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ARGENTINA

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE May 4, 1987

TO Distribution

FROM John M. Page, Jr., Division Chief, LCPI2

EXTENSION 75931

SUBJECT ARGENTINA - Initiating Memorandum
Banking Sector Adjustment Loan

1. Attached please find the Initiating Memorandum for a proposed Banking Sector Adjustment Loan to Argentina.

2. A working-level review meeting to discuss the attached memorandum, chaired by Mr. Picciotto, will be held on Friday, May 8th, at 3:00 P.M. in Room C812. If you are unable to attend, please direct comments to Mauricio Larrain (Room A-942, Ext. 75941).

Distribution

Messrs. Picciotto, LCPDR
Wessels, LCPDR
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Ms. Criddle, LCPI2

Messrs. Köpp, PPDDR
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LOAN COMMITTEE

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LC/M/86-37

cc: Messrs. Barth
Cortes
Ingram

November 17, 1986

Minutes of Loan Committee Meeting to Consider
ARGENTINA - Proposed Trade Policy and Export Diversification Loan
Held on November 12, 1986 in Conference Room E-1208

A. Present

Committee:

Chairman:	Mr. Stern
Finance:	Mr. Qureshi
Legal:	Mr. Shihata
ERS:	Mr. Michalopoulos
OPS:	Mr. Husain
Region:	Mr. Knox

Others:

Messrs/Mmes. Dubey, Gue, Scott, Pfeffermann, Collell, Schultz, de Souza, Fox, Lachman (IMF), Lysy, Nissenbaum, Roger, Schwedhelm, Sokol, Clements, Donovan, El Maaroufi

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Vice President, Economics and Research (for non-project lending)

OTHERS
Standard (see OMS 9.25 page 7)

*Copy to all other Regional Vice Presidents

B. Issues

1. The meeting was called to discuss the proposals in Mr. Knox's memorandum of November 6, 1986 for a Trade Policy and Export Diversification Loan to Argentina. The discussion focussed on the main issues raised in the Country Policy Department's Memorandum of November 11, 1986.

C. Discussion

Macroeconomic Framework

2. The meeting discussed the adequacy of Argentina's present macroeconomic framework. The Region noted that the recent rekindling of inflationary pressures had been mainly caused by expansionary, uncoordinated monetary policy while the fiscal deficit had been kept in check. The IMF Representative agreed and noted that a Fund mission was in the field to initiate negotiations on a new Stand-by. The Fund would press for a reduction of the overall public sector deficit, projected to be 4% of GDP in 1986, to 3% in 1987.

3. Regarding the exchange rate, the Region noted that the Austral had appreciated by about 10% with respect to the July 1985 trade weighted currency basket level. The IMF Representative stated that the Fund mission was considering various options on the exchange rate to promote exports and sustain an agreed level of liberalization, as well as the timing of adjustments. The Chairman indicated that the Bank should coordinate with the Fund and come up with a joint view on the proposed exchange rate and trade liberalization policy.

4. The Region noted that the proposed operation was based on the assumption that agreement on a new Stand-by would be reached by the time of Board presentation. Endorsing this position, the Committee agreed that further major lending to Argentina would be dependent on the removal of the present price controls, and that the Government should be advised accordingly.

Trade Liberalization

5. The meeting reviewed the main elements of the proposed trade liberalization strategy. Given Argentina's prior unsuccessful import liberalization experiences, it was agreed that a gradualist approach was warranted, but without losing sight of the final liberalization objective. The Region said that the Government is committed to this goal, for which important reforms had already been implemented in line with the Bank's recommendations in preparation for this loan. Furthermore, Argentina's tariffs are not excessively high, and, therefore, further efforts should be concentrated on replacing the remaining non-tariff restrictions with an appropriate tariff regime. The meeting agreed with the proposal to reach agreement on a multi-year program of liberalization, coordinated with the Fund, before release of the second tranche.

6. The meeting noted that the proposed loan would provide exporters with a _de facto_ free trade regime for imported inputs. It would thus expose domestic producers of these materials to competition at international prices as a first step towards more general import liberalization. The meeting directed the appraisal mission to quantify the significance of the proposed partial liberalization of imports in terms of its impact on Argentine manufacturing production. The Chairman indicated that, if the production value of the proposed partial liberalization is relatively insignificant, it would be necessary to reach agreement on the phasing out of QRs on the remaining tariff positions within a briefer period than recommended in the Initiating Memorandum. Conversely, if the amount involved in the partial liberalization is relatively significant, a suitably longer period for the phaseout of the remaining QR's would be acceptable.

7. The Committee also instructed the appraisal mission to review existing incentive programs for exporters, some of which reportedly have been the subject of countervailing action by other countries, and to formulate plans for their elimination or modification as appropriate.

8. The meeting discussed the system of import permits for goods entering the country automatically. It was agreed that goods in the automatic list should not require import permits, even if only for statistical purposes, and that the Region should seek a commitment to eliminate these permits before second tranche release.

External Borrowing

9. The meeting discussed the Government's proposal, in order to avoid domestic political difficulties, to use World Bank (in place of its own) balance-of-payments projections in Argentina's medium-term framework paper to be presented to the commercial banks. It was recommended that the paper indicate that these projections are based on data furnished by the Government as a disclaimer, in order to guard against any claim of liability from a third party. The Chairman indicated that it would be more desirable for the Government to present its own projections and that the Region should persuade it to do so.

D. Conclusion

10. Subject to the modifications noted above, the Committee approved the regional proposal to appraise and process the Trade Policy and Export Diversification loan along the lines set out in the Initiating Memorandum, including the proposed US$400 million loan amount.

OFFICE MEMORANDUM

DATE November 13, 1986

TO Distribution

FROM Neil Roger, VPERS

EXTENSION 33773

SUBJECT <u>Loan Committee Discussion--Argentina: Trade Policy and Export Diversification Loan Initiating Memorandum</u>

The Loan Committee (LC) discussed the Initiating Memorandum (IM) for the proposed US$400 million Trade Policy and Export Diversification Loan (TPL) for Argentina on Wednesday, November 13, 1986. Mr. Michalopoulos attended for the ERS.

The LC discussed stabilization issues and the macro-economic framework for trade reform, and particularly the role of the IMF in support of these. There was agreement that the Austral Plan was falling apart and that the current macro climate would not support significant trade reform. The IMF representative explained that a mission was in the field and there appeared to be considerable interest in a standby by the Government. While it is too soon to be sure what will be included, inter alia, actions on inflation, the public sector deficit, price control and import liberalization are likely. The Region are assuming that the Standby will set the macro frame for the TPL. Mr. Stern suggested that the Bank should co-operate with the IMF to determine an exchange rate policy which would facilitate trade reform.

The discussion of trade reform was begun by Mr. Quereshi who suggested that the policy proposals in the IM were "anemic" and not worth $400 million. The Region replied that the gradual approach was necessitated by the unsuccessful previous liberalization episode. They suggested that the proposals for providing duty-free inputs for exporters were substantial liberalization, but acknowledged that the proposals for broader import liberalization were less so. Mr. Quereshi noted that his experience suggested that there would likely be little action on the export side until there was some real action of the import side. He suggested that the Region was proposing improving what was already there instead of making a change to a less restrictive system--say converting QRs to tariffs.

Mr. Michalopoulos supported Mr. Quereshi noting that what was needed was a substantial change in relative incentives as between exportables and importables, and that this was unlikely while importables were provided open-ended protection by QRs. He sought clarification from the Region on the current status of foreign exchange rationing, the nature of the various QR regimes (e.g. are "automatic" licenses truly automatic) and other export incentives. Mr. Michalopoulos suggested that if the Argentines wished to follow a gradual QR liberalization route then they should establish one negative

QR list, and then an action plan for reducing the QR coverage in terms of domestic production.

Mr. Stern asked for clarification of the IMF's likely requirements on import liberalization--the IMF representative suggested that as a waiver had been granted on import liberalization required under the previous Standby, substantial progress within the period of this Standby.

The LC resolved that the appraisal mission should clarify the current QR position and the proposed reforms in terms of the impact on production and not only imports. The Bank and the IMF should agree on an action plan for phasing out QRs as a condition of second tranche release. At the end of the phase-out, there should be no licensing (automatic or otherwise).

The LC also suggested that the appraisal mission look into other existing export incentives and the IM proposals with a view to simplification and unification.

The LC discussed price controls and Bank lending strategy. Mr. Stern suggested that the Government should be advised that the Bank would only proceed with the proposed $1 billion lending program if prices were to be decontrolled.

The LC discussed the sensitivity of projections in medium term framework papers and Mr. Stern suggested should provide its own projections.

cleared with and cc: Mr. Michalopoulos, VPERS

Distribution: Mrs. Krueger, VPERS; Ms. Kim, VPERS
Messrs. Baneth, EPDDR; Cortes, VPERS; deMelo, DRDIE
Ingram, DRDDR; Nogues, VPERS

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Sarath attended

DATE: May 14, 1986

TO: Distribution Below

FROM: Armeane M. Choksi, Senior Adviser, CPD AMC

SUBJECT: ARGENTINA - Practical Approaches to Liberalizing the Economy

1. Further to Mr. McCarthy's memorandum dated May 5, 1986, on the above topic (attached), we are scheduling a discussion on Tuesday, May 20, at 11:00 a.m. in Room N-610. Attached is the suggested agenda for framing our discussion. I have also attached a note from Mr. Balassa on this topic.

2. Mr. McCarthy will present the issues; this will be followed by a general discussion on liberalization of the Argentina economy. We hope you will be able to attend.

Attachments

Distribution

Messrs. McCarthy, Nankani (LC2), Pfeffermann (LCN), Tyler (LCP),
Balassa (ERS), Lal (ERS), Rajapatirana (ERS)
Frischtak (IND), Lluch (DRDLM)

Argentina Division

Country Policy Dept.
Messrs. Dubey, Squire, Huang, Selowsky, Papageorgiou
Barandiaran, van Wijnbergen, Ms. Fox

AGENDA

ARGENTINA

Practical Approach to Opening Economy

1. Problems faced by policy makers

- Policies
- Behavior
- Institutions

2. Record of other countries that have tried (and in most cases failed)

- how was it done
- why did it fail — [illegible] policy
- success stories?

3. If one does not adopt an economy-wide approach what alternative is available

- by sector
- by industry
- by firm
- other disaggregation

[illegible] by [illegible]

4. What is needed to smooth the transition

- complementary policies
- financing
- employment insurance
- other guarantees

(1) speed
(2) [illegible] policies
(3)

[illegible]

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE May 9, 1986

TO Mr. Armeane M. Choksi, CPDTA

FROM Bela Balassa, VPERS

EXTENSION 33779

SUBJECT ARGENTINA - Practical Approaches to Moving the Economy from Inward to Outward Looking

1. This is in reference to Desmond McCarthy's memo to you on the above subject, which was copied to me. I would be glad to participate in the meeting Desmond is proposing. During May I am at the Bank every day until 2 p.m.

2. A few rapid reactions to the memo. While it is incorrect to say that most countries that have tried to open their economies have failed, Argentina is a conspicuous case of repeated failures. In the late 1960s and the early 1970s I was twice in Argentina on official invitation to advise on policy reform but these efforts failed for lack of a political consensus.

3. In a democracy, political consensus is thus a precondition of successful reform. Another precondition is an appropriate macroeconomic policy. Argentina again provides an example of a failure on this count, in the late seventies. But there have been successful cases of reform, albeit most of them outside of Latin America. For an analysis, see Chapter 1 of the draft report on Latin America I recently sent you.

cc: Mr. McCarthy and recipients of his memo of May 5, 1986.

BBalassa:nc

OFFICE MEMORANDUM

NOV 12 1986 cc NR SH

DATE: November 11, 1986

TO: Messrs. Stern, Qureshi, Husain, Shihata, Knox, Mrs. Krueger

FROM: Vinod Dubey, Director, CPD VDubey

EXT: 60061

SUBJECT: ARGENTINA: Trade Policy and Export Diversification Loan - Initiating Memorandum

1. The Loan Committee will meet on Wednesday, November 12, 1986 at 4:30 p.m. in Room E-1208 to discuss the Initiating Memorandum (IM) for a proposed $400 million Trade Policy and Export Diversification Loan to Argentina, circulated under Mr. Knox's memorandum of November 6, 1986. The proposed loan would support a policy package aimed at (a) improving access to imports for exporters; (b) simplifying import and export procedures; and (c) defining a timetable for tariff liberalization, and taking an initial step towards such liberalization.

Stabilization and the Macroeconomic Framework for Adjustment

2. The first step toward adjustment in Argentina is stabilization: controlling the public sector deficit and inflation. The Austral Plan was greeted with great enthusiasm in 1985, and it has reduced but unfortunately not yet controlled inflation. Despite a wage and price freeze, inflation accelerated to a monthly rate of 8.8 percent last August (175 percent on an annual basis). The meaning of the current wage and price freeze given these results is unclear, but what is even more unclear is how to remove the controls without further igniting inflation. Changes have been made in the economic team, and a more restrictive monetary policy seems to be lowering inflation, down to a monthly rate of 6.1 in October. The increased money supply was necessary to finance the public sector deficit, which apparently is not yet lowered to a non-inflationary level. Meanwhile, real interest rates are still high -- which may reflect rational expectations given the size of the deficit and previous money creation. The Argentine economy is clearly not yet stabilized, a prerequisite for effective structural adjustment and the resumption of sustained economic growth. It is proposed that before Board presentation a macroeconomic framework would need to be agreed upon, preferably supported by an IMF Stand-by (para. 10).

- Under these conditions, is it feasible for the Bank to proceed with the proposed loan if no IMF Stand-by is in place? Given the complexities of the Argentina situation, can the Bank adequately monitor stabilization?

- What is the timetable for freeing wages and prices, thus introducing more flexibility into the economy?

The Proposed Adjustment Program

3. It is widely agreed that an adjustment with growth strategy for Argentina will involve a major reallocation of productive resources from the country's current inward orientation characterized by an oligopolistic structure to an outward looking, competitive one. Implementing this strategy requires (a) a change in the incentive structure and (b) increasing the flexibility in the economy to allow a response to take place. Currently, wages and prices are frozen; state enterprises enjoy monopolies or preferential treatment; credit is quantitatively allocated; trade is restricted; and its administration is highly complex. Private sector confidence is still low and investment has not nearly recovered to historical levels. The proposed loan would support measures primarily aimed at reducing exporters' import costs, in hopes of stimulating increased production for export. Further import liberalization would occur later, after export supply has increased. One factor holding back export production is obviously the structure of protection, which renders production for the domestic market more profitable. The proposed measures will alter that incentive structure slightly, but not substantially. If this change in incentives were to be enough to stimulate some export production in the short run while the domestic market is depressed, the pervasiveness of other controls would seem to work against this production being sustained. Further trade liberalization needed to provide the basis of long-term growth should be supported by a flexible economy, including flexible prices, supportive exchange rate policy and a financial sector to intermediate the movement of resources into more profitable sectors. The timetable for the introduction of this flexibility into the economy is not specified in the IM, although several other projects are referred to in paras. 6 and 8.

- Can we expect much production response from the proposed measures, given the other rigidities in the system?

- What is the timetable for embarking on the major structural reforms referred to in the IM and detailed in the January 1986 Baker paper?

The Exchange Rate

4. The Region expects that the volume of imports would increase "significantly" under the policy package proposed in the IM (para. 10). The proposed loan would finance these imports. Normally under an import liberalization program the real exchange rate is adjusted to encourage efficient use of tradables and prevent a loss of reserves associated with the fall in the price of tradable good. Financing the loss of reserves, as the paper proposes, is dangerous since once the finance disappears the reforms are likely to be reversed. The IM reports that the IMF has targetted the July 1985 trade weighted exchange rate as desirable; it is not clear whether this target incorporates import liberalization objectives. In the case of Argentina, a major exchange rate adjustment could run afoul of stabilization. It should be noted that previous import liberalization programs failed because of inconsistencies between trade and exchange rate policies.

- Does the Region have a view on the exchange rate movements required to support a trade liberalization program, and is this view shared by the IMF and the Argentinians?

- Is there a conflict between the stabilization objectives and the trade liberalization objectives of the economic strategy?

The Financial Package

5. The Region does not elaborate on the justification for the size of the loan, although the macroeconomic projections in Annex III indicate that Argentina can use the funds to meet its estimated import requirements. One issue is whether the strength of the proposed program justifies a loan of this size to Argentina. A second issue is whether the complementary financing will be in place by the time the World Bank disburses. Obviously, if there is no IMF program the commercial banks will be hesitant to provide new money.

- Can the Region elaborate on the rationale for the size of the proposed loan?

- What are the prospects for complementary commercial and bilateral financing as called for in the text?

cc: Messrs: Pfeffermann, Gue, Nankani, Scherer, Sokol, Ebiri
Picciotto, Schultz, de Souza

Messrs. Hasan, Kopp, Michalopoulos, Roger, Jansen
Clements, El Maaroufi, Ms. Donovan
Choksi (o/r), Huang, Ms. Fox, El Serafy, Barandiaran

For Loan Committee Meeting
to be held 4:30 p.m., November 12, 1986

Briefing Note

ARGENTINA: Trade Policy Loan

Background

Argentina is a continuing drama. Having one of the ablest people and one of the richest countries in the developing world, it has thwarted her development through erroneous policies since the Depression of the 1930s. Argentina's GNP per person in the 1920s was the seventh highest in the world; today it is not even in the top 50 countries.

The lack of political consensus is still present in the Argentina of 1986. The opposition party to Alfonsín, the Peronistas, will surely reverse many of the policies of today, and everyone expects this to happen. Even in the shorter of runs: within Alfonsín's term in office, tremendous instability in the rules of the game prevail. Most policy changes have been and continue to be ad hoc, arbitrary and discriminatory. You pay the tax on your car in three installments, but the second or third payment may be five or more times the first one as this is one of the ways the Covernment uses to finance their deficits.

In 1986, GDP per capita in Argentina is the same it was in the mid-sixties. The roots of this stagnation lie in the political system but its economic manifestations are manifold: a very closed economy, with a strong anti-export bias; an enormous size of the public sector, including ownership of key productive sectors; and widespread intervention in the economy, with a massive distortion of incentives. All these features are still present in the

Argentine scene, with the added burden of the increased external debt and increased inflation rates (in turn, outcomes of the above). Neither Argentina's political ineffectiveness nor her economic manifestations have changed. Argentina is today a politically fragmented economy, a closed, distorted economy with a bloated public sector.

Are there any hopes? The political strife continues, but there is an important, if unused element: President Alfonsín. Alfonsín has wide support, but he has not made use of it in order to change Argentina's deep rooted and fundamental problems. If he realizes where the key to growth is, he might quite well obtain the necessary support to undertake the necessary adjustments. So far, he has not done so, nor does one finds any strong indication that he is aware of the right course of action.

The Macroeconomic Situation

Inflation rates in the first two quarters of 1985 averaged 25 percent per month. After the Plan Austral was implemented in April 1985, the rates of inflation, on a monthly basis, declined gradually to 11 percent per month in the third-quarter of 1985 and to 2.3 and 2.9 percent per month in the following two quarters. The month with the lowest inflation rate was February with 1.7 percent. The appreciation of the exchange rate in real terms with respect to the U.S. dollar (fixed in nominal terms since April 1985), led to a change in the exchange rate system to a crawling peg. As a consequence of this change in policy, the unions were able to obtain increases in their wages, and prices adjusted leading to another round of accelerating inflation. Last month, the monthly rate of inflation exceeded 6 percent.

The failure of Plan Austral is explained by the lack of fundamental changes in the public sector. Figures on the public sector deficit are tricky: there are several definitions. The one used by the Region (overall cash deficit) shows a reduction from 12 percent of GDP in 1984 to 7.3 in 1985 and only 1.7 in 1986. Other analysts correct this concept by including: (i) non-cash components of the financial deficit; (ii) interest paid on external debt; (iii) interest paid by the Treasury on required reserves; and (iv) rediscounts and other interest paid by the Treasury. Once this is done the revised deficit is 9.2 percent of GDP in 1986.

Another way of looking at the public sector picture is to focus on public expenditure. Total expenditure (excluding interest paid on external debt, and other interest paid on rediscount, required reserves, etc) represented the following shares in GDP:

1984	44.7
1985	42.8
1986	42.1 *

For 1986, the addition of items (i) to (iv) mentioned above, bring the adjusted share of public expenditure in GDP in 1986 to 49.6 percent. Rounding out, half of GDP of 1986.

When these figures are presented (they are not shown in the initiating memorandum) one begins to realize why Argentina's rate of inflation is currently in excess of 6 percent per month. As against the puzzle of conciliating that high rate of inflation with a public deficit of only 1.7 percent of GDP.

---

* The last two quarters of 1986 are projections by Secretaría de Macienda, August 11, 1986.

Very little has then been done to reduce the size of Argentina's public sector; and after the initial effect of reduced expectations of the price-wage freeze together with a fixed exchange rate, the path of inflation has of course accelerated. The only measure taken in this connection has been to increase taxes, from 18.5 percent of GDP in 1984 to 23.4 percent of GDP in 1986.

In the last two months, a new economic team has been appointed. No changes in the public sector picture are apparent, but seemingly monetary policy has tightened, bringing inflation down from the new peak of 8.8 percent in August, 1986 to 6.1 percent in October. Accordingly, interest rates <u>in real terms</u> have reached levels of 5 percent <u>per month</u> recently. Officially, the wage-price freeze is still in effect, having mainly the effect of distorting relative prices, but is no longer effective from the macroeconomic point of view. It is clear that macroeconomic instability is a key characteristic of the Argentinian scene.

<u>Distortions and Trade Policy</u>

Nothing has been done to open the economy, nor to improve incentives. On the contrary, the price-wage freeze and the fixed exchange rate, created further distortions, and a stronger anti-export bias. These aspects receive only sketchy treatment in the Initiating Memorandum.

Distortions in the Argentine economy are high and widespread. Monopolies by state enterprises in key productive sectors, and private monopolies and oligopolies sustained by trade barriers are the norm rather than the exception. The fact that the military control the key sectors of chemical and metal industries makes an opening of the economy the more difficult from the political point of view.

The freeze of wages and prices has further compounded the distortions in the incentive structure; together with the non-market direct allocation of credit it has meant that all key macroeconomic (as well as most relative) prices in the Argentinian economy are distorted.

Clearly only a major structural policy change will untie this distorted incentive picture. And it is also clear that the changes proposed in the loan, although in the right direction, are clearly insufficient by a factor of 40 or 50 to achieve lasting results on exports and growth.

The Real Exchange Rate

The Initiating Memorandum is unclear on the issue of the adequate real exchange rate both in the present context and a context of trade reform. The points made in the Initiating Memorandum (pg. 14 and 15) are the following:

(i) "The IMF has targetted the July 1985 trade-weighted exchange rate of the Austral with respect to a basket of currencies of major trading partners as that which should be achieved by Argentina to maintain export competitiveness. They believe that the real exchange rate which resulted from the adoption of the Austral Plan would be adequate to expand exports". (No indication why.)

