Ministry of Economy
República Argentina
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Argentine Economic Policy in Perspective:
Diagnosis, Policy Response, and Future Challenges

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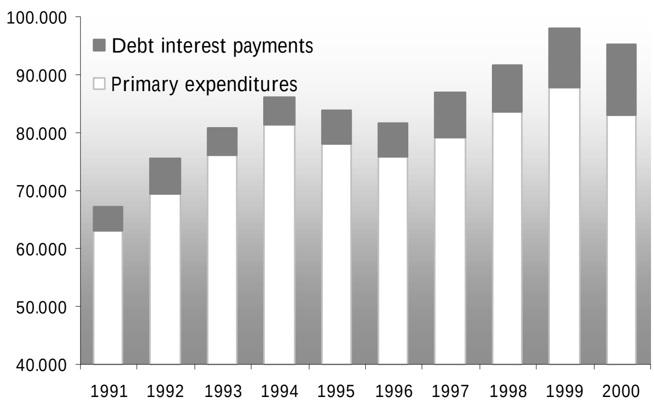
Chart 1:
Consolidated Public Expenditures Performance during the 90's
In millions of US$



Source: Secretariat of Economic Policy, Ministry of Economy.

The Diagnosis

The Argentine economy started in 1991 a phase of deep structural reforms, which triggered a period of high growth and very low inflation. The main pillars of these reforms were the Convertibility Law, which ensured price stability, a widespread privatization and deregulation process, and a significant opening of the economy. At the same time, considerable progress was achieved in terms of fiscal solvency, and the "pay-as-you-go" public pension system was transformed into a fully funded one, strengthening future fiscal performance.

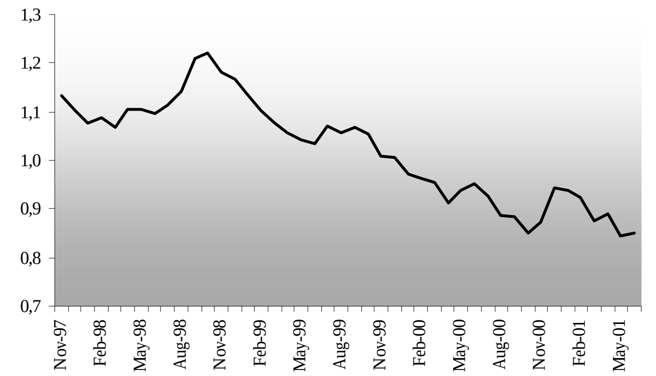
However, since mid 1998 the economy has been trapped in a long-lasting recession. This recession was the result of a worsening external scenario, together with an increasingly complicated fiscal scenario that has kept country risk and interest rates at very high levels.

In spite of an adjustment in overall public spending in 1995 and 1996, the last three years of the previous administration were characterized by an increase in overall public expenditures (at Federal and Provincial levels) as a result of both an increase in primary expenditure and interest payments. The strong increase in the average financing costs of public debt were due to the gradual replacement of previous compulsory debt placed at very low cost, by new voluntary market debt, which in general paid higher interest rates.

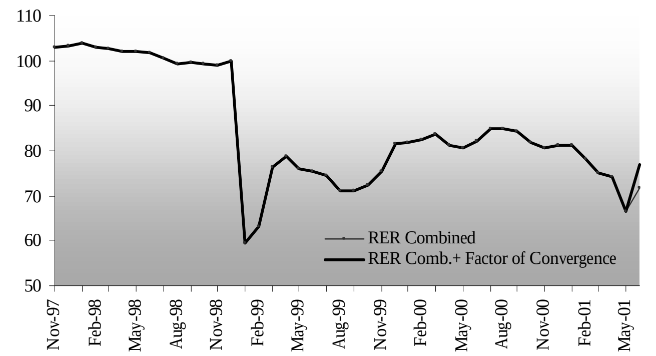
The growth in public expenditures was financed partly through new taxes and partly through new indebtedness. As a logical consequence, the increase in tax burden and the crowding out of private credit induced a strong contraction of private investment. The increase in the tax burden also deteriorated the effectivity of tax collection. At the same time, the speed of structural reforms slowed drastically. While during 1990-1997 global productivity growth reached a 4% annual rate, from 1998 onwards the combination of reduced investment rates and the slower speed of

(Asia, Russia and Brazil) increased the financing cost of the Argentine government, while a deep fall in the terms of trade and the devaluation of the Brazilian currency continued to undermine competitiveness.

