
FINANCIAL STABILITY BULLETIN

**Central Bank
of Argentina**

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Preface

Financial stability (FS) is a state of affairs in which the financial services sector can channel the savings of the population and provide a nationwide payments system in a manner that is efficient, secure and sustainable over time. In the framework of the execution of consistent and stable macroeconomic policies, the robustness of the financial sector in the face of factors that threaten the possibility of carrying out such functions in an enduring manner (by runs on banks, excessive leverage, inadequate risk management policies or distortions in asset prices) serves to define the degree of approach towards a financial stability configuration.

The strong interrelationship between financial stability and sustained economic growth explains why the former is a social good that the state has to generate and protect. This is why the promotion of financial stability is one of the principal functions of most central banks. In order to carry out this task central banks must have available a number of instruments, among which the following stand out: clear rules about the establishment and closure of financial institutions, an adequate prudential regulatory framework, safety nets, effective official supervision with appropriate legal and institutional backing, and mechanisms with incentives for market discipline.

The Central Bank of Argentina, according to article 4 of its charter, has a mandate “to supervise the sound operation of the financial market”. It is the Central Bank understanding that in order to enhance the effectiveness of the policies that it undertakes its usual regulatory and supervisory powers must be complemented by a communications strategy that is transparent and accessible to the general public.

*With this purpose in mind it publishes the **Financial Stability Bulletin (FSB)** that presents an overall assessment of developments in the conditions of financial stability. In the **FSB** the different channels of information that are available on the subject are merged, to provide the Central Bank’s views on the outlook for the financial system. Furthermore, between each half-yearly issue of the **FSB**, the Central Bank releases a monthly Report on Banks to keep the public up to date about the more recent developments in the financial system.*

*According to the depth of detail that the reader requires, the **FSB** can be approached in two different ways. Reading the Central Bank Outlook and the Balance of Risks, together with the summary of each chapter, enables the reader to grasp the gist of the **FSB**. Naturally, a full reading of the **FSB** provides an in depth evaluation of the issues it covers, enriched by the coverage of special topics that are included in the Boxes.*

*The date of publication of the next issue of the **FSB**, with statistics that cover the first half of 2005, will be on September 30, 2005, on the Central Bank website.*

Buenos Aires, March 31, 2005



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CENTRAL BANK OUTLOOK

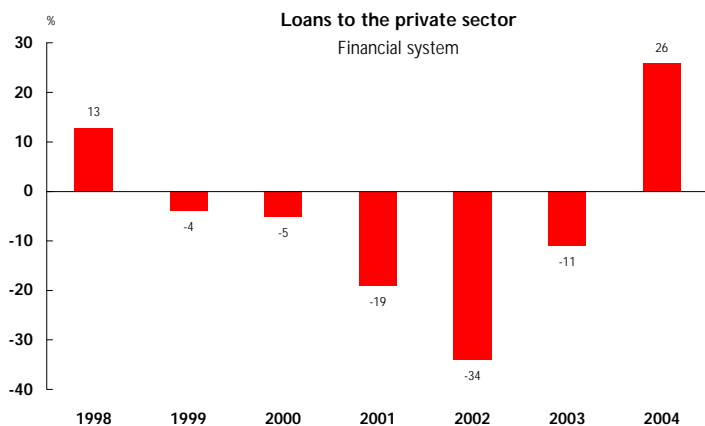
The return to normal conditions in the financial system accelerated in the second half of 2004, with further progress towards the conditions typical of improved levels of financial stability. This performance took place in a favorable macroeconomic environment, noted for both a substantial fiscal surplus as well as a healthy monetary policy. In this setting, the sustained growth in the level of intermediation (and the performance of private credit in particular), the improvement in the general balance of risks and progress in terms of solvency – both through higher profitability and the observed capitalization flow – have all helped to put the financial system in a position of greater strength. These developments are helping the sector to reposition itself favorably, as it recovers the possibility of contributing to sustained economic growth.

Throughout this period, there was a notable shift towards the financial system recovering its main function: taking in people's savings and granting credit for consumption and production. Bank deposits increased again in 2004 (26%), both through sight and time deposits, and market conditions registered a slight recovery (although still at relatively low levels) in borrowing rates in the second half. There was also an increase in the average maturity of term deposits. As anticipated in previous issues of the FSB, the year 2004 was marked by the return of credit to the private sector, under low and relatively stable lending rates. Private loans recovered an upward trend, growing by 26% (30% a. in the second half) after five years of almost uninterrupted decline – with falls of 11%, 34% and 19% during 2003, 2002 and 2001, respectively. In terms of diversification, the increase in commercial credit occurred in almost all branches of production.

The financial sector underwent an improvement in the general balance of risks inherent to the intermediation function, basically due to the consolidation of improvements in net exposure to liquidity and credit risks. With a sight to 2005, robustness to liquidity risk appears to be one of the most noticeable features of the system. Some signs of this are the growing confidence in banks, adequate levels of liquid assets (about 30% of non financial system deposits) and the deepening of interbank markets. The Central Bank's mandate to act as a lender of last resort, and the creation of a repo market for BCRA securities strengthen the sector's position against liquidity problems.

The drive provided by macroeconomic conditions and the process carried out by the Central Bank to adjust prudential regulations, as well as the prudent asset portfolio management policies of the financial institutions themselves, have noticeably improved the banking sector's position in terms of credit risk. In particular, the delinquency level of the financial system's private lending portfolio has declined to half the maximum value reached during the crisis, falling to almost 19% at the end of 2004. Likewise, given the relative performance of provision coverage the potential impact on financial system net worth from possible losses due to private sector non-repayment has

Chart 1
Loans to the private sector
Financial system



Source: BCRA



been drastically curtailed. A continuing strong performance by the different sectors of the economy, banks' ability to assess debtor repayment capacity and portfolio diversification (an increase in private sector and a decrease in public sector exposure) will be the key indicators when monitoring credit risk in 2005.

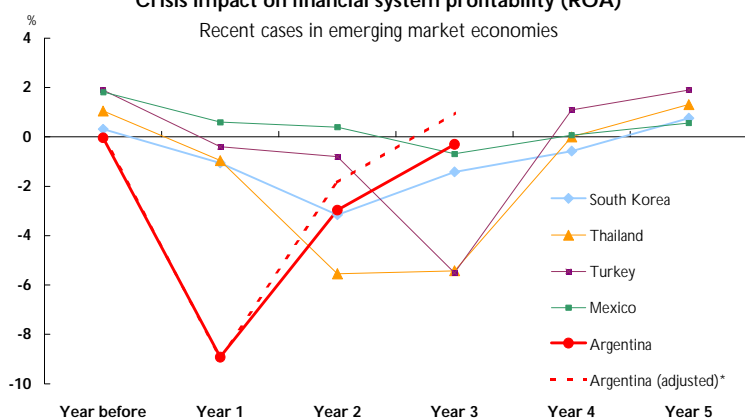
It is worth pointing out that although the financial system's exposure to the public sector is still at relatively high levels, it continued to decline over 2004, dropping by 5 p.p. of total assets, to 42% at the end of last December. In addition to the gradual decline in the level of exposure, there has been a decline in the level of credit risk involved in these types of assets. The latter is linked to the improvement in the outlook regarding the public sector's repayment capacity, given the levels of fiscal discipline observed, and to the improvement in the government's financial position achieved thanks to the favorable outcome of the sovereign debt swap, and the ensuing potential reopening of international debt markets.

Recovering activity in the financial sector produced a significant improvement in its economic performance, which occurred at a rate that surpassed those experienced in most recent banking crises. Only two years following the financial collapse, in 2004 the financial system managed to substantially reduce the levels of loss registered in 2002 and 2003. In particular, excluding the impact from the main adjustments related to acknowledging the past crisis (i.e. court ordered releases and adjustments to the valuation of public sector assets) the financial sector obtained profits equivalent to 0.7% of assets in 2004 (\$1.4 billion), approaching the standard values for emerging economies and those in place domestically before the onset of the crisis. The recovery in profitability has not been without significant volatility, which is expected to continue in the short run. The main factors helping to improve bank profitability include a recovering financial margin – following a substantial increase in interest income due to the higher level of loans to the private sector – the increase in net service income and streamlining of cost structures.

Amid the gradual recovery in profitability, the capitalizations that were carried out in the financial system during 2004 help to uphold the recovery in solvency levels. Positive expectations for financial intermediation in the domestic economy led both national and foreign-controlled institutions to carry out the capitalizations that the Central Bank required for banks to continue to operate domestically. During the second half of 2004, the capitalization flow amounted to \$2.3 billion, occurring mostly (85%) during the last quarter of the year.

To strengthen these results, the Central Bank remains focused on encouraging the correct recovery of financial intermediation. In first place, it asserts that carrying out a firm monetary policy in order to minimize the risk of inflation is an essential component in achieving this goal. At the microeconomic level, the Central Bank's prudential policy will stay focused on developing a simple and transparent regulatory framework, in tune with new macroeconomic conditions. While stressing the importance that banks implement adequate risk management policies, the Central Bank is putting into place a set of measures

Chart 2
Crisis impact on financial system profitability (ROA)
Recent cases in emerging market economies



* ROA adjusted by amortization of payments for court-ordered releases and the effects of Com."A" 3911 and 4084.

Source: BCRA from IFS data, OECD and Global Financial Stability Report (IMF).



to promote the classification of financial system debtors according to their future outlook rather than on the basis of current conditions, which in many cases were affected by the crisis in 2001-2002. Additionally, new procedures are being set up to encourage credit to micro, small and medium sized enterprises, stressing the regional development of lending. This will encourage financing for a sector that has historically been excluded from formal access to credit.

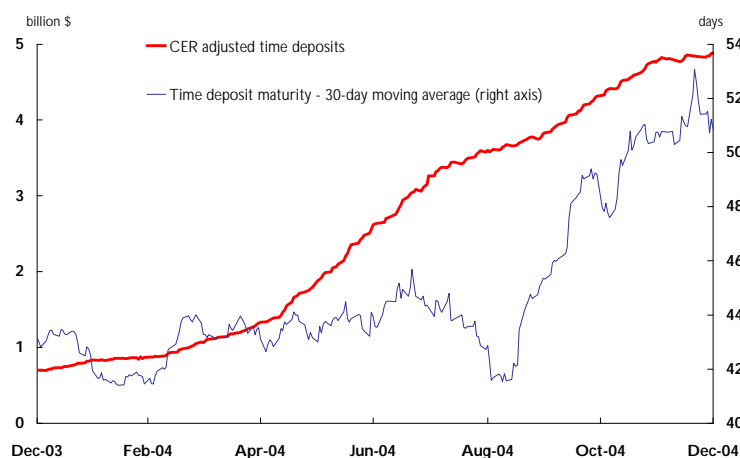
The Central Bank believes that, as short term financing consolidates, the recovery of medium and long term lending will be key to reinforcing the path of sustained economic growth with low inflation. Figures show that there is still much to be done: short-term credit lines increased by 45% in 2004, while those for longer term credit increased by only 12%. As a means of correcting this problem, the Central Bank is looking to enforce a set of measures aimed at achieving an appropriate funding structure. Although the maturity of time deposits has increased over time, mostly due to CER-adjusted deposits, almost 80% of total deposits mature in less than a one month. With this aim in sight, the Central Bank is analyzing, jointly with other institutions, means to improve funding instruments through the deepening of capital markets: authorizing floating-rate time deposits, secondary markets for time deposits, asset securitization and CER-adjusted corporate bonds, among others. In particular, the authorization of the latter would allow funding maturity to be extended, reduce CER mismatching and encourage the development of domestic capital markets. Daily market prices would generate a market assessment of the financial stability of each bank, thereby increasing market discipline.

With the aim of providing a solid foundation for the recovery in intermediation, the Central Bank upholds that there is a need for stimulating the complementary nature of the financial system and capital markets, seizing on the relative advantages of each; for instance, by benefiting from the experience and information that banks obtain from financing micro, small and medium sized enterprise, and from the ability to provide longer term funding that is a distinguishing feature of capital markets.

Although the overall state of the financial system appears to be improving, a series of factors still exist that could become potential sources of instability. In the face of possible changes to the likeliest short-term macroeconomic scenarios, this suggests that monitoring and supervision must be strong. In first place, the financial system remains exposed to foreign currency mismatching risk (an excess of US dollar assets over liabilities), despite partially reducing its sensitivity to exchange rate volatility in the second half of 2004. Given the experience in the 1990s and the absence of a lender of last resort in dollars, the Central Bank established that foreign currency loans must be linked to funds in the same currency and be allocated to entities with a proven ability of generating foreign currency income.

However, the financial system has yet to make substantial progress in reducing its exposure to risk arising from CER mismatches adjusted (due to an excess of CER-adjusted assets over liabilities). Despite short-term profits, this asymmetry

Chart 3
Time deposit maturity



Source: BCRA



carries with it a relatively substantial exposure to real interest rate risk. Strengthening the financial system against interest rate risk is an outstanding issue for 2005. The future behavior of CER-adjusted time deposits and the expected authorization of CER-adjusted corporate bonds will affect the banking sector's exposure to real interest rate risk over coming periods.

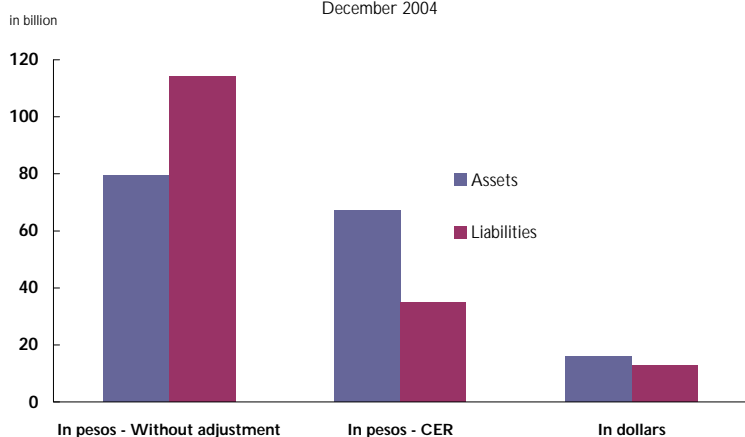
The Central Bank is proposing market solutions to dampen exposure to currency and interest rate mismatching risk. One example of this is the monetary authority's continued support for the creation of hedge markets. The rate of growth in the US dollar forward market accelerated during the second half of 2004. The markets for forward CER and interest rate swap contracts were launched towards the end of the year. These markets must still gain a substantial degree of depth before becoming valid tools for the financial system.

The Central Bank has recently taken the initiative on several matters. On one hand, it launched a procedure to allow financial institutions to make early installment payments from the so-called matching framework for settling rediscounts. Permission to make early amortization payments is directly linked to each bank's recent performance in the granting of loans to the private sector. In addition to improving the Central Bank's net worth, this procedure allows banks to improve their risk ratings, facilitating funding at a lower cost. This process should both encourage a greater supply of private credit as well as an improvement in profitability. In addition to this procedure for reducing debt with the Central Bank, there has been an increase in the voluntary early settlement of rediscounts. Ultimately, both developments are a sign of the gradual recovery in the financial system.

With the aim of reducing the cost of private credit, the Central Bank is taking a set of measures that are helping to reduce the operating expenses of the financial system. In first place, and with the consent of financial institutions, reporting requirements are being simplified. The objective is to effectively rationalize and appropriately channel information, reducing costs for banks and optimizing data management within the Central Bank. In second place, the Central Bank jointly agreed with financial institutions to put in place the so-called Uniform Federal Clearing. These improvements will optimize the National Payments System, facilitating commercial exchange throughout the country. This agreement will produce an improvement for bank customers, promoting an increase in bank use throughout every region as well as a decline in the operating costs due to financial intermediation.

The finalization of the foreign debt swap removes one of the main sources of uncertainty affecting economic decision making, which will favor activity in the financial system and broadly throughout the economy. This will lead to healthier balance sheets and will allow for a lengthening of investment horizons, encouraging the return of the supply and demand for credit for the medium and long run. Capital market development following the swap is expected to provide longer-term funding for the economy and encourage the demand for financial services.

