having a material impact on labor relations or, more importantly, labor costs as collective agreements in Argentina are basically circumscribed to base wages and salaries leaving other important aspects such as functional organization and work procedures to be dealt with at the enterprise level. The minimum remuneration levels established in collective agreements, in practice, are significantly lower than actual salaries. Finally, temporary employment contracts were exempt from labor taxes and social security benefits. This gave rise to distortions in the labor market associated with the incentives for high rotation which, in turn, impacted negatively on the level of frictional unemployment and on the formation of human capital. The net effect of their elimination should be seen rather in the context of Argentina's still large informal sector and the reduction in labor taxes that will be made possible, in a revenue neutral manner, by the draft tax reform bill which is in final reconciliation stage in the Congress.

Fiscal performance continues on an improving trend. Moreover, if allowance is made for the shift of contributions to the private pension system, the federal government balance would already register a surplus. Tight expenditure control is being accompanied by a major effort to improve tax administration and reduce evasion. A robust revenue performance in June and July, centered on the income tax and VAT receipts has continued in August. In explaining the somewhat weaker than projected revenue growth through June, two factors stand out: the more rapid use of accumulated past VAT and other tax credits and the special fiscal treatment granted taxpayers located in vast areas of the Northeast of the country affected by serious floods. The latter alone represents some US$ 330 million (0.1 percent of GDP) of deferred tax revenue. My authorities' commitment to maintaining fiscal discipline has recently been reinforced by the mandatory cut in budgetary appropriations for 1998 of US$ 1 billion, equivalent to 0.3 percent of GDP, and by the indefinite postponement of new large infrastructure initiatives. Similarly, adding to the cumulative effect of the effort undertaken over the past year to strengthen the federal public revenue administration, is the authorization to incorporate some 500 tax lawyers to expedite collection of sizable overdue taxes. Finally, to strengthen intertemporal fiscal solvency my authorities have improved the term-structure of the public debt and their liability management practices and introduced a multi-annual budgeting process with the 1999 budget recently presented to the Congress. The new budget aims at a significant decline in primary spending and at a federal primary surplus of 1.3 percent of GDP, implying a contractive fiscal stance on a cyclically adjusted basis. The strengthening of the budgetary process is being accompanied by accelerated consideration in the Congress of the major tax reform initiative mentioned earlier, advanced with FAD assistance. A “fiscal responsibility law” which imposes the obligation of maintaining a current balance, limits the overall federal government deficit, establishes an anti-cyclical stabilization fund, and strengthens fiscal transparency was also recently approved by the Senate.

Regarding the provincial finances, staff have clearly outlined the authorities’ strategy to bring market discipline to bear, following the record built up in recent years of “no bailout” which contributed to the fiscal adjustment efforts undertaken by most provincial governments since 1995. The recent actions by the Province of Buenos Aires to rationalize expenditure in the area of public works and acquisition of equipment in 1998, to avoid having to resort to market financing, mirrors also the more rapid of key subnational jurisdictions to the changed economic environment.

Perhaps the most critical area for assessing the sustainability of the Argentine economic program, at this juncture, is the soundness of its financial system. Liquidity and capitalization rates are very high by international standards; centered on a 20 percent liquidity requirement on all liabilities and not just on bank deposits. International reserve cover exceeds 100 percent of the monetary base. Systemic liquidity is further buttressed by the existence of contingent repo lines with major international commercial banks, equivalent to 10 percent of total deposits. At the same time, systemic credit risk has been decreased by the establishment of a real-time gross settlement system for large interbank transactions and two private automated clearing houses for small value transactions. Moreover, the share of foreign banks in the domestic banking sector increased from 16 percent in 1994 to over 40 percent currently contributing further to the perception of market participants that the system is capable of successfully weathering the pressures that may arise from the present crisis. The clearest evidence of confidence in the system may be found in the behavior of depositors. Keeping in mind the decline in domestic deposits of 18 percent in less than 3 months following the “tequila” crisis, these continued to rise rapidly through the first semester. More recently, they stabilized at slightly over 20 percent of GDP. Argentina’s still relatively low level of monetization serves to highlight the potential for the further development of its domestic financial market. In any event, what is important is that the process of financial consolidation is taking place in the context of an open economy, a well established structure of market incentives, transparency in operations and strong financial sector supervision. In this regard, the BASIC system of prudential supervision, which includes, among others the obligation for banks to release an independent credit rating and to publicly issue debt obligations, amounting to 2 percent of total deposits, is being applied. Credit risk information is also disseminated on the Internet through a website administered by the central bank. Finally, the recent confirmation by the Senate of the current governor of the central bank for a new term of six years, provides additional reassurance that the thrust of policies in the monetary and prudential areas are broadly supported and will be maintained.

Lastly, as a further response to the turmoil in financial markets and, in particular, the uncertainty surrounding access to foreign capital, my authorities are advancing in the negotiation of a financing package involving the IBRD, the

IDB and domestic institutional investors,. Its aim is to reassure creditors of the public sector´s ability to meet its financial obligations through the first quarter of 1999, amounting to US$ 5.7 billion, without resorting to external market borrowing, selling the government's 20 percent stake in YPF, the privatized oil company, or using the precautionary EFF arrangement with the Fund. This prompt reaction, in the framework of predictability offered by the CBA, builds on the preventive mechanisms for liquidity supplementation which my authorities put in place since the "tequila" crisis. In this regard, the program of diversified, anticipatory borrowing has served to provide a financing cushion covering obligations of about one quarter. Moreover, auctions of short-term treasury bills and notes are continuing on the basis of the pre-announced schedule for the year and with the aim of more fully establishing the domestic money and capital markets, and basically rolling over the relatively small amounts of maturing short-term debt. This week's release by Standard & Poor´s of its latest review of the Argentine economy, maintaining its stable outlook and affirming its rating for short-term domestic debt (investment grade) as well as that for long-term unsecured and foreign currency denominated debt, reinforces my authorities' confidence in the future prospects of the economy.

Mr. Shaalan made the following statement:

This is a well-written, pointed, and a concise staff report that clearly identifies the main challenges facing Argentina in the period ahead. The currently uncertain turbulent financial markets make this discussion particularly timely. In spite of strong and credible economic management in some emerging market economies, the not-too-discriminating financial market players can at times react in a manner that complicates economic management. However, as the case of Argentina shows, the country's most favorable economic performance has to a considerable extent shielded the economy from the contagion phenomenon of the past year.

As I am in agreement with the staff analysis and recommendations, I can be brief.

The major areas identified by the staff as meriting the authorities' attention in the period ahead center around stemming the deterioration in the current account deficit and addressing certain key structural areas in the fiscal and labor markets. These areas are clearly interrelated and meaningful action will be self-reinforcing. Here, we note that Argentina has, since 1991, put in place an exchange regime that has served the economy well--it has weathered the Mexican crisis as well as the Asian/Russian crises reasonably well. It is therefore important in today's financial environment to pursue precautionary measures dictated by the existing uncertainties to safeguard the gains of the past.

Given the projected increase in the current account deficit to 4.4 percent in 1998 in the context of an uncertain financing environment, weak prospects for financing the relatively heavy debt service payments, as well as the domestic political environment, a deficit of this magnitude should not be viewed with complacency. In this regard, we commend the authorities for the measures taken to tighten the fiscal stance in 1998. However, prudence would, in our view, call for serious consideration of tightening fiscal policy further in 1999, including in particular at the provincial level. I underscore this strategy in view of the potentially adverse impact on the budget of weaker economic activity and higher interest payments than is now forecast.

The increased productivity that has been accompanied by introduction of the Currency Board has certainly been an important pillar in the country's ability to maintain its competitiveness. It is important to maintain the momentum of productivity growth. In this regard, skill enhancement and labor flexibility can play an important contributing role. While it appears that the labor reform agenda is facing difficulties in Congress, we encourage the authorities to pursue vigorously the proposed complementary legislation in the labor market. This should be reinforced by the tax reform proposals which, hopefully, will not only enhance the revenue base but will also increase the scope for reducing social security contributions and providing more budgetary resources for further development of human resources, thereby enhancing flexibility in the labor market and with continued productivity improvements.

With these remarks, we fully support the completion of the first review.

Mr. Mori made the following statement:

We support the proposed decision for the completion of the first review under the extended arrangement for Argentina. Despite a difficult external environment, the authorities have been successful in maintaining a remarkable macroeconomic performance under the stabilization and reform program. All performance criteria under the program were observed in March and June.

The key element of macroeconomic management has been the tight control over public spending. This policy has enabled the federal government to meet the performance criteria, even in the event of a revenue shortfall. As a deceleration in output is expected for 1998 and, hence, a further reduction in tax revenue may occur, the authorities are correct to cut the budget for the second half of the year. While the effort to reduce expenditures is necessary, there are limits to this policy in the current fiscal structure, especially regarding the need to preserve social spending programs as far as possible. Therefore, over the medium term, the tax reform proposal presented to Congress—as well as the multi-annual budgeting process—remains essential to provide an improved mechanism to support the government's efforts to promote sustained fiscal consolidation and economic efficiency.

We share the concern regarding the public finances of the provinces. Although measures to strengthen market discipline on provincial borrowing may avoid potential difficulties for macroeconomic management, there is also the need for a well-designed institutional framework to ensure the involvement of the provinces in the overall fiscal adjustment effort. The tax reform seems to address this problem with changes in the formula for revenue-sharing with the provinces to ensure broad maintenance of the current shares of the federal and provincial governments in the total revenue of taxes and social contributions.

In the context of currency board system, the Argentine economy has shown the effectiveness of this policy framework in improving competitiveness basically through increasing private sector efficiency and reducing domestic costs. With price stability, private investments have contributed to enhanced productivity and improved competitiveness, as indicated by robust growth of export volumes. However, these efforts on the domestic front have been made difficult by a deterioration in the external conditions, as reflected by subdued world demand and weak commodity prices.

This adverse external environment demands increased wage and price flexibility. The new labor market law approved by Congress represents a step forward in improving efficiency in that market, but it would benefit from complementary actions in other areas. The proposed tax reform law will also contribute to reduce labor costs by generating additional revenue to finance a cut in employers' social security contributions. Another component is the new law for small- and medium-size enterprises, which would increase labor flexibility. Moreover, investment in human capital needs also to be kept as a high priority as it would contribute to promote a better match with the job skills demanded. The authorities' plan to raise the number of years of mandatory basic general education and restructure secondary education is consistent with the overall policy of enhancing economic efficiency.

The case of Argentina highlights the difficulties imposed on macroeconomic management by high variability in external credit conditions. This effect is more notable in the Argentine economy to the extent that monetary conditions are determined basically by external financing availability and constraints, because of free movement of capital in the context of currency board framework, though a similar path has also been observed to a certain degree in other emerging economies with a more flexible exchange rate. Within the framework of the convertibility regime, a tightening of external financial availability would be reflected in higher domestic interest rates and a downturn in private sector demand, while an expansion in external credit would stimulate domestic demand. In the event, from 1994 to 1998, GDP growth has fluctuated strongly: a very high growth rate of 7.4 percent in 1994 was followed by a sharp contraction of 4.5 percent in 1995 as a result of the Mexican crisis; recovery, in turn, occurred rapidly with a growth rate of 4.2 percent in 1996, accelerating further to 8.0 percent in 1997; with the Asian crisis, real GDP growth is expected to moderate to around 5.0 percent in 1998 reflecting tighter financing conditions, while projections for 1999 seem, at this stage, to be difficult to assess.

This high volatility in GDP growth caused primarily by shifts in capital flows has generated undesirable uncertainty for economic agents. While credit expansion often occurs gradually, a contraction can occur suddenly resulting in major disruptions. Fiscal policy, in this context, is less effective in smoothing GDP growth as this instrument presents certain inflexibilities in the short-run. The volatility of GDP growth not only on a year-to-year but even on a quarter-to-quarter basis has been so high that it has made the outcome of the fiscal and external current accounts less predictable. These uncertainties in the behavior of macroeconomic variables complicate, for instance, budgeting and investment decisions in a longer-term perspective. These episodes underscore the need for the international community to work on a framework of cross-country financing that would assure a more stable flow of resources to support a country's macroeconomic stabilization and structural reform efforts.

Mr. Keshava, speaking on behalf of Mr. Sivaraman, made the following statement:

The excellent staff report, together with the useful buff from Mr. Zoccali, provides a comprehensive account of the current economic situation in Argentina. Our chair would like to commend the authorities for their macroeconomic management and commitment to accelerate the process of structural reforms and particularly the perspicacity of the Argentine Senate in approving a "fiscal responsibility law". We hope more countries will follow this example. The Argentine economy has also benefitted considerably from the efforts of the authorities to create a strong and resilient financial system, by strengthening, inter alia, its banking system in recent years. These efforts have yielded positive results as evidenced by growth in bank deposits despite current turbulence in international financial markets. I fully agree with the assessment of Mr. Zoccali that the Argentine economy is now better prepared to withstand the turmoil affecting globalized real and financial markets. The present precautionary EFF Arrangement is also timely in signaling a sound medium-term policy framework for the country in the current uncertain conditions. As I am in broad agreement with the staff appraisal, I would make a few brief comments.

In the area of structural reform, the staff has expressed disappointment with the new labor market reform law as it may reduce, rather than increase, labor market flexibility in certain respects. However, it must be noted that the new law has been approved by Congress rather than through presidential decrees. The effort of the authorities to build consensus on sensitive issues should be appreciated and it is advisable to pursue a course of action that can be sustained in the long run. The authorities have shown their willingness to pursue complementary legislation in the labor market area and they should be given sufficient time to build consensus on these important issues.

I am satisfied with the fiscal stance maintained by the authorities so far. A shortfall in revenue in the first half of the year has been matched with expenditure restraint. It is hoped that the improvement recorded in revenue performance in the period June - August, 1998 will be sustained and the authorities will persevere with their efforts to strengthen tax administration even further. I welcome the introduction of a comprehensive tax reform proposal in the Congress which aims at broadening the bases of the income tax and the value-added tax and reduce the scope for tax avoidance and evasion. The authorities are encouraged to continue with their efforts for a constitutional reform of intergovernmental fiscal relations, which would strengthen the provinces' own revenue-generating capacity.

