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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/124

10:00 a.m., August 9, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
C. H. Dallara	
	H. G. Schneider
B. de Maulde	
	T. Alhaimus
H. Fujino	
G. Grosche	
J. E. Ismael	Jaafar A.
R. K. Joyce	
A. Kafka	H. A. Arias
H. Lundstrom	H. Fugmann
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
	G. Ortiz
J. J. Polak	
C. R. Rye	
	A. A. Agah, Temporary
A. K. Sengupta	A. S. Jayawardena
	T. A. Clark
S. Zecchini	
Zhang Z.	Wang E.

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

IBRD: S. Scherer, America and the Caribbean Regional Office. Asian Department: Tun Thin, Director. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; M. Guitián, Deputy Director; D. A. Lipton. External Relations Department: C. S. Gardner, Deputy Director; H. P. Puentes. Fiscal Affairs Department: J. C. Tavares. Legal Department: S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director. Treasurer's Department: T. Leddy, Deputy Treasurer; B. Von Numers. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. M. F. Braz, M. Caiola, D. N. Lachman, R. Ramaciotti, B. C. Stuart, I. C. Tandeciarz. Advisors to Executive Directors: P. E. Archibong, J. Hospedales, P. Péterfalvy, G. W. K. Pickering, T. Sirivedhin, E. M. Taha, D. C. Templeman, N. Toé, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: I. Angeloni, W.-R. Bengs, Bo T., Chen J., J. de la Herrán, A. K. Diaby, J. J. Dreizzen, G. Ercel, R. Fox, V. Govindarajan, N. Haque, G. D. Hodgson, L. Hubloue, Z. b. Ismail, J. M. Jones, H. Kobayashi, R. Msadek, J. A. K. Munthali, A. Mustafa, E. Olsen, M. Rasyid, J. Reddy, J. E. Rodríguez, M. Sarenac, L. Tornetta, B. D. White, Yang W. l.

ARGENTINA - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the review of a 15-month stand-by arrangement with Argentina approved on December 28, 1984 (EBS/85/177, 7/26/85; and Sup. 1, 8/7/85).

Mr. Nebbia made the following statement:

> The successful completion of the review of the stand-by arrangement with Argentina will provide important support for the programs of the democratically elected Government of Argentina, which inherited an extremely difficult situation. The economic environment was marked by escalating inflationary pressures and severe fiscal, financial, and external imbalances. Foreign debt had reached five times the annual value of merchandise exports. Interest payments on this debt absorbed resources equivalent to about 8 percent of GDP in 1983 and 1984. The monthly inflation rate had fluctuated in the range of 15-20 percent for several months. Real GDP in 1983 was similar to that of 1975. The cash deficit of the nonfinancial public sector was equivalent to about 14 percent of GDP in the second half of 1983. The external trade and payments system was encumbered by severe restrictions.
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> The performance of some macroeconomic indicators such as output, the current account of the balance of payments, and the fiscal deficit reflected positive achievements during the first nine months of 1984. However, the combination of excessive monetary expansion and the struggle of some economic sectors for higher incomes caused an increase in the inflation rate.
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> By September 1984, it was the view of the authorities that it was essential to reduce inflation and correct external imbalances in order to achieve a satisfactory economic performance. Therefore, under the adjustment program that was then put in place, monetary policy was tightened markedly and interest rates rose sharply. Moreover, there were significant corrections in relative prices, including a sizable real depreciation of the peso, a start in the liberalization of price controls, and an increase in public sector prices in real terms. Although all external performance criteria were met with comfortable margins, inflation remained higher than had been envisaged in the program, and some of the end-December domestic performance criteria were not observed.
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> By mid-February 1985 it was evident that the nominal targets for end March would not be met if allowance was not made for the increasing rate of inflation.
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> In the first months of 1985 there was a widening in the cash deficit of the public sector, mainly reflecting delays in

the adjustment of public sector prices, while monetary policy was eased. These developments, together with continuing steps to liberalize price controls and attempts since March to correct relative prices, such as the exchange rate and public sector prices, led to a pickup in the rate of price increase. In the second quarter of 1985 consumer prices rose on average by 28.5 percent per month, aggravating the recessionary effects of the tight credit policy.

In the financial sector, at end-March 1985, the Central Bank implemented a reform that aimed at increasing the participation of the financial institutions in total financial intermediation. The reform allowed the institutions to offer deposits at nonregulated interest rates in order to reabsorb the financial transactions that had developed outside the institutional market since mid-1982.

My authorities fully agree with the staff appraisal of the Economic Reform Program that is being implemented in Argentina. The behavior of the economy during the first few months of 1985 showed clear signs that the former gradualist strategy was not working satisfactorily. Therefore, my authorities decided to tackle the roots of inflation frontally and drastically by acting simultaneously on its structural causes as well as on its transmission and feedback factors.

Thus the program of economic reform announced on June 15 and described in the letter of July 22 is based on three interdependent elements.

First, it is based on a fiscal policy aimed at a drastic reduction of the overall fiscal deficit in the second half of 1985 to 2.5 percent of GDP. This deficit will be financed through external credit; the Central Bank will not provide credit to the public sector.

Second, a wage, tariff, price, and exchange rate freeze has been established as a temporary and extreme measure, in order to defeat inflationary expectations and the pattern of wage-price indexation.

Third, it is based on a monetary reform that introduced a new currency, the austral, not as a mere device to change the unit of account, but as a means to deindex contracts made under strong inflationary pressures.

From an overall perspective, the economic reform adopted by the Government attempts to attack inflation forcefully through a combination of fiscal, monetary, and income policies that eliminates all possible causes of inflation.

It is worth noting that this decisive action of the authorities was, in spite of the implications for incomes, welcomed and supported by the entire population, a crucial factor for the program to succeed. It is well known that inflation encourages misallocation of resources, capital flight, and lack of confidence. The Government is conscious that a democracy cannot survive with hyperinflation, which has a corrosive effect on the social and political fabric of any country.

The Argentine authorities have attached the highest priority to reducing the rate of inflation, and the key element in the Economic Reform Program, is the reduction of the public sector deficit to a level that does not involve recourse to central bank or other domestic financing.

Following this principle, in the letter of July 22, 1985 the Government committed itself to the goal that the cash deficit of the nonfinancial public sector plus the losses of the Central Bank will not exceed the equivalent of 2.5 percent of GDP in the second half of 1985. This disposition is broadly consistent with the fiscal plan on a cash basis described in the letter of June 11, 1985, when allowance is made for the effects of the decline in inflation on the domestic interest payments of the public sector.

In annual terms, the overall deficit, as envisaged in the budget for 1985, will be of approximately 4 percent of GDP, compared with deficits of 15.5 percent of GDP in 1983 and 12 percent in 1984.

The important cuts in expenditures of about 5 percentage points of GDP as well as the planned increase in revenues of a little less than 3 percent of GDP are fully explained in the staff report and show the determination of the Government in this crucial area. Of paramount importance in the decrease of the public deficit is the reduction of the public enterprises' deficits. In this regard, new measures have been taken to improve expenditure control in those enterprises in which real prices have been substantially increased. My authorities would like to stress that they are ready to take additional actions, if necessary, to meet the fiscal objectives of the program.

Regarding the performance of the public sector, the authorities have informed me that there was no credit from the Central Bank to the public sector in July. It was evident from the information provided by the staff in the supplement issued on August 7, that performance in the area of public finances has been quite impressive since the program started. In sum, the Government is strictly implementing its commitment to reduce the fiscal deficit drastically.

The Argentine authorities believe that the adoption of the monetary policy described in this program is consistent with price stability. The Central Bank will not extend credit on a net basis; it will limit itself to passing on to the public sector the local currency equivalent of foreign borrowings and providing local currency to the private sector only by purchasing foreign exchange.

The financial deficit of the Central Bank will be greatly reduced by virtually eliminating the monetary correction factor as a result of the dramatic fall in inflation.

In line with the new inflationary expectations, free market nominal interest rates have fallen from about 40 percent per month before the new program was implemented in mid-June, to about 7 percent in the last days of July. The regulated rates of interest, under the control of the Central Bank, were fixed at 4 percent and 6 percent for deposits and credits, respectively, at the beginning of the program, and then lowered to 3.5 percent and 5 percent, respectively. The Government is aware that these interest rates are high considering the present low inflationary expectations, but they are deemed necessary, particularly during the first stages of the program, in order to keep resources within the financial system. The authorities expect that interest rates will fall even further as a consequence of the increasing credibility in the program.

The authorities remain committed to avoiding negative real interest rates on regulated deposits and ensuring moderately positive regulated lending rates. The objective of keeping the resources within the financial system has been met beyond the Government's expectations as the demand for monetary asset holdings increased.

An essential ingredient of the monetary reform of June 14 was the creation of a new currency, the austral, which replaces the Argentine peso. This is not intended to be a mere change in accounting units, but provides a device for deindexing contracts made under strong inflationary expectations. It is the replacement of a weak currency with a strong currency. All areas of economic policy are now geared to assuring a sound austral.

Pesos were converted into australes at a fixed rate when the conversion related to cash, while contracts originally denominated in pesos will be converted into australes at a decreasing rate which is intended to reflect the inflationary expectations embodied in the contracts before the change in the system. In other words, the conversion is expected to be neutral, avoiding the otherwise strong redistributive effects from domestic debtors to creditors owing to the sudden drop in inflation. The major purpose of the conversion mechanism is to provide an effective instrument for deindexing the economy. In the past, the widespread use of indexed contracts tended to make it very difficult to reduce inflationary expectations.

The Argentine authorities are committed to maintaining the price freeze only for the period needed to break inflationary expectations and the pattern of wage-price indexation, thereby allowing the strict fiscal and monetary policies to work. This component of the stabilization plan is important to assure the durability and viability of the tight financial policies envisaged in the program.

The relative price structure attained at the moment of the freeze is deemed acceptable by the authorities to meet the targets set in the program. Since the beginning of the stabilization policies in October 1984, the real effective exchange rate has depreciated by 30 percent, real wages have dropped substantially both in the public and private sectors, while real prices charged by public enterprises were 23 percent higher in June than in the first five months of 1985.

We are convinced that the price freeze adopted will ensure that the recession ahead of us will be shorter and less deep than otherwise. Had we not taken this measure, the inflationary inertia would have worsened the situation that today we are faced with.

My authorities expect that the fulfillment of the financial policy targets together with the positive developments in the price indices--both wholesale and consumer indices have shown almost no increase since the new plan was announced--will change the inflationary expectations. Therefore they want to emphasize that the freeze will not be maintained for an extended period and are committed to moving as quickly as possible toward a system where prices are freely set in the market.

In 1985 the Argentine balance of payments will show substantial improvements. These improvements are based on the expected reduction of the current account deficit owing to a growing trade surplus and lower interest payments in line with lower international interest rates. The balance on goods and nonfactor services will increase as a percentage of interest payments from 58 percent in 1984 to 72 percent in 1985.

The exchange rate and credit policies envisioned under the program should encourage capital inflows. Additionally, the Government has started to take steps to attract foreign direct investment, particularly in the petroleum sector.