(ii) "The mission (presumably the Bank's) would obtain the Government commitment to a competitive exchange rate policy based on the average trade weighted level of the Austral of July 1985 with respect to a basket of currencies of major trading partners. Under present circumstances we do not have any reason to disagree with this position (sic)". (Isn't the Region's position now?)

No explanation is given as to why the July 1985 level is adequate for high export growth. There are several reasons, though, why this is wrong. First, the level of 1985 imports was the lowest level at which imports could be imposed, it was clearly an unsustainable low level, and normal resumption of growth would require a much higher import level. To illustrate, if we use imports in 1970 prices (Table 1 of Initiating Memorandum) and make arbitrarily the year 1977 = 100, we observe the following evolution of imports:

Imports (in 1970 prices) (1978 = 100)

1977	100
1978	95
1979	138
1980	201
1981	202
1982	121
1983	118
1984	123
<u>1985</u>	<u>108</u>
1986	118 (estimate)

Clearly, to use 1985 as the base for an export oriented strategy is, to the least, daring. Table 3 in the Initiating Memorandum shows that exports (of goods and non-financial services) were \$10.5 billion in 1985 as against imports (of goods and non-financial services) of \$5.9 billion. However, in spite of this substantial trade surplus, the current account had a deficit of \$1 billion. Again, is this an adequate base for a real exchange rate aimed at promoting exports? It seems redundant to add that in July, 1985 the Argentine economy was as closed as it is now and almost as distorted as it is now.

A more adequate way of finding the proper real exchange rate would be to look at a year where the terms of trade were similar to the present ones, and the current account had a positive trade balance. Still a major adjustment would have to be made because of the substantial increase in the external debt. For example, the external debt to GDP ratio was 28 percent in 1978, whereas in 1985 it reached 75 percent. I do not have the information to make the calculation, but I would not be surprised if it turns out to be 20 percent or more higher than the 1985 level.

The real exchange rate thus calculated would be applicable to an essentially closed economy, and another major adjustment would be called for when a trade liberalization is under way. I would be surprised if this additional adjustment is under 20 percent. Adding the two adjustments we reach a figure substantially higher than the level of July 1985 that the Mission seeks to obtain in the form a committment by Argentina's Government.

Of course, a key problem is <u>how to achieve a real devaluation in Argentina</u>. The pressure of the unions, and the total absence of short-run "money illusion" in a sophisticated inflationary country frustrate attempts of depreciating the currency. This should be another key issue to be discussed by the Region. But, first, they have to identify it as a key issue.

<u>The Loan</u>

The loan does not adequately address the key issues we have discussed above. It leaves the macroeconomic economic policies, particularly the necessary adjustment of the public sector to the IMF, without specifying what macroeconomic policies the Bank should require as preconditions for trade reform. It is altogether different, a program to stabilize the country, which is the concern of the IMF, to a program for export dynamism and growth, which is the Bank's concern. If the Bank does not have a position on the latter, clearly a IMF-only macroeconomic policy need not be consistent with outward oriented growth. The IMF stand on real exchange rates is a clear case in point. They are implicitely giving a higher weight to stabilization (devaluations increase the price level) against growth (real devaluations are required according to the discussion of the previous section). And they are right! Because stabilization is a precondition for successful structural reform. But the Bank cannot take the IMF exchange rate target and make it its own, to achieve outward oriented growth objectives.

The Initiating Memorandum leaves the structural changes in the incentive structure largely undiscussed, mentioning different loans to be made on key sectors for structural reforms, but without an adequate discussion of what reforms precisely are needed, what is an apppropriate timetable, its feasibility, and the coordination problems involved in the timing and sequence of such reforms. It does not even discuss the extent and timing of trade policy reform although the title of the loan starts with "Trade Policy".

Although the Initiating Memorandum states that "the proposed loan is intended to assist the government in introducing trade policy reforms while maintaining a viable and stable macroeconomic framework", it is clearly less ambitious. It essentially aims at establishing a more efficient temporary admission regime for Argentina's export industries. Even totally free and automatic temporary admission regime for all exporters would not provide the basis for sustained growth in the Argentina economy, as the pervasive rigidities and distortions present throughout the economy's structure are excessive.

In order to achieve this automatic and free temporary admission regime it would be necessary to eliminate the whole paraphernalia of different schemes presently at work. From the discussion of the actions or conditionality requested it is apparent that: (i) the TAR regimes proposed will be established on top of several of the present schemes which will only be partially phased out, and (ii) that an automatic and free access temporary admission regime will not be the result of this loan.

Final Comments

1. Argentina is not polically ready to undertake structural reforms, it has not been since the 1930s. Furthermore, its macroeconomic environment is fundamentally unstable and increasingly so. Stabilization is a priority, not trade policy reform. The Bank should have a position on macroeconomic policies for stabilization and particularly its relation to macroeconomic policies for outward oriented growth. The Initiating Memorandum does not address this issue.

2. Trade Policy Reform and other Policies to eliminate the widespread distortions and distorted incentives and policy-caused rigidities should follow the stabilization program, paying particular attention to the content of the policies, timing, sequence and coordination. The Intiating Memorandum does not address this issue, it includes only two lines on the content of trade policy reform and none on the timing, sequence and cordination with other reforms and policies.

3. The issue of the real exchange rate clearly requires the Region to do their homework. An exchange rate policy satisfactory for stabilization purposes cannot be confused with a long-term exchange

rate policy for outward oriented growth. The complexities of the Argentine political structure, particularly the power of the unions, merits an analysis of what is required for a successful real depreciation for long-term growth.

4. Even if a restricted objective for the loan is accepted, it is at all unclear whether the conditionality involved would guarantee a totally free and automatic access without discrimination to all exporters.

5. In view of the restricted scope of the present loan, it would be appropriate: (i) to push for a free, automatic and non-discriminatory TAR; (ii) to call it "Export Promotion Loan" and not "Trade Policy and Export Diversification Loan"; (iii) to reduce the amount of the loan accordingly, (iv) to instruct the region to work on the issues 1 to 3 above, and with that preparation to initiate a policy dialogue on structural reform.

WHD 86/10/17

GROUP OF PRODUCERS OF MANUFACTURES

REAL EFFECTIVE EXCHANGE RATES, NOMINAL EFFECTIVE EXCHANGE RATES, RELATIVE PRICES IN LOCAL CURRENCY, EXCHANGE RATES AND CONSUMER PRICES

INDEX : 1980 = 100

ARGENTINA

(213)

	REAL EFF	NOM EFF	REL PRICE	EX RATE	CPI(SA)	CPI
1982 Q1	63.565	23.225	272.435	17.841	351.211	351.101
1982 Q2	55.824	18.379	302.933	13.562	405.412	401.674
1982 Q3	45.800	11.182	412.484	7.831	573.188	576.556
1982 Q4	40.187	6.964	581.243	4.694	830.828	836.287
1983 Q1	40.099	4.862	824.888	3.208	1217.870	1210.016
1983 Q2	41.360	3.809	1085.071	2.352	1670.754	1661.072
1983 Q3	45.640	2.970	1544.379	1.720	2499.297	2529.525
1983 Q4	46.383	1.900	2474.960	1.054	4202.257	4210.828
1984 Q1	46.750	1.245	3777.745	0.663	6696.267	6613.888
1984 Q2	51.614	0.878	5919.977	0.452	10951.598	10947.638
1984 Q3	54.277	0.569	9700.214	0.271	18752.904	19104.820
1984 Q4	51.499	0.318	16454.609	0.142	33288.798	33181.790
1985 Q1	52.038	0.182	29086.157	0.076	61597.091	60489.679
1985 Q2	46.154	0.086	55966.405	0.035	123747.537	124382.848
1985 Q3	40.714	0.055	73020.080	0.023	167607.589	171156.276
1985 Q4	41.995	0.054	76881.151	0.023	184201.773	183302.212
1986 Q1	43.892	0.054	81330.307	0.023	204217.063	199536.224
1986 Q2	44.136	0.050	88115.368	0.022	224396.772	225764.607
1985 JAN	51.400	0.214	23847.920	0.091	49660.528	48611.175
1985 FEB	53.009	0.184	28626.128	0.076	60398.582	58657.074
1985 MAR	51.705	0.148	34784.424	0.060	74732.165	74200.787
1985 APR	49.904	0.112	44447.895	0.046	96848.745	96063.473
1985 MAY	46.775	0.086	54318.877	0.035	119964.456	120192.486
1985 JUN	41.783	0.060	69132.442	0.024	154429.409	156892.586
1985 JUL	40.649	0.055	73052.343	0.023	165169.495	166611.050
1985 AUG	40.330	0.055	73022.602	0.023	167842.866	171716.286
1985 SEP	41.162	0.056	72985.295	0.023	169810.407	175141.492
1985 OCT	41.020	0.054	74915.473	0.023	176207.727	178551.268
1985 NOV	41.925	0.054	76849.571	0.023	184161.918	182780.488
1985 DEC	43.041	0.054	78878.409	0.023	192235.673	188574.880
1986 JAN	43.892	0.054	80310.732	0.023	199586.142	194286.985
1986 FEB	43.722	0.054	81129.586	0.023	204200.499	197571.616
1986 MAR	44.063	0.053	82550.602	0.023	208864.550	206750.070
1986 APR	44.566	0.052	86078.262	0.022	218220.434	216538.821
1986 MAY	43.862	0.050	87859.758	0.022	223807.444	225258.000
1986 JUN	43.981	0.048	90408.084	0.021	231162.438	235497.000
1986 JUL	44.768	0.046	97064.940	0.020	248346.693	251422.000
1986 AUG	44.111	0.042	103760.328	0.019	266464.053	273508.000

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 12, 1986

TO: Mr. Peter R. Scherer, Chief, LC2AR

FROM: F. Desmond McCarthy

EXT: 76254

SUBJECT: ARGENTINA - Economic Recovery and Growth Mission (CEM)(4/7-4/25/86) Back-to-Office Report

1. An economic mission visited Argentina during the period April 7 to 25, 1986.1/ The main theme of the mission was reactivation and growth. The mission members were: F.D. McCarthy (leader), C. Lluch (labor), C. Frischtak (industry), W. Tyler (trade), A. Verme (private investment), T. Boyatt (export marketing), J. Gonzalez-Fraga (monetary), C. Echeverri (research assistant), and H. Hamaguchi (YP). Messrs. G. Pfeffermann and P. Scherer joined the mission for a few days during the third week.

Political Situation

2. The President continues to enjoy broad popular support. However, the lustre of the early achievements of the Plan Austral are not yet being complemented by an eagerly expected growth phase. The unions have continued to push for redress of the substantial real wage losses incurred since June 1985. Mr. Storani has moved from energy to health. Jorge Lapena, a young technocrat, has become Secretary of Energy where he is expected to be a major positive influence. In replacing Neri by Storani at health, the President is perceived to have made a concession to the unions. The feeling is that Storani will be more flexible in dealing with the health funds which are much prized by the unions. On the other side the President has to contend with rumblings from the military. The ongoing trials seem to be causing considerable embarrassment and so some moves may be instituted to bring them to an early end. There is also some discontent with military pay (and pensions) which may have lost ground before the Plan Austral. Again this requires Presidential action to provide a solution and is expected to have a substantial fiscal cost. All agriculture groups are also unhappy with the depressed prices for their crops and generally poor market prospects. They staged a national strike on April 21.

3. Buffetted on all sides the President has sought to maintain the initiative by:

(a) announcing the movement of the capital to Viedma-Patagonia; a problem here is where the money will come from;

(b) proposing a tripartite economic and social conference between Government, union and entrepreneurs. They met last week. This could involve major changes in all key aspects of labor

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1/ For various logistical reasons some members arrived before April 7 and some stayed later than April 25.

legislation. This, in turn, would have repercussions on most aspects of economic behavior;

(c) on May Day sought to reassure the populace that the recession is over and further announced a cut of US$400 million in taxes on agricultural products together with supplemental assistance to the livestock industry.

Economic Situation

4. National Accounts. The official estimate now shows that real GDP fell by 4.4 percent last year with the industrial sector being particularly hard hit. This sector is now showing some signs of recovery particularly in steel, engines, and textiles. Preliminary figures for the first quarter of 1986 suggest that the sector may now be back at the level of early 1985. The only sectors showing a positive growth rate for 1985 were electricity, gas and water, 1.4 percent, and social and personal services at 1.9 percent.

5. Fixed Investment performance is particularly disturbing with the share in 1985 falling to 11.3 percent of GDP. Typical levels in the decade 1970-80 and as recently as 1981 were over 20 percent. This current depressed level implies that net investment is close to zero and so augurs badly for any incipient recovery.

6. Exports for 1985 increased by US$250 million to US$8,358 million with most of this increase coming from mineral products and chemicals. Imports were constrained by a further US$685 million to US$3,900. Most of this reduction came in the intermediate goods category which adds a further burden to any growth prospects. Even with this strong trade surplus of US$4,458 million the current account showed a deficit of US$1,077 million largely because of net interest payments of close to US$5 billion. The net international reserves position for December 1985 was -US$7,873 million. At that time arrears were US$1,718 million.

7. Prices. The WPI continues to show low monthly changes with the first four monthly figures for 1986 being -0.02, 0.8, 1.4 and 3.0. The CPI increases are way below the pre-Plan Austral level but continue to show stubbornness with corresponding increases for the first four months of 3.0, 1.7, 4.6 and 4.7. This, in turn, means a steady erosion of the real wages. The most recent upward pressure in the CPI has come from increases in public utility charges (average increase in public utility rates of 5 percent), meat, seasonal clothing (winter season), eggs, ham, coffee and tea with a modest offset from vegetables and fruits which were the main culprit in the previous quarter.

8. Exchange Rate. On April 5, Economy Minister Sourrouille announced the first devaluation since the introduction of the Plan Austral from US$1 = A 0.80 to A 0.83. The free market exchange rate responded by falling overnight in absolute terms from 0.93 to 0.91 providing a much ~~needed psychological boost to the authorities. A couple of weeks later a~~ further minor change was introduced from 0.83 to 0.84 which the market again took in stride. On May 5, the free market rate had fallen to 0.895.

9. Interest rates in the regulated market have shown little change in nominal terms. However, the interfirm (free) rate in April became slightly negative in real terms. While the "Tobin" effect should augur well for the availability of medium-term investment financing in the near future (already there are some indications of inventory build-up) it also poses a problem that, if the rate continues to remain low it may not be attractive enough to stay incipient capital flight.

10. Public Finances. The Government remains committed to introduction of a land tax by 1988 but in the current year it seems that the US$70 million land tax is being dropped. It is also likely that the salary minimum could go from its current level of A 80/month approved April 5) to 90 or higher during the year. If it should go higher then the increase would be offset by higher excise/fuel taxes. There is also a major outstanding problem on enterprise pensions which have been the target of court actions to substantiate claims that they have not paid according to legal regulations. This case has now reached the Supreme Court and the Government is anxious to reach some viable settlement. Estimates of the costs involved could be several points of GDP. In view of the number of items which could change dramatically during the course of the year it would be foolhardy to speculate on where the consolidated nonfinancial public sector deficit will settle. It is evident that the budget will not pass in this session and it also seems that the final deficit figure will be in excess of 5 percent. However, undue concentration on such a metric is rather sterile and tends to distract attention from consideration of fiscal stance which is crucial for assessing medium-term prospects. This, in turn, requires careful consideration of major line items and assessment of their likely evolution.

Economic Report - Outline

11. The economic mission took cognizance of the short-term features summarized above and will imbed them in its broader perspective. The mission report will elaborate on the following:

(a) Plan Austral. The positive results of the plan to date include:

(i) Inflation. Current monthly rates remain substantially below pre-plan levels which were in excess of 25 percent.

(ii) Price Stability. Price stability albeit with controls has resulted in efficiency gains as people are no longer compelled to make virtually instantaneous decisions on the disposition of financial assets and also a reduction in information-gathering costs.

(iii) The public sector deficit for 1985 is 4.3 percent of GDP compared to 11.1 in 1983. This has been achieved by some reductions on current expenditures for wages and salaries but principally by increase on the revenue side. This gain in tax receipts has been quite typical in other countries which have achieved sharp falls in inflation.

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(iv) Institutional Changes. Here one finds perhaps the biggest changes but yet benefits in tangible terms will not be evident for a couple of years in most instances. The tripartite economic and social conference marks a major effort to break the traditional oligopolistic cycle of wage pressure and mark-up pricing prevalent in a number of sectors. By raising the negotiations to the ministerial level for a limited period it is expected that a less inflation-prone system will be devised.

(v) The administration of most public enterprises has been changed to bring their finances under much tighter control. This has been done by the appointment of technocrats to key roles in energy, YPF, and tax administration.

(vi) Modern collection techniques are being introduced as part of tax reform measures. These include more extensive use of computers and cross-checking on items such as interest payments and tax returns.

(b) On the negative side a major concern is the sluggish performance of the economy. The success of the Plan Austral on the inflation front has now brought to the fore many deep-rooted problems.

(i) Market organization includes a private sector which, in many instances, has grown accustomed to a protected domestic market and viewed the Government as its main customer while in other instances the Government is a key producer.

(ii) Price Formation. One does find flex pricing in some sectors such as foodstuff, beverages and some in manufacturing. However, much of the industrial sector is oligopolistic. In theory, one may tackle abuses of oligopolistic power by allowing external competition. The mission will seek to provide some ideas on how one might proceed along these lines in the given socio-political reality.

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(iii) Bureaucracy. A complex plethora of public institutions has evolved so that issues of access and exemptions are major considerations for many erstwhile entrepreneurs. The mission will offer suggestions on a number of practical measures to reduce the concomitant inefficiency.

(iv) Labor unions are organized along sectoral lines and seem to devote much of their energy to political goals and a lesser effort to the more conventional role played by unions in other western countries. The interplay of these forces has resulted in many rigidities and inefficiencies.

(v) External Debt. The climate has now been exacerbated by the burden of external debt payments so that players are now faced with a zero or negative sum game. The situation requires a major improvement in confidence on both the domestic and external front. This, in turn, needs careful consideration of a number of economic factors. Macro issues are first addressed and then some specific questions considered.

Macro Issues

12. Macro policy making is circumscribed by the debt situation. There are what amounts to two transfer problems involved. The first is the external transfer which forces a positive trade surplus to transfer debt payments abroad. The second is the domestic transfer. This arises because most of the liabilities belong to the public sector while the private sector earns most of the export surplus. Preliminary analysis suggest that in order to generate its required resources the Government feels obliged to provide a system of prices tilted to encourage the private sector to seek financial rather than real assets. The report will analyze these issues.

13. Monetary policy primarily targets M5 at the beginning of the month so that money supply is primarily controlled by adjustments to reserve requirements. This is a rather cumbersome instrument to try and achieve a balance between appropriate liquidity level, interest rates high enough to attract deposits and yet low enough to provide funds for potential investors. It would seem desirable to introduce open market operations in the near future. this brings real deposit rates in

14. Exchange rate is now adjusted on a crawling peg - something between a passive and active crawl. This seeks to obviate the danger of the rigid system used during the Martinez de Hoz and yet provide some measure of assurance to the private sector on what they can expect. For the moment it is expected to move in harmony with the rate used in the budget of about 2 percent per month. It is felt that this should result in an essentially stable real exchange rate. Some consideration may be warranted at this juncture of introducing a forward market.

15. Fiscal policy continues to be constrained. Central Government's current expenditures on wage and salaries have been cut severely but employment in the provinces and municipalities has increased substantially in the last few years. Public sector investment levels have been compressed to a historic low share of 3.8 percent of GDP. Given the traditional role of public investment in the Argentine economy this compression may be an overkill. Other major items in public sector expenditure are interest payments at 5 percent of GDP and transfer payments of which pensions account for 6.6 percent of GDP. There are also a number of potentially important items which paradoxically do not appear in the fiscal accounts. These include regional development incentives whereby certain provincial governments have the authority to grant exemptions to the federal value-added tax. The economic report will elaborate on various fiscal incentives.

$$(X_p - M_p) + (X_g - M_g) = (S_g - I_g) + \underbrace{(S_p - I_p)}_{\text{fin } S.}$$

Micro/Sub-Issues

16. The mission considered a number of pivotal questions:

(a) What is needed for the resumption of private investment?

There is some private investment but it is rather limited. There is strong demand for the Banade credit line and a US$60 million credit by the Italian government was well received. There is also a major investment of US$300 million being undertaken by one group associated with the petrochemical sector. However, the main obstacle to a resurgence of private investment seems to be that the overall climate is not seen as conducive at this time. This rather ephemeral but oft repeated observation is elaborated on by claims that there are not clear signals or rules of the game which one can count on for a few years. At the same time there are alternate attractive investment opportunities in financial instruments. There are virtually no funds at reasonable rates available for medium-term investment. For the Government this poses a dilemma. If medium-term real interest rates are in fact reduced, will available funds be redirected to productive investments or find their way abroad?

(b) Trade/Marketing. As the Government considers the external sector important for growth it has launched an export promotion scheme. The scheme has been put together rather hurriedly and while one can identify a number of shortcomings, preliminary results seem encouraging. The Secretary of Industry and Commerce, announced that the new special export program will improve the balance of payments by close to US$300 million in the first half of the year and total improvement would rise to US$2.9 billion over the next five years.

what about Gray spec. export

Gradually it is hoped to move towards a broader-based export promotion policy. This, in turn, will require further policy changes and initiatives. Potential exporters indicated a number of problems they faced. These included an inadequate exchange rate, poor financing, limited access to needed imports, deficient infrastructure support (transport, communications, ports) and extremely burdensome bureaucratic requirements. The mission has considered these issues and is developing alternate proposals for financing facilities and simplifying some of the bureaucratic load.

There are also a number of marketing issues. A number of Argentine firms seem to have been quite resilient in export/marketing often under difficult and erratic "rules of the game"! However, many firms, accustomed to a comfortable domestic market situation, have viewed exports more as a vent for surplus especially during more difficult periods. Consequently, many export efforts seem severely handicapped by producers who often lack the tradition of exporting and so do not tend to be market-oriented. Some Argentines have devised successful strategies and this suggests some thought be given to focussing support and incentives for marketing where it could be more cost-effective and better focussed than broad based firm specific supports.

(c) Public Sector Investment. The overall level of public sector investment is too low. However, even within this limited level there is some consensus that much of the investment expenditures are not appropriate to what the current situation warrants. The reason often given is that some projects are "well along" and should be completed. This needs closer examination in line with the analysis in the recently available public sector investment review.

(d) The housing sector generally remains depressed due to lack of financing and depressed demand. The one bright area here seems to be FONAVI. This is financed by a 5 percent wage tax and benefitted from the abrupt drop in inflation. Construction began on 60,000 units since the beginning of 1986.

