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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Argentina: A Promising Effort at Economic Reform

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
August 1968

INTELLIGENCE MEMORANDUM

Argentina: A Promising Effort at Economic Reform

Summary

In early 1967 the Onganía government initiated a program of economic reform that still promises to give Argentina its best opportunity in a generation to begin realizing the potential of its resources. For the first time since World War II, the country has a government that has been both willing and able to attack some of the problems of financial instability and structural imbalance that have long hampered Argentine economic growth. The task of economic reform will be long and arduous, however. The program can succeed only if maintained for a considerable period, in the face of opposition from the many groups that will be hurt, at least temporarily, by general austerity and a redistribution of income.

The new program emphasizes the attainment of financial stability. Measures to bring the rate of inflation well below the average annual increase of 30 percent experienced in recent years include a "voluntary" price control program, a freeze on wages until the end of 1968, and reduction of the government budget deficit by holding current spending fairly steady while increasing revenues. Despite extraordinary pressures on prices during 1967, the program succeeded in laying the groundwork for stability, and during the first half of 1968 increases in price levels have been at a record low.

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of National Estimates and the Office of Current Intelligence.

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To ease the recessionary impact of these stabilization measures and to induce the reallocation of a larger share of available resources to investment and to exports, supplementary incentives have been introduced. Measures implemented during the past year have provided for a variety of growth inducements in the form of tax and credit preferences for investment, new credit arrangements for consumer durables to increase consumer demand, and strong efforts to promote exports. The government also has taken steps to improve the climate for foreign investment in Argentina.

These efforts, combined with a relatively good crop year and a healthy export trade, succeeded in averting a recession in 1967 despite the strong stabilization measures taken. Gross national product (GNP) for the year 1967 as a whole grew by about 2 percent. Pockets of depression persisted, however, particularly in some manufacturing industries, and in 1968 the government launched a large-scale public investment program as a spur to current economic activity as well as to long-term growth. By mid-1968, manufacturing and construction were experiencing a sharp upswing, but the increase in aggregate demand was limited by poor crop yields and export marketing problems experienced earlier in the year.

The economic reform program is being carried out by a team of economic experts headed by the Minister of Economy and Labor, Dr. Adalbert Krieger Vasena. These specialists, who seek to promote free enterprise and foreign investment in Argentina, consulted with the International Monetary Fund (IMF) and other international agencies in drawing up their program and have enlisted strong foreign support for it. The success of the devaluation with which Krieger Vasena launched his program, combined with official foreign assistance, resulted in a substantial strengthening of Argentina's foreign payments position. Foreign reserves have risen to a level not achieved since 1948, and confidence on the part of foreign investors is at a postwar high. Argentina has been able to float bond issues in foreign capital markets for the first time since 1938, competition among foreign suppliers is keen, and direct foreign investment is showing a sharp upward trend. Its healthy state of international liquidity provides Argentina with an important element of flexibility in pursuing the sometimes conflicting goals on the road to stabilization and growth.

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1. It is generally conceded that in no country in Latin America has the contrast between economic potential and actual performance been more pronounced than in Argentina during the last three decades. During the late 19th and early 20th centuries, Argentina enjoyed a long period of rapid expansion under the influence of high rates of immigration and capital inflow combined with large earnings from its agricultural exports. The world depression disrupted such traditional patterns, however, and under the economic policies pursued since World War II, the Argentine record has been one of slow and erratic growth, endemic inflation, and recurrent balance-of-payments crises.

2. Countries that 30 years ago were Argentina's peers in resources and development -- Australia and Canada, for example -- have now moved far ahead. In total economic output, moreover, Argentina has fallen from first to third place among the countries of Latin America during the postwar years. Although its per capita GNP of about \$750 is second only to that of Venezuela, the less modern nations of Latin America have been narrowing the broad gap that once existed. To a large extent, Argentina's depressing economic record reflects the damage inflicted by the policies adopted during the Peron era. The "stop-go" measures and often inconsistent policies of succeeding administrations, however, have served to deepen the structural distortions that they inherited.

Background: Misguided Policies and Their Consequences

3. All Argentine administrations over the past 35 years have been committed to a fundamentally similar economic objective: to reduce dependence on agricultural exports both directly, through promotion of industrial exports, and indirectly, by creating an industrial sector more capable of competing with imports in supplying the expanding -- though still relatively small -- domestic market. By the 1930's, and even more by the early years of World War II, Argentina had acquired a strong economic base for broader industrialization as well as agricultural expansion. The types of policies adopted in response

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to the depression and the war and accelerated after the military coup of 1943 and Peron's assumption of full power in 1945 resulted, however, in a fundamental disequilibrium that has continued to afflict Argentina up to the present time.

Peron's Policies

4. Under Peron, the government initiated a variety of policies favoring rapid industrialization and urbanization -- primarily at the expense of agriculture. Through discriminatory tax, credit, foreign trade, and wage policies, Peron shifted capital and labor from crop and livestock production into manufacturing. The economic program initiated by Peron, moreover, went far beyond an attempt to maximize Argentina's industrial capabilities. Equally important objectives were nationalization of major economic resources and enlargement of the size and power of the urban masses upon which his political support was based. Because Peron used a large part of Argentina's foreign exchange reserves of \$1.7 billion to nationalize foreign-owned industries, railroads, and public utilities and deterred foreign investment in other ways, the burden of further development fell almost exclusively on domestic resources. At the same time, the rapidly rising bill for wages and worker benefits added heavily to the cost of industrial goods and services. The shift in income distribution toward the well-organized groups of urban labor was pronounced. Between 1945 and 1949, while per capita product increased only 10 percent, real industrial wages rose by more than 50 percent. Although money wages continued to skyrocket during the early 1950's, they were outpaced by the rising rate of inflation. As a result, real wages fell by more than 20 percent during 1950-52. Peron undertook major adjustments in economic policies in 1953, but by the time of his overthrow in 1955 the pattern of economic deterioration had not been changed appreciably.

Industrialization and Strains in the Balance of Payments

5. In agriculture, the squeeze on profits resulting from a more rapid increase in costs and taxes than in farm prices weakened incentives and provoked

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a long period of disinvestment. The resulting stagnation in agricultural production, combined with a subsidized increase in food consumption in the urban market, seriously restricted export availabilities. Whereas Argentina had large export surpluses before the war as a result of its natural competitive advantage in agricultural production, a trade deficit totaling more than \$2 billion was incurred during 1948-62 (see Figure 1).