Financing of the external payments during the rest of the program will to a great extent rest on flows from foreign private banks, Fund disbursements, refinancing from the Paris Club, and new official trade credits. This financing provides for the elimination of external payments arrears, a reasonable increase in reserves, and payment of various outstanding loans.

With regard to the exchange and trade system, it is the intention of the Argentine Government to simplify the exchange rate system and to eliminate restrictions on payments and transfers for current international transactions.

In relation to the medium-term balance of payments outlook, the Argentine authorities envisage its improvement mainly through an active export promotion policy in order to secure growth and external balance. As the balance of payments projections are extremely sensitive to exogenous factors, it is important that the external environment will be a positive one, especially in relation to the evolution of international interest rates and protectionism in industrial countries. Cooperation from developed countries in these areas is essential in order to improve the international economic situation, which would certainly help the efforts made through this program to succeed in Argentina. The authorities think this economic program should encourage an important repatriation of Argentine capital. They believe it will be necessary to have an important recovery of imports from the recent very low levels in order to achieve growth in the medium term.

As the staff has described in the August 7 supplement to the staff report, the results that have been achieved after the implementation of the June package are quite impressive. First, public confidence in the program remains very high. The authorities believe that this is a result of several factors: the commitment of the Government to fully implement the program; the perception that the fiscal adjustment is a key element in the program and that progress in cutting the deficit is being achieved with great determination; and the great dissatisfaction and anguish of the Argentine society in relation to the excessively high rates of inflation that we had been suffering.

Second, results on the inflation front are favorable. The inflation rate in July was 6.2 percent, but it did not accurately show the effective price stability as it was calculated on averages which included inflation in the first half of June before the program was initiated. The wholesale price index, which measures the midmonth level of prices, declined by 0.9 percent in July. My authorities believe that these very positive results on the inflation side should be interpreted as a great success of the first stage of the program.

Third, the relative calm in the financial markets and the increasing credibility in the new program have allowed the

Central Bank to begin, before the date formerly established, the process of unfreezing the U.S. dollar deposits in the banks that had been frozen in mid-May. Since August 1, when the freeze began to be lifted, about one half of the deposits have been renewed, while new deposits are being constituted too under the new Central Bank's regulation on this subject.

In view of the comprehensive adjustment program that we have before us today, I would like to request my colleagues to support the proposed decisions. My authorities consider this program as an important step toward the improvement of Argentine relations with the international financial community and also a courageous attempt to correct huge internal and external imbalances.

Mr. Kafka stated that he supported Argentina's imaginative adjustment program, which had been designed to deal with an exceptional economic situation, including a rate of inflation that in June had exceeded 1,100 percent on a yearly basis and had been increasing recently at an accelerating pace. The authorities, by stressing the danger of hyperinflation, had been able to achieve the national consensus that was essential to the success of the difficult adjustment program. Also essential was a high degree of credibility in the program from the very start, which was contributed to by the design of the program and the political constellation supporting it. But neither consensus nor credibility was sufficient to ensure the success of a program such as the one adopted by the Argentine authorities.

The adjustment program could be seen to be made up of two parts, Mr. Kafka observed. One part of the program addressed the root cause of inflation: that portion of the public sector deficit that was derived from its absorbing a share of the real national output that exceeded tax collections and the increase in the real debt. That root cause was attacked by the conventional and most difficult part of the program: increases in public sector revenues and expenditure cuts. The other, unconventional, part of the program attacked the so-called inertial inflation: that portion of inflation that would persist even if the public sector did not attempt to secure an increasing share of the national output mainly because of de facto indexation of prices, exchange rates, wages, and interest on financial instruments.

Consensus and credibility could aid in removing only the contractual indexation of future contracts, Mr. Kafka pointed out. For the program to be successful, there must also be no indexation by law, which, unlike many other countries with high inflation, Argentina was fortunate in having avoided. Thus, the effective deindexation of existing contracts was a crucial condition for the success of the program. The Central Bank had taken over the public debt previously held by other sources in order to simplify the problem of deindexing existing contracts. Furthermore, rather than indexing the capital value of contracts, interest rates were set to include an inflation premium. Therefore, effective deindexation was established by a conversion ratio between the austral and peso value of contracts that would eliminate the estimated inflation component of contractual interest rates. The deindexation of existing contracts might raise grave problems in some countries: it might raise legal or even constitutional issues, and it might present financial problems, depending on the degree to which the financial system holding the deindexed debt was leveraged. Clearly, unless the removal of indexation succeeded quickly, it could prejudice the efficiency of important policy instruments--the exchange rate and interest rate--that made inflation tolerable.

The wage-price freeze was an integral part of the efforts to eliminate inertial inflation, Mr. Kafka noted. Inflationary expectations would have had to have been neutralized by an even more severe monetary policy if the authorities had waited until economic agents had been convinced that inflation was being eliminated. The freeze must be lifted, or at least gradually phased out over time, to avoid excessive price distortion. Unfortunately, domestic interest rates were extremely high in real terms. But lower interest rates that were more in line with the authorities' expectation of inflation could have led to capital flight, a large depreciation of the austral in the parallel market, and an increase in the consumption of goods and other real assets that could have counteracted the anti-inflation objective of the program.

The fiscal policy stance was courageous, particularly in comparison with the policy pursued in 1984, Mr. Kafka commented. The adjustment program relied on the implementation of new control measures over state enterprises, a strict freeze of salaries for the central administration and the public sector enterprises, and the privatization of semipublic enterprises. Those policies were appropriate given the difficulty of dismissing a large number of workers. Moreover, a rational program to lay off workers that did not impair efficiency required time for careful planning. However, as nominal wages in the public sector and particularly in the central administration had been considerably lower than in the private sector, the initial reliance on a wage freeze would present the authorities with a budgetary problem in 1986.

The authorities' aim to allow the monetary base to expand only in line with the net accumulation of reserves, which presumably would reflect the increased demand for cash in terms of australes, was the cornerstone of the program, Mr. Kafka considered. The authorities would need great determination to resist demands for premature domestic credit expansion. The high real interest rates, while perhaps necessary to prevent capital outflows and the so-called flight into real assets, were worrying, as they could distort the economic structure unless reduced rapidly.

In the medium term, no program could be successful if it did not lead to an appropriate real rate of economic growth, Mr. Kafka pointed out. The Argentine authorities were relying on an expansion of exports. The exchange rate in real effective terms on a trade-weighted basis was almost at the same level as at the beginning of 1983--the lowest level recently recorded. But, Argentina's success could not be assured by exchange rate management alone. It would also depend on progress in expanding and developing manufactured goods and, to an important extent, on access to the markets in developed countries. A heavy responsibility rested on the countries of the European Community and the United States to make Argentina's program a success. Import barriers and the existing or planned subsidies for agricultural exports of those countries could prejudice the adjustment program. For its part, Argentina should eliminate its export taxes.

The adjustment program included quantified performance criteria only for three and one half months from the date of the letter of intent of June 11, 1985 because of the uncertainties prevailing at that time, Mr. Kafka noted. He was not certain that the large number of performance criteria were necessary.

Mr. Ortiz noted that the measures announced by the Argentine authorities in June 1985 had shocked the world financial markets. Few, if any, observers had expected Argentina's new economic team to act with such force to tackle the country's endemic economic problems. The elected Government of President Alfonsin had inherited an extremely difficult economic situation characterized by runaway inflation, sluggish performance, and a high level of external debt that constituted a great burden. The authorities had realized that the adjustment program implemented at end-1984 had not succeeded in curtailing inflation, a problem that was so deeply ingrained that it was truly at the core of the economic maladies suffered by the country, and had courageously decided that they must apply drastic remedies.

In the Argentine context, the traditional dilemma between gradual adjustment and shock treatment acquired an entirely new dimension, Mr. Ortiz remarked. The length of the adjustment period was normally determined by the availability of financial resources, and a more gradual approach generally reduced the costs associated with adjustment. However, other considerations were of paramount importance in the authorities' decision to apply shock treatment: the conviction that inflation had to be attacked at its roots and that given the widespread system of indexation and the numerous unsuccessful attempts to stabilize the economy, the only way to eliminate inflationary expectations was simply to eliminate inflation.

The main elements of the program were to reduce the public sector deficit drastically, reform the monetary system, and freeze wages and prices, Mr. Ortiz observed. Although the combination of fiscal and monetary policy was a help to improving the public finances, other elements of the program were also important. The wage-price freeze and the monetary reform were intended to influence inflationary expectations and break the price inertia inherent in the indexing of contracts, as well as to ease the burden of domestic interest payments, thereby helping to reduce the budget deficit.

The authorities aimed to reduce the budget deficit through expenditure cuts and the introduction of revenue measures, Mr. Ortiz said. Spending cuts would be focused on current expenditures, particularly on the wage bill and transfers to public enterprises. In 1985, current expenditures were expected to decline by 4 percent of GDP, while capital expenditure would be reduced by only 1 percent of GDP. Investment cuts might also be made on the side of public enterprises. However, the staff paper, except for noting that the finances of public enterprises would be improved through an increase in real prices of goods and services provided by those enterprises, did not discuss how their operations would be streamlined. Total expenditures of public enterprises were scheduled to decline by 2.5 percent of GDP, but little was said of the measures that would be taken to curtail current expenditures. It could perhaps be assumed that spending cuts would be focused on capital expenditures, implying a drastic fall in overall public investment.

It would have been interesting if the staff had provided an updated macroeconomic picture for 1985 identifying the principal components of the assumed fall in demand of 1 percent of GDP in 1985, Mr. Ortiz remarked. Given the severity of the economic adjustment, the fall in output might be substantially greater than expected. In fact, the most recent information indicated that industrial production in the second quarter of 1985 had been about 9 percent lower than a year earlier, presaging a more severe recession than had been estimated by the staff.

However, the authorities were acting cautiously and were not basing projected revenues on optimistic estimates of economic activity, Mr. Ortiz noted. Estimated revenues from the value-added tax and import duties were based on the assumption of a 20 percent decline in the tax base in the second half of 1985--a conservative assumption indeed. The revenue package was comprehensive as it tapped most of the revenue sources. However, he had some reservations about the imposition of a forced savings tax, which was still pending approval by Congress. Could Mr. Nebbia or the staff comment on the feasibility of imposing and collecting that tax, given that it might have the disadvantage of inducing underreporting of income tax as the reports would identify the proposed savings tax.

The authorities had indicated their determination to meet the fiscal objectives by outlining contingency measures, Mr. Ortiz stated. The emphasis on strict control over the operations of the state enterprises was appropriate. The experience of many countries undergoing adjustment demonstrated that no effort should be spared in controlling the operations of financial enterprises because they were often the cause of budget overruns.

The virtual freeze on the growth of the Central Bank's net domestic assets was consistent with the reduction of the public sector deficit and the level of capital inflows contemplated for the second half of 1985, Mr. Ortiz noted. The currency reform, in addition to reducing the distribution effects between creditors and debtors owing to the drastic reduction of inflation, represented a signal to effect the reduction of the inflation amortization components of the internal debt. However, it was not clear from the staff paper how the reduction in inflation amortization payments was reflected in the budget. Apparently, the easing of payments of the internal debt might be reflected in the reduction of central bank losses.

