

MASTER FILES
ROOM C-525

Q418

December 28, 1992

Statement by Mr. Zoccali on Argentina
Executive Board Meeting 92/157
December 30, 1992

Introduction

My Argentine authorities would like to thank Fund Management and Staff for the very frank and constructive discussions regarding the program parameters for the second year of the Extended Arrangement and for the catalytic role played by the Fund in securing the official external enhancement resources required for the full normalization of Argentina's relations with its commercial bank creditors.

The authorities have been laying the foundation for renewed growth through more stable, transparent and market-based rules. During the last two years, currency convertibility, tax and trade reform, privatization and liberalization of real and financial markets have served to restore private sector confidence and to stretch out planning horizons after years of disinvestment.

Inflation has fallen to the lowest levels in decades while economic activity has been growing rapidly. The average increase of consumer and wholesale prices during the twelve months ending November 1992 was 10.2 percent, down from 58.4 percent a year earlier. Similarly, real growth for 1992 is projected at 7 percent, after a 5 percent increase in 1991. Moreover, the expected attainment during the present year of an overall fiscal surplus of 0.8 percent of GDP points to the underlying sustainability of the policy framework.

Review under the 1992 Program

As was pointed out in the Staff report, the September 30, 1992 quantitative performance criteria were observed with substantial margins and the end-December targets are also expected to be met. With respect to the reform of the Social Security System, incorporated as a structural benchmark of the program for end-October, my authorities have submitted to Congress a proposal entailing a self-financing pension and retirement scheme which at the same time will foster private savings, enlarge the domestic capital market and help to intermediate longer term resources to renewed investment opportunities arising from privatization, deregulation and the systematic downsizing of public sector activities. The significant efforts made since mid-year to develop the widest possible political consensus are beginning to bear fruit in terms of generalized acceptance. In view of other important legislation recently adopted, including the new central bank charter, the authorization for the full privatization of the oil company (YPF) and the revamping of the audit and control mechanisms over budgetary expenditure, enactment of the social security reform is expected before the conclusion of the next program review.

Cognizant of the importance of the reform, my authorities have been adapting the proposal in light of legitimate concerns while keeping intact both its overall objectives and the underlying fiscal targets for the program period. The fully capitalized system will be accompanied by an increase in the retirement age to 65

years for both men and women from the present levels of 60 and 55 years, respectively, taking effect gradually from date of enactment. Additionally, workers' contributions towards the new system will be mandatory while preserving their right to choose amongst pension fund administrators. The fact that the new system would be in place in January of 1994 and that all employees would now be part of the capitalized system, as opposed to only those 45 years old or younger in the earlier proposals, raised the question of equivalency which the Staff answer in their paper. In this regard, my authorities wish to highlight the fact that public sector expenditure in the second half of 1992 already takes into account the increase in pensions to their legal minimum, thus terminating the accumulation of arrears under the present system earlier than programmed. This represents an additional fiscal effort of 0.4 percent of GDP, which would translate into an over-compliance for 1992 of approximately 0.6 percent of GDP. For the program period 1992-94 as a whole fiscal performance would actually exceed the adjusted program projection by 0.5 percent of GDP, with a balance in the overall public sector accounts throughout.

Current Policy Issues

My authorities share the broad thrust of the Staff appraisal, particularly the need to enhance competitiveness through structural reforms aimed at lowering costs. Consequently, I will briefly address the three major issues of concern, namely, the sustainability of the fiscal and trade positions and the consistency of monetary policy.

On the fiscal front, the degree of consolidation cannot be overlooked as the overall balance of the combined public sector shifted from a deficit of 3.3 percent of GDP in 1990 to a surplus of 0.8 percent in 1992. Excluding revenues from privatizations, the overall balance is projected to show a deficit of only 0.4 percent of GDP in 1992 and a surplus, after full debt service payments, of 0.9 percent in 1993.

While strong economic activity has contributed to revenue growth, the fiscal reform has been resolutely centered on the fight against tax evasion and the simultaneous simplification of the tax structure, broadening on the one hand the value added tax base and on the other eliminating distortive taxes such as those on exports and bank debits. General government revenue, excluding privatization receipts, rose as a percentage of GDP from 17.5 in 1990 to 25.5 in 1992 and is expected to reach 27.2 in 1993. Further reductions in tax evasion, particularly of social security taxes, are envisaged during 1993-94. Centralized cross-checking between VAT collection and social security contributions by the Secretariat of Public Revenue is expected to contribute to their growth.

In this context, public expenditure, excluding interest payments, is projected to be 0.8 percent of GDP higher than programmed for 1992, reaching a level of 23.3 percent. Having increased pensions to the legal minimum, thus eliminating the accumulation of arrears for an important segment of the population with fixed incomes, and having selectively adjusted remunerations, particularly to key echelons of the public administration to build up the capacity for policy implementation, my authorities are intent on containing further spending pressure and on increasing the productivity of that expenditure. The 1993 Budget Law enacted on December 23, will

come under the procedures of the new law on Financial Administration and Control of the Public Sector. This is viewed as a milestone for enhanced fiscal discipline as it integrates into one system the budgetary, accounting, treasury and public debt areas. The Treasury will thus be in the position to effectively implement the procedure of quarterly authorizations of expenditure *pari passu* with projected revenue. Finally, the aforementioned legislation also establishes an effective linkage between the individual internal audit offices at each public sector entity and two new external audit administrations, reporting respectively to the Executive and Legislative Branches.