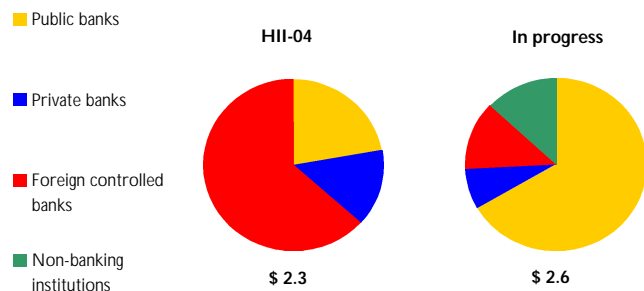
Chart 4
Currency mismatch
December 2004



Source: BCRA



Chart 5
Capital contributions
In billion pesos



Source: BCRA

Expected developments in the domestic and international macroeconomic environment in 2005, jointly with the Central Bank’s prudential and monetary policies, will tend to provide relatively favorable conditions to sustain the healthy development of the financial system. This appraisal involves an appropriate weighting for economic and financial variables to allow the current path of growth with low inflation to continue, as it is the only macroeconomic context that encourages the sustained growth in financial intermediation. Consistently with this outlook, the financial system expects capitalization to continue. Capitalization schemes for about \$2.6 billion are currently pending approval, as both national and foreign-controlled banks are showing an interest in developing their local businesses.

The Central Bank will keep to its task of assessing and monitoring stability conditions in the financial system, encouraging healthy credit aimed at production and consumption. Coordinating with financial institutions and the remaining productive sectors, the BCRA will set the appropriate market incentives to attain this objective. The foundation has already been put in place for the development of a financial system that concentrates on lending and providing payment services. The Central Bank commits itself to keep reinforcing this structure with the aim of encouraging the conditions for strengthening financial stability.

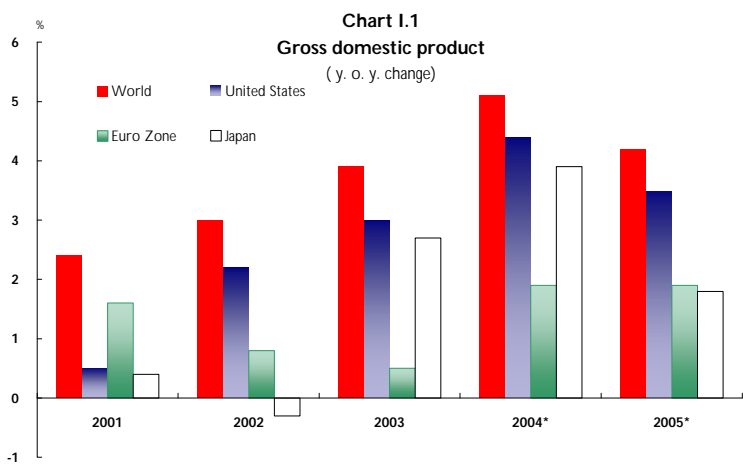
I. MACROECONOMIC CONTEXT

Summary

The international context helps to shape a propitious framework for the progress of global financial markets. Both the financial systems of developed countries and those of emerging economies ended 2004 with a good performance. With more solid macroeconomic policies as a base, persistent global expansion (with a positive outlook for 2005), high liquidity levels, favorable exchange terms and the gradual bias of US monetary policy contributed to increasing the robustness of the financial systems of emerging economies. There are, however, possible risk factors in 2005 which must be monitored carefully: an abrupt correction in exchange rates and interest rates impacting on the magnitude and/or direction of capital flows, and changes in commodity prices.

The local macroeconomic context continues to show strong consolidation, contributing to the healthy growth of the financial system. Firstly, the economy's significant expansion is driving the recovery of the Argentine financial system, permitting, in turn, that this sector begin to contribute to the attainment of a steady path of growth. Likewise, the increase in international trade, public sector behavior and the greater capital market depth helped to improve the solidness of the financial system. Lastly, a prudent monetary policy, bolstered by the confluence of contractive monetary roles for the public and financial system sectors, has been creating a propitious environment for financial development. For this year, and in view of foreseen scenarios which include the continuation of the contraction in the aforementioned sectors, the BCRA has adopted a change in the bias of its monetary policy, maximizing the efficacy of the available regulatory instruments.

It is hoped that in 2005, with a more moderate increase but one closer to a pattern of steady growth, the local economy will stay in line with what was seen in 2004. Consumption and investment will be the main engines driving economic expansion, while the banking system should consolidate the recovery of its essential role of satisfying a large part of local private sector financing needs.



* Forecast
Source: LatinFocus Consensus Forecast

I.1. International conditions

The global scenario continues to show a positive horizon for the activity of emerging countries' financial markets, providing a favorable context for the Argentine financial system. The elevated worldwide growth seen in 2004 and the optimistic outlook for 2005 (see Chart I.1), internationally low inflation, global high liquidity levels and favorable exchange terms comprise the main factors allowing one to project an international scenario especially propitious to the development of emerging economies. Notwithstanding this, although a gradual adjustment process in the US monetary policy is still expected, certain factors are beginning to take shape which increase the risk of inflation, raising the likelihood of scenarios with more accelerated interest rate adjustments.

At the global level, in 2004, financial intermediaries recorded an improvement in their profitability levels and consequently in their net worth situation, in part associated with transnational financial institutions' new risk diversification strategies. This positioned them soundly in the event of possible negative shocks. The financial systems of developed regions, in particular, registered improvement in their asset quality, hand in hand with lower corporate sector delinquency, resulting in greater benefits. The financial systems of emerging economies, meanwhile, began showing signs of consolidation, reflected in an increase in loans granted and in the increases in funding by deposits, profitability and capitalization levels (see Table I.1).

Table I.1
Emerging countries
Financial systems - Main indicators

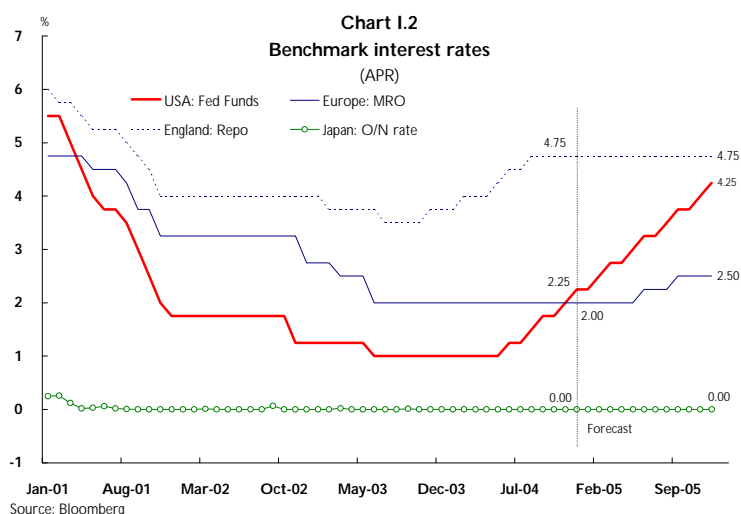
	ROA		Non-performing portfolio / Total financing		Equity / Asset	
	2000	2003	2000	2003	2000	2003
Asia	0.3	1.0	16	10.8	5.7	7.5
Latin America	0.9	1.4	9.2	7.8	10.3	10.2
Europe	0.9	1.4	11.1	6.0	9.5	9.8
Middle East	1.2	0.7	13.6	14.3	9.2	7.3

Source: Global Financial Stability Report, September 2004, FMI

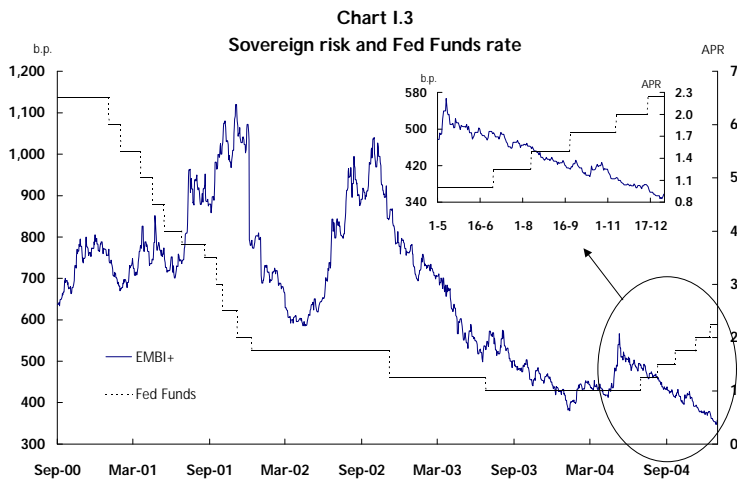
The local financial system, as with the rest of the emerging economies, is exposed to changes in the international flow of capital, strongly tied to US monetary policy. The US economy's great expansion and the acceleration seen in its interest rate, led the Federal Open Market Committee (FOMC) to gradually raise the Fed Funds rate. The most likely scenario expected for 2005 is the continuation of this process of measured increases (see Chart I.2). However, it is believed that, mainly as a result of its improved fundamentals, the region as a whole is better prepared than in the past to face up to a rising US interest rate scenario. This was reflected in the last period, one characterized by frequent Fed Funds level increases simultaneous with systematic emerging country risk reductions (see Chart I.3) and with the successful placement of new debt and the advancing of Brazil's financing for 2005.

The strong depreciation of the US dollar in 2004 against the main currencies leads to questions as to the possibility of an abrupt correction in exchange rates and in interest rates. The evolution of the current account and fiscal deficits, which remained high and could continue to be so this year, upholds this idea. Currently, this represents a threat for the global financial system. The effect at the local level, from the financial point of view, would depend on the change in capital flows.

The growth in bank financing in favor of export projects caused the link between the local financial system and the performance of the export sector to be increasingly closer. In this sense, to the changing value of the dollar one must add the relevance of the behavior of main export product prices. The first half of 2004 witnessed a sharp decline in the price of raw materials



Source: Bloomberg



Source: Bloomberg

(see Chart I.4). These decreases were concentrated in agricultural prices, in particular the soya complex, while the price of primary products continue to show, at least in the short run, a positive trend. In any event, given the historically high levels that the prices of primary products continue to show, a significant increase in the agricultural and livestock sector is not foreseen.

The local export sector, above all the industrial one, was also

strong. The Brazilian economy (our main trading partner): high economic expansion, controlled inflation, appreciation of the Brazilian real, and low sovereign risk levels. In Argentina, however, efforts continue in order to diversify

export markets (such as the recent agreements signed with China). This element will help to strengthen the situation of primary product exporters as well as to permit the entry of new players into the foreign trade arena, thus diminishing exposure to the main

risks of the financial system. Nonetheless, there are still certain elements

of concern in the international financial situation are: a faster than expected increase in the principal international interest rates and the possibility of an abrupt correction in exchange rates as a consequence of global imbalances, in particular of the US

I.2. Domestic conditions

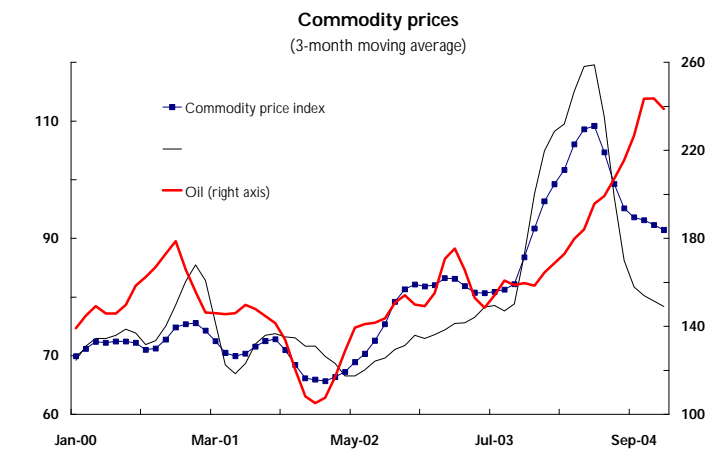
The good macroeconomic performance seen is to the benefit of the reconstruction of the financial system. The increase in financial intermediation activity, in turn, strengthens the positive nature of the economic cycle.

Economic growth in 2004 hit 9%, leaving a carryover effect of the expansion occurred in the last year and a half, not only did consumption and

investment increase in 2004, but net exports also served to drive economic expansion (see Chart I.6).

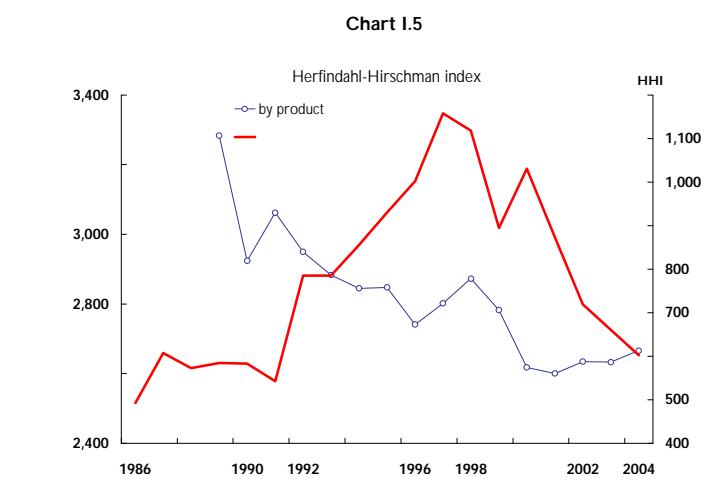
This greater participation in international trade, in addition to showing an improvement in the economic situation of both individuals and companies, opens the door to an excellent market for financial services for international trade. In 2004, basically due to the increase in net exports, which more than offset the rise in exports, the Trade Balance surplus declined. This external sector performance allowed the BCRA to maintain its reserves with levels of around US\$20 billion recorded at the end of

the year. The force of the public sector, leading the Government to reduce its surplus levels (see Chart I.7). Sound fiscal performance sets the



Source: BCRA from World Bank data

force of the public sector, leading the Government to reduce its surplus levels (see Chart I.7). Sound fiscal performance sets the



Source: CEI



within a context of low inflation and growing financial intermediation.

Along these lines, the high growth levels driven by consumption and by investment as well as by foreign trade led monetary policy to continue to be aimed at monetization of the economy in accordance with the activity level increase, thus assuring a path for price levels in line with the band foreseen in the 2004 Monetary Program. In accordance with the change foreseen in price levels and within the framework of the 2005 Monetary Program, the BCRA decided at the beginning of this year to change the bias of its monetary policy by reducing the monetary stimulus, whereby the Bank will maximize the efficacy of monetary regulation instruments.

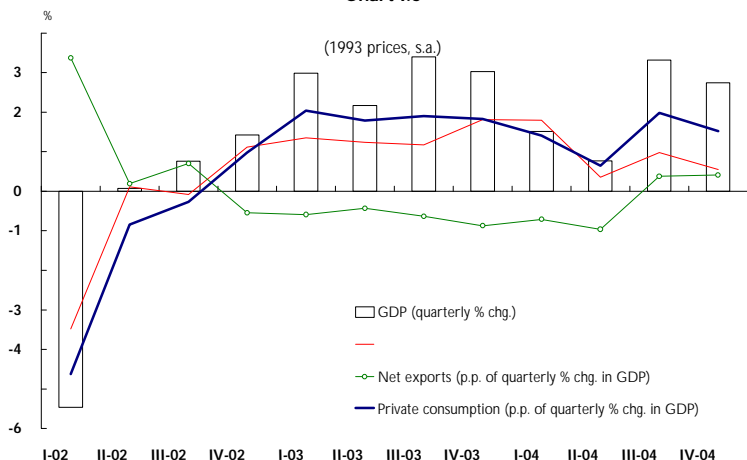
In the second half of 2004, the favorable economic outlook and a series of positive developments (although not free of noise) surrounding the sovereign debt exchange process drove activity in the local capital market forward. This meant that, at the local level, the good performance seen in emerging economies during the period could be accompanied by risk premiums in frank decline.

Local fixed income markets saw greater activity in terms of volumes traded (above all in the last quarter) and a steady increase in prices, with a consequent cut in yields obtained (see Chart I.8). There was also a continuous drop in the margin between the yields of domestic sovereign bonds and comparable US Treasury securities. The evolution of the domestic fixed income market was in large part explained by a growing demand, both from local institutional investors (banks and pension fund managers, or AFJPs) and from abroad. In addition, the securities eligible for the debt exchange saw their ratings upgraded.