(e) Labor/Employment. Here, there are a number of issues. The current institutional structure is rigid. One possibility to introduce some flexibility into this market might be extension of unemployment insurance which is currently available on a highly limited basis. The second major issue here is wage costs. There are a number of wage taxes, some of which are earmarked for housing, health, social welfare. It is not readily evident that this wage cost structure may be in the medium-term interests of the state or even of the workers.

Role of the Bank

17. The Bank has not been a major actor in Argentina in recent years. However, in the current situation it is perceived as having the possibility of providing a crucial link between the country, multilaterals and commercial banks. It can direct much lending towards improving the policy milieu. In many instances results will require a few years. It can also strengthen its technical assistance. At this juncture it also seems appropriate to examine the broad institutional relationship. Are there other vehicles, for instance, for providing export financing, restructuring, generating equity participation and generally providing a much needed boost in confidence to the Argentines. In the short-term there is great need for support. While forthcoming support may not be quite comparable to a Dawes loan, it is essential to get the economy going again, support the needed institutional/policy reforms and then in the medium-term ease into a more conventional posture.

cc: Messrs. Knox, Gue (LC2); van der Meer (LCP); Pfeffermann, Jaspersen (LCNVP); Nankani (LC2DR); Balassa, (CON); Schultz (LCPIDF2); Voljc (IDF); Martinez, (LCFTR); Paz Estenssoro (LCPTR); Israel (PPD); Hanson, (INDFD); Dubey, Choksi (CPD); Kapur (INDRE); Hope (EPDED); Keare (LCPED); Batzella (EGY); Ms. Garcia De Truslow (LCPUR), Thornley (LCPA), Alber (URB), Montes (IND), Rocha (CON)

Argentina Division
Mission Members

FDMcCarthy:md

Attachment 1

ARGENTINA

ECONOMIC RECOVERY AND GROWTH MISSION

Macro Indicators

	1983	1984	1985	1st Qtr 1986
GDP (A bill. of Dec. 1985)	55.1	56.5	54.0	
Growth Rate				
GDP	3.3	2.5	-4.4	
(Industry)	7.1	0.9	-7.3	
(Agriculture)	1.9	3.9	-3.4	
Investment % (GDP)				
Total	15.1	13.0	11.3	
(Public)	6.4	3.9	3.8	
BOP ($US billion)				
Exports (FOB)	7.8	8.1	8.4	
Imports (CIF)	4.5	4.6	3.9	
C-A Def.	-2.5	-2.5	-1.1	
Public Sector-Non-Financial /1				
% GDP (cash basis)				
Expenditures	34.7	31.2	30.1	
(wages and salaries)	9.3	9.9	9.1	
(capital exp.)	7.9	6.1	6.0	
Revenues	23.6	22.9	25.8	
Deficit	-11.11	-8.3	-4.3	

/1 1983, 1984 executed, 1985 executed preliminary figures.

ARGENTINA

ECONOMIC RECOVERY AND GROWTH MISSION

Selected Data
Prices (1985)

	1985								1986			
	May	June	July	August	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	March	April
CPI /1	25.1	30.5	6.2	3.1	2.0	1.9	2.4	3.2	3.03	1.7	4.6	4.7
WPI /1	31.2	42.3	-0.9	1.5	0.6	0.7	0.7	1.0	-0.02	0.8	1.4	3.0
Exchange Rate per $US (monthly averages)												
Official	.525	.737	.801	.801	.801	.801	.801	.801	.801	.801	.801	.828
Parallel	.621	.802	.946	.953	.941	.925	.903	.855	.899	.861	.911	.923
Interest Rates /2 (Monthly)												
Regulated lending rate	32.0	18.0	5.0	5.0	5.0	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Free - Interfirm	34.1	21.4	8.1	8.2	7.7	6.5	6.6	6.7	6.7	6.7	4.9	3.8
Wages Real /3	84.6	79.4	74.8	72.6	71.1	69.8	68.2	66.1	67.4	66.3		

/1 BCRA, percentage change during period, CPI (1974=100), WPI (1981=100).
/2 Commercial Banks, 30-day money lending rates.
/3 INDEC, Industrial Wages (Base 1983=100), average of office and blue-collar series.

Attachment 2

Attachment 3

ARGENTINA

ECONOMIC RECOVERY AND GROWTH MISSION

Schedule for Report

May 15	-	Back-to-Office Report
May 30	-	Mission members submit their contribution
June 27	-	First draft
July 15	-	White Cover
July 30	-	Yellow Cover
August 15	-	Review of Yellow Cover
August 29	-	Green Cover
September 10	-	Discussion with Government

ARGENTINA

ECONOMIC RECOVERY AND GROWTH MISSION

List of Persons Met (Preliminary)

Sr. Forstuber	- Presidente, Camara de Importadores
Lic. Fernando Raimondo	- Asociacion de Importadores y Exportadores
Dr. Bordonovo	- Presidente, Camara de Industria Quimica y Petroquimica
Sr. Santiago Murray	- Director, PROYEX
Dr. Julio Alonso	- Camara de Calzados y Afines
Sres. Sebess, Barrenechea, Carou	- Bunge & Born
Sres. Robert Trbovich, Criscuolo	- Bank of Chicago
Sr. Boiero	- Assoc. Ind. Electromecanicos
Ing. Tomasini	- Ministro de Obras y Servicios Publicos
Lic. Lisandro Brill	- Subsecretaria Politica Exp.
Ing. Jorge Lapena	- Subsecretaria Planificacion Energetica
Dr. Hector Donadio	- Bolsa de Cereales
Mr. Sojit	- Consultant, World Bank
Sr. Enrique Szewach	- FIEL
Mr. Crivelli	- Techint
Sr. Eugenio Giardini	- Junta Nacional de Carne
Dr. Manuel Cywin	- Director, BANADE
Contador Villadeamigo	- Min. Obras Publicas Subsecr. Plan. Transporte
Sr. Armande de Angelis	- BANADE
Sr. Hector Martin	- "
Lic. Beba Carrizo	- Min. de Economia
Cam. Fabr. de Canos	- " " "
Dr. Bernardo Grinspun	- Sec. de Planificacion, Min. de Economia
Jorge Boga	- Assessor, COPAL
Sr. Hober Gonzalez	- Ger. General, COPAL
Sr. Dimant	- Central de Imp. y Exp. de Pieles
Ing. Enrique Martinez	- Subsecr. Gestion y Modernizacion
Sr. Rinetti	- Min. de Economia
Lic. Todesca	- Secretaria de Comercio
Jorge Alberto	- " " "
Sr. Daniel Chuvnovsky	- Latin Equip.
Sr. Hugo Nocheff	- Cam. Ind. Electronica
Lic. Enrique Bour	- Banco Central
Dr. Goyeneche	- Union Industrial Arg.
Sr. Jack Raimudin	- Presidente, Asoc. Febr. Automotores
Lic. Luis E. Garcia	- Subsecr. de Gestion y Modernizacion Ind.
Dr. Rua	- ADIMRA
Dr. Bolero	- "
Sr. Abelardo Lago	- Presidente, Asoc. Fabr. Maquinas y Herramientas

Jorge Katz	- CEPAL
Dr. Roberto Frenkel	- CEDES
Sr. Alfredo Monza	- Dir. Gral., Ministerio de Trabajo
Sr. Julio Berlinsky	- Instituo Di Tella
Sr. Machinea	- Min. de Economia
Sr. Benny Kosocoff	- CEPAL
Ing. Jorge Wolfzun	- Cia. ALPARGATAS
Sr. Borin Pacheco	- Gerente, Banco de Estado do Sao Paulo
Dr. Mario Brodersohn	- Min. de Hacienda
Ing. Carlos S. Frank	- Asst. to President, Techint
Srta. Lidia Rodriguez	- Secr. de la Funcion Publica
Sr. Mario Martinelli	- Ford Argentina
Sr. Daniel Heynman	- CEPAL
Sr. Getulio Steinbach	- IDES
Sra. Edith Pantelides	- Directora, Central de Estudios Demograficos
Sr. Arturo Goetz	- CASAR
Sr. Beliera	- Cam. Fabr. Autopiezas
Sr. Francisco Pate	- Cam. Metales No Ferrosos
Lic. Simon Guerberoff	- Banco Central
Sr. Luis Gimenez	- Banco Roberts
Sr. Norberto Wilner	- SOCKMA S.A.
Lic. Alberto Beccaria	- Min. de Economica
Lic. Lisandro Brill	- Subsecr. Pol. Exp.
Sr. Fernando Santibanez	- Presidente, Banco Financiero Arg.
Prof. Leonardo E. Dimasi	- Asesor Laboral del Presidente
Lic. Alberto Beccaria	- Director, INDEC
Lic. Beba Carrizo	- Min. de Economia
Sr. Aldo Dadoni	- Fundacion Mediterranea
Ing. Lucio Recca	- Ministro de Agricultura
Sr. Hector Dieguez	- Instituto Di Tella
Dr. Silvio Feldman	- Dir. Rec. Hum. y Empleo, Ministerio de Trabajo
Dr. Juan Carlos Gomez Sabaini	- Min. de Economia
Sr. Alvaro Orsatti	- Asoc. Arg. de Especialistas en Est. de Trabajo (OEA)
Dr. Ernesto Feldman	- Banco Central
Sr. Eduardo Trucco	- Banco de Boston
Ing. Guillermo Gotelli	- Cia. ALPARGATAS
Sr. Carlos Rodriguez	- CEMA
Sr. Cesar Allona	- Ger. Adm. y Finanzas, KICSA
Lic. Ricardo Carciofi	- Min. de Hacienda
Dr. Adolfo Blanco	- Durlock S.A.
Sr. Victori Ruiz	- Banco Central
Dr. Vicente Scelato	- Papel Prensa
Ing. Adolfo Canitrot	- Min. de Econ.
Sr. Marin Ruete	- Ger. Financiero, Bridas

Sr. Juan Carlos Masjuan	- Dir. de Finanzas, IBM
Ing. Carlos Franck	- Techint
Sr. J.C. de Pablo	- El Cronista Comercial
Dr. Ignacio Carballeira	- Generte Finan., Banco Ganadero
Sr. Jose Maria Gonzalez Hiras	- Pesquera del Atlantico
Sr. Robert Taylor	- Asesor Financiero, Price Waterhouse
Lic. Emilia Roca	- Subsecr. Planificacion
Sr. Alain Hombreux	- Vice-Presidente, Cia de Seguros Sud America
Sr. Jorge Salvinio	- Cia de Seguros Sud America
Sr. Antonio Losada	- Ger. Financiero, Banco Roberts
Lic. Amancio Lopez	- Secr. Seguridad Social
Lic. Hector Pira	- " " "
Dr. Hernan Detry	- Atanor
Sr. Guillermo Rauch	- Subsecr. Gestion y Modernizacion
Ing. Enrique Martinez	- " " " "

see Baker box for tables

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE March 5, 1986

TO Mr. Jean Baneth, EPDDR

FROM Chukuma Obidegwu, EPDCO CFO

EXTENSION 33834

SUBJECT Baker Proposal for Argentina: Review of Projections

1. Attached are tables 1 to 3 showing historical numbers and the Baker Initiative paper's Base case projections (1985 and thereafter).

2. Table 1 shows the balance of trade, the residual balance projected to finance the large interest payments, and the net capital flows projected to finance the current account deficit. Table 2 shows the projected debt and debt service by source (official and private). Table 3 shows the growth rates of values, prices and volumes in the Base case export projections. As noted in our earlier note, these are reasonable, except for those relative to "other goods" and to "manufactures". We have therefore redone three alternative projections, and examined their impact on key indicators.

Case 1. The MUV price index is substituted for the food price index in inflating the exports of "other goods" (Table 4).

Case 2. The US GNP deflator is used to inflate "other goods" and manufactured exports in place of the MUV index (Table 5).

Case 3. In addition to (2) the US GNP deflator is used for converting constant price GDP to current dollar prices instead of the MUV index - this only affects the debt and debt service to GDP ratios and not any real variables (Table 6).

3. Tables 4 to 6 show the differences between the Base case and each of the three cases outlined above, and Tables 7 and 8 show the export value growth rates obtained in cases 1 and 2. The projections are very sensitive to the price assumptions. For example, changing from the food price index to the MUV index in Case 1 results in a reduction of 4.4 percent in total exports of goods and nonfactor services by 1994 relative to the Base case.

4. In these simulations, it has been assumed that the lower exports are fully offset by higher financing. Further, for the simplicity of calculations, it is also assumed that the additional financing is not amortized during the period under consideration. Given these assumptions, the debt outstanding and disbursed in 1994 is 11 per cent higher in Case 1 than in the Base case. Debt service ratios correspondingly increase--resulting from lower exports and higher interest payments.

5. In Case 3, the only impact of the further change relative to Case 2 is to increase debt/GDP and debt service/GDP ratios.

Attachments.

CObidegwu/JBaneth/kg

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

St

DATE: February 24, 1986

TO: Files

FROM: Vinod Dubey, Director, CPD

EXT.: 60061

SUBJECT: Argentina Medium-Term Growth Framework Study - Minutes of the OPSC Meeting, January 9, 1986

Present: Members: Messrs. Stern (Chairman), Burki, Dherse, Husain, Jaycox, Karaosmanoglu, Lerdau, Knox, Ohuchi, Thalwitz, Wood

Others: Messrs. Carter, Choksi, Clements, Donovan, Dubey, Gue, Huang, Jansen, Jay, Lysy, Picciotto, Scherer, Sokol, van der Tak

1. The meeting agreed with the thrust and conclusions of the paper. The paper was explicit on the implications of accelerating growth while holding the line on modest per capita consumption growth in an attempt to obtain a turning point on Argentina's debt, where repayment could be possible. The meeting concluded that once such a turning point was reached and all external payments were made without fresh borrowing, the choices available on what to do with the foreign exchange surplus should be discussed in the paper, i.e. either repay principal on pre-1986 commercial bank borrowing, increase imports with a view to accelerating growth, increase imports so as to improve consumption levels, or accumulate foreign exchange reserves and earn interest on them. The meeting agreed that the eventual repayment of the principal of the pre-1986 commercial bank borrowing be included in the projections.

2. The meeting also requested that an explanation on the limits to grow beyond 4.5-5% in real terms on a sustained basis be included in the paper, particularly since in the growth experience of Argentina over the past 50 years, though levels of 4.5-5% had been occasionally achieved, they were rarely exceeded, and have never proven to be sustainable over any length of time. More important, it was recognized that 4.5-5% real growth was fairly respectable since population grew only at about 1.5% per annum and large productivity increases would be required in the economy to make this growth possible. In this connection, one speaker indicated that Argentina is a relatively industrialized country with a mature, albeit distorted industrial structure. Consumption levels are relatively high, income distribution is not highly skewed, and most basic needs are, even in the current slump, being met. Furthermore, Argentina is also an agricultural country, dependent on foreign markets for much of its growth momentum. These same markets show only limited potential for Argentina as the century draws to a close. While it is not unreasonable to assume that for a brief period the country could achieve an

average growth of real gross domestic product in excess of 5%, particularly in response to marked improvements in efficiency, such growth, for the reasons outlined above, would not be sustainable.

3. One speaker stated that the paper provided guidance on what needs to be done, in the Bank's perception, in terms of sectoral policies to promote growth. Several speakers indicated concern for the high level of real interest rates prevailing in Argentina. However, the meeting concluded that while medium-term inflationary expectations continued and distortions in the financial system remained, real interest rates would continue to be high.

4. The meeting agreed that the next step was to discuss the paper in the Management Committee and following that with the Fund. After completing such discussions, the paper should be discussed with the Government and presented as the Bank's view of a reasonable medium-term framework and, if possible reach an agreement on the paper. Out of this would evolve a Government medium-term economic program for growth. The paper would then become the basis for discussions of medium-term financing arrangements with the financial community.

026-01 0048

Rajapatirana, Sarath
S 9029

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Mr. Rajapatirana

DATE: January 29, 1986

TO: Mrs. Anne Krueger, VPERS

FROM: Chukwuma Obidegwu, EPDCO and Sarath Rajapatirana, VPERS

EXTENSION: 3834 and 3773

SUBJECT: **Argentina: Baker Initiative Projections**

On January 21, 1986, we, along with Mr. Armington of EPDGL met with Messrs. Carter and Sokol of LAC and Mr. Choksi of CPD to discuss the projections in the Baker Initiative paper for Argentina. Prior to the meeting, the Region provided details of the projections to us. The discussions centered on the projections for debt and debt service, the volumes and prices of export commodities, import elasticities, ICORs and the projections for public investment/public savings. After the discussions, the Region made some adjustments to correct some minor errors that had been pointed out and sent us new projections.

On the debt, the projections imply a gradual rise in the stock of debt in the rest of the 80s and a gradual decline thereafter. The ratio of debt service on long-term debt to exports falls from 67 percent in 1986 to 38 percent in 1994 and there are similar declines for the debt/GDP and interest GDP ratios.

There are three factors that contribute to this: (1) the high growth of nominal exports and GDP expressed in U.S. dollars; (2) the low growth of debt implying low additional financial requirements; and (3) the assumption that the amortization on existing private debt is rolled over until such a time the country is able to pay.

Nominal exports grow rapidly, especially in 1986-90, with a growth rate (end points) of just over 13 percent. This is a combination of real growth of 3.8 percent and price appreciation of just over 9 percent. The Region says that the real export projections for agricultural commodities are taken from an agricultural sector study they have undertaken and partially based on a model developed by EPDCS. These commodities made up 52 percent of merchandise exports in 1984. The rest are manufactures, petroleum and other goods. The "other goods" is the largest single category (23 percent of merchandise exports in 1984) and represents a group of semi-manufactures, mainly of agricultural origin. This composite group is projected to grow by just over 20 percent in nominal terms in 1986-90, consisting of about 5.5 percent real and 14.5 percent price inflation.

The price indices of exports and imports are based on the latest available EPD projections (July 1985). In general, to use these EPD price projections, there are cases where choices have to be made, for example, "other goods", for which there is no direct correspondence to EPDCS price projections. In the Argentine case, this choice is important since "other goods" represents the largest single category of exports. The Region chose the weighted price index of food commodities, which is not an inappropriate choice given that the composite group is made up of agricultural goods. However, one could have chosen the MUV index, as this group is made up of semi-manufactures. Using MUV would have resulted in lower price appreciation and thus lower nominal export growth. Another approach would be to use the EPD projections construct an index for this composite group. This would have eliminated the upward bias in the price index caused by rice and sugar, the two commodities showing very high price appreciation.

To convert the projected real GDP to nominal GDP in U.S. dollars, the MUV index is used; this conforms to the standard parctice. This causes the nominal GDP to expand rapidly in 1986-90 as the MUV is projected to appreciate rapidly. Thus the combination of the initial debt to GDP ratio, the high growth of nominal GDP and low growth of debt leads to a rapid fall in the debt to GDP ratio as well as the interest to GDP ratio. For 1986-90, the projected growth of nominal GDP is 11 percent, this falls to 8 percent in 1990-94. Interest rate on debt is assumed to be almost constant at about 10 percent. Given the initial structure of debt to GDP, debt service to exports, and the projected growth of nominal GDP and exports, it is not surprising that the debt burden declines in comparison with GDP and exports.

The projections imply negligible changes in terms of trade. But with the high initial value of exports compared to imports (ratio of 1.48 in nominal terms in 1984), the gap between projected nominal exports and imports widens (ratios of 1.57 and 1.53 in 1990 and 1994 respectively) even though real imports are projected to grow faster than real exports. Thus the resource balance improves and the financial requirement diminish. The issue here is that the projected imports may be too low and should grow faster in the recovery years since it started from a very low base (1984-85).

With respect to the low growth of imports, there are two issues: (1) the import elasticities used (overall elasticity to GDP in 1986-90 is 1.1) may be too low especially given the current depressed levels of imports, and (2) the ICORs implied by the projections are very optimistic even with the proposed policy changes. The ICORs average out at 4.7 in 1986-90 which is low compared to historical estimates of 5.6 in the 60s and 11 in 1973-80. The resulting ICORs means that the investment projections to achieve the given GDP target are too low; higher investments imply higher foreign capital requirements even with the assumed low import elasticities.

The projections assume that the amortization on existing private debt is rolled over until the country is able to pay, i.e., generated enough trade surplus to meet both interest and amortization payments. This assumption of involuntary lending by the banks is somewhat at odds with the spirit of the Baker Initiative which is that the countries meet their obligations while the banks provide enough fresh money to promote growth. In the years 1987-1990 there are no amortization payments to private creditors, thus the rapid decline in the debt service ratio on long-term debt; it falls from 67 percent in 1986 to 50 percent in 1987 and gradually thereafter. On the relationship between the export growth rate, the rate of interest and the debt burden, the projected nominal export growth rate is higher than the nominal-interest rate in the crucial period 1986-90, thus the debt burden eases. However in the Argentina case, because of the initial high resource balance, it is not necessary for the growth of exports to be higher than the rate of interest (see attached memo by N. Carter to S. Rajapatirana) for the debt burden to ease.

There is also the issue projections for public savings and public investment. The savings projections are too optimistic, rising from 6.9 percent of GDP in 1985 to 10.5 percent in 1995. The Region asserts that the savings are applied to debt repayment in the early years, and besides the high public savings ratios are targets rather than projections. However these maybe unrealistic targets and are inconsistent with the statements of continuing government budget deficits in the text. This may be due to definitional problems between fiscal and national income accounts but these inconsistencies ought to be sorted out and explained.

The Region has done a very careful projection exercise. However, the review of this work points to the need for the assumptions and other peculiarities of the projections to be clearly presented in the text and tables. It would also be useful to state clearly the differences in the parameters and exogenous assumptions between the base and high case scenarios, and what policies result in the changes in the parameters and assumptions. For commodity prices, there is a standard with which to judge the projections, however for volume projections of exports, no clear standard exists. It would be useful in this Baker exercise for the Regions to make clear what their assumptions are with respect to world trade growth. Towards spelling out the assumptions clearly and making the projections more transparent, the staff of CPD and ERS (Armington, Cortes and Obidegwu) are working this week to produce a format for all the presentations for the Baker Initiative.

In summary, the main questions concerning the projections are that the financial requirements may be too low as a result of low ICORs and import projections and somewhat optimistic export price projections. The exclusion of the debt service ratio on existing private debt does not give an accurate picture of debt servicing obligations.

Attachment

cc: Messrs. J. Baneth and R. Chopra, EPDDR
H. Cortes, VPERS
P. Armington, EPDGL
N. Carter, LC2DR

CObidegwu:rcs

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE January 16, 1986

TO Mr. S. Rajapatirana, VPERS

FROM Nicholas G. Carter, LC2DR

EXTENSION 72013

SUBJECT Argentina Baker Initiative Projections

1. Attached, as discussed, are the detailed printouts of the projections we used in writing our "Baker" paper for Argentina. As I pointed out, the model is a standard RMSM with the exception that real per capita consumption is specified as a target and thus GDP is determined endogenously, from the expenditure side, by the model.