Chart 2
External Shocks. US Dollar appreciation and Brazilian Real depreciation
Dollar-Euro Exchange Rate

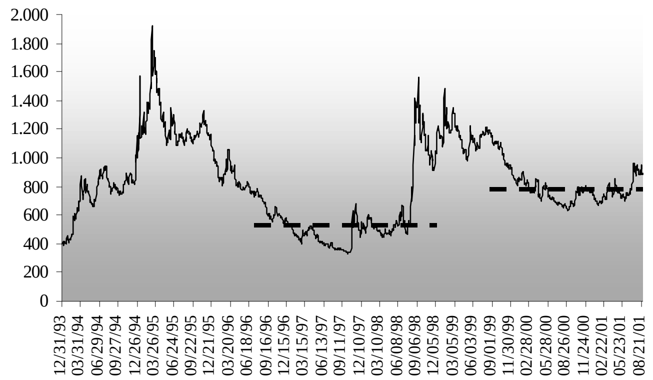


ArgentinaBrazil Bilateral Real Exchange Rate
(With Convergence Factor since June 2001)

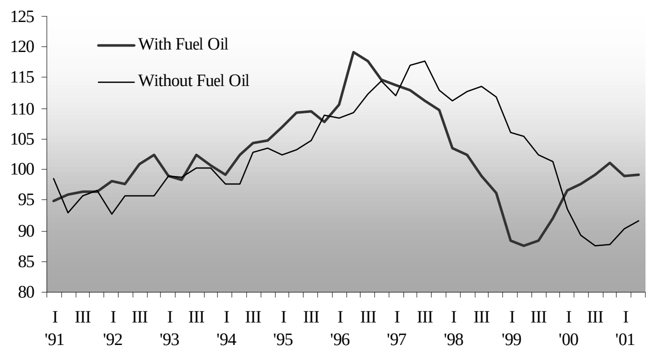


Source: Bloomberg.

Chart 3:
External Shock to the Capital and Current Account of the Balance of Payments
Emerging Markets Risk (EMBI+)



Export Prices



Source: Bloomberg and Secretariat of Economic Policy, Ministry of Economy

structural reforms turned productivity growth negative.

Additionally, external factors contributed to intensify the recessive cycle. The dollar strength generated important deflationary pressures that, contrary to what had happened in the first years of Convertibility, were not offset by productivity growth.

Furthermore, successive international financial crises

In turn the deflationary impact of external shocks eventually started to undermine fiscal performance. In spite of tax rates increases, tax revenue collection continued to weaken, adding to Public Sector disequilibrium, which, in turn, increased country risk and financing costs, creating a vicious circle that increased the depth and duration of the recession.

Thus, from the beginning of President de la Rúa's administration economic policy efforts were focused on

Table 1
Fiscal Efforts. Consolidated Primary Expenditures *
In millions of US$

Item	Year		
	1999	2000	Dif.
National Public Sector	**41.211**	**39.395**	**-1.816**
As % of GDP	*14,5*	*13,8*	*-0,7*
Provincial Sector	**37.187**	**35.838**	**-1.349**
As % of GDP	*13,1*	*12,6*	*-0,6*
Municipalities	**7.973**	**7.876**	**-97**
As % of GDP	*2,8*	*2,8*	*-0,1*
Consolidate	**86.371**	**83.109**	**-3.262**
As % of GDP	*30,5*	*29,2*	*-1,3*

Source: *Secretariat of Economic Policy, Ministry of Economy.*

** Calculation of consolidated public expenditures includes outlays by the non-financial public sector corresponding to the three levels of government, regardless of whether or not they were recorded in their respective budgets, and off-budget expenditure corresponding to federal and provincial health and social security systems. The criterion adopted calculates expenditure in the jurisdiction where executed and not where financed. As a result, to avoid duplication, transfers of funds from the Nation to provinces and municipalities, as well as from provinces to municipalities, have been deducted from the financing jurisdiction and included in the jurisdiction where executed.*

strengthening fiscal solvency. In the year 2000, consolidated public expenditures (accrual basis) decreased about 1.3% as a share of GDP (U$S 3,300 million) (see Table 1) and the provincial deficit contracted 0.5% also as a share of GDP (see Table 2).

However, in spite of these fiscal efforts, the persistent stagnation implied that the deficit of the National Public Sector showed only a very slight improvement of 0.2% as a percentage of GDP (see Table 2).

Unfortunately, political events that took place during the second half of 2000 (in particular, resignation of the Vice President) created concern in the markets regarding Argentina's governability. These circumstances, in turn, increased skepticism regarding the willingness and ability of Argentina to fulfill its debt commitments. The government addressed this problem by putting together a financial shield program that covered most of the financing needs for year 2001.

In spite of a short-term relief, underperformance of the fiscal accounts during the first quarter of 2001 kept international financial markets closed, anticipating a crisis during April and June when the government needed to access international financial markets. In addition, a drastic expenditure reduction program was aborted adding to the sense of unfeasibility to the Government's compliance with its debt obligations.

Throughout this period, in spite of the fiscal deterioration and the stubborn recession, Foreign Direct Investment remained high (Table 3) and exports continued to outperform growth in the rest of the economy. In particular, Manufactures of Industrial Origin grew about 20% per year, as a consequence of the opening of new markets outside Mercosur (see Table 4).

