Board Meeting of November 10, 1998
Statement by Valeriano F. García

Argentina: Country Assistance Strategy, Special Structural Adjustment Loan and Repurchase Facility Support Loan

Introduction:

I would like to start by offering my thanks to Management for the opportunity to discuss this CAS Progress Report and loans for Argentina. In particularly to the staff, for acting well beyond the call of duty when preparing these loans. Under the current international financial crisis, the timing of this package is crucial for Argentina. It is in this respect that I would like to express my authorities’ gratitude to colleagues on the Board for giving consideration to this Special Structural Adjustment Loan at such short notice. Needless to say, my authorities are very appreciative of the Bank’s continued support for the economic and social reform program in Argentina. This report also gives me an opportunity to share with you some of the recent economic events in my country.

Economic Performance:
The Argentine currency board system has been very successful. This exchange rate regime -- together with trade reform, deregulation, and privatization -- has led to unprecedented economic growth. Since the implementation of the Convertibility Plan in early 1991, Argentina’s GDP has grown by almost 40 percent.

During 1997, GDP growth was 8.6 percent, the second highest rate in the world (figure 1). In 1998, economic growth is expected to slow down, as a consequence of the worsening international economic environment.
You may recall that in 1995, as one of the aftershocks of the Mexican crisis, the economy suffered the effects of large withdrawals of bank deposits and international reserves. At the time, this presented a considerable threat to the continuation of the Convertibility Plan; however, the emergence of the Asian and Russian crises has not had the same consequences. This is largely due to a number of measures that the authorities adopted in recent years, and that have substantially increased confidence in the restructured financial system.

Since the onset of the Asian crisis, Argentina’s international reserves have actually increased by 18%, from US$22.2 billion to US$25.4 billion (figure 2). In addition, the inflation rate over the past year has been practically zero, one of the lowest in the world.

**Figure 2: Central Bank International Reserves (US$ billion)**

Moreover, at the beginning of the current crisis, bank deposits totaled US$76.5 billion, compared with US$63 billion at the beginning of the Asian crisis (figure 3). Over the same period, bank deposits in local currency grew by 15 percent while those in US dollars increased by 24 percent. The Argentine financial system continues to be strong and dependable, and this is particularly due to the presence of highly rated foreign banks, which play an important role in the domestic financial system.

**Figure 3: Total Bank Deposits (US$ billion)**

Despite the good development of the Argentine economy, and as a consequence of the global crisis, the behavior of a number of indicators has sounded a strong note of caution in the economy. Since the outset of the crisis, for example, the stock market index has fallen by 50 percent, and peso-dollar spreads have widened considerably (figure 4).

**Figure 4: Spread between Peso-Dollar**
The Timely reaction:

The Argentine Government has announced a series of measures for adjusting the economy still further to the new unstable international conditions. The need for timely action has led to the immediate implementation of measures for reducing public spending over the short term. These include, among other actions, a cut of US$1 billion in spending under the 1998 budget, suspension of a large highway program, and a US$400 million reduction in public works. This brought the fiscal deficit down from 2.2 percent in 1996 to 1.4 percent in 1997, and the estimate for 1998 is 1 percent (figure 5).

**Figure 5: Fiscal Deficit (% of GDP)**

I also wish to emphasize how low public expenditure rates have been in previous years; i.e. 16.5 percent of GDP in 1996 and 16.2 percent in 1997.

In 1989, hyperinflation created such mayhem that 38 percent of Argentines were living below the poverty line, whereas today the figure has fallen to 18 percent. Currently, income distribution and economic opportunities are substantially more equitable.

All these figures clearly indicate that the Argentine economy is sound, and that the Treasury is solvent, mainly as a result of the measures that have been taken -- and continue to be taken -- in order to strengthen the structural basis of the Convertibility Plan (the Currency Board). In spite of this impressive performance by the Argentine economy, and because of exogenous factors, international capital markets are still effectively closed.

The Repurchase Facility Support Loan

This facility is related to the general architecture of a country that has a currency board.
The Currency Board has served not only as a key instrument in abating inflation, but also as a guarantee of fiscal discipline. Let me draw your attention to one important aspect of the implications of a currency board system. Sometimes I feel that we are not aware of all the constraints that such a system exerts on the economy. The most important of these is the lack of a lender of last resort. To address this problem, the Argentine Government has adopted the following policy measures:

- The right of foreign banks to freely establish themselves in the market and to acquire assets. Ownership by foreign banks is now widespread in Argentina.
- The high capital requirements and -- more importantly -- the very high liquidity requirements (20%) imposed on banks. Strengthened banking supervision and increased transparency in financial and fiscal information, in line with IMF recommendations.
- Over 100 percent foreign currency backing on the stock of the monetary base. Note that the essential component of proper currency board operations is only 100 percent backing of the *flow* of monetary transactions. We have chosen the more rigorous 100 percent backing on the stock of monetary base to boost confidence.
- The establishment of a repurchase facility with foreign private banks, amounting to almost 10 percent of total deposits. As part of the World Bank program, my authorities are requesting a contingent facility to cover potential margin.

We view this facility as part of an umbrella for ensuring that the Currency Board functions properly. It is not an emergency facility. It is a prudential facility, in the same way that liquidity requirements for banks form part of prudential regulations, and are not considered emergency requirements, even though they may be used in emergencies. Bank support for a repurchase facility would clearly contribute toward the strengthening of the reforms in the financial system.

To safeguard its financial sector, in a currency board context, Argentina has put in place a safety net that accounts for 40 percent of total deposits, and which operates as follows: (i) the first line of defense is the 20 percent reserve requirement that the Central Bank applies to commercial banks; (ii) as a second line, excess reserve holdings by the Central Bank deposited abroad constitute 10 percent of total deposits, and could be used for rediscounts; and (iii) as a third line, the Central Bank has a repurchase agreement with a group of foreign banks, comprising about 10 percent of total deposits. The World Bank repurchase facility would be part of this architecture.

**The Special Structural Adjustment Loan**

In the current circumstances, we believe that the Bank can play a strategic role, and that this SSAL is the best approach to the problem. The loan will assist Argentina in preventing any potentially negative effects from impacting vulnerable groups, and help in maintaining its commitment to structural reform.

The proposed loan will support the continued efforts of the Government of Argentina to deepen its “second-generation” reforms, which include, among other things: improving the targeting and efficiency of various
social programs that are designed to reduce poverty; providing a minimum safety net for the elderly poor; maintaining levels of spending in key social programs that are important to the poor; improving the system of unemployment insurance and lowering non-wage labor costs; making investment in education more equitable; improving the quality of higher education; strengthening the regulatory framework for health insurance; and developing a competitive managed-care market for providing health care to pensioners.

A sense of urgency

Argentina needs these resources urgently in order to avoid adverse consequences to its economy and ultimately to the poor. Therefore, I would like to reiterate my authorities’ gratitude to the staff, and my colleagues on the Board for giving consideration to this Special Structural Adjustment Loan at such short notice.