6. To an important extent, the weakening of Argentina's foreign trade position also reflects the hothouse atmosphere in which industrialization has been cultivated. Supported by subsidies in various forms and protected from foreign competition by the highest tariffs in Latin America, industrial producers have had little incentive to reduce costs and expand markets. Their major concern has been to protect profit margins by passing on actual and anticipated cost increases to the consumer. Even within the traditional, well-established industries -- food, beverages, textiles, and consumer durables -- costs generally have risen in comparison with those of foreign producers as tariff margins have depressed incentives to modernize. As Argentina moved into production of steel, chemicals, vehicles, and a wide array of relatively sophisticated capital equipment, it came under still greater competitive disadvantages because of the high price of inputs, inability to effect economies of scale, and supply bottlenecks, among other problems.

7. Although Argentina has developed the most diversified industrial complex in Latin America, with production capacity far in excess of domestic needs, industrial prices are among the highest in the area. The high-cost nature of Argentine industry has virtually precluded its entry into external markets, and it thus has been able to contribute little to import capacity. Manufactured goods continue to provide only about 5 percent of export earnings. Despite the adverse policies that it has been working under, agriculture has continued to provide 90 to 95 percent of total export earnings and thus has financed most of the import requirements of the favored industrial sector.

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8. Industry has provided finished products for the domestic market that previously had to be imported, but its requirements for fuel, raw materials, and capital goods have added heavily to import requirements. Imports of finished consumer goods amounted to only 0.3 percent of GNP in 1966. This decline in import requirements, however, only partially offset the sharp rise in imports of raw materials, fuel, and capital goods, which during the 1960's have comprised 92 to 94 percent of imports.

9. Because an inefficient industrial sector is no substitute for an efficient agriculture in financing growing import needs, Argentina has experienced periodic balance-of-payments crises. From time to time, Argentine governments have attempted to ease growing pressure on the balance of payments through devaluation of the peso and administrative restrictions on imports, as well as by tightening credit. These measures usually have resulted not only in recessions but also in sharp increases in the rate of inflation and, within a short time, renewed flights of capital -- thereby paving the way for further balance-of-payments problems.

10. Owing mainly to a couple of record crop years and an increase in foreign demand for meat and grains, total export earnings have grown markedly since the beginning of 1962 (see Figure 1). Much of the gain, however, has gone to the servicing of a large and poorly structured foreign debt. The foreign debt reached a peak of \$3.2 billion in 1963, about two-thirds of which was repayable within five years. Although some relief has been obtained through refinancing, the Argentine government nevertheless has had to hold imports well below the level of the early 1960's to secure trade surpluses sufficient to cover debt servicing obligations. The constraint on imports has both dampened economic activity and accelerated inflation. The burden of a shift to an export surplus (wherein consumption and domestic investment are held below the level of total output) was permitted, moreover, to fall entirely on investment. While consumption continued to absorb about 80 percent of GNP, domestic investment dropped from an average of 23 percent of

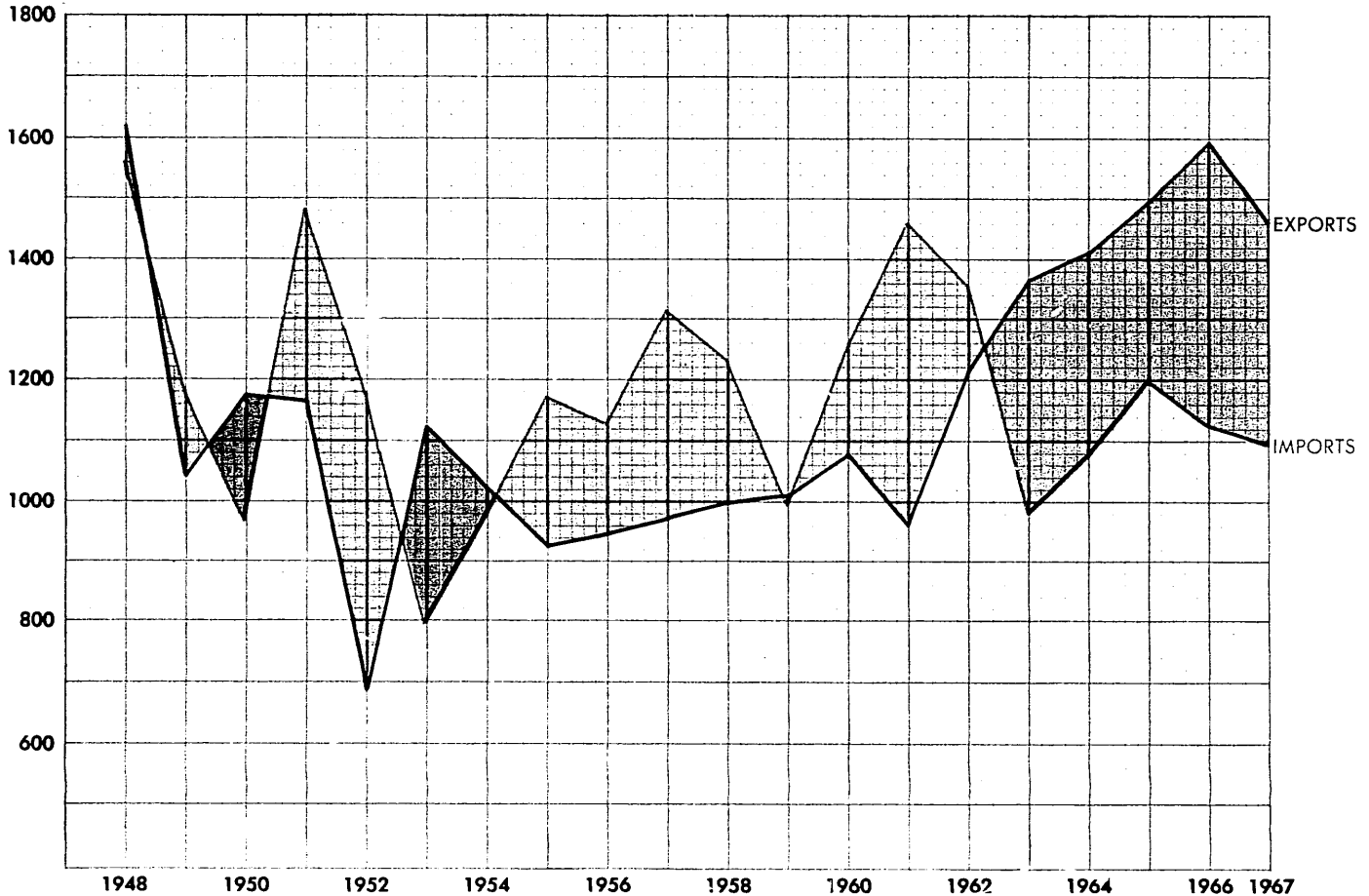
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ARGENTINA: VALUE OF FOREIGN TRADE, 1948-67