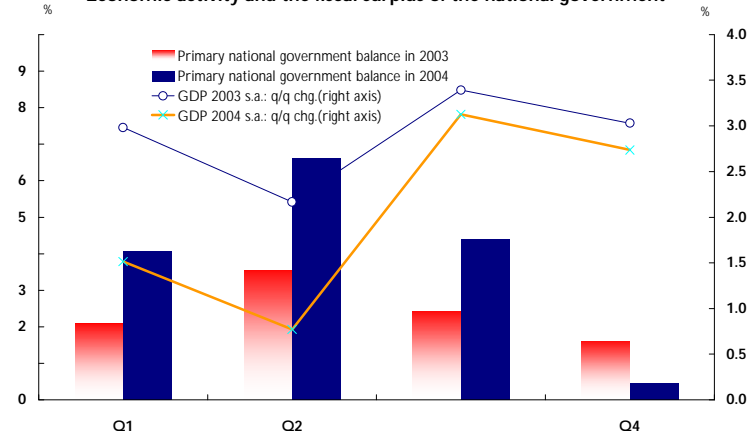
Issues in the primary LEBAC market continued to show considerable activity, in particular in the CER-indexed segment, whose outstanding stock increased 26% during the semester. A gradual decrease in the accepted cut-off rates was seen in the various issues: the interest rate accepted for a non-adjustable bill in pesos with a maturity of nearly 340 days was 5.9% at the end of 2004, with a fall of 30 basis points (b.p.) with respect to auctions 6 months ago, and 260 b.p. below their level in December 2003. The declining trend in yields was also seen in the secondary market for BCRA securities, although less markedly (see Chart I.9). For their part, amounts traded in this market showed certain advances, although they remained below level recorded at the end of 2003.

With respect to the corporate debt market, new advances were seen in the area of debt restructuring, with the closing of important transactions that resulted in new corporate debt issues. Although there is still a differentiation between the companies that had to restructure their bonds and those that were able to continue paying the services on their debt in a timely fashion, the prices transacted on secondary markets also revealed a continuous decline in corporate debt yields. Likewise, the return of some issuers to the primary market (with issues of ONs – corporate bonds – not linked with restructuring processes) was observed. Also seen were certain debt

Chart I.6



Economic activity and the fiscal surplus of the national government

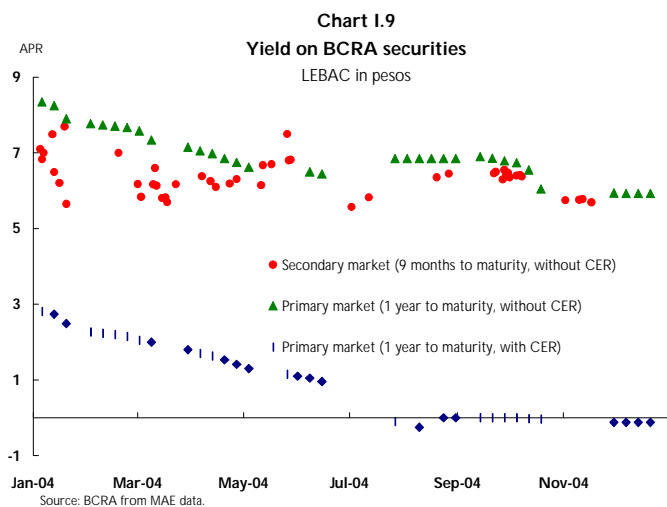


Source: BCRA from Treasury Secretariat and INDEC data

Chart I.8
Yield on most liquid government bonds
Yield to maturity in % - Performing bonds

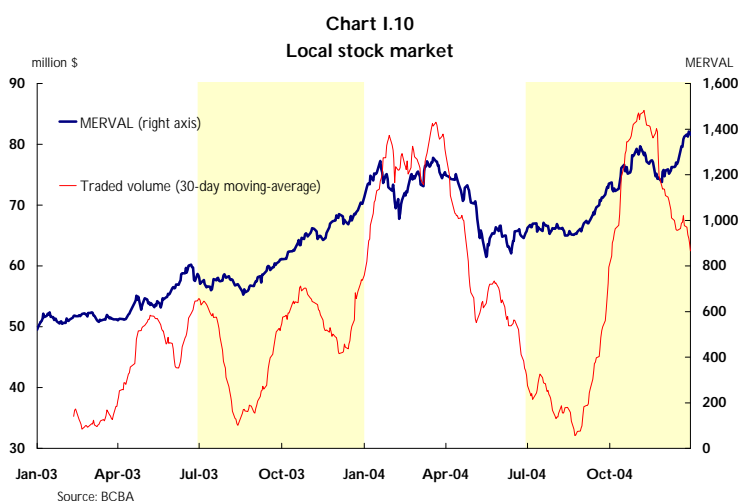


Source: BCRA from BCBA data



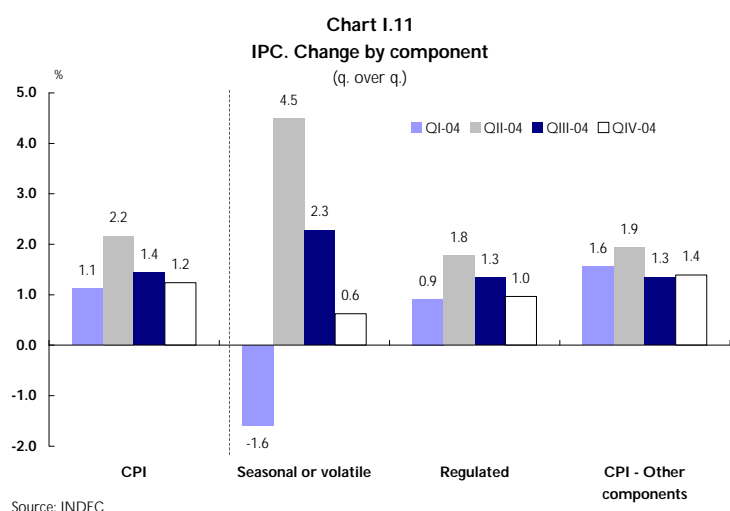
repurchasing transactions. Lastly, within the framework of a gradual recovery in capital market activity, issues linked with securitization transactions involving assets such as mortgages and consumer loans stand out.

Improvements in the corporate environment arising from the favorable macroeconomic performance (confirmed by the balances presented by companies), and the end of the sovereign debt swap exchange had a repercussion on prices agreed in variable income markets, although a considerable level of volatility persisted (see Chart I.10). Particularly noteworthy was the behavior of banking sector shares, with semiannual increases of nearly 50% in their prices. Amounts traded showed no significant changes in relation to the first semester of 2004, although an increase was observed in relation to the same period one year earlier.



As a result of the interaction between economic activity and the revised monetary policy, inflation in 2004 totaled 6.1% (see Chart I.11), nearly 1 percentage point (p.p.) below the lower end of the established inflation target (7%-11%). The reduced dynamism of prices in the second half was mainly in response to the almost total lack of regulated price adjustments and to the lower increases recorded by the most volatile prices. Low inflation levels will help in the advancement of credit and the expansion of financial intermediation in 2005.

It is therefore hoped that in 2005 the economy will continue to grow, although at rates lower than those recorded in the second half of 2004, bearing in mind that part of the fiscal drive recorded at that time had been of a temporary nature. Consumption and investment will continue to provide the main push behind growth within the framework of a new recovery in the participation of salaries in the income and the renewed drive in public and private investment. In this regard, the sharp increase in the public works budget and the granting of tax benefits as per the *Ley de Promoción de Inversiones* (the Investment Promotion Law) constitute a fundamental factor, a process in which the financial system should take on a relevant role in the satisfaction of resulting credit needs.



II. FINANCIAL SYSTEM DEBTORS

Summary

The local financial system continues to strengthen thanks to the positive development seen in all sectors of the economy. The expansion of production and of private consumption, together with a sound fiscal performance contribute notably to the normalization and growth of financial activity. In this sense, the credit risk reduction characteristic of each area of activity and the possibility of financing future private sector expansion are the main direct effects of the economic sectors' progress on the soundness of the financial system.

Bank exposure to the public sector fell by 5 p.p. of assets in 2004, ending the year at 42% of assets. The development of public finances, with record revenue levels and firmer fiscal discipline, along with the positive outlook on the payment of all interest maturities in 2005, favorably position the public sector as a debtor in the short term. This last point is reinforced by the success of the sovereign debt exchange which, while lowering the public debt balance, also significantly improves its payment conditions in terms of interest rate, maturity and currency.

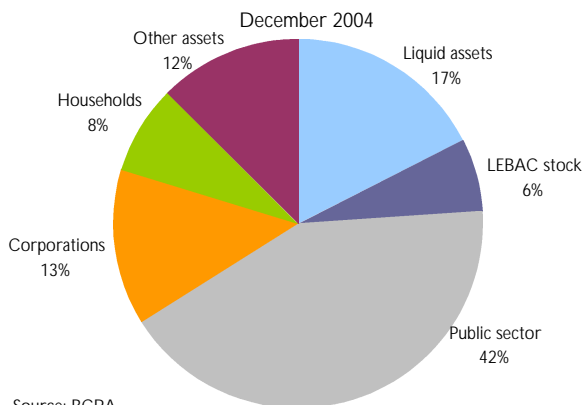
The year 2004 saw the appearance of credit for production. Although still at low levels, credit to companies totaled 13% of financial system assets. Mainly as a result of their good outlook for development and the improvement in their financial profile, companies in all areas of production managed to increase their payment capacity, substantially improving their risk profile. Companies continue to see steady improvement in their financial position: the net repayments and the restructuring of their entire debt (bank and non-bank), an increase in production and the change in the peso-dollar exchange rate help to explain all this.

Favorable prospects for an improvement in employment levels and wages in the short and medium term, and the low level of indebtedness by individuals mean that families represent a relatively low associated counterpart risk. Their improved financial position together with banks' low exposure to individuals (8% of assets) constitute the basis for an important growth potential in assistance to this type of debtor.



Chart II.1

Financial system asset portfolio



Source: BCRA

II.1. Financial system asset portfolio

Just as with all areas of economic activity, financial intermediation is closely linked to local and international macroeconomic performance. In addition, however, financial system strength is directly exposed to changes in the future repayment capacity of the main economic sectors.

As a consequence of the 2001-2002 crisis and arising from the very actions of the financial institutions, the financial system’s principal debtor is by far the public sector (see Chart II.1). Nonetheless, after slumping for 5 years, there was a return of credit to the private sector beginning in early 2003 and gaining momentum toward the end of 2004. The still low levels of exposure to this sector leave much room for its expansion, while currently representing a limited risk.

II.2. Public sector

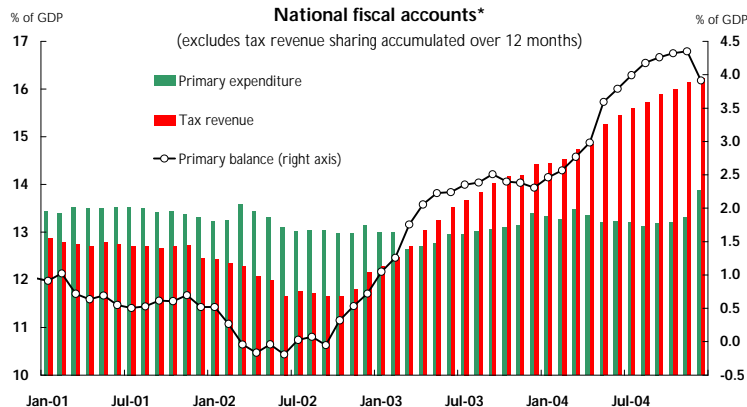
II.2.1. Fiscal conditions

Despite the fact that the inflow of funds from the International Financial Institutions (IFI) continued to be limited, during the second half of 2004 and within a context of good fiscal performance, the Government had no difficulties in meeting all its commitments on performing debt. This was achieved by requiring the assistance of the Central Bank solely in the form of temporary advances, in accordance with the terms of the monetary authority’s Charter.

The National Government’s finances for the second half of 2004 continued on a positive trend (see Chart II.2). This was mainly attained thanks to rising tax revenues, which hit a record high 22.1% of GDP in 2004 (see Chart II.3). The provinces also saw improvements in their accounts. Thus, the consolidated primary surplus (Nation and provinces) was nearly 6% of GDP in 2004, far higher than that foreseen in the agreement with the International Monetary Fund (IMF) and in the 2004 National Budget.

Chart II.2

National fiscal accounts*



*Non-financial National Public Sector
 Note: Primary balance= NFNPS total revenue - Primary expenditure
 Source: BCRA from Treasury Secretariat data

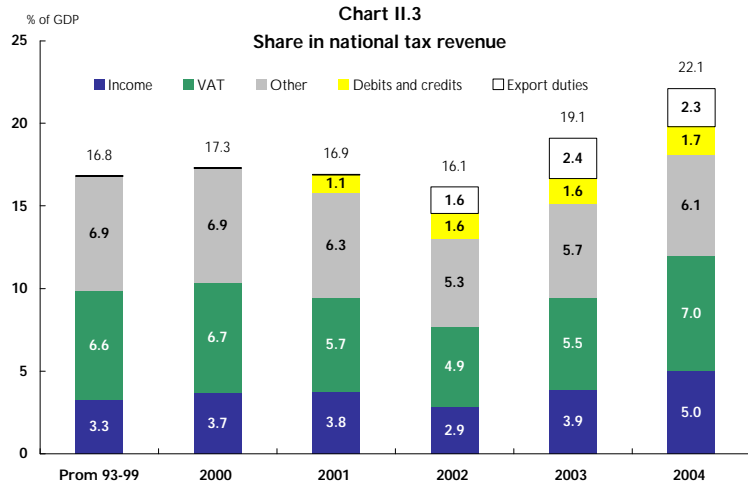
Following the passing of the 2005 National Budget, this discipline in national and provincial accounts is expected to continue. The lower tax pressure anticipated for this year and a new spending increase will explain the lower primary result in 2005 in terms of GDP (around 3.6% at national level, slightly higher than estimated in the Budget). Nonetheless, these resources will allow for the financing of all interest on the pre-exchange performing debt, to which the financial sector records a greater exposure, and will enable the meeting of the post-exchange payments that will be required.

II.2.2. Public debt

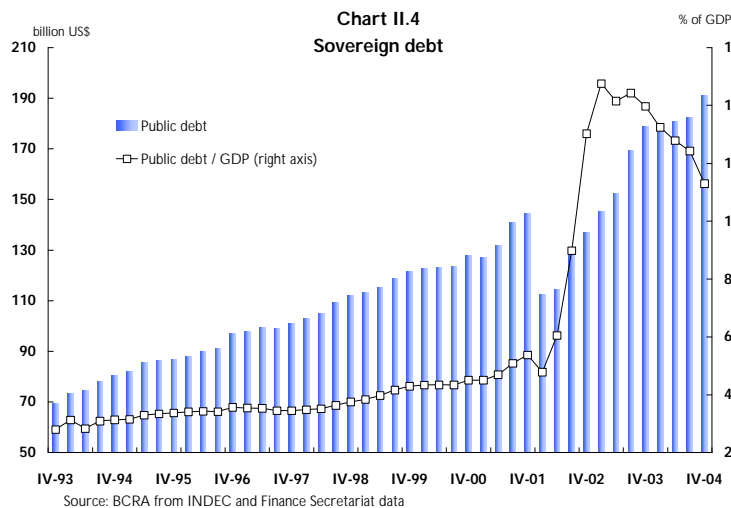
The National Public Debt stock totaled US\$182.5 billion at the end of the third quarter of 2004. Within the context of the important growth observed in the economy, the public debt decreased to 124.4% of GDP, after having reached a maximum level of 152.5% in the fourth quarter of 2002 (see Chart II.4).

Chart II.3

Share in national tax revenue



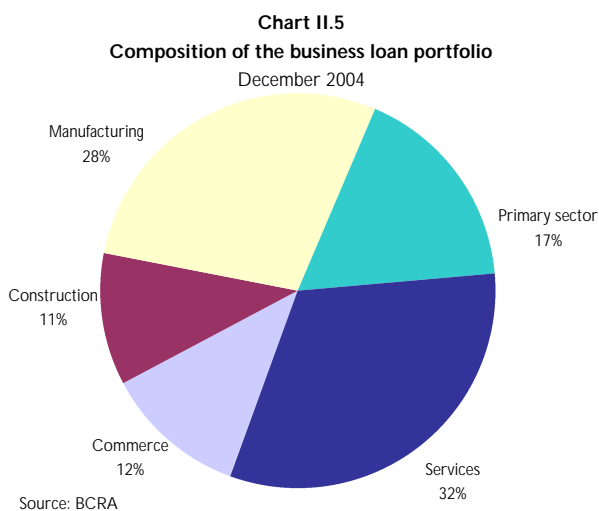
Source: BCRA from Treasury Secretariat data



Significant changes in the characteristics of public liabilities are expected following the end of the debt exchange process. In accordance with the scheme foreseen officially, the Government expects a conclusion to this process in April 2005.