The external current account deficit, which had increased substantially in 1997, has continued to deteriorate in 1998 and is expected to be higher than the level forecast in the program. Though Argentina has had no difficulty in the past in obtaining external financing, the authorities should carefully monitor the current account situation and external market conditions. There is a source of concern in the high public sector external debt service at 39 percent even though it has been declining. The high debt service is obviously a result of high cost of external commercial borrowing. The current account deficit has also been increasing and we would advise the authorities to take effective steps in these two areas.

With these remarks, I support the completion of the first review under the extended arrangement.

Mr. Zamani and Mr. Awang submitted the following statement:

We would like first to thank staff for the comprehensive report on Argentina. The Argentine authorities should be commended for the remarkable progress made in various sectors of their economy. The achievements should impress many of us and certainly should impress the market as well. At least, one sign of that was shown by the reaffirmation of Argentina's investment grade rating by Standard & Poor, something that become increasingly rare in these days. That reaffirmation, granted at the midst of pressures on the region, should contribute to efforts in convincing the market. It is hoped that the not-too-discriminating financial market players should be able to appreciate the performance of Argentina and should assess properly the long term benefits of investing in this country.

The fiscal performance is one of the many achievements that Argentina has made. It has shown an encouraging trend of improvement in 1997 and 1998. Mr. Zoccali in his Buff has indicated that the fiscal performance in the last two months has shown further improvement. In fact, looking from one approach, Mr. Zoccali has indicated that the federal government balance could register surplus. These efforts in maintaining a firm and consistent fiscal stance are indeed welcome. On the revenue side, the authorities are commended for their intention in strengthening the tax administration. On the expenditure side, the authorities' efforts in containing expenditure to ensure compliance with the fiscal ceilings deserve our compliments as well. However, the country should maintain its cautious stance to weather the danger of contagion and therefore are encouraged to stay on course.

Turning to the financial sector, there are things that deserve our mention as well. Contrary to the experience of the "tequila" crisis in 1994 in which the banking system suffered deposit withdrawals up to 18 percent of their deposits, the country now seems to enjoy an increase in deposits which has stabilized at around 20 percent of GDP. At the same time, the banks' capital adequacy ratio has exceeded the norms instituted by BIS by a large margin, thus placing the Argentine's banks on a safer ground from the solvency standpoint. The list still continues, such as the 20 percent liquidity requirement, increased foreign assets of banks as well as the increased share of foreign banks which now accounts for 40 percent of the total assets of the banks.

On the structural developments, it is encouraging to note that remarkable progress has been made in most structural areas and most targeted benchmarks have been achieved as well. These include the tax administration, budgeting and public expenditure management, social spendings and judicial system. The labor market reform had also shown a significant improvement, particularly in the creation of new employment opportunities since the adoption of a new law that was approved by Congress in early September 1998. Further efforts seems justified, however, including the enactment of tax reform that could contribute towards further improvement of the labor market.

With all these achievements, it seems "puzzling" to us that markets still could not differentiate Argentina fully. Some indications have shown the spill over of the crises occurring elsewhere. The spread in Brady Bonds widened to as high as 1600 points at the end of August which in turn affected the domestic interest rates. Therefore, I share Mr. Shaalan's view that despite their many achievements, the authorities need to pay a greater attention on what can be perceived as the weakness. One of them is the deteriorating current account deficit. Even though there seems to be a plausible explanation on the increase in the deficit, yet it may be prudent to maintain a relatively strong external account. Therefore the call for maintaining a conservative fiscal stance is again in order to help secure the necessary reduction in the current account deficit.

The authorities' preparation in weathering the turmoil, if it happens, is commendable. The current arrangement with foreign banks in the form of contingent repo facility, a negotiated financing package with multilateral institutions and other institutional investors as well as other precautionary actions now in place have increased the capacity of the country to withstand the pressure. Reassurance from the Fund recently that was stated, reaffirmation from the Standard & Poor as well as continued supports from other agencies could be expected to contribute significantly in restoring the confidence of the market.

With these remarks, we fully support the completion of the first review and wish the authorities success in facing the challenges ahead.

Ms. Lissakers made the following statement:

During our most recent discussion of Argentina in February, we emphasized the importance of Argentina's strong, consistent and forward-looking macroeconomic and financial policies, which will insulate the country from the worst effects of the financial crisis. While Argentina has certainly not been immune from the general worsening of market conditions for emerging markets over recent weeks, it is clear that the fundamental strength of policy implementation under the convertibility plan has continued to serve as a strong buttress against a more severe financial fallout.

We concur with the staff's assessment regarding the generally strong performance under the precautionary program. Progress on fiscal consolidation, including the additional expenditure measures taken to address revenue shortfalls and the decision to put off large new capital expenditure projects, has demonstrated the authorities' continuing commitment to the program, including in the run-up to next year's election. Similarly, the recent passage by the lower house of the pending tax reform legislation will be an important step toward improving the overall efficiency of the tax structure.

The overruns on provincial balances is certainly a concern, although the authorities appear to be taking steps to address this problem both in terms of reinforcing market discipline and enhancing the dialogue between the central government and the provinces on overall macroeconomic objectives. The proactive measures the Argentine authorities have taken in terms of debt management, including preborrowing and maintenance of limited short-term exposure, helped to mitigate potential concerns arising from the significant current account deficit and the relatively high external indebtedness of the country during a period of volatility in international markets.

The precautionary increases in liquidity requirements for banks, increases in the contingent repo facility, and the continuing enhancements in financial sector supervision have reinforced confidence in the banking sector and the strength of the exchange rate regime. I think the measures that have been taken with regard to the banking sector are indeed, as one looks back over recent years, very, very impressive, and that includes the willingness to really open up the sector to foreign participation, which has served the country well and improved the performance of the whole banking sector. I think there is a lesson there for other countries which have weaker banking sectors.

I note the current efforts, which I think are also very important, to improve the reporting regarding underlying currency maturity positions of banks, and also the enhanced reporting of the off-balance sheet exposures, which is again a model that other countries, including many industrial countries, could emulate. I am glad to see that, in cooperation with the Fund, the Argentine authorities are also improving the quality and timeliness of information on the external exposures of the nonbanking sector, which, as we have seen, can also be something of a booby trap for countries with open capital markets.

Just one more note to add to the list of the many things that the authorities are already doing with the financial sector, I wonder if Mr. Zoccali could tell us what they are doing about the Y2K problem and whether there is an effort to encourage the private sector, in particular the banking sector, to prepare for that. I would say in general that, while many emerging market countries do not have the sort of legacy systems, i.e. aging computer systems, that countries like the United States and many European countries may have and which have imbedded in them the potential for a major difficulty come midnight December 31, 1999, it is an issue that should not be downplayed.

The Federal Reserve has been very actively surveying the investment community in the United States about this issue. Their attitudes toward third countries, is that there is increasing anxiety about what they call the "shadow Y2K problem," which is that foreign investors may pull back from countries that they perceive--rightly or wrongly--as not having addressed the problem and not having prepared for any technical difficulties, and that they will hedge themselves by simply reducing exposures and reducing financial interaction with those markets. That could create, in and of itself, a major difficulty. I think it is something that certainly my authorities take very seriously. I am not particularly pointing to Argentina, but really every member country should take this seriously, and I am very glad that the Fund has organized a seminar on this for the Annual Meetings. I hope every member country will send some experts in this area. As I say, I am not particularly highlighting Argentina; it is just an opportunity to raise the issue.

To return to Argentina specifically, given the volatile climate and the uncertainty of external financing for emerging market countries, there is certainly significant downside risks associated with our projections for interest rates and the growth rate. There may be a need for sharp adjustment; at least one cannot rule out that possibility. Indeed, the growth projections of 4.8 percent in the 1999 budget seem quite optimistic to us. In this context, the precautionary arrangement with the Fund serves as a valuable stabilizer for the authorities' medium-term reform efforts, and I think a very important signal of the Fund's continued support for these efforts and our readiness to provide financial assistance should external pressures increase substantially.

The near-term reforms anticipated under the program are substantial, including continued fiscal consolidation, final passage of the pending tax reform package, progress on the complementary labor legislation and continued strengthening of the financial sector, including through steps toward privatization of Banco Nacion. These measures will help to bolster the already substantial credibility of the reform program, mitigate the uncertainties inherent in the run-up to next year's election, and enhance the underlying flexibility and competitiveness of Argentina's economy.

Nonetheless, additional actions may be required and, in particular, the authorities should stand ready to take additional fiscal measures as they have this year to address any adverse budgetary impact of a downturn in key projections and, as the staff suggests, to facilitate any required current account adjustment. The current account is large enough to give one pause, given today's market climate, even taking into account the underlying structural strength of the Argentine economy. Given the uncertainty about growth in Brazil and the importance of that market, there has to be a cautionary tone to the external situation for Argentina and that is one of the reasons we are perhaps less optimistic than the authorities about the growth outlook for next year.

I just have one final point on the labor reform package recently passed. I agree with Mr. Zoccali's point regard the distortions associated with large-scale temporary labor contracts and their exemption from labor taxes and Social Security benefits. The use of such contracts was indeed a second best solution for reducing Argentina's high unemployment rate and bringing more workers into the formal economy. But I think an important opportunity has been lost to improve the efficiency of collective bargaining and reform regulations related to the probation periods in the current legislation. These steps would have served as an important foundation for addressing unemployment and promoting the productivity improvements Argentina will need to stay competitive. In this context, the forthcoming proposed complementary labor legislation and finalization of a balanced tax reform package that allows for a reduction over time in labor taxes are all the more important.

Mr. Shields agreed with Ms. Lissakers comments regarding the Y2K computer problem, especially the markets' worries about the state of preparation in various emerging market economies. More generally, he also agreed with all of Ms. Lissakers' points raised in her intervention.

The Acting Chairman wondered whether the Y2K computer problem explained why the contagion continued to spread.

Ms. Lissakers pointed out that the *Wall Street Journal* had written an article in its September 22, 1998 issue on the contagion problem. The article had started with a description of how the hedge funds had incurred heavy losses and how investors had reacted to that.

Mr. Grilli made the following statement:

I note with satisfaction the progress made by Argentina since 1995, and the success of its monetary and fiscal authorities in coping with the adverse consequences of the "tequila" crisis and the fallout effects of the current financial crisis. The authorities have shown a great ability to adapt to changing circumstances, which has helped the economy absorb the pressures that have emerged without incurring serious disruptions. In particular, the strict adherence to the requirements of the currency regime and the improved conditions of the banking systems have been crucial. Further, the higher level of liquidity and reserves provide a much stronger cushion to better absorb pressures as they develop. The behavior of depositors also displays improved confidence in the banking sector. These are impressive results, and markets seem to have taken notice.

If one compares performance across countries, one sees that markets have had different reactions, partly owing to the soundness of fundamentals and the record of past and current macromanagement of various situations. Although this differentiation is not always precise, it is nonetheless still there. Argentina, while affected by financial volatility over the past two months, has performed relatively well, and its policy stance has been noted by markets. The firm commitment of the authorities in pursuing stability-oriented policies has paid dividends in terms of growth and access to world financial markets, although this access has declined substantially over the recent past. Even if constrained by a deteriorating global environment, the maintenance of growth prospects at around 5 percent, the positive flow of foreign direct investments, and the public debt management operations conducted so far, are containing the country risk and are being recognized by financial markets. The authorities have reacted promptly to the financial crisis by adopting various fiscal measures and by recently negotiating a financing package, which would allow external debt to be refinanced over the next several months.

We are impressed by the timeliness, courage, and the wisdom of these initiatives, and support the authorities in maintaining a firm ownership of their policies. At the same time, we would encourage them not to lose momentum, patience, or trust, given the serious risks that remain over the near term, such as deteriorating world economic conditions, falling commodity prices, uncertainties linked to the elections next year, and perceived lags and frictions in the implementation of structural reforms. These circumstances require constant attention by policymakers and continued determination to make the right choices at the right time, and also the knowledge that these measures will have the support, if needed, of the international community. Given that there is a Fund-program, the IMF is part of that knowledge.

Over the near term, the more important effects on the Argentine economy are the implications of the international financial impasse. The still high external debt level makes Argentina vulnerable to shifts in international portfolio choices and to further possible squeezes of capital flows. Even if not totally disruptive, the consequences of the recent financial turmoil in Latin America have contributed to push up interest rates, increase spreads, erode financial wealth, and to undermine business confidence. As a result, the economy seems to be slowing down. By looking at the breakdown of GNP, some elements of concern emerge from the decelerating path of investment and increasing level of inventories. Most forecasters believe that there will be a substantial slowdown in the second half of 1999. The Argentine authorities are more optimistic, and I hope that they are right. Slower growth may negatively impinge on labor markets; this is an issue that needs to be underscored.

On the labor market, there is concern over the limited progress made in reducing unemployment, which still remains high at 13 percent, as well as on the skepticism shown by the financial markets on the effectiveness of the new reform. In fact, the net positive effects of the reform are not expected to match the negative effects of the business cycle on employment. Doubts have also been expressed as to the net effect in terms of flexibility introduced or left in the market. Mr. Zoccali makes the point that the abolition of temporary employment contracts eliminates the source of distortion associated with the incentives for high rotations that the previous system had. Although this is a valid point, I wonder if permitting their continued growth would not have introduced higher flexibility in the labor market with substantially positive effects. Similar experiences in other countries with high unemployment levels show that progress over the medium term may be substantial. Under the new reform, the wage bargaining system remains far too centralized. Apart from its effect on wage dynamics, the maintenance of an "ultraactividad" clause represents an element of rigidity. Without an expected boost to employment deriving from either labor market reform or from a better than expected cycle, it is of even greater importance that the ongoing fiscal reforms meet the objectives in terms of the reduction of the social contribution. A rebalancing of the relative price of labor is important at this stage. Any political arrangement which compromises this result would be detrimental to the efficiency gains expected from the fiscal reform. In addition, it should be recalled that the worsening of employment conditions would entail possibly negative implication for growth itself.