One potential problem that might emerge from the tight monetary policy stance adopted by the authorities was the high real interest rates envisaged for the next few months, Mr. Ortiz observed. Such high real interest rates, in addition to having a depressive effect on investment and output, might place an additional burden on the servicing of internal debt, partially offsetting the benefits of lower nominal rates associated with the rapid reduction of the inflation rate. However, a sharp reduction in interest rates might put additional pressure on the parallel market exchange rate.

The authorities intended to maintain the price freeze only for the period needed to break inflationary expectations and the pattern of wage-price indexation, Mr. Ortiz commented. The temporary nature of that measure was entirely appropriate under the circumstances. The depth of the forthcoming recession that Argentina was likely to suffer would depend on several factors, including the balance of payments outcome, which was determined partly by terms of trade and international interest rate movements; developments in domestic real interest rates; the degree to which relative prices were aligned before the introduction of the new measures; and the extent of real wage flexiblity. Could the staff comment in more detail on relative price synchronization and wage flexibility? If at the time of the price freeze, some firms had been caught in the midst of transmitting cost adjustments into prices, a long period of fixed prices would obviously result in operating losses. However, the authorities had indicated that they intended to manage the price controls flexibly so as to accommodate such a situation. Nevertheless, if too many firms were caught in that situation, either the price freeze would be less effective in arresting inflation and inflationary expectations, or a number of firms would suffer losses. If tight credit policies were to be maintained after the price freeze was lifted, generalized price increases would not be validated through money creation; the only adjusting mechanism would be a possible compression of wages and profits. However, given the recent behavior of real wages, there might still be some margin for real wage adjustments.

The authorities had taken measures since end-1984 to align the exchange rate in an effort to promote exports and strengthen the balance of payments position, Mr. Ortiz stated. In addition, they had indicated their intention to liberalize existing restrictions in the foreign exchange market to encourage foreign direct investment and to meet the balance of payments objectives, including the elimination of external payments arrears. The authorities also intended to liberalize the import system during the period of the stand-by arrangement, while rationalizing the current tariff structure. Those steps were consistent with the objective of expanding the export sector, thereby helping the country to attain a viable payments position in the medium term.

The Argentine authorities had embarked on an extremely strict and comprehensive adjustment program, Mr. Ortiz commented. Contrary to what might have been expected given the nature of the austerity measures, the program had been well received and had thus far enjoyed overwhelming support, reflecting not only the great dissatisfaction of Argentine society with the excessively high rate of inflation but also the confidence of the population in its elected Government--the most solid guarantee of the prospects for success of the program that the international financial community could obtain. However, the road ahead would not be easy. The drastic nature of the adjustment measures would inevitably entail costs and sacrifices on the part of the population and a firm commitment on the part of the Government to carry out the program fully. The support of the international community would also be required to provide the necessary financial resources and, more important, to foster the economic conditions conducive to trade and export growth. Protectionism represented a threat to Argentina's medium-term balance of payments prospects. Finally, he strongly supported the proposed decision, commended the authorities for the courageous steps that had been taken, and wished them success in the application of the comprehensive program.

Mr. Ismael remarked that the lack of progress in the early phase of the current stand-by arrangement had been disappointing. However, positive steps had recently been taken. Since the second quarter of 1985, the authorities had shown renewed commitment and resolve. He hoped that a more serious and strenuous adjustment effort would be evident within the program period. Some progress had been made following the earlier policy slippages and setbacks, including the commendable actions taken to tighten credit conditions, correct relative prices, slow wage increases, accelerate currency depreciation, and invigorate the financial system. Those measures should provide the basis for the more forceful and comprehensive program that had been adopted in mid-June 1985. Although long overdue, the new program provided new hope for significant and faster progress in Argentina's economic adjustment.

He strongly endorsed the focus in the new program on combating inflation, Mr. Ismael remarked. Inflation, given its magnitude and entrenched nature in Argentina, should rigorously be attacked head on to establish a sound base for economic growth and external viability. The authorities had experienced the failures and difficulties of implementing programs aimed at gradual adjustment through the simultaneous achievement of several, sometimes conflicting, objectives.

The major elements of the program were sufficiently strong to break the inflationary spiral caused in recent years by the mutually reinforcing effects of wage indexation and lax financial policy, Mr. Ismael pointed out. Wage restraint and a tight financial policy should be at the center of any serious stabilization effort. The temporary wage-price freeze, as well as the pegging of the currency to the U.S. dollar, would also be useful measures in facilitating the elimination of the system of indexation throughout the economy. The authorities' commitment to reduce the public sector deficit and control monetary growth during the second half of 1985 were major steps toward the achievement of economic stability.

Despite the strong elements of the program, the credibility of the Government's economic policies would depend on its ability to implement the program with firmness and consistency, Mr. Ismael considered. Given Argentina's track record, the present program posed an unprecedented challenge to the authorities to restore the credibility of their adjustment efforts, a difficult task with so many uncertainties in the economy. The cost to economic growth of eliminating inflation in such a dramatic way might well be higher than envisaged. It would be interesting to hear the view of the staff or Mr. Nebbia on the extent of the determination of the social partners and the political groups in Argentina to persevere with the austerity program.

The program represented a kind of shock treatment to fight inflation--an acute and paralyzing malady of the economy, Mr. Ismael noted. As such, after a period of time, certain elements of the program--the rigid price control and pegging of the currency to the U.S. dollar-would have to be reviewed so that they did not seriously impair the achievement of the longer-term objectives of the program. Furthermore, control over inflation would constitute only the first crucial step in Argentina's adjustment effort. Adequate attention would then have to be given to the widespread structural problems and rigidities in the economy. If sustainable economic growth and external balance were to be restored, the authorities would have to deregulate the economy, reduce the size of the public sector, and liberalize trade.

He welcomed the authorities' intention to manage the price freeze flexibly and to monitor cost developments of the firms closely, Mr. Ismael indicated. The authorities should be aware of possible distortive effects of the price freeze, especially as some sectors and individual enterprises had been caught in the process of price adjustment when the price freeze had been introduced. How would the flexibility applied by the authorities interfere with the achievement of the target of zero inflation in the second half of 1985?

The planned reduction in the combined deficit of the nonfinancial public sector to 4 percent of GDP in 1985 from 12 percent of GDP in the previous year would represent a remarkable achievement, particularly as the authorities had little room for maneuver, Mr. Ismael remarked. The greater reliance on expenditure reduction than revenue increases was praiseworthy. That shift in emphasis would be made possible by the significant improvement in the operating balance of the public enterprises following their recent price increases, the elimination of the deficit of the social security system, the freeze on public sector employment, and the tight control over the government budget and enterprises. Equally important in the control of monetary expansion was the planned reduction in the operating losses of the Central Bank that would be made possible by the elimination of interest subsidies on credit to the private sector and the decline in interest paid on public sector debt.

The need to reduce the fiscal deficit substantially had made it necessary for the Government to introduce new taxes, including export taxes, import surcharges, and additional taxes on bank checking transactions, Mr. Ismael noted. As those taxes might interfere with the achievement of growth and external objectives, the tax measures should be under constant review, with a view to phasing them out as circumstances permitted. It was encouraging to note that the authorities had already started to move in that direction with respect to export taxes.

The Central Bank would stop extending credits on a net basis in the first few months of the program, Mr. Ismael observed. How long would the Central Bank need to maintain that policy? What target rate of monetary expansion during the second half of 1985 would be consistent with the objective of achieving price stability during the program period?

The authorities were to be commended for their flexible exchange rate management prior to mid-June 1985, which had ensured the maintenance of Argentina's international competitiveness and should contribute significantly to the projected substantial improvement in the external current account in 1985, Mr. Ismael remarked. The pegging of the austral to the U.S. dollar should be kept under review so that the adjustments necessary to meet the balance of payments objectives could be made.

The improvement in the external payments situation resulting from the authorities' adjustment efforts would facilitate a liberalization of the exchange and trade system, Mr. Ismael considered. In view of the authorities' commendable commitment to liberalize all imports and eliminate external arrears by March 1986, he could agree to the temporary continuation of Argentina's multiple currency practices.

The staff's optimistic medium-term scenario indicated that the debt service ratio, while expected to decline, would remain high over the next several years, Mr. Ismael observed. He wondered whether the heavy bunching of maturities in 1986 and to a lesser extent in 1987 were already covered by the restructuring arrangement being worked out with the banks and official creditors. In any case, a further restructuring was likely to be necessary. In light of the new program adopted by the authorities, there was a strong basis for the Fund to support a multiyear restructuring arrangement for Argentina. He agreed with the staff on the strength of the program and its consistency with the attainment of the objectives established under the stand-by arrangement, and he supported the proposed decisions.

Mr. Schneider recalled that at the Executive Board's consideration of Argentina's request for the current stand-by arrangement (EBM/84/190 and EBM/84/191, 2/28/84), his chair had expressed doubts about the authorities' commitment to certain aspects of the program, including wage and financial policies, and the adequacy of the gradual approach to adjustment. The gradualist measures taken by the authorities in late 1984 had been insufficient to deal with the problem of hyperinflation, which called for bold, firm action supported by follow-on measures. The gravity of the situation had called for the authorities to redouble their efforts to create conditions that would permit a revival of economic growth and external adjustment. The economic program proposed by the authorities in June 1985 was welcome; it was a strong and ambitious program that represented an improvement over the previous gradual approach. However, its success would depend, first, on the full realization of the authorities' intentions in a number of areas and, second, on the acceptance of the burden of adjustment by the Argentine population.

It appeared from the authorities' letter of intent and from the staff report that the Government was truly committed to carrying out the program, Mr. Schneider remarked. The framework of the program must be maintained and its execution monitored closely. Press reports seemed to indicate that the general public had largely accepted the need for stronger measures and was supportive of the Government's actions.

The program appropriately aimed to reduce the public sector deficit from its present unsustainable level to 2.5 percent of GDP by the second half of 1985, prevent expansion of central bank credit, impose a wage-price freeze, and achieve monetary reform, Mr. Schneider noted. While the authorities recognized that the wage-price freeze could not be maintained for an extended period, they considered that it should remain in place long enough to break the pattern of indexation and assist in changing inflationary expectations. However, no specific period was mentioned, and it was unclear what would happen when the freeze was lifted. If the price freeze were too short, it would not succeed in achieving the objectives for which it had been imposed; however, if it were too long, new economic imbalances and social problems might be created. Could the staff or Mr. Nebbia give some indication of the Government's likely policy approach to wage issues in the postfreeze period, a factor that would also be crucial to the success of the program?

The projected reduction in the public sector deficit through expenditure cuts and revenue increases was a key element of the program, Mr. Schneider noted. However, the economic effects of a large increase in the tax burden and the capacity of the tax collection mechanism gave cause for concern. If it should prove impossible to realize the projected increase in tax revenues of 2.6 percent of GDP in 1985, an even larger cut in public expenditures would be inescapable.