Figure 1

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GNP in 1960-62 to less than 18 percent in 1963-66,* to the detriment of long-term prospects for growth.

Persistence of Rapid Inflation

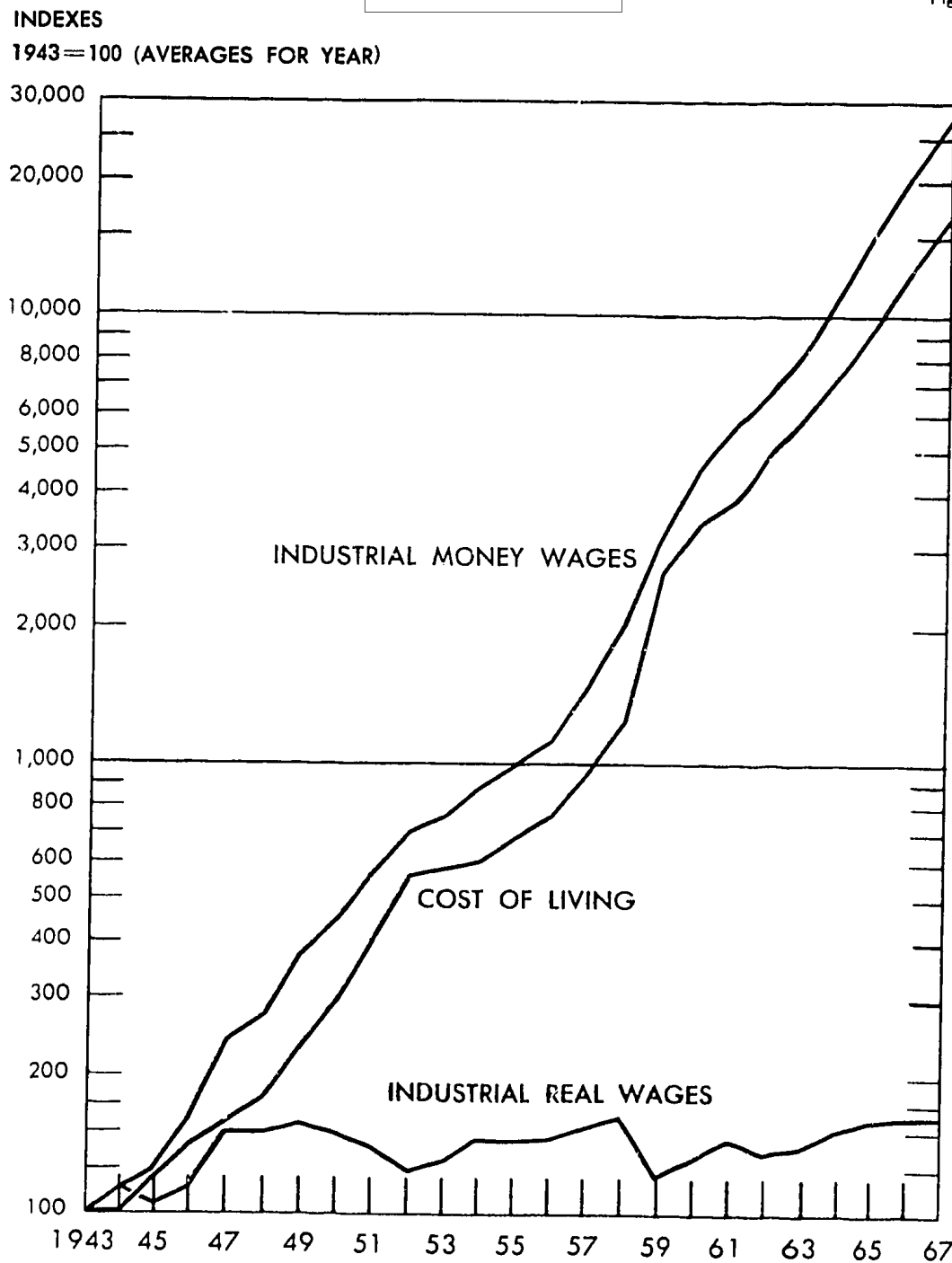
11. Although Argentine production has displayed a "boom-bust" pattern, rapid inflation has continued throughout the postwar period, as shown in Figure 2. The inflationary spiral began under Peron, but the economic policies pursued since his overthrow have served to intensify it. Cost-of-living increases since 1955 have averaged about 30 percent annually. Continued protection of domestic industries from foreign competition has added to the rigidities in domestic supply and provided wide latitude for price rises. In the mid-1960's, for example, import tariffs averaged about 120 percent and ranged as high as 600 percent in some cases. Continued stress on industrialization also has contributed to the willingness of Argentine administrations to countenance wage increases unmatched by gains in productivity. Although Peron began the policy of favoring urban workers, succeeding governments have felt compelled to perpetuate it because of the continued political influence of organized labor. Although at times outpaced by the inflationary spiral (for example, in 1959 and 1962), wage increases in general have exceeded rises in the cost of living. During 1961-66 the real wages of industrial workers rose by about 25 percent, restoring the level of 1958. Increases in real wages during this period pushed up costs substantially and added to pressures on prices despite some increase in labor productivity.

