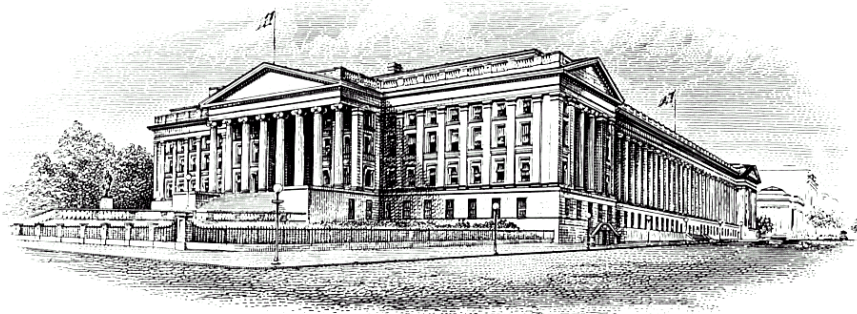




DEPARTMENT OF THE TREASURY OFFICE OF PUBLIC AFFAIRS

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Contact Tony Fratto at 202-622-2910.

U.S. Economic and Financial Policy toward Argentina

Randal K. Quarles

Assistant Secretary of Treasury for International Affairs

Testimony before the Senate Banking Committee

March 10, 2004

Chairman Hagel, Ranking Member Bayh, and other members of the Committee, thank you for inviting me to discuss the Administration's economic and financial policy toward Argentina, particularly the U.S. stance with regard to Argentina's engagement with the International Monetary Fund since 2002.

Economic Context

Let me begin by reviewing the historical context for our engagement. Argentina had made impressive strides in the early 1990s in ending hyper-inflation and introducing important structural reforms in its economy. However, excessive budget deficits during the 1990s, driven in large measure by fiscal arrangements that required the central government to fund spending decisions by the various provinces unhindered by effective central budget constraints, led to the build-up of a large debt burden that the government could no longer service by the end of 2001. Faced with an increasingly desperate situation, the government defaulted on its debt and abandoned the peso's peg to the U.S. dollar. The economic crisis was accompanied by political instability that eventually led to a new interim government led by President Eduardo Duhalde.

In the wake of the default and devaluation, real GDP fell 11 percent in 2002. Inflation rose to over 40 percent, the peso depreciated 69 percent, and unemployment rose to 24 percent. Seeking to avoid a complete collapse of the banking system, the government imposed far-reaching deposit controls. Other government actions, in particular the forced conversion of dollar-denominated financial contracts into pesos, further weakened the banking system. On the

monetary side, the authorities struggled to contend with multiple “quasi-currencies”—representing an astonishing 50 percent of currency in circulation—that had been issued during the crisis to finance spending by the provinces in the face of collapsing revenues.

Transitional IMF Program

The U.S. government worked with the Duhalde administration and the IMF throughout 2002 in an attempt to develop a new IMF program and a set of policies that would stabilize the economic situation. Argentina’s authorities took an extended period of time to develop such a program, in part because of the unsettled political situation.

Argentina launched an eight-month “transitional” IMF program in January 2003, which the United States strongly supported. The purpose of the transitional program was to stabilize the Argentine economy. The program’s eight-month length was long enough to last through the Presidential elections in May and give the incoming government time to develop its policy priorities. The focus of the transitional program was on macroeconomic stabilization, with the expectation that the new administration would have the political mandate for pursuing the more difficult reforms needed to lay the basis for sustained economic growth and for beginning to address its debt default.

To be sure, there were risks associated with launching the transitional program. Many questioned Argentina’s commitment to implementing the macroeconomic policies needed to restore stability. The presence of large-scale deposit controls created a great deal of uncertainty as to the potential inflationary consequences of the monetary program. But the United States strongly backed the transitional program as the most effective way of putting Argentina solidly on the path of economic recovery.

This judgment proved correct. Argentina performed well under the transitional program, meeting its IMF fiscal and monetary targets by wide margins. The central government signed bilateral agreements with the provinces that set clear limits on the provincial deficits in 2003. The government launched a program to retire the quasi-currencies, critical to ensuring that the federal government and the provinces live within their means. The retirement of the quasi-currencies is now complete. And, in the context of improved macroeconomic policies, the government was able to lift the freeze on bank deposits without the inflationary surge or collapse in deposits that many had feared.

The transitional program helped boost confidence in the economy. This confidence underpinned the acceleration of economic growth in early 2003. Real GDP for the year as a whole grew an impressive 8 percent. Unemployment fell to 16 percent by the end of the year, and inflation fell to under 4 percent. During the same period, the peso appreciated 15 percent and foreign exchange reserves increased by \$3.5 billion. In short, the transitional program fulfilled its objectives.

Argentina's Three-Year Program

As the Kirchner administration came into office, it faced the dual challenges of consolidating the achievements of the transitional program and of undertaking the actions needed to lay the basis for sustained economic growth in the years ahead. The latter meant both adopting reforms to deal with the root causes of the Argentine financial crisis and taking steps to address the new problems created by the crisis, including resolution of Argentina's defaulted debt.

Argentina's three-year program launched in September 2003 was designed around these objectives.