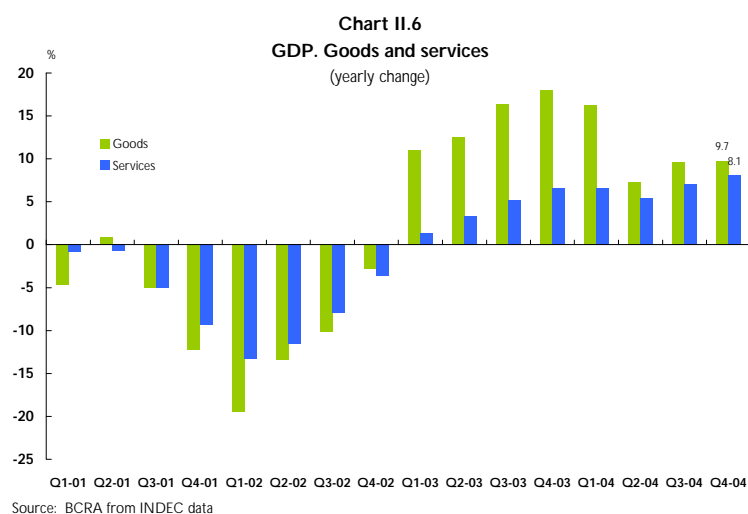
The debt stock post-restructuring will account for about 72% of GDP¹. Even though this level remains high both in historical terms and in an international comparison, the characteristics of indebtedness as regards the maturities profile and interest rate make this level a sustainable one. The average interest rate on the current debt total is expected to decline to 3%, with a greater portion of the debt denominated in pesos. In addition, the profile of capital and interest maturities will be substantially improved, as the exchange proposal diminishes short- and medium-term financial requirements, in particular those for principal maturities, since the new securities to be issued include a considerable grace period.

The successful conclusion of the debt restructuring process eliminates the main uncertainty factor regarding the development of the local economy. During the first half of 2005, however, net financing from the IFIs will represent the greatest uncertainty factor from the medium-term fiscal perspective.



II.3. Corporations

Although a rise in medium- and long-term credit for production is still pending, financing for working capital is growing more strongly than the economic expansion itself. This element demonstrates the relevance of evaluating the situation of the financial system’s main production sector debtors. In this regard, the performance of both industry and the service sector is key to estimating the future of the financial system (see Chart II.5). Although with a lesser exposure to the primary production sector, trade and construction, the soundness of the banking system also depends on the future payment capacity of companies in these areas of production.



Viewing the corporate sector overall, it can be seen that the recovery in the rate of growth by the economy in the second half of 2004 has extended to practically all sectors (see Chart II.6). In the second part of the year, however, the main driving force came from service-related activities.

Although during the second half of 2004 greater growth by industry and construction was observed, following the stagnation recorded in the second quarter, both these sectors maintained growth rates noticeably lower than those witnessed since the second half of 2002 and more in line with a path of steady growth. The agriculture and livestock sector, for its part, saw itself immersed in the midst of a harvest that will be only fair, the result of bad weather and signs that prices were falling from their very high levels.

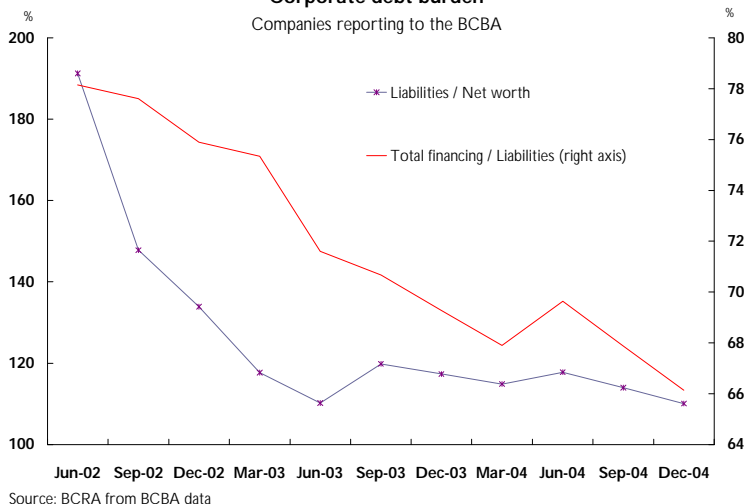
On the aggregate level, the economy still has unused capacity in terms of labor and capital. Some sectors, however, present

¹ Around US\$ 125.3 billion.



Chart II.7

Corporate debt burden
Companies reporting to the BCBA

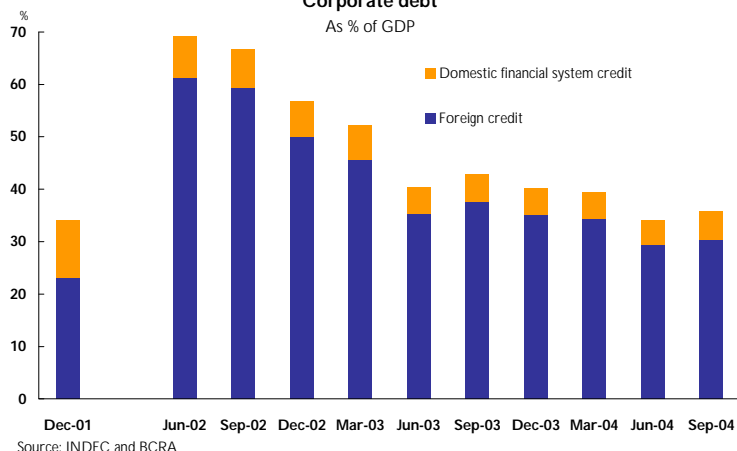


Source: BCRA from BCBA data

certain rigidity in supplying the increase in demand, putting more pressure on the external sector; it is evident that, due to the rate of growth over the last few months, the output gap has continued to narrow. Thus, even with the projected increase in the capital stock, GDP at the end of 2005 should approach its potential level. In this context, credit activity and the resolution of some factors influencing company investment decisions will be fundamental to the expansion of the potential GDP.

With respect to companies' sources of financing, 2004 saw a decreased utilization of companies' own capital in favor of a greater use of formal financing mechanisms in comparison to the previous two years (see Chart II.7). It is hoped that in the short and medium term the local financial system will be able to supply this potential demand for financing, especially through the support for investment projects by micro, small and mid-size enterprises (MIPyME).

Chart II.8
Corporate debt
As % of GDP



Source: INDEC and BCRA

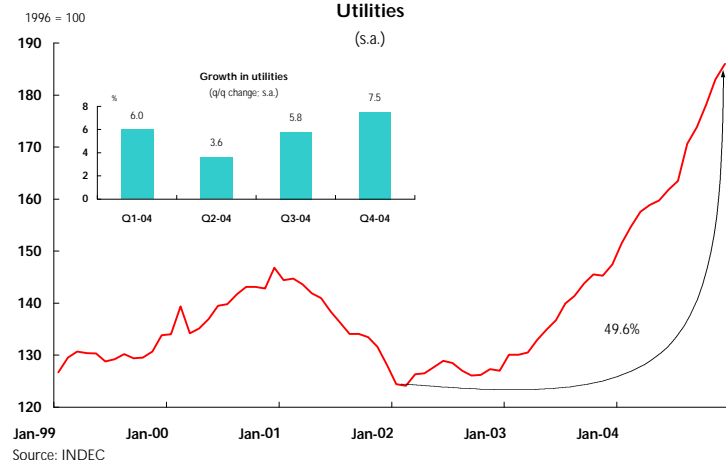
The local financial system is one of the main financing sources for companies that produce on Argentine soil. However, as a result of the high foreign indebtedness accumulated in the 1990s, companies' foreign debt multiplied at the beginning of 2002 (an effect which is thought to be driven by large enterprises), increasing the concentration of foreign liabilities with respect to those of the local financial system (see Chart II.8). Afterwards, the corporate sector gradually reduced by one-half its exposure to the foreign sector during the post-crisis period. Net repayments (with a growing proportion made using companies' own funds), the extraordinary growth seen in production, significant progress in foreign debt restructuring and the appreciation of the Argentine peso explain a large part of this improvement. The sector has thus chiefted levels of indebtedness compatible with its production, thereby gradually strengthening its future payment capacity.

II.3.1. Services

In the second half of 2004, service-related sectors saw an important increase. In addition to the rise that public services have been witnessing since early 2003 (see Chart II.9), there was a considerable expansion in the rest of the private services in the second half of the year. Data from the Public Services Activity Index (*Indicador Sintético de Servicios Públicos*, or ISSP) for the fourth quarter show an increase of 7.5% seasonally adjusted (s.a.), the highest since 1997.

Chart II.9

Utilities
(s.a.)



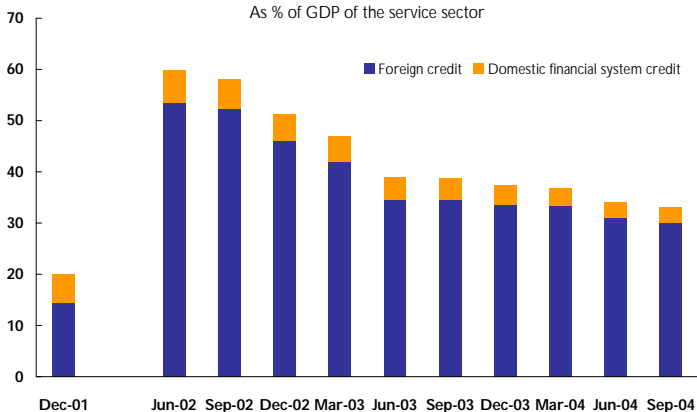
Source: INDEC

Strong investment flows are projected as of this year in public services, hand in hand with the carrying out of important infrastructure projects funded by both public and private capital. Contracts were signed in the energy sector between the Government and private companies for the extension of the Northern and Southern Gas Pipelines and the construction of thermal power plants.

In 2005, it is expected that the concentration of service company foreign indebtedness to the foreign sector will continue to decline. The local banking system (public, and, to a lesser degree, private) will play an important role in the new investment process, with the loans to be granted for the

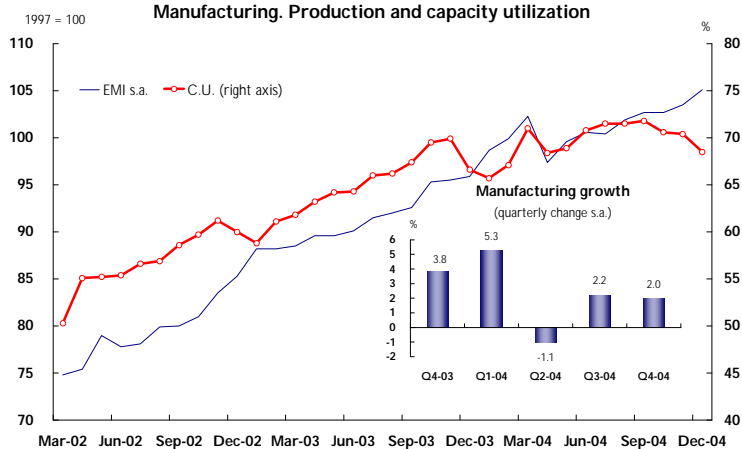


Chart II.10
Service sector debt
As % of GDP of the service sector



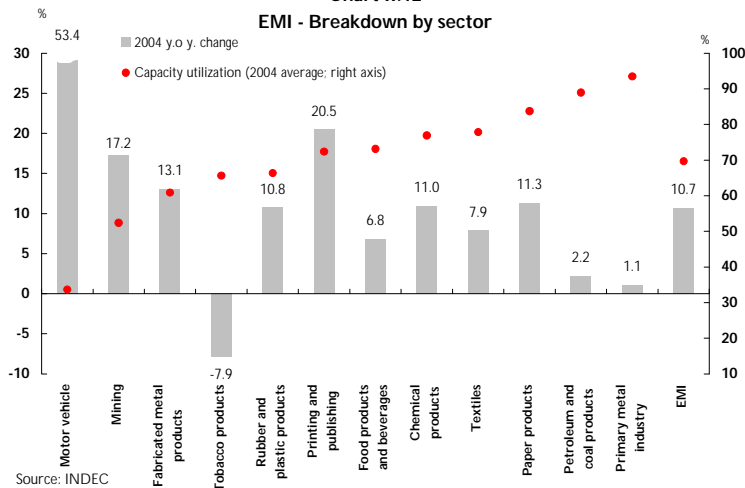
Source: INDEC and BCRA

Chart II.11
Manufacturing. Production and capacity utilization



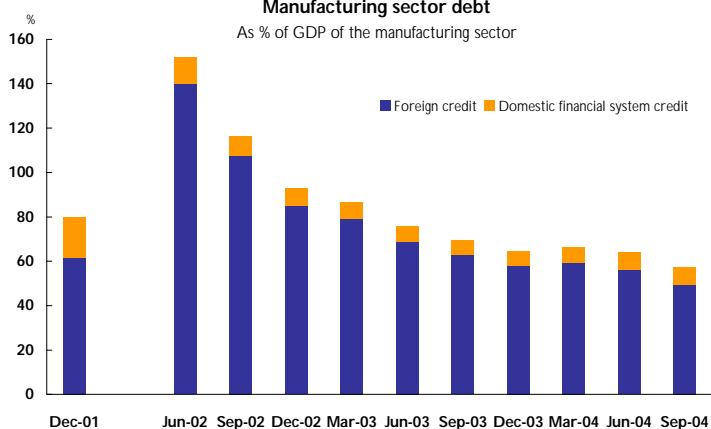
Source: INDEC

Chart II.12
EMI - Breakdown by sector



Source: INDEC

Chart II.13
Manufacturing sector debt
As % of GDP of the manufacturing sector



Source: INDEC and BCRA

construction of the mentioned gas pipelines standing out as particularly significant.

The strong increase exhibited by demand for public services is expected to continue during 2005 on a par with economic growth. In this context, the capacity of supply to meet the growing demand will basically depend on effective launching of investment plans in the sector, with the financial system playing the key role as the provider of funds.

II.3.2. Manufacturing

Industrial activity continued on the upswing during the second half of last year, fully making up for the fall evidenced in the April-June period (see Chart II.11). In general, with the exception of tobacco growers, the remaining sectors showed positive results throughout 2004.

The growth in industrial activity was driven by automobile manufacturers, the plastics industry and by the producers of non-metallic minerals. A determining factor in the development of these industries was the impulse from external demand, reflected by a sharp increase in exports of Manufactures of Industrial Origin, added to the considerable activity seen in recent years by Manufactures of Agricultural Origin. At the end of 2004, exports of manufactured goods already accounted for nearly 64% of the total. This trend is expected to continue during 2005, favored by demand from Brazil and other countries in the region.

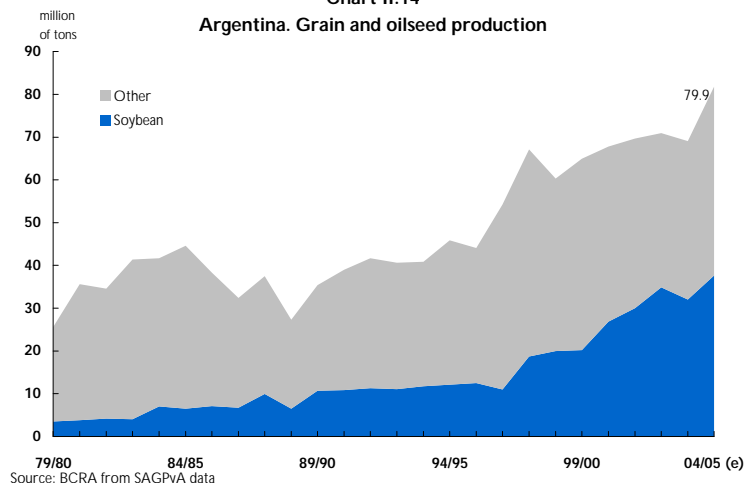
Industrial installed capacity utilization is reaching record levels, although at the aggregate level there is unused capacity (see Chart II.12). Some sectors are already showing signs of reaching the limits of their production potential, resulting in relatively low growth throughout 2004. In this scenario, new investments were announced in various sectors, leading to an increase in their production levels simultaneously with substantially lower increases (or decreases, depending on the sector) in installed capacity utilization.

