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04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/43

3:00 p.m., March 10, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	D. C. Templeman, Temporary
	G. Ercel, Temporary
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
Huang F.	
	Jaafar A.
	J. R. N. Almeida, Temporary
	M. Foot
	I. Puro, Temporary
M. Massé	
	A. Abdallah
F. L. Nebbia	
Y. A. Nimatallah	
	J. de la Herrán, Temporary
H. Ploix	
	J. de Beaufort Wijnholds
C. R. Rye	
	A. A. Agah, Temporary
	A. Vasudevan, Temporary
S. Zecchini	N. Coumbis

L. Van Houtven, Secretary
L. Collier, Assistant
S. L. Yeager, Assistant

Also Present

IBRD: P. R. Scherer, Latin America and the Caribbean Regional Office. Asian Department: P. R. Narvekar, Deputy Director; A. Ariyoshi, U. Baumgartner, I. Otani, S. M. Schadler, B. J. Smith. European Department: L. J. Lipschitz, J. K. Salop. Exchange and Trade Relations Department: M. Guitián, Deputy Director; S. J. Anjaria, J. Berengaut, J. T. Boorman, C. Brachet, A. B. Petersen, C. M. Watson. External Relations Department: C. S. Gardner, Deputy Director; H. P. Puentes. Fiscal Affairs Department: K.-Y. Chu, W. R. Mahler, Jr., F. Sanchez Ugarte. Legal Department: P. L. Francotte, J. V. Surr. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. C. Deppler, P. R. Fenton, S. Takagi. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; C. V. A. Collyns, J. Ferrán, C. M. Loser, C. Ramirez-Rojas, B. C. Stuart. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, G. Nguyen, A. Ouanes. Assistants to Executive Directors: H. Alaoui-Abdallaoui, A. Bertuch-Samuels, B. Bogdanovic, F. Di Mauro, J. J. Dreizzen, R. Fox, G. D. Hodgson, L. Hubloue, S. King, H. Kobayashi, J. A. K. Munthali, K. Murakami, J. K. Orleans-Lindsay, J. E. Rodríguez, S. Simonsen, B. Tamami, L. Tornetta, A. J. Tregilgas, H. van der Burg, B. D. White.

1. JAPAN - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/86/42, 3/10/86) their consideration of the staff report for the 1985 Article IV consultation with Japan (SM/86/24, 2/10/86; Cor. 1, 2/21/86; and Sup. 1, 3/6/86). They also had before them a report on recent economic developments in Japan (SM/86/36, 2/24/86; and Sup. 1, 3/4/86).

The Deputy Director of the Asian Department commented that although the performance of the Japanese economy had been impressive, the authorities faced difficult policy challenges, with painful dilemmas on both the fiscal and monetary sides. On monetary policy, the dilemma had eased somewhat with the strengthening of the yen, which should appropriately lead to reduced interest rates, as had occurred recently.

With respect to fiscal policy, the Deputy Director continued, the dilemmas were more severe. The staff respected the broad consensus in Japan on the need for reduction of the budget deficit and consolidation of the fiscal position. Nevertheless, in view of the need to keep domestic demand sufficiently strong, in the interests of both Japan and the rest of the world, the staff had recommended a certain degree of flexibility in implementing the longer-term objectives of fiscal policy.

Large differences had emerged between the projections of the staff and the Japanese authorities for the balance of payments and, more important, for domestic growth in the next fiscal year, the Deputy Director observed. While the authorities had forecast growth at 4 percent, the staff projection was for just over 2 percent. The Japanese official projections had been made in December-January, whereas the staff projection was more recent and took account of the oil price decline and the appreciation of the yen. Several Directors had commented that probably the official projection was too optimistic and would not materialize; he would add that similarly, the staff projection also might not materialize because of both uncertainties relating to the projections and the likely policy response to any marked slowing down of the economy. Underlying assumptions might not be realized and, moreover, past quantitative relationships on which the projections were based might not obtain because of the large magnitude of recent changes in variables such as exchange rates and oil prices. Moreover, the authorities' record indicated that they would respond flexibly to maintain the strength of domestic demand. During the past 25 years, there had been only 1 year when the growth rate of the Japanese economy had been less than 3 percent. That success was no accident but reflected policy responses.

On trade policy, the staff believed that the protection of agriculture was a significant problem in Japan, because it contributed to inefficiency and misallocation of resources, the Deputy Director of the Asian Department stated. On the side of manufactures, there was a need to remove informal arrangements pertaining to developing countries' exports. As newly industrialized countries gained in competitive advantage, Japan should make room for their exports.

The staff representative from the Asian Department commented that private forecasters had originally projected growth of about 3 percent for 1986/87, based on an exchange rate of ¥ 200 = $1. That rate was out of date; but some forecasters had assumed a stronger yen--for example, the Tokai Bank had assumed a rate of ¥ 187 = $1--and had projected a growth rate of 2.0 percent. Other institutions had provided forecasts under alternative exchange rate assumptions; for example, the Industrial Bank of Japan had estimated that at an exchange rate of ¥ 190, growth would be only about 1.6 percent in 1986/87, compared with an estimated 3.1 percent at the ¥ 220 baseline assumption. The Mitsui Bank had estimated that growth would fall by 0.6 percentage points for every appreciation of ¥ 10 vis-à-vis the dollar, with growth dropping to only 1.2 percent at ¥ 190 = $1. The staff had concluded that the private forecasters' estimates were not inconsistent with its projections.

The staff forecasts had been adjusted to take account of recent exchange rate developments and lower oil prices, the staff representative explained, but the most recent discount rate cut had not been factored in to the extent that it had not shown up in market interest rates. The staff envisaged those recent changes flowing through four basic channels to the economy. First, through the direct balance of payments channel, the staff envisaged export volume declining by about 4 percent in 1986/87, compared with 3 percent growth in the current year, while import volume would increase by about 6 1/2 percent, compared with growth of only 1.3 percent in 1985/86. The withdrawal of external stimulus to growth of 1 1/2 percent of GNP was a direct reflection of external adjustment taking place. The effectiveness of exchange rate adjustment in changing the balance of payments was not yet apparent because of the J-curve effect.

The second channel would be through lower oil prices, the staff representative continued. A decrease to $15 a barrel on average for the current year, for example, would add as much as 0.8 percent to GNP growth. The staff had assumed that the oil price change would be passed through in the next three-six months, but not fully in the utility sector, where only one third of the decrease would be passed on in the form of lower utility rates. The staff had forecast that utilities would hold back two thirds of the windfall profits, which would be used to a large extent to boost investment in the electric utility sector. In addition, windfall profits by the oil companies and the utility sector would tend to boost investment. The staff did not foresee a substantial increase in savings coming from lower oil prices; the arithmetic effect of the lower value of oil imports would amount to a total of 0.9 percent of GNP; savings could increase as much as 0.1 percent of GNP, while 0.8 percent would flow through in higher consumption and investment.

The third channel would be through the terms of trade, as effected through the further appreciation of the yen, which would provide a positive boost to GNP growth of 0.2 percent, the staff representative added.

The fourth channel covered the residual and second-round effects of the export slowdown, the staff representative said. The staff believed that those would be negative and substantial in 1986/87. They would result from the multiplier effect of lower growth in traded goods industries, as well as the effects of export contraction through low wage increases in the spring wage offensive that would take place next month. For example, recently the shipbuilding industry unions had announced that they would not press for any wage increases during the current year. Although it had been noted that wages might be sustained because of cost and productivity gains, the staff considered that, on balance, lower wage increases would result. A secondary result through that channel was the strong accelerator effect on investment. The staff and official forecasts had differed substantially with respect to private investment. Important forces operated in both directions; he agreed, however, with Mr. Fujino on the favorable elements of the investment outlook relating to high technology research and in the nonmanufacturing sector. However, the Japan Development Bank had estimated a short time previously that about 70 percent of all investment decisions in Japanese industry were directly or indirectly related to developments in the export sector. That large proportion explained investment's strong response to the export slowdown as seen by the staff. The positive side of the present recovery was that investment was the element of domestic demand that responded when export demand picked up; the negative side resulting from the same tight relationship should also be kept in mind.

The profit situation facing Japanese industry had already begun to look rather bleak, the staff representative commented. For example, profits in the manufacturing sector in 1985/86 were likely to be 10 percent lower than the previous year. That factor was likely to have a negative effect on investment, adding to the uncertain outlook for the Japanese manufacturing sector. Nevertheless, the staff forecast a respectable growth in private investment of 4 percent. In addition, investment would get a boost from low oil prices, according to the perceptions of the business community as to the durability and extent of the decline and its timing. The positive effects of low oil prices on investment would come only with a lag and would not be significant in the coming year.

With regard to fiscal policy, the staff had pointed out that progress in reducing the general government deficit had been much greater than in reducing the deficit for the general account of the Central Government, the staff representative noted. Although he agreed with speakers that the staff should not be overly concerned about the central government general account deficit, the authorities, who had a responsibility for budgeting, had legitimate reason to consider the deficit a problem because of the level of debt and the share of expenditures that was absorbed by interest in that account. They had accorded priority to that deficit and were not as directly concerned with developments at the broader general government level.

Because of the authorities' priorities and objectives, the staff in its recommendations and discussions had sought to find ways to encourage flexibility in fiscal policy outside the general account budget, the staff representative explained. The objective was to determine a consistent overall fiscal policy while accommodating the authorities' legitimate concerns. For that reason, the staff had called for more spending at the local government level and by public enterprises. The staff endorsed the changes introduced in the budget by the authorities shortly after the Fund mission's visit to Japan. Nevertheless, taking into account recent developments affecting growth, the staff believed some of the opportunities that existed for fiscal flexibility should be applied also in the general account budget, for example, through a tax cut and additional public works spending.

There was a possibility that if a tax cut were put in place a large part of it might be saved, the staff representative remarked. That aspect would be an important consideration when the authorities implemented the planned major tax reform. Another disadvantage of a tax cut was that it might take some time to be put into effect, although an advantage was that the authorities seemed to know the direction in which they were planning to move on the personal income tax side. Therefore the longer-term objectives of fiscal policy would not be compromised.

The merit of additional public works spending was that it could be implemented rapidly, the staff representative commented. The authorities had already announced in their October 1985 stimulatory package the bringing forward of public works spending. By reintroducing the front-loading of public works spending, from the amounts budgeted for the current year--a traditional practice in Japan--the authorities could immediately give some stimulus to the economy, and the gap in the second half of the year in the budget could be made up in due course by supplementary appropriations. He considered the additional public works spending the most advantageous flexible instrument, although he realized the authorities must also consider other aspects.

The postal savings system had an extensive network of branch offices that made it a powerful competitor for deposits, the staff representative said. It had implicit government backing and was exempt from some of the reserve requirements and other regulatory arrangements that applied to the banking system. Therefore in discussing deregulation, banks were concerned about their competitive position vis-à-vis the postal savings system. The public was a powerful lobby, and it had been assured of high interest rates from the postal savings system; the political resistance to deregulation and to perhaps lower deposit rates in the system was another impediment to change.

At the same time, the postal savings system had no flexibility in its asset management, the staff representative continued. The need for an institution like the postal savings system as conduit to generate savings for public sector investment had arisen at an earlier time in history and perhaps no longer existed in present circumstances. But changing the system would call for careful consideration because of the sizable amounts of money and flows of resources--both in the private sector and in public investment--that would be entailed. The staff had noted that reform of the postal savings system was crucial to further liberalization of the financial system in Japan. Although much had been accomplished, the authorities would need to make further progress soon in that area if liberalization of the financial system were to proceed as desired.

At the previous meeting, speakers had noted that the staff's balance of payments forecast in the report for the 1984 Article IV consultation had substantially underestimated the size of the current account surplus in 1985/86, the staff representative recalled. In the first ten months of the current year, the current account surplus in fact had amounted to $45.5 billion on a seasonally adjusted basis. Had the surplus continued to run at that rate for the remaining part of the year, the surplus might not have been too much above the staff's estimate made one year previously. The staff now believed that the surplus in the last two months of the year was likely to run at a substantially higher rate than earlier forecast. The Japanese authorities believed that the surplus for the current year would be less; much would depend on the speed with which lower oil prices were translated into the trade figures.

In the present staff report, instead of providing quantitative medium-term projections, the staff had prepared a section dealing with the forces underlying savings and investment behavior, the staff representative said. From that point of view, substantial and continued surpluses were not expected to disappear in the short term. Some projections, which had been made to determine the evolution of the current account position if the exchange rate persisted at the current level, indicated that if external market growth continued at the current level of 3-4 percent and if growth in Japan in the remainder of the decade was about 4 percent, the current account surplus in the year 1990 would be no lower in dollar terms than currently, or somewhat higher. The evolution of the current account position as envisaged by the staff in that scenario included a steep rise in 1986/87 as the J-curve effect predominated over the five quarters following an exchange rate change. Subsequently, the volume effects would become predominant, so that in 1987 some decline in the current account surplus would be noticeable. After those volume effects would have worn off, the longer-term effects, both of market growth in the rest of the world on Japanese exports and of demand growth in Japan on Japanese imports, would predominate in the medium term.

The current account surplus, in itself, was a way in which the interaction of policies and developments in different countries found their resolution, the staff representative explained. While large imbalances might be a problem in themselves, the main problem with the large Japanese current account surplus was that it provoked protectionism. Therefore a reasonable current account surplus for Japan in 1990 would be one that was consistent with harmony in international relations and that did not provoke protectionist problems; zero balance was not a reasonable objective in any medium-term framework. However, not only the level but the incidence of the surplus was important in determining whether it was reasonable. A continued unchanged surplus by 1990, but one that at the same time provided a greater resolution of the bilateral surplus with the United States, would probably render it more benign. In fact, the staff's scenarios projected a significant dip in the current account surplus vis-à-vis the United States by 1987 because the adjustment in the exchange rate for the yen that had taken place was much greater vis-à-vis the U.S. dollar than other currencies.

In the medium-term framework, three main factors could work on the surplus: the growth in demand abroad, the growth in domestic demand, and the change in relative prices as influenced by the exchange rate, the staff representative noted. The most powerful effect on Japan's current account surplus was through changes in external demand. Japan's economic success was, in essence, that it found a growing market and moved to meet demand effectively in both export and domestic markets. The elasticities on the export volume side were quite high, although the level of external demand could not be controlled by the Japanese authorities, and obviously no one would wish to prescribe that the world should go into recession simply to correct Japan's current account surplus. Nevertheless, in looking at the current account scenarios, the level of growth in foreign demand was a very important input in the evolution of the surplus. If the world grew 1 percent faster or slower a year until 1990, the surplus in Japan's current account position would be higher or lower by about $10 billion by 1990.

Demand in Japan had the least powerful effect in a statistical sense on the current account surplus, the staff representative pointed out. The composition of Japan's imports, which were heavily dominated by oil and raw materials, was relatively inelastic with respect to Japanese growth. The volume of imports of manufactures was much more responsive to demand in the Japanese economy, but they were a relatively small part of the total import bill.

The exchange rate was the most powerful instrument, among those available to the authorities, to affect the current account position, the staff representative continued. An adjustment in the value of the yen had significant effects on the export side. Imports were less responsive to price changes arising from the exchange rate because of the imports' compositional effects. The staff had prepared alternative scenarios which indicated that if the yen were to become substantially stronger in the period ahead, the current account surplus would be considerably lower by 1990. However, even with a further substantial appreciation of the yen, the surplus would remain not inconsiderable in dollar terms, despite fundamental forces working on the current account position and the savings investment balance. Other possible policies to reduce the surplus would be changes in tax incentives for savings and deregulation and liberalization mechanisms currently being considered by the authorities. Meanwhile, other countries would also have an effect, for example, the efforts of the United States to address its fiscal problems.

In the past 11 months, the yen had appreciated by 15 percent in real effective terms, the staff representative from the Asian Department stated. That appreciation had taken place from a very low level. Compared with the past ten years, when the Japanese current account position had been more often in surplus than deficit, the present real effective value of the yen was still somewhat on the low side. It was therefore difficult to state that the yen had, by its recent move, reached a level that in historical terms was obviously overvalued. The real difficulties being faced by small and medium-sized export-oriented industries in Japan had not arisen because the yen was too strong based on past relationships. The authorities' policy of not resisting a higher yen in the event the market pushed in that direction, however, seemed to be appropriate. Certainly a weakening of the yen would not be something to aim for from an external adjustment point of view.

The staff representative from the Exchange and Trade Relations Department observed that the future path of Japan's current account surplus depended on the policies that would be taken and the reaction of the exchange rate over the next several years. However, even taking into consideration the alternative scenarios, there was a certain winding down of the Japanese current account surplus in real terms or relative to GNP, perhaps reflecting the winding down of U.S. requirements of savings from Japan for the financing of the U.S. fiscal deficit.

Japanese capital flows already included large amounts--through bond issues, bank lending, and direct investment--to developing countries, the staff representative continued. About two thirds of foreign bond issues in Japan were in the name of developing countries or multilateral lending institutions. It was also important to note that the depreciation of the yen would have the effect of making certain sectors in Japan less competitive and thereby possibly stimulating more flows of direct investment. One mechanism that would be important in that aspect was the World Bank's Multilateral Investment Guarantee Agency, which was well on the way to operation.

Short-term government securities amounting to about ¥ 500 billion had been issued in Japan for the first time in February 1986, the staff representative from the Exchange and Trade Relations Department said. Those securities had a six-month maturity and a minimum denomination of ¥ 100 million. The staff was not certain about their prospects, but there was scope for issuing maturities of other than six months in the future. The issue was a relatively small one compared with other international treasury bill markets, but it was Japan's first. A withholding tax arrangement was associated with the issue, and the staff was not clear at present what the mechanism and timing of that withholding would be, especially with respect to foreign holders. There were restrictions on the holdings of those instruments, for example, by pension funds. The staff would have further discussions with the Japanese authorities on capital markets in May 1986.

