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Statement by Mr. Lavagna

Statement by the Honorable Roberto Lavagna
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I - The Global Economy and Financial Markets

1. We welcome the rebound of activity and trade in the world economy and the prospects of a continued strength during the current year, with expected world GDP at record levels. There are, however, significant down-side risks including recent geopolitical developments that are particularly worrisome. On top of the social, political and humanitarian challenges that they encompass, they compound the pressures for increases in energy prices stemming from greater world demand and supply constraints.

2. From a medium-term perspective, the world economy is at a critical juncture. The globalization process, with a potential for supporting growth and of raising standards of living all over the world, is being challenged by several interrelated developments. The external current account imbalances are escalating in the wake of the exceptionally supportive macroeconomic policies in the U.S., which reinforce the one-engine framework that has been prevailing in the world economy for quite a long time. These imbalances are bound to be corrected sooner or later and there is a risk that protectionist trade measures may resurface, generating retaliatory responses from other countries. We are hopeful that the lessons from economic history have been duly learnt and that protectionist pressures will not find their way into actual policies.

3. It is crucial that the trade liberalization process be intensified by all countries so that the benefits of globalization be evenly spread out to all regions of the world. This need is most evident with regard to subsidies, tariffs and non-tariff barriers in advanced economies, affecting commodities produced by developing countries. Whereas subsidies offset developing countries' comparative advantages as commodity producers, tariff escalation virtually penalizes their efforts to add-value to their exports. On top of this, tariffs and non-tariff barriers deprive these countries from market based sources of foreign exchange earnings, forcing them to rely excessively on debt creating flows, including from official multilateral financing or concessional aid. A clear commitment to eliminate production and export-related subsidies and to dismantle tariff escalation schemes and to grant effective access into advanced economies' markets is crucial for a successful conclusion of the Doha Development Round, on which much of the future of the world economy rests; thus, all efforts should be aimed at reaching that goal.

4. In the financial sector area, the challenges are not less daunting. International external imbalances create the need and the pressure for a devaluation of the U.S.

dollar. This is being resisted by some external-surplus countries that favor foreign demand as the main driving force for stimulating their economic growth. In particular, several emerging Asian countries have opted for avoiding the appreciation of their currencies through massive foreign exchange intervention resulting in a significant accumulation of international reserves. Against this backdrop, a pronounced appreciation has taken place in other regions, as in the case of the euro zone, which could cope with the contractionary impact of less competitive exports by adopting a looser monetary policy stance. By contrast, the vigorous domestic demand growth in the U.S., favored by exceptionally supportive fiscal and monetary policies, should call for a careful handling of the transition to a more neutral policy stance. At that point in time, potentially adverse consequences for asset prices may occur if expectations are not carefully managed. Of particular concern in this regard is the impact of higher interest rates on wealth and income of overextended consumers which so far have been the driving force of economic activity, particularly U.S. consumers, characterized as the "consumers of last resort" of the world economy.

5. The paradoxical situation of abundant liquidity and very low rates of inflation and even deflationary pressures in some parts of the world could be seen as representing another benefit of global markets, either by undermining the pricing power of domestic producers or by resulting in a rapid increase in the productive capacity vis-à-vis a less dynamic demand expansion. It is important to realize, however, that while consumer price inflation may be subdue, asset price inflation remains to be a significant risk for many countries. However, given the low consumer price inflation and the weak domestic demand conditions still prevailing, monetary tightening should not be seen as the only way to avoid a boom-bust cycle in asset prices. Indeed, the view that central banks should not target asset price inflation is widely accepted. However, unambiguous signs of asset price inflation —that may endanger the stability of financial systems and could have potentially serious macroeconomic consequences if a bubble develops and bursts— should not be disregarded. Against this backdrop, structural policies —aimed at improving competition, market transparency and a fairer access to financial resources— should play a crucial role for enhancing the effectiveness of short-term macroeconomic policies and creating the conditions for a favorable investment climate. Similarly, we welcome the increased emphasis on the balance sheet approach to surveillance, where issues of mismatch of asset and liabilities may exacerbate the costs of a boom bust cycle in asset prices.