All the same, industry continues on its path toward record levels of production, which are likely to be broken during the first half of 2005. In a context of growing internal demand and the development of new markets, companies have begun to plan on the basis of a medium-term horizon. Although during the post-crisis period investment projects in large companies were in large part financed by the companies themselves so they could be carried out, it is expected that credit from the banking sector will play a greater role in this regard. In the segment of micro, small and medium-size enterprises (MIPyME), the most active since the crisis, banking credit is an essential input if the demand for investment and plant modernization is to be met. The financing of industry with its own capital should begin to give way to bank financing.

In the post-crisis period, industry has been showing improvement in its financial position as it reaped the gains from growth in industrial activity, the debt restructuring processes with creditors abroad and the favorable evolution of the peso-dollar exchange rate (see Chart II.13). The recovery of its financial profile and the optimistic outlook for the development



Chart II.14
Argentina. Grain and oilseed production

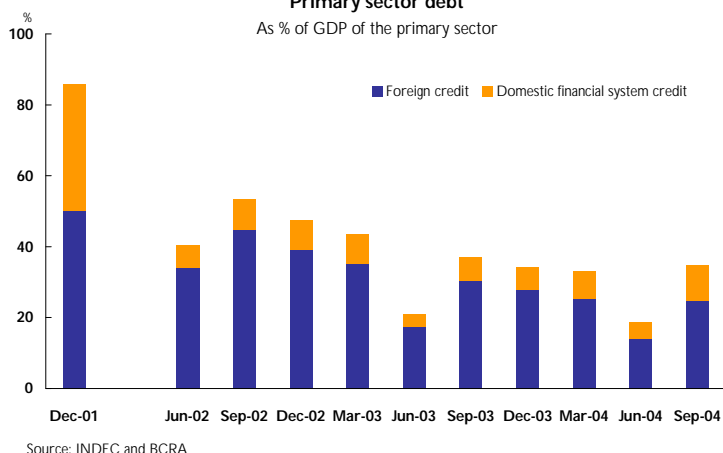


of the sector indicate that in the medium term the conditions will be favorable for the payment capacity of industry.

II.3.3. Primary sector

In light of the initial results of the small grain harvest and the total surface area sown, an important increase in the 2004/05 season's harvest is foreseen (see Chart II.14). In any event, profitability in the agricultural sector will fall this year compared with the exceptional levels seen in the previous three years due to the drop in international commodity prices. Despite the lower expected prices, however, the sector's profitability should still be above the average seen between 1990 and 2000, even with the inclusion of export duties.

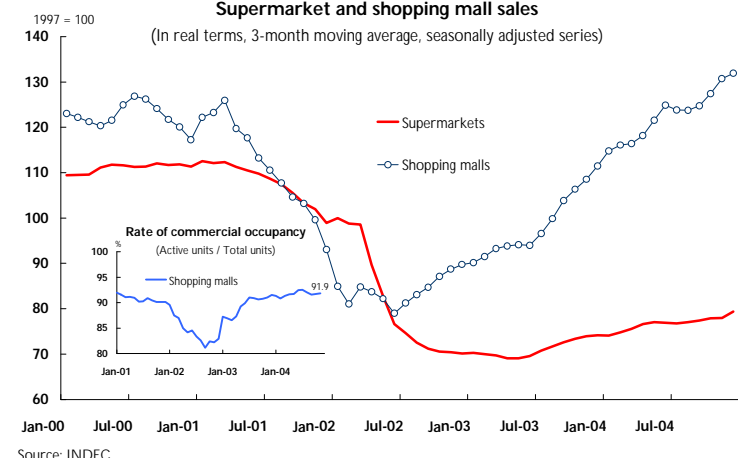
Chart II.15
Primary sector debt
As % of GDP of the primary sector



Dairy and livestock production, in terms of cattle slaughter and milk production, continued with its strong showing in the second half of 2004. The reopening of foreign markets and the recovery of internal demand for meat allowed the sector to close out 2004 with the highest slaughter levels for the last 15 years. The dairy sector likewise managed to recoup production levels and reach volumes in the vicinity of 1999's high, thanks to the sharp increase in foreign demand that led producers to utilize nearly the whole of their installed capacity. Within this context, some dairy production firms began projecting investments.

Prospects for 2005 in the agriculture and livestock sector are generally favorable. The strengthening of foreign demand, with the recent reopening of some markets, together with the growth in domestic demand, the improved sanitary rating and the path of international prices will be key to the development of the sector. In addition, recent agreements signed with China, the main destination for vegetable oil production and a potential purchaser of meat products, reinforce the favorable expectations for 2005.

Chart II.16
Supermarket and shopping mall sales
(In real terms, 3-month moving average, seasonally adjusted series)

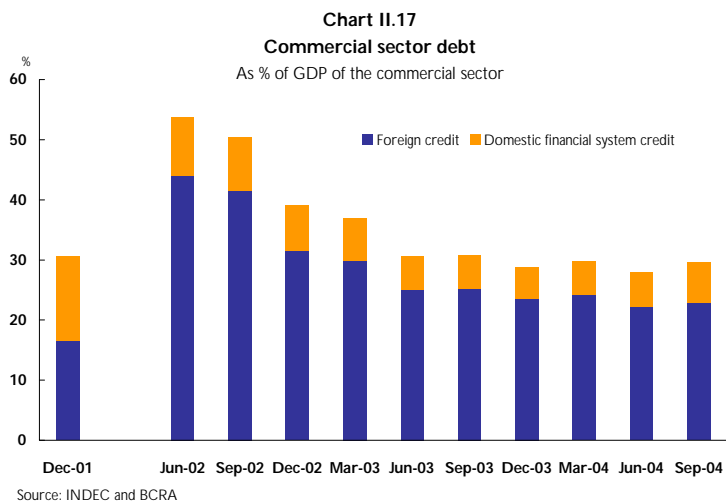


Added to these positive expectations in terms of production levels and profitability are the systematic improvement in the sector's financial profile. Always bearing in mind the high seasonality proper to the activity, primary sector enterprises, especially oil companies, greatly reduced their exposure to the dollar in the post-crisis period (see Chart II.15). Currently, a strengthening in the primary sector's capacity to meet its short- and medium-term obligations can be observed.

II.3.4. Commerce

During the second half of 2004, retail sales continued on the upward path in seasonally-adjusted terms with respect to the first half of the year. In addition to benefiting from the rise in employment and consumer loans, sales received an additional boost in the fourth quarter from the fiscal measures (some of an extraordinary nature) adopted by the Government. In addition, the resurgence of consumer financing with credit cards contributed to driving consumption in the last quarter of 2004.

Supermarket sales rose at a real rate of 2.9% in the second half, continuing with the good performance evidenced in the first half of the year (see Chart II.16), leading companies to further



increase the number of sales points, a policy which will continue during 2005. For their part, shopping center sales also increased in real terms, although at a slower rate than during the first half.

Companies in the commercial sector record a relatively low level of indebtedness, tending more to finance themselves with their own funds (see Chart II.17). Even though, like other companies with foreign debt, their financial profile was also affected by the end of the currency board system, the increase in production since then is slowly making up for this deterioration.

II.3.5. Construction

Unlike with the case of industrial activity, the recovery of the construction sector required an additional quarter (see Chart II.18). Following the stagnation seen during the second and third quarters of 2004, construction got back on to the path of growth in the fourth quarter. Despite the deceleration experienced, housing construction continued to comprise the main factor behind the sector's growth. Home-building, which is already at levels similar to those recorded in 1998, is expected to continue growing at moderate rates, driven by increased public and private investment and the resurgence of mortgage lines.

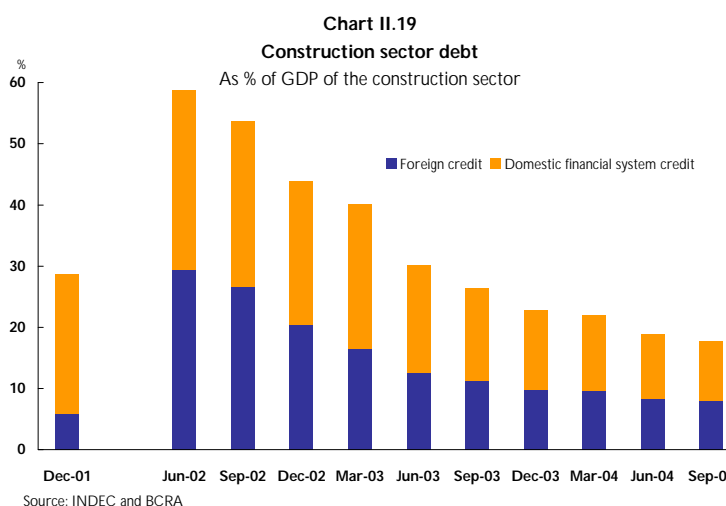
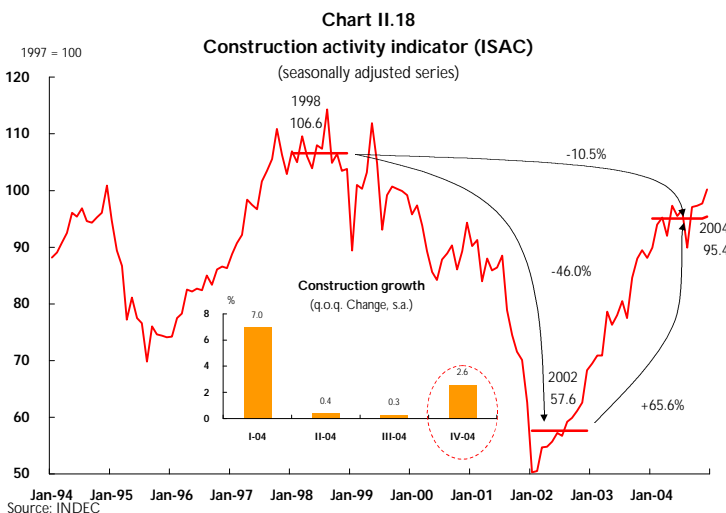
Commercial and industrial construction also witnessed positive changes in the fourth quarter of 2004 in line with the growth in economic activity. For 2005, announcements of supermarket and shopping center construction projects have been made, as well as for some industrial plant projects. Likewise, given the fact that the real estate market for offices has recovered during 2004, a recovery in the construction of this type of property is foreseeable.

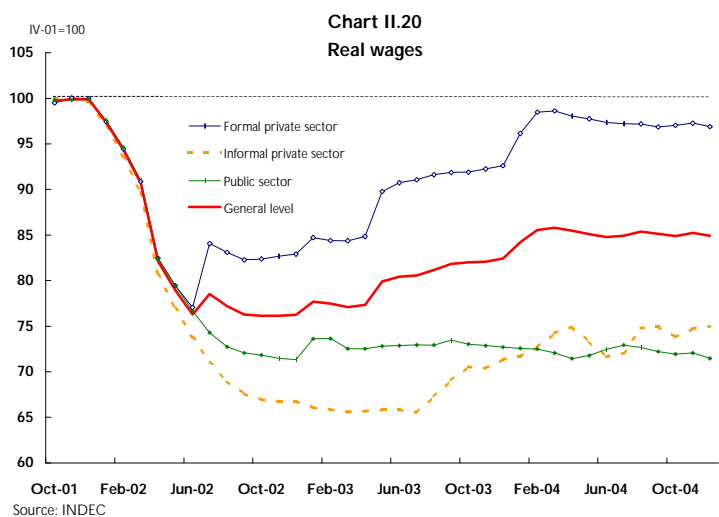
In addition, the Government increased the carrying out of public work projects during the last quarter of 2004. A sharp increase in such projects is projected for 2005, in accordance with the 2005 National Budget. Leading projects to be carried out include the National Housing Plan and projects to increase natural gas transport capacity. On the basis of these projects and the still high profitability arising from the construction of homes, it is expected that construction activity will continue in 2005 along a favorable path, although with growth rates below those observed in the post-crisis period.

Construction, in particular that of residential dwellings, has a long tradition of self-financing (see Chart II.19). Relatively low indebtedness both in terms of the local financial system and with foreign creditors is an indicator of the solid financial position and the broad growth potential of credit to companies in the area of construction.

II.4. Households

In 2004, salary increases (see Chart II.20), the rise in employment levels and the improvement in the financial profile





of households shows a strengthening in this sector's payment capacity in the short and medium term.

In the second half of 2004, private consumption began to grow once again, following the considerable deceleration seen during the second quarter. There was a 2.9% s.a. expansion in the third quarter, with the fourth quarter also having shown a significant increase, as demonstrated by most early indicators.

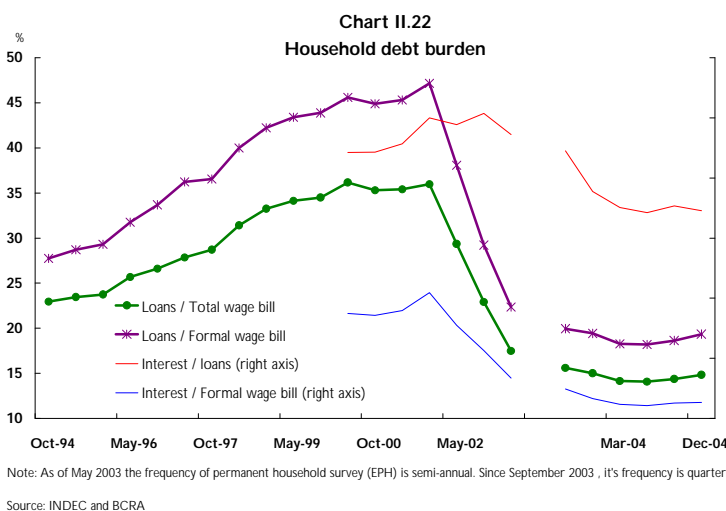
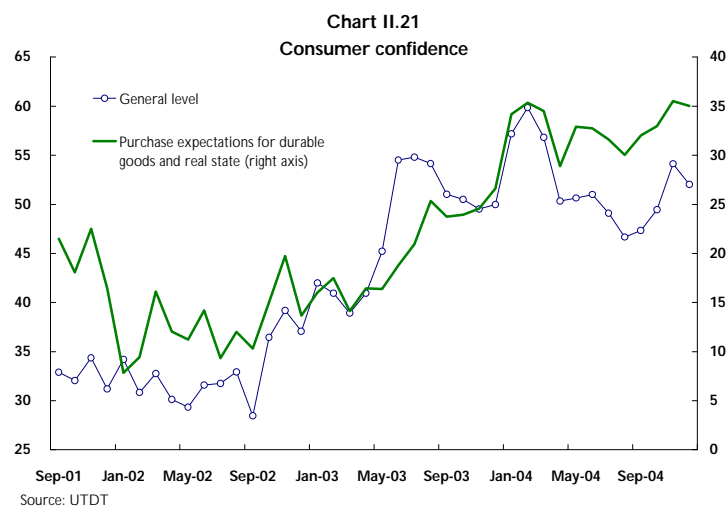
Part of the increase in public spending had as its effect the restoring of the income of those population sectors with a greater propensity for consumption. Standing out in this sense are the one-time payments in December 2004 to retirees, pensioners and beneficiaries of social plans; increases in public wages and pensions granted as of mid-year; and the increase in family allowances. Furthermore, the Government also ordered the postponement of December's income tax payments and withholdings until the first months of 2005. The increase in private salaries, established by decree as of January 2005, is also expected to contribute to boosting private consumption.

Some of these above measures, however, had a temporary impact, as they represent one-time payments or simply postponements in the tax payment schedule. All the same, even though the greatest stimulus was seen in December 2004 and, to a lesser extent, in the first months of 2005, the net impact of the Government's decisions will mean a permanent increase in salaries and wages.

Increased consumer confidence and greater access to credit favored the sale of home appliances during the third quarter of 2004, with a 66% y.o.y. increase (see Chart II.21). These sales continued on the rise in the fourth quarter of the year, driven mainly by sales of air conditioners and electronics.