Mr. Fujino commented that there was broad agreement between the staff and his authorities on the basic direction of Japan's policy stance, and a basic endorsement by Executive Directors of Japan's medium-term strategy. However, many Directors had expressed the need for flexible policy management and had observed that the withdrawal of fiscal stimulus would be inappropriate when there appeared to be a likelihood of downside risk in the economy. In fact, within the framework of the medium-term objective of fiscal reform, flexibility was well embodied in the budget for 1986/87, which placed particular emphasis on the expansion of domestic demand.

In 1986/87, total actual public work expenditures were projected to increase by 4.3 percent, and financial investment and loan program allocations for housing loans were expected to rise by 10.5 percent and for public works by 11.9 percent, including sewer facilities and highway construction, Mr. Fujino continued. The economy would continue its moderate growth, supported exclusively by domestic demand and the flexible use of fiscal resources. Japan's track record demonstrated the authorities' responsiveness to the needs of the economy.

Some questions had been raised about the prospects for economic growth in 1986/87 because of a large difference between the official forecast and the revised staff forecast of 2.1 percent, Mr. Fujino recalled. Indeed, the staff calculation of the impact on the economy of the latest appreciation of the yen was surprising. Although the staff had carefully explained that the projections were subject to considerable uncertainty, he was concerned because Fund projections tended to stand alone. The staff's revised projection for the current account surplus in 1985/86 was $59 billion. However, for the ten months April 1985-January 1986, the surplus was actually $44 billion. The current account surplus had been $6 billion in February-March 1985, while the average monthly surplus had been $4.4 billion from November 1985 to January 1986. The final outcome for the year might exceed the official forecast of $51 billion, but by no more than $1-2 billion. To reach the staff's estimate of $59 billion, Japan would have to accumulate a surplus of $7 billion in both February and March, which was unrealistic. The projection base for the current fiscal year was also reflected in high figures for the next fiscal year.

The staff's revised projection for GNP growth in 1986/87 was 2.1 percent, Mr. Fujino noted. Domestic growth was forecast to reach 3.7 percent; however, there was a negative foreign balance because of Japan's net contribution to trading partners. Although that contribution provided stimulus to Japan's trading partners, the figure of minus 1.5 nevertheless seemed too large. He had many reservations about the staff projections for domestic growth. Excessively negative projections could, unfortunately, be counterproductive rather than provide appropriate guidance. Imbalances, especially in relative terms, should be considered the inevitable adjustment items in a transitional period from a large surplus to a more sustainable surplus.

He firmly believed that the Japanese economy would continue to respond positively to changing developments, Mr. Fujino said. The policy package announced by the authorities, the two reductions in the official discount rate in five weeks by 1 percentage point, and the improved terms of trade would work to support the growth rate forecast by the Japanese authorities, based on domestic demand. Under those favorable circumstances, each component of demand and each decision-making unit in the economy would respond positively to produce more growth. In past years, immediately following a sharp increase in the exchange rate of the yen the growth rate had registered 5 percent. In recent years, growth had never fallen below 3 percent, with the exception of 1974/75 when the sharp rise in oil prices had affected economic activity in Japan.

One component of domestic demand was plant and equipment investment, where demand was strong for high technology and research, Mr. Fujino remarked. Replacement investment was also increasing in a very competitive environment.

The Japanese authorities had considered that passing through the benefit of yen appreciation or price reduction to consumers--especially in the case of utilities--would not be very helpful in stimulating demand, Mr. Fujino remarked. Rather, a major part of that benefit would be retained by the utility companies and would be used for investment purposes, a more effective way of supporting demand. Private consumption growth had increased moderately, and past experience indicated that that trend would be further accentuated by an improvement in the terms of trade, brought about by the appreciation of the yen and the reduction in oil prices.

Residential investment was another important item, Mr. Fujino continued, and it had increased steadily for the past four months at an annual rate of 1.3 million new housing starts, compared with 1.5 million new housing starts annually in the United States. The trend in Japan would be further supported by lower construction cost and interest rates; in addition, the policy measures embodied in the authorities' current package would add additional stimulus to construction.

During the previous Article IV consultation discussion on Japan, he had stressed the importance of an exchange rate relationship that reflected the economic fundamentals in each country in order to rectify external imbalances, Mr. Fujino recalled. Since the agreement of the Group of Five in September 1985, the exchange rates of major currencies had moved in the direction that had long been desired. There was no doubt that the recent strengthening of the yen would work to reduce the current account surplus to a more sustainable level. At the same time, the authorities were fully aware that close policy coordination was essential for sustained economic growth, and the policy package currently being implemented was fully in line with the authorities' objectives.

Another priority was free market access, and while the Japanese domestic economy was open, further efforts would be made to remove any impediment to imports and to make import procedures more transparent, Mr. Fujino stated. Measures embodied in the Action Program would be implemented steadily, because the authorities believed that a liberal trade system was the cornerstone of the world economy and that a reduction in the current account surplus should be achieved through increased trade. The staff had noted that, because of the J-curve effect of the appreciation of the yen, the current account surplus would remain large in the next fiscal year, but, although the dollar value might in fact be expanding, that nominal development hid the negative real impact on Japanese growth which, at the same time, through the change in the exchange rate was making a real contribution to the world economy.

For effective balance of payments adjustment, full advantage had to be taken of the opportunity provided by the strengthening of the yen through a swift response on the part of entrepreneurs and an appropriate change in the industrial structure, Mr. Fujino remarked. The financial support being given to small and medium-sized companies affected by the appreciation of the yen was intended primarily to given breathing space to corporations to enable them to shift to other lines of domestic products. The authorities did not intend to subsidize or to offset the adjustment of the exchange rate. Japan's past record of structural adjustment had been exemplary in many respects.

Many speakers had stressed the importance of further liberalization of interest rates, Mr. Fujino observed. His authorities' firm policy was to promote liberalization, but gradually so that it would not disturb the monetary growth targets. The process of interest rate liberalization which began with deposits in large denominations, would progressively cover smaller deposits. Particular attention had to be paid to the need to strengthen small deposits and to the competitive position of the postal savings system. Extensive studies that were under way on related matters would be useful in providing guidelines.

Short-term government bonds had been issued in February 1986 for the first time, amounting to ¥ 517 billion, and would be followed by a further issue, resulting eventually in a widening and deepening of the short-term market, Mr. Fujino said. Owing to tax and other administrative considerations, the purchase and holding of such bonds was limited at present to corporations or similar institutions. Despite that limitation, the issue was innovative and would contribute to the development of Japanese capital markets.

The Chairman made the following summing up:

Executive Directors noted that Japan's domestic economy continued to perform well in 1985. Even though growth had receded from the high 1984 rate, it was sustained in line with its medium-term potential. Prices continued to be virtually stable and inflationary expectations nonexistent. Directors observed that the sustained good performance of the Japanese economy over the past three years attests to its underlying strength and the skill of the authorities' policy management. Recent months have witnessed new efforts at coordination among the major industrial countries in formulating their policies. In this and other contexts, the Directors welcomed the Japanese authorities' willingness to cooperate internationally and to take into account in their policy formulation the views expressed in multilateral forums.

The success of recent international efforts in encouraging a shift in exchange rates more in line with economic fundamentals has started a process of external adjustment that will have an important impact on Japan's domestic economy in the coming year. Thus, despite the sharp decline in oil prices, which would on its own have a stimulatory impact on economic activity, Directors generally agreed that, because of the substantially stronger yen, growth will tend to slow considerably in 1986/87 to a level below the economy's potential. Official forecasts prepared earlier on less current assumptions were, in the view of many Directors, not likely to materialize without significant policy action. Directors noted the large withdrawal of stimulus likely to arise from the external sector as well as the withdrawal of fiscal stimulus, and were concerned about the present prospect of a sharp deceleration in economic growth. They stressed that it was in the vital interest of the international community, including Japan, that strong growth be sustained in Japan, and urged the authorities to take this into account in formulating their policies.

Directors noted the authorities' objective of reducing fiscal deficits and agreed that, over the medium term, fiscal consolidation efforts should be continued to preserve fiscal flexibility and prepare for the economic effects of an aging population structure. In the past, the authorities have pursued these goals flexibly, and Directors believed that this approach should be employed again in present circumstances, without prejudice to medium-term fiscal consolidation. Although the proposed general account budget for 1986/87 provides for a further considerable reduction in the deficit, broadly in line with the authorities' medium-term objective, the authorities have taken action at other levels of government in the direction of providing support to the economy. While welcoming these steps, Directors considered it likely that without additional measures, fiscal policy would continue to withdraw stimulus from the economy at a time when growth was expected to slow, and nearly all Directors urged the adoption of additional fiscal measures, at least to avoid such a withdrawal. In this connection, Directors referred mainly to spending at the noncentral government level and public works expenditure; an income tax cut in anticipation of the major tax reform under consideration was also mentioned. With regard to the tax reform, Directors expressed the view that, in addition to promoting equity, efficiency, and simplicity, the tax system should move in the direction of encouraging a better balance between aggregate saving and investment in the economy. Directors urged the authorities to reduce the present, in their view excessive, fiscal incentives for savings.

During 1985, monetary policy continued to be constrained by the need to avoid actions that might encourage a weakening of the yen. Indeed, the authorities permitted a significant tightening of monetary conditions in the final months of the year in order to consolidate the strengthening of the yen promoted by actions among the major countries. With a substantial appreciation of the yen apparently firmly established, Directors agreed that there was now scope for monetary policy to be directed toward promoting strong domestic demand. Directors welcomed the recent decline in short-term interest rates that had more than offset the earlier monetary tightening, and the latest reduction in the discount rate effective today. The downward pressure on prices that would follow the appreciation of the yen and lower oil prices provided scope for a further reduction in interest rates.

The external current account surplus widened considerably in 1985, partly as a result of the relative weakness of the yen and only moderate domestic demand growth, which failed to strengthen as had been expected. The current account surplus appears likely to widen substantially further in dollar terms in the coming year, in part reflecting the J-curve effect of the appreciation of the yen. Thereafter, this appreciation would be expected to contribute to a considerable reduction in the surplus. Nevertheless, sizable external surpluses are likely to continue over the medium term, the product of fundamental savings and investment relationships in Japan. Directors also observed the decline in Japan's imports from the developing world that appeared to have occurred in 1985 and, more generally, the sluggishness in recent years of Japan's total imports. While noting that Japan's surpluses have played a positive role by providing savings to the rest of the world and thus limiting interest rates, Directors emphasized the role of appropriate and compatible policies in Japan and the other major industrial countries in promoting harmonious external economic relationships. Several Directors wondered whether there was not room in some areas for larger wage increases in order to stimulate domestic demand.

Large current account imbalances have contributed to rising protectionist sentiment on a global level, posing a significant threat to Japan's and the world's trading environment. In this connection, the prospect that trade volumes would move in the direction of reduced surpluses as a result of recent exchange rate developments was seen as a positive development. Directors welcomed the market-opening steps taken by Japan in the past year. The Action Program announced by Japan promises important progress in the direction of reducing inhibitions to imports over the next two-and-a-half years and should be implemented with determination. Directors urged the authorities to take further action to ensure that Japan's markets are fully open, especially by reducing restrictions on agriculture and simplifying the regulatory framework. Care must also be taken to avoid policies that inhibit the structural evolution of Japan's industry. Many Directors expressed concern that recent measures aimed primarily at small exporters in difficulty should not delay the impact of the yen's appreciation upon the course of Japanese exports.

Directors generally endorsed the authorities' steps in the direction of liberalization, privatization, and deregulation of the economy and viewed them as playing a potentially useful role in stimulating private sector activity and growth; Directors urged that these policies be expanded forcefully. Ongoing progress in financial liberalization--although too gradual in the view of a number of Directors--was carried forward in 1985 by widening the availability of banking instruments with free interest rates, easing restrictions on Euro-yen markets, and increasing the scope for foreign financial institutions to participate in Japan's markets. While welcoming the recent introduction of short-term government bonds, several Directors noted high minimum denominations, restrictions on the holders of these bonds, and the applicability of the withholding tax; they believed that an easing of these restrictions would contribute to financial development. In addition, Directors noted that the further liberalization of small-denomination deposits would require reform of the postal savings system, and they encouraged the authorities to consider such action urgently in order that the momentum of financial liberalization not be lost.

Directors commended Japan on the important role it has played in channeling finance to developing countries, through both bank lending and providing ready access to its capital markets. They also welcomed the support Japan has given to the efforts to strengthen the debt strategy; indeed, Japan's participation in this endeavor will be crucial to its success, given the need to channel excess savings of Japan to developing countries. The importance of facilitating, through official policies, more normal access to commercial flows of countries rebuilding their creditworthiness was also noted. Directors welcomed the plan of doubling official development assistance over the next seven years, but a number of them saw room, and expressed the hope, for an even larger increase in aid given the relatively low level of ODA in relation to GNP and the very high savings ratio of the country.

It is expected that the next Article IV consultation with Japan will be held on the standard 12-month cycle.

2. ARGENTINA - 1985 ARTICLE IV CONSULTATION; REVIEW UNDER STAND-BY ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors considered the staff report for the 1985 Article IV consultation with Argentina and the review of its stand-by arrangement (EBS/86/39, 2/21/86; and Cor. 1, 3/7/86). They also had before them a report on recent economic developments in Argentina (SM/86/35, 2/25/86).

Mr. Nebbia made the following statement:

Within the context of the stand-by arrangement approved in 1984 and in view of the developments in economic indicators during the first half of 1985, the Argentine Government decided to change its strategy and move from a gradual approach to a bolder program of frontal attack on inflation through a combination of fiscal, monetary, and incomes policies. The strategy was based on a drastic reduction of the fiscal deficit--which was to be financed solely through external credit--monetary reform and a tightening of monetary and credit policy, and a wage-price freeze.

This review offers an opportunity to assess the results of the adjustment program about eight months after its implementation. In general, the authorities are pleased with the results already attained and are encouraged to pursue with the same political determination, the attainment of their final goal, namely, re-establishment of financial stability to ensure an environment conductive to sustained growth.

In the months following the adoption of the economic plan the fiscal deficit was reduced markedly; the rate of inflation declined sharply; and the rate of growth of money--although much lower than before the plan began--continued at a relatively high rate, owing to a major strengthening in the balance of payments rather than an expansion of central bank credit. The increase in the monetary aggregates reflected an increased demand for real cash balances and therefore was not inconsistent with the price stability target.

The results on the inflation front were indeed important, with the rate of increase in consumer prices falling from a monthly average of 28 percent in the second quarter of 1985 to 6 percent in July and to a monthly average of 2.4 percent in the period August 1985-February 1986. The wholesale price index showed even more successful results: it increased at an average rate of 1/2 percent during the eight months from July 1985 to February 1986. It is important to recall that in the months prior to the implementation of the program, the inflation rate was not only very high, but rising.

The sharp cutback in inflation has been accompanied by a recovery in output, following a sizable contraction in June and early July that reflected a drop in final demand as consumers delayed their spending, a large liquidation of inventories, and a delay in intermediate sales because of uncertainties over prices. As my authorities stated in their letter of February 20, 1986, the success of the program thus far has been helped by a change in price expectations based on breaking inertial inflation and tackling of both the demand and cost factors in inflation.

It is also important to stress that the drastic slowdown in inflation is causing important changes in microeconomic behavior. Consumers are now able to "memorize" prices, something that was nearly impossible when prices varied almost daily. They can thus make price comparison more easily than before: price competition works more effectively as a means to attract customers. Firms also have a stronger incentive to watch their costs closely, because it is no longer possible to automatically pass them through to consumers. These changes are still only incipient, but they indicate some of the positive consequences that will result from a sustained stabilization of the economy.

Although some of the performance criteria contained in the program were not met, my authorities are nevertheless satisfied that the overall thrust of policy has been appropriate to achieve the objectives of the program.

The staff report describes the evolution of the economy over the period covered by the stand-by arrangement and, in particular, the radical change that has occurred since mid-June 1985. But when assessing the results, it is important to put the achievements in different areas in perspective, thereby highlighting the authorities' strong determination to implement the program.

The progress achieved on adjustment during the second part of 1985 can be assessed using the data in the staff report. The magnitude of domestic and external adjustment during this period has been impressive. The overall fiscal deficit, which amounted to 12 3/4 percent of GDP in the first half of 1985, was reduced by two thirds to 4 1/2 percent of GDP in the second half of 1985, owing to sharp reductions both in the deficit of the nonfinancial public sector and in the losses of the Central Bank. As a consequence of the strong adjustment effort, the public sector has not had to resort to demand financing from the Central Bank, except for the counterpart of funds borrowed abroad. This was possible in spite of the large amount of interest due on the foreign debt. In fact, if debt servicing is factored out, fiscal result for the second half of 1985 would actually show a surplus.

The higher than projected level of expenditures was mainly due to estimation errors at the time the program was designed and to difficulties in establishing effective control over the operations of certain public enterprises.

The objective for 1986 is to comply with the principle that the public sector deficit must be brought down to a level that can be covered by available foreign financing. The budget for 1986 that was recently submitted to the Congress provides for a public sector deficit of 2.9 percent of GDP, which represented an important effort to reduce the deficit to about one half of its 1985 value.

According to the measures contained in the budget, the fiscal reduction will be achieved through reducing expenditures on the order of 1 1/2 percent of GDP, and increasing revenues. A more effective tax administration, stricter expenditure control procedures as well as a careful management of public enterprises, will be pursued to bring the cash deficit down to the targeted level.