The strength of exports and the continued inflows

Table 2
Fiscal Efforts in Year 2000. National and provincial level.
In millions of US$

Item	National Public Sector (*)			Provinces (**)		
	1999	2000	Dif.	1999	2000	Dif.
Primary expenditures (cash basis)	**55.000**	**53.706**	**-1.294**	**34.984**	**33.502**	**-1.482**
As % of GDP	*19,4*	*18,8*	*-0,6*	*12,4*	*11,8*	*-0,6*
Tax revenues	38.625	40.671	2.046	27.845	27.253	-592
Non Tax revenues	17.050	15.496	-1.554	3.591	4.308	717
Primary surplus	**876**	**2.720**	**1.844**	**-3.194**	**-1.363**	**1.831**
As % of GDP	*0,3*	*1,0*	*0,6*	*-1,1*	*-0,5*	*0,6*
Debt Interest Payments	8.223	9.656	1.433	1.431	1.855	424
Fiscal Deficit	**7.347**	**6.936**	**-411**	**4.625**	**3.218**	**-1.407**
As % of GDP	*2,6*	*2,4*	*-0,2*	*1,6*	*1,1*	*-0,5*

(*) Cash basis, excluding BCRA Cuasifiscal Surplus (**) Accrual basis.

Source: *Economic Report Nº 36, Secretariat of Economic Policy, Ministry of Economy.*

Table 3:
Foreign Direct Investment during the 90's

	92-95		96-99
Petroleum	$ 2.001	153%	$ 5.061
Mining	$ 16	5,740%	$ 921
Manufacturing	$ 3.242	244%	$11.145
Electricity	$ 3.360	53%	$ 5.148
Trade	$ 515	377%	$ 2.456
Transportation & Telecom.	$ 258	884%	$ 2.535

Manufacturing	92-95		96-99
Food & Beverages	$1.690	68%	$ 2,836
Paper	$ -44	NA	$ 822
Chemical	$ 888	292%	$ 3.482
Cement	$ 106	289%	$ 414
Basic Metals	$ 151	884%	$ 793

Amounts in millions US$. Annual averages

Source: Secretariat of Economic Policy, Ministry of Economy.

of FDI reveals that Argentina has a healthy economic structure. Therefore, economic policy should focus on the four issues which may be responsible for the persistence of a recession in an otherwise solid economic environment: establishing an effective government coalition, stimulating economic growth, ensuring fiscal solvency, and ensuring appropriate financing and full compliance with the government's debt obligations.

Table 4:
Export Growth during the 90's. Successful Stories

	1992		2001 *
Agriculture	$4829	62%	$7825
Industrial	$2824	236%	$9479
Energy	$1081	345%	$4809
Primary	$3500	74%	$6104

Industrial	1992		2001 *
Chemicals	$533	225%	$1735
Plastics	$148	306%	$600
Rubber	$40	315%	$165
Paper	$128	233%	$425
Textiles	$122	176%	$335
Metals	$644	129%	$1475
Transport Material	$405	666%	$3100

Amounts in millions US$

(*) Projected.
Source: Secretariat of Economic Policy, Ministry of Economy.

The Policy Response

The government acknowledges that no measures to encourage economic activity can be successful without previously strengthening the macroeconomic fundamentals. All efforts have been focused toward that objective through (i) consolidation of an effective government coalition, (ii) enhance fiscal solvency; (iii) reduction of financial vulnerability, and (iv) implementation of a (supply and demand side) growth strategy.

An effective government coalition

Since March 2001, for the first time in 18 years of democracy, Argentina has a National Unity Government with broad political support, including other political parties than those included in the Alianza. In a sign of important political support, President Fernando De la Rúa obtained an exceptional delegation of legislative powers by a Law that was enacted within 6 days and supported in the Lower House by almost all the political spectrum.

Delegated powers dramatically improved governability and enable the Executive to modify laws. In the first days the economic team improved the Anti-Trust Law, eliminated exemptions on Income Tax, generalized the VAT, reduced VAT on capital goods, and implemented other important initiatives (see Table 5). Without the delegated powers it would have demanded two years to enact this legislation. Moreover, the National Congress has recently approved an important fiscal reform proposed by the Executive Power.

Fiscal Policy: short and long run objectives

On the fiscal front, the initial efforts were focused on the fulfillment of the Fiscal Responsibility Law and the achievement of the commitments made with the IMF. In fact, to fulfill these goals the government implemented at the begging of 2001 a fiscal adjustment of about $3.8 billions, based not only on tax hikes but also on significant spending cuts: $2.7 billions from the new Financial Transaction Tax; $0.2 billion from other taxes; and $0.86 billion due to reduction of public ex-