12. The government's large budget deficits have been an increasingly important source of inflationary pressure. Growth of tax receipts has been sluggish and in real terms has been eroded by the pace of

* *Statistical measures of investment overstate its relative size by a wide margin because of high tariffs on imports of capital equipment and the high cost of domestically produced capital goods. An Argentine study estimates that, if calculations were made at US prices, the share of investment in GNP would be approximately half the indicated rate.*

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Figure 2 ^{25X1}



ARGENTINA: INDEXES OF INDUSTRIAL WAGES, COST OF LIVING AND REAL WAGES, 1943-67

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inflation. Between 1961 and 1964, revenues in real terms declined by 40 percent, falling from 9.5 to 5.6 percent of GNP. Increasing subsidies to the poorly run state enterprises established under Peron, high costs deriving from a badly deteriorated infrastructure, and a rapidly rising wage bill all have contributed to the steady increase in current expenditures. By 1964 the budget deficit was the equivalent of 50 percent of expenditures and more than 5 percent of GNP. Despite some improvement, deficit financing has continued to be a major source of inflationary pressure as new money was created by the Central Bank to cover the fiscal gap.

Sluggish and Unbalanced Growth

13. Despite its favorable endowment of human and material resources and relatively advanced level of economic and social development, Argentina has become one of the laggards in the race for economic expansion. Since 1943 the growth of GNP has averaged only 3 percent annually, and GNP per capita has averaged only 1 percent annually (see Figure 3). In the 12 years since Peron's ouster, the average rate of economic growth has continued at this same depressed level of 3 percent, and during 1962-67 it averaged only 2 percent, or little more than the rate of population increase. From 1956 to 1967 the Argentine economy was unable to sustain growth for more than two successive years. GNP declined, for example, in 1962-63, grew by about 8 percent in 1964 and in 1965 with the impetus of record harvests, declined again in 1966, and rose in 1967.

14. By hobbling agriculture and pushing industrialization in an inefficient and indiscriminate manner, Argentina has succeeded in greatly reducing the relative importance of agriculture in the economy. From 1935 to 1965 the share of agriculture in GNP fell from about 29 to 17 percent, while the share of industry rose from 29 to 40 percent -- a relatively high percentage by both Latin American and world standards.* Similarly, the agricultural labor force has undergone a long decline, while the industrial labor force has expanded greatly. Between 1946 and 1960, for example, the agricultural labor force declined by 15 percent while the industrial labor force increased by more than 30 percent.

* *The percentage share of industry in Argentina's GNP probably is somewhat exaggerated by the comparatively high prices of Argentine manufactures.*

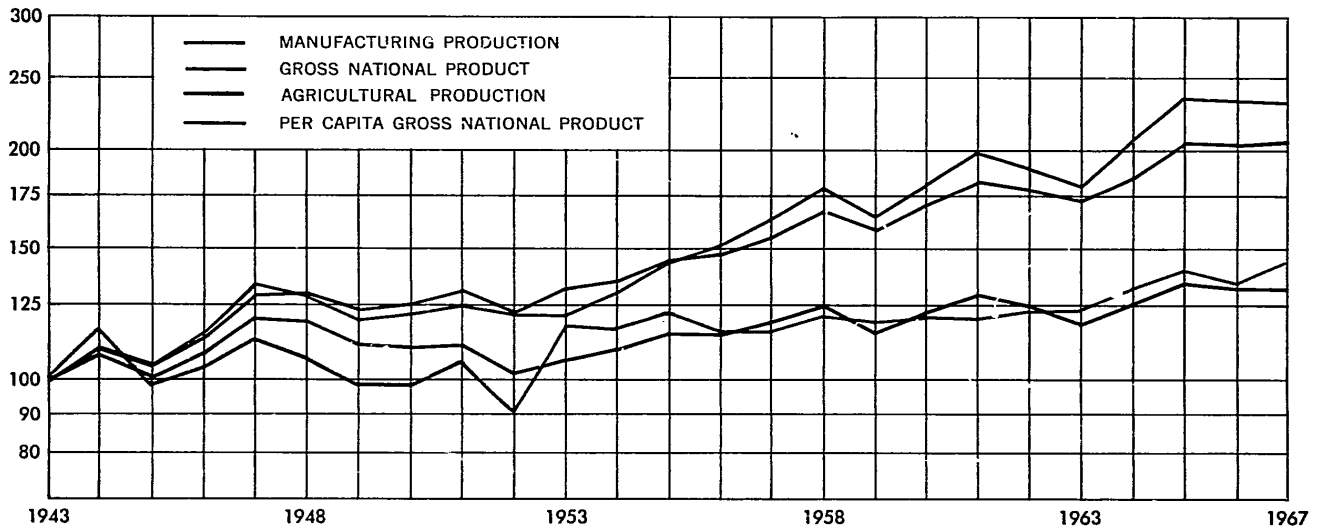
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Figure 3

ARGENTINA: INDEXES OF GROSS NATIONAL PRODUCT,
PER CAPITA GROSS NATIONAL PRODUCT, MANUFACTURING,
AND AGRICULTURAL PRODUCTION, 1943-67

INDEXES
1943=100



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Economic Reform Program

Policy Problems

15. Any Argentine government faces a formidable task in attempting to move the economy toward sustained growth. Although economic reform programs have been attempted in the past, they have been short lived and ineffectual, mainly because political considerations have ruled out necessary but unpopular changes.* Any meaningful program of stabilization and development requires the allocation of a larger share of available resources to investment in productive activities. No Argentine government in the past has been both willing and able to impose the restraints on current consumption that such a shift would entail.

16. Even an authoritarian government intent upon staying in office until the job is done is under important constraints in instituting economic reform. The consequences of the policy errors of three decades ago can perhaps be ameliorated, but they cannot be erased. Existing industries -- however inefficient -- cannot in general be wiped out. The government cannot undertake a massive shift of unneeded urban workers to rural areas, whatever Argentina's natural advantages in agriculture and self-imposed handicaps in industry. Nor is there any quick way for the government to divest itself of inefficient public enterprises. Moreover, even where there is greater freedom to act, moves to improve conditions in one area can aggravate problems in others if counterbalancing steps are not taken, and may do so even then. At best, an economic reform program as complex as that required in Argentina involves a most difficult task of timing and coordination.

17. The Illia government was ousted in June 1966 in large part because of its inability to move toward the solution of Argentina's economic problems.