Monetary policy in the second half of 1985 has been consistent with my authorities' commitment--expressed in their letter of July 22, 1985--that the Central Bank will not finance the public sector, except for the counterpart of funds borrowed abroad, and essentially will not extend credit to the rest of the economy on a net basis. That commitment has been reiterated for the period of the present program in the letter of February 20, 1986. The monetary program for 1986 is consistent with an expected inflation of 2 percent per month.

The rapid success in curbing inflation as well as the increasing confidence of the populace in the stabilization program had led to a rising demand for money. M1 and M5 have increased by 105 percent and 66 percent, respectively, in real terms during the second half of 1985. Moreover, the reduction of inflationary expectations and the renewed confidence are highlighted by the fact that the remonetization of the economy is based on currency and demand deposits rather than on time deposits that yield interest.

The absence of shortages in the goods markets as well as the low spread in the parallel exchange market confirm my authorities' belief that the expansion of the monetary aggregates has not given rise to inflationary pressures or a deterioration in the balance of payments position. The sharply reduced demand for index-linked deposits is a good reflection of the growing confidence in price stability.

The net domestic assets performance criterion has been fulfilled with a wide margin both as of July 31 and September 30, 1985. That overperformance is due to larger external inflows by the private sector than had originally been envisaged. The performance criteria with regard to non-negative real regulated interest rates has also been met.

Although nominal free interest rates have declined from more than 40 percent a month in the first half of June 1985 to about 5 percent at present, they still remain excessively above the effective increase in prices. My authorities think that the consolidation of the remonetization of the economy, the continuation of the improvements in the fiscal area, and further steps to be taken to reduce intermediate costs and to raise the efficiency of the system will bring down interest rates to levels consistent with the current low rate of inflation.

Developments in the inflation area have been very positive. My authorities consider that the temporary wage-price freeze was necessary to break inertia inflation. Moreover, taking into account the strong demand policies that have been pursued, the freeze has prevented a harsh recession and a large redistribution of income that would have made the continuation of the program politically and socially unfeasible.

The Government is aware that price and wage controls are not innocuous. But the freeze has not enforced an artificial price structure. First, it has been a complement and not a substitute for aggregate demand policies. Second, given the large mark-ups that were common before the economic reform--owing to price uncertainty and the high nominal implicit interest charged on sales with postponed payment--the freeze has not proven to be prejudicial in economic terms for most producers. Third, although the movement of relative prices is constrained, potential distortions are probably much less serious than those resulting from unsystematic and sharp price shifts during the period of high inflation. Fourth, prices for goods with volatile supply, such as some highly seasonal agricultural goods, are not subject to control. Where problems were detected as a consequence of the price freeze, the Government acted flexibly to resolve them. Finally, the "key" prices were adjusted before the start of the program so as to avoid future upward pressures; the real exchange rate is relatively high, so that it allows a substantial trade surplus, and public sector prices were increased in real terms. Real wages have indeed come down. However, as a partial compensation for that decline the drop in the inflation has benefited workers directly, since they were among the main holders of noninterest-bearing cash balances.

After the six-month wage freeze, the Government decreed a 5 percent general wage adjustment effective at the beginning of 1986. Private firms have indicated that they can absorb the wage adjustment without raising prices. In addition, private firms are permitted to raise wages by an additional 5 percent in 1986, provided that such an increase can be justified in terms of productivity gains and that it is not passed through to prices. The recent special adjustments in the wages of certain categories in the National Administration were aimed at attaining a partial recovery of salaries that had been excessively depressed in some sectors, among others, the personnel in the education, health, and judiciary areas.

The Government intends to gradually remove price controls through agreements at the sectoral level in order to move as soon as possible to a situation in which prices are determined in the market.

Although inflation in Argentina since mid-1985 has been higher than in industrial countries, the effective value of the austral in real terms has not risen, as the austral has depreciated along with the U.S. dollar against other major currencies. Also, the spread between the exchange rates in the official and parallel markets has been extremely low since June 1985. My authorities are committed to ensure that the exchange rate will be compatible with the achievement of the balance of payments objectives of the program.

The overall balance of payments deficit in 1985 reflected a better than projected performance in both the current and the capital accounts. However, my authorities think that the 1986 outlook will reflect a worsening in the current account. Exogenous factors have contributed to these projections, mainly a sharp decline in agricultural export prices and the damage to crops as a result of floods during 1985.

Regarding the official balance of payments projections for 1986 that appear on page 17 of the staff report, my authorities want to emphasize that, although a great deal of uncertainty surrounds several components of the balance of payments, they believe the projections are both realistic and appropriate.

Regarding the medium-term balance of payments outlook, three considerations should be emphasized. First, considering that the balance of payments projections are extremely sensitive to exogenous factors, it is essential that the external environment be a positive one; especially in relation to the evolution of international interest rates and protectionism in industrial countries. My authorities want to reiterate that the cooperation of developed countries in these areas is important to enhance the external environment, which would facilitate the achievement of a successful economic program. Second, although they are confident that this economic program should encourage capital inflows, they want to rely also on the use of concerted external borrowing. Third, they believe it will be necessary to have an important recovery of imports from the recent low levels to achieve growth in the medium term.

In the first quarter of 1986, Argentina will reduce arrears by $600 million, and the remaining arrears are to be eliminated by mid-1986. The Central Bank recently has issued regulations providing for the automatic provision of foreign exchange for payment abroad of private interest obligations, and the Government is fully committed to eliminating all restrictions on payments and transfers related to services other than tourism by May 15, 1986.

Regarding trade policies, the list of goods that can be imported under automatic license was broadened in January 1986 to 73 percent of base-period imports. The Government is committed to include, before May 15, 1986, the rest of the imports that were to be placed on the automatic list by end-March 1986.

The Minister of Economy has recently reaffirmed that Argentina's recovery will be based on the simultaneous expansion of productive investment and exports. That will be the only way to move the country toward a stance where stability, external equilibrium, and growth are consistent. Within that framework the Minister has announced: The Government's decision to sell its interests in the nation's largest steel and petrochemical plants; special programs for nontraditional exports aimed at increasing their value by $500 million in 1986; and the reduction in export taxes of many agricultural products including maize, sorghum, peanuts, cotton, rice, tobacco, vegetables, and fruits (taxes on wheat, linseed, sunflower seed, wool, and other products had already been reduced).

These measures, together with other decisions adopted in the petroleum, gas, fertilizer, and communication sectors, underline that the present policies to promote growth are not those used in the past to reactivate the Argentine economy, and that a deep change in the roles played by the public and private sectors is contemplated in the new strategy.

Finally, my Argentine authorities have requested an extension of the stand-by arrangement by May 31, 1986. It is their intention to request, at the expiration of the curent stand-by arrangement, a new arrangement in support of the implementation of a program of sound economic policies.

Mr. Almeida said that the essential part of the Argentine program had been successful: it had attacked the roots of inflation, and the combined public sector deficit had declined by two thirds to only 4 1/2 percent of GDP in the second half of 1985. Significant progress had been made in the public enterprise sector, and he was pleased to note that the authorities intended to sell several public enterprises. He supported both the proposed program and the requested waiver and modifications. However, his chair was still dissatisfied with the exaggerated number of performance criteria for reasons previously discussed during the seminar on the design of Fund programs (Executive Board Seminar 86/1 and 86/2, 2/25/86).

Because the wage-price freeze was an integral part of the effort to eliminate inertial inflation, he did not agree with the staff that price controls should soon be removed, Mr. Almeida continued. As a result of the measures already taken, real money had increased at an extraordinary rate in the past six months, which could bring about an inflationary surge if price and wage controls were lifted immediately. Thus it was important that the freeze be phased out gradually but in time to avoid the appearance of excessive price distortions. As Mr. Nebbia had pointed out, the freeze had not been a full one, because wages had been allowed to increase by 5 percent at the beginning of 1986, and the Government had acted flexibly in those areas where the supply of goods was volatile. Consequently, price distortions were at present almost nonexistent.

No program could succeed in the medium term without assuring a positive real growth rate, and for that reason he was disappointed that the question of growth had not been carefully examined in the staff paper, Mr. Almeida remarked. Moreover, there was no clear discussion on the options available to the authorities in the coming years or any explanation given for the continued fall in GDP in the second half of 1985 and failure of investment to start to recover from its depressed levels. He asked the staff to comment on those matters. Moreover, the staff's balance of payments projection for the medium term was disappointing; it provided only a single scenario and lacked any sensitivity analysis except for interest rates. Also, the staff had not explained why direct investment and repatriation of capital could be expected to reach the levels forecasted, which implied achieving a rate of growth of 100 percent in just three years.

Argentina was counting on export expansion to facilitate economic recovery and success in that area could not be achieved through exchange rate management alone, but would depend importantly on access to markets for primary products in developed countries, Mr. Almeida observed. Lower import tarriffs and reduced subsidies in those markets could be the key factor for the success of the Argentine program.

Mr. de la Herrân observed that after several attempts to stabilize the economy through the traditional, gradualist approach, which failed to cope with the difficult economic situation and led to a complete loss of confidence in that approach, the Argentine Government had courageously taken the risk of embarking on a much bolder economic strategy the previous summer. When the stand-by arrangement for Argentina had been discussed in August 1985 (EBM/85/124 and EBM/85/125, 8/9/85), sufficient data had not been available to judge the practicability of the program. Nonetheless, to date the results had been impressive and the austral plan had become the center of attention not only of banks and international institutions but also of countries facing similar difficulties. Remarkable results had been achieved in several areas: inflation--the problem central to meeting economic targets in Argentina--had abated; the consumer price index had declined from 32 percent in June 1985 to a monthly average rate of 2.5 percent during August 1985-January 1986; the public sector deficit had fallen from 12 3/4 percent of GDP in the first part of 1985 to 4 percent of GDP at the end of the year; and the balance of payments had strengthened remarkably.

The decline in the public sector deficit from more than 12 percent of GDP to 3 percent of GDP over a short period of time clearly indicated the authorities' tight fiscal stance, Mr. de la Herrân noted. The question remained, what would be the most suitable combination of expenditure cuts and revenue increases? Previously, there had been a number of slippages on the expenditure side with regard to program targets; however, it was understandable that in a hyperinflationary situation such as that experienced by Argentina the previous year, revenues might be overestimated and outlays might be underestimated, and both the authorities and the staff had acknowledged that some estimation errors were to be expected. At present the outlook had changed dramatically, and the Government should be able to gauge fiscal sector behavior more accurately. The objectives set forth in the budget for 1986 reflected the authorities' strong determination to implement measures to sharply reduce the fiscal deficit. On the revenue side, receipts were expected to increase substantially owing to major tax reforms. In that connection, the authorities should consider lessening their reliance on export taxes--thus far a basic revenue source--and instead rely on a broader tax base. The inclusion of such concepts in the fiscal reform already sent to the Parliament was most welcome.

The Government had announced measures to reduce the size of the public sector by selling off parastatals in basic sectors, such as steel, mining, and petrochemicals, Mr. de la Herrân observed. He agreed with that strategy as a means to stabilize the public sector in the medium term. However, in the short term it would be necessary to improve the balance sheets of loss-making parastatals in order to make them attractive to public sector investors. He wondered whether the World Bank would be involved in reforming the public enterprises, and if the stand-by arrangement included performance criteria related to potential financial claims that might arise as a consequence of privatization.

Monetary policy, which contributed importantly to maintaining a low rate of inflation, had aimed at virtually freezing the growth in the Central Bank's domestic assets, Mr. de la Herrân commented. As a result of the authorities' success in that area, real interest rates had reached a high level, which at present was in the range of 30 percent to 40 percent. Because the cost of credit exceeded in most cases the profitability of investments, high interest rates posed a serious problem that might bring about a further decline in economic activity. For the private sector, high rates implied that enterprises' debts would increase at a faster pace than the value of their productive assets. For the public sector, high interest rates meant that domestic debt servicing outlays would grow at a fast rate, jeopardizing the Government's fiscal target. Consequently, the Government was facing a dilemma of maintaining zero credit growth to the public and private sectors or raising some doubts about its commitment to maintaining a low rate of inflation. Both the authorities and the staff considered that further improvements were necessary in the fiscal sector. In that regard, the dilemma faced by the Government could be resolved through moderate increases in credit to the private sector as further progress was made in reducing the fiscal deficit.

He agreed that the stability of the exchange rate of the austral would be one of the main guideposts for the credibility of the entire program, Mr. de la Herrân remarked. Recent trends in the value of the U.S. dollar on international markets provided the Argentine authorities some margin to keep the austral pegged to the dollar as programmed. In that regard, there was some risk that suddenly lifting wage and price controls might lead to a weakening of the austral's exchange rate, thereby fostering capital flight and ultimately resulting in the failure of the program. Thus, although he shared some of the staff's concern about the possible effects of a prolonged price freeze on resource allocation, he considered that actions to eliminate wage and price controls should be implemented carefully. The target of zero wage increases and zero currency depreciation could continue to be the paramount objective of policy.

Capital flight had occurred not only in Argentina but also in most heavily indebted countries and was most damaging to the domestic economy, Mr. de la Herrân stated. In Argentina, the possibilities for repatriating vast sums of capital at present placed aboard were not clear and would depend on the credibility of the policies implemented and on the treatment flight capital would receive once it was repatriated. Moreover, financial conditions in markets abroad would also influence the outcome. He hoped that the spirit of international cooperation that had emerged to solve the debt problem would extend to designing policies that would attract capital wherever it was most needed. Finally, he strongly supported the proposed decisions.

Mr. Massé recalled that when the stand-by arrangement for Argentina had been reinstated in July 1985, he had supported the considerable initiative and courage of the Argentine authorities in moving to a much stronger adjustment effort. At that time, he had emphasized that wage and price controls were necessary but would serve only as a temporary cap on inflation. Once removed, a resurgence of inflation could occur if inflationary expectations were not broken by means of tight credit and fiscal policies.

Since then, Argentina had made some important and valuable gains, but the adjustment measures had not been implemented as completely or as forcefully as required to break the inflation cycle and return the economy to growth, Mr. Massé continued. However, impressive results had been accomplished in three key areas. First, inflation had been reduced from an average monthly rate of 32 percent in June 1985 to about 2 1/2 percent in the period August 1985-January 1986, owing primarily to the maintenance of tight wage and price controls. Second, the combined public sector deficit had been reduced significantly from 13 percent of GDP in 1984 to a little more than 4 percent in the second half of 1985. The consolidation of the public accounts was not yet as complete as was necessary, but steps had been taken in the right direction. Finally, the current account deficit had been substantially reduced over the past year, allowing the authorities more flexibility in dealing with their debt problems.

At the same time, many of the measures needed to support further adjustment had only been partially implemented, Mr. Massé added. The second phase of adjustment would not be easy to implement, and wage and price controls would have to be phased out carefully. The broad strategy of introducing structural measures aimed at promoting growth were appropriate. In that context, he welcomed the authorities' intention to move increasingly toward a system of market-determined prices, and to tackle such structural areas as the size of the public sector, tax reform, financial reform, and measures to expand agricultural production. Both the Fund and the World Bank had a role to play in those reforms.

Although considerable adjustment had taken place, the current projected fiscal deficit still exceeded financing available from abroad and therefore not only posed a threat to price stability but also crowded out new private sector investment, Mr. Massé observed. The commitment to reduce the budgetary deficit was the single most important element in Argentina's overall adjustment strategy. Without further reductions in the fiscal deficit, removing wage and price controls without a resurgence of inflation would be difficult.

In that light, the recent generous pay increases to civil servants were disturbing, Mr. Massé remarked. In particular, the 21 percent increase in the wage bill of the National Administration was of considerable concern, since it both increased the fiscal burden and provided an undesirable signal to wage behavior throughout the economy. Of equal concern was the authorities' inability to implement contingency measures as required, despite provision for such measures in the program. Failure to act had resulted in a spending increase rather than the planned decrease. He would appreciate any comments by the staff or Mr. Nebbia on why those measures were not implemented. The unacceptably large deficits of the State Oil Company had also contributed to budgetary overruns.

As for the 1986 fiscal plan, a combined public sector cash deficit of 3 percent of GDP should be the absolute ceiling if the overall strategy of reducing inflation and encouraging private sector investment was to succeed, Mr. Massé considered. To meet that target would require substantial revenue gains and the tight administration of government spending. He was therefore disappointed that the budget proposed a 2 1/2 percent increase in real expenditure by the National Administration. The proposed real increase was hard to accept under the circumstances, and made it all the more important that the authorities dealt effectively with the losses of the State Oil Company and of the Central Bank. The authorities should devise contingency plans in case any slippage occurred and implement those plans quickly, because strong measures would be required to prevent the need for greater retrenchment later.

On monetary policy, he was pleased to note that credit policy had been broadly consistent with performance criteria, Mr. Massé commented. However, excessive use had been made of rediscount facilities that were automatically available to banks. The Central Bank had already taken measures to reduce the attractiveness of those facilities, but the authorities should continue to follow a restrictive policy on granting rediscounts. The continued high real level of interest rates was one indication that inflationary expectations were still strong. He agreed with the staff that expansionary measures to lower interest rates would be unwarranted and damaging at present because they would only increase inflationary expectations. To ensure lower rates, the fiscal position should be strengthened, thereby reducing inflationary expectations through overall demand control. Such measures would allow for the timely removal of price controls, which were undoubtedly having an adverse effect on relative prices over time. However, given the choice between refueling inflation by lifting controls now or adding to distortions by leaving controls in place somewhat longer, he would opt for maintaining controls until there were clear and lasting signs that inflationary expectations had diminished.