Table 5:
Enhanced Governability. New measures approved

Description	Norm	Date
Increase in consumption goods' tariffs and reduction in capital goods' tariffs	Resolution 8/2001 Resolution 27/2001, Ministry of Economy	3/27/2001 4/10/2001
Competitiveness plan for capital goods	Decree 379/2001	3/30/2001
Tax on debits and credits of current accounts	Decree 380/2001	3/30/2001
Competitiveness Law: delegation of legislative powers	Law 25.414	3/30/2001
Modification of Anti-trust Law	Decree 396/2001	4/1/2001
VAT generalization	Law 25.405 Decree 493/2001 Decree 498/2001 Decree 845/2001	4/4/2001 30/4/2001 2/5/2001 25/6/2001
Acceleration of VAT reimbursements	Law 25.406	4/4/2001
Modification of Central Bank Chart	Decree 439/2001	4/18/2001
Competitiveness plan for meat processing	Decree 448/2001	4/23/2001
Expenditure Cuts	Administrative decision 43/01, Chief of Cabinet	4/24/2001
General Regulatory Framework for Competitiveness Plans	Decree 730/2001	6/6/2001
Competitiveness Plans: agreements with provincial governments	Decree 761/2001	6/12/2001
Competitiveness Plans Implementation: creation of beneficiaries' roster Agreements Formalization: cotton, vehicles and car parts, textiles, clothes and footwear, cultural sectors, fruit production, wood and furniture, tourism, agriculture, cargo transportation, rice	Resolution 1039/2001 Agreements Signed	6/12/2001
Convergence factor	Decree 803/2001	6/19/2001
Reduction in maximum import tariffs from 35% to 27%; reduction in export reimbursements by 7 percentage points	Resolution 220/2001	6/19/2001
Increase in diesel tax and reduction in fuel tax	Decree 802/2001	6/19/2001
New regulatory scheme for energy sector	Decree 804/2001	6/21/2001
Enhanced Convertibility Law	Law 25.445	6/25/2001
Increase in Labor Tax as a prepayment for VAT	Decree 814/2001	6/22/2001
Zero Deficit Rule	Decree 896/01	7/13/01
Zero Deficit Rule	Law 25.453	7/30/2001
VAT collected on cash basis	Law 25.453	7/30/2001
Increase in Labor Contributions for Service Companies (except SME)	Law 25.453	7/30/2001
Increase in VAT tax rate on Cable TV and fuel tax	Law 25.453	7/30/2001

penditures (see Table 6). Public expenditure reduction is part of a broader objective to fight excessive bureaucratic public expenditures and corruption, one of the government's primary goals.

One of the key tools of the fiscal adjustment process has been the implementation of the new Financial Transactions Tax (FTT), which because of the difficulty to evade allowed sustaining tax collection. However, its main contribution will certainly be focused on its use in the fight against tax evasion. In the near-term the FTT will be fiscally neutral, given that its receipts will be fully computed as an advance payment for VAT and Income Tax. The information obtained from the FTT, together with the use of checking account information, will make the FTT a fundamental tool in the fight against tax evasion. To complement this, changes in BCRA rules have been focused in eliminating a set of distortions in the Minimum Liquidity Requirements, reducing the operative cost of checking accounts, encouraging their use.

One of the long term objectives of the new fiscal policy is to generate a more efficient and equitable tax structure while reducing tax pressure over the private sector. To achieve this goals, distorsive taxes will be gradually eliminated until converging into a two tax system: VAT (which will be reduced to 16% in the long run) and income tax.

Nevertheless, convergence toward a new tax system requires for the gradual reduction of distorting taxes to be accompanied by mechanisms that will substantially reduce the levels of tax evasion. The possibility of computing some taxes as payments toward the VAT is the mechanism by which the government takes advantage of good collection and control mechanisms presently in place, while incorporating a larger number of taxpayers to the system.

Within this framework, the government has moved ahead in the use of easy-to-collect-taxes as a pre pay-

TABLE 6
Initial Fiscal Adjustment to accomplish IMF Targets
In millions of US$

Fiscal Adjustment	Million of $
Higher Revenues	**2.900**
Financial Transaction Tax	*2.700*
Other	*200*
Expenditures reduction	**860**
ANSES (Social Security)	*440*
Administrative Cuts	*420*
Total Fiscal Adjustment	**3.760**

Source: Secretariat of the Treasury, Ministry of Economy.

ment mechanism. In addition to the FTT, it established uniform employers' contributions, at 16%. In the cases where the new rate may imply an increase relative to previous obligations, the increment will be considered a pre payment towards the VAT (thus increasing the tax burden only on those who were previously evading VAT). Second, the government increased the tax on diesel oil. Again, the increase will be partially taken as payment towards the VAT, a measure that prevents an impact on companies' costs while fighting tax evasion.

The recently announced privatization of tax-arrears-collection adds another tool in the ongoing efforts to reduce evasion. A Fiduciary Fund is created with fiscal assets and liabilities, with the twofold purpose of improving fiscal collection and alleviating the financial constraints of many companies. As a first step in this direction, VAT credits will be documented. These credits will constitute the liabilities of a Fiduciary Fund that will incorporate as assets the total amount of outstanding arrears to the local IRS (DGI) (approximately $15,000 million). The Fund's liabilities, on the other hand, have an approximate value of $5,000. The fund will issue certificates to the companies that have documented credits against the DGI. These certificates will be used to guarantee credits, obtain working capital and settle debts.

The new Fiduciary Fund will be managed by banking entities, in order to minimize information asymmetries, consequently reducing the discount factor applied to certificates. The privatization of collection management substantially improves the incentives to maximize tax collection (in arrears), allowing at the same time for a substantial amelioration of the financial situation of the companies by making liquid, assets that were previously immobilized. Furthermore, improvement in collection management will reduce the incentives for tax evasion.

Finally, recent approval by the Legislative Power allows payment of VAT to be collected on a cash basis, instead of on an accrual basis (scheme presently in force). The measure will facilitate the taxpayers' financial management and the control of compliance of tax obligations, based on banking operations. As noted, the tax on financial transactions and the encouragement in the use of current accounts will be the core of the new control mechanism.