The overall strategy and objectives of the program were designed primarily to address the root causes of inflation, Mr. Schneider observed. Therefore, the program's success depended crucially on the strict implementation of demand management measures rather than of structural measures. However, the bleak medium-term prospects for the balance of payments indicated that structural adjustment was also needed. Assistance from the World Bank in that area would be most desirable. It would be useful if the World Bank staff representative could provide information on the outcome of the recent staff visit to Argentina to review the country's industrial growth problems and public investment program. Any sizable reduction in the deeply rooted imbalances in the Argentine economy would require the full implementation of the Government's intentions as outlined in the program. The authorities were faced with a very difficult task from both economic and political standpoints. However, there was no other viable course of action. Finally, he supported the proposed decisions.

Mr. Joyce noted that the resources provided to Argentina by the Fund in the past two and one half years--about SDR 837 million--and the programs associated with them had failed to achieve their purpose. The damage to the adjustment effort and the economy through delays and slippages in the implementation of the most recent program had been substantial. The authorities had been unable to bring inflation under control and to muster the domestic support necessary to implement the difficult and demanding program.

At the present meeting, in the context of a review under the stand-by arrangement, the Executive Board was being asked to approve a revised adjustment program for Argentina, which in effect, was a new program, Mr. Joyce observed. While the objectives were basically the same as those of the original program, the authorities now seemed determined to take the steps necessary to make the adjustment program work. In addition, they appeared to have much wider support; there was apparently an awareness by the public that strong medicine and rapid adjustment were more likely to succeed than a gradual approach, during which public support could wear thin and adjustment falter.

The authorities were to be commended for the ambitious course of action they had charted and for the dramatic steps they had already taken, Mr. Joyce remarked. A good start to the program had been made, with the creation of a new currency, introduction of monetary reform, depreciation of the exchange rate, and implementation of wage and price measures. However, it was essential that the authorities take further action, particularly in the fiscal and monetary areas. If the program were to have any hope of success, the Government must not only remain committed to the objectives, but also ensure that the measures were implemented in a decisive and timely manner.

One of the most dramatic aspects of the current program was the monetary reforms that had been introduced, particularly the creation of the austral and the deindexation of financial instruments, Mr. Joyce remarked. The reform, together with the wage-price freeze, had cut inflation overnight from 1,000 percent to zero by government decree. But the broader implications for the economy were not yet clear. Furthermore, it was uncertain whether or for how long the freeze could be maintained. Clearly, the measures taken thus far should arrest, or even break, inflationary expectations. But wage and price controls could not be maintained indefinitely. Furthermore, those measures would work only if the public were convinced that the Government would take all the steps necessary to attack the root causes of inflation--in particular, through a continued commitment to fiscal and monetary restraint.

The impact on income and asset redistribution of the shift from high to low inflation was a matter of concern, Mr. Joyce commented. Another matter to consider was how to ensure that disincentives to capital accumulation were avoided. However, if the monetary reform were successful and price and investment stability were restored, Argentina would have provided a lesson to other highly indexed, high inflation economies.

At the heart of the adjustment effort was the authorities' commitment to reduce the budget deficit to 8 percent of GDP through expenditure cuts and revenue increases, Mr. Joyce observed. The efforts to improve monitoring and control of expenditures throughout the public sector were welcome, but he was concerned about the mix of measures being used--in particular, the new export taxes and import surcharges, which could discourage a transfer of productive resources to the traded goods sector of the economy. He urged the authorities to replace those taxes as soon as possible with other revenue measures. Did the authorities intend to lift export taxes on some industrial goods, and how might that action affect present fiscal projections? The temporary forced savings scheme was less than ideal, as it could encourage tax evasion. More permanent revenue-raising measures should be sought.

The sharp increase in prices for goods and services provided by public enterprises was welcome, a course of action that should help to eliminate their operating deficits, Mr. Joyce stated. Nevertheless, the overall public sector was expected to register a deficit of 2.1 percent of GDP in the second half of 1985, suggesting that further action was called for. Could the staff indicate whether the monitoring system and the expenditure controls would be extended to the provinces, where problems of arrears had appeared in the past?

The commitment to avoid extending any new net credit, at least during the first months of the program, was strong but necessary medicine to buttress fiscal policy and attack the root causes of inflation, Mr. Joyce remarked. The losses of the Central Bank, which had reached 5 percent of GDP in the second quarter of 1985, clearly had to be reduced drastically. More generally, the current environment provided a good opportunity to improve the efficiency of the financial system by widening the nonregulated sector and dismantling the system of high reserve requirements and continued central bank lending to the commercial banks. What was the present scope of transactions in nonregulated instruments? The authorities' commitment to maintain positive real rates of interest and to adjust regulated rates in line with movements in the nonregulated market was welcome. However, real interest rates of up to 9 percent were higher than necessary to bring about the desired degree of adjustment. He would be grateful if the staff or Mr. Nebbia could comment on that matter. The Government and the Central Bank would also have to monitor institutional developments carefully; it might be that the number of banks and branches in Argentina had been excessive, contributing to the current weaknesses. The Government should limit the extent of its financial assistance to institutions facing liquidity problems.

The medium-term outlook demonstrated that, even given some generous assumptions and a continuing commitment to strong policies by the authorities, the debt service ratio would remain above 6 percent until 1990 and that continuing debt restructuring and refinancing would be needed, Mr. Joyce noted. In those circumstances, it was essential that relative prices encouraged transfer of resources to the external sector. The large depreciation of the real exchange rate by some 30 percent between September 1984 and June 1985 represented an important step toward a better pricing structure, but it was questionable whether the exchange rate adjustment had gone far enough under the program. The present exchange rate, which was fixed at present, remained above the real rate in early 1983. Moreover, the terms of trade had deteriorated since then and further exchange rate action might be needed if the authorities were to liberalize import restrictions. Their commitment to keep the exchange rate under review was appropriate, and he was pleased to see that exchange rate policy would be included in the October review of the adjustment program. While Argentina's program was strong, it was no stronger than the circumstances demanded. Its success depended on the resolution of the authorities to stay the course, even if events did not unfold as expected. Finally, he supported the proposed decisions.

Mr. Grosche remarked that the Argentine authorities had embarked on a comprehensive and bold stabilization program following a number of short-lived and unsuccessful efforts. They had appropriately abandoned their gradualist approach in the fight against inflation, an approach that had been inadequate to overcome the sizable internal and external imbalances. Developments in the first quarter of 1985 had been disturbing, as the adjustment efforts initiated in October 1984 had not been sustained. Decisive corrective action had clearly been urgently needed to reverse the alarming trends and to revitalize the stand-by arrangement with the Fund.

The currency reform, together with the plan to avoid public sector recourse to domestic financing, represented a serious effort to tackle the underlying causes of the economic problems--in particular, the high inflation rate and the deep-seated inflationary expectations, Mr. Grosche observed. The measures taken thus far and envisaged under the program went in the right direction and should provide a more stable economic environment, thereby restoring confidence and providing the conditions for sustainable growth in the medium term. While the stabilization program was generally appropriate, he had doubts about some of the objectives and relationships between the specific measures. In particular, he was concerned about one of the assumptions on which the financial program had been based, that there would be virtually no inflation in the second half of 1985. Though recent price trends indicated a welcome decline in the rate of inflation, it was difficult to believe that inflation would be zero. The price freeze could not be maintained for an extended period, and necessary corrections in relative prices might inhibit the achievement of the goal of zero inflation. Moreover, cost pressures were great, particularly because of the high real interest rates.

The fiscal objectives were also ambitious, especially the target to reduce the combined deficits of the public sector from 12.5 percent of GDP in the first half of 1985 to only 2.5 percent of GDP in the second half of the year, Mr. Grosche pointed out. That reduction relied to a considerable extent on expenditure reduction and revenue increases, which might be difficult to realize given the low level of economic activity. A significant increase in the tax burden might negatively affect medium-term prospects for economic growth. He also had doubts about the appropriateness of the high export taxes, which, apart from creating distortions in the economy, constituted a disincentive to exports, thereby endangering the achievement of the export targets. He therefore welcomed the recent reduction of export taxes. In the future, fiscal consolidation should be focused on reducing public expenditures--in particular, by cutting the deficits of the public enterprises. The success of the program depended on a firm and timely implementation of all the envisaged measures. Fiscal policy would play a decisive role in that regard.

The authorities had wisely designed a set of contingency measures to be implemented should there be deviations from the official targets, Mr. Grosche noted. Strict adherence to the adjustment program would be necessary to safeguard the authorities' credibility and to ensure continued support by the population and Argentina's creditors, especially as Argentina would need further debt restructuring in the period ahead. He fully supported the proposed decisions. The stabilization measures already implemented and envisaged constituted a highly commendable effort and indicated the authorities' firm determination to embark on a difficult adjustment path.

Mr. Fujino remarked that it was regrettable that immediately after Executive Board approval of the stand-by arrangement in December 1984, the program had gone off track and the adjustment efforts had been almost abandoned. Repeated suspension of the stand-by arrangement could be seen by the international community as a sign of weak determination by the authorities and would be detrimental to continued international support. The revised adjustment program was welcome and contained bold steps toward adjustment. It was heartening to learn from Mr. Nebbia that the program was supported by the Argentine population. However, since a considerable amount of uncertainty was involved in the program, the authorities should implement the stated measures with firm determination to avoid the recurrence of undesirable developments in the economy. Contingency measures, including those regarding the cash deficits of the budget, should be implemented if any deviations from the program were detected.

The program being considered by the Executive Board, though bold and courageous, was only the starting point of adjustment for Argentina given the depth and seriousness of the economic imbalances, Mr. Fujino considered. Close collaboration between the authorities and the staff in monitoring developments would be most important. The staff paper provided insufficient information on recent performance in major economic areas. It was essential that data was collected and supplied in a timely manner to allow the authorities to control developments and to facilitate the financial support from the international community.

A particularly uncertain aspect of the program was the extent to which inflationary expectations would be reduced, although judging from the favorable reception of the program by the population, considerable success on that front was likely, Mr. Fujino remarked. However, significant distortions in relative prices existing under the present price freeze might give rise to a jump in prices when the freeze was removed. Therefore, the authorities should be vigilant in avoiding any deviation from the original program, even if the rate of inflation turned out to be higher than expected. The authorities had established an ambitious target for reducing the fiscal deficit, Mr. Fujino noted. The introduction of measures, including strict penalties, to improve control over public expenditures was welcome as past slippages had come mainly from insufficient control over expenditures. However, the deficit reduction program relied too heavily on the revenue side, particularly on taxes on consumption and external transactions. A strengthening of the tax collection mechanism would be important to secure the necessary revenue increase. In the longer term, a study should be carried out to determine how the tax structure could be broadened and revenues from individual and corporate income increased.

Expenditure cuts were insufficient, and there was an additional risk of expenditure overruns should inflation exceed present expectations, Mr. Fujino observed. The widespread occurrence of postponed payments and a buildup in arrears by the national administration in order to meet the performance criteria for end-1984 was highly undesirable. Would the recent measures to improve monitoring over domestic arrears prevent a recurrence of those developments?

The achievement of the fiscal target should reduce the extent of monetary creation, Mr. Fujino remarked. He welcomed the authorities' indication that the Central Bank would be issuing currency only against foreign exchange. It was important that the Central Bank would not automatically provide credit to the public sector, even if the borrowing requirement of that sector exceeded present projections. At a minimum, loans to the public sector should be made at appropriate interest rates rather than provided interest free, as at present.