The maintenance of a competitive exchange rate since July 1985 had played an important role in strengthening the current account, Mr. Massé observed. In view of the poor prospects for international commodity prices, measures to improve exchange rate competitiveness would have to continue. He was therefore encouraged that the authorities intended to monitor closely domestic developments and adjust the exchange rate accordingly. It was also appropriate that the authorities remove export taxes as soon as possible to ensure adequate returns to exporters facing declining commodity prices, since export taxes were not compatible with a shift in resources toward the traded goods sector. Of course, other revenue measures would need to be implemented to replace those taxes if there was to be no weakening in the fiscal position. That external arrears were not eliminated under the program as originally planned was cause for concern, and he therefore welcomed the authorities' intention to eliminate arrears by midyear.

Looking to 1986 and beyond, the unfinanced balance of payments gap of $3.3 billion in 1986 appeared unduly large, Mr. Massé noted. However, the overall financing requirements might be significantly overestimated, especially if the competitive exchange rate began to encourage nontraditional exports. The projected growth in imports should also be matched to some extent by increased trade financing. In light of the uncertainties involved, it might be appropriate for the staff to outline a more comprehensive balance of payments scenario, including sensitivity analyses, for the next Board discussion on Argentina.

Argentina had made important strides in recent months in consolidating its adjustment effort, but the implementation of policies had not been as complete as had been hoped for, Mr. Massé concluded. The challenge for the remaining months of the stand-by arrangement would be to strengthen the momentum of adjustment. Since the program initially entailed a high level of purchase relative to quota, the reduction in purchases proposed by the staff was appropriate under the circumstances. He supported the proposed decision.

Mr. Goos observed that in the previous seven months the authorities had made considerable progress in addressing some of the fundamental problems of the Argentine economy. The most impressive achievements were the rapid reduction of the rate of inflation and the successful elimination of a number of mechanisms that had in the past tended to perpetuate spiraling inflation. Of course, the success on the inflation front had been achieved largely through strict controls on wages and prices. It was encouraging, however, that those controls had not yet resulted in the emergence of parallel markets for goods and services to any significant extent. Nevertheless, as the Board had emphasized during its previous review in August 1985, the policy instrument of wage and price controls could be used effectively only temporarily. Accordingly, the Government's economic strategy would face its real test only when those controls were lifted and the adjustment process would have to proceed without the safety net those controls had provided.

Against that background, the crucial role of fiscal and monetary policies in setting the stage for the dismantling of controls could hardly be overemphasized, Mr. Goos remarked. The considerable progress that had been made over the past year in reducing the fiscal deficit was most welcome. However, the budget consolidation was far from complete not only with regard to the deficit but also with regard to the excessive share of the Government in GDP. It was particularly worrisome that recent adjustment had relied exclusively on revenue measures and that the current budget provided for another strong increase in the National Administration's spending by no less than 8 percent in real terms after allowing for external interest payments. He therefore fully agreed with the staff that renewed efforts to curb public expenditure were urgently needed. Such efforts were crucial to create the room necessary for tackling the overdue rationalization of the revenue system, particularly its heavy reliance on foreign trade taxation. Fiscal stabilization would undoubtedly have to include further progress in rehabilitating public enterprises as well as cutting current outlays. In that regard, he shared the staff's concern about the special wage increases granted recently in the National Administration.

There had been an impressive slowdown in monetary expansion, Mr. Goos observed. Nevertheless, the increase in monetary aggregates in real terms during the second half of 1985 was cause for concern. Of course, it was somewhat comforting that the increase had originated from an improvement in net official reserve holdings rather than from an extension of net domestic credit by the Central Bank. Nevertheless, it was not clear why changes in those reserve holdings should be an appropriate yardstick for monetary policy and its aim to contain inflationary pressures, particularly in view of the short-term fluctuations in net reserves. In any event, considering that inflationary expectations were probably not fully eradicated, it would seem advisable to err on the side of caution and to maintain a restrictive monetary policy stance. He also welcomed the authorities' reaffirmation that they would not seek a reduction of interest rates through more expansionary credit policies but rather through further progress in consolidating public finances and improving the system of financial intermediation. In that context, he would appreciate further comment by the staff or Mr. Nebbia on the plans for a major reform of the financial system, which had been mentioned in the staff paper, particularly on the envisaged scope of the reform and possible World Bank involvement.

He was concerned about the officially projected deterioration of the balance of payments during 1986, and in particular, the foreign trade account, Mr. Goos continued. In that connection, several questions came to mind. First, apart from the short-term effects of the recent floods on crop exports--which would be felt mainly in the first quarter of 1986--indications were that the agricultural sector was being seriously impaired by present economic policies, particularly by an increasing tax burden imposed on agricultural producers and their inability to raise prices in the face of creeping costs and inflation. He invited the staff to comment on the likely impact of those developments, including the persistently high interest rates, on agricultural investment and export prospects. Second, real GDP was expected to grow by 8 percent over the year ending in the second half of 1986. Such a strong growth rate would explain to a large extent the steep increase in imports projected for 1986. Accordingly, a less ambitious growth target would probably be more appropriate considering Argentina's difficult external circumstances. In any event, in view of the extremely high debt service burden, he agreed with the staff that such rapid import growth would be prudent only if financed by a larger share of nondebt-creating capital inflows. Finally, export developments in 1985 seemed to support the authorities' view that pegging the exchange rate to the U.S. dollar had not endangered Argentina's competitive position thus far. It was also true that the recent decline in the value of the dollar would tend to strengthen Argentina's competitiveness vis-à-vis non-dollar areas. However, a considerable inflation differential between Argentina and the United States was bound to exert downward pressure on the austral, as was already indicated by the doubling of the spread between the official rate and the parallel market rate between December 1985 and January 1986. He therefore wondered whether it would not be advisable to work toward a complete liberalization of the exchange rate. A more flexible exchange rate policy could not only have a favorable effect on the current account but also on the desired repatriation of Argentine assets held abroad.

He welcomed the authorities' intention to seek a new stand-by arrangement with the Fund after the expiration of the present one, Mr. Goos remarked. Intensified cooperation between the authorities, the Fund, the Bank, and other external creditors was the key to assuring the eventual success of the ongoing adjustment effort. However, he strongly felt that a new program would have to spell out more specifically than the present one the measures to be taken in the areas of both macroeconomic and structural adjustment. Fiscal policy would have to place particular emphasis on expenditure control rather than on revenue measures. Also, the program should include some timetable for the early phasing out of interventionist policies, particularly price and wage controls, and it would have to focus on interest and exchange rate policies conducive to the repatriation of flight capital. Finally, he supported the staff appraisal and the proposed decision.

Mr. Templeman observed that since the dramatic shift in policy in June 1985, the Argentine authorities had been pursuing a two-part economic strategy aimed at restoring economic growth with a sustainable external position by means of a bold approach to re-establish financial stability, coupled with structural reform. Such an approach to economic adjustment must be ambitious in formulation and forceful in execution in order to have the desired impact--namely, to reduce inflation on a durable basis and establish the foundation for the recovery of investment and economic growth. Those conditions were true both because of the direct relationships between strong policy and strong real economic effects and because the essence of the bold approach was to maintain the authorities' credibility in order to reverse inflationary expectations and alter overall economic behavior. A slip back into gradualism could greatly undermine the strategy's chances of success.

Among some important successes, one of the most notable was a marked improvement in confidence, Mr. Templeman continued. Wage and price increases had been sharply cut following the freeze, and there was not much evidence of suppressed inflation. The rise in February's consumer price index by only 1.7 percent--the lowest increase since the strengthened program was begun--was particularly heartening. The combined public sector and central bank deficits had been sharply reduced. Initial steps were being taken to privatize some public enterprises in the steel and petrochemical sectors. The growth of the money aggregates had declined dramatically, as had nominal interest rates, and there was some indication that the demand for real money balances had increased with the improved inflationary outlook. In addition, both the current account deficit and the overall deficit in the balance of payments were significantly below targeted levels in 1985.

Nonetheless, slippages had occurred and weaknesses were evident in some areas, Mr. Templeman remarked. Both GDP and real capital formation had continued to decline at least through the third quarter of 1985, so that capital formation had now fallen substantially for five consecutive years. Although adjustments had not yet had much effect on those two areas, a turnaround in investment and growth would be critical to the ultimate success of the program. Wages remained a problem, following the failure in 1985 to reach a consensus among labor, management, and Government. The authorities should consider developing a system to match wage adjustments with productivity gains. The problem of exiting from price controls also had not been solved, although controls had been relaxed somewhat recently. The efficiency of public enterprise operations needed to be improved, and too much emphasis had been placed on revenue measures to reduce the fiscal deficit. Although nominal interest rates remained high, they had contributed to strongly positive real interest rates since mid-1985, with some favorable effect. Liberalization of the trade and payments regime, including the elimination of external arrears, had been disappointing despite the stronger than expected balance of payments outcome in 1985. Those slippages and weaknesses did not mean that the program had not been successful to date but rather indicated that the Argentine authorities had set for themselves some ambitious goals, which required equally ambitious policies if a high degree of success was to be achieved.

The structural component of the program had necessarily received somewhat less attention to date because of the need to focus first on establishing a noninflationary environment as the basis for economic recovery and a sustainable external position, Mr. Templeman observed. A good start had been made in improving that environment. In addition, some elements of reform were already apparent and others would need attention. For example, in the fiscal area, export taxes were to be cut further and a land tax was to be introduced. Better expenditure control was needed throughout the public sector. Public enterprise reforms involving consis tently realistic pricing, partial privatization, and generally improved management of current and investment operations would be important both to fiscal balance and to efficient resource allocation. The authorities were contemplating a major reform of the financial system. The wage and price freeze was meant to end the formal indexation of wage costs, and perhaps other labor market reforms would be needed. Further liberalization and reform of the trade, payments and customs tariff regimes was clearly needed. Also, the regime for foreign direct investment should be carefully examined. He understood that the Argentine authorities intended to request a new stand-by arrangement when the present one expired in May. He hoped that the authorities, together with the staff and in cooperation with the World Bank, would begin now to plan strong structural reform efforts to be an integral part of the new arrangement.

The long-term success of the adjustment effort depended on restrained fiscal and monetary policies to control excess demand, Mr. Templeman remarked. A reduction in the size of the public sector and its deficit was fundamental. Although the deficit had already been sharply reduced, the reduction had largely been the result of revenue measures--some of which were of a stop-gap nature--and a substantial increase in the tax burden. Revenue measures had included, for example, a compulsory savings scheme and undesirable trade taxes. Also, between 1982 and 1985 the ratio to GDP of public sector revenues on a commitment basis had risen by more than 4 percentage points. However, the ratio of expenditures to GDP had been substantially reduced in that period as a result of cuts in transfer payments, extrabudgetary operations, and interest payments--although the interest burden seemed to have been shifted in part to the Central Bank. Impressive cuts in the combined deficit had been achieved in the last half of 1985, and the deficit ratio to GDP of the nonfinancial public sector of 3 percent on a commitment basis and 2 percent on a cash basis were targeted for 1986. However, significant overshooting had occurred in both of the last two quarters of 1985, and the indicative deficit limit for the first quarter of 1986 had had to be revised upward. Even though the overshooting might seem small, the program was an ambitious one and the authorities' credibility was at stake.

He would be interested in further comments by Mr. Nebbia or the staff on a number of fiscal issues, Mr. Templeman continued. First, the staff questioned the realism of a 2 percent cash deficit, based on a 3 percent commitments deficit. Second, a reduction in the Central Bank's quasifiscal losses was called for, but would apparently depend partly on unidentified "other measures." Third, the staff reports lacked detail concerning the authorities' ongoing plan for dealing with the financial problems of the State Oil Company, and reported data suggested that the deficits of the gas company and the railroads might also need some attention. Fourth, information on the partial privatization of public enterprises, including those in the steel, petrochemical, and mining sectors would be welcome. Finally, he supported Mr. Massé's comments about contingency planning in the fiscal field.

Although there had been a sharp drop in the monetary aggregates since June, a monthly increase on the order of 5 percent, such as in December, was still considerable in terms of the inflation goal, Mr. Templeman commented. He would be interested to know the prospects for real money demand and the possibility of bringing down nominal interest rates without a resurgence of inflation. Although program credit ceilings had been respected, central bank rediscounting had exceeded expectations--offset by increases in reserve and portfolio investment requirements--with the effect of raising the cost of credit to the banks and sustaining high nominal interest rates. He hoped that that pattern would not be repeated in 1986, that reserve requirements could be better enforced, that the commitment to allow regulated interest rates to be at least zero in real terms would be respected, and that the regulated part of the market would be expanded. He would also be interested to know about the financial market reforms alluded to in the staff report.

The successful termination of wage-price controls would depend on restrained policies in the fiscal and monetary areas, Mr. Templeman observed. However, it was disappointing that no consensus had been reached on future wage policy among labor, management, and Government, and that the authorities had had to decree general wage increases for both the public and private sectors. Although modest general wage increases might be consistent with containing inflation in 1986, the 21 percent rise in the wage bill of the National Administration seemed excessive. He wondered what were the current prospects for the removal of administrative controls over wages. He noted some difference in emphasis between the authorities and the staff with regard to the timing and scope of the phase out of price controls and would appreciate further comment on the matter.

Argentina clearly faced continuing balance of payments difficulties, despite the sharp reduction in the ratio of the current account deficit to GDP from over 8 percent in 1981 to less than 2 percent in 1985, Mr. Templeman noted. He shared the staff's concerns about the prospects of a large rise in the current account deficit from $1.3 billion in 1985 to $2.3 billion in 1986, with an unfinanced gap of perhaps $3.3 billion. Those prospects underlined the importance of focusing promptly on the current account during discussions concerning a new stand-by arrangement. The freezing of the austral/dollar exchange rate the previous summer had involved some serious risks. Fortunately, owing in part to a declining dollar, the present rate was not obviously out of line. Nevertheless, care must be taken to assure that the austral did not become overvalued. A competitive exchange rate, realistic interest rates, and structural measures to strengthen Argentina's competitive position were all crucial to stimulating the growth of nontraditional exports and to preventing the chronic problem of capital flight.

Developments concerning the liberalization of trade and payments were disappointing, Mr. Templeman remarked. For example, the automatic licensing of foreign exchange for private sector imports and for nonfinancial service payments had been postponed from mid-March to mid-May. Furthermore, the second stage of liberalization of such import licensing had been accompanied by sharp increases in some import duties, with rates up to 90 percent and broader coverage, partly motivated by trade protection to help create a domestic computer industry. The 10 percent import surcharge--initially a six-month measure--was at present expected to be maintained for about 18 months. Export rebates for nontraditional exports, which had been eliminated in June 1985, had been partially reintroduced. He hoped that better progress on liberalization could be made under a new stand-by arrangement.

Argentina's foreign debt had accumulated rapidly in the early 1980s, Mr. Templeman recalled. The ratio of debt to GDP had risen from 48 percent in 1980 to 76 percent in 1985, while the debt service ratio had risen from 32 percent before rescheduling to 91 percent in 1985, after having peaked at 125 percent in 1983. The key to reducing the debt and debt service ratios was to foster the growth of GDP and exports. Even though it might take some time to reduce the debt burden, the medium-term scenario showed a considerable decline in the debt ratio to 53 percent by 1990 and in the debt service ratio to 66 percent. Unfortunately, both figures, especially the debt service ratio, would remain quite high, and the staff foresaw the need for continued debt rescheduling. To attain access to international capital, Argentina would need to work closely with its creditors. Elimination of arrears by mid-1986, even if somewhat delayed, should help, but pursuit of sound policies was of the utmost importance.

In sum, he had pointed to some problems and weaknesses in the program to date because the Argentine authorities had set a high standard against which to be judged, and it was important that the Argentine experiment succeed, Mr. Templeman remarked. The improvement in confidence was a positive factor, and strong economic adjustment and economic reform were both crucial to success. He urged the authorities to continue their efforts, not just for the remaining period of the present stand-by arrangement, but especially when formulating and implementing a new program later in the year.

Mrs. Ploix said that the economic reform program initiated the previous summer had been radically needed, and the measures had been drastic. The Argentine Government had demonstrated a remarkable shrewdness in choosing a policy path that called for not only political courage but also relentless tenacity. The decision to cooperate actively with the Fund had been an important element of that reform plan. Despite the criticism directed toward the Fund's interventions, the Fund played a central role in defining and following the progress of adjustment programs as well as coordinating their financing.

At the time the Argentine program was last reviewed, a balanced appraisal of its policy measures was difficult since the economy was still in a state of shock and it was still too early to evaluate their likely impact, Mrs. Ploix recalled. As both the authorities and the Fund's staff recognized, the scope and vigor of the reforms meant that errors of appraisal were unavoidable in many areas. The present discussion would not be hindered by such uncertainties because the staff reports provided a clearer idea of the present state of, and the medium-term outlook for, the Argentine economy. Nevertheless, gray areas did remain, particularly with regard to the balance of payments, where previous uncertainties had not been completely dispelled and where differences of view had arisen between the staff and the authorities. It was regrettable that such a crucial point had not been clarified, and she looked forward to an assessment of those essential elements during the discussion of a follow-on stand-by arrangement.

She supported the comments and recommendations made in the staff appraisal, Mrs. Ploix continued. It was essential to prevent slippages in demand policies: public spending needed to be reduced; monetary policy must carry a large share of the burden in the stabilization effort; and the adequacy of the exchange rate must be closely scrutinized. The margin of maneuver remained extremely narrow, and relentless tenacity would be needed as well as careful monitoring of every aspect of every policy.

As France's experience had demonstrated, the removal of a general wage-price freeze must be managed cautiously, Mrs. Ploix observed. With regard to prices, the two-stage approach recommended by the staff appeared appropriate. The first stage, which was still being implemented by the authorities, was precisely designed to permit sectoral adjustment. The second stage--the stage of intersectoral relative price adjustment--was equally necessary. Even if shortages had as yet been avoided, price distortions were increasing rapidly and, in the long term, it would not be sufficient to liberalize prices only in those sectors where competition was sufficiently strong.