Zero Deficit Rule

However, by early July 2001, it became clear that all these mechanisms were not enough to eliminate market concerns regarding sustainability of fiscal policy. Therefore, with the intention to improve the markets risk perception of Argentina and to avoid the vicious debt dynamic cycle that would inhibit any long-term growth possibilities, the government decided to immediately implement a new key structural reform: the "Zero Deficit Rule".

The lack of flexibility of the exchange rate, which rules out any attempt at diluting wages through devaluation or inflation, requires added flexibility on the spending side. Through the Zero Deficit Rule, Argentina has taken the path of building this flexibility explicitly, making the exchange rate regime more sustainable.

Under this new rule the government makes explicit the objective of not increasing its outstanding debt position by implementing from H2 2001 onwards a yearly balanced budget.

In light of the fact that market concerns regarding Argentina's economic performance have often been driven by (or at least have been influenced by) political or legal concerns, it seems worthwhile to underline some legal aspects of the adjustment mechanism. First of all it should be stressed out that, the "Zero Deficit Rule" was politically and legally supported by the approval of the National Congress. Moreover, the core of the rule is based on a Law which has the legal status of "Public Order Norm" (Norma de Orden Público) and is therefore not subject to judicial procedures which may stop its implementation. It should also be added that the horizontal spending cut mechanism also eliminates the usual court argument of discrimination. Most importantly, it does not create unpaid expenditures.

Finally, it is worth mentioning that similarly to the role played by the President of the Central Bank in accomplishing Convertibility Law, accomplishment of the "Zero Deficit Policy" is a primary responsibility of the Secretary of the Treasury.

In order to soften the burden of the fiscal adjustment for low income public employees and pensions beneficiaries, the National Congress proposed a complementary set of measures: (i) to increase labor contributions for service companies; (ii) to delay implementation of the reductions in the income tax and tax on fuels (gasoline); and (iii) to increase VAT tax rate on Cable TV (to 21% from current level of 10.5%). On the expenditure-side, the adjustment coefficient (currently 0.13) will be applied to all budgetary items, except wages and pensions lower than $500.

Zero Deficit Rule: the next step after Convertibility

In the late 80's the chronic reluctance to balance the budget led to hyperinflation and social chaos. This was only overcome with the Convertibility Law, which pegged the currency to the dollar and thus did away with independent monetary policy. However, Convertibility ruled out the possibility of printing money but it did not rule out the possibility of issuing debt.

That is, although the Convertibility did not prohibit fiscal deficit per-se, it did implicitly limit its scope to the market-willingness to increase its Argentine debt positions. The financial market turbulence that started in late 1997 throughout Asia, spreading to the rest of emerging markets (with particular emphasis to Russia in 98 and Brazil in 98/99), together with the slowdown in global economic growth, affected investors risk appetite to a point where Argentina faced (despite moderate fiscal and debt ratios) enormous difficulties in convincing bond holders to increase their positions in sovereign debt. The result is that, 10 years after Convertibility was introduced, Argentina has put so much pressure on bond markets that it has reduced their value to unprecedented levels. The solution, once again, is simple and transparent rules: the rule is to achieve immediately a zero deficit target.

Moreover, the Zero Deficit Rule should imply a deep cultural change in public sector performance. The new rule should bring about a rapid restructuring of the state as public employees become virtual "shareholders" and hence will be committed on an efficient use of public resources.

Financial policy: the role of the debt exchange

To tackle the financing problem the government carried out a voluntary debt exchange that in the short run will be useful to reduce the roll-over risk that Argentina faces. The operation allowed for a substantial decompression of financing needs over the next five years. The debt exchange allowed Argentina to reduce it's financial commitments in U$S 16,000 million during the next five years while providing a U$S 7,800 million reduction in the next 18 months.

The debt exchange followed three objectives. First, to reduce roll over risk, increasing the flexibility to handle the public debt. Second, to smooth the shape

Table 7:
Financial Program for 2002 (Preliminary Figures)
Low exposure to market turbulence (in billions of US$

Instrumented Debt Amortizations (public bonds and multilaterals excluding short term debt) (*)	21,1
Other Amortizations	1,0
Fiscal Deficit (original IMF target)	5,0
Short-term debt (**)	0,5
Total Financing Requirements (before Debt Swap, "Zero Deficit Policy" and IMF package)	**27,6**
Debt Swap Effect	**4,3**
Interest reduction	1,5
Amortization reduction	2,8
Financing Requirements after Debt Swap	**23,3**
Fiscal Deficit Reduction net from interest reductions (Zero Deficit)	**3,5**
Financing Requirements after Debt Swap and "Zero Deficit Policy"	**19,8**
Committed Financing Sources (including IMF package and others)	**14,7**
Multilateral and bilateral	8,6
Institutional Investors (basically Local Pension Funds)	1,7
MLR Bond (BCRA)	2,0
2001Financial Cushion	2,4
Financing Requirements after Swap, "zero deficit" policy, and committed financing sources	**5,1**
Supplementary Reserve Facility roll-over	**2,9**
Financing Requirements after Swap, "zero deficit" policy, committed sources and SRF roll-over	**2,2**

(*) Includes $743 millions of Bono-Pagaré '02 (Letes' exchange).
(**) Excludes $1,5 billion of Letes roll-overed by local investments funds.

of debt obligations. And finally, to adjust the financing needs to better match them with the needs imposed by the transition of the social security system (from a pay-as-you-go into a fully funded one).