2. The notion that the "export growth rate must be greater than the interest rate" in order to overcome a debt problem, is a perhaps useful, but certainly not universal rule of thumb. It also suffers from dimensional problems (debt is a stock, exports are a flow). The Argentine case is an instance where the "rule" does not hold. Consider the following very simple model of debt:

1. $dD = M - E + iD$

where M, E, and D are imports, exports and debt, and i is the interest rate. This yields:

2. $dD/D = M/D - E/D + i$

3. The problem is then to look for conditions such that $dD/D < 0$. In the Argentine case, there is a large resource surplus, equivalent in 1985 to 8.5% of the total stock of debt, leaving a shortfall of only 1.5% when compared to the roughly 10% interest rate. Given that the interest rate is projected to be approximately constant over the projection period, all that is necessary to overcome the debt problem is for the resource surplus to debt ratio to grow until it exceeds the interest rate, and this is in fact what happens in the Argentine projections. Note that in the short run it is not even necessary to require that exports grow faster than imports provided that they are sufficiently larger than imports. Once the resource surplus exceeds interest payments, debt can be paid off and the "problem" collapses very quickly. This is an interesting variation on the debt problem and one that not surprisingly, has not been explicitly dealt with before.

Attachments

cc: Messrs: Sokol LC2PB, Hwa EPD

NGC:pw

P 1866

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

JAN 29 1986

OFFICE MEMORANDUM

cc SR

DATE: January 28, 1986

TO: Mr. Ernest Stern
(through Mr. A. David Knox)

FROM: Miguel Schloss, Acting Director, LC2

EXT: 72255

SUBJECT: ARGENTINA - Proposed Agricultural Sector Loan; Summary of Negotiations

1. This is to record the principal developments during the recent negotiations on the above mentioned loan. The negotiations were concluded on January 17, 1986 in meetings with the chief Argentine representative, Mr. R. da Bouza, Director of External Finance, Ministry of Economy. He was accompanied by Messrs. Abramovich and Peyrou of the Agricultural Secretariat and Mr. Garramon (consultant). Messrs. Sokol, Abbott and Oliver conducted the negotiations for the Bank, with Mr. Nissenbaum also participating. We were able to negotiate the proposed loan essentially on the terms and conditions approved by the Loan Committee on December 6, 1985 (ref. LC/M/86-01). There were three principal changes, discussed below.

2. Import Licensing. We obtained assurances of Government action to remove fully assembled tractors and agricultural machinery from the "prohibited" classification of import goods. The Argentines asked, however, and we agreed, that the tractors and machinery be classified under the "automatic entry" classification as a condition of the loan's second (rather than first) tranche. They noted that the prices of these items which are made in Argentina are competitive with those of comparable imports, since they are an exporter of such items. More important, the negotiators contended, imported tractors and machinery are sold in Argentina under attractive financing terms which domestic manufacturers could not match because of the credit restrictions of the Government's stabilization program. They felt that this would penalize domestically-produced tractors and agricultural equipment and impair the recovery of the industrial sector. On this account, and in order to give the Government more time to consider providing credit for locally produced agricultural machinery, we agreed to redesignate the classification of these items in two steps; i.e., from "prohibited" to "prior approval" as a condition of effectiveness, and from "prior approval" to "automatic entry" as a condition of the second tranche.

3. Import Tariffs. The Argentine negotiators agreed to provide assurances of the removal of the temporary increases in tariffs on agricultural imports imposed in June 1985. They concurred with the removal of these increases affecting fertilizer, and voluntered to advance this action from a condition of effectiveness to a prerequisite for Board Presentation. However, with respect to herbicides and other agricultural chemical inputs, they requested that the elimination of the temporary increases in tariffs covering these items become a condition of the second tranche. Their argument was that, since the major part of insecticide and

herbicide imports would not be required in large amounts until the end of 1986, the postponement of the import tariff reduction would not affect production possibilities. More importantly, given the size of the Government's fiscal deficit, the Argentines requested a delay in the tariff's removal in order not to lose the US$5 million equivalent in revenues involved, which might be needed to meet the public sector deficit quarterly target agreed with the Fund. We agreed for these reasons.

4. Export Taxes. The Argentine negotiators agreed to the removal of the temporary increases in export taxes imposed in June 1985. Here too, however, they requested a change in the timing of this action in order to better align it with agricultural production practices in the country and to soften its impact. The Government has, in fact, already removed the temporary increase in the case of wheat (a winter crop). The export tax for wheat is now below the May 1985 level. For other crops, the Argentines proposed to make the reduction a condition of loan effectiveness, in place of a condition of Board Presentation. They contended that the fiscal revenues that would be lost (under the earlier deadline) were very important to meet the public sector deficit quarterly target agreed with the Fund. They also stated that a two-month delay in reducing export taxes would not affect incentives to farmers' production since the new price signals are not required before the projected time of the release of the first tranche. On this basis, we agreed.

5. In this connection, the Argentine negotiators expressed considerable concern that the present declining world market prices for their agricultural exports may pose problems for their projected elimination of export taxes in January of 1987, the envisaged date for release of the second tranche. They speculated that these prices might fall even more than the Bank's projections foresaw. If so, the Government feared that it might not be able to fully reduce export taxes on all agricultural products to exactly the 70% of the May 1985 levels specified in the loan covenants if it were to continue complying with the IMF stand-by targets. They therefore requested the possibility of compensating for such exogenous factors. In response, we agreed to propose to Management that the extent of the export tax reduction needed to release this tranche could, alternatively, be determined by Bank-Government agreement on a level which would be based on a reasonable forecast of the fiscal revenues to be generated by the Federal land tax and such other fiscal measures affecting public sector revenues and expenditures in 1987. The draft Loan Agreement also provides that the Government satisfy the Bank that it has prepared (condition of effectiveness and put into effect (second tranche) fiscal measures sufficient to compensate for any revenue losses resulting from the aforementioned reduction in export taxes without increasing agricultural sector taxation. The minutes of negotiation record that the Government will provide the Bank with details on the entire budget for our examination to ascertain compliance with these conditions. In this connection, we agreed during negotiations on a side letter which defines how the export tax reduction would be calculated.

6. In addition, you requested that the schedule for preparation of the land tax provide satisfactory arrangements for its approval and implementation prior to disbursement of the second tranche. The minutes of

negotiation record that the enactment and initial implementation of the land tax would be criteria of "satisfactory progress" for the release of the second tranche.

7. Finally, the Argentine Delegation requested the use of the Brussels Tariff Nomenclature Code to define the products ineligible for Bank financing since its Central Bank uses this nomenclature, rather than the SITC provided by the standard IBRD documents. After consultation with PPD and following the precedent of the recent SAL credit to Malawi, the Bank negotiators agreed to this request since we believed that it would facilitate disbursement of the proposed loan.

cc: Messrs. Qureshi, SVPFI; Husain, OPSVP; Shihata, LEGVP; Mrs. Krueger, VPERS; Rajagopalan, PPD; Gue, LC2DR (o/r); van der Meer, LCPDR; van Gigch, LCPDR; Otten, LCPAC; Scherer, LC2PB (o/r); Quijano, Pfeffermann, LCNVP; Dolenc, LCNVP; Carter, LC2DR; Collell, LEG; Barahona/Grothe, LOA; Ebiri, McCarthy, LC2PB (o/r).

Cleared with and cc: Sokol, LC2PB; Abbott, LEG; Oliver, LCPAC

HJNissenbaum:jvw/mac

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

SH

DATE January 24, 1986

TO Mr. Ernest Stern
(Through: Mr. A. David Knox)

FROM Spiros T. Voyadzis

EXTENSION 72181

SUBJECT Argentina Debt Workout Paper: Discussions with ERS

Per your request, please find attached a memorandum which reflects the discussions that have taken place with ERS on the Argentina debt workout paper. All issues of substance have been resolved.

Attachment

cc: Mr. Rajapatirana, VPERS

NGC:pw

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 24, 1986

TO: Mr. Spiros T. Voyadzis, Acting Director, LC2

FROM: Nicholas G. Carter, LC2

EXTENSION: 72013

SUBJECT: Argentina - Debt Workout Paper

1. Following the Management Committee meeting on this paper, we were asked to meet with ERS to clear up several questions they had concerning the paper and its methodology. Accordingly, we sent them a complete copy of our background calculations and then Jose Sokol and I held a meeting with Messrs. Rajapatirana, Choksi, Obidegwu and Armington on January 21.

2. A question raised at the Management Committee meeting was whether Argentina could work its way out of the debt problem if "the average interest rate on external debt was greater than the growth rate of exports." It was explained to ERS that this observation, which relates to the evolution of several creditworthiness indicators, was useful only in situations where trade was in balance or in deficit. In the Argentine case, there is currently a large trade surplus which serves to offset the effects of the interest rate. They agreed with us that in the short run a trade surplus was more crucial to solving a debt problem than was the long run growth or exports or, in fact, the interest rate itself.

3. It was pointed out that the Debt/GDP ratio on Table 2A seemed in error (CPD had made the same observation); in fact, this is a typo which does not affect the underlying analysis and will be corrected in the next version. ERS also raised several minor points on the model itself, the most significant of which results in a small improvement of the outlook in the base case after 1990.

4. A more general question was raised concerning the fact that (a) the ICOR in the projections (1986-94) is significantly lower than past averages; and (b) that the ratio of imports to GDP is also lower than past experience. The answer to the former concern is part of our overall assertion that the Plan Austral is the base for our analysis of Argentina. The changes in the performance and efficiency of the economy which are implicit in the Plan include a significant lowering of the ICOR. A similar argument applies to imports, with the added observation that restraint on imports is vital for a debt workout, and that after the point where it was no longer necessary to obtain net inflows from the commercial banks (and thus where total debt outstanding could begin to fall) the authorities could opt for the choice of significant increases in imports. However, the framework of our analysis was such that the model assumed excess foreign exchange would be used for the repayment of 1982-85 debt arrears.

5. There are in addition two points that remain to be worked out. First, ERS is not comfortable with the tables attached to the paper and would like to propose "a more transparent presentation". Second, they are not in agreement with the presentation of commercial bank debt and would

/...

like to see tables showing the payment of all amortization due with corresponding inflows in the form of "voluntary" lending. Our presentation treats these transactions on a net basis for all commercial debt contracted prior to the beginning of 1986. These two points are presentation problems rather than issues of substance and affect the guidelines for all the debt workout papers, not just the Argentina one. ERS has agreed to come up with new presentation guidelines in collaboration with CPD. We will not, however, give to the Argentinians any papers dealing with the possible sources of external funds.

6. Finally, the question of commodity and inflation forecasts. The analysis of all the debt workout papers is based on EPD guidelines issued in September. These in turn were based on the June 1985 commodity and inflation projections. EPD was scheduled to issue new projections last month, but as a result of the unsettled petroleum market this was delayed. When these data are made available we would expect to incorporate them into our projections, ideally before we discuss the paper with the Argentine authorities. However, we do not expect such revised projections to affect materially our assessment of the future of the Argentine economy.

cc. and cw: Mr. Sokol
cc: Mr. Rajapatirana

Comments to the Report and Recommendations on a Proposed Agricultural Sector Loan to Argentina (Report No. P-4161)

1. The state of the economy

In mid June 1985, the Government of Argentina implemented a stabilization package the centerpiece of which was the announcement of a commitment not to print money for financing fiscal deficits. The companion policies of this stabilization program were: strictly enforced controls on wages, prices and the exchange rate; significant increases in real prices of goods and services produced by public sector enterprises; and increased taxation on wealth and, in particular, on foreign trade through increased export taxes and import tariffs.

In June the monthly inflation rate as measured by the CPI was 30.5%. Since then this figure has been: July 6.2%; August 3.1%; September 2.0%; and October 1.9%. As a consequence of natural disasters (floods), that resulted in a reduced supply of foodstuffs, inflationary pressures during November have increased. Assuming a 3% inflation rate for November, accumulated inflation since the introduction of the stabilization program is 17.2% (five months).

This inflationary trend under a fixed exchange rate regime is dangerous. Expectations of devaluation approximated by the difference between the black market and official exchange rate remain positive. Since June 1985, this differential - which could also be attributed in part to exchange controls - has fluctuated between 7% and 15%. Because of this, and also because the basis of the fiscal adjustment has been increased taxation the incentives for capital flight remain high. This flight is being halted by a restrictive monetary policy, and the annual real interest rate now stands at 40-50%.

Lending money under this situation is risky for the World Bank and can be costly to Argentina. The worst that could happen to this country is for loans to be transferred abroad as capital flight while at the same time, recording an increase in foreign debt.

The current characteristics of the stabilization program cannot last much longer. The price and wage controls must be lifted, and the size of the public sector must be reduced. I cannot think of any scenario under which Argentinians will decide to bring back their savings, while at the same time, the size and economic role of the Government remains unchanged and tax pressures remain high. Estimates put accumulated capital flight at around US$25 billion. No one could lend to Argentina as much, and nothing could be better for this country than nationals reinvesting part of their savings in their own country.

The loans being considered by the World Bank to Argentina do not addres the issue of the economic role of the Government, and how to reduce it. Also, they do not analyze the determinants of capital flight. This agricultural sector loan is no exception. Therefore, my first comment is for the loan to incorporate a sector discussing the determinants of capital flight - probably the single most important problem of the Argentine economy - and how this loan would help to reduce this flight.

2. Characteristics of the loan

Paragraph 58 of the Draft President's Report states: "An agricultural sector loan of US$350 million is proposed, including the financing of complementary studies and institutional development amounting to US$9 million. The loan would support the Government's efforts to depart from its reliance on easily-collectible but production-negative export taxes for agricultural sector taxation, and to introduce an effective federal land tax. Loan proceeds totalling US$341 million would finance general imports and would be released in two equal tranches following compliance with conditions for their release (paras. 61 and 62)."

The conditionality of the loan is stated in paragraphs 60, 61 and 62. To quote the main parts:

a) Para. 60 states that: "Presentation of the proposed loan to the Board would be contingent on: (a) submission to Congress of a draft land tax law acceptable to the Bank; (b) the removal of the temporary increases in export taxes imposed in June 1985; and (c) presentation of a program (to be approved by the Bank) for preparation of the land tax schedule, . . ."

b) Para. 61 states that: "The first tranche of US$170.5 million, projected to be disbursed before June 30, 1986, would be released upon effectiveness of the loan, which is subject to receipt of evidence of: (a) removal of the temporary increases in import tariffs on agricultural inputs imposed in June 1985 and redesignation of tractors and agricultural machinery to the "prior approval" classification for imported goods; and (b) definition and approval of alternative tax provisions in amounts sufficient to compensate for any revenue losses resulting from the export tax reduction and to ensure fiscal stability without increasing the overall tax burden of the agricultural sector as compared to its May 1, 1985 level. . . ."

c) Para. 62 states that: "The second and final tranche of US$170.5 million, projected to be disbursed in January 1987, would be released after receipt of evidence of: (a) reduction of the export tax on agricultural commodities to no more than 70% of the rates in force on May 1, 1985, except for meat products which should not be greater than the rates existing then; (b) the Borrower has put into effect alternative tax provisions that will generate additional fiscal revenues in amounts sufficient to compensate for any revenue losses resulting from the export tax reduction without increasing the overall tax burden of the agricultural sector as compared to its May 1, 1985 level; and (c) the Borrower shall have made satisfactory progress in implementing the agreed land tax preparation schedule (para. 59), including a simulation of the fiscal revenue effects (federal and provincial) of the land tax rates included in the land tax program (para. 53), and all studies being financed under the loan."

Finally paragraph 63 states that: "A total of US$341 million of the sector loan would be disbursed within 12 months of loan effectiveness against general imports, excluding specific items. This is appropriate because: (a) there are currently no restrictions on the acquisition of foreign exchange for imports of agricultural inputs; and (b) the limited volume of eligible agricultural imports would not allow quick drawdowns of each tranche."

3. Comments and Recommendations to ERS

a. This loan was envisaged initially to support the substitution of export taxes by a land tax. In theory this is good policy. The original idea and the economic principle behind it have gone down the drain.

Now, the conditionality is that the reduction in export taxes be substituted by ". . . alternative tax provisions in amounts sufficient to compensate for any revenue losses resulting from the export tax reduction. . ." This is bad economics and bad politics. It is bad economics simply because there is no tax as distortion free as the land tax, and there is no basis for assuring that resource allocation will improve if export taxes are substituted by other taxes. Also, there is nothing inherently good in the May 1, 1985 date. The null hypothesis which I would put forward is: at this date the tax pressures on the agricultural sector were excessive. It is also bad politics simply because, I cannot see why this switch - export taxes by other taxes - will buy votes for the Government.

I would suggest that the Bank relinquish the suggestion to increase other taxes. My second recommendation is therefore, for the World Bank to request the Government to present a plan for reducing government expenditures in an amount commensurate with reduced export tax revenues, i.e. just forget about the idea of raising general taxes. I don't think this can be done, and in any case as said, it is bad policy for Argentina.

There are three additional comments which ERS has made before and which this new version does not incorporating. These comments refer to exchange rate policy, the import regime for intermediate and capital goods for the agricultural sector, and the use of reference prices.

b. With regard to the exchange rate, the loan is predicated on the belief that ". . . the government has committed itself in its agreements with the IMF to exchange rate adjustments that would maintain export competitiveness." (para 34). The loan does not discuss precisely the nature of Argentina's deal with the IMF. In any case, since June 1985 there has been no adjustment of the official exchange rate, and export competitiveness at least vis a vis the US has been declining.

The Bank cannot justify this loan without making every possible effort to make sure that a sustainable relative price shift in favor of exportables will eventually take place. Therefore, my third recommendation is for the Bank to discuss exchange rate policies more thoroughly. If the Bank cannot incorporate some form of exchange rate conditionality, it should discuss at the minimum some targets on trade balance, i.e. imports will increase but so should exports. Otherwise there is s real danger that the money will be used to maintain disequilibriums and currency overvaluation.

c. Once again, the loan is hiding the true dimension of the problems associated with the import regime and in particular those referring to intermediate imports and capital goods for the agriculture sector. Prior to the release of the first tranche the Government must show evidence of removing ". . . the temporary increase in import tariffs on agricultural imports imposed in June 1985, and redesignations of tractors and agricultural machinery to the 'prior approved', list. . ." These would reduce only marginally, if at all, the discrimination that the agricultural sector suffers from the import regime.

This loan ignores what has been said elsewhere on the Argentine import regime. Report No. 58416-AR Argentina: Strategies Towards Industrial and Export Development, September 1985, p82, concluded that ". . . 1,300 positions in the Import Nomenclature correspond to goods that can only be imported subject to a prior consultation regime. In the local jargon, this is known as Anexo II; imports under this category represented 10% of the 1984 imports. In these cases, the DJNI (Declaración Jurada de Necesidades de Importación) applications are channeled through the Secretaria de Industria to the Camara (Producers' Association) of the specific industrial branch. In theory, the Camara just voices its opinion, although, in practice, the Secretaria de Industria always follows the recommendations of the Camara. If the Secretaria de Industria/Camara yields a positive opinion, the DJNI is issued without any further consultation with the Comision Asesora Honoraria de Importaciones. If the opinion is negative, the case is brought to the attention of the Comision which, in most cases, will rubberstamp the recommendation of the Secretaria de Industria/Camara. Again, price competitiveness is not a significant consideration, and the criteria tend to be even more protectionist than in the case of goods covered under Anexo I (import prohibitions) since the private sector input in the decision-making process is supposed to be completed within three weeks; in actual practice, however, it may take up to two to three months, especially when the Secretaria de Industria must get the opinion of two or more Camaras involved. . . ." I agree 100% with this analysis and consequently the conditionality of the loan of shifting tractors and agricultural machinery to the prior approval list is meaningless.

Therefore, my fourth recommendation is simply that if the World Bank is serious about reducing the direct discrimination suffered by the agriculture sector because of import regime, then non-tariff barriers on all intermediate inputs and capital goods for agriculture should be substituted by ad-valorem tariffs. This could be monitored by assessing periodically how much imports are increasing in the corresponding tariff lines. Better perhaps, would be for part of the loan to be disbursed against these types of imports and not against general imports as currently suggested.

Having said this, I should mention a couple of misgivings I have about this conditionality. First, there is the broader question of how the import regime, in general, affects the agriculture sector. My impression is that for this sector, this is a more fundamental issue than the narrower one addressed by this loan.

Second, the loan should discuss the economic consequences of undertaking a partial import liberalization for agriculture. The loan should also consider the extent to which a discriminatory and partial reduction of import barriers could have adverse consequences for a broader import liberalization that the Government may want to undertake in the near future. The political reaction to a partial liberalization might be important, therefore jeopardizing the political commitment that could begin to be built for a broader trade liberalization attempt.

The fourth comment is a minor one and refers to the possibility that the reference prices used as the basis for levying export taxes could be adjusted upwards to compensate for the reduced export taxes to maintain revenues. This possibility is not contemplated in the report. My fifth recommendation is to include this possibility as part of the analysis.

I will put my fifth and final comment in question marks. How can the World Bank ever justify spending US$9 million in technical assistance for agriculture? 1/ Do we know how this money will be invested? Isn't this amount a confession that the knowledge, the World Bank has of the Argentine agricultural sector, is inappropriate for justifying a loan of US$350 million?

4. Final remark

My impression is that since the early 40s no government of Argentina has had as much a commitment to work in favor of the national (as opposed to sectoral) interest as that of President Alfonsin. Without a shadow of doubt it deserves and needs the political support of the international community.

But on the economic front the problem is different. One needs

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1/ The Bank is about to approve or has approved another Technical Assistance Loan for Argentina of around US$10 million.

first to build the confidence of the private sector. The confidence is not built by wage-price controls and increased taxation. Perhaps this was necessary in the short-run for breaking inflation expectations. But now, nearly six months after implementation of the stabilization program, these controls and taxes are damaging both private confidence and resource allocation. The likelihood for a successful and long-lasting stabilization under these conditions is not high.

Alfonsin is a charismatic leader and has the political support and strength for making structural changes that enhance the national interest of the country. He needs to phase out rapidly wage-price controls and reduce government expenditures. Later, he needs to open the economy. But most important of all, President Alfonsin and more generally the leadership elite need to be convinced that this is an appropriate course of action for Argentina. Otherwise, conditionality is meaningless.

When one looks at the problem in this broad way then the strategy of sectoral lending that is being followed by the World Bank does not appear to be appropriate to the needs of this country. Sectoral projects do not address global issues. But if macro-problems and policy-induced rigidities are not addressed and phased out, and the confidence of the private sector strengthened, then loans to Argentina will increase the debt burden of this country without changing its capacity to repay it. If, in any case, these loans are made, then I'm convinced that "the apparent solutions of today's problems compound tomorrows's problems."