The overall goal of limiting wage increases to the extent permitted by productivity gains was well designed, Mrs. Ploix continued. That objective was an ambitious one, and she regretted that no agreement had been reached during the Economic and Social Conference. The general increases decreed for both private and public sectors in 1986 were only temporary policy actions. In particular, the authorities would have to monitor as closely as possible wage adjustments in the public sector, which could send the wrong signals to the overall economy.

She agreed with the staff that a cautious attitude should be adopted toward expenditures and that special emphasis should be placed on management of the public sector, Mrs. Ploix commented. Indeed, strict management of public enterprises was indispensable for the success of the entire plan. The difficulties experienced in 1985, notably in the operation of the State Oil Company and the National Mortgage Bank, were worrisome. The management and investment program needed to be strengthened and rationalized, and she welcomed the discussions on that subject which were to take place with the World Bank. The authorities' intention to reduce the size of the public sector--a measure all the more difficult to implement because of the relative narrowness of Argentine financial markets--was a step in the right direction. She also welcomed the plans for the long-awaited major reform of the financial system, as its operating costs were unbearable in the longer run. All those structural policies were needed to ensure the soundness of the Argentine economy.

As to external policy, she welcomed the overall design of the program, particularly the elimination of all arrears by mid-1986, the automaticity of payments and transfers related to services other than tourism, and the broadening of imports under automatic license, Mrs. Ploix stated. However, she shared the staff's concern about the levies on both import and export trade. Even if the rate increases had been motivated by fiscal considerations, the authorities must not allow such measures to become permanent. Recent developments might not put in danger the long-announced commitment to liberalization. In that respect, the recent lowering of the export tax rate for agricultural products was a step in the right direction. Finally, she looked forward to more precise information on the medium-term balance of payments outlook and invited Mr. Nebbia or the staff to provide any further information that would shed light on that essential area.

The courageous path chosen by the Argentine authorities was a necessary one, and there was little margin for maneuver, Mrs. Ploix noted. Therefore, all measures should be implemented, as well as contingency plans if they appeared necessary, to avoid possible slippages. Such efforts required the difficult and austere exercise of discipline, all the more difficult because some assumptions seemed optimistic and because the outlook for recovery, particularly in the investment sector, seemed unclear. Finally, she supported the proposed decision.

Mr. Ercel remarked that Argentina had adopted an interesting approach to the problem of adjustment in a hyperinflationary economy. The overall strategy and objectives of the program launched by the Government in June 1985 had been designed primarily to address the root causes of inflation by strictly implemented demand management measures accompanied by a freeze on wages and prices, supported by adequate external financing. That basically sound mix of policies had been successful and had provided an appropriate framework for the necessary internal and external medium-term adjustments.

Two impressive results had been achieved--a sharp decline in inflation and a better than expected performance of the current account, Mr. Ercel continued. In addition, a relatively quick recovery of output in late 1985 boded well for attaining the desired medium-term growth rate. The success of the program so far was the result of the Argentine authorities' determination to carry through a comprehensive program and the attitude of the Argentine people who, by accepting the need for strong measures, had assured the necessary political support for the program.

Nevertheless, a key element of the program--the reduction of the public sector deficit to 2.5 percent of GDP by the second half of 1985--had not been realized, Mr. Ercel pointed out. Moreover, there was still the important question of what would happen when the freeze on wages and prices was lifted. The authorities favored a gradual price decontrol through sectoral arrangements under which first the smaller firms and only later the larger firms would be allowed to raise their prices in a manner consistent with developments. That approach was not only difficult to implement but would also increase price distortions and extend the freeze. However, introducing a system of market-determined prices at present might rekindle inflation because inflationary expectations had not yet been sufficiently reduced. It was crucial that the economy be guided along some middle path to avoid both of those risks.

He fully shared the staff's concern over the behavior of the fiscal accounts during the second half of 1985, which was less favorable than had been projected, particularly with regard to expenditures, Mr. Ercel added. It was important that the fiscal deficit be contained within the target limit of 3 percent of GDP, which would require careful monitoring of both commitment and cash calculations of the total budget deficit. According to the staff report, excluding the accumulation of unpaid bills and supplementary budget allocations, the difference between the commitment and the cash calculations of the deficit were smaller during periods of low inflation than during periods of high inflation. The desired paring of the deficit in 1986 would require contingency measures, especially to control expenditures. Although the ratio of public sector cash spending to GDP, at about 30 percent, was not expected to be reduced in 1986, a sizable cut in public expenditures would soon become unavoidable.

On monetary policy, monetary aggregates would have to be controlled through central bank credit policy because of the difficulty of evaluating the demand for money, Mr. Ercel considered. Another possible alternative to a tight monetary stance might be controlling credit throughout the banking system. He invited staff comment on the feasibility of that approach. Previously, the volume of bad loans in the banking sector had shown a tendency to increase, thereby squeezing the supply of credit available to the productive sector. If that tendency continued, it would place additional upward pressure on interest rates, artificially raising the rates in the free segment of the financial system. Moreover, the authorities' intention to lower reserve requirements for private banks, coupled with their overall policy of monetary restraint, might fail to achieve the desired reduction of real interest rates as long as the volume of bad loans continued to increase. He invited staff comment on that point.

Since the devaluation of the peso by 18 percent in June 1985, exchange rate policy had played only a limited role in the adjustment process, Mr. Ercel noted. However, exchange rate policy was closely linked with the issue of the wage-price freeze. He wondered how the conduct of exchange rate policy was to be coordinated with the Government's planned gradual removal of price controls. The recently announced economic measures in Brazil, which bore some resemblance to the Argentine program, included neither an initial devaluation nor a freezing of the exchange rate. He would appreciate some clarification from the staff regarding the effects of exchange rate policy on the economies of Brazil and Argentina in the context of their wage-price freeze. In conclusion, he supported the proposed decision.

Mr. Nimatallah said that Argentina's economic performance had been most encouraging in the areas of the combined public sector deficit, the rate of inflation, the balance of payments, and external payments arrears. However, it was important that the authorities sustain the momentum created by the 1985 initiatives if those measures were to achieve their goal of restoring balance with growth to the economy. For that reason credibility on the inflation front would have to be maintained and additional policies for reducing structural obstacles to sustained growth would be required.

The Argentine authorities were aware that the conduct of short-run macroeconomic policies could be complicated by persistent inflationary expectations that would take some time to subside, Mr. Nimatallah observed. Any misconstrued signals of a softened stance on inflation could create uncertainties for savers and investors. Therefore, extreme caution in the conduct of fiscal and monetary policies was essential to convince all participants in the economy that the back of inflation had been broken. In that regard, Mr. Nebbia's statement that the authorities' objective for 1986 was "to comply with the principle that the public sector deficit must be brought down to a level that could be covered by available foreign financing" was welcome.

The appropriate stance of monetary policy at present was to keep domestic credit creation at a minimum and to satisfy increased demand for money through changes in net foreign assets only, Mr. Nimatallah remarked. He welcomed the recent measures taken to reduce the attractiveness of the rediscount facilities, which should result in a more efficient allocation of credit. It was important, however, that the underlying process of shifting resources from the government sector to the private sector be intensified. That process should be based on measures to enhance the capacity of the private sector to use those resources efficiently. As savings were shifted from the public sector by reducing the size of Government through both lower expenditures and lower taxes, the private sector should be encouraged to carry the responsibility of employing those savings productively and efficiently. Among the factors to encourage private sector investment were lower interest rates, reasonable labor costs, easier access to raw materials--both locally produced and imported--and, of course, tax reforms.

In the longer run, structural reforms on all fronts were necessary to lay the foundation for Argentina's return to a path of sustained growth, Mr. Nimatallah pointed out. The authorities had already taken a number of commendable measures.

On the external front, more action was needed in several areas, Mr. Nimatallah remarked. First, it was important to sustain confidence in the economy, not only to encourage the repatriation of capital flight, but also to encourage new foreign investment. Second, to encourage export industries, the authorities might not only have to phase out export taxes but also might have to introduce incentives to encourage export industries.

Third, it was important that import-competing industries be concentrated as much as possible in those areas where Argentina had a comparative advantage. To complement those efforts, Argentina's trading partners should open their markets to Argentine products.

Significant economic adjustment was often achieved at a cost of some loss of growth in the short run, Mr. Nimatallah observed. However, the authorities were aware of the longer-term benefits of controlling inflation, such as better resource allocation, enhanced efficiency, and encouraging capital inflows, to increase confidence in the economy. It was therefore important that the authorities stay their present course. He hoped that the Fund and the authorities would come to an agreement on a follow-on stand-by arrangement. Finally, he supported the proposed decision.

Mr. Fujino recalled that in June 1985 the Argentine authorities had embarked on a comprehensive and courageous program to eradicate the long record of high inflation and to reverse economic stagnation. To quickly bring down the high inflationary expectations, the authorities had introduced a new currency unit, had pegged the exchange rate to the U.S. dollar, had adopted a temporary wage-price freeze, and, most important, had made a firm commitment regarding a major tightening of financial policies, including a commitment that the Central Bank would no longer finance the public sector. The program had been based on the conviction that in order to minimize the transitional costs in terms of output and employment involved in reducing the rate of inflation, the best strategy would be to tackle high inflation through a once-and-for-all irreversible policy change rather than through a gradual anti-inflationary strategy.

The new strategy had produced many positive results, despite some slippage on the fiscal front, Mr. Fujino noted. The monthly rate of inflation had declined from more than 30 percent in mid-1985 to about 2.5 percent in terms of the consumer price index and 0.5 percent in terms of the wholesale price index. Following a short period of heavy liquidation of inventories, industrial production began to recover in August 1985. That development might support the authorities' view that their strategy was more conducive to economic growth than a gradual anti-inflationary strategy. The external balance had turned out to be better than expected, partly reflecting improvements in the capital account. The beginning of a repatriation of Argentine assets held abroad would be an encouraging sign, reflecting improved confidence in the economy, as was indicated in the staff's medium-term balance of payments projection. The official projection for 1986 was more pessimistic. He would appreciate any further elaboration on the likely prospects of net inflows of domestic capital.

Despite those positive results, it was not clear whether inflationary expectations had fully subsided, Mr. Fujino remarked. Underlying inflationary expectations were difficult to ascertain for several reasons. The economy was still under pervasive price controls. The fiscal deficit had been reduced substantially, but remained well above the original target, owing primarily to the substantial expenditure overruns, and domestic financing had been required in the second half of 1985. Perhaps most worrisome was a large special pay increase granted at the beginning of the year to a wide range of National Administration employees, which substantially exceeded the general wage increase of 5 percent for the private sector. To restore wage and price stability, the Government must take the lead in restraining wages. The unavailability of a complete picture of expenditure overruns during 1985 was also a source of concern, because overruns largely reflected errors in the estimates prepared at midyear, including overspending by the State Oil Company. Interest rates remained high compared with the observed inflation rate. He agreed with the authorities that interest rates reflected both pressures from the fiscal side and inflationary expectations that remained above the level of observed inflation. Clearly, any attempts to lower interest rates by monetary expansion would be counterproductive.

Those observations suggested that further major tightening of fiscal policy and continued restraint in monetary policy were essential to convince the public that the Government was firmly committed to the anti-inflationary strategy and that there was therefore no risk of reverting to the previous wage-price spiral, Mr. Fujino considered. He hoped that the pursuit of those policies would permit an early lifting of price controls. The need for price liberalization was particularly great in view of exchange rate policies. The austral had appreciated significantly in real terms against the U.S. dollar during 1985. Although Argentina's overall competitive position had not eroded much because of the depreciation of the U.S. dollar against other major currencies, the present exchange rate arrangement involved a considerable risk of competitive loss. Appreciation of the exchange rate increased the risk of a possible outflow of domestic capital. Therefore, a gradual but flexible adjustment mechanism should be introduced as soon as possible. The authorities' indication that the exchange rate would be adjusted as needed did not provide a sufficiently strong commitment in that respect.

He agreed with the staff that a combined fiscal deficit in 1986 equivalent to no more than 3 percent of GDP should be viewed as a minimum requirement and that the authorities should stand ready to adopt any additional measures to ensure the achievement of that objective, Mr. Fujino continued. Emphasis must be placed on expenditure cuts in view of repeated overspending in the past. He strongly expected that the measures innumerated by Mr. Nebbia for more effective tax administration, stricter expenditure control, and the careful management of public enterprises would be forcefully implemented. However, he questioned the appropriateness of the provision in the proposed budget for 1986 for an 8 percent increase in real expenditures by the National Administration, excluding external interest payments, and a 4 percent increase in the wage bill in real terms.

On monetary policy, rediscounts had grown rapidly in the last half of 1985, and it had to be offset by a substantial increase in the reserve requirements, Mr. Fujino noted. Although some measures had been recently taken to reduce the attractiveness of the rediscount lines, further steps should be taken as needed.

The substantial delay in eliminating arrears owing to "administrative delays" was regrettable in view of the substantial overperformance with respect to the external balance, Mr. Fujino remarked. He strongly expected that arrears would be cleared by end-June 1986 as projected.

Some progress had been made in liberalizing imports and reducing export taxes, but much more remained to be done, Mr. Fujino remarked. As for the official balance of payments projection for 1986, he agreed with the staff that it had overstated the magnitude of the unfinanced balance of payments gaps. In particular, if the authorities intended to forcefully implement the appropriate financial policies, a marked deterioration in the capital account as indicated in the projection was doubtful.

In sum, he had some questions about the adequacy of the adjustment measures contained in a modified stand-by arrangement, Mr. Fujino indicated. Nonetheless, he welcomed the substantial progress that had been made under the new strategy adopted in June 1985 and considered it crucial that the momentum of adjustment be maintained. With those considerations, he supported the proposed decision.

Mr. Wijnholds observed that the new policy measures implemented by the authorities in June 1985 represented a radical breach with the past. During the Board discussion of those measures in August 1985, it had been stressed that those policies would only be successful if they were implemented radically. Nevertheless, although the situation had improved considerably in the last half of 1985, substantial slippages had occurred that might undermine the Government's credibility, which was of essential importance to the program's success. The deficit of the nonfinancial public sector had amounted to 3 percent of GDP, compared with a projected level of 1.4 percent, and the divergence between the deficit target and the outcome for 1986 was likely to widen. The elimination of arrears had been delayed, notwithstanding a substantial improvement in the balance of payments.

Although the wage and price freeze was to have been temporary, the authorities' intentions with regard to its removal were not yet clear, Mr. Wijnholds continued. Furthermore, structural reform in the external and financial sectors was long overdue and should be pursued vigorously. Financial and technical support from the World Bank in those areas could be helpful. However, the staff report lacked an assessment of the World Bank's activities in Argentina and he invited comment from the staff or Mr. Nebbia on that subject.

The deviation from the targeted deficit reduction and its continuation in 1986 was also worrisome because it had been caused primarily by spending overruns, Mr. Wijnholds added. Table 7 of the staff report showed that in nearly all categories, except that of interest payments, government expenditure was expected to rise in 1986, and he noted in particular the rise in capital expenditure and in the wage bill. Government expenditure in real terms was to increase by 8 percent in 1986. He agreed with the staff that the large wage increases granted recently to a large number of civil servants was worrisome. Those developments would make it difficult to achieve the desired reduction of export taxes while staying within the limits of the overall deficits. Those export taxes should be abolished as soon as possible in order to stimulate the growth of exports, which was clearly needed for Argentina to strengthen its debt servicing capacity. He therefore urged the authorities to exercise greater spending restraint, especially as part of the deficit for 1985 and that for 1986 would be financed by transfer from the Family Allowances Funds.

Concerning monetary policy, a cautious stance was needed, Mr. Wijnholds stressed. The growth rates of the monetary aggregates, though reduced in recent months, were considerably higher than originally contemplated. However, as that outcome might have been caused by an increased demand for money resulting from the disinflation process and could be traced back to the strength of the balance of payments, inflationary consequences might be limited. Yet, growth rates of monetary aggregates that continued to be two or three times that of the present inflation rates would eventually have an inflationary impact. Considering the significant difficulties in the fiscal area, the burden on monetary policy would become even greater, which underscored the need for a more restrictive monetary stance. If monetary growth did not decelerate further, inflationary expectations would again rise, capital flight would not be reversed, and the chances of successfully unfreezing prices and wages would be jeopardized.

He welcomed the intended reform of the financial system, Mr. Wijnholds remarked. The reserve requirements on certain categories of deposits were nearly 100 percent, which was an unhealthy situation. Moreover, the financial system was highly regularized. Those factors tended to limit the competition between banks, thereby contributing to high interest rates. The reform of the financial sector should therefore be an important element in any follow-on program. It was encouraging that the authorities intended to reduce the size of the public sector and increase the efficiency of public enterprises. The recent announcement that government interests in some enterprises were to be sold was an important first step in that direction.

In the external sector, the deterioration of the current account was a serious development that would contribute to an increased financing gap for 1986 combined with lower exports, Mr. Wijnholds added. Thus, the ratio of external debt to exports--already the highest among the Latin American countries--would rise to over 500 percent. He therefore agreed with the staff that the official projection of the overall balance of payments deficit was too large and should not be the basis for planning purposes. The figure of $878 million, which had been set as a performance criterion for the overall balance of payments deficit for the first quarter, still seemed to be somewhat excessive.

It was regrettable that external payments arrears would not be eliminated by March 1986 as had been targeted, Mr. Wijnholds commented. It was of great importance that the authorities achieve the reduction in arrears targeted under the revised performance criteria and eliminate the remaining arrears by mid-1986. Further delays could only negatively affect the flow of capital to Argentina and undermine its position as a host country for foreign direct investment.