Which was the cost of the debt exchange? It has been wrongly inferred that having carried out the debt exchange in extremely adverse circumstances has locked-in debt costs so high that it opens questions regarding the country's fiscal solvency in the long term. Although new debt has a yield of 15.29%, it is also true that as the old debt was rescued below its nominal value thus generating a substantial return to the government. The repurchase of bonds had a yield of 14.94%. Thus, the Argentinean government paid just 35 extra basis points, while in return improved substantially the outlook of financing needs in the next years.

The debt exchange smoothed public debt expirations intertemporally, reducing financing needs for the year 2001. As a consequence of a successful debt exchange, most of the financial needs are covered throughout the end of the next year. Indeed, Argentina's financing needs for 2002 are low after taking into account the IMF-led aid package, the May 2001 Debt Swap, and the recently approved "Zero Deficit Policy Rule". As Table 7 shows, each of these programs progressively reduced Argentina's short-term financing needs for 2002.

The row "Total Financing Requirements" amounted, prior to the implementation of the mentioned programs, to U$S 27.6 billions. This amount was mainly composed by debt amortizations (excluding $ 1,050 millions of letes roll-overed by local investment funds) and a U$S 5 billion fiscal deficit (according to the original IMF target, consistent with Fiscal Responsibility Law).

While the May Debt Swap represented financing-needs-savings (reductions in both interests and capital amortizations for 2002) of U$S 4.3 billions, the "Deficit Zero Policy" is designed to reduce the remaining U$S 3.5 billions fiscal deficit to zero (i.e. the U$S 5 billions target net of the U$S 1.5 billion reductions in interest payments). Both measures therefore reduce the actual 2002 financing needs to U$S 19.8 billions.

Adding already committed financing sources for 2002, such as the IMF program (including its extension at August 2001) and private pension funds flows, together with a likely roll-over of the BCRA Bond (Minimum Liquidity Requirement Bond) and the use of 2001 financial cushion, one obtains "almost secured financing sources" of U$S 14.7 billions. Thus, the relevant exante 2002 Financing Needs stand at U$S 5.1 billions.

This figure is considerably lower than the amount that Argentina obtained throughout the last (crisis driven) years from capital markets and therefore seems a very reasonable target. However, if Argentina's access to financial markets continues to be closed, the Argentine Government has the option to request an extension (roll-over) of the IMF's Supplemented Reserve Facility (US$ 2.9 billion).

U.S. Treasury's proposal for debt service relief: a market-based scheme

The U.S. Treasury has put forward a proposal for debt service relief. The approach emphasizes a voluntary and market-friendly scheme, with the objective of creating new and better (less costly) instruments.

However, the optimal use of these new instruments must be addressed by taking into account the main features of the Argentine debt problem.

The "optimal" use of new financial sources will depend on where the government thinks market concerns are focused, that is on liquidity or solvency. Debt buyback, for example, allows withdrawing high-yield debt from secondary markets (thus reducing the stock of nominal public debt and eventually improving market's perception regarding fiscal solvency) and replacing it by low-cost debt. The other choice consists on securing current and future financing needs with the new collateralized debt issues, which improves liquidity and *de facto* reduces marginal interest rates.

A conceptual distinction between the key variables underlying debt sustainability analysis should be useful to provide an analytical framework to address the Argentine case and the "optimal" use of new financial sources: (i) the level of nominal public debt or the debt to GDP ratio; (ii) average interest rate of the public debt; and (iii) marginal interest rates (paid by the issue of new debt).

A first point to emphasize when thinking about debt sustainability is debt to GDP ratio. With a public debt to GDP ratio of 44% (52% consolidated public sector), it is not obvious that Argentina has a debt overhang. Moreover, Argentina's ratios improve considerably after adjusting the debt stock by average maturity.

A second point is the key distinction between average and marginal interest rates. It is a common mistake to confuse average and marginal interest rates when taking to practical territory the concepts of standardized sustainability analysis (such analysis focuses on long run equilibrium, where both average and marginal interest rates are equal, although in reality they are not).

At first glance, average interest rate of the Argentine public debt reaches a reasonable level (less than 9%). It is clear that under normal (rollover) conditions, the interest burden should not be a problem for the government. However, average financing costs of public debt increased during the 90's due to the gradual replacement of previous compulsory debt placed at very low cost, by new voluntary market debt, which in general paid higher interest rates. Thus, it is on reducing marginal interest rate that the actions should be focused.

The Treasury's proposal is an important step in addressing the alternatives for providing debt service relief with a market friendly scheme and sustainability for the Argentine fiscal program.

Growth Policies: the role of 'competitiveness plans'

The implementation of the so-called "competitiveness plans" (which encourage investment, employment and growth through tax alleviation), while aimed primarily at stimulating investment, also play a special role in rationalizing the tax system. That is, the gradual generalization of these sectorial programs, which focus on the elimination of distorsive taxes, will work over time as a mechanism to rationalize the whole tax structure.