Julio J. Nogués
January 9, 1986

Comments to the paper on "Argentina: Baker Initiative Country Study

I. Introduction

The paper assumes that the Austral stabilization program will stick. I will start by summarizing my recent comments which argue that, there are several signals suggesting that agents still don't believe that this will be the case. In my view, future versions of the paper should discuss the link between stabilization and structural reforms more thoroughly.

The second section will present some specific comments on some of the numbers in the paper, while the final section will discuss the strategy prepared for implementing the Baker proposal.

II. Sustainability of the Austral Stabilization Program

In mid June 1985, the Government of Argentina implemented a stabilization package, the centerpiece of which was the announcement of a commitment not to print money for financing fiscal deficits. The companion policies of this stabilization program are: strictly enforced controls on wages, prices and the exchange rate; significant increases in real prices of goods and services produced by public sector enterprises; and increased taxation on wealth and, in particular, on foreign trade through increased export taxes and import tariffs.

Ex-ante, the target was to reduce the fiscal deficit from around 12.5% of GDP recorded during the first semester of 1985, to 2.5% during the second semester. I understand that this later figure is now in the 3% - 3.5% range. On average, it is estimated that the reduction of the fiscal deficit was accomplished 75% through increased government revenues and 25% by reduction of expenditures and particularly, real wage reductions of public sector employees.

In June the monthly inflation rate as measured by the CPI was 30.5%. Since then this figure has been: July 6.2%; August 3.1%; September 2.0%; October 1.9%; November 2.4% and December ~~2.5%~~ 3.2 ~~(expected)~~.

The stabilization plan is now facing some problems of both domestic and external origin. In fact, monthly surveys of price expectations - although with a declining trend, have shown that they are systematically above recorded inflation rates. There are several real factors which might be entering into the formation of price expectations. These include:

- Expectations of wage increases. Starting in January, the government has granted a 5% wage increase. This has left labor union leaders quite unsatisfied and in fact, a national strike has been announced for January 24, 1986.
- Expectations of devaluation fuelled by continued domestic inflation above international levels. Also, bad weather has reduced the 1986 crop and as a consequence, the export cost for 1986 is put in the neighborhood of US$ 500 million.
- Lack of policy coordination and commitment. So far, the economic group at the Ministry of economics is 100% comitted to price stabilization. But this group does not control all government expenditures. Until recently, this was the case with public enterprises. In fact, the targetted fiscal deficit of 2.5% of GNP for the second semester of 1986 was not accomplished because YPF - the state owned oil company - increased its expenditures. Since late December, all public enterprises are under the control of a new State

Secretariat, and hopefully the budget of these enterprises will begin to be closely monitored.

Given this scenario, it is reasonable to argue that the incentive for capital flight - a topic that is nowhere discussed - remains high. In order to check this flight, the government has to follow contractionary monetary policies which in practice implies real interest rates of 40%-50%. Clearly if this process continues, a financial crisis will sooner or later emerge. Under the assumption that the government maintains its commitment not to print money to finance the fiscal deficit, the urgent policy actions which in my view will reduce uncertainty and boost the confidence of the private sector are:

- Move to a more flexible exchange rate system and phase out price-wage controls. This is easier said than done, particularly in a scenario where price increases might trigger the resurgance of a wage-price spiral inflation. Nevertheless, this is absolutely necessary and in my view, the elimination of controls should be accompanied by a stringent monetary policy and most important of all, by a Presidential announcement that the commitment not to print money for financing fiscal deficits will be maintained. This might trigger a short-run decline in output, but the alternative to this is a costly crisis similar in nature to the one suffered by Argentina in the early 80s.
- Implement some drastic reductions of government expenditures. This could imply privatization of some major public enterprises and reduction of public sector employees. 1/

1/ For example reduction of 100,000 government employees while keeping them on the payroll for one year would cost approximately US$ 300 million. Golden handshakes financed by World Bank loans are in the Argentine situation socially profitable.

- Announce some tax reductions. Argentinians are constantly making cost-benefit analysis of whether or not to pay taxes. As government expenditures have increased - and in 1984 they represented 59% of GDP - and higher tax rates and new taxes have been introduced, total tax collections as a proportion of GDP have been declining. 1/ It is reasonable to hypothesize that, the situation is such that those who pay taxes are in fact those who expect to receive a subsidy from the government. The widely held belief that the Argentine government is highly inefficient has been documented in recent polls which show that a majority of the population favores privatization.

These are priority actions. I see few chances for a long-lasting price stabilization and therefore for structural reform policies if these suggestions are not implemented urgently. Only after price stabilization and macro-economic stability have been assured, and the confidence of the private sector has been boosted, should other major policy actions be implemented. As said, the paper under analysis ignores these issues. This in my view, is its major shortcoming.

II. Specific comments

The paper has several tables including numbers cranked out of a model which is nowhere specified and whose mechanical output depends on assumption of a base period. Given that apparently there is little economics behind the analysis, I would suggest deleting this from the body and including it in the appendix.

1/ Today this proportion is 20%.

Other specific comments include:

- p. 2 para. 7. Argentina grew at an average annual growth rate of 9% between 1900 and 1925. Why assume a 4.5% growth rate for the upcoming years?
- p.4 para. 12. The level of the real exchange rate might be appropriate but as said before, the accompanying policies to the fixed exchange rate are such, that expectations of devaluations are mounting. It is necessary to move to a more flexible regime.
- p.4 para 14. Real export growth is expected to be 5%. Under the good conditions assumed in the paper, I don't see why export growth could not be higher. This would occur if international prices of commodities start to grow as the dollar depreciates, and a free trade regime is created for manufactured exports. These exports in recent years have declined while those of other developing countries have surged.
- The estimate in page 5 of the appendix (para. 13), on intermediation spreads is too high. At most they are in the order of 2%.

With regard to the figures in the tables:

- Figures in Table 1 on real export and import growth rates do not match with my numbers. For example, according to my estimates the real export growth rate was 1.1% during 1984. Preliminary estimates for 1985 show that in nominal terms, they have stagnated. This compares with a real growth rate of 12% used by the World Bank. Correcting these figures is important for at least being accurate in the base period.
- The figures of total outstanding debt in Table 2.A do not match with

those in Table 4.1. For 1990 there is a difference of US$ 1.8 billion.

- Between 1985 and 1990 estimated disbursements are US$ 14.7 billion. (Table 3.A.2). On the other hand, repayments for the same period add to US$ 5.2 billion. (Table 3.A.3). The difference should be increased debt which does not match the debt figures presented in Table 2.A.
- Table 2.A shows that the debt-service ratio declines from 61% to 42%. Balance of payments figures and assumptions on interest rates should be included in order to disentangle several of the variables such as the debt-service ratio. In principle, this ratio cannot decline unless the real interest rate is lower than the real export growth rate. According to country economists of the region, part of the explanation comes from here. There is apparently another assumption put into the model according to which the amount of short term debt will decline. Short-term debt is basically debt associated with trade flows. Why this debt should decline, and how this consumption works in the model is totally unclear for me.
- In this same table it is not at all clear what explains the increase in public savings while private savings stagnate at a level of 11% of GDP. Also why does this figure decline to 10.9% in 1988.

III. Lending Strategy

Overall, the paper reads as a justification of the lending strategy that the World Bank has devised over the last months. The details of this strategy are presented in the appendix where numerous sectoral and policy based lending projects are presented. The analysis presented here strikes me as a fishing expedition, where the energy has been put in covering all possible aspects of a loan, and not on whether the sum of all projects is good or bad for Argentina. There are risks associated with this lending strategy. I want to give a couple of examples, and then suggest that there might be superior strategies of implementing the Baker proposal.

The greatest risks I see, is that many of the ideas that are included in the pipeline of projects are not good for Argentina. Take for example, the agricultural sector loan that seeks to substitute export taxes for a land tax. As this World Bank document states the ". . . reform of agricultural sector policies will be criticized by the conservative agricultural producers who are dead set against a land tax" (p.13 para 41). There is every reason to justify this reaction. International prices of Argentine exportables are at an historical low level. In addition export taxes, numerous other taxes, inefficiencies of public sector services such as roads and ports, price controls, etc. imply that in recent years, the agricultural producers have had low or even negative rates of return. I know this from my own family's experience.

But probably of greater importance for determining the political reaction of landowners is that they expect that export taxes will never be eliminated. At most the World Bank loan might only give them a two year assurance of lower export taxes. Landowners expect that the land tax will in the end be added and not substracted from other taxes. They are unhappy with these World Bank loan.

A similar conclusion can be stated with regard to other objectives of the World Bank. For example in p. 7 of the appendix (para. 20) the objective is to raise tax revenues from 20% of GDP to 25% by 1990. This is bad economics and bad politics.

There might be other ideas which might imply risky suggestions and/or inconsistencies between loans suggested in the pipeline. In attempting to be more constructive, I would like to suggest an alternative way for implementing the Baker proposal. This is for the World Bank to agree with the government of Argentina on what are the fundamental problems of this economy. Based on this diagnosis a lending program could be build and simple indicators used to monitor targets. In my view these basic problems are:

- the government spends too much
- the economy does not export and grow

Assuming that this is the case, the World Bank would agree with the Government of Argentina on a program that would address these issues. Compliance and disbursements could be monitored through simple indicators of reduced government expenditures and increased exports. The specifics of how to reduce expenditures and attain export targets should in principle be left to Argentina. Obviously, the technical advice of how to do things will remain of importance, but in my view, it is the government through its own experience and learning process which should design a feasible sequencing of sustainable policy actions.

The benefits of this strategy are several. From a World Bank point of view

- it reduces the World Bank resource costs of thinking of every possible loose end in numerous sectoral loans;
- it minimizes the number of times when confrontational dialogues between the World Bank and the Government of Argentina might take place regarding numerous conditionalities;
- it minimizes the risks of the World Bank making inconsistent recommendations as exemplified above;
- it moves the World Bank in favor of the private sector, and therefore improves the image it has in Argentina. Some people in the private sector of Argentina feel unhappy about so many World Bank loans to the government.

But probably most important of all, it recognizes that the politics of the policy actions are best understood by the Argentinians themselves. It is they who are in the best position to design politically feasible and sustainable welfare increasing policy actions leading to reduced government expenditures.

January 7, 1986

Mr. Julio Nogues

Julio,

RE: Argentina - Baker Initiative Country Study

The Managing Committee has been asked to consider for Monday, January 13, 1986 the paper: Argentina - Baker Initiative Country Study. I would appreciate it if you could prepare a brief on it for Mrs. Krueger. The paper is enclosed. (Kindly return the paper with your brief.) Could you please send your brief to me by c.o.b. Thursday, January 9, 1986. Thank you.

Sarath

Sarath Rajapatirana
Chief, Policy Analysis Unit

cc: Mr. Finger, DRDIE
Mr. Ingram, DRDDR

THE WORLD BANK

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LOAN COMMITTEE

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January 6, 1986

19

Minutes of Loan Committee Meeting to Consider
ARGENTINA - Agricultural Sector Loan
Held on December 6, 1985 in Conference Room E-1208

A. Present

Committee:

Messrs. E. Stern (Chairman)
Husain, OPSVP
Gue (Acting RVP)
Michalopoulos (Acting VPERS)
Wood (Acting SVPFI)
Scott (Acting LEGVP)

Others:

Messrs. De Azcarate, CPDDR
van der Meer, LCPDR
Pfeffermann, LCNVP
van Gigch, LCPDR
Otten, LCPAC
Collell, LEGLC
Abbott, LEGLC
Sokol, LC2PB
Lysy, PBDCP
Clements, SVPOP
Lewis, AGREP
Fitchett, AGREP

B. Issues

A meeting of the Loan Committee was called to discuss the proposed Agricultural Sector loan of $350 million to Argentina as described in the documents submitted to the Committee under cover of a memorandum dated November 22, 1985 from the Acting Regional Vice President. The discussion focussed on the issues outlined in the Country Policy Department's memorandum of December 5.

C. Discussion

1. Introduction of land tax: The Committee raised questions about the timing of the measures which the Argentines proposed to undertake in order to bring about one of the major objectives of the policy package supported by the proposed loan: the reduction and eventual elimination of the export taxes on agricultural products. The Chairman stated that the introduction of a federal

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COMMITTEE
Senior Vice President, Operations (Chairman)
Senior Vice President, Finance
Vice President & General Counsel
Vice President, Operations Policy
Regional Vice President concerned*
Vice President, Energy & Industry (for lending in these sectors and SALs)
Vice President, Economics and Research (for non-project lending)

OTHERS
Standard (see OMS 9.25 page 7)

*Copy to all other Regional Vice Presidents land tax was an essential component of the desired reforms. He therefore concluded that the schedule for preparation of the land tax (to be approved by the Bank before Board Presentation) ought to provide satisfactory arrangements for approval and implementation of the tax prior to the disbursement of the second tranche.

2. Fiscal Measures. The Committee also raised a question as to whether Government expenditures might be reduced so as to offset any reduction in revenues from the elimination of export taxes. It was agreed that, apart from new revenues, expenditure reductions could compensate for the revenue reduction from the export tax losses. In this connection, the release of the second tranche would be conditioned on the Borrower putting into effect fiscal measures sufficient in total to compensate for any revenue losses resulting from the export tax reduction.

3. Import Licensing. The Committee asked about the proposals for modifying the discriminatory effects against agriculture of the import licensing system which the Government introduced in 1983. The Region had proposed that fully assembled tractors and agricultural machinery, currently the only agricultural inputs prohibited, be redesignated from the "prohibited" to the "prior approval" classification for imported goods. After discussion, the Chairman concluded that the change, a proposed condition for release of the loan's first tranche, should instead provide that tractors and agricultural machinery be classified under the "automatic entry" provisions.

D. Conclusion

4. Subject to the clarifications noted in paras 1-3, the Committee approved the recommendation to proceed with the negotiation of the proposed loan on the terms and conditions proposed by the Region.

Krueger S 9035

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 5, 1985

TO: Messrs. Stern, Qureshi, Husain, Shihata, Dherse, Knox, Mrs. Krueger

FROM: Luis de Azcarate, Director CPD

EXT.: 60063

SUBJECT: ARGENTINA: Proposed Agricultural Sector Loan

1386

1. The Loan Committee will meet on Friday, December 6 at 11:00 am in Room E-1208 to discuss a proposed $350 million Agricultural Sector Loan to Argentina. Despite its title the operation focuses on a reduction of export taxes incurred by the agricultural sector while setting up a land tax that would not impair allocative efficiency. It will be recalled that the Loan Committee had discussed the Initiating Memorandum for this loan in May (when the proposed loan was set at $250 million) at a time when the macroeconomic situation was highly unstable. The Committee authorized the Region to proceed with processing the operation and requested clarification of its objectives and conditionalities. Drastic macroeconomic adjustments were effected in June which have resulted in a great improvement in the policy framework, although, for the benefit of stabilization, the export taxes were actually raised. The Committee may wish to focus on the following issues.

The Macroeconomic Climate

2. It is still too early to judge whether the June reforms would be viable, leading to a stable macroeconomic environment. In case the stabilization program fails, would it still be possible to proceed with the current operation, or is it likely that the export taxes would be reinstated? The President's Report (para. 71) draws attention to the possibility of such a failure, which would have inhibiting implications for policy reforms and jeopardize the sectoral development program. And in case the IMF program were suspended or failed to be renewed, should we not seek assurances about the macroeconomy before we release the second tranche? Paragraph 23 candidly mentions that execution of Bank-assisted projects in Argentina had suffered in recent years from policy reversals, bureaucratic procedures, curbs on public investments stemming from the need for fiscal austerity and from private sector's reluctance to invest in an uncertain environment. In the Region's judgment, has this situation changed?

The Sectoral Program

3. Previous Bank lending for agriculture in Argentina has been relatively small and rather problem-prone. The current operation is the first Bank sector-wide operation, the question may be asked whether the package of reforms proposed addresses the most pressing issues in the sector. The package covers the reduction of export taxation, raising alternative sources of fiscal revenues including the proposed land tax, rationalizing agricultural import tariffs and regulations, initiating studies and supporting institutional improvements. A discussion might be useful of

the Region's medium term program in agriculture, other sectoral lending operations planned, what reforms they would seek, and any prospective projects that would fit into the framework of the sector's development.

The Proposed Land Tax

4. Agricultural taxation has traditionally been a convenient source of fiscal resources, providing about 11% of federal revenues. The Government would undertake to replace this source by the proceeds of a new land tax, yet to be developed. The Government is in no position to assess the optimal level of taxation that should fall on agriculture (Annex IV, page 5); hence studies would be initiated to examine alternatives to the export taxes. The federal land tax proposed is fraught with many difficulties and political uncertainties. The revenues from it would lag well behind the proposed removal, to apply from the 1985/86 agricultural season onwards, of the 9 percentage points hike in the export tax imposed in June 1985, and the reduction to 70% of the May 1985 tax levels by second tranche relase, expected in June 1987, and further to 50% by the 1988 tax year. Further reductions are envisaged in a second phase when sectoral studies of taxation have been completed.

5. The imposition of the land tax requires many steps. Inter alia an emergency law has to be proposed to Congress, which for "constitutional reasons" would have a different label, viz: "tax payment advance against profit, capital and net worth taxes"; [has this been presented in November as cited in Annex IV?]. The law, though renewable, would be valid only for five years, and various preparatory activities have to be completed to address institutional, agro-economic and cadastral issues, as well as tax collection and sharing arrangements between the provinces and the center. Will these steps impede the land tax? And given the technical complexity of the proposals, is the timetable proposed for implementing the land tax in Annex V too ambitious? Can we expect the federal land tax to generate $300 million a year by mid-1986 and over $500 million by 1988 (Annex IV, page 5)? In this context, is a quick disbursing operation the right vehicle for supporting this long-term program?

Loan Conditionality

6. Annex III lists six conditions that must be satisfied before Board presentation including a policy statement on the mecroeconomy and on agriculture, defining alternative sources of fiscal revenue, and establishing a steering committee, an Executive Committee for implementing the tax (all before negotiations) and submission to Congress of a draft land tax law, as well as removal and reduction of export taxation as mentioned above. Also expected is a detailed program for tax prepartion and implementation of the federal land tax. What are the chances of these conditions being satisfied in FY86?

7. One of the proposed conditions for the second tranche release is that the borrower had "put into effect alternative tax provisions that will generate additional fiscal revenues in amounts sufficient to compensate for any revenue losses resulting from the export tax reduction without increasing

the overall tax burden of the agricultural sector..." While the impact of the reduction of the export tax on revenues may be ascertainable, would it not be too early by second tranche release to assess the revenue which would actually be raised by the new tax?

cc: Messers. van der Meer, Gue, van Gigch, Pfefferman, Quijano, Gregory, Carter, Scherer, Otten, McCarthy, Nissenbaum, Ebiri

Messrs. van der Tak, Rajagopalan, Baneth, Jansen, Rajapatirana, Clements, Kopp, Ms. Donovan
Dubey (o/r), Huang, El Serafy

SH

September 20, 1985

Mrs. Krueger

Anne,

Managing Committee Consideration of the CPPs for Argentina, Brazil and the Philippines

The Managing Committee will consider the Argentina, Brazil and the Philippines CPPs on Monday, September 23, 9:30 a.m.

Attached are the following briefs:

Argentina

- Julio Nogues' note commenting on the CPP and recent developments.
- Costas' note on the OPSC discussion.
- Vittorio Corbo's note to Costas on the CPP for the OPSC discussion.
- Mr. Stern's memo to the MC members, including the OPSC postscript and the agenda for the OPSC meeting.
- You will see that both Mr. Stern's memo and the OPSC postscript mention the proposed Agricultural Sector Loan, which is to be the first of the policy-based lending operations proposed in the CPP. You will remember that we had some problems with that loan as submitted to the Loan Committee and that you sent a memo to Mr. Knox clarifying some differences of opinion.

Brazil

- Alan Gelb's brief on the CPP.
- A note by Neil on ERS research involvement proposed in the CPP and in Botefego's note (see below).

- A brief prepared on the Brazilian debt situation by Marcos Sugar (EPDED).
- Costas' comments on the OPSC meeting.
- Mr. Stern's memo to MC members including the OPSC agenda and the postscript.
- Comments on the Brazil CPP prepared by Jose Botafogo for MC members.

The Philippines

- A short note by Costas on the Philippine situation.
- Keith Jay's brief on the CPP.
- The OPSC agenda and postscript.
- C. Obidegwu's report on OPSC meeting.
- A CPP update from the region.

Sarath

Sarath

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

SEP 20 1985

cc CM
NR
JN

DATE: September 18, 1985

TO: Mr. Andre R. Gue, Acting Regional Vice President, LCNVP

FROM: Peter R. Scherer, Division Chief, LC2

EXT.: 76251

SUBJECT: ARGENTINA - Mrs. Krueger's comments on the Agricultural Sector Loan

1100

1. The following summarizes our response to the points raised by Mrs. Krueger in the Loan Committee meeting of August 19, 1985 included in her memorandum to Mr Knox, dated August 23, 1985. We share the general concerns expressed in her memorandum and will continue to address them, as necessary and appropriate, in our ongoing dialogue with the Government.

2. Mrs. Krueger is concerned that reference prices for agricultural exports could be set above the market to compensate for reductions in tax revenues. The indicative price system ("precios indicadores") was introduced by the previous Government specifically to avoid the underinvoicing of exports and thus determine the minimum value of foreign exchange earnings declared by exporters to the Central Bank. The indicative prices on grains exports are adjusted daily and have, since their inception, reflected international prices, as Mrs. Krueger's memo notes. They have not, thus far, been manipulated for tax purposes, and we believe it unlikely for that to occur. Because of their perceived importance for controlling underinvoicing we would not seek the elimination of the reference price system. We will continue to monitor its use, however, and seek the appropriate assurances that it not be used as a hidden tax on exports.

3. The memo also expresses the concern that discrimination against agriculture may have been increased by the introduction of an import licensing system in 1983 in the face of Argentina's severe foreign exchange scarcity. Under the licensing system, imports are treated under three categories: automatic entry, entry subject to review and approval, and prohibited entry (items in the last category can be appealed on a case-by-case basis). The only agricultural inputs currently prohibited are fully assembled tractors and selected other agricultural machinery, even though Argentina tractors appear to be broadly competitive with those in the U.S. in both quality and price. That is not the case, however, for certain of the other equipment items, such as subsoilers and drain excavators. It is our intention to address the general issue of import licensing and tariff structure in the context of the proposed trade policy loan. Should progress there be delayed, however, we would seek removal of agricultural equipment from the prohibited list, as well as a reduction of import duties, via the agricultural sector loan.