For 2005, a continued increase in private consumption, in the order of 6.5%, is expected. Driving this behavior will be a further increase in wages and salaries and a deepening of the credit market, within a context of improving macroeconomic expectations.

Although short-term consumer credit has begun to expand, there is still a great potential for growth in the households segment. The low relation between the indebtedness of this sector with respect to its income, in historical terms, is evidence of this (see Chart II.22). Thus, the good financial profile of households added to an optimistic outlook in the areas of increased productivity and employment make this sector a very attractive one for bank financing.



III. STRUCTURE AND ACTIVITY

Summary

In general, the evaluation of financial stability in emerging countries is focused on the banking system. Despite the importance of this sector on the intermediation process mainly of minor-size participants, the role of Non-bank Financial Intermediaries (NBFIs) is starting to have a greater impact. The Central Bank has observed a trend towards growth in the short and medium-term by NBFIs.

From 2003 onwards, within a favorable macroeconomic environment, Non-bank Financial Intermediaries began to show signs of growth, and during 2004 this trend was reaffirmed. Equity funds recorded outstanding growth in 2004. Pension funds grew considerably during the year, a rise associated with increases in formal employment and wages. Insurance companies also recorded steady expansion in 2004, as the insurance market continues to recover. Lastly, the setting up of trusts as instruments for consumption and production financing has also showed a renewed boost.

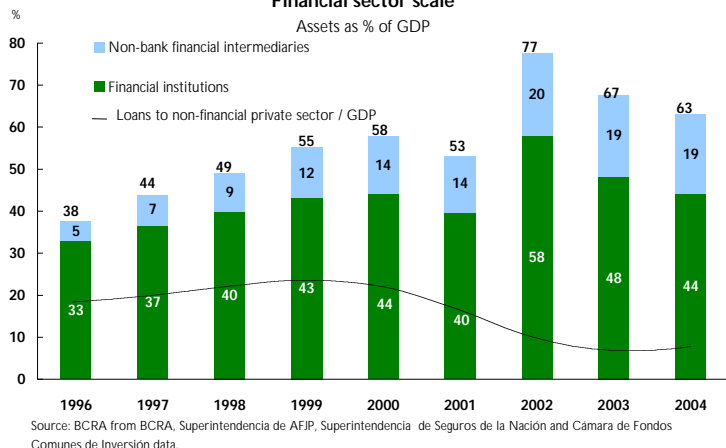
In the banking system, during 2004, outstanding improvements were achieved in the adapting of its structure to the post-crisis scenario. Employment levels within the sector started to rise, and the financial system increased its payroll with more than 1000 new employees. This phenomenon took place along with a rise in productivity. In line with the process of adaptation of the financial system's physical structure, during 2004 a reduction in the number of financial institutions was recorded. Part of this reduction was accounted for by global strategies adopted by multinational banks, whose subsidiaries were withdrawn from several countries at the same time.

During 2004, the key feature of banking recovery was the increasing speed of the asset normalization process within this sector, mainly achieved through rises in credit funding to the private sector (26%), at the cost of public sector assets. During the second half of 2004, the process of private credit expansion was further developed (30%a.), particularly led by consumption lines (71%a). Consumer loans led the way, growing 116%a, at the same time as there was a 5 p.p. reduction in their interest rate, which reached nearly 20% by the end of the year. Looking forward to 2005, the level of liquid assets portfolios, along with the expansion of the funding basis, supports predictions of important credit growth potential.

Furthermore, during 2004, the return to normal levels by financial system liabilities continued, basically as a result of deposit growth (26%). This positive trend was also recorded during the second half of the year (15%a), led by public sector deposits (19%a.) and boosted by private sector as well (14%a.) During this period, there was a notable increase in CER-indexed time deposits (25%a.) These movements occurred within a context of low interest paid for deposits, although they showed a slightly upward shift during the second half. These developments were translated into slight improvements in the maturity structure of bank funding, setting the basis for the financial system to increase credit supply in the medium term.



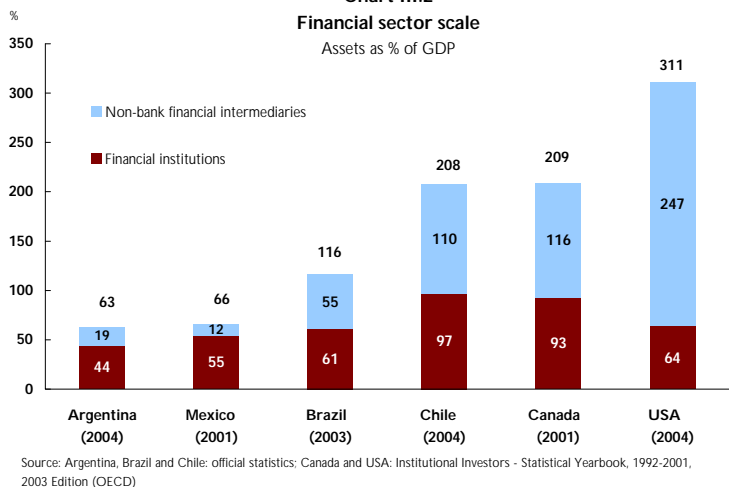
Chart III.1
Financial sector scale



III.1. Financial sector

The banking sector is of particular relevance among formal financial intermediaries in Argentina, as well as in most emerging countries. That is the reason why, when evaluating financial stability conditions, the analysis is usually focused on this sector. Nevertheless, the increasing importance of Non-bank Financial Intermediaries (NBFi) and their greater interconnection with financial institutions must also be taken into account, adding thus new features to liquidity issues and solvency of participants (see Chart III.1). This means that new dimensions are to be considered regarding the evaluation process of the overall financial stability conditions, with the aim of maintaining sustained economic growth in a low inflation environment. The Central Bank is aware of this point for which it proposes a special paragraph in the Financial Stability Bulletin (FSB) to cover this analysis, trying as well to identify the interrelationship between participants, although maintaining the focus of analysis mainly on the banking sector. Information on Pension Funds (PF), Insurance Companies (IC) and Mutual Funds (MF) is included in this approach to the subject.

Chart III.2
Financial sector scale

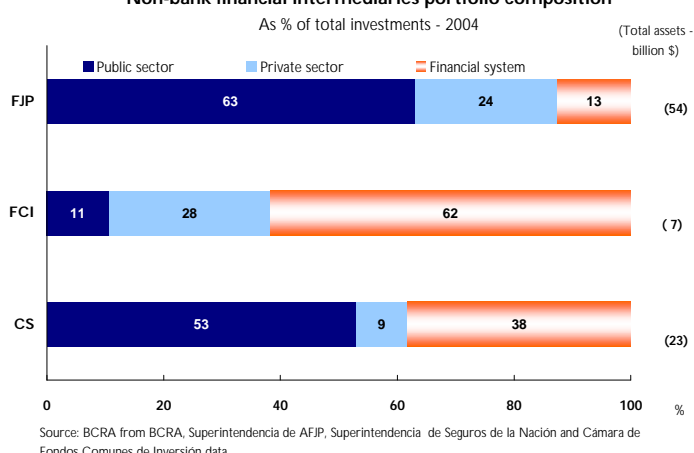


The domestic financial sector shows high potential for development, given the favourable macroeconomic outlook and in view of the experience recorded by other countries. In relation to the latter in particular, a marked difference can be observed in each country's financial sectors in GDP terms. A sample analysis, from both emerging and developed countries, reveals that Argentina, like Mexico, records low banking and NBFi participation in the economy (see Chart III.2). At the same time, other Latin American countries such as Chile and Brazil present a higher-level development of NBFi than Argentina, mainly as a result of improvements made in pension funds and investment companies respectively. In some developed countries, with deeper financial systems, financial intermediation is focused on capital markets.

III.1.1. Non-bank Financial Intermediaries

NBFi assets are gradually starting to diversify, even though they still maintain significant exposure to the public sector (see Chart III.3), a feature that was accentuated by the 2001-2002 crisis. During the second half of 2004, Pension Funds (PF) recorded a 7 p.p. decrease in their public sector exposure as counterpart to the 5 p.p. rise in private sector financing. Mutual Funds (MF) also recorded increasing private sector exposure during the same period (3 p.p.), a trend seen to lesser extent in the case of Insurance Companies. This increasing NBFi participation in credit to the private sector constitutes a growing financing instrument for the productive sector, and is a trend that is expected to be strengthened after the sovereign debt exchange process.

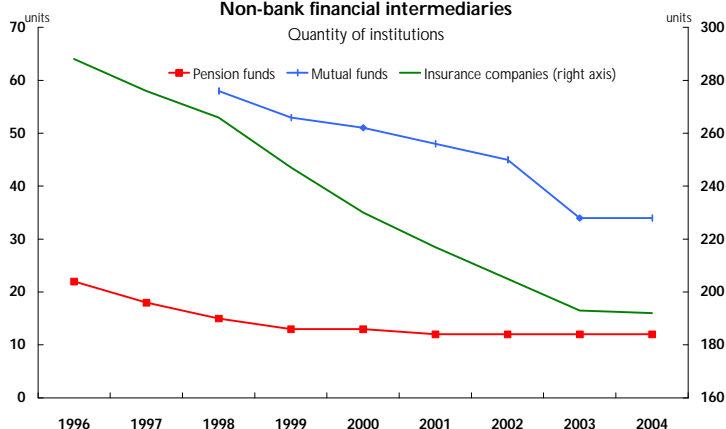
Chart III.3
Non-bank financial intermediaries portfolio composition



Domestic market development of Non-bank Financial Intermediaries led to higher-level concentration, particularly as a result of the process by which small companies were acquired by large institutions, in order to obtain larger market share consistent with economies of scale exploitation and greater potential for risk diversification (see Chart III.4). Considerable reduction was recorded in the number of Pension Funds managers (PF) due to the takeover of small managers by larger companies. A strongly-contractive Insurance market was associated with different factors



Chart III.4
Non-bank financial intermediaries
Quantity of institutions

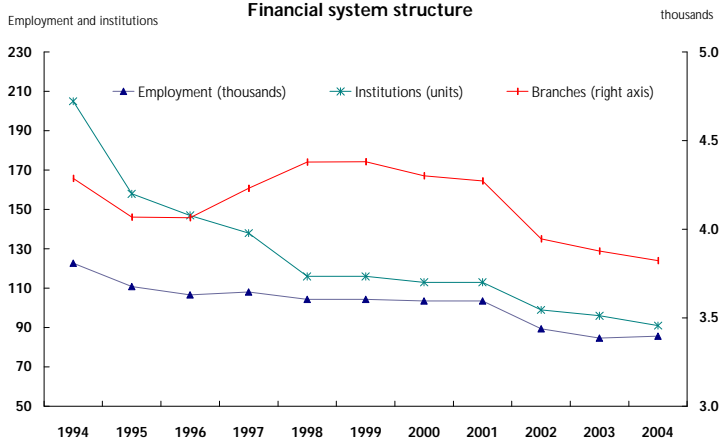


Source: BCRA from BCRA, Superintendencia de AFJP, Superintendencia de Seguros de la Nación and Cámara de Fondos Comunes de Inversión data.

such as the natural departure of less-efficient companies, sector re-arrangement and the liquidation of the National Institute of Reinsurance (IndeR). In addition, the number of Mutual Funds managers was cut by half over the last 7 years, a trend on the rise during the post-crisis period. Such developments in the NBFIs markets slowed during 2004, although they are expected to continue in a more moderate manner in the future given the outlook for profits from a larger market share.

In addition, financial trusts started to exert greater influence in financial intermediation, in line with the increasing trend for the securitization of bank loans. This mechanism provides financial institutions with more resources in order to expand their credit activity.

Chart III.5
Financial system structure



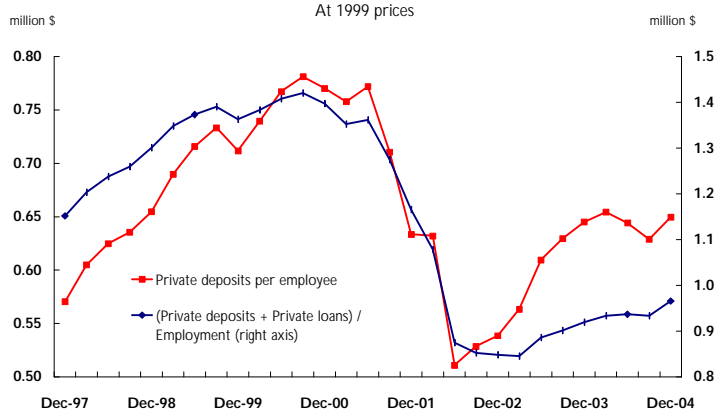
Source: BCRA

Every type of financial intermediary poses inherent risks which affect their sector and global financial stability, basically due to the existence of different types of sector interconnection. In this respect, investment by type of institution in another, such as acquisition of Mutual Fund units by Pension Funds or through their deposits in banks, opens a direct channel by which a sector's liquidity needs may affect those of the rest. In addition, shareholdings among companies from different financial segments constitute another transmission channel, a situation commonly associated with so-called financial conglomerates. Some large-scale banking institutions participate in NBFIs with the purpose of diversification. These links make potential vulnerabilities of a conglomerate's company affect profitability, and consequently, it could impact on the group solvency as a whole with possible systemic effects.

Different regulations within each financial sector could cause distortions, which may lead to inefficient resource allocation. The existence of less-taxed segments or those with relative advantages in their operating system presents arbitration opportunities, especially in a context of growing similarity between financial products. In view of these situations further analysis and follow-up is necessary.

III.1.2. Financial system

Chart III.6
Factor productivity
At 1999 prices



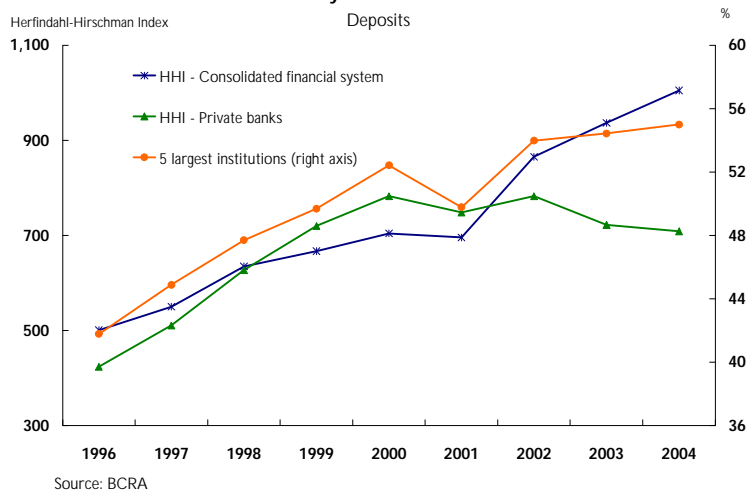
Source: BCRA

During 2004, the financial system structure has taken a step forward in the process of adapting to the new post-crisis scenario for banking, and started to show encouraging signs for future outlook. The employment level within the sector recorded a rise from last March onwards, increasing 1.2% during 2004 (see Chart III.5). This behaviour was achieved in a context of significant productivity gains by factors in recent years (see Chart III.6), partly associated with technological progress and the taking advantage of lower operating costs. The financial system re-sizing process led to a reduction of 5 financial institutions in 2004, a situation affected by the international context for the consolidation of banking operations. Although during the same year a fall was recorded in the concentration of deposits in private banks, at financial system level, growth was recorded, linked to concentration of government deposits in public banks (see Chart III.7)

As a consequence of the economic and financial crisis, the number of foreign-owned banks operating locally fell, which modified the



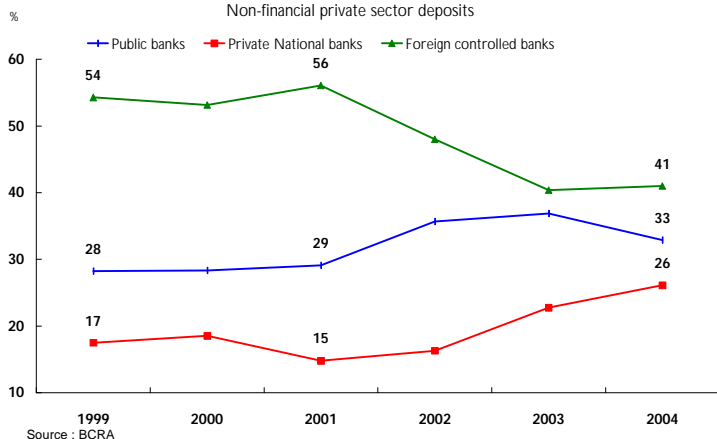
Chart III.7
Financial system concentration
Deposits



share of private deposits held by this group of banks from 2002 onwards (see Chart III.8). This mainly took place through the takeover of foreign institutions by private domestic institutions. Likewise, from 2003 onwards, although deposits in foreign-owned institutions have risen, their relative share of the total has remained unchanged.