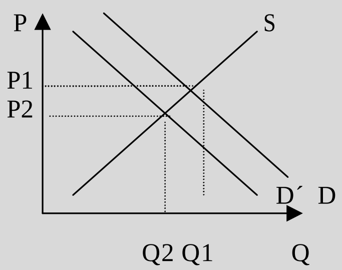
However, it is almost impossible to fully and immediately reduce distorsive taxes given the tight fiscal restriction that the public sector faces. Thus, the government has decided instead to perform a gradual approach picking up sectors or geographical areas and exempting them from the payment of those distorsive taxes that in one way or another will be eliminated in the medium term. As a consequence, competitiveness plans do not provide any special incentives relative to those corresponding to the long-term tax structure that will be applied to the sector, and consequently do not induce any long-run distortion in the allocation of resources.

Competitiveness plans allow corporations belonging to the chosen sectors to compute 100% of their employer's contributions as payment toward the VAT and to be fully exempted from the payment of the Presumed Minimum Income (Asset Tax) and Interest Tax, which play a high burden on investment projects. In general, these programs have not included explicit subsidies.

The sectors chosen in the competitiveness plans were mostly hit by adverse (demand or supply) shocks. The rational is that adjustment costs in these sectors (sometimes to a lower steady state level of economic activity) should be smoothed out by tax policy (see Chart 4).

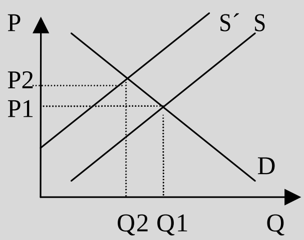
Chart 4:
Competitiveness Plans. Sectors chosen

Adverse demand shock
Sectors which suffer reductions in prices and quantities



Sectors:
Apparel
Footwear
Meat
Wood
Vehicles

Negative shock of supply
Sectors which suffer reductions in quantities while their prices increase



Sectors:
Auto-part
Cultural
Textile

Source: Secretariat of Economic Policy, Ministry of Economy.

The sectorial approach has additional advantages: it allows the Federal government to negotiate with labor unions and provinces the removal of certain regulations and the reduction of distorsive provincial taxes as well as to loosen labor contracts, demanding at the same time a clear commitment from corporate managers to reduce prices and to get workers to the formal economy. This "political-economy benefit" is not possible with horizontal tax reductions.

Enhanced Convertibility and Convergence Factor: improving competitiveness and smoothing price changes to spur economic growth

An appropriate framework to achieve growth and investment requires reducing vulnerability to international monetary shocks. In this sense, we have made important progress in our Convertibility regime, by proposing an enhanced scheme.

By being pegged to the US dollar the strength of this currency generates important deflationary pressures. To smooth the (contractive or expansive) macroeconomic effects and price changes due to long-lasting swings in the Dollar exchange rate, the Argentine Government proposed to enhance Convertibility, by incorporating the Euro as backing of the monetary base and by setting the exchange rate of the Argentine Peso as a simple average of Dollar and Euro. This enhancement will be operational the moment the Euro/Dollar exchange rate reach unity, in order to avoid a discrete exchange rate jump of the Argentine Peso. The "Enhanced Convertibility Law" was recently approved by the Congress.

The enhanced Convertibility preserves the fundamental characteristics of the current regime: (i) full backing of the monetary base by international reserves; (ii) strict limits to Monetary Policy; and (iii) freedom of choice of currencies to perform economic transactions. But it reduces real exchange rate volatility and the need of deflationary or inflationary adjustments in response to international monetary shocks.

To anticipate the benefits of the enhanced Convertibility, a trade compensation mechanism called "convergence factor" was created. Exports will be rewarded with an adjustable reimbursement (currently known as *reintegros*) that results from computing the difference in the present exchange rate (1$ = 1 US$) and the corresponding Dollar/Euro basket (at the outset that difference was of approximately 7 cents) set forth in the enhanced Convertibility Law. This reimbursement is not fixed, but fluctuating according to the daily quote of the Dollar/Euro exchange rate. Similarly, imports will pay a tariff, also adjustable and of the same magnitude.

These trade measures will be paid in the same way that tariffs and *reintegros* are paid today. In order to initially compensate the effects of the convergence factor effect the maximum import tariff on consumer goods and reimbursements on exports were reduced 7 percentage points.

This mechanism preserves convertibility in its present form for peso holders, fully respecting their property rights. The reference to the new Convertibility (that sets the peso exchange rate as a simple average of Dollar and Euro) makes it possible to implement the improvement in competitiveness that would have been obtained should the enhanced convertibility been in force, without incurring in the costs associated to a peso devaluation.

How will the system evolve? As was expressed, the convergence factor anticipates at the commercial level the benefits of the new enhanced Convertibility. Thus, the convergence factor will fluctuate on the basis of the Dollar-Euro exchange rate and, to the extent that these currencies get closer to parity, it will converge to zero. When the Dollar-Euro parity is reached, the new Convertibility will be effective (with the value of the Peso determined on the basis of a currency basket of 50% Dollar and 50% Euro), and therefore the need for the factor will disappear.

The only goods that do not receive nor pay the convergence factor will be fuels. These goods enjoy high prices in the international markets, and given that our trade has a significant surplus in this area, its exclusion implies that the fiscal result of the scheme is positive. The elimination of reimbursements adds to the fiscal savings of the measure.