* *Argentina has had seven presidents during the past 15 years, and the average tenure of Ministers of Economy during this period has been 10 months.*

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But the new military government headed by Juan Carlos Onganía assumed power with no clear idea as to how to go about stabilizing and modernizing the economy. Although the new government was in a more powerful position than its predecessors to enact economic reforms, there was no consensus on economic matters in Onganía's cabinet, and it floundered on the question of choosing the most effective path to follow. Gradualists fought with advocates of shock methods, developmentalists with monetarists, and advocates of a free market system with supporters of greater government involvement. During its first six months the Onganía government moved against some obvious targets for reform such as the port situation and work rules for the railroads, but by the end of 1966 little had been accomplished in the economic field. Inflationary pressures in the form of wage and price increases and credit expansion were stronger than before the revolution.

18. Increasing disgruntlement among the military leaders, stemming largely from the lack of a decisive economic policy, finally brought a cabinet shakeup in December 1966 and the appointment of Dr. Adalbert Krieger Vasena as the new Minister of Economy and Labor. Krieger Vasena, an internationally respected economist who was serving as the Argentine representative at the Kennedy Round talks in Geneva at the time of his appointment,

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[redacted] new economic team drew up and launched a broad and complex program for financial stabilization and economic development. As Krieger Vasena explained it, his program did not rest on shock methods but was designed to attack problems in all sectors simultaneously in such a way that the costs would be shared equitably.

19. The current reform program attempts simultaneously to halt inflation, achieve a surplus in external accounts, and increase the rate of economic growth. Thus, it reflects a necessarily complex intertwining of economic variables. First, the peso was devalued substantially in order to make exports cheaper and more competitive and imports more expensive, and thus to improve the balance of payments. Second, the government took two steps to

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counteract some of the inflationary impact of devaluation: imposition of control over both wage and price increases and sharp reduction of tariffs. The latter step, by lowering domestic prices of many imports, was also designed to force greater industrial efficiency through operational improvement and investment. Third, the government planned a reduction in the budget deficit. Initially, this would come through an increase in tax revenues rather than through a reduction in government payrolls that would add to unemployment. Fourth, in order to facilitate the ultimate transfer of excess government workers to more productive employment and to limit the recessionary effects of the stabilization program as a whole, the government offered tax concessions and other incentives to private investment, both foreign and domestic. Finally, the government increased sharply its outlays on public investment in order to spur current economic activity as well as long-term economic growth.

Devaluation

20. The most highly publicized reform was the devaluation of the Argentine peso from 250 to 350 per US dollar on 13 March 1967. At the same time, the government lifted almost all restrictions on international payments and transfers. The government hoped that pegging the peso at a rate considerably higher than that prevailing in the black market would not only stop the outflow of capital but also induce the return of flight capital already lodged abroad. In addition to stimulating exports, the devaluation was designed to encourage direct foreign investment, which had been reduced to a trickle. To improve further the climate for foreign investors, the Onganía government signed new settlements with petroleum companies that had had their contracts annulled under Illia in 1964 and issued a new law to permit broader foreign participation in the exploitation of Argentine petroleum resources.

21. When the peso was devalued, export taxes of 16 to 25 percent were reinstated on traditional agricultural products. This measure reduced the effective rate of exchange for exports of meat, wool, and grains to 262.5 pesos per US dollar and

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of other products to between 280 and 294 pesos. Relevying of these taxes, which had only recently been removed when the peso went from 220 to 250 to the US dollar in November 1966, brought criticism from farming circles. On the whole, however, the farmers' opposition was moderate, probably reflecting the validity of the government's position that these products were competitive before devaluation and that limitation of windfalls from devaluation was necessary to fight inflation.

22. At the same time, the government reduced import duties by an average of about 45 percent to largely offset the rise in import costs implicit in a devaluation. It also completely revised the tariff system, with the aim of eliminating distortions that dampened investment. High tariffs had discouraged expansion in some industries by making imported raw materials too expensive and had discouraged modernization in others through excessive protection from foreign competition.

Fiscal Reform

23. One of the government's primary goals has been reduction of the deficit of the public sector through the lowering of current costs and an increase in tax revenues. Although the program drawn up by Krieger Vasena's economic team did not provide for any cutback in government expenditures in real terms during 1967, a greater proportion of total expenditures was earmarked for investment. Expenditures on current operations were to be held down by limiting the wage bill and by imposing strict ceilings on the amount of budgetary support permitted to cover operational deficits of the public enterprises. In April 1967 the wages of public employees were frozen until the end of 1968, after the granting of moderate increases. The maximum increase permitted was 15 percent, compared with annual increases averaging more than 30 percent in 1965 and 1966. A drive for greater efficiency throughout the government was initiated to further reduce the burden of salary payments, which throughout the 1960's have been absorbing an increasingly large portion of expenditures. The major provision of this drive is an "orderly shift" of an estimated 100,000 surplus public employees to more productive employment.

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The timing of this shift in personnel was left open, however, and it appeared that the main thrust of the government's plan would not be carried out until the private sector was able to absorb employees and until new public work programs could be started.

24. Although the budget for 1967 did not provide for a reduction in expenditures, the deficit was to be held to one-seventh of total expenditures, compared with one-third in 1966. Tax revenues, in real terms, were to increase by 30 percent. A large part of this increase was scheduled to come from the export taxes relieved with the peso devaluation and from temporary emergency taxes on property. The rates of many sales and excise taxes also were raised and placed on a pay-as-you-go basis to reduce the eroding effects of inflation on receipts. The government, moreover, took steps to tighten the administration and collection of taxes. Strict limitation of budget deficits is one of the guidelines agreed upon by Argentina and the IMF, adherence to which is essential to drawings on standby loans.

Income and Price Policies

25. As an important part of its stabilization program, the government also took the unprecedented step of imposing restrictions on the growth of incomes in the private sector. Severe government reprisals broke organized labor's attempt to launch a general strike in March 1967 and splintered union leadership. Against this background of weakened opposition, the government introduced a wage policy that permitted increases of between 8 and 24 percent (depending upon the date of the last readjustment) and then froze wages until the end of 1968, the same as for public employees.

26. The government's price control program originally relied heavily on the deflationary effects of wage restrictions, along with reduction of import duties and control of demand through credit and fiscal measures. Later announcements, however, showed that the government was prepared to take more direct action if necessary in attacking the "inflationary mentality" of producers and retailers. It threatened to free imports of certain goods and

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use other methods of forcing businessmen to cut costs and increase efficiency. In April 1967, moreover, the government passed a new price control law involving stiff penalties that can be applied administratively (fines of 10,000 to 5,000,000 pesos, imprisonment up to 90 days, and closing of the establishment for up to six months).