Notwithstanding the doubts that he had expressed on a few subjects, he was prepared to go along with the proposed rephasing of purchases, Mr. Wijnholds concluded.

Mr. Rye remarked that the radical program adopted by the Argentine authorities in mid-1985 remained broadly on course despite slippages. Although a number of performance criteria had not been observed and the second review of the arrangement had been delayed, deviations from the program were small, particularly relative to the ambitious improvements it sought to achieve.

The substantial progress the Argentine authorities had made since June 1985 was commendable, Mr. Rye continued. The results achieved, especially on the inflation front, had been sufficiently impressive to restore confidence in the economy and credibility to economic policies. But that confidence and credibility remained fragile and could quickly crumble if the results achieved so far were not taken further and consolidated. While it was understandable that in aiming for such a dramatic improvement in policies and performance, some targets would not be met on the first attempt, it was important that deviations should be followed up quickly and addressed decisively. The staff paper left the impression that the strength of followthrough was not measuring up to that of the initial actions taken last June.

Fiscal policy had fallen short of what had been targeted, particularly on the expenditure side, and wage pressures had not been entirely contained, Mr. Rye noted. The substantial wage increase in the National Administration in particular had not been helpful in that regard. He wondered why those adjustments had not been made in June 1985 when they would have been less damaging. Prospects for an early exit from wage and price controls were not encouraging. Those controls were not viable in any but the short term, but more progress needed to be made against inflationary expectations before it would be advisable to lift them.

The official projections for the balance of payments in 1986, which foresaw a reversal of the progress made in 1985, were also disquieting, Mr. Rye commented. If it could be concluded that the shortfalls experienced so far reflected unnecessarily ambitious initial targets, there would perhaps be no great cause for concern. But the external financing gap projected for 1986 was large, and even an inflation rate as low as about 2 percent a month was unlikely to be consistent with a continued fixed relationship between the austral and the U.S. dollar and the maintenance of competitiveness.

In sum, the Argentine authorities should quickly address the policy shortcomings that had been identified by the staff so as to push home the substantial progress that they had made so far, Mr. Rye remarked. In that connection, he welcomed the authorities' attention to seek a follow-on stand-by arrangement with the Fund and looked forward to reviewing policies and developments in the Argentine economy in greater detail when that request was brought to the Board. Finally, he supported the proposed decision.

Mr. Foot said that progress under the authorities' financial program since July 1985 had been impressive. There were some slippages toward the end of the year, but as far as public finances were concerned, those slippages were perhaps as much a reflection of the ambitious task that the authorities had set for themselves as of any major failure in implementation. However, there was a problem of expenditure overruns in the second half of 1985, particularly in the state enterprises, and there was clearly room for tightening expenditure control. It was also disappointing that the timetable for reducing arrears and liberalizing imports as well as for deregulating private sector external debt service payments was not observed, despite the better than expected balance of payments and reserve positions. As to arrears--and he believed that new interest arrears to the commercial banks had emerged in January--they seemed to be mainly the result of administrative problems which he hoped had been resolved. He invited staff comment on that point. Also, the footnotes on page 71 of the staff report explaining how the reduction of external arrears was to come about were puzzling; four exclusions and two caveats were given to three figures so that it was not clear what the reduction in arrears amounted to or what the exclusions related to.

The adjustment program was entering a more difficult phase, and the authorities should make every effort to maintain the momentum achieved by sticking to the terms of the current stand-by arrangement and negotiating a follow-on stand-by arrangement, Mr. Foot considered. Top priority should be given to maintaining downward pressure on inflation. Inflationary expectations remained high, and against that background, the gradual dismantling of the wage-price freeze would be difficult but necessary. And in a period when it was intended to introduce more flexibility into the determination of wages and prices, it was important to keep public finances and the creation of credit under tight control. At such times, it was also advisable, if possible, to avoid appearing to benefit employees whose pay was clearly within the control of the Central Government. Import liberalization and the privatization of public enterprises could contribute importantly to creating a more competitive environment and keeping down the pressure to raise prices. The authorities should press ahead with the implementation of those elements of their program. In that regard, he wondered whether any provisional timetable for privatization had been set.

The details of the financial plan for 1986 had yet to be finalized, Mr. Foot noted. He supported the staff's reservations about the widening in the overall balance of payments deficit that was forecast in the official projections and about the 1986 target for the public sector deficit which--considering the authorities' intentions to limit that deficit to what was financeable from external sources--appeared to be on the high side.

The continuing reduction in the public sector deficit continued to rely too much on revenue increases, Mr. Foot commented. The high level of export taxes and the substantial tariffs imposed on certain classes of imports would have particularly harmful effects on future resource allocation. A slight reduction in overall spending in real terms was expected in 1986, largely as a result of lower interest rates. The 8 percent real increase in real expenditure of the National Administration--excluding interest payments--was at first sight too high even compared with the expected fairly buoyant 4 percent real growth rate. On the revenue side, he wondered when the remaining components of the tax reform were likely to be implemented and what their probable revenue effect would be.

The effect on competitiveness of maintaining the austral's link to the U.S. dollar should be kept under close review, and he welcomed the authorities' commitment to adjust the exchange rate as necessary to achieve balance of payments objectives, Mr. Foot added. He agreed with Mr. Goos that detailed consideration of a free exchange rate system could be worthwhile.

On monetary policy, the continued existence of high inflationary expectations together with the uncertain evolution of the demand for money in present circumstances suggested continued caution, Mr. Foot remarked. He fully endorsed the staff comment that real interest rates might not be as high as suggested when compared with actual inflation rates.

In sum, the authorities had made substantial progress in achieving their ambitious objectives, Mr. Foot commented. But the economy was entering a more difficult period, and it would be important that the authorities demonstrate their continued commitment to adjustment, the more so if the confidence of creditors was to be retained and the assumed increase in banks' exposure in the medium-term balance of payments projection was to be fulfilled. To that end, the remaining elements of the present program should be vigorously implemented and negotiations on a follow-on stand-by arrangement should be swiftly concluded. He supported the proposed waiver and the revised phasing of purchases.

Mr. Zecchini noted that the strong adjustment program adopted in mid-1985 was entering its second stage following a period of initial shock measures, and that the first results were positive. The sharp fall in the inflation rate and the decline in the deficits of the external current account and the nonfinancial public sector were important signs that the austerity program had been correctly implemented and was producing the expected results. Although several program limits, pertaining mainly to Treasury outlays and the public deficit, had not been respected, the program was proceeding toward its goals of reducing financial and external imbalances and was laying the basis for sustainable economic growth. The evaluation of economic policies and the monitoring of developments was difficult because of the weakness of the statistical base. It would therefore be advisable that the Fund cooperate with the authorities in a major overhaul of the statistical base in order to improve the policymaking process and give more meaning to the Fund's performance criteria.

Argentina's adjustment effort should be encouraged and supported so that the progress made thus far was not made in vain, Mr. Zecchini continued. He therefore agreed to the extension of the stand-by arrangement, the waiver of certain performance criteria, and the proposed decision.

As the stabilization process progressed, broadening the focus of policy action would become more urgent, Mr. Zecchini considered. As standard demand management measures reached their limits in fostering higher economic activity and larger utilization of potential resources, they would have to be complemented by institutional reforms and improvements in the operations of economic mechanisms. Structural measures were also necessary to ensure a smooth transition from the administrative controls on wages and prices and other emergency measures to a proper functioning of the market mechanism in guiding production as well as the allocation of resources. An appropriate framework for those measures, which should span the medium term, might be an enhanced surveillance arrangement with the Fund or a more innovative financial arrangement such as that illustrated in the debt initiative proposed by the U.S. Secretary of the Treasury.

As to the fiscal position, despite the progress made toward reducing imbalances, more adjustments were needed both to dispel the uncertainties that still surrounded the present trends and to support balanced economic growth, Mr. Zecchini commented. It was essential that the deficit be reduced to no more than 3 percent of GDP to leave more room for monetary strategy to engage in pursuing price stability. Also, the structure of expenditures and revenues should be improved in line with predetermined consolidation programs.

The 1985 expenditure overruns accounted for 2 percent of GDP as a result of automatic increases as well as lack of control over some expenditure items, Mr. Zecchini observed. For instance, although public enterprise operations were affected negatively by the decrease in overall economic activity, they were also subject to large inefficiencies.

Shifting portions of fixed investment expenditure from the public sector to the private sector would therefore seem advisable. Similar advice would apply to the State Oil Company, whose economic prospects appeared particularly uncertain not only with regard to its operations but also as a result of present world market trends. On that point additional information from the staff would be helpful. Overall, public expenditure should be restructured so as to enlarge the investment opportunities for the private sector and strengthen the environment for cost-effective production.

Restructuring of the revenue side should be directed toward the same objective, Mr. Zecchini continued. Phasing out taxes on exports must not be delayed. Moreover, temporary tax relief measures should be introduced to provide additional incentives to fixed investment. At the same time, offsetting revenue sources had to be found to meet the overriding objective of achieving a budget deficit of less than 3 percent. Those additional revenue measures should also be strengthened if economic growth failed to reach the 4 percent forecast for 1986. In that connection, he would like to know the staff's assessment of the possible revenue shortfall owing to slower growth of nominal GDP.

Real interest rates were still highly positive, Mr. Zecchini noted. That outcome was perhaps the result not only of recent monetary stringency but also of the persistence of inflationary expectations beyond the very short term. Although reversing inflationary expectations was a difficult task, setting precise quantitative targets for the range of expansion of monetary aggregates would significantly ease those difficulties. Of course, in setting the range for monetary aggregates, due allowance should be made for recent declining trends in money velocity. However, excluding international reserve accretion from the monetary base creation target was not advisable because doing so could result in a loss of control over monetary aggregates in instances of strong balance of payments performance. In that respect, the staff and the Argentine authorities should draw on the experience gained from the Brazilian monetary expansion of 1984-85.

Making monetary targets known to the public in advance and closely complying with them might offer the authorities the most appropriate anchor to market expectations, thereby paving the way to a decrease in real rates, Mr. Zecchini considered. However, the possibility of such a strict monetary targeting would depend on the degree of economy exercised by the Central Bank with respect to covering the borrowing requirement of the Treasury. Serious consideration should be given to explicitly guaranteeing the independence of the Central Bank's action aimed at preserving monetary stability through some institutional reform, such as a legal provision. Such independent action would benefit from other reforms directed toward improving the operations of the banking system. Curtailment of the recently excessive rediscounts and the establishment of sounder lending practices would reduce the interventions of the Central Bank in support of the financial system and would increase efficiency in the allocation of financial resources. In sum, it was important to eradicate inflationary expectations and habits, which would allow lower real interest rates, higher fixed investment, more confidence in business prospects, and capital repatriation.

On external policies, Mr. Zecchini observed that the degree of openness of the Argentine economy had decreased significantly in the past four years. As measured by the ratio of the sum of imports and exports to GDP, the degree of openness had decreased from 38 percent in 1980 to 19 percent in 1984. More active consideration should instead be given to gradually opening the economy, which would involve a rapid phasing out of current export taxes and rebates as well as the present multiple currency practices. Other tariff and nontariff barriers to trade should be gradually dismantled in line with the future strengthening of the external position. At the same time it was essential to avoid any appreciation of the real exchange rate, mainly by compressing the inflation differential with major trading partners.

Mr. Jaafar considered that the strength of the June 1985 policy initiative had been a crucial factor behind the current impressive progress on many fronts in the Argentine economy. The most decisive success had been the containment of runaway inflation, which had been achieved through the right combination of monetary, fiscal, and income policies. It was important that those gains be preserved and consolidated through the implementation of similar policies, modified in the light of performance and present circumstances.

The performance in public finance for the second half of 1985 could have been better, Mr. Jaafar considered. The larger than planned overall public sector deficit, unless effectively contained in the present quarter, could threaten the crucial inflation objective in the period ahead. For example, the deficit in the second half of 1985--which exceeded the equivalent of 4 percent of GDP--was large, as it was more than could be comfortably financed from external resources. Two major factors might account for those excesses: the operation of the State Oil Company (YBF) and estimation errors. Apparently, the oil company had been the major contributor, with cost overruns in 1985 well above the equivalent of 1 percent of GDP compared with a planned target of striking an approximate balance. As for expenditure overruns due to estimation errors, it was regrettable that the planned contingency program had not been adopted when the errors arose.

The 1986 budget should reflect those concerns, Mr. Jaafar continued. The target deficit for the 1986 budget, equivalent to nearly 3 percent of GDP on a commitment basis and to 2 percent of GDP on a cash basis, seemed reasonable despite the staff's observation that the difference was too fine. In view of budget performance in 1985, he would have preferred a narrower deficit in the interest of pursuing a somewhat more vigorous inflation objective and strengthening the external position. The present budget plan for 1986 appeared to allow little room for deviation. Although a revenue shortfall did not appear imminent, the possibility of expenditure overruns might again threaten the 1986 plan. He therefore wished to strongly stress the need to avoid any supplementary spending measures in the 1986 fiscal year and to contain effectively any deviation from the budget. He also agreed with the staff that the burden of the budgetary measures had fallen disproportionately on the revenue side rather than on expenditure cutbacks in 1985 and that seemed to be true for the 1986 budget as well.

Monetary policy in the second half of 1985 had been broadly consistent with the program target except for the better than anticipated net international reserves performance, Mr. Jaafar observed. Nevertheless, it was crucial that monetary policy be nonaccommodative in the coming months. Despite the impressive gains on inflation, monetary policy management had not been made any easier. In the period ahead, the authorities would need to strike a proper balance between preserving the momentum of the stabilization program and promoting saving and investment in the pursuit of growth. In the interest of achieving the growth objective as soon as possible, less restrictive money and credit policies might be advisable. Although the somewhat high real interest rate in 1985 was cause for concern opting for a more expansionary stance aimed at pushing down the level of interest rates, under present circumstances, would be a mistake. A far more sensible course was the pursuit of a strict fiscal stance as envisaged for the present quarter. He agreed that an expansionary credit policy was counterproductive in terms of the stabilization effort, which led him to question the need to lower the reserve requirement as proposed, since doing so would also lead to undermining the monetary objective. If it was important that the reserve requirement be lowered to attain more efficiency and flexibility, he would feel more comfortable with that move if adequate allowances were also made to offset the expansionary impact on the banks. In that regard, limiting both the volume of rediscounts and narrowing the spread between the market interest rate and the discount rate would become more important.

The freeze on wages and prices in June 1985 had been an essential element of the stabilization strategy and had been intended by the authorities to be a temporary means to stop the wage-price spiral resulting from the long-entrenched policy of indexation, Mr. Jaafar noted. The timing for dismantling that freeze was at present crucial because the longer the freeze continued, the harder it would become to remove it. Although at the moment there was no evidence of any cost-price distortions directly traceable to the freeze, such distortions could emerge in coming months unless strict fiscal and monetary measures were implemented to defuse any remaining inflationary expectations. He therefore attached particular importance to the authorities' intention to dismantle the wage-price freeze as soon as possible. The fiscal and monetary policies outlined in the program for the remainder of the stand-by arrangement, if fully implemented, would--in his opinion--permit an early lifting of the freeze.

Balance of payments developments remained a serious concern, Mr. Jaafar remarked. The projected widening of the current account for 1986 was unfortunate in that it was mainly due to poor commodity prices and severe flooding in late 1985--all circumstances beyond the authorities' control. He noted the staff's reservations concerning the official projections for the balance of payments for 1986 and agreed that there were many more uncertainties surrounding those projections that needed to be looked into more closely. Therefore, the suggestion was well taken that the Board should examine the balance of payments for 1986 and the medium term more comprehensively at another time, perhaps during its discussion on a follow-on stand-by arrangement. The balance of payments projection for the first quarter of 1986 may not be as weak as expected owing to the lower cost of oil imports, which could be a significant factor in narrowing the projected deficit. It was important of course for the authorities to preserve export competitiveness by keeping the exchange rate at appropriate levels.

In sum, it was crucial that the impressive gains made since last June be maintained through the continued implementation of stabilization policies, Mr. Jaafar concluded. Although projections for the medium term indicated that Argentina's external position would remain extremely difficult, it nevertheless appeared manageable within the context of the assumptions made on exports and GDP growth rates. The recent decline in international interest rates also increased the possibility of a better medium-term scenario. Finally, he supported the proposed decisions.

Mr. Vasudevan remarked that the Argentine program was on the threshold of success and worthy of support. The inflation rate had been brought down from a monthly average of 28 percent in the second quarter of 1985 to a monthly average of 2.5 percent in the period from July 1985 to January 1986. Price expectations had shifted dramatically. As a result of the wide-ranging measures announced on June 14, 1985, inertial inflation had abated and both the demand and cost factors in inflation had been tackled. Had there been no major monetary reform, adjustment in the exchange value of the newly introduced austral, and wage-price freeze, it was doubtful that the program would have proceeded as successfully as it had. The anti-inflation strategy had been a success, not because of the existence of the program per se, but because of the authorities' commitment to the program's basic objective of demand management and the sweeping measures that had been implemented. That success was reflected not only in the abatement of price increases but also in the reduction of the current account deficit during 1985.

When the program went off track in early 1985, the Fund had revised the program to suit the exigencies of economic developments, Mr. Vasudevan recalled. In that sense, the program was not rigidly cast. Yet, at the time the reform measures were undertaken, their impact on various economic variables over time could not be exactly estimated. Without knowledge of the transmission process once severe adjustment measures were launched suddenly and unexpectedly, neither the authorities nor the Fund staff could have made estimations that would approximate outcomes. Thus, it was understandable that fiscal expenditure overruns in the second half of 1985 were largely the result of estimation errors. It was therefore necessary to be flexible in viewing developments since June 1985.