During the last three years, the adjustment recorded by foreign-owned banks has been explained by different circumstances. These can be classified as withdrawals from the market, sales of institutions and transfers to trusts (see Chart III.9). The first group consisted of 4 small branches of foreign-owned banks that withdrew from market by selling assets and settling liabilities, mainly in accordance with their global strategies. Furthermore, 4 foreign-owned institutions² sold their local branches to private domestic agents, implementing strategies for simultaneous withdrawal from various countries. These takeovers explained, to some extent, private domestic bank growth in the financial system. Finally, three banks were transferred to financial trusts at the beginning of 2002, when the group controlling them decided to stop acting locally. In 2004, one of these institutions was sold to a private domestic bank.

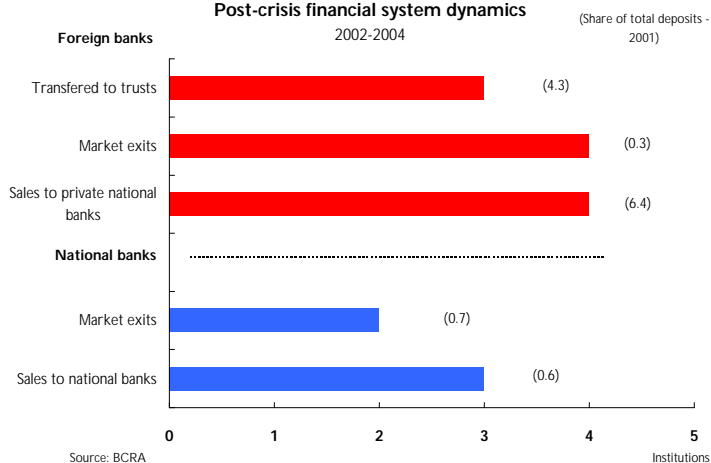
Chart III.8
Breakdown by type of institutions
Non-financial private sector deposits



III.2. Activity and financial situation

During 2004, financial activity recorded steady growth, reversing the trend registered in 2003. Financial system assets rose by 2.6% in real terms during the year, a situation mostly explained by the upturn in private credit and larger liquid assets holdings (see Chart III.10) Throughout 2004, on the asset side, the key feature of financial intermediation stability was the rise in lending to the private sector (see Table III.1). In line with growing asset diversification in institutions during 2004, exposure to public sector recorded a fall, reflecting the effects of amortization, sales and gradual regulatory alignment of government securities to market prices (see Chart IV.10 in the Risk Management chapter). In addition, a rise was recorded in liquid assets and in the purchase of Central Bank securities by institutions, which contributed to keep liquidity indicators at levels consistent with good coverage in the face of liquidity risk (see page 36 in the Risk Management Chapter). Likewise, liquidity levels constitute an encouraging sign of credit potential by the financial system if the favourable macroeconomic environment is maintained.

Chart III.9
Post-crisis financial system dynamics
2002-2004



Credit to the private sector rose by 30% a. during the second half of 2004, reflecting the effects of improvements in the macroeconomic context and the impulse provided by the Central Bank, with an increase of 26% for the year (see Table III.2), a figure that rises to 39% if mortgage lines are excluded. Credit behavior during the second half of the year was driven by consumption-related lines (71% a.) and commercial lines (33% a.), while collateralized loans began to grow slowly (5% a.)

During the second half of 2004, consumption-related lines were boosted by consumer loans (116% a.) These loans benefited from a 5 p.p. reduction in their average interest rates, compared with the first half of the year, reaching a level of 20% at the end of 2004.

² Situations excluding assets and liabilities are included according to Law 21.526 – Art. 35 bis.

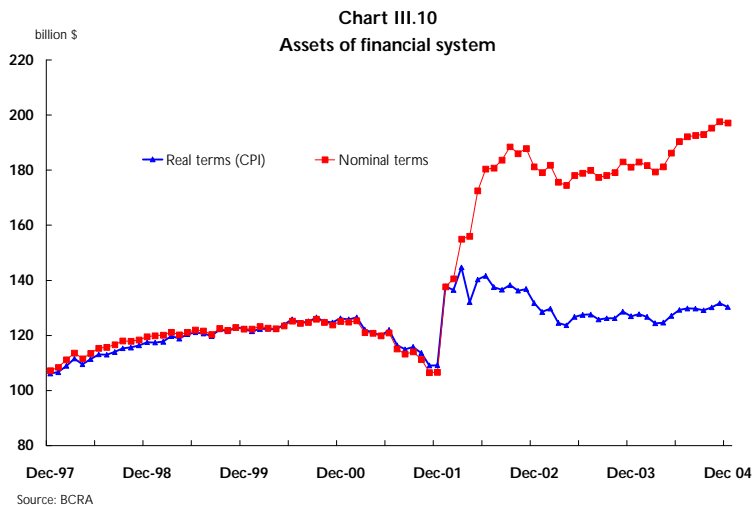


Table III.1
Balance sheet
Consolidated system total - %

	Dec-03	Jun-04	Dec-04	Half-yearly change H2-04 (%)
Assets	100	100	100	4
Liquid assets	15	18	17	3
LEBAC	4	5	6	21
Lending to the private sector (*)	19	19	21	13
Lending to the public sector	48	45	42	-2
Other assets	15	13	13	4
Liabilities + Net worth	100	100	100	4
Public sector deposits	9	15	16	9
Private sector deposits	39	39	42	10
CEDRO with CER	3	2	1	-48
Liabilities with the BCRA	15	14	14	1
Outstanding bonds, sub. debt and for. credit	13	11	9	-12
Other liabilities	9	8	7	-3
Net worth	11	10	10	5

(*) Total loans do not include provisions.

Source: BCRA

Table III.2
Loans to the private sector by type of banks
% change based on balance sheet total

	2004	H1 - 2004	H2 -2004	Share of total 2004
Public banks	23	6	43	28
Commercial	54	35	76	19
Consumer	119	69	183	24
Collateralized	-3	-9	5	42
Other	-15	-24	-5	27
Private banks	26	28	23	70
Commercial	42	64	24	80
Consumer	39	37	41	69
Collateralized	-1	-5	3	57
Other	13	-9	42	72
National private banks	58	68	48	24
Commercial	63	86	43	33
Consumer	43	42	44	32
Collateralized	40	39	41	15
Other	152	140	163	12
Foreign banks	12	12	11	46
Commercial	29	51	12	47
Consumer	35	34	35	37
Collateralized	-11	-14	-8	42
Other	0	-20	25	60
Consolidated financial system	26	21	30	100
Commercial	45	57	33	100
Consumer	57	44	71	100
Collateralized	-1	-7	5	100
Other	7	-12	31	100

Does not include accrued interest or CER/CVS adjustments.

Balance sheet totals not adjusted by transfers between loan portfolios and trust funds or by loans written off balance sheets.

Total system includes data from public banks, private banks and non-bank institutions.

The private bank group includes three financial institutions currently undergoing a restructuring process and under administration of a national public bank.

Commercial loans include overdraft, acceptance of promissory notes and export credit.

Consumer loans include credit card and personal loans.

Collateralized loans include pledge-backed loans and mortgages.

Source: BCRA

Likewise, credit card loans rose by 32% a., also within a context of interest rates reduction.

Commercial loans were led by promissory lines (52% a.), with an average interest rate of 10%. Export financing and pre-financing transactions, included in this category of loan, increased nearly 1.5 times in the second half.

Finally, the positive performance by pledge-backed credit lines (with an increase of 59% a. in the second half of 2004) was responsible for a slight rise in collateralized loans. Interest rates paid by these lines fell by around 3 p.p. in the second half of the year, ending 2004 at 11%. At the same time, mortgage loans still suffer from the effects of the crisis, reflected in a 2.3% a fall in their balance, despite the downward drift seen in interest rates for transactions for less than 5 years. Given the significant 110% rise in the average amount granted in mortgage loans during the second half of 2004, the balance of such loans is expected to increase during 2005.

Public banks recorded an increase in lending during the second half of 2004, mainly in consumption-related lines. Private banks, with a 70% market share, showed uniform progress during the year, with commercial loans recording the largest rise. Within private banks, domestic institutions recorded a larger rise in lending than foreign-owned ones, although the latter still hold a larger market share.

At the same time as the asset structure is improving, a considerable step towards normality has been recorded by financial system liabilities. Total deposits increased 26% during the year, a variation which was accounted for mainly by the public sector, which doubled its deposits in 2004. The latter contributed with 17 p.p. of total growth, while private sector deposits contributed 9 p.p. .

During the second half of 2004, private sector deposits increased sharply (see Chart III.11), raising their share in total funding (liabilities plus net worth) for banks by 3 p.p. to 42%. Private sector deposits recorded 14% a growth during the second half of the year, mainly associated with a 26% a rise in time deposits, within the context of a slightly upward trend in interest rates, while sight deposits rose by 22% a.

In the case of time deposits, CER-indexed deposits recorded the largest relative increase during 2004, totaling 7 times their level at the end of 2003 (see Chart III.12). Institutional investors, mainly Pension Funds Managers (AFJP), were responsible for this rise, as they benefited by channeling funds into inflation-protected instruments. This growth impacted positively on the financial system, as it increased the average maturity of banking liabilities as well as reducing real interest-rate risk (see page 46 in the Risk Management Chapter), thus allowing financial institutions to increase medium and long-term financing for productive activities and household consumption.

Foreign liabilities continued to decline during 2004, due to routine bond repayments and debt capitalization (see Chart V.8 in the Solvency chapter), totaling a 22% reduction in dollars.

**BOX 1 : BCRA POLICY TO PROMOTE PRIVATE CREDIT**

In a context of financial normalization, the Central Bank focused its cautious post-crisis policy on several points: avoidance of risk of exchange mismatches, prudential treatment for the public sector according to its risks, granting temporary facilities that enabled gradual adaptation for those institutions severely impacted by the 2001-2002 crisis, and lastly, the removal of any possible regulatory obstacles to the granting of new loans or the re-financing of debts, when they are not justified by the risk of the transaction, and taking into consideration extraordinary situations resulting from the crisis period. This prudential policy is an inherent part of the monetary policy scheme that has as its purpose to consolidate a reference interest rate which supports the yield structure of the economy and facilitates risk assessment of loan lenders and takers, stimulating medium and long-term financing.

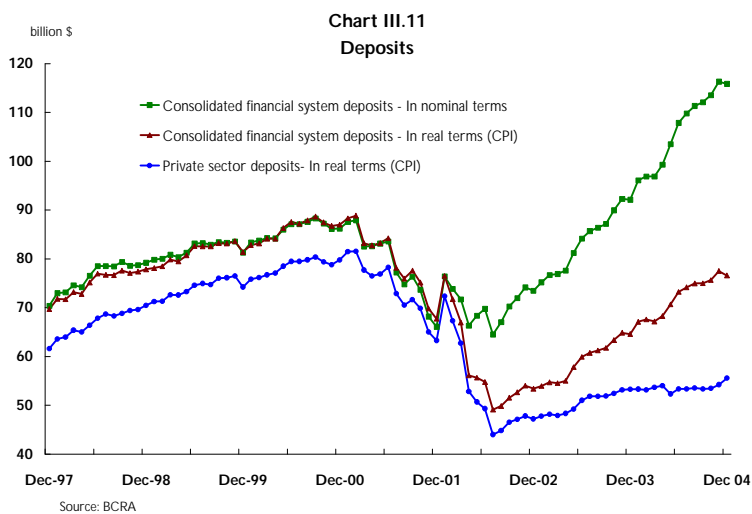
In order to encourage private sector lending, the Central Bank is implementing a series of microeconomic measures, with the aim of eliminating redundant requirements and stimulating SME financing, in particular:

- o Commercial debtors refinancing their liabilities and showing high future repayment capacity can be classified as performing until the end of 2005.
- o Banking institutions can granting new loans above the current limit of 300% of debtor's net worth (until the end of 2005 and subject to a global maximum of 15% of adjusted stockholders' equity)
- o In refinancing processes with principal haircuts carried out until 2005, the loss the institution records due to the discount and improvements to collectibility of the remaining loan balance for the same reason will be given recognition by means of a reduction in provision requirements and an improvement in debtor classification.
- o Elimination of margins for promissory note discounts (checks and invoices accepted as self-liquidating preferred class A guarantees) drawn by companies with high-level credit quality.
- o Guaranteed loans with minimum-risk assets (such as time deposits in the same institution) will be considered as covered with self-liquidating preferred class A guarantee, even when the residual term of the assistance exceeds the 6 month period fixed by general rule, and up to 12 months.
- o Implementation of modifications encouraging the use of guarantees granted by Reciprocal Guarantee Companies (SGR) duly registered with the Central Bank.
- o Increase in the maximum commercial credit amount, from \$200 thousand up to \$500 thousand, set as a reference on the basis of which an institution can choose to assign consumption portfolio standards for both debtor classification and credit fractioning and grading.
- o Financial institutions are exempted from requiring salary receipts (or any other income statement) when granting consumer loans up to \$15,000 as long as they use statistical methods to evaluate their customer's payment capacity.

Market instruments were approved or are still under study that will contribute to the elimination of existing mismatches in the financial system and promote medium and long-term financing. These instruments will enable financial institutions to extend the term of their liabilities term and unload risk on capital markets:

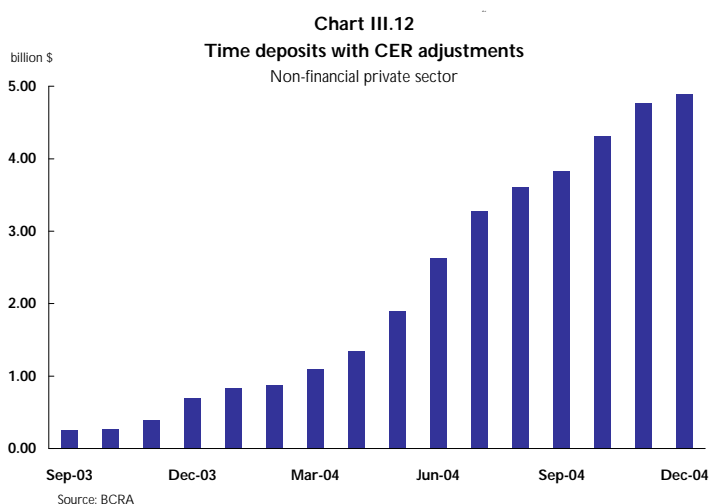
- o Authorization of time deposits for minimum term of 180 days, paying its rent in advance with a durable good.
- o Extension of minimum term of CER-adjusted time deposits (from 90 to 270 days)
- o Up dating of indicators for term investment with variable yield based on the evolution of specific commodities prices, and automation of some procedures.
- o Encouragement for the development of secondary market time deposits.
- o Assessment of the authorization so that financial institutions can issue CER-adjusted corporate bonds.
- o Encouragement for asset securitization by promoting origination and uniform administration of mortgage loans.

Furthermore, the Central Bank has regulated the setting-up of regional credit cooperatives, and has made it easier to set up branches in public utility cooperatives in areas where there are no financial services being provided. These measures are expected to boost regional credit growth, especially that related to SME productive projects.



The reduction in Central Bank rediscounts gathered pace during 2004, with the settlement of more than \$1.8 billion under the matching scheme (see page 18 of Financial Stability Bulletin I-04), reducing this liability to 14% of total funding. In 2005 these liabilities are expected to decline rapidly, given the mechanisms for early repayment and tendering created by the Central Bank for the settlement of future installments, allowing institutions to rapidly improve their financial position³. In addition, CEDRO totals fell notably during 2004 to only 1% of total funding, when institutions allocated more than \$4.7 billion to meet maturities of these certificates and court ordered payments.

In addition, total assets held by financial institutions are expected to continue to recover in line with the steady normalization of the financial system after the 2001-2002 crisis, with a growing participation by loans to the private sector. On the side of liabilities, the rise in CER-adjusted deposits will help develop longer terms to maturity for financial institutions funding and lower interest rate mismatching in order to boost medium and long-term credit. Regarding the latter, the Central Bank is analyzing the introduction of new CER-indexed medium-term funding instruments.