The wage and price policies involved a considerable amount of uncertainty, Mr. Fujino considered. Few other Fund-supported adjustment programs had included a wage-price freeze. It was understandable that the timing and method of removing the freeze in Argentina had not been discussed, given the exceptionally high inflation rate preceding the freeze and the need to break inflationary expectations. Public sector revenues and expenditures were likely to be severely affected by wage-price developments after the freeze. The planned reduction in the public sector deficit might not be attainable if developments were unfavorable. The price freeze might create distortions in the cost structure of the various sectors of the economy, depending on the stage of advancement in cost adjustment of those sectors when the freeze had been imposed; bottlenecks might arise from the short supply of some essential goods; a black market might develop; and pressures for additional nonwage benefits might emerge. Could the staff or Mr. Nebbia indicate what sort of measures might be introduced to inhibit such undesirable developments? Could they comment on the timing and possible method of eliminating the wage freeze?

The depreciation of the austral in June 1985 had been an appropriate step toward strengthening the competitiveness of the export sector, Mr. Fujino remarked. However, the envisaged 20 percent increase in nontraditional exports was an ambitious target that might not be met. Also questionable was the exchange rate arrangement under which the austral was fixed to the U.S. dollar. Given the uncertain development of domestic prices, a more flexible exchange rate policy would be desirable in the period after the removal of the wage-price freeze. He urged the authorities to review the exchange rate policy as soon as possible, at the latest, by the time the freeze was removed.

Even under the optimistic assumptions relating to the repatriation of capital and export growth, Argentina's balance of payments prospects were precarious and highly sensitive to developments in international interest rates, Mr. Fujino observed. The uncertain outlook underscored the need for continuous adjustment efforts in the medium term. It would be unwise at present to embark on a program of economic expansion based on the assumption of a resumption of voluntary lending by the commercial banks. He appreciated the bold steps taken by the authorities to break inflationary expectations, but in order to carry out the necessary adjustment successfully, more cautious and detailed planning was called for. Finally, he supported the proposed decisions.

Mr. Polak welcomed Argentina's new adjustment program. The initial adjustment program discussed by the Board on December 28, 1984 had not been viable, and it was not surprising that it had gone off track in very little time. Considering the importance to the Fund of full documentation of both failures and successes, the brief section in the staff paper on Argentina's performance in the first quarter of 1985 did not fully satisfy his curiosity about what went wrong. It would have been useful if the staff had informed the Executive Board more promptly about developments in early 1985. While the Executive Board had been was kept informed about programs that were progressing well, information was less readily available on programs that had gone off track and for which reviews could not be completed. Short staff papers, of the length typical for information notices, should be provided as a matter of routine in such cases.

There was good reason to believe that Argentina's phase of indecisive, ambiguous, and insufficient adjustment was over, Mr. Polak considered. The measures taken in the previous month constituted a fundamental attack on inflation. The authorities had demonstrated particular courage in undertaking and executing the revised adjustment program. Their determination expressed in the letter of intent dated July 22, 1985 was impressive. The radical stabilization plan broke the tradition of gradualism and reverted to the shock treatment that had proved effective in a number of European countries some 60 years previously.

In Argentina, as in the earlier European stabilization programs, the crucial component was the cessation of central bank financing of the budget deficit, Mr. Polak remarked. The strong budgetary measures, together with the inflow of foreign financing, were essential to achieve that objective and to inspire confidence. The limits on the deficit of the public sector and the losses of the Central Bank were given on a cash basis and data on a commitment basis were unavailable quarterly. A decree was to be issued shortly establishing a better system for monitoring the evolution of domestic arrears, and he wondered whether the Fund should have received further commitments from the authorities regarding the elimination of domestic arrears.

Following the cessation of domestic credit expansion by the Central Bank, the expansion of money supply would depend on capital inflows, especially the return of flight capital, Mr. Polak noted. Successful stabilization should unleash a large demand for money, following the shrinkage of the real money supply in response to hyperinflation. The needed inflow of funds would occur only gradually as foreign resources were attracted by high interest rates and extremely tight liquidity conditions. As those conditions had prevailed since the announcement of the new program, he was surprised by the authorities' decision to reduce or halt capital inflows through the official market. In the immediate poststabilization period, only the market could give an indication of how much liquidity was needed. As long as capital outflows remained controlled, the risk of excessive domestic liquidity arising from foreign inflows should be very small.

The very high real interest rates must be considered as only transitional in nature, Mr. Polak remarked. It would take some time to establish confidence in the austral, even with the sympathetic reception that the new program had received. Even with the current high interest rates, the spread between the exchange rates in the parallel and official markets was in the order of 20 percent. While interest rates remained high, investment and output would be adversely affected as was already evident from the decline in industrial production. After the financial turmoil that Argentina had gone through in the past 40 years, it was, unfortunately, impossible that stabilization could be achieved without a crisis. Similar crises had occurred in the European cases mentioned earlier, but they had not lasted long. As Mr. Nebbia had once said, after so many years of crises of inflation, a single stabilization crisis might well be the lesser evil.

The authorities' intention to keep the exchange rate under scrutiny, with a view to ensuring the achievement of the balance of payments objectives, was appropriate, Mr. Polak considered. While it was necessary to freeze the exchange rate as part of the adjustment program, the risk of the rate being frozen at an inappropriate level could not be precluded. Thus, some flexibility must be maintained without giving the impression that the present rate would be easily abandoned.

There was a conflict between the fiscal and the balance of payments objectives of the program as reflected in the various export taxes, Mr. Polak commented. He welcomed the recent measures to reduce the export tax on a wide range of commodities. The expansion of industrial exports was urgent in order to limit the duration of the recession. The contingency fiscal measures outlined by the authorities were important in ensuring confidence in the program.

The authorities' monetary policy was not sufficiently incisive, Mr. Polak considered. In its previous paper on Argentina, the staff had explained that the financial system was inefficient because it had been saddled over the years with cumbersome regulations that had given rise to the emergence of an informal financial market. It appeared that little had been done to remove those inefficiencies. There were still three separate markets in the financial system: the regulated, the nonregulated, and the informal market. Credits in the first two markets were limited quantitatively by a ceiling imposed by the authorities, who also dictated interest rates, thereby controlling both the quantity and the price of credit. There was also a curious linkage between those markets: even though there was a weekly auction of treasury bills, between the auctions, the Government set interest rates. He doubted whether that complicated system encouraged savings and the efficient allocation of resources. What was the significance of credit ceilings if part of the total flow of credit could move back and forth between the banks and the informal market, which had no ceilings? Within the context of the program, there was a strong case for liberalization of the monetary system and of the flow of capital. Monetary signals, such as the movement of interest rates and the replenishment of the real money supply, had an important role to play in bringing the Argentine stabilization program to a successful conclusion. It was therefore of paramount importance that those signals were as free as possible from the effects of administrative interference. Finally, he endorsed the proposed decisions.

Mr. Rye noted that since the Executive Board's previous discussion on Argentina, the entire situation in the country had changed for the better. The former program had been widely regarded as inadequate. However, the authorities had recently taken a courageous but necessary decision to introduce a dramatic change in policies aimed at eliminating inflation. They had recognized that a continuation of the gradual strategy would have involved an extended period of weak economic activity and high interest rates and would, thus, have been difficult to carry through to a successful conclusion.

The key measures introduced by the authorities were appropriate, particularly the sharp cut in the public sector deficit, virtual cessation of credit expansion by the Central Bank, introduction of a wage-price freeze, and pegging of the exchange rate to the U.S. dollar, Mr. Rye remarked. The wage-price freeze and the pegging of the exchange rate were not entirely in accord with, and perhaps even ran contrary to, the Fund's usual prescription. But Argentina, with an inflation rate of over 1,000 percent, was not a typical case. The adoption of firm monetary and fiscal policies in the context of an otherwise "hands off" approach might be sufficient to eliminate inflation in an economy where prices were increasing at about 20 percent a year, but experience had shown that those policies were insufficient when extremely high inflation was deeply institutionalized, as in Argentina. A temporary freeze on wages, prices, and the exchange rate might be an essential element in any practicable scheme to break the inflation cycle.

It appeared from the charts in the Appendix to the staff paper (EBS/85/177) that the key relative prices had been aligned relatively well at the beginning of the price freeze, Mr. Rye observed. The real effective exchange rate had depreciated by about 20 percent in 1984, resulting in the restoration of external competitiveness at about the average level of 1983. Real wages in manufacturing had declined by about 15 percent from their mid-1984 peak level. In fact, the rate of inflation following the freeze might imply a somewhat larger reduction in real wages. The real prices for publicly provided goods and services had increased sharply. While some of those relative price adjustments might not be sufficient in the medium term, it was helpful that they had been made before the freeze; it would clearly have undermined the authorities' overall strategy if the Government had been forced to make major adjustments within the freeze period. However, firm financial policies remained the key element of the program. If the return to more flexible wage and exchange rate arrangements was to be achieved in the near term, underlying inflationary pressures would have to be completely eliminated. The maintenance of very firm monetary and fiscal policies throughout would be crucial to that endeavor. Meanwhile, with a pegged exchange rate, the external accounts would be vulnerable to excessive domestic demand pressures. Argentina's external debt position left no margin for any deterioration in that area.

Nevertheless, the real effects of severe demand restraint policies, necessary as they were, should be considered, Mr. Rye noted. The projected fall in GDP in 1985 of only 1 percent might be unrealistic, particularly given the sharp downturn in manufacturing output in June. But more important than the short-run reduction in real GDP was the continuing decline in fixed investment. Fixed capital formation had fallen in each successive year from 1981 to 1984, cumulatively by nearly one half, and a further fall had been recorded for the first half of 1985. The high rate of inflation and low level of confidence had clearly been the main reasons for that erosion in investment, but those factors should become less important influences in the future.

The high real rate of interest on loans threatened to be a problem, Mr. Rye considered. Even the lower nominal interest rate of 5 percent a month converted, in the absence of inflation, to an annual real rate of about 80 percent. A further easing in interest rates at present would be inconsistent with the immediate need for firm financial policies. It was no coincidence that a significant spread between the official and parallel market exchange rates had re-emerged when interest rates had been eased slightly in early July 1985. However, if the short-term financial strategy was successful in holding inflation to a low level--and indications were thus far encouraging--investments financed at current interest rates could not be viable in the medium term. Therefore, it was crucial that any investment financing taking place should be only of a short-term nature. Alternatively, provisions should be made for loan contracts to be renegotiated. Otherwise, the period ahead could be disruptive for businesses and the financial sector. Mr. Nebbia had commented on that subject in his opening statement, but he would appreciate any further comments from the staff.

The Argentine program did not entirely correspond with the recommendations traditionally made by the Fund, Mr. Rye observed. In fact, the revised program reflected the initiatives of the Argentine authorities themselves. It would be useful if the staff, in the light of the Argentine experience, could give some attention to the appropriate design of adjustment programs for high inflation countries in its forthcoming paper on the theory and design of adjustment programs. The performance criteria proposed for the revised program were appropriate, although there might be too many of them. The October review was rightly focused on the balance of payments, exchange rate, and exchange and trade restrictions. But the staff should examine the mix of revenue measures and the approach to be adopted in the postfreeze period.