27. Resort to direct price controls under the law of April 1967 has been rare because business leaders agreed to collaborate in a "voluntary" price control program. In mid-May 1967, 85 major Argentine and foreign companies agreed to cooperate with the government in restricting price increases, and many smaller firms subsequently followed suit. The positive response of the business community stemmed partly from the view that it is in its interest to make the government's stabilization program work and partly from the promise of preferential treatment for cooperating enterprises in regard to credits, import licenses, government purchases, and tax benefits. In the background, of course, is the threat that the government will enforce existing measures or enact even more distasteful legislation should the voluntary program prove inadequate.

Incentives for Private Investment and Production

28. Recognizing that effective action against inflation requires concurrent efforts to promote economic growth and cure the structural ills of the economy, the Ongania government in mid-1967 introduced a variety of production incentives. The rash of legislation that was issued was designed to counteract the recessionary pressures normally attending stabilization efforts as well as lay the basis for long-term economic growth. The government thus aimed at limiting the reduction in domestic demand while increasing, through devaluation, external demand for both traditional and nontraditional products. As one means to increase consumer demand in the face of an expected fall in real wages, the Central Bank issued a regulation establishing a new type of commercial bank credit for the purchase of consumer durables. In effect, the bank issues the borrower a book of checks to cover his purchases, and the seller can use these checks to pay his supplier

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provided the supplier is one of the 1,400 firms subscribing to the "voluntary" price control agreement.

29. A large part of the legislation issued during the first few months of the economic reform program was designed to offer a direct stimulus to private investment -- both foreign and domestic. New laws revising the land tenure system and permitting a revaluation of industrial assets reduced some of the basic obstacles to investment. Other legislation liberalized credit requirements for imports of capital equipment and reduced the costs of borrowing for investment. Moreover, a 100-percent deduction from taxable business income was permitted for purchases made between 1 June 1967 and 31 December 1968 of machinery and equipment for industry and a specified list of capital goods for agriculture. The provision that the equipment be new and of domestic origin was meant to stimulate local industry and offset advantages given to imported goods under earlier legislation. Tax incentives also were given for the retention of breeding cattle, for maintenance of a high level of beef production, and for increased utilization of technical expertise, pesticides, and other agricultural inputs. Other legislation liberalized the terms for investment credits, declared tax-exempt any interest on credits to finance imports of equipment, and raised the deduction for costs of technical assistance from 10 percent to 50 percent. Subsequent decrees extended tax and credit privileges to investment in housing construction and mining development.

Public Investment Policy

30. The Ongania government favors the reduction or elimination of state involvement in sectors in which private capital, either foreign or domestic, is willing to invest. It has encouraged private participation in such basic industries as fuels, power, steel, and petrochemicals by granting tax and import privileges similar to those allowed the state-owned enterprises that previously enjoyed virtual monopolies in these fields. To obtain private assistance in the rationalization of public enterprises, moreover, the administration issued a decree in June 1967 that legalized the sale of up to 49 percent of the shares of

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any state enterprise to private interests, with proportionate representation on the board of directors.

31. Sharply expanded investments by the public sector in the economy's infrastructure nevertheless are still an important part of the development program. The government planned to finance a large portion of public investment expenditures from budget revenues, earnings of public enterprises, and other public resources within the confines of the IMF budgetary guidelines. In addition, long-term development credits were negotiated with international financial organizations to assist in launching a variety of power, transportation, irrigation, and housing projects as well as other basic industrial and agricultural programs. Taking advantage of the increased confidence in foreign financial circles inspired by the first months of the economic reform program, the Argentine government also moved, for the first time in many years, to exploit the international capital market to help finance its investment program.

Progress of the New Program

32. The Ongania government introduced its economic reform program in an expeditious manner, under relatively favorable circumstances, and its progress to date is encouraging. The government's success does not derive from any extraordinary insight into Argentine economic problems or newly found combination of policy instruments. The program is making progress largely because this administration, unlike previous ones, actually is taking appropriate, wide-ranging measures and is giving the impression that a new era of economic policy has arrived. The various military groups were united in their backing of the program. Indeed, Krieger Vasena's burst of activity on the economic front effected a degree of cohesiveness among Ongania's military supporters that had not been evident since the early weeks of the revolution. Although Ongania appealed for broad popular support for the reform program, he showed that he was willing to adopt a more authoritarian stance, if necessary, to carry it out. The degree of authority afforded the new economic team enabled

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it to launch its wide-ranging program and to move quickly to correct imbalances as they arose.

33. The Argentine effort to strengthen the foreign payments position has been highly successful so far -- in part because of strong international support. Early in the drafting process, Krieger Vasena enlisted the counsel of the Inter-American Committee of the Alliance for Progress (CIAP), the IMF, and other international agencies and incorporated their suggestions into his program. As a result, financial and technical support from official and private sources abroad was immediate and enthusiastic. Within the first few months of the program, Argentina received about \$400 million in standby credits from the IMF, the US Treasury, and a consortium of North American, European, and Japanese banks as well as important development loans from other organizations.

34. The devaluation with which Krieger Vasena launched his economic program further strengthened Argentina's financial position. Through the purchase of foreign exchange offered from private holdings, high net earnings from trade, and drawings on standby loans and other credits, the government raised the reserves of the Central Bank to a level not achieved since 1948. The Central Bank's holdings of gold and convertible foreign exchange rose from less than \$200 million at the time of devaluation (13 March 1967) to more than \$700 million by the end of the year (not including \$200 million in available standby funds on which no drawings have been made to date). During 1967 as a whole, Argentina registered a balance-of-payments surplus of \$480 million, primarily as a result of a reversal in the flow of private capital after the devaluation. Despite a continued high level of debt repayment, the total net inflow of capital during the year amounted to \$310 million compared with a net outflow of \$250 million in 1966 (see the table). About three-fourths of this improvement derived from unspecified transactions involving short-term capital, indicating the strength of the peso at its new rate. As of mid-1968, foreign reserves continued at the high level attained during the preceding year, and no real pressure against the peso was evident. Indeed, taxes averaging about 18 percent on Argentina's main agricultural exports afforded considerable maneuverability short of further devaluation.