On the fiscal front, the progress achieved so far by the authorities is impressive, especially with regard to the control of public expenditures. Several factors have contributed to establish a sound public finance framework, such as the containment of the federal deficit at a low level, the public debt management initiative pursued to meet borrowing requirements cheaply and smoothly, improvement in tax administration, and the introduction of multi-year budgeting. Notwithstanding all these initiatives, the short-term prospects are complicated by the prospect of slippages on the revenue side because of weaker than expected growth. The retrenchment measures adopted by the government provide some room for maneuver to cope with potential slippages in 1998. However, some risks remain in 1999 when presidential elections will be held. Although the authorities' commitment to fiscal discipline is not being questioned, the worsening global environment, the domestic uncertainties coming from the presidential elections, and the delicate balance between federal and state governments requires strict containment of public expenditure and continued credibility of fiscal policies.

We believe that Argentina, by continuing to act in a forward-looking, prompt, and courageous way, can navigate successfully through the rough financial waters that one can expect in the rest of 1998 and 1999. Of course, they obviously have to watch for changes. We wish the authorities good luck in their endeavors..

Mr. Guzmán-Calafell made the following statement:

The merits of an efficient management of economic policy are clearly reflected in the evolution of Argentina's economy over the last three years. Output growth showed a rapid recovery from the 1994–95 crisis, and is expected to register an average annual rate of growth of about 6 percent in real terms in the period 1996–98. Simultaneously, inflation has remained very low, private sector deposits in the banking system have grown rapidly, export volume has registered a healthy expansion, and so on. The Argentine authorities are to be commended for this impressive performance.

Like other emerging markets, Argentina has been affected by the turbulence observed in recent months in the world economy. But I fully share the authorities' view that Argentina's solid fiscal position, strengthened banking sector, and strong commitment to the currency board have increased substantially its capacity to weather these shocks.

Notwithstanding revenue shortfalls, the strengthening of the fiscal position has continued during 1998, and I agree that the projected overall deficit of 1 percent of GDP for this year is appropriately tight. While I share the staff's concerns on the expected overrun of the provinces' aggregate deficit in 1998, I believe the authorities are right in trying to tackle this issue through market discipline. I also see merit in the staff's suggestions to reinforce these efforts through dialogue and suasion. The authorities' budget targets for 1999, incorporating a fiscal deficit of 0.7 percent of GDP, should contribute to preserve macroeconomic stability. However, the orientation of next year's fiscal policy will need to respond to the constraints resulting from the evolution of the current account deficit, and the availability of resources to finance it. Here the picture is mixed. On the one hand, I take the point that the economy is already decelerating and that political uncertainties and tighter external financing conditions are likely to reduce the size of the deficit. But, on the other hand, the risks stemming from the possibility of further terms of trade shocks must not be underestimated, particularly in light of the strong dependence of the external sector on commodity exports. In addition, export demand may be affected adversely by the deceleration of economic activity in major trading partners. Under the exchange regime in place, and with uncertain prospects in international financial markets, great prudence in the management of public finances is essential, and the authorities must stand ready to adjust fiscal policy as needed to face these challenges. From a longer term perspective, the promotion of domestic savings is perhaps another area where additional efforts should be made to maintain the current account deficit within sustainable levels. As evidenced in table 1 in the report, national savings have increased only marginally since 1995 and no significant change is expected in the medium term. I would appreciate some additional staff views in this regard.

Policy developments in the monetary area are encouraging. I welcome the authorities' emphasis in strengthening the financial system and maintaining adequate margins of bank liquidity to face potential problems. Mr. Zoccali's useful buff statement provides a clear picture of Argentina's efforts in this area. I am also glad to see that the authorities are following closely potential maturity mismatches in banks' on- and off-balance sheets. The strong growth of private sector deposits is an indicator of confidence of economic agents in the domestic banking system. It is worth to point out in this respect the staff's projection that these deposits will increase by about 20 percent in 1998 despite the uncertainty resulting from the external shocks. On the other hand, I note that deposit growth is explained to a significant degree by the increase in foreign currency deposits, and I would like to know if the staff sees any risks from this development.

I have little to add to the staff's comments on external policies. I agree that external competitiveness remains appropriate and I welcome the implementation of trade policy in line with commitments under the program. I would only note that I fully share the staff's view on the importance of completing quickly the surveys on the foreign assets and liabilities of the private sector. In the face of recent experiences, an adequate assessment of the possible risks linked to the exposure of the non-financial public sector is essential.

The efforts of structural reform under implementation in Argentina are remarkable. Unfortunately, the authorities are facing Congressional opposition for some of the reforms, and the failure to obtain approval for all the labor market proposals presented to Congress is especially worrisome since unemployment is currently one of the main problems affecting the economy. Although the unemployment rate has declined significantly during the last two years, it remains at very high levels, and there is a risk that unemployment will rise again if the economy decelerates significantly in 1999. As explained in the report, the authorities are working on complementary legislation to create a severance pay fund and to allow the phasing of the special labor statutes in some sectors. I welcome these efforts, but I would like to have more details both on their relative importance in reducing unemployment and on the prospects for political support for these measures.

With these comments, I congratulate again the Argentine authorities for their skillful implementation of economic policy and I wish them every success in their endeavors to face the current uncertainties and consolidate the progress made to date.

Mr. Kwon made the following statement:

I am extremely impressed by the strong and consistent efforts made by the Argentine authorities to reform their economy, and I congratulate them for their ongoing commitment to a strong policy package. As the staff notes in the appraisal, the authorities have made efforts on all fronts to strengthen their economy and keep the program on track, despite the negative effects of the Asian and Russian crises. I generally agree with the staff's analysis, but would like to highlight a few points.

On fiscal policy, I would like to acknowledge and commend the authorities for their commitment to implement important second generation fiscal reforms, such as setting a three-year fiscal balance and expenditure targets, adopting the Fiscal Responsibility Law, and strengthening public expenditure management. These changes highlight the growing sophistication of Argentina's approach to fiscal management, and should pay dividends both in terms of market stability and improved economic performance.

On the aggregate fiscal picture, it is somewhat disappointing that the mission was not able to discuss the fiscal outlook in more detail. I agree with the authorities that growth is likely to moderate significantly in 1999, but it would have been useful to get a sense from the staff of just how much further they expect growth to slow. Does the 4.5 percent growth figure in the program remain valid? If not, then why have the authorities indicated that they do not consider that there is a need for further fiscal tightening beyond that already contemplated in the program? Presumably, this is in effect a further fiscal tightening on a cyclically-adjusted basis than what was originally envisaged under the program. It is unclear from the staff report whether the staff believes that a 0.7 percent deficit target for 1999 is achievable, even under current growth forecasts, with the steps that the authorities have outlined to reduce expenditure. We agree with the staff's statement in paragraph 21 that the adequacy of such efforts, as well as the need for complementary revenue-raising measures, will have to be assessed in light of overall prospects for the economy and, in particular, for financing availability. I would add that this should be a priority for both the authorities and the staff in the coming months.

I strongly support the authorities' intention to intensify the dialogue with the provinces and strengthen market discipline over provincial borrowing to ensure that central government fiscal efforts are not effectively undone by fiscal decisions at the provincial level. This is very important at the current juncture. I am also encouraged by progress in the discussions with the provinces on the constitutional reform of intergovernmental fiscal relations.

Concerning the external sector, like the staff and previous speakers have mentioned, I am concerned about the widening external current account deficit in light of the rather uncertain prospects for external financing. Furthermore, while I agree that slower growth in 1999 will help to moderate the current account deficit, I noticed that the assumptions in the program for export growth in 1999 seem to be rather optimistic. For example, according to the program, the terms of trade in 1999 is projected to improve by 1 percent and the export growth rate in volume terms by 10.5 percent. To what extent does the staff believe these assumptions remain valid, given continued low world commodity prices and the uncertain outlook in many of Argentina's major trading partners?

I welcome the authorities' efforts to strengthen data on private sector external debt. Experience in Asia has demonstrated the value of such information for decision making.

Turning to monetary policy and the banking sector, I am encouraged by the progress that has been made in strengthening Argentina's banking sector and by information that there is no evidence of any significant currency or maturity mismatch in both on- and off-balance sheet items. However, I wonder if the staff could shed some light on the extent to which the recent fall in stock markets might weaken the banking sector. The stock market index has decreased by 40 percent since July 1998 and by more than half over the year. Could this be a source of fragility in the banking sector, as was seen in many Asian crisis countries?

With these remarks, I support the completion of this review and wish the authorities every success on their policy endeavors.

Ms. Lissakers noted that paragraph 8 in the report stated that deposits in the banking system have continued to rise at a rapid rate, while, at the same time, the domestic interbank rate has increased by less than 300 basis points. Although that increase might be considered moderate relative to the increase in Brady bond spreads, 300 basis points was considered a large increase for domestic interbank rates. That kind of increase in spreads suggested that there was a decrease in confidence, at least at the margins, rather than an increase in confidence. In other words, depositors were asking for a higher rate of return to keep their money in Argentine banks. The staff might want to rethink their blanket assertion because the two pieces of information were not necessarily consistent. She asked the staff to elaborate on that issue.

Mr. Konan made the following statement:

The authorities' continued adherence to sound macroeconomic policies and to wide-ranging structural reforms resulted in the strong recovery from the recession following the "tequila" crisis in 1995. Indeed, despite an adverse external environment, economic growth was impressive, the fiscal position strengthened, the unemployment rate decreased, and foreign investment increased. In 1998, economic activity is expected to remain strong—albeit at a lower pace than in 1997—reflecting mainly robust domestic demand. Inflation remains subdued, while reform of the labor market brought the unemployment rate further down. The authorities deserve to be commended for this encouraging development, which undoubtedly put the country in a better position to withstand the ongoing market turbulence. We share, however, the view that to sustain the momentum of economic performance, the authorities must be vigilant to the current turmoil in international financial markets.

From Mr. Zoccali's helpful statement it is heartening to note that in 1998 the fiscal performance continued on an improving trend during the second half of the year. Indeed, revenue performance was robust as a result of major efforts to improve tax administration and tax collection, at the central and federal government levels. Moreover, a tax reform proposal, with a view to increased tax revenue by 0 .8 percent of GDP, was submitted to Congress. On the expenditure side, tight expenditure control was implemented and mandatory cuts representing 3.4 percent of GDP were made in budget appropriations, while new investment spending for large infrastructure was postponed indefinitely. Despite these fiscal adjustment efforts, commendable progress was made in areas of social spending, particularly in the restructuring of the National Social Security Administration. It is also encouraging to note that Congress is accelerating the consideration of tax reform proposals. However, given the delay in approving such proposals, will the expected revenue enable compliance with the 1998 fiscal targets? If not, are additional revenue measures being envisaged by the authorities? Could the staff comment on this issue. Further, in order to establish the country's fiscal credentials and to bolster market confidence in the economic reforms under way, the authorities have announced another cut in government spending, mainly in public works for 1998 and 1999. Could the staff specify the size of these latest cuts envisaged? Mr. Zoccali's statement has provided information on efforts being made by the province of Buenos Aires to realize expenditures in that area. However, given the latitude granted by the federal constitution to the provinces in their resource management, what corresponding actions have been undertaken by the other provinces to comply with the decision of the central government?

On external policies, the current account deficit—at 3 .5 percent of GDP in 1997—was largely financed by sizable foreign direct investment inflows. For 1998 as a whole, notwithstanding the competitiveness of the Argentine economy noted during the first half of 1998, economic activities are expected to decelerate reflecting falling oil and other commodity prices. This will result in a wider external current account deficit, which will continue to be financed by foreign direct investment inflows. Under such circumstances, we remain concerned by uncertainties regarding the duration of the current turmoil in international financial markets, and we concur with the staff that the external current account deficit needs to be further reduced. In that context, given the soundness of measures previously implemented, and those under way to reduce vulnerabilities to external developments, and given the one-to-one peg of the domestic currency against the U.S. dollar, it is not clear what immediate measures could be envisaged by the authorities for a successful containment of private sector demand. Staff comment will be appreciated.

On structural reforms, the significant progress achieved in budgetary systems and procedures, as well as in social spending, are commendable.

Concerning the financial sector, we welcome the measures to further improve supervision and we share the view that the increase in foreign ownership of Argentine banks will help strengthen the banking system and support investor confidence. In that context, we encourage the authorities to make every effort to accelerate the completion of the privatization process of Banco de la Nacion Argentina, the leasing of telecommunication frequencies and nuclear power plants. Moreover, we welcome action undertaken to intensify poverty alleviation through social programs, as well as widespread sectoral support to improve the flexibility of the domestic labor markets. The new law which was expected to facilitate new job opportunities through a significant reduction in dismissal costs for new employees will achieve a 30 percent reduction, according to the staff report. We would be interested in hearing from the staff whether such a rate is satisfactory for new job creation. With these comments, we wish the join authorities all the success in the ahead.

Mr. O'Loughlin made the following statement:

I would like to begin by joining other Directors in praising the efforts and achievements of the authorities of recent years. With all the performance criteria met in March and June, and the authorities' continuing intent to treat the Arrangement as precautionary, this chair supports the conclusion of the first review under the Extended Arrangement. We consider it important, in the present unsettled financial environment, to maintain the Fund's support for Argentina by signaling our continued approval of the broad thrust of policy there.

However, we wonder if the staff report may not be too sanguine on prospects in light of ongoing international developments. Key risks to the outlook at present include slowing global growth, the possibility of restricted access to external financing and, unavoidably, contagion. These could well lead to slower domestic growth and wider current account and fiscal deficits than projected.

Real GDP projections, both in the program and in the recently-released 1999 budget, appear somewhat optimistic in light of recent developments. As financial market turbulence in Latin America has intensified, higher borrowing costs and a sharper slowdown than previously envisaged in at many of its trading partners point to poorer short-term growth prospects. Certainly, private sector analysts take a less sanguine view than staff and the authorities, with recent projections of growth for 1999 considerably below the 4 percent suggested by staff. We wonder how staff see the balance of risks to this projection ?

Alternative scenarios could be extremely useful at this juncture. They would assist the preparation of contingency measures to ensure that the program could remain broadly on track even in the face of further adverse developments. One wonders, for example, what impact deeper or more widespread devaluations in Latin America might have on the economy or the currency board arrangement; and if the authorities are well-advanced in terms of identifying their options for dealing with possible developments so as to minimize the risks posed to the progress of recent years.

