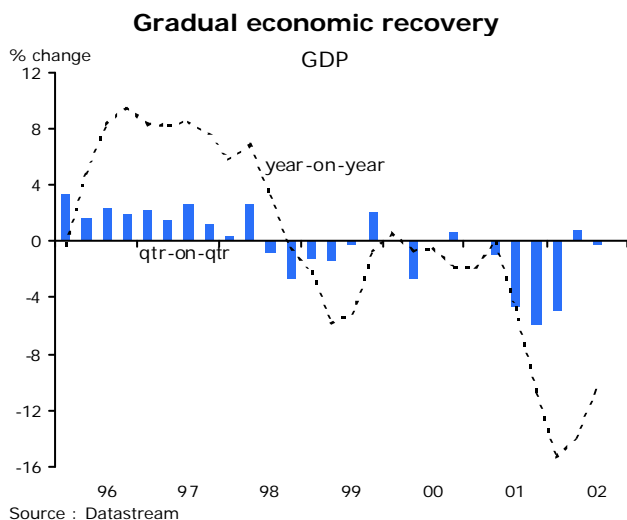


Country brief : Argentina

The Argentine economy appears to be bottoming after its deepest recession in 2002 and negative growth in the preceding three years. The government has forecast real GDP growth of around 4% for 2003. Economics@ANZ's projections are more subdued, with growth closer to 3% reflecting the risks that could threaten the recovery. Given the tasks ahead to help bring the economy back to a sustainable growth path and restore investor confidence, it is too soon to say that the economy is out of the woods.

Positive signs emerge for economy

The Argentine economy has endured four years of recession with the steepest decline of an estimated 11% in 2002. GDP per capita has slipped to around US\$2,800 in 2002 from over US\$7,000 in 2001. However, it appears that the economy is bottoming. Real GDP was flat in the third quarter after a small positive in the second quarter, although in year-on-year terms, the declines were significant (-10.1% in Q3 02 and -14% in Q2 02). Annual industrial production growth has turned positive after declining for 18 months. It rose by 7.8% over the year to December 2002 and 8.5% over the year to January 2003, helped by the substitution of imports with locally-made goods. Imports plunged by 56% in 2002. Inflation ended the year at 41% (average inflation was 25.8% in 2002) and the government has projected an easing to 22% by December 2003 (annual inflation was 40.4% in February). Real wages have fallen markedly given the sharp jump in the CPI and about a 5% increase in the average nominal wage.



On 24 January, the IMF approved a US\$2.97 bn stand-by credit arrangement for Argentina through to August 2003 and agreed to extend by one year US\$3.8 bn in payments that would fall due during the first eight months of the year. This was a welcome respite for Argentina given its heavy debt service obligations and low reserves. However, these actions were based on the premise that the transitional stand-by credit will be succeeded by a multi-year IMF arrangement after the presidential

election in late April. Arrears to the World Bank and the IADB were cleared and additional funding is likely in coming months.

Some issues clouding the outlook

Political leadership. Presidential elections are due on 27 April, with a second-round vote on 18 May. The new president is scheduled to take office on 25 May. Factional disputes within the Peronist party have seriously undermined it. Primary elections were scrapped and instead, three presidential candidates have emerged from the Peronist party namely: former president Carlos Menem, Santa Cruz Governor Nestor Kirchner (backed by current president Eduardo Duhalde) and Adolfo Rodriguez Saa, president for a brief period in December 2001. The other candidates include Leopoldo Moreau (backed by the UCR (Radical) party), centre-left Elisa Carrio, formerly of the Radical party but has now formed the Alternatives for a Republic of Equality Party, and conservative former Economy Minister, Ricardo Lopez Murphy (Recreating Argentina Party). The next administration, likely to be Peronist-led, is not expected to enjoy a strong mandate given the political infighting. This has increased uncertainty over future macroeconomic policy initiatives.

Relations with the IMF. A more comprehensive agreement has to be negotiated with the IMF to secure fresh financing. Some of the conditions likely to be set by the IMF include banking sector reform, increases in utility tariffs and fiscal reform (eg. tax reform, revenue-sharing system with the provincial governments). In addition, limits on judicial policy-making will also be expected to avoid further strain on the already-complex policy environment. For instance, in February 2003, the court suspended a government decree to increase electricity rates by 9% and natural gas rates by 7% as part of the agreement with the IMF. The government is currently appealing the decision. (Utility rates have been frozen since early last year). The Supreme Court's ruling in March 2003 on the lawsuit from San Luis province against state-run Banco de la Nacion, effectively overturning the decree that ordered dollar deposits to be converted into pesos, has heightened uncertainty over the impact on the already-weak banking sectors.