4. As regards the real exchange rate, our calculations indicate, and the Fund confirms, that the Austral had depreciated somewhat against a trade weighted basket of currencies between its inception and the recent Loan Committee meeting. We estimate that the Government has devalued the Argentine Currency by about 20% in real terms since taking office; viewed in a longer term perspective, the exchange rate at present is at its lowest level since 1968. However, should the exchange rate remain fixed, or otherwise lag behind differential inflation, there would, of course, be cause for concern. We do not expect the Government to allow that to happen, and it is committed to maintaining export competitiveness under its program with the IMF. We have long urged the maintenance of Argentina's export competitiveness via a realistic exchange rate policy and will seek appropriate assurances in that regard in both agricultural sectors and trade policy loans. The Fund will continue to play the lead role in this regard, however.

JSokol/FLevy:mac

cc: Messrs. Stern, Knox (o/r), Mrs. Krueger

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE August 26, 1985

TO Sarath Rajapatirana, VPERS

FROM Julio J. Nogués, DRDIE Julio

EXTENSION 61257

SUBJECT Comments to the June 10, 1985 Argentina Country Progam Paper

I. BACKGROUND

1. The Stabilization Program

In June 1985, expected inflation for that month was around 30%, and some operators in the market were discounting an inflation rate of 60% for July. In mid-June the Economic Cabinet introduced a stabilization program having the following characteristics:

(1) A commitment not to print money to finance public sector deficits. This commitment has the strong backing of President Alfonsin.

(2) Generalized wage and price controls including controls on the exchange rate.

(3) Increases in the prices of goods and services provided by public sector enterprises. The increase should have been of such a magnitude so as to eliminate losses.

(4) Increased taxation based mainly on higher export and import tariff rates.

So far, measured against the objectives of stabilization and taking into account the initial situation, the program can be judged as a success. The Central Bank has stopped printing money - except against increase in foreign exchange reserves - and inflation rates in July were 6.2% and -0.9% according to the CPI and WPI indices respectively. Inflation during August is expected to be in the neighborhood of 4-5%. The World Bank is therefore, at this stage facing a country which is apparently doing an important effort in stabilization. But as I will discuss, the characteristics of the stabilization package leaves little room for future growth.

2. Political Background

As said, the President himself - a charismatic figure for Argentines - is backing the stabilization program. For him, this has been a radical departure from the type of policies he supported during public sector. The World Bank cannot lose what I think could be an opportunity for dismantling distortions. Unfortunately, the CPP is timid in all these respects. Here are some of my comments.

(i) It is not at all clear what will be the dialogue of the World Bank with Argentina in regard to exchange rate policies. In paragraph 40 of the CPP, one reads: '...key short-term targets for fiscal, monetary and balance of payments have been set under the stand-by with the Fund. The Bank's role in these areas will consequently be supportive but rather passive while the agreement is in force. This also applies to exchange rate policy, although we may play an active supporting role related to our proposed policy-based lending...' Given the story of exchange rate instability of Argentina, I think it is extremely important for the World Bank to come and discuss the appropriateness of the real exchange rate and more generally, exchange rate policies.

(ii) The issue of import policy including non-tariff barriers and tariff structure are practically omitted from the CPP. In paragraph 40 of the CPP, there is only a very vague statement that reads '...The potential framework for our cooperation with the government would include such areas as reforming the trade regime, public investment...'. Nevertheless, loan conditionality as envisioned at this stage is not addressing the issue of import barriers.

(iii) The CPP is also not addressing the issue of the size of the public sector. Apparently, there will be some work done on the efficiency of management of the public sector, but I do not expect this to have a major impact. Efficiency of the Argentine economy will not increase significantly without an important reduction in the size of the public sector. Basic industries and services such as steel, paper, aluminum, petrochemical, telephone, gas, water supply, electricity, railroads, airline companies, etc., etc. are owned by the public sector. The efficiency standards of these enterprises is extremely low, and the only way to increase significantly the productive efficiency of these industries and of the economy in general, is to shift their property to the private sector. At this stage, the economic cabinet is aware of this and plans are being prepared for addressing the problem. The World Bank should accompany these efforts.

(iv) I do not know where Argentine policies stand in terms of barriers to foreign direct investment. Nevertheless, I understand that President Alfonsín is introducing liberal rules for foreign investment in the petroleum and petrochemical industry. It would be good for the World Bank to reinforce this tendency and discuss more broadly this issue. I doubt whether Argentina has the necessary savings that will be necessary to finance an important shift in the structure of its productive process. At present, interest payments on the foreign debt are absorbing around 50% of domestic savings. Hopefully some of the capital that flew will come back. In any case, this would depend on confidence, and being more liberal towards foreign investment will hopefully push nationals to bring their savings back.

(v) Finally, increased taxation on wages has been reintroduced recently. The CPP is not discussing this nor other factor market distortions in general.

III. Strategy of the CPP

What exactly are the goals of the CPP? The first two recommendations of the CPP listed in p. 24 state that:

(a) "The Bank should plan for a lending program of between US$500 and US$600 million in the first phase (FY85-86). The level of lending in the second phase (FY87-90) would be determined on the basis of performance; the proposal of US$1.25 billion is a general indicator rather than a firm lending target. The bank should finance 35% of project cost or the foreign exchange cost, whichever is higher, up to a maximum of 50% of project cost."

(b) "The first lending operations would concentrate on strengthening the export capacity and competitiveness of agriculture, rationalizing the development and use of hydrocarbon resources, strengthening the transport of infrastructure necessary for exports, and preparing a reform program for public sector management. The analytical work would initially focus on public investment and decision making processes, and on the policy framework for industrial development with emphasis on exports.

Therefore, the overall strategy of the CPP is based on sectoral lending and sectoral policy conditionality. However "...inadequate macro performance,..., would severely constrain aggregate lending." The meaning of inadequate is not discussed.

IV. **Recommendation to ERS**

The Argentine economy won't grow unless it gets rid of policy induced distrotions. Unfortunately, the stabilization program has reinforced many of these distrotions. While apparently successful in terms of inflation this program has increased taxation, and barriers to trade. The burden of the stabilization efforts are falling on the private sector as the size of the public sector has so far remained untouched. Perhaps this was necessary given the short-run economic and political constraints at the time when the stabilization program was designed and implemented.

In any case, the inefficiencies of the public sector are so obvious and costly that a consensus among the population has grown that here is where the major problems are. As said, I'm sure that this preoccupation is also present at the cabinet level, and something will begin to be done after the November elections.

The CPP does not reflect this preoccupation. It is supporting the notion that public sector investment should improve '...the efficiency of existing capacity...' (para. 26), and '...public sector management...' (para. 41). Personally, I don't expect the payoffs of investments associated with these goals to be high. On the contrary, they could very well reinforce the Argentine bureaucracy. There is only one way out, and this will be to sell the public sector enterprises. If this is done, I think that the confidence of the private sector will increase significantly.

The CPP should therefore discuss more thoroughly:

- The size and the role of the public sector and eventually, a strategy for privatization.

- The role of import barriers, and a strategy for dismantling them. Also, the revenue and tax issues associated with moving to a more open economy.

- The role of direct foreign investment in Argentina's growth strategy.

- The impact of factor market distortions.

One final comment. On page 35, the CPP mentions that it is cooperating with the government in its efforts to install an economy-wide planning model. In the past, this type of exercise has been costly and I would strongly recommend that the World Bank withdraw from cooperating with the introduction of any instrument that could increase the sense of reliability of planning exercises to policymakers. Actual policymakers already have an educational bias towards planning. The

World Bank need not come and reinforce this bias. More generally, I think the technical assistance loan needs to be discussed thoroughly. From the CPP it is not at all clear what will be done with this money.

cc: J. M. Finger, Chief, DRDIE
V. Corbo, DRDDR

JJNogués/jm

OFFICE MEMORANDUM

DATE: August 23, 1985

TO: Mr. David A. Knox, LCNVP

FROM: Anne O. Krueger, VPERS *AOK*

EXTENSION: 69001

SUBJECT: Agricultural Sector Loan to Argentina

1. You will recall that at the Loan Committee meeting on August 19, 1985, I raised, among other matters, the following issues on the loan mentioned above:

(i) In Argentina, export taxes are levied on reference prices and therefore it is possible that the Argentinian authorities could increase these prices as a way of compensating for reductions in tax revenues resulting from lowered export tax rates. Raising the reference prices to maintain revenues would also maintain the discrimination against exports.

(ii) Discrimination against the Argentine agricultural sector may have been increased significantly by the import regime introduced in 1983. Under this regime, everything that is domestically produced in sufficient quantity to meet domestic demand cannot be imported. This also applies to inputs used by the agricultural sector.

(iii) Since the introduction of the new stabilization program in mid-June 1985, the real exchange rate as measured by the nominal exchange rate of Australes per US dollar times the ratio of some measure of US prices to domestic prices has been declining. Therefore, Argentinian exports are losing international competitiveness gained through the mid-June exchange rate reform.

In response to my comments, the regional staff asserted that: the system of reference prices was no longer in place; intermediate and capital goods for the agricultural sector can be freely imported after paying import duties implying that quantitative restrictions were removed; and that the real exchange rate has not been declining recently.

2. I have rechecked the comments I made with my staff, who confirm that they are valid. My staff maintain that:

(i) There still is a system of reference prices on which export taxes are levied. Apparently these reference prices have been in line with international prices, but the type of policy behavior which I have suggested above cannot be ruled out.

(ii) Argentina continues to make use of quantitative restrictions. In 1983, Argentina introduced a general system of import licensing. Apparently there has been a discriminatory relaxation of import controls, i.e., imports coming from other Latin American countries are less controlled than imports coming from third countries. Nevertheless, the controls on imports coming from third countries are providing the bulk of protection to Argentine import-substituting industries, including those producing intermediate and capital goods for the agricultural sector, i.e., tractors, agricultural machinery, pesticides, fertilizers, etc. The agricultural sector loan must deal adequately with the issue of non-tariff barriers.

(iii) Taking account of the behavior of the consumer price index, the Argentine real exchange rate has been appreciating since the introduction of the stabilization program. In mid-June, when the new stabilization program was introduced, the exchange rate was fixed at Austral 0.80¢ per US$1. In July, the CPI inflation rate in terms of Australes was 6.2% (the WPI rate was -0.9%) The expected CPI inflation rate for August is of the order of 4%. The US inflation rate has been much less. Thus the real exchange rate is showing a tendency to decline and there is a chance that Argentine policymakers could attempt to repeat their past mistakes, i.e., to try to use the exchange rate as an instrument of price stabilization. Thus we believe that the exchange rate should be an important issue for discussion in preparing this loan.

I trust the above points clarify the position I took at the meeting and why. I look forward to seeing a loan document that reflects the points I have raised.

JNogues/SRajapatirana:mc

cc: Mr. E. Stern

OFFICE MEMORANDUM

DATE August 22, 1985

TO Sarath Rajapatirana, VPERS

FROM Julio J. Nogües, DRDIE Julio

EXTENSION 61257

SUBJECT Comments on the Decision Memorandum on the Argentina Agricultural Sector Loan to Argentina

1. In my previous memo of May 22, 1985 I mentioned the following problems associated with this loan:

- The chaotic state of the economy and the underlying policy errors;
- The risk that export taxes be reintroduced;
- The discrimination against the agricultural sector because of the protection granted to industries producing intermediate and capital goods for this sector;
- The need to strengthen the conditionalities of the loan.

The following paragraph will analyze how the decision memorandum (DM) is tackling these and other issues.

2. The state of the economy

In mid June 1985, the government of Argentina announced a stabilization package whose centerpiece has been an announcement of a commitment not to print money for financing fiscal deficits. The companion policies of this stabilization program are: strictly enforced controls on wages, prices and exchange rate; significant hikes in the prices of goods and services produced by public sector enterprises, and increased taxation on wealth and in particular on foreign trade through increased export and import tariffs. There are a couple of comments regarding the relationship between this stabilization program and the proposed loan. I first tackle issues relating to the exchange rate policy.

(i) In July the inflation rate as measured by the CPI has been 6.2% and in August it is expected to be once again close to 5%. Thus in the presence of a fixed nominal exchange rate, the real exchange rate is declining fast and the statement made by the DM in paragraph 2, that: "The incentive for agricultural has improved since the time of the loan committee meeting, because the devaluation of the Argentine currency has overcompensated the rise in taxes and duties' might not hold by now. There is a need to add some measures of real exchange rate: i.e. how it has been changing in recent years and months, and whether it is believed to be at an appropriate level.

(ii) The stabilization package has reduced but not eliminated the differential - which I commented in my previous memo - between the black market and the official exchange rate. This differential now is close to 20%. This is occurring even with a real interest rate that has been higher than 5% in July. The conclusion is simple. In the stabilization package the exchange rate has been set too low.

(iii) This is a major problem with the stabilization program, but it is certainly not the only one. More generally, this program has reduced the inflation rate but at the cost of reinforcing controls, and of taxing the private sector. There is practically no effort being put by the government to reduce the size of public sector expenditures. The stabilization program will not succeed if controls are not relaxed soon, and the outlook for growth is dim unless there is an important reduction in public sector expenditures. This is important in order to implement a structural program of shifting relative prices in favor of exportables. Without this relative price shift I see no outlook for growth in Argentina.

3. <u>Risk that export taxes will be reintroduced.</u>

(i) As forcasted in my previous memo, export taxes have been reintroduced, this time for stabilization purposes. This is bad policy, and unfortunately one that the World Bank is supporting. (See Aid Memorie left to the Government of Argentina on June 30, 1985 paragraph 3). I would prefer the World Bank to be truly committed to the goals of the loan. Under no circumstances should the government of Argentina (GOA) reintroduce and/or increase export taxes. This I hope will reduce the government budget constraint and therefore push it to use more efficiently the resources it is able to extract from the private sector.

(ii) A side comment. Export taxes are levied on reference prices which have not so far been mentioned in any of the documents which I have read regarding this loan. It is possible that GOA could reduce export taxes in line with the conditionality of the loan and compensate this by increasing reference prices. The loan should contemplate this.

4. <u>Discrimination against agriculture coming from protection to intermediate inputs and capital goods.</u>

The World Bank is requesting among the conditionalities for disbursement of the first tranche that GOA '...reduce import tariff on general agricultural inputs to not more than the May 1985 level, and import tariffs on agricultural machinery...to a schedule agreed upon during negotiations.' In my previous memo I stated that in 1983 Argentina introduced across the board import licensing, and I understand that these policies continue to be enforced quite strictly. In particular those goods that are domestically produced are forbidden to be imported. Therefore, it is not tariff but the import licensing regime, the instrument providing protection and affecting profitability of the agricultural sector.

5. Conditionality of the Loan The comment I made on this issue in my previous memo referred to the softness of the conditionality of the loan, particularly with respect to the disbursement in the first tranche. In the new version of the loan this conditionality has been strengthened. Nevertheless, I have some additional comments on this issue.

(i) In the first place, among the conditionalities of the second tranche, the DM states that: by then (1987) GOA should have in place a land tax that compensates for the fiscal revenue that would have been generated by maintaining export taxes at the May 1985 levels. This is a clear fiscalist objective. My impression is that the agricultural sector in Argentina is already heavily taxed. If the conclusions of the studies which are planned to be carried out show this to be the case, then the World Bank should emphasize less taxation on agricultural. Remember, a necessary condition for increasing Argentine growth prospects is to enhance the profitability of this sector. Unfortunately recent forcasts predict that it is not unlikely for international prices of Argentine exportables, to continue declining. In this event, meeting the goals of the second tranche will lead to reduced profitability of agriculture.

(ii) In the second place, account should be taken on the issue of non-tariff barriers affecting the cost of intermediate and capital goods used by the agricultural sector. As said, these NTBs and not tariffs are the binding instrument for providing protection.

(iii) Finally, as said, there are already indications that the real exchange rate is beginning to decline. This might lead, once again, to exchange real exchange instability. This should not happen. Perhaps the World Bank should strengthen its position regarding stability and appropriateness of the exchange rate policies.

cc: J. Michael Finger, Chief, DRDIE

JJNogúes/jm

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ARGENTINA

Country Program Paper

Sciselby

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Postscript

65. The Operations Policy Sub-Committee discussed the Argentina Country Program Paper on June 27, 1985. The main items considered were recent economic developments, country-Fund relations, recent arrangements with creditors, and the impact of these developments on creditworthiness. Also discussed were the policies needed to achieve higher growth, the areas of policy that should be the focus of Bank attention, and the content of the lending program.

66. The OPSC noted that while the results of the stabilization program as revised in June 1985 were not yet secure, important major reforms described as "shock treatment" had been introduced and the vicious circle of inflationary expectations may have been broken, although the prospects for medium-term growth remain uncertain. To promote a more rapid rate of development, four areas would be emphasized in the Bank's program: (a) exchange rate policy and export incentives; (b) policies to encourage foreign investment; (c) rationalization of industrial incentives; and (d) the efficiency of the public sector. A forthcoming technical assistance operation will lay the groundwork for our involvement in reforming public sector management.

67. The meeting recognized the fact that the dialogue with Argentina had been dormant for some time, and that our approach has to be gradual. It also noted that despite the risks involved, it was essential for the other creditors to see the Bank playing a role in the restoration of Argentina's creditworthiness. The Chairman suggested that, when conditions allowed, consideration be given to eliciting fundamental structural reforms to be supported by an appropriately sized trade/industrial policy loan.

68. The proposed Agricultural Sector Loan would be the first of a possible series of policy-based operations. However, should agreement on policy conditionality for the Agricultural Sector operation prove to be impossible, it was neither feasible nor desirable for it to be substituted by other policy-based operations, and the FY86 lending program would accordingly be reduced. It was further agreed that should there be severe difficulties in compliance with the IMF Stand-by Arrangement, the Bank's program would be re-examined.

69. The OPSC endorsed the cost sharing arrangement proposed in the CPP (35% of project cost or the foreign exchange cost whichever is higher up to a maximum of 50% of project cost). It approved the program proposed for lending $385 million in FY86, and concurred with the Region's plan to prepare a Country Brief for Argentina by the end of FY86 and a new CPP a year after that.

70. The Chairman directed that the CPP be sent to the Managing Committee for discussion.

July 16, 1985

copy sent to Nogues 7/18/85

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LOAN COMMITTEE

JUL 18 1985

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930

Minutes of Loan Committee to Consider
ARGENTINA - Agricultural Sector Loan
Held on May 24, 1985 in Conference Room E-1208

A. Present

Committee:

Messrs. E. Stern	Messrs. F. Levy, LC2DR	N. De Souza, LEG
D. Wood, FPBVP	R. Clements, SVPOP	D. Purcell, LCPAC
A. Golan, Actg. EISVP	E. Köpp, SVPOP	S. El Serafy, CPD
V. Rajagopolan, OPS	P. Scherer, LC2PB	R. Zagha, LC2PB
H. Scott, LEGVP	A. Otten, LCPAC	D. Fitchett, AGR
S.M.L. van der Meer, Actg. RVP	A. Rigo, LEG	J. Olivares, AGR
Mrs. A. Krueger, VPERS	E. Schuh, AGRDR	W. Nickel, LCPAC

B. Issues

1. The meeting was called to consider the issues emerging from the Initiating Memorandum submitted to the Loan Committee, under cover of Mr. van der Meer's memorandum to Mr. Stern of May 19, 1985, specifically to address the following questions:

(a) the objectives of the proposed loan;

(b) the difficulties which it might confront;

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Senior Vice President, Finance	Vice President, Development Policy
Vice President and General Counsel	Vice President and Controller
Vice President, Projects Staff	Senior Operations Adviser
Regional Vice Presidents	Others in attendance

(c) the proposed conditions for release of the first and second tranches; and

(d) the amount of the Loan.

C. Discussion

2. Loan Objective. During the discussion, it was agreed that the achievement of the main purpose of the Loan--substitution of a land tax for present export taxes--would improve incentives in the agriculture sector and help increase exports and remove the traditional instrument through which successive Governments had penalized Argentine agriculture. The estimates of production response to the envisaged tax reforms indicated in the Initiating Memorandum were considered reasonable and sufficiently large to justify the proposed policy changes. At the same time, it was pointed out that export taxes were not the only constraints to Argentina's improved agricultural performance, i.e. import licensing and tariffs on imports of agricultural equipment also affected negatively the price of agricultural inputs. It was therefore agreed that these other constraints should also be addressed in the analysis of the proposed loan.

3. Difficulties Facing the Loan. It was noted that Argentina was on the verge of becoming a case of "hyperinflation". Therefore, questions were raised whether it made sense to reduce or eliminate the export tax, which is easy to collect, and substitute for it a tax on land which is more difficult to implement and collect. The Region recognized this difficulty and stated that it shared the concern of the IMF that a change in tax legislation should not result in a reduction in fiscal revenues and in the tax burden on agriculture. It emphasized that "revenue neutrality" was one essential feature of the loan. The forthcoming appraisal mission, which included a tax management specialist from the Fund, would make a thorough assessment of alternative agriculture based taxes that could compensate for a reduction and ultimately elimination of the export taxes. The introduction and collection of substitute agricultural taxes commensurate with a satisfactory reduction in export taxes, to be determined during appraisal, would be a condition for the release of the second tranche. It was also noted that it was unusual for the Bank to include enactment of legislation as a tranche condition. This feature was recognized but was not considered to be a major difficulty.

4. Government Commitment. In the recent past, export taxes had been eliminated and then reinstated, and this could conceivably happen again. Argentine governments had historically relied on export taxes as a prime source of fiscal revenues and as a way of subsidizing consumers. Questions were therefore raised in respect of the stability of the proposed policies, particularly once the loan was fully disbursed. The Region said that it recognized that the risk was not negligible. On the other hand, implementation of a tax on land would create a structural change that would make it very difficult to reinstitute an export tax in addition to the land tax. It was thus reasonable to believe that the shift from indirect to direct taxation, which the proposed loan would encourage, might produce a basic, long-term change.

5. Political Aspects. It was recognized that the consequences of the proposed policy changes might include a rise in food prices, thus contributing to a reduction in real income. This might severely affect lower income groups and pose problems in obtaining Congress' approval of legislative changes. Both difficulties were

acknowledged. However, the Government was fairly confident that it could get legislative approval. It was decided that there should be assessments of the possible extent of reduction in real income for the lower income groups.

6. Conditionality. Several speakers noted that the first tranche of the proposed loan would be disbursed for measures which were already taken, notably a reduction in the export tax. They felt that the proposed loan conditions should be strengthened. The Region noted that the measures already taken had been discussed with the Bank and had been taken in the expectation that this would pave the way for an agricultural sector loan which, in turn, would be linked to a broader reform program. The Government had also introduced several measures recommended in the last CEM, such as removal of tariffs on fertilizer imports. Finally, for the first time in Argentina, reductions in export taxes (such as the one in early 1984) had taken place simultaneously with a depreciation of the peso in real terms.