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1965-68

| | Million US \$ | | | |
|---|---------------|-------------|-------------|----------------|
| | <u>1965</u> | <u>1966</u> | <u>1967</u> | <u>1968</u> a/ |
| Current account | 184 | 253 | 180 | 66 |
| Trade balance | 295 | 469 | 369 | 290 |
| Invisibles balance | -111 | -216 | -189 | -224 |
| Capital account | -168 | -250 | 310 | 11 |
| Direct investment | 47 | 30 | 19 | 30 |
| Suppliers' credits | 132 | 160 | 149 | 187 |
| Drawings on long-term loans and bond issues | 39 | 13 | 59 | 170 |
| Debt amortization | -319 | -448 | -366 | -386 |
| Short-term and other capital | -177 | -188 | 231 | 10 |
| Compensatory financing | 110 | 183 | 218 | 0 |
| Net errors and omissions | 0 | -7 | -10 | 0 |
| Balance-of-payments surplus or deficit | 16 | -4 | 480 | 77 |
| Change in reserves (minus = increase) | -16 | 4 | -480 | -77 |

a. *Estimated.*

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35. Fiscal reform efforts thus far have been equally successful, and the IMF guidelines on deficit spending have been adhered to. The budget deficit in 1967 was cut to half that of 1966, mainly because total revenues increased by some 66 percent in current prices. About half of this increase derived from the reimposition of export taxes after the devaluation and the application of an emergency property tax. Improved tax administration yielded better than a 50-percent increase in income tax revenues as well as substantial increases in sales and other indirect taxes. Total revenues in real terms increased by nearly one-third and surpassed the 1961 level for the first time. The 27-percent increase in expenditures (amounting to virtual stability in real terms) was in accordance with the government's plan and attributable mainly to a sharp growth in capital expenditures. All of the increase in transfers to public enterprises went into investment. The deficit was reduced from 34 percent of total expenditures in 1966 to 13 percent in 1967 and from 3.7 percent of GNP to 1.4 percent -- by far the lowest level recorded in the 1960's. The reduction in borrowing from the Central Bank was even sharper than had been planned and was facilitated by the first successful sales of treasury bills in 20 years.

36. In impact on the populace, the government's progress toward price stabilization has been perhaps its most impressive achievement. Although the increase in the cost of living reached 27 percent in 1967, the government did succeed in establishing a basis for greater price stability and in limiting the impact of the inordinately strong pressures operating during much of the year. Despite the large devaluation in March and the wage increases permitted in April and May, by the third quarter of the year a tendency toward stability already was evident in the indexes of both wholesale prices and construction costs. The government also moved quickly to limit the speculative price increases arising from disruptions in production and transportation due to abnormally bad weather during the latter half of the year. On a seasonally adjusted basis, the rise in the cost of living during the first five months of 1968 measured only 3.5 percent -- a distinct improvement over the 9-percent increase during the comparable period of 1967.

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37. Despite the freeze on money wages, real wages in mid-1968 had not deteriorated below the level prevailing when Krieger Vasena was appointed in March 1967. After peaking with the wage increases permitted in April and May 1967, the index of real wages fell steadily and by December was some 7 percent below the pre-freeze level. In January of this year, however, the government increased take-home pay by decreasing employees' social security payments, and the index of real wages increased to a level somewhat higher than that of March 1967. Because of the general stability of prices since then, real wages have held firm. To mitigate the pinch that will come from moderate price increases expected during the next few months, the government arranged for both public and private employees to receive at midyear half the annual bonus of a month's wages that is traditionally given at the end of the year.

38. The stabilization effort has not brought on a recession, as might have been expected. Thanks mainly to good crops and a healthy export trade, GNP for 1967 grew by about 2 percent, following a decline in 1966 of about 1 percent. Serious pockets of depression nevertheless persisted in important branches of industry, and manufacturing output as a whole declined during the last half of the year. The need to draw down large inventories accumulated during the extended recession of 1966 was partly responsible for sluggish activity in some industries, but it also was apparent that domestic investors were pursuing a cautious policy. The disappointing response of the domestic private sector to the spate of investment incentives legislated in 1967 was a key issue in the government's decision to launch a public investment program totaling some 319 billion pesos (US \$911 million) in 1968. Although large investments in fuels and power, transportation and communications, and other parts of the infrastructure are needed badly, they are being undertaken at this time primarily to support demand.

39. As a result of the sharp increase in public investment and a continued high level of consumer demand, an upswing in industrial and construction activity has been evident in 1968. Manufacturing

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output grew about 4 percent during the first quarter compared with the same period in 1967, and production in the extractive industries and the construction sector increased by 10 percent and 17 percent, respectively. The unemployment rate, moreover, dropped to its lowest point in years -- 5.6 percent as compared with the 6-percent average during the boom year of 1965. The increase in aggregate demand, however, has been moderated by the drop in farm income and in exports during this period. Farm output during the first few months of 1968 was almost 7 percent lower than during the same period in 1967, mainly because of drought that particularly affected livestock production. Farm incomes were further affected by the 16-percent drop in exports during the first quarter, which derived not from a lack of price competitiveness but from marketing problems (for example, the British ban on meat imports from Latin America, drawn-out negotiations on sales of wheat to Brazil, and stiffer marketing conditions in the United States, Spain, and the European Common Market). By midyear, however, agricultural conditions had improved and exports had picked up, although not to their 1967 level.

40. Although private domestic investment activity has been comparatively sluggish, funds are readily available. Government officials indicate that, despite the decline in interest rates over the past year, the more rapid fall in the rate of inflation is now causing a readjustment in the capital market. As a result of the shift in the real cost of money from a negative rate of about 10 percent last year to a positive rate of about 5 percent this year, banks are experiencing some difficulties in placing loanable funds. As of 1 June, the Central Bank cut back by 50 percent the reserve requirements of commercial banks, which further eases credit and should force a further decline in interest rates. Should the expansionary impact of this move prove too great, the government intends to apply countermeasures to protect its plans to further lessen the rate of increase in the money supply.