If the growth assumptions underlying the recently-released budget bill prove optimistic, the accompanying revenue and hence overall fiscal forecasts will also be at risk. In that context I have some concerns about the prospect that expenditures could be appropriately restrained. First, the prospective overrun on the provincial authorities' aggregate 1998 deficit raises a question over the effectiveness of the steps taken to ensure that the provinces play their part in macroeconomic adjustment, to which staff and Mr. Zoccali have pointed: an elaboration of the goals of the intended "intensified dialogue with the provinces" would help to clarify if this is a justified doubt. Second, is the ability to restrain day-to-day spending put in question by the fact that the government, in making recent necessary reductions, was unable to avoid cutting planned infrastructural investment ? Third, I am told that Congress approved a tax on cars late last week to finance an increase in teachers' salaries. It is not clear to me how this gels with the "fiscal responsibility law" adopted earlier this month. Will the tax approved fully offset the related spending increase in the short run, and more especially in the longer run ? What signal is being sent to investors by cutting planned infrastructural investment on the one hand, and following that up with increased taxation to fund higher current outlays on the other ?

Turning to the external account, I wonder how the staff views the risk that the deficit may widen next year due to weaker external demand and further declines in commodity prices ? It seems to me likely that next year's external deficit, also, will be higher than now projected. With this possibility in mind, staff intimate that there may be need for fiscal tightening to counter the possibility of external financing difficulties; that is, tightening beyond the cyclically adjusted negative impulse of a half percentage point of GDP already implicit in the federal budget for 1999. That is understandable against the background of increasing uncertainty in financial markets including, and heightened risk of a sustained period of restricted access to capital markets. Such action would, of course, further dampen an economy already experiencing a significant slowdown. That poses the question whether further fiscal tightening might undermine consensus around the sound policies which have characterized recent years. I wonder how staff sees the balance of risk to Argentina's future from these two sources?

Finally, may I again note this chair's support for the proposed decision. We wish the authorities well in the period ahead, and hope that the risks which are clearly present in the international situation do not mature to Argentina's disadvantage.

Mr. Ono made the following statement:

It is encouraging that Argentina's economy has continued its good economic performance, led by an expansion of domestic demand through foreign direct investment in the private sector after the "tequila" crisis. Real GDP in 1998 is expected to reach 5 percent and the fiscal deficit to decline to 1.6 percent of GDP. In spite of adverse external shocks, such as the contagion of the Asian and Russian crises and the sharp decline in international commodity prices, the authorities have succeeded in lowering inflation and decreasing unemployment by maintaining a tight fiscal policy. At the outset, I commend the authorities for having met almost all the economic performance criteria under the EFF program.

However, I am somewhat concerned that the current external deficit is expected to increase in 1998, owing to an expansion of the trade deficit, and that unemployment, even though it has decreased somewhat in 1998, still remains high. The federal government's fiscal deficit has decreased over the past two years, but, on the other hand, the provincial government's deficit has increased during the first half of this year. This also merits attention. As the staff mentioned, it is important to continue firm and consistent macroeconomic management and make an effort to tighten market discipline with respect to provincial borrowing.

This chair has no problem supporting the proposed decision. But I would like to make a few comments, for emphasis.

First, on the external front, given the need to tighten the fiscal stance affected by the expansion of the current account deficit in 1998 and prospects that there is no assurance that the external environment will improve in the near term, as the staff noted, I would like to stress the necessity of maintaining a disciplined stance on macroeconomic policy.

Second, regarding fiscal policy, it is encouraging that the fiscal deficit has declined thanks to a strengthened tax administration and an improved expenditure control system. However, the fact that expansion of the provincial government's spending overran the program target in the first half of 1998 is a matter of concern. It is necessary to increase the revenue of provincial governments. In this context, it is welcome that the authorities have begun to tackle tax reform, including rationalization of the revenue sharing mechanism.

Third, on structural reform, it is encouraging that progress has been made on almost all the structural reform benchmarks under the program, including tax administration, privatization, and banking sector reforms. However, I share the staff's concern that labor market reform has made little progress to date. I, therefore, join the staff in encouraging the authorities to make more modifications that would preserve some degree of flexibility, especially concerning collective bargaining. Given the double digit inflation and the increasing current account deficit, it is necessary to improve productivity and external competitiveness by addressing labor market reform decisively in order to maintain sustained economic growth in Argentina over the mid-term.

Finally, it is very commendable that Argentina's economy has been barely affected by the recent turbulence in international capital markets, especially in Latin America, thanks to disciplined policy management. Having said this, given the uncertainty as to the future course of the regional turbulence, in particular in Brazil, which has close economic ties with Argentina, the authorities need to monitor the situation more cautiously and to strengthen crisis management. The staff paper mentioned that the current account deficit has mainly been financed by foreign direct investment and official financing, and Argentina so far has not experienced difficulties in accessing foreign capital markets despite the turbulence. In addition, Argentina is prepared to absorb external shocks with precautionary resources and credit lines with private banks. Meanwhile, the terms and conditions of funding in international capital markets might be growing more severe; for example, recently, the Brady bond spread widened sharply. I, therefore, would appreciate it if the staff could explain the current situation and comment on what sort of financing might be available in the event the turbulence in Latin America worsens.

Mr. Lehmussaari made the following statement:

At the outset, I would like to commend the Argentinean authorities for their strong progress in macroeconomic management and achievements in the structural reform agenda. Economic growth and inflation performance has been impressive. Also, good progress has been made in the financial sector. Moreover, a lot has been done to shelter the economy from adverse external developments the policymakers are now faced with. Argentina, like many other emerging market countries, remains, however, vulnerable to the sudden and unpredictable changes in investors' sentiment.

Since I am broadly in agreement with the staff appraisal, I only want to make a few comments.

First, although the unemployment rate has fallen substantially since 1995, the unemployment rate is still high at around 13 percent. The fact that the unemployment rate has remained high despite strong economic growth indicates that structural impediments may play an increasingly important role. Therefore, to improve the effective functioning of the labor market is crucial for maintaining growth and reducing unemployment rate further. Moreover, raising the employment in the formal sector of the economy may require a more reformist approach to labor market rules and regulation. I join the staff in regretting that labor market reform falls short of the needed labor market liberalization, and urge the authorities to make every effort to proceed with the additional initiatives outlined in paragraph 6 in the policy memorandum. Given the significance of the labor market reforms in the program, I take it for granted that progress in this area will be covered with due emphasis in the next review.

Turning to the external side, I join the staff by noting that both the current account deficit and the external debt service are relatively high. In 1999 alone, public sector's external debt service is expected to be around US$12.5 billion and the non-financial and financial sector's roughly US$5.6 billion. Although the level of gross international reserves of the central bank appear to be at the comfortable level of US$24 billion, the external environment may turn out to be more volatile, and significant risks for foreign financing exist. This is of course a concern. Moreover, according to yesterday's Financial Times, US$2 billion still need to be raised to bridge this year's funding gap, and another US$14 billion is still uncovered for next year.

A slowdown in economic activity would of course most likely reduce the current account deficit. However, staff points out that up to 60 percent of the deterioration of the trade deficit this year is due to a decline in the terms of trade. Economic situation in neighboring Brazil makes the outlook all the more uncertain. Here, like Mr. Guzman, I would like to ask the staff whether there are any viable policy measures to improve private savings in the near future. What I have in mind is measures such as full elimination of tax deducibility of interest payments, etc.

On a related issue, I recognize the efforts made for further consolidation in the 1999 budget presented to Congress, but at the same time I wonder what kind of a dent the budget would get if economic growth falls short of the forecast.

Finally, like many other speakers, I believe that further progress on the central government's possibility to control the provincial finances is called for. Whereas strengthening the market discipline over the provinces' borrowing would be a useful step, as underlined by the Argentine authorities, it may turn out to be insufficient, and therefore some constitutional reforms regarding intergovernmental fiscal relations should be considered.

With these comments I can support the conclusion of the first review under the extended arrangement for Argentina.

Mr. Alosaimi made the following statement:

I join others and commend the Argentine authorities for their skillful economic and financial management. The economy has been able to withstand the current turmoil in the international financial markets. During last year and this year economic growth was strong, inflation remained low, and private investment increased substantially. Nevertheless, the challenge is to maintain sound macroeconomic policy and continue with structural reforms to boost confidence in the economy.

Now, let me highlight a few points for emphasis.

On the fiscal front, the uncertainty in the international markets underscores the importance of maintaining a firm fiscal stance. The authorities' continued commitment, as emphasized in Mr. Zoccali statement, is encouraging in this regard. The recent expenditure cut as well as the approval by the Senate of the "fiscal responsibility law" are a manifestation of fiscal discipline. However, as Ms. Lissakers said, weaknesses in provincial finances and intergovernmental fiscal relations remain a source of concern. Here, I join Mr. Grilli in welcoming the authorities approach to rationalize provinces' borrowing.

In the monetary and banking areas, like Mr. Guzman, I think the currency board arrangement has served the country well and has mitigated adverse external shocks. The authorities' continued preservation of high currency cover for deposits in the banking system is reassuring. In this context, I agree with staff that the recent surge in the off-balance sheet derivative transactions calls for close scrutiny of new developments in the area of currency and maturity mismatches.

On the structural front, while I welcome the progress made thus far, advances in labor market reform have been limited. It is my hope that the ongoing preparation on complementary legislation will increase labor flexibility and lead to a further reduction in unemployment. As Mr. Shaalan noted in his gray, the tax reform proposal will also enhance efficiency in the labor market.

With these comments, I support the proposed decision to complete the first review under the extended arrangement and wish the authorities further success.

The Deputy Director of the Western Hemisphere Department, in response to questions and comments, made the following remarks:

The staff has looked at the financing prospects for the remainder of 1998, and has taken into account the good probability that quick-disbursing structural adjustment loans by both the IDB and the IBRD will be disbursed in November or December 1998. The staff is reasonably assured that the financing requirements for the fourth quarter—amounting to about US$7.5 billion, which includes the current account plus the scheduled amortization on external debt—can be met without significant losses of reserves. Of course, if the turbulence in international markets were to accelerate, leading to a further drying up of external financing in the fourth quarter, the economy would need to adjust through a further increase in interest rates, which would lower domestic activity and the current account. The prospects are more uncertain in 1999, for which only a part of the financing is already reasonably in hand. The staff's calculations suggest that the financing requirements could range—depending on the current account prospects—from US$26 billion to about US$19. The staff has designed different scenarios, which reflect different assumptions about the availability of external financing, counting on the loans with the IBRD and the maintenance of a sustained level of foreign direct investment. Depending on other autonomous capital inflows, the current account would need to decline under these different scenarios to 3 percent of GDP, from 4.5 percent of GDP currently expected for this year to 4.25 percent under the restricted financing scenario. Of course, the implications of a substantially reduced availability of financing on growth could be significant. The estimates of growth in the different scenarios range between a deceleration to a 2 percent increase, compared to the 4 percent in the current unrestricted financing scenario and compared to 4 .8 percent in the authorities' own projections.

When the staff was negotiating the extended arrangement, it was in the wake of the attack on Brazil and the turbulence in financial markets. Financing prospects for Argentina, including the prospects for growth, looked dim. In fact, the staff's forecast under the program underestimated potential growth and actual growth in 1998. At that time, even among the staff, there was significant concern that Argentina could face a year of little or no growth and a drying up of external financing. Ex post, this did not turn out to be the case. Thus, the uncertainties are considerable, and the possibility cannot be excluded that in the course of next year both the growth rate and the current account may need to be adjusted substantially downward. However, with the convertibility arrangement, the adjustment mechanism would tend to operate automatically through an increase in domestic interest rates, which would thereby curtail the still quite strong growth of private sector activity, particularly of investment. The public sector would be affected from a substantial cyclical shortfall in revenue at the central government level. The scope for offsetting this substantial shortfall in revenue with expenditure restraint would be limited. Certainly, investment spending can be postponed, and the authorities have shown in the course of this year that they can hold the lid firmly on discretionary spending. However, this spending has been contained for a number of years, and it is becoming increasingly difficult to find margins for reduction. Thus, it may be difficult to avoid additional revenue-raising measures if the budget deficit at the central government level were to be kept at the targeted level in the face of a significant autonomous shortfall in revenue, induced by a cyclical downturn. At the provincial level, however, since expenditures have been rising rapidly in recent years, there would be more scope for reducing spending and offsetting any cyclical shortfall in revenues, which, incidentally, would be translated to the provinces because of the automatic revenue-sharing mechanism. The emphasis of the authorities on market discipline for the provinces is well placed. In fact, the experience of the provinces' finances during the "tequila" crisis and in the immediate aftermath was that market discipline was effective, in conjunction with the firm policy of no bailout by the federal government, at enforcing adjustment in spending at the provincial level.

Clearly, a major shortfall in growth would not leave the labor market unscathed, although it may have some effect on labor participation, which has been rising rapidly in recent years. In this regard, the progress that has been made with the reduction in dismissal costs for new employees is significant, but probably not enough to compensate for the elimination of the subsidized labor contracts. We agree with Mr. Zoccali that those contracts presented some shortcomings from a social standpoint, but also from the standpoint of efficiency. By promoting a high rotation, they did not encourage enterprises to invest in human capital and in the training of workers. The planned reform of the tax system, which contains sufficient revenue-raising measures to permit a reduction in social security contributions by one third, would help moderate labor costs. Also, by raising the relative price of capital through the provision that eliminates or reduces the deductibility of interest costs, it would help stimulate the demand for labor, within the context of a general deceleration in activity and its impact on unemployment. A positive impact from the planned tax reform can be expected to reduce the deductibility of interest payments by enterprises. This will stimulate more corporate savings, and reduce the current bias against equity financing. More generally, a reduction in continued consolidation of the public finances and a reduction of the public sector deficit will also improve the public component of national saving and help create the environment for the continued growth of investment, with a reduction in the current account deficit. Also, in the context of a cyclical deceleration of demand, one would expect savings to rise as a precautionary measure, as concerns about employment prospects may worsen.