7. Performance Criteria. Some participants felt that the proposed loan amount was too large. It was decided that the Region should proceed with the appraisal of the proposed loan, for which the Bank should consider a loan of about US$250 million. If a larger amount was needed to accelerate the implementation of the reforms, and if Argentina's negotiations with the IMF and commercial banks produced satisfactory results, an increase in the loan amount to US$300 or US$350 million might be considered.

RZagha/WNickel:kmc/vv

OFFICE MEMORANDUM

DATE July 1, 1985

TO Mrs. Anne O. Krueger

FROM C. Michalopoulos

EXTENSION 60027

SUBJECT OPSC Review of CPPs for Argentina, Brazil and Mauritius

1. Argentina

The CPP received widespread support. The discussion focused on the importance of the success of the short-term stabilization program. The Region felt that early indications were that the program will take hold. The unions don't like it, but have indicated that they will go on strike against it.

The major issue was the role that the Bank can play through its programs to support medium-term adjustment in the context of a highly distorted trade policy environment. I stressed in the discussion that, in our view, it was important that once it was clear that the stabilization program was being adhered to, we should immediately try to push ahead for an industrial SAL or a similar instrument which would be conditioned on a significant reduction of the effective tariff rates from the level that prevails at present, which is probably in excess of 100 percent on the average. I also suggested that this should probably happen some time in early CY86. The Region stated that while this was a high priority in their view, it would be impossible to do it as early as I had suggested because there has been no dialogue on the subject and entrenched interests could be expected to mount strong opposition to such a liberalization. Ernie Stern asked whether the Bank could overcome these objections if it came up with a sufficiently large loan. The Region stressed that we had limited experience in a policy dialogue with Argentina and it would not be advisable to move very fast in this area. They said that they would like to see the implementation of the FY85 Agricultural Loan as the first priority for this year, and then move to a loan that focuses on trade liberalization early in the next fiscal year. The objectives of the Agricultural Loan were to some degree undermined by the recent Government actions to increase export taxes on agricultural products, but the Region has assurances from the Government that the export tax will be rolled back by the end of the year and substituted by a land tax. CPD expressed concern that implementation of a land tax may take some time and thus we may not be able to disburse a significant amount of our Agricultural Loan in the coming fiscal year.

The discussion then moved to the question of what happens if the stabilization program does not work, or works with fits and starts. It was generally agreed that if the stabilization program

P-1866

failed in an obvious way, we should review the whole situation anew. It was unclear what will happen if Argentina and the IMF engaged in an off-again, on-again dialogue over the next several months, as could well happen.

2. Brazil

The Brazilian situation was described as one where the Government was close to agreement with the IMF, but it was clear that the Brazilians were unwilling to agree to the type of draconian measures to reduce inflation and the balance of payments deficit that Argentina just took. Apparently the Fund has been pushing the Brazilians to eliminate completely their deficit, which now runs at 6-7% of GDP, but the Brazilians are unwilling to do this and may be willing to agree to about half that reduction.

I asked about the exchange rate and stated that I thought it was appreciating and wondered what the Fund had to recommend about it; the answer that the Region gave me was that the Fund was not concerned about the exchange rate and they thought that it was doing alright; also, that while the exchange rate had been appreciating, in the last couple of months it had stopped doing so. This, in my view, has to be checked further if the CPP goes to MC. The Region also indicated that the kind of debt rescheduling package now being contemplated would be quite generous with long periods for rescheduling, but it would need somewhat more closer involvement by the IMF relative to what the IMF did with Mexico.

On the side of the Bank programs in support of this stabilization and restructuring effort, the main issue that was raised had to do with the Region's desire to do a large-scale review of the public sector as a vehicle for subsequent lending to improve public sector effectiveness. Ernie Stern expressed serious doubts that it was necessary to do a lot of additional analysis prior to lending in the area. I said I thought it would be useful for the Region to explore how to help the private sector directly, especially in the context of providing working capital, and this was supported by Dherse. The Region did not seem to be very interested in such an approach however, and we need to watch it as the Region pursues some of its lending programs to a number of state development banks with weak financial positions.

Another issue raised was whether it was necessary to continue with a fast-disbursing program in Brazil and the Region's rationale for doing so. I argued unsuccessfully that we should not be considering a program as a gap filling one, because if Brazil was successful in its stabilization efforts the amount of additional private capital inflow that they may be able to obtain would far outstrip any increments that we can provide in the form of fast-disbursing funds.

The overall impression is that the Bank views Brazil as doing pretty well, especially in comparison with Argentina, and is willing to provide it with considerable resources even if the stabilization program now contemplated does not stick.

3. Mauritius

The discussion on Mauritius focused primarily on two issues: 1) Mauritius' export prospects, and 2) what the Region was planning to accomplish with the two loans that it was contemplating: an Industrial Sector Loan and a SAL.

On the export prospects, I suggested that it probably would be very useful for the Region to think about how to help Mauritius restructure its economy so that it is not solely dependent on sugar and textiles for its exports. The second and most important issue was raised by Ernie Stern, who felt that the Region was not getting anything additional through the two lending operations that it was proposing and that it could attain its objectives in tariff reform in one of the loans rather than two. CPD indicated that it felt Mauritius was getting a lot of aid on a per capita basis and while the economy was doing better than some others in Africa, it had not demonstrated such a fantastic performance as to warrant so much assistance. It was further suggested by Ernie Stern that the Bank's exposure in Mauritius should not increase as much as it was being proposed and that Mauritius was in good enough shape to try to obtain some additional funding from the private sector.

The impression that one got from this discussion was that we are again far more careful dollar-for-dollar in the way we are treating small countries than in the way we treat large ones.

cc: J. Baneth, V. Corbo, A. Gelb, E. Hwa, [redacted] N. Roger

SH

June 26, 1985

Mr. Corbo

Vittorio,

Here are some quick reactions to your draft on Argentina CPP

1. I fully concur that the issue which looms large now (making the present CPP draft much less relevant) is the stabilization issue.

2. However, after the stabilization phase comes the crucial issues of (a) restoring or improving creditworthiness by supporting export growth and liberalization of the trade regime (at present there are high export duties) and (b) laying the basis for growth by increasing efficiency and restoring investments. Also some stabilization measures (e.g., increase in export taxes could hurt efficiency).

3. You may want to elaborate little more on these medium-term issues as this is the Bank's grist. This could be done by expanding your sections III and IV to a more action-oriented basis, especially because the CPP as you quote in section I includes everything. And it has no priorities attached to the objectives and no actions are defined.

Sarath

SR:rm

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 25, 1985

TO: Operations Policy Sub-Committee

FROM: Luis de Azcarate, Director, CPD

EXT.: 60063

SUBJECT: ARGENTINA CPP: OPSC Review

1. Attached is an agenda and comments on major policy issues identified by CPD and PBD for consideration by the Sub-Committee. The suggested agenda items are:

a) Recent Economic Developments;

b) The Policies Needed to Achieve Higher Economic Growth;

c) The Rationale for Bank Lending;

d) The Content of the FY86 Lending Program;

e) Cost-sharing; and

f) Staff and Budget Implications.

2. The Review meeting will be held on Thursday, June 27, 1985 at 3:00 p.m. in Room E-1208.

Attachments

cc: Regional Office: Messrs. Gue
van der Meer
Pfeffermann
Jaspersen
Levy
Scherer
Ebiri
Nissenbaum
Gregory

Messrs. Ryrie
Jansen
Huang

ARGENTINA COUNTRY PROGRAM PAPER

Topics for Discussion

Economic Performance and Development Strategy

1. Argentina has been battling with its external debt problems since 1982 and has concluded a number of rescheduling agreements with its creditors. The difficulties have worsened of late, with inflation accelerating and arrears developing on servicing the external debt, which now exceeds $50 billion or 70% of GDP. Service interest alone amounts to 8% of GDP and consumes half the export proceeds. While the economy's problems are deeply rooted and structural, no medium- or longer-term reform can begin without a successful stabilization program. The civilian government that assumed office 15 months ago has been slow to address the urgent problems inherited from its military predecessor as this involved painful choices that would alienate powerful political groups, and the program worked out with the IMF in late 1984 had to be abandoned early in 1985. A new economic team came in in February, however, and has started some long-delayed reforms. A more realistic agreement, with the Fund has been concluded, and a new currency issued at a realistic exchange rate. There have been significant advances in pricing policy, public sector organization, interest rates and taxation. A $483 million bridge loan led by the US has been arranged to enable Argentina to reduce its interest arrears to commercial banks (payments were more than 6 months overdue in early June) and already some payments on arrears have begun. Given the rapid shifts in the situation over the past month, it would be useful for the Region to update and elaborate on the recent policy changes and the arrangements reached with the IMF and the creditors?

2. Beyond stabilization, the CPP argues, the key development objectives are clear and there is agreement on them between the Bank and the Government. Exports need to grow to reduce the burden of debt service, thus accelerating GDP growth and allowing consumption to rise somewhat. (Per capita income was 13% lower in 1984 than it had been in 1974.) Private sector morale needs to be boosted, private capital flight arrested and reversed, and the efficiency of the public sector enhanced. While there can be little economic growth in the next two years if stabilization is to succeed, growth could accelerate after 1987. The CPP provides two scenarios for the period 1985-90: one involving an average annual growth of GDP of 2.2% which is regarded as more likely, and another with 3.4% average growth. Both scenarios assume moderate investment and no changes in economic structure, but rely on policy change to encourage domestic resource mobilization, greater utilization of capacity, reducing the anti-export bias in agriculture, and restoring incentives to manufacturing industry. Perhaps the Region could clarify the policies underlying the two scenarios, indicating the specific measures that need to be taken to achieve higher growth?

Level and Composition of Bank Lending

3. The CPP proposes a visible Bank presence that would give support to the authorities and act as a catalyst: a FY86 lending program of $385 million, leading to a 5-year (FY85-89) aggregate of $1665 million. This is a little below the norm ($1800 million). Lending in the outer years is to be taken as indicative only since a review of the strategy is recommended in a year's time. There are obvious risks in lending substantial amounts to a country with such limited creditworthiness in the medium-term. Given the small share of the Bank in gross capital flows, the Region could perhaps discuss the impact that the Bank's involvement might have on other lenders.

4. The FY86 program is dominated by an agricultural sector loan whose main thrust is the removal or reduction of export taxes and replacing them by a land tax. Apart from the appropriateness of reducing tax revenues in the middle of the stabilization process -- the land tax would need some time to be developed -- there has been a recent rise in export taxation, announced at the time of the June 11 devaluation. As the first tranche of the Agricultural Sector Loan would be released in recognition of prior reductions of the export tax, perhaps the Region would explain the consistency of the recent reversal on export taxation with the changes envisaged under the sector loan. In the absence of an Agriculture Sector Loan, the remainder of the FY86 program, (port and water supply projects) would not boost exports in the near term. The Region has sent large missions to Argentina in FY85 to look at public investment and the industrial sector. Could the Region elaborate on the merits of alternative quick-disbursing operations to encourage exports and rationalize public investment?

5. In para. 32, the CPP mentions the possibility of a worst case scenario where the current stabilization efforts might fail. In para. 45 "inadequate macro performance" is again mentioned as a possibility, which would be countered by reduced Bank lending. In case of failure to comply with the IMF Stand-by, para. 54 further states that we would make an independent estimate of progress in the fiscal, balance of payments and domestic resource mobilization areas. The Region may wish to discuss the criteria by which Bank lending would proceed in the absence of an IMF Stand-by.

Other Issues

6. Cost-sharing. The CPP proposes (para. 48) a cost-sharing ratio of 35% of project cost or the foreign exchange cost, whichever is higher, up to a maximum of 50% of project cost. Despite Argentina's high per capita income, the Committee may wish to consider that this ratio is justified in view of the fiscal constraints Argentina will operate under for the next several years.

7. Staff and Budget Implications. The Indicative Statement with its attached table (Attachment 4) shows nearly 200 staffweeks devoted to economic work in FY86 and the FY86-90 program contains 17 lending operations -- double the number in the already approved program (FY85-89) -- which would require substantial increases in staff and other resources for the Argentine program. Could the Region discuss the staff and budget implications of the proposed program?

8. Timing of the Next Review. In keeping with the proposed phasing of the lending program (FY86, and FY87-90) the CPP proposes (para. 44) that a Country Brief be prepared towards the end of FY86 and a new CPP towards the end of FY87. By the latter time, Argentina's compliance with the Fund program would be clarified, as would its receptivity to Bank advice under the proposed FY86 Technical Assistance Loan, and its record of disbursement of existing loans.

Annex I compares the lending program proposed for Argentina in the CPP with those previously approved.

Annex II presents a comparison of various country peformance indicators.

ARGENTINA

Annex 1

	FY79	FY80	FY81	FY82	FY83	FY84	FY85	FY86	FY87	FY88	FY89	FY90	FY80-84	FY85-89	FY86-90
Operations Program (No.)															
Approved, January 1979	2	3	4	4	4	3	..	..	..	..	..	..	18	..	..
Proposed, June 1985	1	2	2	3	1	-	1	8	4	5	2	3	8	20	22
Lending Program (No.)															
Approved, January 1979	2	3	3	3	2	2	..	..	..	..	..	..	13	..	..
Std. Table IVa, Nov. 1984	1	2	2	3	1	-	-	2	2	2	2	..	8	8	..
Proposed, June 1985	1	2	2	3	1	-	1	5	4	3	3	2	8	16	17
Lending Program (Cur. $m)															
Approved, January 1979	306.0	175.0	230.0	320.0	200.0	300.0	..	..	..	..	..	..	1225.0	..	..
Std. Table IVa, Nov. 1984	96.0	237.0	68.0	400.0	100.0	-	-	175.0	325.0	200.0	200.0	..	805.0	900.0	..
Proposed, June 1985	96.0	237.0	68.0	400.0	100.0	-	180.0	385.0	475.0	325.0	300.0	150.0	805.0	1665.0	1635.0
Lending Program (Const. FY85 $m)															
Approved, January 1979	383.5	219.3	285.0	384.6	228.3	321.9	..	..	..	..	..	..	1439.1	..	..
Std. Table IVa, Nov. 1984	120.3	297.0	84.3	480.8	114.4	-	-	163.2	284.1	164.7	156.0	..	976.5	768.0	..
Proposed, June 1985	120.3	297.0	84.3	480.8	114.4	-	180.0	359.1	415.2	267.7	234.0	111.2	976.5	1456.0	1387.2
Commitment Deflator (FY85=100)	79.8	79.8	80.7	83.2	87.4	93.2	100.0	107.2	114.4	121.4	128.2	134.9			

Note: November 1984 Review Group Decisions: FY85-89 - IBRD $900 million.

PBDCP
6/18/85

ANNEX II

COMPARATIVE COUNTRY ANALYSIS

	ARGENTINA	BRAZIL	KOREA	PORTUGAL
Economic Structure				
Population 1983 (millions)	28.8	129.7	40.0	10.1
GNP Per Capita 1983	2030.0	1890.0	2010.0	2230.0
% Agriculture in GDP 1983	15.3	12.7	14.0	8.0
% Industry in GDP 1983	35.4	32.7	39.0	40.0
% Services in GDP 1983	49.2	54.6	47.0	51.0
Debt Service Ratio 1983	70.6a/	47.4b/	13.6	26.7
Economic Performance				
Real GDP Growth Rate 1973-83	0.4	4.8	7.5	n.a.
Gross Domestic Investment/GDP 1983	14.2	18.1	27.0	29.0
Exports GNFS/GDP 1983	14.7	11.3	37.0	32.0
Resource Balance/GDP 1983	5.7	1.9	-1.0	-13.0
Gross National Savings/GDP 1983	10.9	9.6	24.4	11.4
Recent Social Indicators				
Population Growth Rate	1.4	2.3	1.7	0.9
% Change in Crude Birth Rate 1965-83	12.0	-22.9	-36.3	-34.8
% Change in Crude Death Rate 1965-83	1.1	-28.7	-46.1	-10.0
Infant Mortality Rate (per 1,000) 1983	41.0	69.0	32.0	26.0
Life Expectancy (years) 1983	70.0	64.0	68.0	71.0
Adjusted Education Enrollment Ratio				
- Primary	119.0	96.0	100.0	121.0
- Secondary	59.0	32.0	89.0	50.0

Lending Program	FY80-84	FY85-89 c/	FY80-84	FY85-89 d/	FY80-84	FY85-89 d/	FY80-84	FY85-89 d/
Nominal IBRD US$M	805.0	1665.0	5323.0	7000.0	2844.5	3200.0	574.3	850.0
p.c.p.a. Lending US$	5.6	11.6	8.2	10.8	14.2	16.0	11.2	16.5
p.c.p.a. Constant 1985 US$	6.8	10.1	9.5	9.5	16.6	14.0	14.0	15.0

Sources: Argentina and Brazil CPPs
1985 Draft World Development Indicators
Table IVa

a/ Attachment 3c figure
b/ Includes payments on short term debt
c/ CPP Proposal
d/ Table IVa

Country Policy Department
June 18, 1985

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 25, 1985

TO: Mr. Costas Michalopoulos

FROM: Vittorio Corbo VC

EXTENSION: 69788

SUBJECT: Argentina CPP

I. SUMMARY AND CONCLUSIONS

The CPP recommendations are based on the following objectives: "The Bank's strategic objectives at this time should be to use our analytical work and lending operations in support of Government efforts to reactivate the economy through export-led growth, increase the availability of foreign exchange and stabilize the economy. We would simultaneously perform the ground work for a subsequent phase of Bank activity, directed to supporting the country's efforts to enhance its international competitiveness, increasing domestic resource mobilization, improving public sector management, and strengthening the external finances. Key short-term targets for fiscal, monetary and balance-of-payments have been set under the stand-by with the Fund; the Bank's role in these areas will consequently be supportive but largely passive while the agreement is in force. This also applies to exchange rate policy, although we may play an active supporting role related to our proposed policy based lending. The potential framework for our cooperation with the Government would include such areas as reforming the trade regime, public investment, the financial sector and public enterprise management; improving resource mobilization and public sector pricing; strengthening the social infrastructure; and rationalizing the regulatory environment."

Tendency to spread our resources all over in a messy situation

In more specific terms the CPP recommends that the Bank should plan for a lending program of between US$500 and $600 million in FY85-86 and US$1.25 billion in FY87-90. Lending would concentrate on strengthening export capacity and competitiveness of agriculture, strengthening the infrastructure for exports and a rationalization of the public sector.

II. BACKGROUND AND THE ISSUES BEING DISCUSSED

Argentina tried in late 1978 to stabilize the economy (with an inflation rate of 174% in 1978) by using the pre-announcement of the exchange rate, with a decreasing rate of devaluation, as the main stabilization tool.

A combination of risky financial undertakings and a mostly externally financed public sector deficit gave origin to a lengthy period of peso appreciation. Indeed, the real exchange rate dropped from 100 in 1978.IV to only 50.8 by 1981.I when the policy was abandoned.

Furthermore, as the inconsistency between the large public sector deficit and the nominal exchange rate trajectory became increasingly apparent to most economic agents, capital flights set in creating a balance of payment crisis. The financial crisis that started to appear in early 1980 and was magnified following the large devaluation of late 1981 and early 1982 resulted in a massive Central Bank intervention.

The Central Bank intervention took the form of a reduction in the real liabilities of debtors and the rescue of commercial banks. The reduction in demand for base money at a time of expanding public sector and monetary authority deficits resulted in a sharp increase in inflation (to 600% in 1984 and running close to an annual rate of 1,300% in early 1985).

One should also mention that contrary to what many people think, (and to what the CPP states at the beginning of para.4) liberalization in Argentina extended mostly to the financial sector. Indeed, at the peak of trade liberalization in late 1979 average effective protection was 91%. Of course the substantial peso appreciation achieved in late 1980 was a de-facto liberalization. However, following the sharp devaluation started in March 1981 and protectionist policies, average effective protection rates increased above the pre-appreciation period.

Argentina faces today, on the economic front, three major tasks: First, how to stabilize the economy, i.e., how to reduce its present inflation rate. Second, how to generate a current account deficit compatible with the existing foreign financing. Third, how to recover growth. It is widely accepted now by most economists that with inflation close to hyperinflation levels, the most appropriate policy is a shock treatment. The shock treatment would require an elimination of the public sector deficit (close to 10% of GDP today).

The recovery of output compatible with the available level of financing of the current account deficit would require a sharp and sustainable change in relative prices in favor of exportables and a rationalization of the protection system to import competing sectors. Thus, one should be careful that the stabilization program does not jeopardize the medium term recovery of growth.

The recently announced stabilization package calls for a reduction in the public sector deficit from 10% of GDP to only 2% of GDP. Furthermore, the Treasury will stop getting financing from the Central Bank. Accompanying measures are a sharp increase in prices of public utilities, increase in import taxes, increases in export taxes for grains, and a compulsory saving programs for middle and upper classes. The success of this stabilization program will depend crucially on two elements: First, the success of the government in reducing the government deficit to a level compatible with available non-inflationary financing at a moderate real interest rate. Second, the ability of the government authorities to sell their program to economic agents in Argentina. This last element calls for an acceptance of a large reduction in real wages (of the order of 25%) by the trade unions.

I have been told by sources in Argentina that the financing of a reduced government deficit for the first two months is insured. However, after the second month the sustainability of the stabilization program depends crucially on the ability of the government to increase real tax revenues and reduce expenditures and in this way to generate a public sector deficit close to 2% of GDP. Furthermore, from the begining it will be an uphill fight convincing the economic agents that stabilization is possible.

This is especially so for a country where 100% plus inflation has been in place for a good part of the last 15 years. Given this past history, the program has no more than a 50% chance of success.

III. MAIN ISSUES FOR DISCUSSION

As Argentina just announced a major stabilization effort, most of the projections of the CPP are outdated. Indeed, the IMF just sent a new mission to Argentina to update its program. The main issue that we should face now is how to contribute to the success of the stabilization effort and how to assure that incentives are in place for resources to go into tradable sectors. This will require a rationalization of the protection system as well as establishing the appropriate mechanisms to ensure the much needed supply response in exportables. Another important issue, given the size of the public sector, is to establish clear mechanisms for privatization and/or to increase the efficiency in the operation of public enterprises.

IV. RECOMMENDATIONS ON ERS POSITION

There is no doubt that the major problem facing Argentina now is how to stop inflation. The economic cost of an inflation that is running at 30% per month are just outrageous As the government has just announced a radical stabilization program aiming at stopping inflation we need to re-assess our participation in the light of the different elements comprising the stabilization package. In particular, we need to assess the implication for competitiveness of agriculture (a major export sector) of the recent measures.

If the government is able to reduce the public sector deficit substantially and thus to eradicate inflation we should be ready to come in with programs to strengthening the exportable sector and to improve the efficiency of the public sector. In the mean time in our policy dialogue we should encourage the government to go through with the stabilization effort.