Fiscal and monetary developments in the second half of 1985 reflected a major effort at restraining demand, Mr. Vasudevan noted. Gross domestic expenditures had declined both in consumption and in investment. On an annual basis, the fall in gross domestic expenditures in the third quarter was about 13 percent. Demand restraint was also manifested in the decline in the imports of goods and nonfactor services. Manufacturing output had declined sharply in the third quarter by about 30 percent on a yearly basis. The rate of unemployment had risen in all major cities. Real GDP, which was estimated to have declined by 4.5 percent in 1985 compared with an increase of 2.4 percent in 1984, appeared to have recovered somewhat in recent months.

The pace of economic activity could pose a constraint to policymaking, Mr. Vasudevan remarked. Further cuts in expenditures in an effort to reduce inflation and achieve external balance might become counterproductive. Investment in domestic industries had been insufficient in recent years. Capacity restraints were being felt in the manufacturing sector, and installed capacity had been much reduced as a result of opening the economy to foreign competition in the late 1970s and early 1980s. It would therefore be necessary to raise investment expenditure in order to improve productive capacity.

The 1986 budget plan appeared to be well conceived, Mr. Vasudevan commented. Reducing the combined public sector deficit to no more than 3 percent of GDP would be consistent with the aim of avoiding any domestic financing of the public sector. That objective was the minimum that could be achieved. The budget plan for 1986 allowed for a marginal fall in current expenditures compared with 1985, whereas capital expenditures were expected to increase slightly, which would be a welcome development in view of the need to raise productive capacity.

The authorities' commitment "to move gradually to remove price controls through agreements at the sectoral level which would establish undertakings on the part of business as regards their price behavior" was commendable, especially in view of the many uncertainties about the ultimate outcome, Mr. Vasudevan considered. In view of the lags in response, a significant improvement in output within the short term--during the first quarter of 1986--was doubtful. He therefore supported the authorities' view that the wage-price freeze should be eliminated in a gradual manner. In that context, some flexibility in the performance criteria for the first quarter of 1986 was appropriate. He noted that the limits set for the combined public sector deficit would be consistent with a deficit amounting to 4 percent of GDP.

Monetary policy should continue to keep inflation under control and channel resources to efficient sectors, Mr. Vasudevan remarked. The rediscount mechanism should be used cautiously and in a restricted manner. Reserve requirements could be reduced but should be enforced strictly. Interest rate policy should follow a course that was consistent with the current rate of inflation.

Official projections showed a considerable deterioration of the balance of payments for 1986, Mr. Vasudevan noted. The staff considered that those projections underestimated the likely rise in nonagricultural exports for net capital inflows but had agreed that in view of the many uncertainties, the final position could be better assessed during the discussion of a follow-on stand-by arrangement. Considering that almost 80 percent of Argentine exports were agriculture-oriented, the prospects of realizing larger export receipts at a time when commodity prices were falling were limited. In view of the composition of exports, the beneficial effects of a further depreciation of the austral was uncertain. Nonetheless, exchange rate policy would have to be flexible in responding to wage and price developments. For the medium term, the projections based on present assumptions indicated the possibility of balance of payments viability at the turn of the decade if adjustment measures continued to be undertaken in the interim.

He had noted with interest Mr. Nebbia's description of the policies envisaged by the authorities--namely, selling the Government's interests in the steel and petrochemical plants, improving nontraditional exports, and reducing export taxes on many agricultural products--to promote the growth of the Argentine economy, Mr. Vasudevan remarked. He supported the authorities' request for an extension of the stand-by arrangement to end-May 1986 and supported the proposed decision.

Mr. Huang remarked that the authorities' effective implementation of their bold economic adjustment program since mid-1985 was commendable and that the accomplishments of the program had been outstanding. In less than nine months the inflation rate had fallen from a monthly average of 28 percent to 2.4 percent. That sharp cutback in inflation had been accompanied by a recovery in output. The authorities and the Argentine people had shown admirable determination, courage, and dedication in their pursuit of economic adjustment. He was in broad agreement with the staff appraisal and wished to make only a few observations.

The overall fiscal deficit had been reduced from 12 3/4 percent of GDP in the first half of 1985 to 4 1/2 percent of GDP in the second half of 1985, Mr. Huang noted. A reduction of two thirds was an impressive achievement and reflected the high priority that the authorities had continuously given to fiscal consolidation. Further efforts were being made to cut government spending, improve the management of public enterprises, and enhance tax administration to bring down the public sector deficit to the targeted level. All those policy measures would undoubtedly contribute to not only containing aggregate demand but also lowering interest rates. Considering the importance of consolidating the fiscal position, every effort should be made to avoid any slippage in that area.

The authorities' commitment that the Central Bank would essentially not extend credit on a net basis was welcome, Mr. Huang continued. Maintaining a cautious monetary stance, tightening the granting of new rediscounts, and narrowing the gap between the cost of a rediscount line and market interest rates were among the more important measures that should be firmly undertaken. He fully agreed with the staff that a lasting way to reduce interest rates was through strengthening the fiscal position and reducing inflationary expectations rather than through monetary expansion.

The wage-price freeze had played a central role in reversing inflationary expectations, Mr. Huang observed. The changes in expectations had created a favorable environment for fostering sustainable stabilization. The authorities had intended the freeze to be temporary and planned to gradually remove price controls whenever conditions permitted. Although one could easily argue that the wage-price freeze should be removed as soon as possible, in view of Argentina's recent record of hyperinflation, a premature withdrawal might harm the stabilization achieved so far, particularly when demands for wage increases were rising.

Despite the projections showing that Argentina's current account position would worsen in 1986, the authorities had assured all of their creditors that all external payments arrears would be paid by the end of June 1986, Mr. Huang noted. The authorities had also indicated that the balance of payments gap in 1986 would be appropriately financed. He believed that the authorities' strong determination to carry through their bold economic adjustment program would significantly strengthen cooperation between Argentina and its creditors. He welcomed the authorities' commitment to eliminate the restriction on payments and transfers as well as their intention to broaden the range of automatic import licenses. Finally, he supported the proposed decision.

Mr. Alhaimus said that in response to the strong measures taken by the Argentine authorities, some major achievements had been made since mid-1985. The rate of inflation had been sharply brought down from the phenomenally high level it had reached during the second quarter of the past year, the combined public sector deficit in the second half of 1985--as a percentage of GDP--was about one third of its size in the first half, and the overall balance of payments deficit in 1985 had been about $1 billion lower than had been programmed in midyear. Nonetheless, a sharp decline in GDP growth had prevailed in 1985, and slippages had occurred in the implementation of the program with the Fund. Difficult policy choices, therefore, had to be made to ensure that the achievements already made would not prove temporary.

Perhaps the most delicate issue facing the authorities was how best to conduct the transition from the wage-price freeze, which had made a useful contribution to reversing the well-entrenched inflationary expectations, Mr. Alhaimus commented. Already, some moves had been made away from the freeze in early 1986 in both wages and prices. While those moves had been seen as steps toward reducing the price distortions of the freeze, some fears were also felt that a rapid thawing would rekindle inflationary expectations to the extent that a further freeze might prove inevitable later. In the circumstances, the cautious approach intended by the authorities seemed to be less risky, especially if complemented by firm demand policies. A factor that might also ease transition was the flexible manner in which the freeze had actually been administered, which made the shift from the freeze somewhat less drastic.

Active policies in the fiscal area would also be necessary, Mr. Alhaimus considered. The combined public sector deficit--despite the large improvement--had been well above the level originally programmed. In addition, keeping the deficit within the limit of 3 percent of GDP for 1986 would require a major effort, as the authorities now recognized. Efforts were particularly required on the expenditure side. Attention was also being given to the deficit of the State Oil Company, which had reached 1 percent of GDP. The authorities contemplated certain measures in 1986 to address that particular deficit, including greater involvement of the private sector, and reportedly, bids for oil exploration contracts had already been received. However, in light of the sharp decline in international oil prices and the consequent impact on profitability, he invited the staff to assess the prospects for private sector involvement in the oil field.

The outlook for the external sector was uncertain, Mr. Alhaimus remarked. The authorities' projection of an overall balance of payments deficit in 1986 well above that of 1985, resulting in an unfinanced gap of $3.3 billion, was particularly worrisome, especially given Argentina's heavy debt burden. A decline in agricultural export prices and the damage caused by floods had contributed to that worsening outlook. Those added difficulties made it all the more necessary to focus on a strategy of growth and export expansion. There was little discussion of those crucial issues in the staff paper, which instead deferred them to the forthcoming discussion of a follow-on stand-by arrangement. However, Mr. Nebbia had given some indication of the present thinking of the authorities, and he looked forward to more elaboration of the intended growth strategies in the period ahead.

Finally, he supported the proposed decisions, Mr. Alhaimus concluded.

Mr. Agah stated that Argentina's economic and financial performance under the stabilization plan adopted in June 1985 had been impressive. In spite of considerable deviations from some targets for the second half of 1985 and delays in implementing some measures and in completing the review, performance with respect to the plan's main objective had been encouraging, as inflation had substantially abated. The monthly inflation rate in February 1986--at 1.7 percent--was the lowest rate since December 1974, compared with a year-on-year inflation rate of 1,127 percent reached in June 1985. Although real GDP had contracted significantly in 1985 and private investment remained low in spite of the progress made against inflation, economic activity had begun to recover. Furthermore, even though the public sector deficit had been higher than programmed, the fiscal adjustment achieved was impressive, as the deficit had been reduced by two thirds from the equivalent of 12.75 percent of GDP in the first half of 1985 to 4.5 percent in the second half of the year. The higher than projected level of expenditures reflected to some extent the difficulty of estimating accurately expenditures at the time the program was designed, largely because of the far-reaching nature of the measures implemented and uncertainties with respect to their actual impact on various aggregates.

In view of those uncertainties, many Executive Directors had insisted on a sufficient degree of flexibility under the program during the Board's discussion of the last review of the stand-by arrangement, Mr. Agah recalled. He therefore welcomed the proposals for granting a waiver for nonobservance of performance criteria and for extending the adjustment period to the end of May 1986. Such flexibility was amply justified by the strong political determination shown by the authorities throughout the past nine months and by their continued adherence to the thrust of the adjustment program.

The success of Argentina's adjustment efforts had been due not only to the authorities' determination or the radical character of many of the reforms introduced in 1985--including the elimination of central bank financing of the public sector deficit, the adoption of a new currency unit to facilitate the deindexation of financial assets and the temporary wage-price freeze--but also to wide public support for the stabilization plan, Mr. Agah commented. In light of recent social developments, it would be essential to strengthen the recovery of economic activity to maintain public support for the adjustment strategy. Although there had been considerable progress in combating inflation, the pressures for increasing real growth and reducing unemployment were tremendous. It was equally important that the authorities resist expansionary policies in responding to those pressures in order to ensure lasting stabilization and the restoration of a growth environment, the more so because performance with respect to inflation continued to reflect largely price controls and the wage freeze.

He supported the proposed decisions and welcomed the authorities' commitment to the June 1985 anti-inflation strategy, which they intended to strengthen further by seeking a new stand-by arrangement, Mr. Agah remarked. The proposed extension should ensure an appropriate transition between the two arrangements.

The staff representative from the Western Hemisphere Department said that before turning to specific policy questions he wanted to comment on a statement by an Executive Director that the weakness of the data base in Argentina hampered the monitoring of events and the evaluation of policies. The staff had noted some of these data deficiencies in Appendix II of the staff report, and the Fund was providing some technical assistance to help the authorities to improve the data base.

Some Directors had remarked that economic activity had been declining, the staff representative recalled. In fact, although real GDP had declined on average in 1985, industrial production had begun to recover in late July-August 1985. The more recent data suggested that in the last quarter of 1985, industrial output had increased by about 5 percent on a seasonally adjusted quarterly basis. Despite that increase, industrial output in the last quarter of 1985 had been somewhat below the level of a year earlier.

It had been noted that in view of the projected deterioration in the balance of payments in 1986, a growth target for real GDP of 8 percent from the fourth quarter of 1985 to the fourth quarter of 1986 was probably on the high side, the staff representative remarked. The staff considered that that target probably could not be achieved in the present circumstances because consolidation of the anti-inflation effort would require a further tightening of fiscal and monetary policy. It would, however, be possible to achieve positive growth, though at a more moderate rate.

The reasons why investment had not been picking up lay in the general economic situation and the continuing pressures coming from the fiscal side, the staff representative explained. Interest rates were high, in part because the fiscal position remained weak, and consequently there was some crowding out of the private sector. Capacity utilization in some sectors was low, although some investment might occur because of changes in the composition of demand. More generally, the private sector was operating in an environment where it was as yet uncertain that it would be able to obtain an adequate return on investment. The existence of price controls was a deterrent to the return of investor confidence.

The timing of the removal of price controls was a difficult issue, and a number of Directors had cautioned the authorities not to move too quickly, the staff representative noted. Having pondered the various advantages and disadvantages, the staff concluded that controls should be removed soon because in its judgment they were already becoming ineffective and were posing serious problems. The Government had granted wage increases nationwide, including special increases for the public sector, which indicated the beginning of the loss of the controls' effectiveness. The pressure on prices was becoming increasingly evident, and the Government had recently eliminated controls on the important beef sector at the farm level, which had resulted in a substantial increase in beef prices. Over time, the Government might find itself in a situation where it would have to remove controls under pressure, resorting to a solution that was less satisfactory than if it had planned the removal of controls carefully. In the staff's view, there was no time left before pressures would require the removal of controls.

On fiscal issues, one of the staff's main concerns was the permanence of the gains that had been made over the past nine months in reducing the overall deficit, the staff representative remarked. The staff's doubts about whether a 3 percent deficit on a commitment basis was consistent with a 2 percent deficit on a cash basis were based on some historical relationships. In times of high inflation, the cash deficit had been substantially lower than the deficit on a commitment basis; spending at the end of the year was part of the deficit on a commitment basis but not on a cash basis, and the value of the cash carryover into the next year was substantially greater than the carry-in from the previous year. With lower inflation, the difference between the deficits measured on a cash or commitment basis would be less. Moreover, in the past two years, the budget had been passed very late in the fiscal year so that many commitments may not have reached the cash payment stage before the end of the year. Spending agencies with all likelihood had used their budget allocations during the last two months of the year, with actual payments taking place in the following year. That situation was not expected to be repeated in 1986; the budget had been submitted at the beginning of the year and was already being considered by the Congress, although its enactment was expected to be delayed for a few more months. It also was necessary to note that the cash deficit included extrabudgetary expenditures that were not included on a commitment basis, which tended to raise the level of the cash deficit relative to the deficit on a commitment basis.

The staff had no further information on the details of the plans for privatization of public enterprises, the staff representative stated. The World Bank had been discussing with the authorities their plans to privatize the chemical sector--and would be advising the Government in that area. As for private sector involvement in oil production, at the time the staff papers had been issued bids had been received from both Argentine and international private companies. Although investment in the oil sector likely was not as attractive as it had been previously, given recent developments in the world market for oil, some private sector involvement in that area still was possible.

The central bank losses were expected to be reduced through recent increases totaling 1 percentage point a month in the interest rate on certain lines of rediscounts, the staff representative remarked. The new rate was expected to be 1 point higher than the free market rate, and although it was not possible to indicate what that would represent in terms of reducing the deficit, it nonetheless was a step in the right direction. The central bank operating position in any case would be largely influenced by changes in the demand for narrow money. If demand for narrow money increased substantially, as it had in the last half of 1985, the Central Bank could use those cost-free resources to invest in foreign assets or rediscounts and thus make a profit on those operations.

The policy set in mid-1985 had provided for virtually no increase in central bank credit to the private sector, but credit to the private sector had actually increased, the staff representative commented. For the banking sector as a whole, there had been a substantial increase. During most of the second half of 1985, the Central Bank obtained most of the increase in resources accruing to the banking system through increases in reserve requirements and various other investment requirements. However, the Central Bank returned most of those resources to the commercial banks in the form of rediscounts. The rediscount policy did not necessarily affect overall monetary policy but had important effects on efficiency. For that reason the staff welcomed the authorities' intention to reduce both rediscounts and reserve requirements.

On financial reform, a policy consistent with a reduction of reserve requirements while maintaining an appropriately tight overall monetary and credit policy stance would be an important step toward strengthening the position of the commercial banks, particularly by making it easier for them to compete with nonbank financial intermediaries, the staff representative pointed out. The authorities were planning some measure of financial reform, and he understood that some of those plans were being discussed with the World Bank, though the plans were still at a preliminary stage.

A number of Directors had noted the difference between the staff's balance of payments projections for 1986 and those of the authorities, the staff representative recalled. The staff had explained those differences in the paper, particularly with regard to industrial exports. In fact, Mr. Nebbia had referred to a plan to achieve an increase of $500 million in industrial exports in 1986 under new programs that would involve some budgetary cost. To the extent that those programs were implemented--and the staff understood that they were being implemented--a somewhat higher figure for industrial exports could be expected since the authorities had not made any allowance for the effect of those programs in their projections. On the import side, the staff considered that a substantial increase was possible, depending on the strength of the economic recovery, exchange rate developments, and fiscal and monetary policies. Official projections, however, assumed an increase in the value of imports of 15 percent in dollar terms, which in the staff's view was inconsistent with the moderate output growth expected in 1986, the pursuit of restrained fiscal and monetary policy, and an appropriate exchange rate.

The medium-term projections, of course, could not indicate with confidence what was going to happen, the staff representative observed. Some Directors considered the staff's figures for foreign direct investment to be somewhat optimistic. The staff, however, considered its estimate to be relatively conservative, although admittedly high figures in 1985 reflected special factors that would not necessarily recur in future years. The high figures for 1985 reflected in part a scheme to facilitate the capitalization of foreign debt; some $500 million of private debt with government exchange insurance had been capitalized and converted into equity under that scheme. The staff considered that room for that kind of transaction continued to exist, while the official estimates for direct investment in 1986 made no allowance for such operations.