The mechanism by which these payments will be done are totally fiscal with no participation of the Central Bank or monetary authorities, which will continue to exchange one peso for one dollar as required by the Convertibility Law. The fact that the Central Bank plays no role in this mechanism implies that the international reserves that back Convertibility are in no way altered nor can the backing be put in danger. Thus, the introduction of the convergence factor in no way weakens either the commitment to Convertibility or the strength with which it can be defended.

In terms of trade policy, the convergence factor has several benefits: (i) it protects the economy from further appreciation of the Dollar; (ii) it rationalizes trade policy by homogenizing export subsidies and tariffs across all activities; (iii) it reduces "Mercosur's trade or commercial preference" and to the extent that the euro and the real tend to move together (a pattern that has been strongly present in recent years) it shields the economy from further depreciation of the Brazilian currency.

Trade policies to stimulate growth

Trade policy has been actively used to improve the profitability of the private sector and to stimulate investment. For this purpose, three sets of measures were applied: (i) reduction in tariffs to capital goods; (ii) deepening commercial integration with the rest of the world; and (iii) changes in the general structure of tariffs and exports' reimbursement.

Competitiveness plans have privileged sectors which were hardest hit by the recession, by means of tax reductions (in all governmental levels) and by loosening labor contracts. At the same time the most dynamic and successful sectors have also benefited from pro-investment plans. For these (i) tariffs were reduced on capital goods, and a competitiveness plan for the capital goods sector was implemented; and (ii) VAT was reduced 50% on all capital goods. It is estimated that there has been a reduction in the cost of capital in the order of 21% for domestic capital goods and of 11% for those from abroad.

To compensate the fiscal impact of the measure, the reduction to capital goods' tariffs was initially accompanied by an increase in consumer goods' tariffs. However, Argentine trade policy continues to be focused on a more aggressive opening to the world. To this purpose, the government is pursuing commercial integration to the global economy with Mercosur as a launching pad, through the delegation of decision power to a centralized negotiator that should minimize coordination frictions.

The centralized negotiator should considerably accelerate negotiations of bilateral commercial agreements with the rest of the world. Table 8 shows that Argentina has a very limited access to markets with strong non-tariff barriers. These barriers are generally aimed at

Table 8:
Potential increase in exports due to new commercial agreements
In US$ millions

	Canada *	USA*	Mexico *	EU **
Total imports in which NTTB (1) obstructs Argentine exports	49.961	222.339	31.719	180.586
Total Argentine exports in sectors with NTTB (1)	98	1.118	108	3.796
Argentine share of total trade with NTTB (1)	**0,20%**	**0,50%**	**0,30%**	**2,10%**
Total imports in which 'Core' NTTB (1) obstructs Argentine exports	9.614	64.768	14.071	78.934
Total Argentine exports in sectors with 'Core' NTTB (1)	56	864	28	1.764
Argentine share of total trade with 'Core' NTTB (1)	**0,60%**	**1,30%**	**0,20%**	**2,20%**

(1) NTTB: Non tariff trade barriers

(2) 'Core' NTTB: Antidumping barriers, compensatory measures, import prohibitions, non-automatic import licenses, seasonal tariffs

(*) Year 1997 (**) Year 1998

***Source:** National Commission of External Trade* protecting agricultural products, of which Argentina is an efficient producer. Thus, Argentinean share in this market is a modest 0.5% in the US market and a 2.1% in the European Union market. Hence, there exists a huge potential to increase exports as a result of new commercial agreements that could open market access for these products. The recent proposal of the US Government (for a 4+1 negotiation) and the European Union (to renegotiate quota access) are expected to accelerate integration with both markets.

The convergence factor implies important changes in the structure of tariffs and export reimbursements. As noted, import tariffs on consumer goods and the maximum reimbursement on exports were reduced 7 percentage points. This measure considerably reduced tariffs and reimbursement dispersion, thus reducing dramatically the price distortions caused by trade policy.

Moreover, because of being temporary (that will disappear in case the Euro/Dollar exchange rate reaches unity), it solves the political economy problem that arises when the government judges necessary to reduce tariffs and export subsidies. Eventually, when the Euro and the Dollar reach parity, the mechanism disappears, leaving the economy with less distorsive and lower trade barriers.

Final Remarks and Future Challenges

Argentine macroeconomics has been subject to substantial noise during 2001. However, the policy measures implemented to strengthen fiscal and financing performance have been firm and effective. In particular, Argentine government decided to cut wages and pensions, in an unprecedented move, as a way of reducing the fiscal deficit. We hope these strong measures will be priced-in as soon as the market realizes that Argentina will not devaluate nor restructure its debt.

What's next in the agenda? In the near term the government's economic agenda will focus on pending structural reforms that should ensure Argentina sustainable economic growth. On the fiscal front, those reforms will be centered on further reducing unproductive government spending (mainly bureaucratic) and further progress in the fight against tax evasion in order to gradually reduce "across the board" cuts in wages and pensions, as well as putting in place a tax sharing agreement with the provinces, which should provide better incentives for the design of fiscal policy and the control of public expenditures. Other key structural reforms to improve Argentina's growth perspectives will focus on further deregulation of the health care and the pension system.