Given the relatively small size of the stock market in Argentina and the fact that the bulk of assets of the banking system are not invested in shares, but in loans to corporations, the recent decline in the stock market should not have a strong impact on the banking system. In general, the banking system is quite resilient to shocks, including external shocks; for example, its foreign currency exposure is positive. Further, there have not been any significant indications of difficulties in the banking system as a result of the current turbulence in the domestic financial markets. The overall level of deposits has not increased as it did in the first half of 1998. Also, there has not been a decline in deposits as was the case during the "tequila" turbulence. The shift in the composition of deposits toward dollar-denominated deposits has been relatively small, amounting to about 3 percent of the total. However, the increase in the overnight rate is some matter for concern. Certainly, it would have been difficult to presume that in a completely open capital account system, domestic interest rates could be insulated from sharp increases in spreads on Argentina paper abroad.

Mr. Daïri cautioned that the staff needed to be clear about the kind of advice it was giving to the authorities. If there were risks of a downfall, the staff should not propose anything that would accelerate that downfall, which could possibly spread to the region. It would be more appropriate to develop a framework in which any sign of a significant decline in economic activity could trigger some contingency measures to prevent such a risk from materializing. Otherwise, the events that occurred in Southeast Asia would be repeated in Latin America. The Fund should be prepared to prevent, even if it needed to deviate from its traditional advice, a country that, by all accounts, has been performing well from falling victim to its own good performance. Although having an open capital account was considered a good thing, it could also import a recession.

Mr. Zoccali said that he was uneasy with Mr. Dairi's last comment. His authorities felt that the sort of policy framework and incentive structure that was in place in Argentina would be recognized over time. Although volatility was high and should be expected to have an impact if it was sustained, the authorities considered that on the basis of the available information, the markets would be able to differentiate.

That tied in with the expectations and more pessimistic growth scenarios that had been put forth, Mr. Zoccali continued. If the international environment remained adverse, then one would be talking about a different ball game all together and not just for Argentina. Given Argentina's policy framework, which was both clearly understood and predictable, and the incentive structure that was in place, one needed to keep in mind what had actually happened in the economy following the "tequila" crisis, and even after last October's test of the markets. The Fund's growth projection for 1997 of between 4 and 4.5 percent had fallen short of the actual 8.6 percent real GDP growth figure for the year. In that regard, the incentive structure was sufficiently different from that of other emerging market economies as a result of the reforms that had been put in place since 1991 so as to fully justify the faster and sustained recovery following the 1994/95 test of the markets.

Another variable to keep in mind—that was something that was left implicit in his statement—was the issue of domestic vulnerability, Mr. Zoccali stated. Domestic deposits had traditionally been a sensitive variable throughout Argentina. In fact, domestic depositors, perhaps reflecting some sophistication, and certainly acting on the premise that there was no money illusion, had been quick to leave at the first sign of turmoil. What had happened since last October and more generally since 1997 was that deposits in the system had continued to increase. Therefore, the perception of pessimism should be tempered. If Argentina were to face a continued adverse global economic environment, the type of financing requirement scenarios that were being discussed might need to be reconsidered, and there could even be a case for allowing the automatic stabilizers to work more fully.

On the issue of the Y2K computer problem that Ms. Lissakers raised, Mr. Zoccali pointed out that that had been a concern for the authorities for some time. About a year and a half ago, they had begun to take concrete measures. They had convened technical meetings with the relevant banking system representatives, and had disseminated the BIS checklist of issues to be addressed. The authorities had also required trial runs in the system. There remained some concern that all of the official banks might not be up to speed; however, he could assure Ms. Lissakers that, at least at the central bank, trial runs had been made, and the potential problems seemed to have been more or less addressed. The Argentine authorities were watching the situation closely through periodic meetings to assess how the private sector was evolving in its own problem resolution.

Mr. Daïri said that he would completely agree with Mr. Zoccali if the markets behaved rationally, but they did not.

Mr. Grilli noted that, under a currency board arrangement and with no chance of using, to a great extent, monetary policy, the external environment could impose further risks, such as a terms of trade shock and reduction of access to capital markets. If both occurred at the same time, then, as Mr. Zoccali said, "It was a different ball game." However, if only one of the shocks persisted, such as a terms of trade shock, assuming moderate access to capital markets, the burden of policy adjustment to maintain or improve the real exchange rate fell on fiscal policy. That had been the type of response the authorities had followed, which was the correct response.

Mr. Donecker said that he agreed with Messrs. Grilli and Zoccali. Under a currency board arrangement, the recommended policy action was the maintenance of a prudent fiscal stance. If the authorities deviated from that, and if they showed weaknesses in policy implementation in that area, they could face much greater problems.

Mr. Qi made the following statement:

> I join other speakers in commending the Argentine authorities for their continued excellent performance in managing their economy since the approval of the EFF. The macroeconomic indicators, growth, consumer prices, which show signs of neither inflation nor deflation, the fiscal account, and the current account are all market friendly. However, Argentina is not being treated fairly by the markets, which are demanding too much of this country without taking

into account of all the favorable developments. Although it is important for the authorities to take more measures to avoid possible financial turmoil, the international community, in particular the markets, should show more composure and soberness in assessing the situation in Argentina. I am therefore pleased that the latest review and rating released by Standard and Poor's considers Argentina's outlook stable and affirms its investment rating.

On the fiscal front, I welcome the authorities' efforts to strengthen tax administration and tighten spending in order to offset the shortfall in tax revenues that has been caused by factors beyond the authorities' control. I note that the overall fiscal deficit in 1998 is going to fall, as programmed, to 1 percent of GDP from last year's figure of 1.4 percent of GDP. With the authorities' strong commitment, this declining trend will persist for the coming years under sustained fiscal management.

On the monetary policy, the evolution of the inflation rates has demonstrated the usefulness of the currency board arrangement, which is critical for the build-up of public confidence in the monetary system and economic growth. From recent experience in Hong Kong, however, there is a high likelihood that a currency board system could be used by some market speculators in crisis situations to manipulate both the money market and the stock market. In this regard, the staff may wish to comment on the situation in Argentina. It may be advisable that the authorities remain vigilant and take timely measures to strengthen the relevant regulations and supervision of both markets to avoid or reduce the impact of such speculative attacks. I am pleased to see the continued progress being made in strengthening banking supervision and prudential standards, and share the authorities' view on the importance of maintaining the high cover of liquid foreign reserves for deposits in the banking system. The successful introduction of a real-time growth settlement system for large interbank transactions, as well as the establishment of two privately-owned automated clearing houses for small-value retail transactions, are also welcome developments.

On external policies, exports have increased rapidly in real terms in the first half of 1998, despite a slight real exchange rate appreciation associated with the strong U.S. dollar. The export diversification strategy and the productivity gains are undoubtedly the most important factors in the fast export growth. Despite this favorable development, the terms of trade deteriorated sharply against Argentina in the wake of the Asian crisis, entailing a larger than programmed current account deficit for 1998. However, I agree with the staff's analysis that, with imports decreasing and the terms of trade improving in the coming years, the current account deficit can also be on a sustainable path, with much of it financed by FDI. I note that there will be an increase in portfolio capital inflows this year. I would like to hear the staff's view on the overall role of these inflows in the Argentine economy, given the fragile and volatile nature of this capital, especially after reading the Wall Street Journal article referred to by Ms. Lissakers.

With these remarks, I support the proposed decision, and wish the authorities the best of luck and further success in their future endeavors.

Mrs. Zador made the following statement:

Argentina's performance under the first year of the EFF has been remarkable. All performance criteria have been substantially exceeded. In spite of intensifying external financial pressures and pre-election political debates, the government has shown a firm determination to keep the economy on track and move ahead with structural reforms. As mentioned by Mr. Zamani and Mr. Shaalan, the recent reaffirmation of Argentina's investment grade rating by Standard and Poor's is rare for emerging markets these days. I hope that it can orient the markets and contribute to regaining investor confidence.

Argentina's overall performance justifies the success of the convertibility plan, which has been the basis of economic stability and growth since 1991. The currency board arrangement has worked well, delivering both price stability and rapid growth, and has greatly improved Argentina's resistance to exogenous shocks. Despite recent misfortunes in the external sector and the threat of further pressure on the currency, Argentina's exchange rate regime remains credible, and, provided the authorities' commitment remains firm, should continue to be an adequate framework for adjustment. Since the arrangement imposes a certain rigidity on monetary policy, the bulk of the adjustment burden will fall on the fiscal policy side and will require greater flexibility of all production factors, including investment and labor.

Developments in the current account must be carefully watched by the authorities. Although a current account deficit of 4.5 percent of GDP is not considered excessive for a developing country passing through a stage of intensive capital accumulation, it is risky in light of the deteriorating outlook for GDP and if it must be financed by a recourse to volatile and unreliable capital markets. The continuing worsening of the external environment has revealed the soft spots in the economy; namely, the high vulnerability to terms of trade shocks, the still low share of manufactured exports with high value added, and the heavy debt service burden. Under these circumstances, it is crucial to maintain, and even increase, export competitiveness by increasing labor market flexibility, while preserving Argentina's comparative wage cost advantage, and by increasing the number of skilled workers to attract more FDI to boost revenues from labor-intensive exports.

The slowdown in output growth has paradoxically helped keep the growing current account deficit under control. Last year, the economy showed signs of overheating, with consumption beginning to accelerate, thus increasing imports, which until then had been mostly investment goods. The contraction in public spending and the slowdown of consumption due to increased interest rates have worked in the right direction, producing a sharp drop in the growth rate of import volume. We are encouraged that the government has succeeded in maintaining the vigor of private sector investment, keeping the decline in export volumes lower than the decline in imports.

It is difficult to see today whether a larger fiscal tightening than that already contemplated by the EFF program will be needed. The next staff mission should examine this issue carefully. Given the overall deterioration of growth prospects in the world economy, it seems wise to prepare contingency plans for the next year's budget. This work should include precautionary scenarios based on lower output, higher interest expenditures, and decreased availability of financing. I therefore applaud the introduction of multi-year fiscal planning and the adoption of the Fiscal Responsibility Law, recently approved by the Senate. Both should convey a confidence-building signal to the markets.

Argentina's labor market reforms do not yet satisfy the staff. Although a more flexible labor market is important under a pegged exchange rate regime, I do not view the situation as seriously as the staff. If my understanding is correct, the staff agrees with the authorities that Argentina has achieved considerable wage and price flexibility in recent years and that its competitiveness is still adequate. The effects of the additional effective peso appreciation have been offset by continued low wage growth and by the impetus given to productivity by the investment boom. In addition, unemployment is decreasing and productivity continues to increase, owing to investments in new technology. Could the staff explain what are the threats to these favorable developments. I also fail to understand why the staff views centralized collective bargaining so negatively. From 1995 to 1997, this system produced near zero growth in nominal industrial wages, suggesting that the trade unions are aware of the trade-off between wages and unemployment.

Argentina's banking system is now a pillar of strength which has helped the country shrug off the effects of the Asian crisis. The banking industry has undergone a major transformation in terms of concentration and foreign ownership, and has gained in competitiveness thanks to modern banking technology. The banking system now enjoys stronger public confidence, and a larger share of total liquidity now passes through its channels. I particularly appreciate the authorities' efforts to increase the system's overall liquidity by imposing higher liquidity requirements on banks. Reserve requirements and the contingency provisioning now account for 30 percent of total deposits, twice the level at the time of the Mexican crisis. In fact, this liquidity buffer replaces the central banks' lender of last resort function, and I agree with the authorities that the cost of these extra reserve holdings is offset by the lower risk premiums they make possible. The weakest point is still the large share of bad loans, which are concentrated in three state-owned banks. I encourage the authorities to move ahead with restructuring and privatizing these banks. Another point the authorities should watch closely is the fast-growing external debt of nonbank financial institutions. I welcome the authorities' efforts to complete their survey on this component of Argentina's external debt by the end of 1998.

With these remarks, I support the completion of the first review.

Mr. Zoccali clarified an impression that perhaps he might have given in his statement regarding Argentina's credit rating. Standard and Poor's had maintained its stable outlook and had affirmed the rating structure for Argentine debt instruments, including the investment grade rating that applied to short-term debt, both in pesos and dollars. Standard and Poor's had also kept unchanged its rating for long-term debt, both in dollars and pesos. The rating that Argentina had received for sovereign long-term debt in foreign currency and in pesos continued to be BB and BBB minus, respectively. Certainly, the authorities' objective was that all of Argentina's debt be rated as investment grade.

Mr. Yakusha made the following statement:

> I am pleased to remark that the Argentinean economy continues the robust trend recorded in recent years, the international financial markets' turbulence notwithstanding. Real growth is strong, inflation is subdued, and the budget deficit is well within the target. Those macroeconomic data, together with several sectorial developments -- such as the progress achieved in banking -- provide a sound base for further achievements. I commend the Argentinean authorities for their continuous commitment to stabilization and progress and of course I support the proposed decision.
>
> While my overall impression is very positive, I wish to comment on an issue which would require continuous and I would say even stronger vigilance: the external sector. Indeed, the Argentinean economy has been weathering the storm quite well. Stronger fundamentals, a better track record and higher reserves contributed to this outcome. However, the external position is fragile; a total external debt exceeding 400 percent of exports, the public debt service only mounting to 40 percent of exports, and interest payments representing more than 28 percent of exports in 1998 are far from comfortable. It is encouraging that the authorities pay full attention to those matters, as proved by the wise decision to implement a policy of pre-borrowing, take advantage of favorable terms in the international financial markets in 1997, and lengthen the maturity of new debt. More recently, the increased liquidity requirement and a further expansion of the contingent repo facility with foreign banks should cushion the impact of further adverse developments in the financial markets. It is reassuring that the public sector will be able to meet its financial obligations in the next half year, without resorting to external market borrowing, selling the government's stake in the oil company, or using the precautionary EFF arrangement, and/or reaching agreement with international and regional development banks. I commend the authorities for their prudence in managing foreign exchange reserves, in this difficult environment.
>
> It seems to me though that the fundamental problem is the deficit of the current account, and recent developments in that area are not that good. In 1997, the deficit grew to 3.5 percent of GDP, in support of a rapid output expansion. In 1998, the current account keeps deteriorating, while real GDP is no longer that strong. Exports growth in the 1990s was indeed impressive, but their share in GDP is still modest, and they appear to be lower than programmed in 1998; meanwhile, imports are higher, and FDI are lower this year. External developments do not look conducive to an improvement, any time soon; partner countries might not be able to absorb rapidly growing exports from Argentina, commodities and other export products from countries with weaker currencies might become more competitive, while conditions in the financial markets might remain adverse. Having in view developments in recent months, the medium-term scenario appears a bit too optimistic to me.