The trade deficit, estimated at US\$1.2 billion for 1992, has been linked by some to the real appreciation of the peso, in view of its fixed parity with the US dollar since April 1991. In assessing the trade imbalance the level and composition of imports deserve particular attention. Despite their trebling since 1990 as a result of trade liberalization and strong economic activity, they represent only 8 percent of GDP and are comprised mostly of intermediate and capital goods, with a direct bearing on future productivity gains. Exports, on the other hand, are projected to grow in 1992 by 6.2 percent in value terms notwithstanding the weak international environment and regional spill-over effects.

The external measures announced last November should be viewed as motivated by trade and not exchange rate considerations. The statistical tax on imports, excludes most capital goods, and is considered temporary in nature. My authorities believe that any distortions should be eliminated as the pent-up demand for imports tapers off or as additional exports result from increased private investment in non traditional sectors and hopefully from a conclusion to the Uruguay Round of trade negotiations. It is also important to take stock of the fact that the same package of trade measures also included the elimination of the Patagonian industrial promotion scheme and further diluted the remaining industrial subsidies.

This being said, Argentina's external trade flows should continue to expand as a result of the full-fledged process of privatization and of the structural transformation underway at the macro and micro levels. As these changes translate into greater efficiency and reduced costs, historical real exchange rate comparisons influenced by bouts of past hyperinflation become unreliable at best. Moreover, statistically significant indicators of competitiveness have yet to incorporate the effects of the elimination of foreign exchange controls, export taxes, fuel oil and gas oil taxes, the deregulation of port services and renewed access to foreign financing, to name but a few of the simultaneous changes taking place in the economy today. Consequently, my authorities have reaffirmed their commitment to convertibility and to the nominal anchor. Measures were introduced to advance substitutability between the peso and the dollar, reducing in the process both transaction and financial costs. Thus, given the fiscal stance described above, the authorities were able to reverse the exchange market uncertainties which briefly appeared last November. Central Bank sales of foreign exchange, amounting to US\$230 million, have given way to record purchases of around US\$1.3 billion in December, reflecting in part seasonal liquidity needs. Nevertheless, future sales of foreign exchange should be expected as part of the normal functioning of the convertibility scheme.

Sizable capital inflows are responsible for the overall surplus in the balance of payments projected for 1992. The reversal of decades of capital flight continues and is accompanied by regained access to external financing by a growing number of domestic borrowers. The main difference between this experience and that of the late 70's and early 80's in this regard is that these equilibrating flows are private and in the context of a major modernization drive of the economy. To the extent that the marginal efficiency of the investment exceeds the cost of its financing there is no ex-ante reason to anticipate future problems. Moreover, increasing private sector foreign liabilities are a sign of confidence in the policy framework and perhaps more importantly of a growing commitment to price and exchange rate stability at the micro level.

With respect to monetary policy, the sustained pace of remonetization after the hyperinflationary troughs of 1989-90 has been accompanied by a further drop in inflation. M4, defined as M3 plus foreign currency deposits, has increased almost 100 percent in GDP terms since the Convertibility Law was introduced and now approaches 18.5 percent. This level is similar to the one reached at the height of the Austral Plan but is still below that of earlier historical peaks or of those prevailing in traditionally more stable economies. Higher levels of monetization in Argentina would benefit intermediation by reducing the ratio of operational costs to deposits, thus allowing for further declines in spreads and interest rate differentials, particularly for those borrowers which do not yet have access to external resources. This having been said, my authorities have shown caution in reducing the very high legal reserve requirements during the current year, which for example still stand at 71 percent for demand deposits, a higher level than originally envisaged under the program. In this same vein, swap operations to smooth intra-monthly liquidity needs have been undertaken in limited amounts so as not to unduly influence market interest trends which are a key variable of adjustment in the present policy framework.

The recent measures introducing, inter alia, checking accounts in dollars and new flexibility for banks to integrate part of their legal reserves on peso deposits also in dollars will help to strengthen the financial system, reduce the risks of runs on deposits and produce greater interest rate convergence between the domestic and international money markets. A very important externality of Argentina's bi-monetary arrangement is that the dollar may be used for all transactions, except the payment of wages and taxes. With the dollar in wide usage, the contractionary effects of an unanticipated flight from the peso could be expected to be quite limited.

Last, but certainly not least, the recent signing of the debt and debt service reduction accord with commercial bank creditors on December 6th. marks the final major hurdle for the complete normalization of the public sector's external contractual obligations. Strict adherence by the participating official institutions to the planned sequence of authorizations of enhancement resources is deemed essential given the substantial amounts of collateral to be acquired. Total public indebtedness both domestic and external, including obligations to pensioners and suppliers will thus have been reduced to approximately 42 percent of GDP by end 1993, lowering the country's exposure to interest rate risk and enhancing the prospects for sustained medium-term external viability.