A few Directors had referred to the possibility of unifying the exchange rate, the staff representative noted. The staff would be stressing the need for a substantial degree of exchange rate flexibility during the forthcoming negotiation of a follow-on stand-by arrangement. The authorities were well aware of the problems that could occur if the exchange rate was out of line, and they had emphasized their genuine commitment to assure an appropriate rate. The experience with the grossly overvalued exchange rate in the late 1970s and early 1980s was a vivid memory in the minds of Argentine policymakers.

The first footnote on page 71 of the staff report defining external payments arrears was intended to exclude from arrears payments that were formally overdue but that were expected to be refinanced, the staff representative explained. If there was even an understanding in principle that certain payments would be refinanced those payments were excluded from arrears under footnote 1. Footnote 2 indicated that some of the arrears at end-December 1985 represented obligations that possibly could be refinanced or canceled without using the disposable foreign exchange reserves. The reduction in arrears that the authorities were attempting to achieve in the present quarter, amounting to about $600 million, was based on cash payments. If some of the arrears were in fact reduced without cash payment, an adjustment would be made in the targeted reduction in arrears for the first quarter.

The medium-term projections assumed an improvement in the terms of trade, the staff representative indicated, but the expected improvement in the terms of trade was small and did not have a significant impact on the forecast.

The staff supported the reduction of taxation on agricultural exports, the staff representative remarked. It was difficult to determine whether the return on agricultural output was adequate, but there had been a substantial real depreciation of the currency over the past 18 months and it might not be unreasonable to assume that the agricultural sector was competitive notwithstanding the large decline in export prices that had taken place. The staff would be carefully examining that problem during its next mission. In any event, the staff wanted to make it clear that it supported a general reduction in foreign trade taxation not only on exports but also on imports in ways that would not impair the prospects for a strong fiscal position.

A Director had asked the staff to compare Argentine and Brazilian exchange rate policies, the staff representative recalled. In Argentina, the authorities had adjusted the exchange rate prior to inaugurating their adjustment program because it was judged at the time that the exchange rate was somewhat out of line and they wanted to keep the exchange rate unchanged for some time without causing difficulties. To the extent that financial policies were intended to achieve a low rate of inflation, the policy of pegging the austral to the U.S. dollar would not have given rise to serious risks. In Brazil, it had not been made clear how the exchange rate would be managed.

The World Bank involvement in Argentina in recent years had been limited, the staff representative noted. Net disbursements had been fairly small with no important new lending operations for several years. He understood that the World Bank was actively seeking to expand its lending operations in Argentina as well as its policy advisory role and that some projects were under active consideration, in particular an agricultural loan tied to some reduction in export taxes and other initiatives over a broad spectrum of areas. The staff had not gone into details of the World Bank lending program because it was still at a tentative stage.

A staff mission would be going to Argentina in about a month to begin discussions of a follow-on program and would be taking careful note of the suggestions Directors had made with regard to the kind of program they thought would be advisable, the staff representative from the Western Hemisphere Department concluded.

The staff representative from the World Bank stated that the Bank was already considering ways to step up its lending on technical assistance programs to Argentina in the near future. With respect to privatization, the program for the petrochemical sector was expected to be in place by the end of the year, and it was also expected that government interest in those companies would be divested by that time. Efforts to privatize the steel company would be more difficult, because it involved major decisions on the future and direction of the Argentine steel sector, not only the publicly owned enterprises.

The Government was moving cautiously on financial sector reform, the staff representative continued. However, the analyses in support of a reform were being completed and it was expected that reforms would be initiated by the middle of 1986 and would include the role of the Central Bank and the public banks and increasing the efficiency of the Central Bank's supervisory role and of the private banking system. The World Bank was interested in helping the Government modernize in particular the system for housing finance.

More specifically, the World Bank had long been cooperating with the State Oil Company, and although progress was slow, the company was being modernized, the staff representative remarked. Cost centers had been established, modern management information systems were being introduced, and the investment program had been reduced by eliminating some of the more risky exploratory efforts as well as low-yielding wells. The reduction of the investment program had a negative effect in that production was likely to decline until the private sector was able to pick up the slack, which it was expected to do as a result of some of the new incentives being provided by the Government. The World Bank was also interested in modernizing the public telecommunications company. The Government was expected to act on that and other fronts in the near future.

With respect to trade liberalization, the World Bank's Executive Board would be considering a large loan in support of a tax reform for the agricultural sector in order to shift the tax burden from exports to a land tax and thereby stimulate production, the staff representative from the World Bank stated. The World Bank supported the Fund's initiative to help the Argentine Government eliminate quantitative trade restrictions. The World Bank had had technical discussions with the authorities on possible elements of the reform, including the rationalization of import and export procedures. He expected that the effort to rationalize the trade regime would be complemented by a program to support the promotion of exports.

Mr. Nebbia noted that Directors generally believed that the Argentine program was on track and that many of the ambitious targets set in 1985 had been achieved. Although 1986 might be a difficult year, compared with the situation nine months earlier, economic management should be somewhat easier. In particular, because of the sharp reduction in the rate of inflation, his authorities were more optimistic about their efforts to pursue external policies oriented toward improving the overall efficiency of the economy and attaining a sustainable rate of growth.

The sharp reduction in the fiscal deficit had contributed importantly to curtailing inflation, Mr. Nebbia continued. In February the consumer price index had risen by 1.7 percent over 1984, and wholesale prices had increased by 0.8 percent. That positive development on the inflation front confirmed his authorities' view that the wage-price freeze had worked as a result of consistent market forces. He considered it unrealistic to believe that prices would have declined so sharply in such a short period solely as a result of a wage-price freeze, as some Directors had suggested.

The Government was convinced that the freeze could not continue much longer but was exercising caution in lifting the freeze, Mr. Nebbia added. He was encouraged to learn that most Directors agreed that the freeze should be removed gradually, which should give the staff some indication of how soon the freeze should be deregulated. Certainly, it would be difficult to agree on performance criteria for a phasing out of wage-price controls.

On wage policy, it should be remembered that real wages had declined significantly--by more than 20 percent--between 1984 and 1985, Mr. Nebbia observed. The Government was preparing to implement a wage policy for the balance of the year that would be consistent with, and subordinated to, the adjustment program and the program's goals with respect to inflation. A 5 percent wage increase had been granted nationwide and a 25 percent increase had been granted to particular sectors of the National Administration. The latter increase had not applied to the entire National Administration but to those employees involved in education.

Since the Government had taken office, public sector expenditures had been reduced from 5 percent of GDP in 1984 to 3 3/4 percent of GDP in 1985, Mr. Nebbia pointed out. The priority given to improving budgetary control over the public enterprises was reflected in the recent creation of a new office headed by the Secretary of State and directly responsible to the President of the Republic. The Government was particularly making efforts to strengthen cost-effectiveness. The Government was working in close collaboration with the World Bank to improve expenditure control over the public enterprises as well as their efficiency. That was however a slow process and the Government was determined to do its utmost to improve public enterprise operations.

Unfortunately, the projected balance of payments financing gap was large, Mr. Nebbia remarked. An important factor in closing that gap would be an increase in overall exports, which would depend importantly on the behavior of agricultural export prices and volumes. The authorities and the staff disagreed on the prospects for increasing industrial exports and thus the role those exports would play in the balance of payments. Industrial exports had increased by 45 percent in 1985, and the authorities expected a further increase by 10 percent in 1986. The authorities would strive to attain the level of exports projected and were still trying to reach agreement with the staff on projections for the balance of payments.

As for the capital account, the outcome would be determined by a number of items, Mr. Nebbia suggested. For example, in 1986 about $1.2 billion in bonus and promissory notes would fall due, and that nonrecurring component was an important item in the authorities' capital account projections. It was difficult to anticipate capital repatriation, particularly because of the benefits and incentives provided by countries receiving flight capital. The policies followed by other countries would contribute importantly to the success or failure of Argentina's efforts to repatriate flight capital.

His authorities were determined to closely monitor the evolution of exchange rates, Mr. Nebbia remarked. As yet, the depreciation of the U.S. dollar against other currencies had offset the impact of high internal inflation on the exchange value of the austral. Developments in international exchange markets, together with the reduction of export taxes on many agricultural products, had allowed the Government to maintain the new currency at a constant rate vis-à-vis the U.S. dollar since May 1985. Another important indicator of the correctness of the exchange rate was the spread between the official and parallel exchange rates, which had been kept below 20 percent during the last months of the program.

The Chairman then made the following summing up:

> Directors were impressed by the determination shown by the authorities in implementing the bold program introduced in mid-1985, which had succeeded in bringing about a sharp reduction in the rate of inflation. They were encouraged that the balance of payments had continued to strengthen and that substantial progress had been made in normalizing the external payments situation. While acknowledging the major efforts made by the authorities previous year to reduce the overall fiscal deficit, Directors were concerned, however, about the slippages that

had occurred in the implementation of the program, particularly on the fiscal side. They emphasized that firm resolve was needed to bolster the stabilization effort and to reduce distortions and rigidities in the economy in order to break inflationary expectations and to put the economy on the path of sustained economic growth.

Directors noted that the combined public sector deficit in the second half of 1985 had exceeded the programmed limit and had necessitated significant amounts of domestic financing. The fiscal plan for the first quarter of 1986 indicated that this situation persisted. Many Directors believed that a public sector deficit equal to 3 percent of GDP in 1986, which is the objective of the authorities, was the maximum that could be envisaged and that the authorities should stand ready to implement, if needed, additional measures in order to achieve that objective and to establish the basis for a further reduction in the fiscal deficit in 1987.

In this regard, Directors commented that the fiscal effort since mid-1985 had focused too heavily on revenue measures and regretted the expenditure overruns that had occurred in the second half of 1985. They urged the authorities to take measures to reduce the size of the public sector and observed that such a policy should focus on renewed efforts to cut current outlays, to rationalize the operations of the public enterprises, and to limit capital outlays to those with clear priority. The sizable increase in outlays in real terms embodied in the National Administration's budget for 1986--excluding external interest payments, real spending would rise by 8 percent--was in the view of a number of Directors too large and not in line with the need for fiscal discipline. Directors welcomed the recent announcement that some major steel and petrochemical companies would be transferred to the private sector and urged the Government to deal also with the problems of the State Oil Company.

Directors observed that credit policy would be crucial to the success of the stabilization effort. They urged the authorities, in view of the persistence of inflationary expectations, to err on the side of caution in the implementation of monetary policy. Directors were encouraged that the authorities were committed to tightening the provision of rediscounts and to enforcing compliance with reserve requirements more vigorously, so that reserve requirements could be reduced for all banks within the constraint imposed by the overall credit limit. Real interest rates remained high, but prospects for their reduction hinged on a lasting improvement in the public finances and on a further reduction in inflation.

Several Directors noted that the Government had decreed a wage adjustment for the private sector at the beginning of the year that appeared to be consistent with relatively low inflation, provided that further adjustments were limited in size and frequency. However, a number of Directors were worried by the substantial special pay increases granted recently to a large proportion of national administration employees; these increases were regarded as excessive and, aside from the implications for the public finances, they carried a risk of undermining wage restraint throughout the economy. As regards prices, Directors were concerned that maintenance of the price freeze would lead to distortions, and noted the authorities' intention to apply the controls in a flexible manner. Most Directors took the view that the authorities should move gradually in lifting wage-price controls.

In the external area, a number of Directors noted that official estimates pointed to a significant widening of the current account deficit in 1986, largely reflecting a deterioration in Argentina's terms of trade. They were concerned by the substantial unfinanced balance of payments gap projected for 1986 and felt that the authorities should aim at narrowing that gap.

In light of the rate of inflation projected for 1986, Directors urged the authorities to maintain a close watch over the adequacy of the exchange rate and to avoid a deterioration of Argentina's competitive position. They were fully in agreement with the emphasis put by the authorities on export growth, and stressed that such an objective would be best served by ensuring an appropriate exchange rate. A number of Directors pointed to the need for exchange rate policy to encourage the repatriation of Argentine capital. The authorities' indication that the exchange rate would be adjusted as necessary to achieve the balance of payments objectives of the program was welcomed.

Concern was expressed about the delays that had occurred in reducing external arrears and in opening up the exchange and trade system. Directors noted, however, that the revised program envisaged a substantial reduction of external arrears during the first quarter of the year, and they welcomed the authorities' undertaking to eliminate remaining arrears by mid-1986. They also noted the plans to place most goods on the automatic import list by mid-May 1986, and the authorities' intention to keep any import duty increases to levels that would not frustrate the objective of liberalizing the import regime. Directors supported the authorities' plan to phase out export taxes as well as the emergency import tax, but emphasized that these actions would require offsetting measures in the fiscal area so as not to impair the program's fiscal objectives.

Directors felt that, on balance, the economic program presented in the letter of February 20, 1986 from the Argentine authorities provided a reasonable basis for achievement of the objectives of the program. In this respect, it bears repeating that the planned reduction of the combined fiscal deficit to no more than 3 percent of GDP in 1986 was regarded as essential by many Directors. They welcomed the intention of the Argentine authorities to request a new stand-by arrangement to follow the current one. Directors urged the authorities to maintain the momentum of the stabilization program and stressed that, in considering a new arrangement, consistency of financial policies with the basic strategy of the program as announced by the authorities in mid-1985 would be essential. In particular, they would expect the new program to curb further inflationary expectations. The program should include actions on the side of public spending that would ensure a lasting improvement in the public finances as well as actions to avoid market distortions and to improve the allocation of resources and prospects for growth.

It is recommended that the next Article IV consultation with Argentina be held on the normal 12-month cycle.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. Argentina has consulted with the Fund in accordance with paragraph 4(d)(iii) of the revised stand-by arrangement for Argentina (EBS/85/177, 7/26/85, Attachment I) and paragraph 37 of the letter of June 11, 1985, attached to the revised stand-by arrangement, in order to reach any necessary understandings on additional measures to ensure achievement of the program's objectives.

2. The letter of February 20, 1986 from the Minister of Economy and the President of the Central Bank of Argentina will be attached to the revised stand-by arrangement, and the letters of September 25, 1984, December 26, 1984, June 11, 1985, and July 22, 1985, heretofore attached to the revised stand-by arrangement, shall be read as supplemented and modified by the letter of February 20, 1986.

3. Accordingly, the quantitative limits and dates of the revised stand-by arrangement shall be read as subject to the modifications and additions set out in the paragraphs and tables listed below of the letter of February 20, 1986, for the period from March 31, 1986 through the expiration of the revised stand-by arrangement.

(a) The ceiling on the net domestic assets of the Central Bank, as described in and under paragraph 4(a)(i) of the revised stand-by arrangement, shall be modified and supplemented as described in paragraph 12 and Table 2 of the letter;

(b) the limit on the combined deficit of the nonfinancial public sector and the Central Bank, the sublimit on the cash deficit of the nonfinancial public sector, and the limit on treasury outlays, as described in and under paragraph 4(a)(ii) of the revised stand-by arrangement, shall be modified and supplemented as described in paragraph 9 and Table 1 of the letter;

(c) the target for net international reserves, as described in and under paragraph 4(b)(i) of the revised stand-by arrangement, shall be modified to apply for the period including January, February, and March 1986, as described in paragraph 15 and Table 3 of the letter;

(d) the schedule for the phased elimination of external payments arrears, as described in and under paragraph 4(b)(ii) of the revised stand-by arrangement, shall be supplemented as described in paragraph 17 and Table 4 of the letter;

(e) the understandings on regulated interest rates, as described in and under paragraph 4(c) of the revised stand-by arrangement, shall be modified to apply for the period including February, March, and April 1986;

(f) the proportion of base period imports subject to automatic licensing, as described in and under paragraph 4(d)(ii) of the revised stand-by arrangement, shall be modified as described in paragraph 19 of the letter; and

(g) paragraph 4(f) of the revised stand-by arrangement is amended by substituting "May 15, 1986" for "March 15, 1986."

4. Paragraph 1 of the revised stand-by arrangement is amended by substituting "May 31, 1986" for "March 27, 1986" and, in the light of paragraph 22 of the letter of February 20, 1986, by substituting "SDR 1,182.5 million" for "SDR 1,419 million."

5. Paragraph 2(a) of the revised stand-by arrangement is amended to read:

(a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 236.5 million until February 20, 1985, the equivalent of SDR 473.0 million until September 20, 1985, the equivalent of SDR 709.5 million until March 10, 1986, and the equivalent of SDR 946.0 million until May 20, 1986.

6. The Fund finds that the review contemplated in paragraph 4(d)(iii) of the revised stand-by arrangement has been concluded, and that Argentina may proceed to make purchases under the revised stand-by arrangement.

Decision No. 8217-(86/43), adopted
March 10, 1986

Exchange System

The Fund welcomes the intention of Argentina to eliminate restrictions on payments and transfers related to profits, dividends, royalties, and services other than tourism and restrictions giving rise to external payments arrears, in the context of a comprehensive balance of payments adjustment program supported by a stand-by arrangement from the Fund. It encourages Argentina to further simplify the exchange system and to eliminate all restrictions on payments and transfers for current international transactions. In the meantime, the Fund grants approval for the retention of the practices described in items 1(a)-(b), items 2(a)-(b), and items 2(e)-(f) of Appendix III of EBS/86/39 (2/21/86) until May 31, 1986 and the practices described in items 2(c)-(d) of the same Appendix until May 15, 1986.

Decision No. 8218-(86/43), adopted
March 10, 1986

APPROVED: November 18, 1986

LEO VAN HOUTVEN
Secretary