More specifically, a sharp increase in both FDI and exports in 1999 and subsequent years is less likely, unless recent developments will soon reverse their impact. In a shorter term approach, the international environment would affect any country facing debt problems, but its impact could be even higher for a country bound by a currency board regime, which considerably limits the authorities' marge of maneuver. In view of this situation, are the authorities preparing other contingency measures? What is the alternative scenario, if the international markets turmoil continues? I would appreciate staff comments.

Mr. Szczuka made the following statement:

I feel that I have to make two statements today, one based on the staff paper and the staff's statement and the other based on the augmented assessment presented today by the staff, with the deteriorating growth prospects and more difficult situation on the external financing side. I will start with the basic statement and then come back to a second statement at the end.

Over recent years, the Argentine authorities have implemented sound and disciplined macroeconomic policies. This has led to a major improvement in economic stability and strengthened the economic agents' confidence in Argentina. Low inflation, robust growth of private investment, and a declining albeit still relatively high unemployment rate are the results of several years of skillful economic policies.

Argentina has weathered relatively well the contagion following the Asian crisis in the second half of 1997. However, with the outbreak of the Russian crisis, the economy has come under renewed pressure, and substantial risks have emerged. The first risk is the continued decline in export prices, followed by the heavy dependence on a few major trading partners, like Brazil, with about one-third of the share. Negative developments in those countries could create a strong external shock to the Argentine economy. A more intermediate risk is the impact of financial market turbulence, which affects Argentina mainly through reducing access to, and increasing the cost of, external financing and forcing up domestic interest rates.

On monetary policy, the strict adherence to the currency board arrangement has served the country well during the last seven years. However, in the coming months the costs of maintaining such a peg may again be rising, in the form of increasing interest rates, rising unemployment, and declining growth. Clearly, dropping the currency board would involve much higher costs to the economy. Thus, it is heartening to hear that the government and all major candidates for next year's election are fully committed to maintaining the current regime.

On fiscal policy, the authorities' swift reaction to revenue shortfalls is commendable. I also welcome the additional fiscal adjustment package for the latter part of 1998. Moreover, I am happy to note that the authorities have submitted a budget for 1999—although we do not know all the details—that reflects a firm commitment to fiscal discipline. Unfortunately, some provinces have not yet developed the same sense of fiscal discipline as the central government. Although the overrun in the consolidated public sector deficit is modest, I agree with the staff that the government should do more to ensure the deeper involvement of the major provinces in the fiscal consolidation process through dialogue and moral suasion. Like the staff, I would also caution that the adequacy of the fiscal response should be reassessed in the case of a continuation of external turbulences, and I am certain that there is no room for any slippages on the fiscal side. I also welcome the staff's comment on whether the much reduced flexibility in conducting fiscal policy, which would result from the adoption of the Fiscal Responsibility Law, is something which is recommended, given that the authorities are not able to conduct an active monetary policy. What kind of macroeconomic policy measures would they have if there is no flexibility on the fiscal side?

Over the last few years, significant progress has been achieved in the financial sector. I welcome the substantial efforts that have been made to strengthen banking supervision. The banks' balance sheets look healthy, with an increasing part of deposits covered by liquid reserves. Certainly, increased competition through the much expanded presence of foreign banks has helped to strengthen the whole sector. As a result of these developments, the financial sector has been only slightly affected by the turbulences coming from abroad. This can be seen by the recent growth in bank deposits. However, Oxford Analytica indicated that there was a 20 percent decline in August in the commercial banks' deposits. I believe that this information is wrong. Could the staff please clarify.

The Deputy Director of the Western Hemisphere Department said that the most recent data available (through September 1998) had not indicated that banks' deposits had declined.

Mr. Szczuka stated that the recent slowdown of deposit growth and the growing share of dollar-denominated deposits should be seen as an early warning signal.

Concerning the lines of credit provided by a number of investment banks, although it was a protectionist measure, there were merits to such a safety net, as mentioned during the recent discussion involving the private sector in resolving financial crises, Mr. Szczuka continued. However, that instrument rendered only limited protection in times of market turbulences and distressed conditions. He also felt that the survey on the foreign assets and liabilities of the nonfinancial private sector should be concluded swiftly, thus allowing for a more adequate assessment of the associated risks for the banking sector.

On the external sector, exports had strongly increased in real terms in the first half of 1998, despite an appreciating currency that reflected the strength of the U.S. dollar, Mr. Szczuka said. Moreover, it was encouraging that an increasing share of exports had been directed to Nafta countries and to Europe, thus lowering the dependence of Argentina on the economic cycle of the Mercosur countries. Several factors spoke for a relatively favorable outlook for exports. First, labor market conditions ensured further wage moderation. Second, productivity growth should remain high, as the effects of the high investment level in recent years should be more visible in the economy. Third, with the U.S. dollar possibly experiencing some downward pressure, the situation might look more friendly from the exchange rate side. However, weaker world demand, unfavorable terms of trade developments, and stronger competition from countries whose currencies have depreciated sharply could bring harsher times for Argentine exports. Also, in view of continuing robust import growth, he agreed with the staff that the situation needed to be monitored carefully, and contingency measures should be prepared to allow the country to act swiftly in case the situation deteriorated.

Such prudence was especially advisable, given Argentina's high external debt service ratio, Mr. Szczuka pointed out. However, he disagreed with the staff that that ratio was considered only a relatively high debt service ratio, because this was the factor which was preventing Argentina from obtaining the investment grade rating as quoted by Standard and Poor's. The debt service level, which exceeded 40 percent of export revenues, and the debt-to-export ratio, which exceeded 200 percent, were close to the ratios one saw in some highly indebted poor countries. There was also uncertainty resulting from the current account deficit, and the question was to what extent it could be financed through additional capital imports. It was also worrying that the medium-term scenario presented in the staff paper did not show any improvement in the current account deficit over time, and was even indicating some increase in the debt-to-GDP ratios.

On structural reforms, Mr. Sczcuka welcomed the recent steps to reduce dismissal costs, such as creating incentives for job creation. Unfortunately, in other areas, the new labor law had brought some regress, as it promoted further centralization of collective bargaining and maintained the practice of "ultraactividad". However, that had to be seen in the context of the forthcoming elections. The authorities were also encouraged to continue with the privatization program.

Finally, Mr. Szczuka supported the conclusion of the first review under the extended arrangement and agreed to the proposed decision. As indicated at the outset of his intervention, he moved on to his second statement.

The staff had indicated that a deterioration in growth was certainly possible, Mr. Szczuka stated. He wondered whether the markets were that irrational when spreads on Argentine debt were exceeding 1,000 basis points. He felt that the markets were not completely rational because they saw the exposure coming from the external debt service side, which was higher than in other countries in the region. Further, there seemed to be an inherent volatility in the currency board arrangement because of the exposure of interest rates to changes in capital flows. Investors who were originating the capital flows knew how important they were to the growth prospects of the Argentine economy. That was why that type of reaction, to some extent, could be better understood, However, it clearly pointed to the areas where the Argentine economy was vulnerable, even though, on average, it was doing extremely well. More generally, the question of debt service ratios and debt should be addressed more forcefully.

Mr. Daïri made the following statement:

> I would like to assure Mr. Zoccali that I had no intention to doubt the authorities' commitment, nor their ability and skillfulness in managing their economy. I merely intended to point to the risks to the recession and to draw attention to the need to consider these risks carefully.
>
> Argentina's economic performance continues to be strong. Thanks to the skillful management of the economy, they have done a good job of weathering the recent crisis in international financial markets. The relatively

high rate of economic growth, the subdued inflation, and the declining rate of unemployment are all encouraging indicators. The authorities' strong commitment to meet both performance criteria and the benchmarks of the precautionary extended arrangement with the Fund is also commendable. We thank the staff for a well-written paper and concur with its appraisal.

On the fiscal side, the authorities have cut expenditure during the first half of 1998 to offset a shortfall in revenue. They have also announced further cuts for the second half of 1998, with two-thirds of these cuts affecting current expenditure.

Concerning the financial sector, I concur with the staff that the authorities' continuing efforts at strengthening the banking system have made it more resistant to external shocks. As appropriately stressed in Mr. Zoccali's statement, the soundness of Argentina's financial system is perhaps the most critical area for assessing the sustainability of its economic program. Having said this, I wonder what would be the likely implications of maintaining high interest rates on the real sector of the economy and on the banking sector.

The progress made on implementing the structural reform agenda attests to the strong ownership of the reform process. On the labor market, Mr. Zoccali's remarks are comforting. Clearly, the authorities are doing their best to move forward in this area, although they will need more time to reach a national consensus on such a sensitive issue. We welcome the recent adoption by the Lower House of Congress of the tax reform legislation, and encourage the authorities to redouble their efforts at achieving an early approval of this legislation.

With these remarks, we wish the Argentine authorities every success in their endeavors, and support the completion of the first review under the extended arrangement.

Mr. Donecker made the following statement:

We fully support the staff appraisal and the proposed decision. Argentina has achieved substantial progress with regard to the stabilization of its economy. We appreciate and welcome the authorities' commitment and corresponding timely actions to maintain a firm and consistent stance of fiscal and other macroeconomic policies, and to carry forward their structural reform agenda. Notwithstanding these achievements, we share the staff's concern about the expected expansion of the aggregated fiscal deficit of the provinces, the insufficient progress with regard to clearly desirable reforms of the labor market, and the level and trend of the current account deficit. The achievement of greater labor market flexibility is of particular importance with regard to the defense of Argentina's external competitiveness, since the exchange rate instrument as a corrective measure is not available to policy makers under a currency board arrangement. Thus, I am pleased to note from Mr. Zoccali's statement that "it is understood by all the parties that the process of labor market reform is by no means concluded." We, too, encourage the authorities to persevere in their efforts to increase labor market flexibility and to maintain an appropriately tight fiscal stance, including strengthened efforts to improve revenue collection.

The recent turbulences in global financial markets underscores the need for continuing efforts to further strengthen the banking system. In this context, it appears advisable, as other speakers have already mentioned, to conduct and to conclude the announced survey of foreign assets and liabilities of the nonfinancial private sector as soon as possible in order to allow for a better risk assessment. Against this background, I would like to ask the staff how it assesses the risk that contagion or spillover effects from the Brazilian economic and exchange rate crisis might become so strong that the authorities may be forced to exit from their currency board arrangement.

Finally, I would like to ask the World Bank representative whether the World Bank has any program in the pipeline to support Argentina's economic program.

Mr. Milleron made the following statement:

The overall policy framework is characterized by three main features. First, a full and clear insertion into the world economy; second, a continuous effort to reinforce the capability to withstand the turmoil in the environment; and, third, correct policies to adapt to external shocks when necessary. Under the currency board framework, fiscal policy has to be the main tool. The question is: is it sufficient? I took note of what was said by the staff on some room for maneuver existing on the side of the provinces' fiscal adjustment. I also noted that, in light of the recent turmoil in international markets, some additional support from the World Bank and IDB was requested by the Argentine authorities. The idea of a preventive mechanism for liquidity supplementation is certainly an interesting approach. Perhaps we could devote more time to examine the various types of financing cushions that could be envisaged. As a member of the Bank Board, I hope that the attempt to reinforce the capability of the Argentine economy to withstand external shocks will be fully working as soon as possible.

The authorities' intention to launch a survey on the short-term external debt of the nonfinancial private sector seems interesting. It would be useful if the staff could provide more information in this area.

It would be interesting to know more about the staff's assessment of off balance sheet derivative transactions, which have grown rapidly in the recent period.

It is not clear why the indicator of the real effective exchange rate is based on the consumer price index. It might be beneficial to also include some information on unit labor costs. Staff comments would be appreciated.

Mr. Munthali made the following statement:

Despite the impact of the Asian crisis and the continuing volatility in the financial markets that would affect economic performance in 1998 and in the ensuing year, prospects for overall growth remain comparatively strong even with the anticipated slowdown in the third quarter as shown by the recent available indicators included in the supplementary buff statement by the staff. It is reassuring that, since the "tequila" crisis of 1995, this recovery has been broad-based and is being led by strong investment demand and a rapid expansion of exports. It is also significant that this expansion is taking place under relatively stable price conditions, with consumer prices remaining subdued. The rate of unemployment is a source of concern as it remains at an uncomfortably high level, despite significant reduction following the recent economic expansion.

Mr. Chairman, we are in broad agreement with the staff analysis and could endorse most of the policy recommendations to reinforce the adjustment program, especially given the vulnerability of the economy against the increasing turbulence in the international capital markets that have dogged most emerging market economies. In that context, the authorities were wise to put in place a strong program of economic adjustment and reform under a precautionary arrangement with the Fund which has thus far effectively anchored policies in response to the contagion effects of the Asian crisis. Thus, with the economic fundamentals remaining highly favorable, Argentina has been able to withstand the negative effects of such exogenous shocks, including the most recent problems in Russia.

However, the staff and many previous speakers have drawn our attention to the risks associated with the widening of the current account deficit in the balance of payments and the still high level of external debt service. The potential destabilizing effect of both of these developments have been mitigated to a large extent by pre-borrowing and the currency board arrangements. Since much has already been said, it will suffice to note that there are also important underlying developments which give confidence that the Argentine economy is better placed to withstand the global nervousness in the financial markets. Firstly, export growth has been robust in recent years not only in terms of volumes but also with regard to market diversification, a point that was covered by the staff in response to questions raised by certain lead speakers. This strong export performance has been reinforced by strong improvements in productivity associated with a substantial increase in investments, presumably in profitable export industries. Secondly, the authorities have adopted a comprehensive approach in the management of the country's external indebtedness. In this connection and like Mr. Milleron, we would encourage the authorities to complete their surveys of foreign assets and liabilities of the private sector expeditiously in order to provide a complete picture of the country's foreign currency exposure.

Overall, the authorities deserve to be commended for the stance of macroeconomic policies, including a strong and credible program of fiscal consolidation, firm and consistent monetary policy which has rightly been accompanied by comprehensive efforts to strengthen the banking system.