With respect to concrete actions, we recommend that while the stabilization program is given a chance to work, we start discussions on appropriate actions to expand exports, rationalize the protection structure for import competing sectors and an improvement in the operation of public enterprises. Sectoral program loans in this specific area could play an important role in our lending programs with Argentina.

cc: Messrs. S. Rajapatirana (VPERS), G. Ingram (DRDDR)

June 25, 1985

Mr. Michalopoulos

Costas,

Because the brief on the Argentina CPP prepared by Jim de Melo is not adequate, I am attaching the note by Julio Nogues for the Argentina Agricultural Sector Loan (5/22/85) as well as a note I prepared. Together they should give you a general picture of the Argentine economy.

Sarath

Sarath

Attachments

P.S. Vittorio Corbo is also preparing a note on the CPP which will be given to you soon.

June 24, 1985

Mr. Michalopoulos

Costas,

The attached briefing note by J. de Melo falls far short of notes prepared by others. According to the discussion we had with G. Ingram, we should bring this to Greg's notice.

We sent him a reminder on the Argentina CPP on May 29th. Working level draft was available to him from before and we sent him the final version of the CPP on June 18, 1985. He did the SAL II on Chile after much protest. And there he just lifted paragraphs from the document and did not take the time to do a proper job.

I think a memo from you to Greg with a copy to him will have a salutary effect.

Sarath

Sarath

Attachment

SR:rm

S. Hume

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE June 19, 1985 — received at PAU 6/24/85

TO Mr. Jean Baneth, EPD

FROM Jaime de Melo, DRDPR JdM

EXTENSION 61218

SUBJECT Argentina CPP.

1. During FY 80-84 Bank lending to Argentina was only two-thirds of the planned U.S.$1,225 million. Frequent changes of government have made it impossible to sustain a fruitful policy dialogue. The recommendations from this CPP are that the Bank should target lending of about U.S.$650 million during FY 85-86 and, depending upon performance, shoot for lending in the U.S.$1 billion for FY 87-90. (The CPP recognizes that aggregate lending will be constrained if macro performance is inadequate). The proposed lending program would reverse the past trend starting in FY 79 whereby net transfers have been negative. Finally, the proposed lending program is primarily oriented towards investment projects and not policy-based lending so as not to box ourselves into a situation where we would attempt to extract paper commitments from the government which they would not deliver.

2. The broad areas of concentration would lead to a lending program that would:

a. Increase international competitiveness

-- raise agriculture productivity
-- help develop an effective export promotion strategy for industrial exports

b. Improve domestic resource mobilization

-- raise public utility prices
-- improve and rationalize the tax structure

c. Improve public sector management

-- public enterprise management upgrading, etc.

These areas of concentration appear reasonable in view of the current economic macroeconomic imbalances and long-run bottlenecks I describe below.

3. Argentina is suffering, above all, from a public sector deficit induced inflation. The fiscal deficit is about 15% of GDP with one third going to pay the external debt, another third the internal debt and the remainder to finance the excess of current spending over current

revenues resulting in part from inefficient (and costly to operate) public enterprises. Inflation is cruising at 20-30% per month and the inflation tax base has eroded to the point that real interest rates of up to 10% real per month must be paid to the public to induce them to finance the public sector deficit since there are no other sources of financing.

4. Last week, a bold program including price and wage freezes and the promise of halting the printing press was announced. This should help (can it become worse?) but there are elections in November so action is likely to be limited until then. Some of the announced measures, however, tend to discriminate against exports so that the recessionary impact of the policies (which cannot be avoided) may be directed towards the wrong sectors -- that is, towards sectors with net foreign exchange generation potential. If so, the Bank should warn the government of the potential medium-term damage of these policies.

5. Leaving aside the internal debt crisis of the banking system which calls for the inevitable recognition losses now or in the future, the second major bottleneck towards the road to recovery is the lack of confidence in the economy. Even though Alfonsin is popular, no one is going to invest as a "wait and see" stance is pursued because of the perception that the current situation cannot go on. This raises the issue of whether the scenarios in table 1 are not too optimistic. In any case, even if they aren't the conditions and links which will be necessary to achieve them (a low real wage -- or equivalently a high real exchange rate -- coupled with some productivity increases) are not spelled out.

6. In sum, the strategy in the CPP recognizes the realities of the Argentine politico-economic environment and proposes a reasonable course of action even though some of the bottlenecks for long-term growth outlined in paragraphs 4 and 5 could be more forcefully brought out.

JDM:mda

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Cc SK
SH for
your files
Sr

DATE May 28, 1985

TO Mr. Julio Nogues, DRDIE

FROM Anne O. Krueger AOK

EXTENSION 69001

SUBJECT Argentina Agricultural Sector Loan

Your briefing note on the Argentina Agriculture Loan was excellent. I wanted to let you know that I appreciate the effort you put into it.

cc: Messrs. G. Ingram
M. Finger

5/23/85

Loan Committee Discussion
May 24, 1985, at 2:30 p.m.,
Room E-1208

ARGENTINA: Proposed Agricultural Sector Loan

Please see attached: an initiating memorandum for Loan Committee discussion; a briefing note prepared by Julio Nogues; a memo on issues for discussion at the Loan Committee prepared by CPD and a memo from Peter Scherer (Chief of Argentina Division) to the Fund and Fund position on the loan.

My notes below supplement the briefing note by Julio by addressing the issues in the order raised by the CPD memo. The CPD memo arrived after Julio had prepared his briefing note. This note responds to the concerns expressed in the CPD memo with respect to the forecasts of production and export responses to the reduction of exports taxes on five import-export commodities (see paras. 21 to 25 in the initiating memo) and underlines the IMF/Bank positions on the proposed loan.

The first issue raised in the CPD memo (para. 2) is whether it is worthwhile to consider medium-term structural adjustment in the context of a loan as the present one to reduce export duties, when in fact the economy is in a substantial macroeconomic imbalance as evidenced by the 30 percent monthly rate of inflation, a 30% margin between the official and market nominal exchange rate, the continuation of import restrictions introduced in 1983, negative real interest rates, and a large volume of external debt. We agree with the CPD position that the first priority clearly is short-run macro stabilization. The issue is then to examine whether this loan supports or runs contrary to the stabilization effort. The estimates of supply response of exports of the five major commodities (wheat, maize, sorghum, soybeans and sunflower) are based on modified form of the EPDCS world grain/soybean model. I quote below a note from D. Mitchel of our Commodities Division who has been involved in this exercise.

> "Relative prices for agricultural commodities are important in determining producers output levels even under conditions of hyper inflation. This occurs because price relatives are maintained through government support prices and links to the world market and generally reflect producer profit opportunities. Hyper inflation does increase producer uncertainty and results in reduced application of purchased inputs such as fertilizer. In this respect hyper inflation has a depressing effect on production. It also has a tendency to reduce the production of crops which require larger amounts of purchased inputs relative to crops which are less intensive users of purchased inputs. Hyper inflations impact on agriculture is magnified by the long period between planting and harvesting which allow large real

price changes. Many of these elements are reflected in the parameters of the model because it has been estimated over a period of rapid inflation. The results may be less applicable to a period of low inflation."

Basically, we can take the position that, if the Fund takes care of the macro-stabilization issue, it makes eminent sense to reduce export taxes to offset the bias against exports. However, the bias in Argentina arises not only from export taxes but also from (a) the undevalued nominal exchange rate; (b) quantitative restrictions and tariffs on imported inputs used in the production of export crops. The best way to evoke an increase in exports as will be a devaluation and reduction of import protection by replacing the quantitative restrictions with tariffs. This will also satisfy the IMF concern (see note attached to the Peter Scherer memo) that the proposed substitution of land taxes for the export tax may not generate enough revenue which in turn will raise the fiscal deficit and exacerbate the macroeconomic imbalance. Our position is that direct efforts to reduce the fiscal deficit through cutting public expenditure combined with the reduction of export duties is superior to attempting to reduce the export duties while keeping the fiscal deficit unaffected by this operation.

The second issue raised by CPD is the adequacy of conditionality attached to the loan. The first tranche is released almost carte blanche. It only requires (a) GOA make a statement of agricultural policy including a provision to eliminate export taxes within a specified period (see para. 18 of the initiating memo). No timetable is stipulated for this; (b) give an undertaking that export taxes will not be increased and commission a study to define a program to substitute land taxes for export taxes. 1/ The mission should be encouraged to introduce more substantial conditionality to release the first tranche subject to the proviso that macroeconomic situation is being handled by GOA in consultation with the IMF.

The third issue (para. 4) raised in the CPD memo relates to the substitution of land or another alternative tax for export taxes. CPP doubts whether the imposition of a land tax is politically feasible or whether it is advisable to do away with a revenue raising tax in a situation of excess demand. (Here they buy the Fund position which opposes the removal of the land tax on revenue raising grounds.) There is here a clear conflict we have seen before between revenue mobilization (a Fund concern these days) and adjustment of relative prices to improve resource allocation. We could consider a devaluation, reduction of public expenditure and replacement of import restrictions with tariffs (with the possibility that as licenses premia are reduced domestic prices will fall) as means of avoiding the conflict between resource mobilization and improving allocation.

1/ Incidentally, the report implicitly assumes that land taxes are neutral with respect to the trade regime which is a questionable assumption for a country that exports agricultural products.

The fourth issue (para. 3) relates to whether this $350 million loan could finance general imports and help to cover the fiscal gap which could open up with the reduction in export duties. The region proposes a general import credit arguing that a loan to finance agricultural imports would be non-optimal. This argument has merit. However, since the loan is clearly for balance of payments support, it must be made in the context of a strong stabilization effort. That is, while a stabilization effort is proceeding, the Bank helps to improve medium-term trade and growth prospects. Otherwise, the loan has less merit and we are substituting for the Fund and providing funds in a distorted environment.

The fifth issue relates to having an update on the balance of payments situation, given that there are many reports of mounting arrears on debt repayment. The question here really boils down to creditworthiness. We could support this request and seek the opinion of the finance complex. However, we may note again that at the crux of the debt issue is the macroeconomic imbalance.

A sixth and final issue raised is whether the Bank will review public investment programs and whether the region envisages other loans to this sector. We could support this however we need to emphasize again the macroeconomic balance concern, improvement of the incentive structure has to be done within a stabilization context. A dialogue must be built around this issue.

SR:rm

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

SH

MAY 23 1985

DATE May 22, 1985

TO Sarath Rajapatirana, VPERS

FROM Julio J. Nogués, DRDIE

Julio

EXTENSION 61257

SUBJECT Argentina - Comments to the 'Agricultural Sector Loan'

Per your request, I enclose my comments on the above.

Attachment

JJN:sw

cc: J. Michael Finger, DRDIE

I. Economic conditions

The economic conditions of Argentina can be characterized by a significant macroeconomic imbalance, major policy induced distortions on factor and goods markets, and increasing government intervention on the economy.

When Mr. Alfonsin started his Presidency in late 1983 the monthly inflation rate was in the neighborhood of 15% and had a tendency to accelerate. During recent months the inflation rate has been around 30%. This has occurred in spite of a significant reduction in the real price of beef and more generally of the international price of Argentine exportables.

The proximate causes of this run-away inflation is not only a fiscal deficit which continues to be huge in spite of some reductions in public expenditures, but also as well, a continued attempt by residents to reduce peso holdings as interest rate ceilings in the controlled segment of the financial market have been set well below inflation rates. Pricing policies are also affected by continued fears of an eventual attempt by the government to tighten its price controls. Finally, during 1984, one of the major economic goals of the government was to increase real wages by 12%. This attempt at redistributing income not only increased government expenditures but also as well, lowered profit rates, thereby reducing still further the incentives to invest in Argentina.

Other major policy induced distortions include the reimposition of high wage taxation, and continued across the board import licensing and foreign exchange controls. Also, exchange rate policy has been uncertain, and only in recent months has there been an explicit attempt at devaluing at least as fast as the increase in domestic prices. Finally, given the extended controls on international payments a parallel market has flourished. On average over the last two years I would guess that the differential between the exchange rate in this market and in the official market has been in the order of 30%.

Obviously, the balance of payments problems have continued increasing. Argentina has followed a confrontational approach to its debt problem, which has severely curtailed its access to international capital markets. Also, and in spite of its trade surplus, the current account has been negative since 1980.

Finally, the small growth recorded during 1984 has apparently vanished. Recent estimates would indicate an important negative growth during the past quarter of 1985.

In summary, the macroeconomic imbalance of Argentina is huge and distortions across factor and commodity markets have reduced severely the competitive forces. I see no prospects for growth unless the macroeconomic situation of the economy is improved significantly and some competitive forces are reintroduced. What is needed is a commitment by the leadership elite to move in this direction. Unfortunately, I still see much reluctance on the part of policymakers to act forcefully.

II. The proposed agricultural sector loan

This agricultural sector loan of US$350 million will be offered to the government in exchange for a commitment on its part to reduce and eventually eliminate export taxes. Reduced tax revenues would be compensated by a land tax.

The World Bank plans to release the loan in two tranches. The first tranche would be practically free of policy conditionality. In order for this tranche to be released the World Bank would require some type of assurance from the Government of Argentina (GOA) that export taxes would not be increased from present levels, and that a 'study commission' has been duly constituted by GOA. This commission would analyze the major characteristics and ways of implementing a land tax which would substitute export taxes.

The major policy conditionality comes in the second tranche when the World Bank would request GOA to reduce export taxes of wheat, maize, sorghum, soybean and sunflower from their present levels 1/ to around 11.5%.

The World Bank estimates that by introducing this policy, Argentina's gross foreign exchange earnings would increase by US$805 million by 1987, i.e. after the proposed tax reduction has taken place. This figure would increase to approximately US$1,430 million by 1990 if export taxes on these five products were completely eliminated. Therefore, the reduction of export taxes appears to have important foreign exchange implications. This finding is in line with previous estimates I recall on the economic costs of export taxation in Argentina.

III. Comments

Export taxes have been among the most significant policy-induced distortions of Argentina. Present export tax rates are not high in comparison to historical peaks and very likely also in comparison to the historical average. These taxes have been used not only for fiscal purposes but also as well for protecting domestic producers using agricultural goods as inputs and

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1/ Products and current export tax rates are the following:

Product	Export Tax Rate (%) */
Wheat	19.5 (25.5)
Maize	22.5 (31.5)
Sorghum	21.5 (32.5)
Soybean	17.1 (23.2)
Sunflower	14.5 (22.0)

*/ Figures between brackets indicate export tax rates at the end of 1984.

also for maintaining low food prices. Because the relative importance of these objectives has changed over time, the effective exchange rate faced by agricultural producers has been very unstable. Dismantling these export taxes will therefore imply that the exchange rate will now be the major determinant of the returns to agriculture. Assuming that the GOA comes to an agreement with the IMF, then it is likely the case that the future path of the real exchange rate will be more stable and more realistic than the past.

Therefore, because of static as well as dynamic considerations I strongly support this policy. Despite this, I do see some problems which are important to clear out before this loan could be fully supported.

1. <u>Conditionality on the first tranche</u>

As discussed, the first tranche of this loan is practically empty of conditionality. The first section of this report has sketched some of the major structural problems also as well, the short-run behavior of the economy.

It should be clear that Argentina is suffering the consequences of a chaotic management of its economy. Unless the short-run macro-economic management of the economy is improved significantly there is the danger that new loans to Argentina will in the short-run be financing inefficient projects and/or external disequilibriums, and/or capital flights, all of which in the long-run serve to increase the debt burden of the country but not its capacity to repay this debt. This improved management would by itself provide the biggest boost to enhance Argentina's growth prospects. If these policies are appropriately framed, they should reduce and/or eliminate the differential between the parallel and the official exchange rates. This differential actually implies a tax on exports higher than that of explicit export taxation.

2. <u>Risks of a policy reversal</u>

The Initiating Memorandum stresses some risks associated with switching from a scheme of export taxation to one of land taxation which I would like to emphasize. These refer to the possibility of '...reinstallation of export taxes...' and the likelihood that substitute taxes will be evaded.

In my view these risks are closely interlinked. Export taxes account for 20% of the central government tax revenues. If the government fails to collect revenues on the proposed substitute taxes, then the incentives to reintroduce the easy-to-collect export taxes will increase.

The incentives for tax evasion are expected to increase among other things with the degree of 'financial repression.' As discussed, Argentina's monthly inflation rate has been around 30% in recent months. The private sector has to a great extent been crowded-out by the need to finance the fiscal deficit. In this scenario I expect for every private agent to be seeking actively a way to evade tax payments. If the substitution of export taxes by a land tax increases opportunities for tax evasion, then there should be no doubt that the private sector will profit from them. This will obviously increase the fiscal deficit and therefore the inflationary trend of the economy. Things would end being worse off.

These brief comments raise technical questions such as: Will the land tax be easily collected? Will it compensate for reduced export taxes? These are important technical questions which should be given an answer. As said, GOA - as part of first tranche conditionality - should create a 'study commission' whose work should answer these and other questions before the second tranche is released. I would suggest that these answers should be ready even before the first tranche is released. The idea of a land tax is an old one in Argentina, and preliminary answers to questions such as those posed above should be available. In any case, the World Bank should minimize the risks of releasing the first tranche and finding at a later stage that, the requested policy conditionality is financially unsound.

3. Political considerations

Historically in Argentina, there has been a political opposition by landowners to the idea of substituting export taxes with a land tax. In part this could be explained by 'self interest', but, there is also a fear that in the long-run export taxes will not be finally dismantled. In this case, the introduction of a land tax and/or increase in land tax rates will have served the purpose of increasing the tax burden of the agriculture sector.

I think, that the foundation of this fear is rooted in the political instability of Argentina. Such instability is still present and I understand that in recent months there have been important confrontations between private landowners and the Secretary of Agriculture.

Finally, a land tax, I have been told, must be approved by the Parliament and it is not at all clear that this will be easy.

4. Pricing policies of intermediate imports

The agricultural sector has been obliged for decades to buy its intermediate and capital goods to protected domestic producers. This has been another way of discriminating against the agricultural sector. The Initiating Memorandum states that '...While taxation on imports of farm machinery and certain agrochemicals is currently high (up to 38%), they do not appear to have been a significant disincentive to production...' (p. 8).

In 1983 Argentina introduced across the board import licensing, and I understand that this policy continues to be enforced quite strictly. In particular those goods that are domestically produced are forbidden to be imported. Therefore, domestic prices of intermediate imports and capital goods for the agriculture sector are expected to exceed international prices by a margin that is higher than that represented by ad-valorem tariffs. One way of reducing this discrimination would be to allow agricultural producers to benefit from the drawback system i.e. to put them in the same footing as the exporters of non-traditional exports.

IV. Conclusion

It is my view that a shift in the domestic terms of trade in favor of agriculture is a sine qua non for increasing the growth prospects of Argentina. I would like to see the World Bank move forcefully in this direction. There are many policy changes that are needed to move the Argentine domestic terms of trade close to international relative prices. The reduction and/or elimination of export taxes is one of these, but there are others in which so far I haven't seen the World Bank moving into.

But before any of these sectoral policies can be attempted with some degree of confidence that they will be long lasting, the economy needs to be stabilized. I would attach a high probability of reversal of the policy suggested in this loan if implemented under current conditions.

INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

cc. SR

DATE: May 21, 1985

TO: Messrs. Stern, Qureshi, Husain, Shihata, Knox, Dherse and Mrs. Krueger

FROM: Luis de Azcárate, Director, CPD

SUBJECT: ARGENTINA: Proposed Agricultural Sector Loan

704

1. The Loan Committee will meet on Friday, May 24 at 2:30 p.m. in Room E-1208 to consider a proposed $350 million Agricultural Sector Loan for Argentina. The following are selected points which the Committee may wish to discuss.

2. This operation, though focusing on reforming certain aspects of agricultural policy, is essentially a budget support loan with implications affecting the whole Argentine economy. The Initiating Memorandum rightly draws attention to serious economic problems including inflation, the budgetary deficit, public enterprise management and inadequate resource mobilization without spelling these problems out in detail. Latest reports indicate that efforts at stabilization are not entirely successful and inflation is said to have reached 30% in April, a figure which, if compounded monthly, would add up to an annual rate of inflation of 2300%. In conditions of hyper inflation such as those prevailing now in Argentina, can we meaningfully talk about medium-term adjustment of relative prices? How can we measure the revenue from taxation, or estimate public expenditure, or gauge the fiscal deficit? And are the various calculations made about the comparative profitability of crops (passim, particularly paras. 21 and 22) still valid? And can we judge the level of prices that would provide adequate incentive to farmers? All this would raise the question as to whether it is worthwhile to talk of medium-term structural adjustment in conditions of rapid inflation before some degree of stabilization is underway.

3. According to the Initiating Memorandum (para. 17) "the reductions in export taxes in the context of the preparation of a possible Bank loan, complemented by recent peso devaluation [would] be considered sufficient for release of the first tranche of the sector loan". Considering the proposed size of the loan is such conditionality sufficient? While Board presentation would be conditioned on the initiation of a study of export taxes, the time frame for completion of the study and implementation of its findings is not specified.

4. At the heart of the adjustment is the gradual substitution of a land tax or other alternative taxation for the existing taxes on exports. What are the chances for regional and federal agreement to the proposed land tax and what are the prospects for congressional approval? Since clearly a long transitional period is required for the change, the "additional tax instruments" that will be needed in the interval (para. 15 (b)) require

careful identification and assessment. Besides, is it advisable to do away with a revenue-raising tax in the current conditions of excess demand? The Uruguay experience shows that eliminating such a tax while stabilization is being pursued runs contrary to the logic of short-term economic management and might have to be sacrificed until stabilization is complete.

5. The idea that the loan would finance the import of non-agricultural inputs seems to merit discussion as the proposed loan amount ($350 million) exceeds the expected total imports of agricultural inputs in 1985, of which only $200 million is foreseen to be eligible. Since it is argued that the loan would contribute to bridging the fiscal gap that would arise from reducing export taxes, should we not assess the origins of the fiscal gap and seek also to rationalize public expenditure?

6. The Initiating Memorandum properly mentions the fact that servicing interest on the foreign debt absorbs 60% of all export earnings. There are also many reports about mounting arrears on debt repayments. Can we have an updated picture of the balance of payments with projections similar to those worked out in Annex I on the financial impact of export tax changes?

7. It is not clear from the memorandum if public investment in agriculture would be reviewed under the program, and if so how such a review would fit in with the tasks of the public investment review mission currently in Argentina. Besides, what kind of lending operations in support of agricultural investment do we envisage following this sector loan?

cc: Messrs. van der Meer, Gue, Gonzalez-Cofino, van Gigch
Pfeffermann, Scherer, Otten, Levy, Sokol, Zagha
van der Tak, Rajagopalan, Baneth, Schuh
Dubey, Kavalsky, El Serafy