The above requirements will be difficult to address given the fragile state of the economy, uncertainty

over strength of political support and recent experience where negotiations between the IMF and the Argentine government remained deadlocked for almost a year before the recent transitional agreement. Nevertheless, with a large repayment of about US\$2.9 bn due to the IMF in September, negotiations must begin in earnest once the new administration is formed. Successful negotiations with the IMF would help discussions on the restructuring of public debt owed to foreign creditors which amount to some US\$50 bn but it will be a long process.

Fiscal and monetary management. A consolidated primary surplus (ie. excluding debt payments) of 2.5% of GDP for 2003 has been set as part of the IMF agreement. This is an improvement from a surplus of 0.5% of GDP in 2002 and a deficit of 0.9% of GDP in 2001. A windfall from export levies, a higher price level, VAT revenue, and restraints on government expenditure have helped to improve the fiscal balance thus far. In January, a primary surplus of over Ps800 mn was recorded, exceeding the IMF target of Ps424 mn. The criteria in the months ahead, however, are more difficult.

Sustaining this improvement in fiscal accounts will be a tough task. Some of the challenges include pressures for restoring public sector wages and pensions at a time when spending restraints are a priority, eliminating certain tax breaks and introducing further tax hikes during a weak economic environment, and fighting tax evasion. In addition, a commitment from Argentina's provinces to adhere to strict fiscal goals and refrain from issuing bonds to fund current expenditure, needs to be maintained as failure to meet the IMF-agreed conditions is likely to prevent new financing. The debt service burden will remain high. Even if a significant proportion of debt is rescheduled and/or written off, a larger primary budget surplus will still be needed to alleviate debt service pressures.

Tight monetary targets have also been set. These include the reduction of the monetary base (pesos and quasi-currencies) and a floor on net international reserves, which reduces the scope for the central bank to sell foreign exchange to absorb pesos.

Weak banking sector. Deposit withdrawal restrictions have gradually been lifted. By December 2002, all current account deposits frozen under the "corralito" were released. Time deposits, mostly converted to indexed certificates of deposit (Cedros), are gradually being released. The central bank has allowed banks to advance the encashment of Cedros on condition that repayments of central bank rediscounts of an equal amount are made. Thus far, the impact on the banking system of the relaxation of restrictions has been limited, helped by high interest rates and a stabilisation of the peso. There has also been an easing in capital outflows and faster growth in deposits. Nevertheless, uncertainty over the ramifications of the Supreme Court's ruling on

pesification of deposits will hang heavily over the banking sector. In addition, corporate sector bankruptcies and poor asset quality underscore the fragility of the banking environment.

Maintaining peso stability. After the 1:1 peso-US dollar peg was broken on 10 January 2002, the peso dived to around Ps3.81/USD at the end of June before gently strengthening against the US dollar. As of 28 February 2003, it was trading at Ps3.19/USD, an appreciation of around 20% from end-June 2002. The peso's depreciation last year has significantly lifted export competitiveness but a sustained strengthening of the currency will erode some of these benefits. Currency controls have gradually been relaxed and this has helped to limit the pace of peso appreciation. The measures include raising the limit that exporters can keep in US dollars, relaxing restrictions on import payments and allowing foreign companies to send dividends abroad. Nevertheless, the current trend of the peso could easily be reversed, reflecting renewed investor nervousness. This, in turn, would fuel inflation fears and seriously dent the economic/banking sector progress thus far.

Peso appreciation since H2 2002



Conclusion

The government has forecast real GDP growth of around 4% for 2003. Economics@ANZ's projections are more subdued, with growth closer to 3%, reflecting the risks ahead that could threaten the recovery. Firm political leadership will be critical in ensuring that the economy returns to a sustainable growth path, backed by responsible fiscal and monetary management and the normalisation of operations as restrictions imposed at the height of the crisis are eliminated. Given the tasks to be addressed before investor confidence is restored and investment flows return, it is too soon to say that the economy is out of the woods.

Jasmine Robinson
Economics@ANZ Email: robinsj7@anz.com



Represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited
ABN 11 005 357 522
10th Floor 100 Queen Street, Melbourne 3000, Australia
Telephone +61 3 9273 6224 Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited
ACN 005 357 522
Minerva House, PO Box 7, Montague Close, London, SE1 9DH, United Kingdom
Telephone+ 44 207 378 2121 Fax+44 207 378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc.
(Member of NASD and SIPC)
6th Floor 1177 Avenue of the Americas
New York, NY 10036, United States of America
Tel: +1 212-801-9160 Fax: +1 212-801-9163

NEW ZEALAND by:

ANZ Banking Group (New Zealand) Limited.
Level 10 215-229 Lambton Quay Wellington, New Zealand
Telephone +64 4 496 7000, Fax +64 4 496 7360

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