We are encouraged to learn from the staff that most commercial banks have become relatively resilient as a result of these efforts. Moreover, the authorities are pursuing important structural reforms which will be critical in underpinning the gains in economic efficiency and productivity. The reform agenda is commendably ambitious and comprehensive and we would encourage the authorities to remain vigilant in view of the continuing vulnerability of Argentina to changes in market sentiment.

With these brief remarks, I support the proposed decision and wish the authorities every success in their economic management.

Mr. Palei made the following statement:

I support the completion of the first review under the extended arrangement

In the media it is often mentioned that the authorities are ready to accept 100 percent dollarization as a way to alleviate the continued pressure on the peso. What is the staff's opinion on the authorities' attitude to such a potential hypothetical development? One would assume that acceptance of complete dollarization would keep interest rates in Argentina under a certain level. In fact, domestic prime interest rates increased by only 300 basis points, which is a much smaller change than the change in Mexico or in comparison with the spreads on Brady bonds. I would appreciate it if the staff could comment on the issue of dollarization, and to explain what the implications for the currency board arrangement and interest rates would be.

With regard to standards, could the staff comment on the key indicators in the banking sector and how are they different from the Basel standards. If they differ significantly, why is that so?

Mr. Szczuka shared Mr. O'Loghlin's view that the report was too sanguine about the prospects of the Argentine economy. Further, there were no financing assurances for 1999. The staff had mentioned that US$26 billion was needed next year to fill the financing gap. Assuming that there were problems with access to markets, what would happen then if there was no access to this amount of money? Also, the stock market has dropped by 40 percent, interest rates have increased, and unemployment remained high. That information presented a different picture of the Argentine economy than what one would get after reading the report. That was why he had pointed out that there were two assessments of the Argentine economy.

The Deputy Director of the Western Hemisphere Department clarified that the US$26 billion figure had referred to the external financing requirements, as defined by the projected current account deficit under different scenarios, plus scheduled amortizations of external debt. It did not refer to the financing needs for the public sector or for the treasury. Under different scenarios, the current account deficit projection, including scheduled amortizations, could range between US$26 billion under the baseline scenario, to below US$20 billion under the scenario of significant financing constraints, which would improve the current account deficit. At the moment, there was considerable uncertainty about the financing prospects for 1999. Even the maximum figure of US$26 billion was below what was projected for the year, and more or less in line with what had been achieved in terms of actual financing in 1997. However, the US$26 billion requirement was not out of range if market confidence were to recover and the current turmoil were to be overcome in the course of 1999. Nevertheless, such a scenario was probably on the optimistic side. It would therefore be desirable for the authorities to begin to gear their policy thinking about 1999 to a lower growth prospect. However, it was difficult to anticipate whether that would be in the order of 3 or 2 percent. The staff had also prepared a scenario of a virtual drying up of the financing possibilities to highlight that, even under the most extreme assumptions, and assuming that substantial support would be forthcoming from the international financial institutions, including the drawings under the EFF, the resulting decline in reserves would not be incompatible with the maintenance of the convertibility regime.

Clearly, under a scenario of a sharp decline in external financing, the economy would have to adjust, the Deputy Director continued. That adjustment would take place through a deceleration of domestic demand and possibly through a decline in domestic demand. The distribution between the private and the public sector would be determined by the amount of the reduction in the fiscal deficit, by the improved export performance, and by an increase in market shares, as exports have proven to be relatively cyclically sensitive. Also, the external environment would be an important determinant of how the adjustment in the current account would be distributed between domestic demand and export growth.

Given that Brazil accounted for almost a third of Argentina's exports, an exchange rate adjustment in Brazil would have repercussions on the rate of growth of Argentina's exports, the Deputy Director stated. However, Argentina has made substantial progress in 1998 in diversifying or redirecting its exports away from Mercosur, which had been rising rapidly as a share of Argentina's exports toward other regions of the world—particularly Nafta—which had stronger demand growth and improved export prospects. The main risk to Argentina from the turmoil in Brazil would not be through the current account, it would be through the capital account. However, Argentina was well placed to resist attacks on its currency, barring the hypothesis of a major flight of capital in the form of a sharp decline in domestic deposits. In that context, the "tequila" crisis had shown that the authorities had been able to maintain the convertibility regime in the face of a sharp decline in domestic banking sector deposits. Moreover, the domestic banking system had been more fragile, when liquidity requirements had been lower. Also, Argentina had not had the safety net for the contingent repo facilities, and the central bank's reserve had been lower than they were now. Therefore, unless there was a catastrophic scenario, Argentina should be able to withstand substantial pressures and, for some time, a substantial decline in external financing from the levels that it had enjoyed in recent years, but with some costs in terms of the scope for growth of both output and employment.

The staff regretted that the authorities were not able to make greater progress in securing greater flexibility of the labor market through the recent reform effort, the Deputy Director remarked. While it was true that the labor market in Argentina over the past few years had exhibited considerable flexibility, that had been achieved through a sharp increase in unemployment and an increase in marginalization of the labor market. Labor market reform should allow greater flexibility, so as to permit a return to a formal labor market, which had been marginalized as a result of existing rigidities. Although the staff did not have an ideological bias against centralized bargaining, the emphasis in Argentina has been on full centralization of bargaining, particularly with regard to basic wages. As mentioned by Mr. Zoccali, a number of large multi-national companies and privatized enterprises had been able to introduce, through enterprise level agreements, greater flexibility in actual arrangements of production, permitting increases in efficiency and productivity. However, the current legislation represented a step backward because it reduced the status of enterprise level agreements vis-à-vis collective agreements. The staff had strongly opposed that feature. The government had agreed to change that during a debate in Parliament; however, it had been unable. It was hoped that, especially if economic activity were to take a downturn, the unions would exhibit a certain degree of responsibility and allow the continuation of the flexibility that had already been built in decentralizing the enterprise level agreements when they expired. The law was such that when those agreements expired, they were automatically replaced, unless they were renegotiated within a year by the sectoral level agreement.

From informal conversations with the World Bank, no decisions had yet been taken on a financial support package by the World Bank, the Deputy Director said. The Bank was considering providing Argentina with a structural adjustment loan in the order of US$2 billion to be disbursed over two fiscal years, with a substantial part in calendar year 1998. In addition, a financial sector adjustment loan was being considered to recapitalize the deposit insurance corporation and to augment the contingent repo facility. The staff believed that the IDB was intending to match the World Banks's structural adjustment loan.

With regard to the Fiscal Responsibility Law, the ceiling on the public sector deficit has to be viewed in connection with two other important features of the law, the Deputy Director noted. One was the provision to increase the transparency of the fiscal accounts, and the other was the creation of a fiscal stabilization fund that would provide, over time, the degree of flexibility to adjust fiscal policy to cyclical fluctuations.

The staff representative from the Western Hemisphere Department, in response to a question by Mr. Qi on the vulnerability of Argentina to speculation, said that interest rates in Argentina were tightly linked to world markets and the stock market was too shallow to make it profitable for investors to undertake that kind of speculation.

The survey on the external debt position of the nonfinancial private sector was in its final stages, the staff representative continued. The authorities were in the process of surveying about 300 of the top 500 companies, and asking them to provide information every six months, going back to 1991, on all their assets and liabilities. That information should be available later in the year.

On the banking system, the off-balance derivatives or positions were essentially guarantees and options, the staff representative explained. Options amounted to about 5 percent of on-balance sheet assets, while the put options on the asset side slightly exceeded their equivalent on the liability side.

If the real effective exchange rate were to be weighted in terms of unit labor costs, the picture would be more positive than what the CPI-based index indicated, the staff representative said. On the basis of 1991 equals 100, the CPI-based real effective exchange rate showed an appreciation of about 14 percent, while the unit labor cost index showed a depreciation of about 30 percent. Indeed, the difference was significant.

Mr. Yakusha pointed out that Table 6 reflected the assumptions on foreign direct investment contained in the original program, while Table 8, which might have been prepared at a later stage, presented a more optimistic picture for foreign direct investment inflows. Recently, there had been a significant drop in the Argentine stock market. It had also been assumed that for the next year or two, FDI inflows to emerging markets would be more modest than what had been thought a year ago to six months ago. What were the reasons for such optimistic projections in foreign direct investment inflows for Argentina?

The staff representative from the Western Hemisphere Department responded that that was due to a classification problem. Table 6 had lumped together all flows relating to the public sector, including the part of foreign direct investment, particularly privatization, that went under the public sector classification. Adding that component to the one reported for the private sector made the two tables compatible. Concerning privatization receipts, the mortgage bank would be privatized soon, and most of that revenue would be available in 1999. During the 1995 "tequila" crisis, foreign direct investment had actually not declined. Normally, foreign direct investment projections were made in the context of a longer view.

Mr. Zoccali made the following concluding remarks:

> Staff replies have been very comprehensive and I share the views of Mr. Reichmann on foreign direct investment. Indeed, a short-term cyclical downturn would not be expected to have a major impact on FDI, although some of the projects that are in the pipeline--and the pipeline is very substantial--could be postponed.
>
> Mr. Milleron addressed the issue of competitiveness head on. In fact, we should keep in mind that between 1990 and 1991, productivity growth in the manufacturing sector increased by some 10 percent per year. In this regard, continuing to focus on a CPI-adjusted real exchange rate is misleading.
>
> On the issue touched on by many people, that of the survey on debt, I would not like to give the impression that there is no information. In fact, the available private debt statistics already cover the full universe of bank sector liabilities. Similarly, the nonfinancial public sector debt information shows a debt stock of about US$15.3 billion, of which only US$1.3 billion matures before the end of the year. It includes negotiable obligations which are the bulk of the foreign debt borrowing of private nonfinancial corporations, as well as multilateral lending to these private entities and syndicated bank loans. The survey that is being conducted should help to better identify the trade credit float and any other short-term indebtedness. In any event, the debt-servicing capability of the private sector has not been questioned. Some major private corporations have even made public their contingency plans for punctual servicing in the case that, for example, access to new securitized debt should be curtailed during a prolonged period. Some have already embarked on a process of divestiture; others have redone their own cash flows. But, what is noteworthy is that they are very conscious of their commitments and do not want to repeat any of the problems that became manifest in 1995, in particular.
>
> The 1995/96 post-tequila experience, has, as I said before, tempered the behavior of both the public and the private sector. In this regard, if the country could survive a 18 percent drop in total deposits in three months and additional reforms were introduced to deal with this exceptional volatility, the economy

should certainly be much better positioned to deal with an adverse scenario in the future.

As there were many questions, perhaps I could address some of those issues bilaterally, but I would like to come back on one in particular which is labor-market reform. I think Ms. Zador touched on this, in the sense that there has not really been a trade-off between unemployment and wage competitiveness. Moreover, many of the reforms of a structural character that have been implemented in Argentina have received very broad-based support, and this includes that of the unions. In this regard, Mr. Sivaraman has advised us of the need to build consensus on sensitive issues such as labor reform, and to pursue a course of action that could be sustained in the long run. This, obviously, is very close to my authorities' own line of thinking, particularly as Argentina has come a long way and is now engaged in implementation of second generation reforms where consensus-building is crucial, particularly in this period of run-up to elections.

I do not want to prolong further today's discussion. Consequently, it remains for me to thank my colleagues for their usual strong interest in Argentina and for their continued support for the policies being implemented. I should assure them that my authorities will do everything that will be required to maintain the consistency of their policy framework. If this means a strengthening of policies, I am certain that they will not fail to do so. Finally, I will convey fully the thoughtful observations that have been expressed.

The Executive Board took the following decision:

1. Argentina has consulted with the Fund in accordance with paragraph 3(c) of the Extended Arrangement for Argentina (EBS/98/6, Sup. 1, 2/5/98) and paragraph 2 of the letter dated December 3, 1997 from the President of the Central Bank and the Minister of Economy and Public Works and Services of the Republic of Argentina, to review progress in realizing the objectives of the program supported by the arrangement.

2. The letter dated September 8, 1998 from the President of the Central Bank and the Minister of Economy and Public Works and Services of the Republic of Argentina, with its attached Policy Memorandum, shall be attached to the Extended Arrangement for Argentina, and the letter dated December 3, 1997 with its attached Policy Memorandum and tables shall be read as supplemented by the letter dated September 8, 1998 with its attached Policy Memorandum.

3. The Fund decided that the review contemplated in paragraph 3(c) of the Extended Arrangement for Argentina is completed. (EBS/98/160, 9/10/98)

Decision No. 11804-(98/103), adopted
September 23, 1998

4. EL SALVADOR—STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the request by the government of El Salvador for a 17-month Stand-By Arrangement in an amount equivalent to SDR 37.68 million (EBS/98/163, 9/11/98; Sup. 1, 9/28/98).

The staff representative from the Western Hemisphere Department reported that the latest economic indicators for El Salvador showed that economic activity continued to grow by more than 4 percent in the year through July 1998. Prices had declined by 1.2 percent in August 1998, bringing the annual inflation rate to 2.2 percent in the year through August. Nontraditional exports had also continued to grow strongly, over 12 percent in the period January-August compared to the same period in the preceding year, while import growth had decelerated to below 5 percent, with imports of consumption goods expanding by less than 3 percent. Those latest indicators showed that developments continued to be in line with envisaged performance under the program for 1998.

Mr. Toribio and Mr. Rodriguez submitted the following statement:

We thank Fund's management and staff for their continuous and intensive collaboration with our authorities. Also, we want to convey to them our authorities' appreciation for the constructive dialogue and helpful advice during the discussions for a new Stand-by Arrangement.

As evidenced by a series of consecutive arrangements with the Fund, the Salvadoran authorities have been deeply committed to macroeconomic stabilization and structural reform, aiming at creating the conditions to sustain higher growth rates and alleviate poverty. The authorities view the current program that is being submitted for Board approval as an opportunity to ensure the consolidation of the stabilization process during a preelection period and to advance in the reform efforts. As it has been the case with previous arrangements, this one will also be treated as precautionary.

Recent Developments

As mentioned in the last Board meeting on El Salvador, macroeconomic performance in 1997 was strong, even better than expected. Inflation fell to 2 percent and economic activity recovered its pace, growing at 4 percent. The fiscal deficit was reduced to 1.7 percent of GDP, whereas the current account actually showed a surplus (0.9 percent of GDP) rather than a deficit as indicated by preliminary data.