41. With the sharp buildup in foreign reserves and the successful initiation of the stabilization program, response on the part of foreign investors has become more positive. By late 1967 -- for the

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first time since the prewar period -- confidence in the Argentine economy among foreign financial circles was sufficient to permit the floating of a \$25 million government bond issue in the European capital market. As of June 1968, about 70 percent of the issue had been sold, and its guarantor, the West German Deutschebank, agreed to back another bond issue for an equal amount in September under even more favorable terms than the first. In June 1968, Argentina was able to enter the US private capital market -- also for the first time since 1938 -- with a bond issue of \$25 million, which is being handled by a New York brokerage firm. A fourth issue, planned for listing on the European and New York stock exchanges in November of this year, will be backed by the same German and US sponsors.

42. Competition among foreign suppliers for orders associated with Argentina's prospective large public investment program has yielded sizable amounts of suppliers' credits. During the latter part of 1967, suppliers' lines of credit totaling \$70 million were obtained from six countries as a result of Krieger Vasena's money-raising trip to Europe. Since then, major suppliers have been offering increasingly favorable terms of credit in their attempts to gain a foothold in the Argentine market. Together with aid from various international organizations, external financing totaling some \$370 million has been obtained by the Argentine government since February 1967.

43. Direct foreign investment in Argentina also has shown a marked upward trend. In 1967 the Argentine government authorized 159 plans for direct private investments totaling \$72 million, compared with authorizations of \$32 million in 1966. This upward trend appears to be continuing in 1968.

Prospects

44. Although progress has been achieved under the economic reform program, continuing -- and, in some areas, increased -- constraints on expenditures for consumption will be necessary. Inflationary pressures should continue to ease in 1968 because of the price control program and the freeze on wages

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and utility rates. Most of the price increases deriving from the devaluation have already worked themselves out. The healthy state of foreign exchange reserves together with the resurgence in foreign capital inflow should provide sufficient flexibility to permit imports to rise in response to increased industrial requirements and any food shortages that might arise from an onslaught of bad weather. If the government holds the line on the reforms already introduced, the increase in the cost of living should be substantially reduced, and the government may well reach its goal of only a 10-percent increase in 1968 and virtual stability in 1969.

45. Argentina should be able to avoid serious balance-of-payments strains during the next few years if present policies are maintained and if world demand for its traditional exports remains strong. Under these circumstances, total Argentine exports probably could grow an average of about 5 percent annually. Chances of reaching such a rate will be improved if some progress can finally be made in exporting manufactured goods. Because real wages in industry appear to be little higher now than in the late 1940's and industrial labor productivity presumably has increased somewhat, the cost disadvantage of Argentine manufactures presumably has become less pronounced than formerly. Imports probably could grow at a somewhat more rapid rate, inasmuch as Argentina now has a small surplus on current account, foreign exchange reserves are relatively large, and the inflow of long-term capital is likely to increase. Import capacity will be further improved after 1969, when debt servicing obligations are scheduled to drop sharply. These servicing obligations have absorbed an average of 30 percent of commodity export earnings in recent years and probably will absorb about one-fourth of earnings in 1969.

46. The heavy burden placed on resources by the public investment program possibly will give the reform program its first real test, forcing the government to reconsider the desired balance between financial stabilization and the aim of "getting the economy moving again." Although part of the program will be financed through foreign credits and perhaps

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through domestic bond issues, final success from the standpoint of financial stabilization depends upon the government's ability to effect increased public savings by boosting tax revenues and improving operational efficiency in the public sector. With the ending of the emergency taxes and the likelihood of further reductions in export taxes to protect agricultural incentives, increases in revenues will be more difficult to obtain. Further large cuts in current expenditures also may be difficult to realize, especially through the removal of superfluous personnel. The government payroll in Argentina long has served as a hedge against unemployment, and the administration probably will continue to be hesitant to undertake large-scale dismissals or major shifts in personnel into more productive employment.

47. The response of business to the "voluntary" price program, the success of government offerings on the domestic capital market, renewed interest in the stock exchange, and increased activity by foreign investors all are signs of a greater degree of business confidence. But, hopeful as these signs are, the economy is still susceptible to crises of confidence, and severe tests are likely to occur. Private Argentine enterprises will be difficult to reorient because of their long tradition of protected inefficiency, and the transformation of state enterprises will be a long, costly, and politically sensitive process. As the barrier to imports afforded by the devaluation diminishes, producers and retailers will be under increasing pressure to cut costs and hold down prices. The sacrifices that labor will have to make in terms of lower real wages and possible greater unemployment to improve efficiency may well cause the resurgence of organized unrest. Business will become increasingly impatient as profits are squeezed and bankruptcies become more frequent. A basic test will come in the ability of the government to maintain its policies in the face of accusations that domestic industry is being sold out to "foreign interests".

48. Perhaps the most difficult adjustment will be that of reducing the dependence of the rest of the economy on the proceeds from agricultural production. If Argentina is to realize more rapid and

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stable rates of growth, it is essential that a larger share of these proceeds be reinvested in agriculture itself and that much larger savings be generated in the nonagricultural sectors to finance their own investments. Higher returns for agricultural producers will directly increase the resources available to them for investment, but assurances that these returns will continue over time are necessary to encourage farmers to invest in long-term improvements in agricultural technology rather than in other sectors.

49. Consistency in basic approach is the most important requirement for the long-term success of the government's program of stabilization and economic development. The inflationary psychology and skepticism that have pervaded the Argentine economy for so long cannot be erased quickly. All participants in the economic life of the country must be convinced that the present economic policies will continue into the future before they will make the necessary changes in their patterns of investment, production, and consumption

50. There clearly are no quick, easy solutions for Argentina's economic ills. If crops are good and world prices remain high for major Argentine exports, the process of adjustment will be easier. The cure will be painful and lengthy, nonetheless. The greatest danger to the government's program is that various groups will become increasingly disenchanted and impatient because Onganía and Krieger Vasena cannot perform a miracle. Their dissatisfaction will test the government's resolve to continue programs that can bring necessary changes only over an extended period. The government will have to continue its economic policies for five years or more to change the atmosphere created by years of "stop-go" approaches to deep-seated economic problems. Given its human and physical resources, there is little material reason why Argentina cannot achieve the growth and prosperity that have so long eluded it. For the first time since World War II, the ability and willingness of an Argentine government to undertake suitable economic reforms offer some hope that the Argentine economy can begin to realize its potential.

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