The fiscal and monetary framework of the program, as well as the institutionalization of central bank independence and gradual shift to inflation targeting, is designed to entrench macroeconomic stability in order to keep the current recovery going.

Fiscal problems were at the core of Argentina's financial crisis. A poor system of inter-governmental fiscal relations encouraged excessive spending by Argentina's provinces. As spending increased faster than government tax revenues, deficits were financed by heavy borrowing and printing the so-called quasi-currencies. The three-year program not only mandates strict limits on provincial deficits and borrowing, but also provides for a comprehensive reform of the federal-provincial fiscal framework to prevent the problems that led to the crisis from recurring. Since widespread tax evasion and low tax collections have been chronic problems in Argentina, the program includes new measures to strengthen tax administration and fight illegal tax evasion. The program also aims to phase out distortive taxes that were introduced during the crisis—such as the financial transactions tax—and replace them with a tax regime more conducive to economic growth.

The crisis, and government actions during the crisis, seriously damaged Argentina's banking system. As a result, lending by banks to the private sector plunged. Restarting bank lending to the private sector is essential for increasing business investment and spurring economic growth. Argentina's program establishes a framework for restoring health to the banking system by providing compensation from the government to address balance sheet damage done by the previous government, clarifying the regulatory environment, establishing capital standards designed to facilitate the strengthening of bank balance sheets over time, and requiring banks to develop business plans for achieving specified capital requirements. It also includes measures to assess and address the special issues related to the role of public banks in the Argentine banking system.

Another key area affected by the crisis was the utilities sector. Under its program, Argentina has undertaken to work with the World Bank to resolve the problems in the utilities sector, including ending the price freeze and redesigning a tariff structure, reestablishing a coherent regulatory framework, and renegotiating concession contracts. Utility tariffs had been frozen since February 2002 despite the falling peso and rising inflation, creating large losses for the utility companies. Ending the price freeze and taking the other actions needed to create a

stable regulatory framework are essential for encouraging investment in this key sector to support Argentina's needs for the future.

Finally, a key objective of the program is to facilitate the successful resolution of Argentina's defaulted debt. Argentina has \$100 billion in private sector claims outstanding. Its debt restructuring is the most complex in emerging markets history. This is not only because of its size, but also because of the number of different currencies and legal jurisdictions in which the debt was issued, as well as the number of different types of bondholders involved, including sizeable holdings by retail investors in Italy, Japan, and Germany.

The program provides the broad policy framework to underpin a debt restructuring agreement between Argentina and its creditors. The program requires Argentina to work in good faith with its creditors to reach a collaborative agreement that restores debt sustainability. The fiscal targets of the IMF program beyond 2004 were specifically left undefined above a certain 3 percent floor, precisely to give Argentina and its creditors room to negotiate over the terms of the debt restructuring. It is the responsibility of Argentina to work with its creditors to achieve a debt restructuring deal that will define the increase in the primary surplus above 3 percent that is needed to cover debt service on performing and restructured debt.

IMF lending policies require transparent and constructive negotiations by Argentina with its private creditors to secure the broad creditor support in a debt restructuring needed to achieve a sustainable debt situation and facilitate Argentina's progressive reintegration into international capital markets. Argentina will need substantial investment to generate economic growth over the long term.

Argentina's Performance under the Three-Year Program

Argentina has continued to perform well on its fiscal and monetary policies under the three-year program, extending the gains it made under the transitional program. The government's budget performance to date has exceeded the program targets by a significant margin demonstrating that with a determined effort Argentina can indeed collect taxes. There has also been important progress in strengthening the institutional and legal framework for tax administration. In the area of inter-governmental finances, the central government has concluded agreements with the provincial governments limiting provincial spending and borrowing, consistent with the requirements of the program. Work on the more far-reaching reforms of the system of inter-governmental fiscal relations is also moving forward.

Progress in other structural areas of the program up to now has been less satisfactory. Although the government has implemented new regulatory standards for the banking system, there have been delays in finalizing the agreed compensation to banks for the actions taken by the government during the crisis. Bank lending remains extremely depressed. Argentina's progress with the World Bank on reform of the utilities sector has also been slow, though the Argentine government did recently agree to raise tariffs on electricity and gas for the first time since the crisis.

It continues to be essential for Argentina to make progress on debt restructuring with private creditors. The government's announcement that it has made arrangements for the hiring of investment banking advisors to handle its debt exchange is a step forward. In addition, we expect to see over the upcoming weeks Argentina take the concrete steps necessary to negotiate with representative creditor groups on the terms of its restructured debt. The negotiation process needs to build mutual trust and allow creditors real input into the design of the offer. This is the surest way for Argentina to achieve the broad creditor support needed for a comprehensive and sustainable debt restructuring.

Conclusion

We want Argentina to succeed: to succeed in stabilizing its economy in the wake of crisis, succeed in resolving its defaulted debt, and to succeed in laying the basis for long-term economic growth.

The United States has been a forceful advocate for IMF engagement with Argentina in pursuit of these ends. Argentina has made important progress during the last year. The current IMF program provides a framework for Argentina to raise the living standards of its people and move beyond the past to a prosperous future. Consistent implementation of this program is the key to success in these areas, and we are continuing to work with Argentina and with the IMF to encourage this implementation.