6. The exceptional level of liquidity under which the world economy is now operating has also had important consequences for developing countries in general, which have benefited from buoyancy in private capital inflows and a marked reduction in country risk spreads. These favorable developments have also been supported by responsible macroeconomic and structural policies in developing countries which give reassurances that, once international monetary conditions change, developing countries will remain attractive to international capital. A reversal of the monetary policy stance in advanced economies will have, nonetheless, a non-trivial impact on capital inflows to developing countries. Spreads and volumes could result negatively

with foreseeable consequences on nominal exchange rates. This, again, points to the importance of focusing IMF surveillance on potential balance sheet weaknesses. Developing countries should aim at avoiding to depend on non-sustainable levels of external financing and to modify the composition of capital inflows from private and official debt-creating types towards placements in stocks and FDI. This shift would entail several advantages. On the one hand, domestic and foreign investors would share the risks of productive activity; on the other hand, the benefits of FDI could cross-cut the entire economy as FDI, usually, comes associated to other important benefits such as the absorption of new technology and know-how and the possibility of improved access to export markets .

7. In addition, an orderly resolution of external imbalances could contribute to larger investment flows to developing countries by reducing the amount of global savings, channeled to the U.S. economy and redirect them to support domestic demand and growth in other countries, including the developing world. Developing countries, on the other hand, should continue to maintain a favorable investment climate that attracts foreign capital through sound policy implementation and institutional and regulatory changes, i.e., strengthening of the judiciary, tax administration and public expenditure management. The many transparency initiatives in place will not only help the Fund in its surveillance activities, but they will also serve to improve the quality and amount of information available to market participant, thus contributing, in a scenario of sound policies, to larger and sustained investment flows to developing countries. The present buoyancy in China and India and other Asian, as well as Latin American countries, gives great hope that a more balanced world economic growth can also be reached through greater participation of developing countries.

8. To conclude, while every country should follow the policies that better fit their own medium-term interests, the best way of serving this medium term interest is through cooperative arrangements to redress the current imbalances that threat global macroeconomic stability. A greater understanding of what those policies are would certainly contribute to create the necessary incentives and political support in each country to implement them. The Fund should play a critical role in articulating those policies, helping individual countries in this endeavor, but most importantly, it should also continue helping the international community as a whole to reach a common understanding on what is needed for ensuring a sustainable and equitable growth of the world economy

II – <u>Crisis Prevention and IMF Surveillance: Priorities, Tools and Modalities</u>

9. The most critical role of surveillance is to flag the main challenges facing individual countries and the world economy and to influence governments' policies so as to prevent that those challenges become crisis. Crisis prevention should be the foremost goal of Fund's surveillance. We welcome in this regard the emphasis given to the

promotion of sound policies including structural reforms in advanced economies.. On emerging markets and developing countries in general, the heightened emphasis on vulnerability exercises, debt sustainability analyses, and balance sheet mismatches more generally should help the early detection of impending vulnerabilities. We deem important to continue the work on alternative instruments that provide a precautionary financial shield against external capital account shocks for members implementing sound policies.

10. The impact of Fund's policy advice rests primarily on its quality and soundness. This requires that management and staff should give due consideration to the pace and sequence of implementation of reforms. In this respect, it is important that the institutional, political and social realities of members be duly factored in so as to offer a realistic policy advice that may be effective and that may serve to elicit ownership on the part of members' governments. Members should be presented with alternative policies from which to choose in order to achieve the agreed goals of stable and equitable growth. The new emphasis on stocktaking, that is analyzing and discussing with members past performance in implementation and the effectiveness of policy advice is encouraging since it will serve both the Fund and the members to learn from past experiences and will help to build a candid working climate between staff and the authorities.

11. The area of crisis resolution will unavoidably be part of the Fund's work in the foreseeable future. We welcome the progress being reported on the widespread adoption of collective action clauses (CACs), including by several industrial countries, and the fact that there is no evidence so far that CACs may have had any material impact on spreads. It remains to be seen, however, if even a generalized use of CACs will render some of the features contemplated in the SDRM proposal unnecessary or if we will have to revisit some aspects of the mechanism to further facilitate the process of debt restructuring. In addition, we support the work being advanced in regard to the Code of Conduct to guide relations between sovereign debtors and private creditor, which is predicated on the need of transparent and candid dialogue between all parts involved. The recent agreement within the Paris Club, characterized as the Evian approach, also offers encouraging possibilities of affording exceptional treatment to countries that are facing unsustainable debt burdens.

12. The concept of the Fund as a learning institution should continue to be promoted. It is critical to learn from past experience in program countries, including through the fresh perspective approach, but this should also be extended to non-program countries, particularly those of systemic importance. The testing of Fund policy advice against new evidence and alternative points of view is critical in this learning process. In this regard, the Internal Evaluation Office has made important contributions through several reports. It has provided general advice regarding surveillance, such as the support for greater candor, the benefits of more stocktaking; and also on issues affecting program design, such as the need to avoid excessively

optimistic assumptions. The IEO's most recent report on fiscal adjustment in Fund-supported programs and the action plan that followed on its recommendations contain particularly useful insights. The need to justify fiscal adjustment more fully in IMF programs and of focusing more on the formulation and implementation of key structural and institutional fiscal reforms, as well as that of making explicit the linkages of fiscal adjustment to growth are important contributions of the IEO's study.