The success of the Argentine program was crucial for the future of the national economy and the well-being of the population, and, more generally, for the resolution of the world debt problem, Mr. Rye considered. The authorities were approaching their difficult task with courage and realism, and they deserved the fullest support of the Fund and its member governments, particularly in terms of export opportunities. He supported the proposed decisions.

Mr. Nimatallah remarked that Argentina had been facing a serious economic crisis for some time. By mid-1985, the economy had reached a point where drastic remedies had been essential. He therefore welcomed the authorities' fundamental change in policy stance. The measures taken since June were bold and far reaching, addressing the underlying causes of the imbalances. If implemented firmly and persistently, those measures should do much to restore domestic and external balance to the economy.

A major objective of the new program was to bring inflation under control and reduce inflationary expectations, Mr. Nimatallah noted. The high rate of inflation in Argentina had complicated economic management, created uncertainties for savers and investors, and distorted resource allocation. A lower rate of inflation was therefore a necessary condition for achieving a balance between savings and investment and for putting the economy on a course of sustainable growth. Success on the inflation front would depend on firm fiscal, wage, and monetary restraint. The recent shift of fiscal policy aimed at reducing the public sector deficit significantly in the present year was appropriate. While the measures taken to enhance revenues and cut spending were commendable, there was scope for reducing current expenditure further. He encouraged the authorities to reassess spending programs and identify priorities carefully in the months ahead.

A wage-price freeze had clearly been needed to break the harmful pattern of indexation, Mr. Nimatallah remarked. In an environment with exceptionally high inflation, a wage-price freeze could be a useful, temporary policy instrument to bring down inflationary expectations. However, such a freeze should be imposed only in the short term and with flexibility. Nevertheless, the authorities must convince all sectors that inflation was permanently under control.

He supported the tightening of monetary policy, Mr. Nimatallah indicated. He hoped that the authorities would be able to channel sufficient credit to the private sector as they intended, although he was unclear how that would be done given the strict limits on credit expansion in the program. Could the staff comment further on that point?

The control of inflation in a country such as Argentina would inevitably involve some redistribution of income and would be resisted by some elements of the population, Mr. Nimatallah stated. However, it was imperative that the authorities avoid any slippages and sustain their anti-inflationary policies. Appropriate contingency planning would be needed. The authorities should remain committed to take whatever additional measures might be necessary to achieve the objectives of the program.

The authorities aimed to reduce the overall balance of payments deficit, eliminate arrears, and liberalize the exchange and trade system, Mr. Nimatallah noted. Economies such as Argentina's needed to expand their exports in order to grow and repay their debt. The authorities should take measures to make the export sector the leading growth sector in Argentina. In particular, they should re-examine the recently introduced export taxes. The adoption of a more realistic exchange rate policy should strengthen competitiveness, and he urged Argentina's trading partners to keep their markets open to Argentine exports.

While short-term stabilization might be the first priority, attention should also be focused on correcting the structural weaknesses in the economy that stood in the way of growth, Mr. Nimatallah said. An essential requirement for Argentina was a well-designed investment program, perhaps with World Bank assistance, aimed at improving resource allocation and promoting private sector activities. Could the staff or Mr. Nebbia comment on Argentina's plans for the medium term? Finally, he supported the proposed decisions.

Mr. Orleans-Lindsay stated that he welcomed the renewed commitment and decisive efforts of the Argentine authorities to continue implementing a strong economic program to deal with the endemic inflation problem and to establish and maintain conditions that were consistent with the achievement of lasting price stability and the elimination of inflationary expectations. The new program had a better chance for success than previous programs, although clearly its success depended on the firmness with which the authorities implemented the measures envisaged under the program.

It was reassuring to note that a contingency plan had been developed to counter any unforeseen developments that might prevent the authorities from meeting their fiscal objectives under the new antiinflationary strategy, Mr. Orleans-Lindsay remarked. Careful monitoring of fiscal developments would be crucial to assist in the prompt activation of the contingency plan if the program were to remain on track. He endorsed the staff appraisal and supported the proposed decisions.

Mr. Zecchini said that the economic program initiated by the authorities in mid-June 1985 was courageous. It tackled the country's serious problems with full recognition of the present difficulties. It was a strong program in terms of the adjustment in public finances and the implied correction in relative prices. In view of the way the economic situation had evolved between January and June 1985, a drastic course of action like the one chosen by the authorities was indeed the best solution in terms of the probability of success and of limiting costs during the transition to monetary stability. The revised program offered a better chance of success than the previous program approved in December 1984, about which some Executive Directors had expressed doubts. He supported the continuation of the stand-by arrangement and would follow developments in the coming months with great interest.

The measures adopted by the authorities included the most drastic actions that could be envisaged in the areas of incomes, fiscal, and monetary policies--namely, a total wage-price freeze, the virtual elimination of the fiscal deficit, and a currency reform, Mr. Zecchini observed. In terms of the prior actions that had been taken, the present program was one of the strongest programs that Argentina had presented to the Executive Board for approval. However, if some of the measures adopted--the heavy tax burden on foreign trade, wage-price freeze, high real interest rates, and forced savings plan expected to be adopted by Congress--were kept in place for more than just a few months, they would distort the working of the markets and hamper the growth of foreign trade, with negative consequences for the economic recovery. Such policies constituted strong therapy, which, in the longer term, was capable of being as harmful as it was indispensable in the short term.

A program such as the one adopted by the Argentine authorities was inevitably composed of two phases, Mr. Zecchini considered. In the first phase, in which the vicious cycle of inflationary expectations had to be broken, the psychological impact of policy measures was predominant. In the second phase, the goal was to take advantage of the favorable conclusion of the first phase by putting the economy on a sound recovery path. Different policies were appropriate in each of the two phases, and measures that were necessary in the first phase could easily prove disastrous in the second phase. The October review would be an appropriate time to examine the results of the first phase and to carefully reconsider the measures implemented during the earlier part of the adjustment process.

Some of the emergency measures that could be considered appropriate at present might be viewed as inappropriate in more normal circumstances, Mr. Zecchini pointed out. For example, the high export taxes, although tempered by selective export rebates, discouraged a much needed recovery of exports. Therefore, he welcomed the authorities' decision to reduce those taxes selectively. The import surcharge of 10 percent, in addition to the real depreciation of the currency in May-June, while exerting inflationary pressures, should constitute a strong obstacle to imports, thereby facilitating economic recovery. Taken together, those two fiscal measures would not facilitate an increase in the openness of the Argentine economy, which had declined, in terms of the sum of imports and exports as a ratio to GDP, from about 38 percent in 1982 to 23 percent in 1983. Some other revenue-raising measures were likely to hamper the recovery and create inflationary pressures, including the tax on gasoline and the forced savings plan. In addition, the tax on checking transactions might be an obstacle to the authorities' efforts to channel financial transactions through the traditional intermediaries.

The points he had just raised did not apply to the policy package implemented by the Argentine Government in mid-June, but would become relevant only if some of the adopted measures became permanent features of the economy, Mr. Zecchini remarked. During the first phase of adjustment, any measure was appropriate if it helped to build confidence in the new policy stance and to stabilize inflationary expectations. However, in the second phase, good economic administration was crucial. Tax measures of an emergency nature would have to be substituted with other revenue-raising provisions, preferably of a direct form, and public expenditure cuts. Moreover, the wage-price freeze could not be successfully sustained for long. Finally, and perhaps most important, no economy could survive for more than a short time with a stable currency, zero inflation, and interest rates at about 6 percent a month. Interest rates would have to come down, otherwise they would become incompatible with economic growth in the context of price stability. There was no other alternative.

In sum, he supported the economic measures put in place by the Argentine Government, Mr. Zecchini stated. The first phase had been well conceived, properly announced, and effectively presented to the public in

Argentina and elsewhere: it had been a political success. He hoped that the first phase could be continued, and he looked forward to the October review to examine the details of the second phase.

Mr. Clark said that when the current stand-by arrangement had been approved in December 1984, his chair had been among those that had expressed doubts about the adequacy of the proposed measures and about the strategy of gradualism. Developments since then had unfortunately shown that those fears had been well justified. It was also disappointing to note that Argentina represented a case in which a Fund-supported adjustment program had gone off track within a few days of being approved.

Against that background, it was all the more welcome that the Argentine authorities had committed themselves to a courageous program that held out the prospect of bringing inflation under control and tackling some of the underlying problems in the economy, Mr. Clark observed. The program would not be easy to implement: there were bound to be considerable strains both in the period of transition and in the longer term, as previous distortions in the economy were eliminated. The Government would need great determination to see the adjustment through. He broadly endorsed the objectives of the program.

Fiscal policy was clearly central to the adjustment effort, Mr. Clark continued. While he welcomed the emphasis being placed on tighter control of the public enterprises, he would be interested to hear the staff's view on whether the administrative structure to implement that policy was in place. Was there scope for a major effort of privatization of the public enterprises, given the heavy involvement of the public sector in industry? The projected improvement in the fiscal position in the second half of 1985 depended considerably on revenue measures. The export taxes were not fully consistent with the program's other objectives, and he welcomed the recent reduction in some of them. The proposed treatment of the forced savings plan was puzzling. The staff was justified in including as revenue the 10 percent deindexation--or even that plus some imputed real interest saving--but it was unclear why the whole of the initial capital value of the deposit should be regarded as revenue. The forced savings plan would, according to the staff's calculations, contribute 1 percentage point of GDP to the fiscal improvement in the second half of 1985.

The authorities had made provisions to secure more or less positive real interest rates, Mr. Clark noted. However, he wondered whether measured inflation, even in the future, would be a good indicator of expected inflation, and, therefore, whether the formula outlined on page 15 of the staff report would in fact secure nominal interest rates that were sufficiently high. Also, if financial institutions ran into difficulties, pressure might be exerted on the Central Bank. It would not be surprising if such difficulties emerged, given the turbulent conditions that were bound to follow a major restructuring of the economy. It would be useful if the staff or Mr. Nebbia could offer any further comments on that point.

The staff did not comment in detail on the likely consequences of the adjustment program on employment, Mr. Clark said. The more severe the effects on unemployment, the more difficult it would be to maintain popular support for the adjustment effort. What policy approach would be adopted regarding wages after the freeze was lifted?

The medium-term export projections were based on the assumption of volume growth of 8 percent a year from 1987 through the end of the decade, Mr. Clark remarked. While Argentina had substantial export potential, such growth rates might be optimistic in the context of slower growth in world economic activity. One important consideration in export performance was the real exchange rate. How would the pegging of the austral to the U.S. dollar be reconciled with the need to maintain competitiveness? Could the staff provide an update on the status of the commercial bank financing package?

In sum, he welcomed the reinforced adjustment effort, which now seemed commensurate with the level of access that had been provided, Mr. Clark noted. The crucial requirement currently was to implement the program with determination in such a way that external and domestic adjustment moved in step. A successful outcome would not only be welcome for Argentina but also point the way for a number of other countries that had suffered from persistently high inflation.