Based on the economic developments for the first half of 1998, the outlook for the remainder of the year is favorable. Output has continued to grow at a similar rate and, although inflation has risen slightly as a consequence of El Niño and the adjustment in electricity tariffs, it is declining once again and the target should be met with ease. The current account surplus persists as nontraditional exports and remittances have continued their strong pace, while import growth has decelerated. International reserves have increased further, covering seven months of imports and 113 percent of base money. On the structural front, several reforms have been implemented, making significant progress in different areas.

Fiscal policy has remained prudent as the deficit has been in line with projections and the program is on track. There have been numerous pressures on the budget that have been resisted, whereas others such as the wage increase and the subsidy on electricity consumption have been offset, taking additional actions to reduce expenditure. In this regard, it must be noted that wages had not been adjusted since 1995 and that employees' contributions to the pension system were increased as part of the pension system reform. The temporary electricity subsidy was deemed necessary. In the context of the privatization process the elimination of an existing cross subsidy, from businesses to residential customers, required an increase in electricity tariffs that was too large to be implemented all at once.

Monetary policy has been carefully managed to achieve the inflation and balance of payments objectives, limiting the scope for attracting short-term capital inflows. To this end, interest rates were allowed to fall in the beginning of the year, while credit to the private sector has been decelerating.

In the light of last year's incidents in the financial system, the authorities have taken decisive steps to improve the soundness of the system. All financial institutions were thoroughly audited with technical assistance from the IDB, this lead the Superintendency of Financial Institutions to strengthen loan classification and increase the banks' risk-weighted capital requirements. Furthermore, the central bank issued regulations reducing commercial banks' access to external borrowing and setting narrower limits for short-term external debt. In addition, draft legislation has been submitted to congress, establishing stronger requirements to license new financial institutions, limiting lending to related parties, and creating a deposit insurance agency. Legislation dealing with money laundering and penalties for illegal financial transactions has also been presented to congress.

Some important structural reforms have been implemented in other areas. Four electricity distribution companies were sold in January and the telephone company was privatized in July, generating jointly over $800 millions in privatization proceeds (8 percent of GDP). In April, the pay-as-you-go pension system was replaced by one based on individual capitalization accounts, which are privately managed under the regulation and supervision of the Superintendency of Pensions. As part of this reform, other actions have been taken, including an increase in contribution rates.

The Program for 1998-1999

The Salvadoran authorities remain fully committed to continue addressing important challenges, consolidating macroeconomic stabilization, and further strengthening the domestic financial system, while devoting substantial resources to social, environmental, and infrastructure projects to enhance productivity and growth potential. To this end, the authorities view the economic program for 1998–1999 as an important step in the right direction. The stated objectives in terms of growth, inflation, external current account position, and international reserves are based on realistic assumptions and should be attained without major social strains, given the country's track record of economic stability and policy implementation.

On the structural front, the authorities plan to proceed with the sale of the remaining sugar mill already in progress, scheduled to be completed by end-1998, and with the privatization of the Mortgage Bank by June 1999. Also, the authorities intend to finish implementing the pension system reform in 1998. Additional efforts are being made to further enhance the soundness of the financial system. A new Banking Law is expected to be approved by end-1998, whereas another round of comprehensive audits of financial institutions is under way, and should be concluded by February 1999.

The fiscal deficit envisaged in the program (2.7 percent of GDP in 1998 and 2.5 percent in 1999) reflects the increase in the wage bill, the reduction of public savings after the sale of the telephone company, as well as a transitory increase in public investment for key infrastructure projects financed "below the line" by privatization proceeds. On the revenue side, despite the reduction in import tariffs, the tax GDP ratio is expected to increase slightly as a result of improvements in tax administration. In addition, following FAD recommendations to further strengthen revenue collection, the authorities intend to eliminate additional tax exemptions and introduce a new tax procedures code.

As in the past, the authorities are committed to cut public expenditures if fiscal receipts were to fall short of projected levels. Furthermore, no eventual savings in specific outlays will be offset by corresponding overruns in other expenditure categories.

Monetary policy will aim at maintaining current levels of inflation and achieving balance of payments objectives. The growth of credit to the private sector will continue decelerating through 1998 and 1999. The introduction of improvements to the auction mechanism for the issue of CAM's, as well as a reduction and unification of reserve requirements, will lead to smoothing out monetary policy management, eliminating distortions in the financial system.

On the external sector, the outlook for the overall balance of payments is strong, notwithstanding the effect of lower coffee exports and the possible effects of the current turmoil in international financial markets, which could intensify as the crisis affects other regional economies. As projected in the program, net capital inflows (including privatization proceeds) will allow not only for an adequate financing of the current account deficit, but for an increase in gross international reserves and a simultaneous prepayment of external debt and a net redemption of CAMs, which should help send a clear and distinct message to financial markets.

The central bank has followed a policy of intervention in foreign exchange markets, which has kept a constant parity without any significant cost in terms of reserve accumulation or depletion. In the authorities' view, the policy has yielded positive results, the real exchange rate is broadly consistent with the long-run equilibrium exchange rate and no new circumstances have arisen to avail a different exchange rate strategy. On the contrary, in a preelection period and in light of the turbulence in financial markets, changes in the exchange rate system could provoke speculative capital flows, which are not warranted by current fundamentals. The authorities will continue to monitor closely balance of payments developments and will adopt the necessary fiscal and monetary policies to ensure stability and maintain export competitiveness.

Conclusion

In 1997 and through 1998, most indicators of the Salvadoran economy have pointed to a very positive performance. The present Stand-By Arrangement will support the continuation of this performance, which the Salvadoran people appreciate as a way to consolidate the achievements of the peace process, effectively reduce poverty, modernize the economy, and enhance social progress.

El Salvador will continue making all necessary efforts to reform its economic structures with full transparency, including fulfillment of the Special Data Dissemination Standards requirements.

Mr. Sobel made the following statement:

I would like very briefly to commend El Salvador for its continued record of highly favorable economic policy stewardship. Since the end of its tragic civil war, El Salvador has put in place a sound policy framework with the support of consecutive precautionary standbys. Performance has been strong, and the scope of reforms progressively deepened.

Today's request shows that the authorities remain committed to this course. In particular, they are to be commended for the proposed trade liberalization measures, the planned reform of the pension system, this year's privatization program, the use of a portion of the proceeds to pay down debt, the effort to strengthen the role of indirect monetary policy instruments and the authorities' subscription to the SDDS. These reforms, along with continued sound macropolicies, should strengthen the private sector and longer-term growth.

I had a few comments. First, the authorities have stuck by their exchange rate system for several years despite repeated staff advice to increase flexibility. In today's paper, the authorities again express reluctance to modify the policy given elections in mid-1999. Yet, the paper did not indicate whether the authorities are really prepared to consider a change thereafter. While the authorities' exchange rate management has proven most successful, we have sympathy for staff's position that over time greater flexibility may be needed. If real thought is being made to changing the exchange rate regime, we would note that in Eastern Europe, some countries moved with success from a fixed exchange rate anchor and peg and then to a crawling band in order to balance the need for an exchange rate anchor and greater flexibility. Second, we noted that staff's medium-term fiscal projections point to a continuing deficit of 2-3/4 percent of GDP and wondered why, given concerns about competitiveness, staff didn't urge that greater deficit reduction be pursued as a mans of lessening burdens on monetary policy and the exchange rate. Third, we commend the authorities for their efforts to put in place the banking law and to improve supervision. Perhaps staff could elaborate on El Salvador's progress in strengthening its financial system since last year's adverse developments.

Ms. Turner-Huggins commented that considering the 12 percent increase in exports and the deceleration in import growth to below 5 percent for the year competitiveness would not seem to be a concern. To the extent that inflation remained low in El Salvador and that the government saw that as an important objective, more exchange rate flexibility would not appear to be needed at the moment, although that issue should be kept under review.

Mr. Sobel clarified that over time, there might be a need for greater flexibility.

The staff representative from the Western Hemisphere Department agreed with Ms. Turner-Huggins' view that the appreciation of the exchange rate in real terms did not seem to hinder the growth of exports, and the growth of imports was moderate. The staff's recommendation to increase flexibility was based on several factors that might change over time, including the terms of trade, the evolution of remittances and the impact of devaluations in the region. With respect to the last, it needed to be borne in mind that the devaluation of the Mexican peso in 1995 had affected the competitiveness of El Salvador's maquila exports in the U.S. market. Those factors meant that it would be preferable if the exchange rate was allowed to move in line with the fundamentals when necessary.

The staff did not believe there would be any need for large adjustments of the exchange rate in either direction and considered that it stood at an appropriate level, the staff representative emphasized. The main objective of exchange rate flexibility would be to avoid a situation in which a change in the fundamentals would result in disequilibria that would lead to speculative attacks against the currency, create expectations that the authorities would not take the appropriate fiscal measures, or compromise the objective of increasing nontraditional exports. If the structural measures to increase productivity in the area of nontraditional exports did not have the intended result, then exchange rate flexibility could be used as a tool.

In terms of the policy framework for increased exchange rate flexibility, there was already an active interbank exchange market, and the central bank intervened to maintain the exchange rate de facto fixed to the U.S.dollar. Steps were being taken to strengthen market mechanisms and to reduce the existing bias in favor of transactions in foreign currency. The banking system also was being strengthened. Therefore, the required measures to operate a more flexible exchange system were being taken.

Exchange rate policy would probably move in the direction referred to by Mr Sobel, toward some system of bands, and not toward a free float, the staff representative believed. The authorities were concerned that any uncertainty at the domestic and at the international level linked to the national elections could create pressure on the exchange rate and on reserves that would not be justified from the point of view of the fundamentals.

There were three main reasons why a faster decrease in the fiscal deficit had not been aimed for, the staff representative continued. First, El Salvador had access to the financing to cover the fiscal deficit without imposing undue pressures on the private sector. Second, essential public investments needed to be made in the areas of infrastructure—especially rural infrastructure, which had been damaged by the recent civil war— and health and education. Third, while the pension system had been modified to introduce private pension funds, central government transfers to the existing system would have to continue for some time. The system was being strengthened through an increase in contributions as well as in the time needed to qualify for a pension, over a period of five years, from 25 years to 30 years. There was therefore still considerable pressure on public expenditure. Trade liberalization measures and the reduction in import duties were constraining the revenue side, and the authorities did not wish to pursue the only alternative, which would be to increase the value-added tax above 13 percent. Additional revenues might come from privatization, but that was uncertain.

The staff believed that more could be done to reduce the size of the public sector, the staff representative concluded. The authorities had already made some effort in this respect, but they were simultaneously constrained by the need to increase security and to strengthen the health and education sectors. Although the deficit was not decreasing, it was compatible with maintaining inflation at the level of trading partners, and would not erode the competitiveness of the country. With a rate of growth close to 5.5 percent, and the support of institutions such as the World Bank and the IDB, El Salvador should be able to attract some additional private investment.

Mr. Rodriguez made the following concluding statement:

> The authorities' current view of the exchange rate policy is well justified. They have managed fiscal and monetary policy, and exchange rate policy responsibly, and given the coming elections, they have little scope to make further commitments. The fiscal deficit projections are conservative. Perhaps more can be done in terms of tax collection, an area in which important reforms are being implemented.
>
> I thank Executive Directors for their comments, which I shall convey to my authorities. This is one occasion on which one would like to think that silence means strong endorsement of the Fund staff appraisal, and I would find it very positive in this case. I should like to thank the staff for its work on El Salvador and express my authorities' appreciation for the support they have received from the staff and management.

The Executive Board took the following decision:

1. The government of El Salvador has requested a Stand-By Arrangement for a period of 17 months from September 23, 1998 to February 22, 2000 in an amount equivalent to SDR 37.68 million.

2. The Fund approves the Stand-By Arrangement set forth in EBS/98/163, Supplement 1.

Decision No. 11805-(98/103), adopted
September 23, 1998

5. BOLIVIA—INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—COMPLETION POINT

The Executive Directors considered the completion point document, prepared jointly by the staffs of the Fund and the International Development Association, on the Initiative for Heavily Indebted Poor Countries for Bolivia (EBS/98/159, 9/4/98; Cor. 1, 9/14/98; Cor. 2, 9/16/98; and Sup. 1, 9/23/98).

The Executive Board took the following decision:

1. The Fund, as Trustee (the Trustee) of the Trust for Special ESAF Operations for the Heavily Indebted Poor Countries and Interim ESAF Subsidy Operations (ESAF/HIPC Trust Instrument) established by Decision No. 11436-(97/10), February 4, 1997, determines that:

(i) the conditions specified in paragraph (ii) of Decision No. 11575-(97/94) adopted September 10, 1997, for Bolivia to reach the completion point have been met;

(ii) the external debt sustainability target for the net present value of the debt-to-exports ratio for Bolivia is within the range specified in paragraph (iii) of Decision No. 11575-(97/94); and

(iii) satisfactory assurances have been received regarding the exceptional assistance to be provided under the HIPC Initiative by Bolivia's other creditors.

2. Accordingly, the Trustee confirms that, in accordance with Section III, paragraph 3(d) of the ESAF/HIPC Trust Instrument, the SDR equivalent of $29 million shall be made available by the Trustee to Bolivia in the form of a grant that shall be paid on September 28, 1998 to an account for the benefit of Bolivia established and administered by the Trustee in accordance with Section III, paragraph 5 of the ESAF/HIPC Trust Instrument; the proceeds shall be used by the Trustee to meet Bolivia's debt-service payments on its existing debt to the Fund as they fall due, in accordance with the schedule specified in the table attached to EBS/98/159, Supplement 1 (9/23/98).

Decision No. 11806-(98/103) adopted
September 23, 1998

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/98/102 (9/22/98) and EBM/98/103 (9/23/98).

6. EXECUTIVE BOARD COMMITTEES—NOMINATION

The Executive Board approves the nomination of Mr. Pickford to replace Mr. O'Donnell on the Committee on Administrative Policies, the Committee on Interpretation, and the Committee on Liaison with the World Trade Organization.

Adopted September 22, 1998

7. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 98/8 are approved.

APPROVAL: March 26, 2001

SHAILENDRA J. ANJARIA
Secretary