13. Closely connected to the issue of fiscal adjustment and growth is the adverse impact of continued fiscal adjustment on public investment, particularly in infrastructure. This has been observed in many country programs over the years, where the point seems to have been reached in which medium-term growth prospects are at stake. We support the advice to make the utmost efforts in making room within the budget for higher levels and qualitatively improved public investment in infrastructure. A set of fiscal indicators to evaluate fiscal policy is called for to allow adequate consideration of the current fiscal balance. Private Public Partnerships (PPPs) seem to offer good possibilities of easing the constraints in infrastructure investment, thus, helping to enhance growth prospects. Establishing appropriate legal and regulatory frameworks for PPPs and reflecting the fiscal costs and risks including the contingent liabilities associated to those operations are of the essence to ensure macroeconomic stability and fiscal sustainability. Multilateral Development Banks (MDBs) can play an important role, not only in redirecting lending to finance infrastructure projects, but also in providing the reassurances on the quality and cost-effectiveness of the projects they finance, as well as helping to build the countries' own capacity to evaluate their investment programs and prospective PPPs and to monitor their implementation. We look forward to further progress in the analysis of these issues and in the implementation of the proposals that have been recently discussed by the Board.

III - <u>Enhancing IMF Support to Low-Income Members</u>

14. Regarding low-income countries, it is encouraging to see that the goals and the means to reach them, as defined in the Millennium Development Goals and in the Monterrey Consensus, are clearly understood by all parties involved and that the strategy is beginning to bear fruit. It is also clear that it is not only a matter of increased aid flows but also of trade liberalization and the reduction of trade-distorting subsidies in the advanced economies, particularly in the agricultural sector, which will afford low-income countries the necessary resources to reach a sustainable growth path and a reduction in poverty levels. We welcome the Bank-Fund collaboration that is taking place on low-income country programs and conditionality, and look forward to further progress in this critical area for the success of the international community efforts, and those from low-income countries, supporting growth and poverty reduction in those countries. The Poverty Reduction Strategy Papers (PRSP) along with the Poverty Reduction and Growth Facility (PRGF) represent a sound analytic and operational framework to face these challenges.

15. In any event, notwithstanding the key roles to be played by the multilateral institutions through timely financial and technical assistance support, including *inter alia* to ensure sustainable debt levels and to reduce vulnerability to exogenous shocks, in the end the success of the undertaking depends to a large extent on the low income countries themselves. Efforts in implementing sound economic policies and, in particular, in strengthening their institutional settings through good governance, transparency, and sound fiscal administration are decisive for international donors to feel compelled to support those efforts and to generate a virtuous cycle of much needed increase in external resources, sound policies, high and sustained growth, and the desired reduction in poverty.

IV - Remarks on the Southern Cone Countries

16. The Executive Board of the IMF has recently extended Bolivia's one-year Stand-By Arrangement, and negotiations are underway to complete the pending program review. The policy framework aims at continuing the fiscal consolidation efforts, both by means of expenditure containment, as well as by more progressive revenue mobilization based on a tax reform.

17. In Chile, GDP growth is expected to accelerate to a range between 4½-5 percent in 2004. Favorable external demand conditions and improved terms of trade are complemented by benign financial conditions and strong economic fundamentals in fueling the export-led recovery. The supportive monetary policy in a context of very low and stable inflation, and the fiscal impulse coherent with a structural surplus of 1 percent of GDP, support the healthy growth of domestic demand.

18. Paraguay's Stand-By Arrangement is an essential factor for its economic recovery. Growth is expected to increase to 3 percent this year, inflation has already fallen to the low single digits, the currency has recovered from previous weaknesses, and official reserves have risen significantly. Moreover, the fiscal situation has improved, with a small surplus projected for 2004, and the authorities are pressing for an early passage of the Fiscal Adjustment Law. Other important developments include the congressional approval of the reform of the pension system and improvements in bank regulation.