Mr. Dallara stated that the authorities had made imaginative and courageous adjustment efforts. While it was somewhat regrettable that the first review of the Argentine stand-by arrangement had taken so long to be considered by the Executive Board, the dramatic action taken by the authorities in June 1985 to end the upward spiral of inflation had been worth waiting for. That action had greatly improved the prospects for achieving the principal goals embodied in the program. In each of the key areas in the revised program, the objectives and targets were stronger and more ambitious than had originally been envisaged, suggesting not only that the adjustment program would get back on track but also that there was a greater chance of success with regard to its key objectives.

While the wage-price freeze imposed in June could help to reverse inflationary expectations and halt the historic pattern of wage indexation, the aims of the freeze could clearly not be achieved without strong and comprehensive fiscal restraint, Mr. Dallara considered. The 1985 public sector budget, on a commitment basis, called for such restraint, with the aim of reducing the deficit from 12 percent of GDP in 1984 to 4 percent of GDP in 1985. On a cash basis, the budget deficit would fall from 8.2 percent of GDP to 3.6 percent of GDP. While revenue growth would be an important component in that reduction, expenditure restraint would be equally or even more important when measuring the change in the deficit ratio on a commitment basis. The strengthening of controls over spending, the imposition of penalties for failure to comply with budget limits, the introduction of measures to avoid or at least register domestic arrears, and the implementation of the hiring freeze should help to limit expenditures. Although the motivation for the June increase in export taxes and the new 10 percent surcharge was understandable, the authorities should eliminate those taxes as soon as the fiscal situation permitted. He welcomed the recent reduction of some export taxes.

Particular attention in the fiscal area was correctly being given to strengthening the financial position of the public enterprises, Mr. Dallara noted. An improvement on that front was important not only because of its favorable effects on the financial position of the public sector but also because efficient public enterprises could make a better contribution to economic growth. The preparation of a fiscal contingency plan was commendable. Consistent and comprehensive implementation of the fiscal measures in order to achieve the goals embodied in the fiscal program were essential to ensure the success of the wage-price measures. Close monitoring and, if necessary, corrective action would be needed to ensure that fiscal developments in the public enterprises sector were consistent with the program targets.

The strengthening of the fiscal balance was to be supported by a monetary policy that avoided the extension of credit to the public sector by the Central Bank, at least initially, with liquidity being provided to the public and private sectors only to the extent that the Central Bank purchased foreign exchange receipts, Mr. Dallara commented. He welcomed the authorities' commitment to maintain positive real rates of interest on deposits and loans, and to adjust regulated interest rates in line with movement in unregulated rates and with developments in the exchange markets and domestic prices. The continued expansion of the unregulated market was a step in the right direction.

While he did not generally view wage-price freezes with much favor, under Argentina's circumstances it could play a useful role, Mr. Dallara considered. However, it would have a chance of success only if large price distortions had not been bottled up when the freeze had been imposed, if it succeeded in changing inflationary expectations, and if it were supported by the necessary strong financial restraint. Substantial adjustments in the exchange rate and in the prices of public goods and services had been introduced prior to the freeze, suggesting that relative prices might not have been far out of line when the freeze had been introduced. The tightening of fiscal and monetary policy should also help to support the freeze, and the initial favorable reaction of the Argentine population offered some hope that inflationary expectations could be turned around. However, there were clearly limits to the duration of such a freeze, and there would inevitably need to be some flexibility in price adjustments. Did the staff have any indication of when the freeze would be lifted?

The projected strengthening in the external current account and the overall balance of payments in 1985 was welcome, Mr. Dallara stated. However, the debt would remain large, and there could well be a need for additional debt reschedulings. He would be interested in hearing from the staff the status of the financing arrangements. The authorities' efforts could be successful only if there were adequate external financial support. Timely and efficient implementation of the financing arrangements, particularly from the commercial banks, was essential.

Some reflow of Argentine capital had taken place, and additional flows of capital would return as the program continued to build confidence, Mr. Dallara commented. Improved economic performance would also help to induce foreign direct investment, which was projected to increase substantially in the medium term. The authorities should aim to make specific changes in foreign direct investment policy, which was at present unclear and perhaps insupportive, in order to generate the needed inflows of foreign investment.

Argentina's trade performance would depend on the country's price competitiveness, Mr. Dallara remarked. The real effective exchange rate had depreciated to about the average level reached in 1983, suggesting that Argentine exports should be competitive. However, the temporary freezing of the exchange rate presented some risk, and the authorities should keep in mind the significant risk of maintaining a possibly inappropriate rate for any period of time. He regretted that the slippage in the program earlier in 1985 had prevented any progress toward liberalizing restrictions on trade and payments. He welcomed the authorities' commitment to their original liberalization aims, particularly to increase progressively the share of imports subject to automatic licensing, to eliminate arrears, and to provide for the remittance of profits, dividends, and royalties. He urged them to accelerate those measures if possible.

He supported the bold changes in Argentina's economic strategy for growth and adjustment, Mr. Dallara commented. The revised program was difficult and demanding, and the room for slippage was minimal. He encouraged the authorities to monitor developments under the program closely so that any problems could be detected at an early stage and corrective action taken as soon as possible. Initial signs were encouraging, but perseverance by the authorities and patience on the part of the population would be essential for the success of the program.

Mr. Sengupta stated that he supported the proposed decisions. The adjustment efforts undertaken by the authorities since June were extremely courageous, particularly as the agreement had been temporarily suspended because the authorities had not met the performance criteria for end-December 1984 and end-March 1985. In recent years the Executive Board had not come across such bold actions as those contained in the revised program to fight inflation and bring about fiscal and external balance. The Managing Director had taken a pragmatic view of the problem and persevered to ensure that such an important and large program as Argentina's would not fail.

The revised program presented by the authorities had gone beyond the staff's expectations, Mr. Sengupta noted. The Government had formulated a stabilization plan in consultation with the staff by June 11, 1985. However, the Government had realized that given the magnitude of the imbalances, a gradual anti-inflation strategy would not be sufficient. It had therefore undertaken a strong monetary reform and implemented a wage-price freeze by mid-June. Those quick and sudden actions, including the introduction of a new currency unit and the wage-price freeze, were appropriate to ensure that the adjustment program succeeded. There was no one key element of adjustment. Rather, a comprehensive package of measures was required to put the economy back on track.

The authorities were committed to pursuing an exchange rate policy that was appropriate to the circumstances in Argentina, Mr. Sengupta observed. The real exchange rate of the austral in June had been about 12 percent lower than in April, bringing the cumulative depreciation since September 1984 to 30 percent with respect to the U.S. dollar and the currencies of other trading partners. While exchange rate action would enhance competitiveness, especially given the restrictive stance of fiscal and monetary policy, exogenous factors, such as protectionism and international interest rates, might inhibit an improvement of exports. Trade barriers against Argentine exports by the European Common Market and the United States should be removed to ensure the success of the program. In 1984, about 44 percent of Argentina's exports had been directed to industrial countries. An increase in the volume of exports in the medium term would depend largely on the trade actions of those countries, assuming that the terms of trade did not deteriorate. How sensitive to exchange rate depreciation were the agriculture and agro-based products that represented more than 80 percent of Argentina's exports? Could the staff indicate what policy actions, national or international, were necessary to achieve the 8 percent export growth projected in the medium term?

If import volume grew by about 11 percent a year up to 1990, as estimated, the projected annual growth in real GDP of 4 percent should be realized, Mr. Sengupta considered. However, in recent years there had been considerable import compression. The staff had urged the authorities to place all imports, other than luxury goods, on the automatic authorization list by March 1986. An increase in imports would not increase the growth rate in 1985. In fact, the rate of growth in 1985 was projected to decline by 1 percent. The medium-term assumption that imports would improve growth was valid only for 1986 and beyond. What would happen if exports did not grow as predicted and import growth of 11 percent could not be financed? What would be the effect on GDP growth, if imports were extensively liberalized, as suggested by the staff? What proportion of the slower growth of imports would be accounted for by consumer goods and what proportion would contribute to growth in output? What were the assumptions behind the projected increase of 66 percent in nondebt-creating capital flows, such as capital repatriation and foreign investment, between 1985 and 1987? He was pessimistic about foreign investment prospects and was uncertain that capital would return unless major incentives were introduced.

The authorities' main problem would be to limit the public sector deficit and eliminate inflationary expectations, Mr. Sengupta observed.

A lasting social consensus could be achieved if inflation were reduced in the short run and output and unemployment growth maintained in the medium term. Deindexation was necessary to eliminate inertial inflation, but it was indexation that made inflation tolerable. The staff's hope that the authorities would stay the course even if events did not conform to the projections might be wishful thinking. It was therefore necessary to consider how the international community could help Argentina to succeed in its efforts. The assumptions behind the medium-term outlook should be clearly spelled out and a sensitivity analysis presented. The financial flows from the commercial banks and from other sources needed to implement the program should be ensured.

He had no major problem with the main elements of the program, although the projected decline in real GDP of 1 percent in 1985 was cause for concern, Mr. Sengupta stated. The program had too many performance criteria. A review of the program would be held by end-October 1985 to take stock of the external financing secured in support of the program and to examine the objectives with respect to the balance of payments, external arrears, external debt, and the exchange system. The progress in import liberalization could also be analyzed at the time of the review and understandings could be reached on placing all imports of nonluxury goods on the automatic authorization list by March 1986. The phasing of the remaining resources available under the stand-by arrangement could also be determined at that time. He wondered whether the amount to be phased was SDR 946 million or SDR 709.5 million. The program was strong, and according to press reports in the past weeks, the Argentine population had accepted the new situation. Such broad support was required for a democratically elected government to implement such an adjustment program.

Mr. Zhang remarked that Argentina's current strong and comprehensive adjustment program was designed to tackle the difficult situation facing the country. The spirit and essence of the program was reflected in Mr. Nebbia's opening statement that "my Argentine authorities consider this program an important step toward the improvement of Argentina's relations with the international financial community and also a courageous scheme to correct huge internal and external imbalances." He strongly supported the proposed decisions.

The authorities had abandoned the gradual approach to adjustment and had adopted a shock treatment strategy to deal with the structural causes of the imbalances, Mr. Zhang noted. They fully appreciated the serious political, economic, and social consequences for democracy in Argentina if the continued high inflation degenerated into hyperinflation. Thus, in contrast to the earlier orientation, the new adjustment policy emphasized a direct and concerted attack on all aspects of inflation. The various drastic measures adopted in the fiscal, monetary, and wage-price fields constituted an integrated program to achieve that goal. Argentina was one of the few countries that had adopted an explicit incomes policy in its adjustment program. The support of all sectors of the population for the wage-price freeze, in spite of its implications on the distribution of income, was important. The lack of such support had been one of the main reasons why earlier adjustment programs in Argentina had failed.

The present adjustment program was an integrated program that contained the necessary elements for a successful realization of short-term economic stabilization, Mr. Zhang considered. The authorities had expressed their determination to carry out the program fully and quickly. It was encouraging to note from the supplement to the staff report (8/7/85) that the stabilization program had thus far been successful and that public confidence in the program was high. He wished the authorities continued success in their adjustment efforts.

The staff report unfortunately lacked a fuller description and analysis of some factors that were important not only for short-term stabilization but also for medium-term economic growth, Mr. Zhang pointed out. The report had included little discussion of the real economy, the development of which was important in any stabilization program. It would be interesting to hear about the overall supply situation and whether there were any large accumulations of inventories. Real GNP was no higher at present than in 1975. What were the prospects for future growth after initial stabilization was achieved? What pattern of growth in national expenditures was envisaged? What measures had been taken as part of the monetary reform package to deal with speculative capital? How would the Government prevent any recurrence of the wage-price spiral when the present freeze was lifted, particularly as some sectors might attempt to regain their previous share of the national income?

Mr. Mtei remarked that in their recent policy decisions the authorities had attempted to address most of the concerns expressed by Directors when the stand-by arrangement had been approved in December 1984. He welcomed the Government's acceptance that a stricter set of adjustment policies than the gradual policies undertaken earlier were more appropriate to deal with the deep-seated imbalances in the Argentine economy. The revised program was ambitious, particularly given Argentina's recent performance, and left little room for error. Success would depend on a number of factors: the implementation of policies as outlined in the letters of intent; increased export earnings, which depended on ease of access by Argentine goods to the markets of major trading partners; debt rescheduling; and an inflow of new financing, which would enable Argentina not only to pay its arrears but also to maintain the critical level of imports necessary to lay the basis of a sustained economic growth.

If the authorities were able, as planned, to reduce the budget deficit from 12 percent of GDP in 1984 to 4 percent of GDP in 1985 there would be no need to make recourse to central bank financing, Mr. Mtei observed. The decision to freeze wages and salaries represented a major shift in policy and was an important step in the right direction. Given the high rate of inflation in Argentina and the inflation spiral that had been built into the economy through the system of indexation, it would be necessary to limit wage increases for some time. A reduction in the budget deficit depended on the achievement of the projected increase in revenues in the second half of 1985, suggesting that there was still a problem in controlling expenditure. Improved control over expenditure was essential in order to prevent the tax system, particularly the high export taxes and the import surcharge, from becoming a burden on the economy. Although the staff had stated that the revenue estimates had been based on conservative assumptions, the authorities should be prepared to implement contingency plans as quickly as possible in case, for example, Congress did not approve all of the proposed measures.

The turnaround projected in the financial position of the public corporations was welcome, Mr. Mtei said. Continued improvement in the performance of those corporations through large price increases and improved productivity was essential for the medium-term viability of the Government's financial position. Had the staff considered the possibility of selling some of the public enterprises to the private sector, a plan of action typically proposed by the Fund and the World Bank? Argentina would perhaps be more suited to such a recommendation than many developing countries.

The staff paper had included little discussion of developments in the real sector of the economy or about growth prospects, Mr. Mtei stated. An annual growth rate of 4 percent had been projected in the original program for 1986-89. What was the projected growth rate under the revised program? It would have been helpful if the staff had provided some information on the investment program in the public sector and on the areas to which private investment was being directed. Economic growth was essential in Argentina if political and social pressures were to be avoided. He supported the proposed decisions.

Mr. de Maulde noted that the revised economic adjustment program put in place in June 1985 by the Argentine Government had been drastically needed. The basic duty of any government was to provide its citizens with security and order and with reasonable economic and financial stability. That condition had not been met in Argentina in the first months of 1985. The rate of inflation had reached about 25-30 percent a month, while the economy had been deteriorating rapidly. The currency had lost credibility, and the population had had little confidence in the authorities. Conditions had been ripe for a complete change in approach. The authorities had demonstrated remarkable shrewdness in choosing the path of political courage, which had already paid dividends in economic and political terms. Other democracies faced with crises had not always measured up to the challenge. He fully agreed with the staff appraisal and urged the authorities to implement the program strictly. On fiscal policy, greater emphasis should be placed on cutting expenditure than on increasing taxation. The export and import taxes should be phased out. Overall, the program contained the elements necessary to correct Argentina's longstanding imbalances. Finally, he supported the proposed decisions.

Mr. Alhaimus commented that the revised adjustment program represented a fundamental change of approach to Argentina's severe economic and financial crisis. Most notable was the shift from the gradualist strategy previously adopted to a more active and decisive approach. The aim to halve inflation in the short term and the strong measures being undertaken to stabilize the economy were welcome. However, the implementation of those policies would be fraught with the difficulties associated with a well-entrenched system of inflationary expectations and complex social pressures.

One of the most reassuring aspects of the revised program was the emphasis on policies designed to attack the root causes of inflation, particularly through strong fiscal adjustment, Mr. Alhaimus considered. The centerpiece of the program was the objective of reducing the public sector deficit to a level that did not involve recourse to domestic financing; the combined public sector deficit was to be reduced from 12.5 percent of GDP in the first half of 1985 to 2.5 percent of GDP in the second half of the year. Fiscal policy involved a wide range of measures, and specific contingency measures had been formulated in light of uncertainties in the fiscal outlook. The envisaged sharp fall in central bank losses, which had reached disturbing levels in 1984 and early 1985, was also welcome.

The staff's recommendation regarding further measures on the revenue and expenditure policies raised some questions, Mr. Alhaimus stated. On the revenue side, the staff observed that the recent measures under the 1985 budget had increased the tax burden to the extent that raised questions about the economic effects of the increase in taxation and the capacity of the tax collection system. In discussing ways to avoid the high export tax and the import surcharge, the staff called, inter alia, for developing alternative sources of revenue. What alternative taxes would be preferable from the standpoint of their economic effects on the capacity of the tax collection system? On the expenditure side, the staff described the reduction in the public sector deficit as "drastic," but pointed to the possibility of further action. He wondered whether there was significant scope for such action in the immediate future.

The other areas of adjustment had been appropriately geared to ensure the success of the program, Mr. Alhaimus considered. Credit expansion would be limited, the wage-price freeze would be maintained for some time, and the exchange rate policy was expected to contribute to a shift of resources toward the export sector. The public response to the Government's policies had been positive thus far. Finally, as the adjustment program seemed to be strong, he could support it. Numerous difficulties lay ahead and the success of the program would depend on the authorities' resolve to resist pressures that might send the program off track.

Mr. Agah remarked that, in retrospect, the evolution of the Argentine economy must be seen against a domestic background of excessive demand and inflationary pressures and an international background of high interest rates and stiff protectionist measures. While 1984 was a year of consolidation for the newly elected Government, economic performance had erred on the side of high inflation and poor economic growth. Any contradictions in the economic policy of the authorities throughout 1984 had been a consequence of social pressures and the need to achieve a national consensus, which later proved to be vital for the successful implementation of the revised adjustment program. Conscious of the need to put the Argentine economy back on track, the authorities had requested a Fund-supported stand-by arrangement aimed at controlling inflation and correcting the external imbalances. Given the imbalances of the past few years in terms of the high rate of inflation, large budget deficit, and weak balance of payments position, it was unrealistic to expect the economy to improve rapidly. The performance criteria set under the first stand-by arrangement could not be met under normal circumstances. The measures taken by the authorities in the fourth quarter of 1984, while appropriate, had been insufficient to break the inflationary spiral. Nevertheless, prices had been raised by 9 percent in real terms by end-1984, and real wages had continued to decline, as indicated by the index of industrial wages which had been 17 percent below its July 1983 level. The balance of payments deficit had been reduced following the 17 percent devaluation of the peso in the last quarter of 1984 owing to a stronger capital account. However, the current account had not improved, as exports had declined.

The stabilization effort undertaken at end-1984 had not gained momentum by the first quarter of 1985, as public sector spending and the fiscal deficit had risen markedly, while wage adjustments in January and March had been in excess of inflationary objectives, Mr. Agah noted. The rise in prices had accelerated, the peso had appreciated in real terms, and the balance of payments deficit had increased owing to a weakening in the capital account. Even though agricultural output had increased, real GDP had risen only slightly as manufacturing activity had continued to decline.

More effective adjustment measures had been taken in the second quarter of 1985, and a national consensus was being developed, Mr. Agah stated. Credit conditions had been tightened, public sector prices had been raised, the currency had been devalued in May and June, and the Central Bank had begun to make institutional changes with a view to improving the competitiveness of the financial system. The adjustment program had only been in full swing after the beginning of the third quarter of 1985 and, more specifically, following the introduction in June and July of corrective measures aimed at fighting inflation through monetary restraint, fiscal adjustment, and moderate cost increases. Stringent measures had become necessary in view of the persistently high inflation, low growth rate, and heavy burden of interest payments. To tackle the fiscal problem, the authorities had reduced public spending and increased revenues. The overall budget position was estimated to be 12 percent lower than initially planned, while a wage-price freeze had been introduced to help break the inflation spiral, and tax measures had been implemented to reduce the fiscal deficit by about 2.5 percent of GDP. Public enterprises had been brought under strict control, and their losses curtailed through price increases.

The authorities had demonstrated their determination to improve the external accounts, Mr. Agah continued. A campaign to promote exports was being conducted, the exchange rate was being kept in line with the appreciation of the peso in relation to currencies of the trading partners, and a limit had been established for the total and short-term external debt of the public sector. The monetary reform introduced in June 1985 through the creation of a new currency unit, the austral, would help to deindex contracts made in a period of high inflationary pressure. The improvement in the balance of payments position and the population's confidence in the Government's adjustment program had made it possible to unfreeze the U.S. dollar deposits in commercial banks.

The world economic crisis that had affected many countries in 1984 had also influenced the Argentine economy, Mr. Agah said. The difficulties encountered by Argentina were not all of its own making. Against the difficult background described earlier, the performance of the authorities was commendable, particularly their determination to reduce drastically inflationary pressures, cut the fiscal deficit, and improve the balance of payments position. In light of the results achieved thus far and the positive expectation from the continued program of adjustment, he could support the proposed decisions.

Mr. Fugmann stated that he agreed with the staff appraisal and was impressed by the strength of the new, bold adjustment effort.

The Executive Board agreed to continue its discussion on the the review of the stand-by arrangement with Argentina in the afternoon.

2. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Wang on the completion of his service as alternate Executive Director for China.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/123 (8/7/85) and EBM/85/124 (8/9/85).

3. CAMEROON - 1985 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange

Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1985 Article IV consultation with Cameroon to not later than August 26, 1985.

Decision No. 8046-(85/124), adopted
August 7, 1985

4. MOROCCO - 1985 ARTICLE IV CONSULTATION AND REQUEST FOR STAND-BY ARRANGEMENT - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1985 Article IV consultation with Morocco to not later than the end of August 1985.

Decision No. 8047-(85/124), adopted
August 7, 1985

5. ASSISTANT TO EXECUTIVE DIRECTOR - EXTENSION OF OVERLAP PERIOD

The Executive Board approves the appointment of an Assistant to Executive Director and the request for an extension of the overlap period as set forth in EBAP/85/205 (8/2/85) with the proviso, requested by one Director, that approval of the request should in no way be taken as an indication of a willingness to see the overlap period exceed 15 business days in normal circumstances (EBAP/85/205, Sup. 1, 8/7/85).

Adopted August 7, 1985

6. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to an Executive Director as set forth in EBAP/85/208 (8/7/85) is approved.

APPROVED: May 6, 1986

LEO VAN HOUTVEN
Secretary