19. Peru's performance continues to be favorable, with a real GDP growth of 4½ percent on average under the 2002-2003 Stand-By Arrangement. Inflation is kept in the low single digits under an inflation targeting regime, the external position remains robust, and fiscal consolidation is a key element of the authorities' medium term strategy. In addition to prudent macroeconomic policies, Peru's favorable medium-term outlook is supported by the authorities' commitment to implementing structural reforms, reducing vulnerabilities, and actively pursuing free-trade initiatives

20. The recovery of the Uruguayan economy has been robust, with rapid growth led by exports to markets outside the region and with a sharp reduction in inflation and unemployment. Financial indicators remain supportive, including a continuous recovery in local deposits. These results reflect the success of the authorities' program, which has overcome the crisis and restored stability while respecting property rights.

21. The Argentine economy, in turn, has systematically proven most forecasts wrong starting in mid-2002, and still today is common to hear voices that question the sustainability of the economic recovery. However, after a strong real GDP growth rate estimated at 8.7 percent during 2003, the growth momentum of the Argentine economy continues encompassing practically all areas of economic activity. Sound macroeconomic policies, including the elimination of the quasi-monies and the appropriate level of the exchange rate, a favorable external environment, and the high degree of popular support for the government, in the context of a smooth political transition, have all contributed to strengthen investors and consumer confidence which is, in fact, the real underpinning of economic activity in Argentina these days.

22. Inflation, on the other hand, has remained subdue at less than 3 percent per annum. All fiscal and monetary targets of the program with the Fund continue to be met with wide margins. Revenues are being sustained by the strength of the economy and by a much improved fiscal administration aimed at combating tax evasion. On the expenditures side a continued control, in particular over wages, is also contributing to achieve levels of primary surplus beyond those committed in the program. This represents a considerable effort considering the sudden impoverishment suffered by the Argentine people with 50 percent living under the poverty line and over 25 percent under the extreme poverty line. The fiscal effort that Argentina is undergoing, and is willing to continue making should be put in perspective. The 3 percent of GDP primary surplus that, in these very difficult economic, social and political circumstances Argentina has achieved largely surpasses its past fiscal performance. It entails in fact a turnaround of 5 percentage points of GDP when compared with the 2 percent average primary deficits during the 90s, when the social constraints faced by the country were substantively less demanding and when Argentina's economic policies were cherished as a model to be followed by other emerging economies. The present strong fiscal position has set the right conditions for addressing the projected structural fiscal reforms, starting with the earlier reduction of the distortionary financial transaction tax.

23. The banking system which has been one of the areas most affected by the December 2001 crisis is showing signs of renewed strength. The government has compensated banks for the impact of asymmetric *pesoisation* and is in the process of doing so with regard to asymmetric indexation. The recovery of the banking system over the medium term will, nonetheless, be predicated on a return to profitability in the context of a renewed confidence both on the part of depositors and of the banks in

their willingness to grant new loans. Both developments are, in fact, already starting to take place. Total deposits grew 19 percent in real terms during 2003. At the same time, a clear reversal of trend was observed in terms of profitability of the system. Credit to the private sector has also increased in particular for consumer loans, while non-performing loans continue to show a declining trend with clear improvements in the consumers portfolio.

24. On the utility sector reform, upward adjustment in tariffs have already started with an increase in the electricity and gas tariffs for large size non-residential consumers of between 10-35 percent. In addition, the recent joint fact-finding mission of Bank-Fund staff has contributed to a more fluid exchange of information that will facilitate the reform process of the utility sector with a view to renegotiate the concessions in a timely and efficient manner. In addition, it will help to ensure consistency of the new concessions with the regulatory framework that is under discussion.

25. The most recent crisis in the energy sector has highlighted the need to speed up the process of normalization of contracts with privatized companies, where adequate pricing policies and a clear and enforceable commitment to appropriate levels of investments will be present. It should also be highlighted that the energy crisis also reflects a much higher than expected level of demand due to the vibrant pace of economic activity, which we all welcome. However, it was also due to much higher than average temperatures during the summer months which points to a rather negative development that seems to be affecting many countries.

26. On the upcoming restructuring of the non-performing public debt the Argentine government is committed to seek in good faith an agreement with private creditors. In that context, Argentina will only assume commitments that could be fully honored over the medium-term. Accepting an excessive debt service that could jeopardize economic and social recovery is in the interest of nobody, as it would only bring more instability to the region and to financial markets.

27. Finally, the Report of the Acting Managing Director to the Committee highlights the importance of the Fund's preferred creditor status in order for the Fund to be able to meet the legitimate financial needs of members. Let me ratify, once more, that Argentina adheres fully to the preferred creditor status of the Fund and of the IFIs in general. This has been unambiguously proven by the US$ 7 billion in negative transfers to these institutions since the beginning of the crisis in January 2002.