³ For further details see Box in Page 54 in the Inflation Report - First Quarter 2005.

IV. RISK MANAGEMENT

Summary

The crisis in 2001-2002 had a strong impact on the exposure of the financial system to the principal risks involved in the process of funds intermediation. Partly as a result of the local macroeconomic context and the appropriate prudential policies implemented by the Central Bank, financial institutions were able to strengthen their position in the face of liquidity and credit risk. Nevertheless, in the short and medium term it will still be necessary to protect the financial system against exposure to the risk from real interest rates. Conclusion of the sovereign debt exchange will strongly favor the development and the strengthening of the financial system.

The financial system is well placed to confront liquidity risk in 2005. The road being traveled towards the definitive stabilization of the financial system is helping to rebuild depositor confidence in banks. In addition, the leading indicators of systemic liquidity have recorded a sound performance in both historical and international terms. This performance has benefited from the deepening of call money markets, which have helped to smooth over specific liquidity problems. Furthermore, the containment network designed by the Central Bank to meet the liquidity requirements of individual banks (through its role as a lender of last resort and its activity in the repo market) forms part of a transparent regulatory framework that helps to strengthen the credibility of monetary policy.

In 2004 the financial system improved its position in relation to credit risk. Banks diversified their portfolios, lowering their positions in public sector assets, at the same time as the Government strongly increased its repayment capacity. In addition, the growth in lending to the private sector, on the basis of an improved risk profile in all areas of business activity as well as for households, significantly increased the robustness of the financial system in the face of the credit risk represented by the private sector. In the short and medium term this portfolio diversification process is expected to continue (with a decline in public sector lending and increased financing of private sector consumption and sound investment projects), helping to shrink the threat to net worth from the exposure to credit risk.

Although the financial system is exposed to the volatility of the peso-dollar exchange rate (because it has larger volume of assets in foreign currency than liabilities), financial institutions as a whole have succeeded in moderating this source of risk, and are expected to continue along this positive path. On the other hand, banks have made little progress with the improving of their exposure to the mismatching of assets and liabilities because of CER (more CER-adjusted assets than liabilities). This latter element represents one of the relatively weaker points of the local financial system, and the Central Bank is working on the development of market solutions to help overcome this mismatching. The steady support of the monetary authority for hedge markets, such as dollar and CER futures and interest rate swaps, are one example of this.

Lastly, when evaluating the exposure of banks to the risks for which the activity is noted, mention should be made of the positive effect of the steady improvement in economic and financial variables, which will enable growth to continue while inflation remains low, this being the only macroeconomic context that will set the basis for sustained growth in the level of financial system operations.



IV.1. Liquidity risk

As the traces of the financial crisis in 2001-2002 are left behind, the financial system has steadily regained depositor confidence. This steady return to normal by the financial system is improving the reputation of the sector, with an increase in deposits at the same time as interest rates have remained relatively low. These elements have led to the consolidation of the level of cover against liquidity risk. In turn, it is expected that the dynamism of lending to the private sector in 2004 will continue, with a moderate reduction in liquidity risk coverage indicators in 2005 that will not threaten the strength of the financial system in the short or medium term.

In the second half of 2004 the financial system slightly reduced its liquidity level (cash, current account at the Central Bank and Central Bank repos) by 0.9 p.p., to a level of 30% of non-financial sector deposits (see Chart IV.1) This indicator has remained very stable since the second half of 2003. If purchases of Central Bank bills are included, the liquidity ratio has recorded a rise of 1.4 p.p. for the six months, ending the year at 40%. The high inflow of funds to banks in the form of deposits, particularly from the public sector, applied partly to the purchase of Central Bank bills and partly to the gradual recovery in lending to the private sector, have explained this behavior.

Mainly because of the stimulus provided by monetary policy, financial institutions have carried out a notable switch in the composition of their liquid assets. With the aim of switching its monetary policy towards an interest rate system, the Central Bank is gradually switching to a liquidity policy that is increasingly less compulsive and more linked to market incentives. In mid-2004 the Central Bank created a repo market that had grown significantly by the end of the year. Banks switched their reserve surpluses to the repo market performing transactions against Central Bank bills (see Chart IV.2).

Even when taking into account the past crisis and the current low average life of deposits, bank liquidity levels are high in both historical and international terms. Among emerging economies, the local financial system records one of the highest proportions of liquid assets to deposits, and at the same time this proportion is very far from the levels of financial systems in developed economies (see Chart IV.3).

In the second half of 2004, both public and private banks complied with the minimum cash reserve requirements of the Central Bank (see Chart IV.4). The setting up of the repo market using Central Bank securities led to a sharp reduction in surpluses for both types of institution to a precautionary level of around 2% of total deposits. Although a large number of banks performed such transactions, public banks were the main force behind this reduction, lowering their cash reserve surpluses by 8 p.p. of deposits during the second half of the year. By the end of 2004 only one smaller financial institution recorded a shortfall in reserve compliance.

Chart IV.1

Liquidity risk coverage

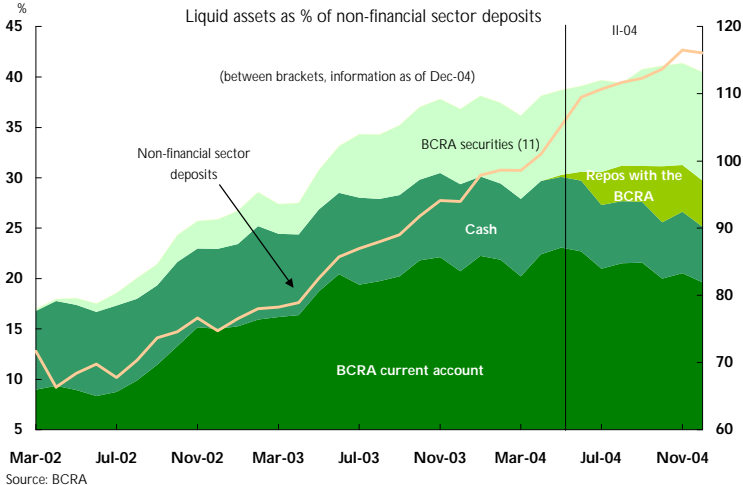


Chart IV.2

Remuneration on liquidity holdings

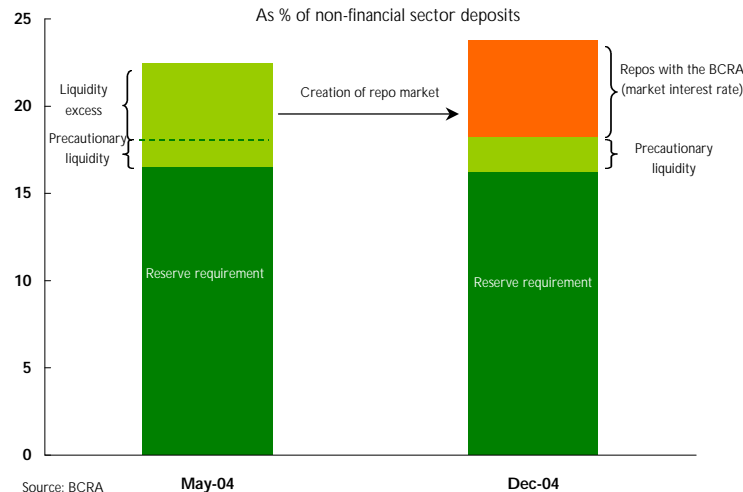
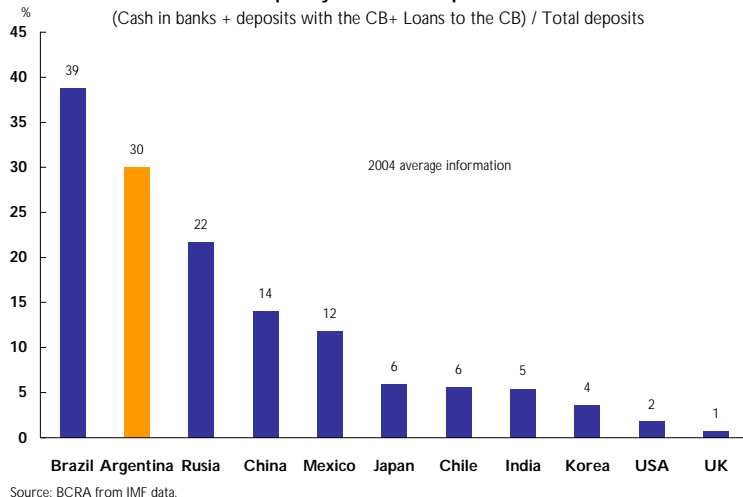


Chart IV.3

Liquidity reserve compared



**BOX 2 : APPROACHES TO THE EVALUATION OF FINANCIAL STABILITY**

The crisis episodes recorded during the 1990s have dramatized the need to be able to count on tools that make it possible to detect and monitor strengths and weaknesses in financial systems. Although the possible causes of banking crises and the collapse of financial institutions are numerous, information on the fundamental variables of the financial system and their links to the rest of the economy could be of use in the early identification of banks in trouble or systemic problems. This has led international financial institutions and Central Banks to place greater emphasis on the development of methods for detecting early warning signs of impending crises. In this context, the Central Banks in various parts of the world have assigned resources to the construction and publication of tools that enable informing the public about risk factors, thus promoting market discipline, that is to say, control by the public over bank actions.

The design of these tools begins with the selection of the variables. These are chosen taking into account macroeconomic, microeconomic and institutional factors. Macroeconomic elements include variables such as output figures or interest rates, which affect the financial system either because of their direct influence on bank decisions or because they create unsuitable conditions that could indirectly threaten the solvency of financial institutions. At microeconomic level, the choice of variables centers on the banking sector, using, for example, data on deposits, loans, or portfolio quality, among others. The measurement of institutional factors presents greater difficulty, as in many cases they involve qualitative variables, such as design of the payments system, the supervision framework and the presence of safety nets (such as the format of the deposit insurance system or the power of the Central Bank to act as a lender of last resort). The definitive selection of the variables depends in the final instance on the characteristics of the country. Once the process has been completed, the evaluation of the financial system can be based on two sets of tools: an indicator-based approach and crisis prediction models.

The first of the focuses consists in the systematic monitoring of a group of indicators, comparing information during periods of calm against that recorded at times of crisis. The core idea is the existence of thresholds for the various indicators which, once exceeded, mark the existence of vulnerabilities. The most reliable indicators are those that display a sharper difference between normal times and times of crisis, providing a signal with greater precision. In addition, it is useful for the purpose of analysis to build compound indicators that take into account a group of indicators, gathering all the information in a single index, making it possible to perform an overall evaluation of the financial situation using a single instrument. Such indicators usually add together weighted warning signs for the chosen group of variables. The flexibility of the indicators system resides in the possibility of building both early warning indicators, with a predictive capacity, and indicators of financial strength, enabling the identification of weaknesses in the banking sector.

The indicators approach possesses a large number of virtues that have led to its widespread use at international level. In the first place, it enables the processing of a wide number of variables that common to different countries. This makes it possible to establish international comparisons, fundamental in the evaluation of the financial system. In addition, it also facilitates historical comparisons, by making it possible to build the indicator for previous periods. In second place, the simplicity of their preparation together with the clarity in the communication of results, transforms them into a transparent tool for use by the general public, with wide-scale use by investors. These characteristics make them appropriate for use in regular publications by Central Banks, enabling a continuous monitoring of the vulnerabilities of the financial system.

Nevertheless, the use of indicators also implies a series of limitations. First, as they are not based on a general analysis framework enabling the interaction between variables, there is a possibility that different indicators could throw up contradictory results. In second place, the quality of the information influences the results, which could provide a distorted view of reality because of errors in the data, either from measuring faults, a high level of informality, or the unavailability of information, in particular in emerging economies. Lastly, the existence of different risks depending on the country in question, linked to the presence of specific events that will take place in future, with major consequences (such as the process for the exchange of local sovereign debt) condition the interpretation of indicators, which are extremely sensitive to events not yet revealed.



Table A.2.1
Principal indicators used in the Evaluation of Financial Stability

Asset quality	Results	Liquidity
Loans (or financing) by sector Exposure to major debtors over assets (or capital) Provisions (with security) covering non-performing portfolio Loan Provisions Ratio of non-performing portfolio net of provisions Loans over guarantees Lending to private sector over assets Lending to public sector over assets	Return on assets Return on equity Interest income ratios Other income ratios (excludes interest income) Other expense ratios (excludes interest payment) Costs to personnel ratio	Liquid assets ratios Loans (or deposits) over total assets Loans over deposits Loans and/or deposits by currency CB Loans over total banking sector liabilities
	Sensitivity to market risk	Capital situation
	Maturity of assets and liabilities Net foreign currency position	Capital compliance over risk-weighted assets Assets over net equity Excess capital compliance over capital requirement

Source: BCRA

The second group of tools includes the crisis prediction models. In this approach, the economic and statistical analysis is used to measure the influence of the different variables on the probability of occurrence of an event. These models use a comprehensive focus, enabling the interaction of variables from the real and financial sectors, combining multiple risk factors in a single estimate. These tools possess a greater formal development than the use of indicators as warning signs. In addition, use of these models indicates the relative importance of the variables in explaining the probability of crisis, analyzing the contribution of each factor in relation to the financial system as a whole. In particular, they make it possible to determine more precisely the effect of macroeconomic shocks. This enables forecasts to be made under different scenarios, integrating different variables with a single result.

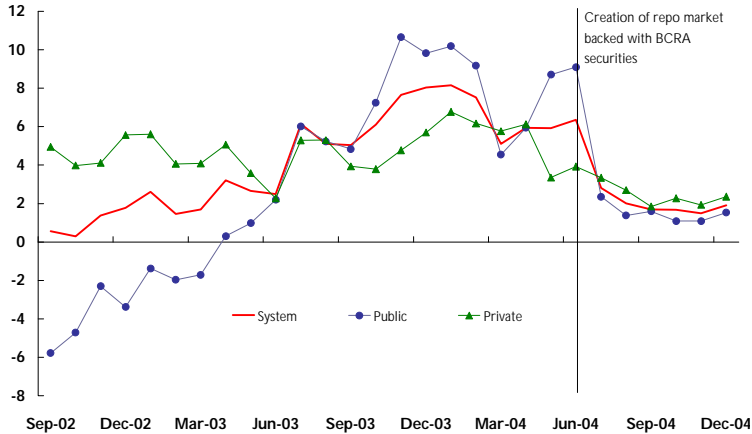
Although the use of models makes it possible to correct certain failings in the use of indicators, it is open to criticism. First, because the lack of a common definition of crisis prevents comparison and hinders analysis of results. Second, the lack of availability of historical data is another factor that affects the calculation of models. The Argentine case in particular is an eloquent example of this. As a result of the crisis in 2001-2002, the task of evaluating in a quantitative manner financial stability conditions has been virtually impeded. Nevertheless, in the face of significant difficulties in approximating the equations for the behavior and distribution of probability associated with such a methodology, the BCRA has opted to present a qualitative appreciation of the conditions leading to financial stability in the short term (see Balance of Risks on page 65).

Furthermore, the construction of these models, less transparent for the public, does not constitute a tool that replaces continuous monitoring by means of indicators of vulnerability of the financial system. These difficulties become more evident in the case of emerging economies, where frequent structural changes distort the information provided by figures. In addition to these weaknesses, as with the use of indicators, the existence of specific events not yet defined conditions the results obtained by the models, estimated using time series without taking into account possible future events.

Taking into account these factors, in performing its task of monitoring the conditions of financial stability the BCRA has adopted a comprehensive approach, attempting to combine the information provided by a series of indicators at macroeconomic and microeconomic level with forecasting models. Furthermore, the BCRA, in line with a worldwide trend, and as restrictions on statistical analysis are gradually lifted, is beginning to develop stress test models, which consist in putting the strength of the financial system to the test in crisis situations with a low probability of occurrence. These methodologies, added to analysis of the links between the variables of the real economy and the international economy and situated in a broader framework that makes it possible to identify possible strengths and weaknesses in the financial system, help to monitor financial stability. This has as its purpose to assist in the taking of decisions, at the same time as it is disclosed half-yearly in the issues of the Financial Stability Bulletin.



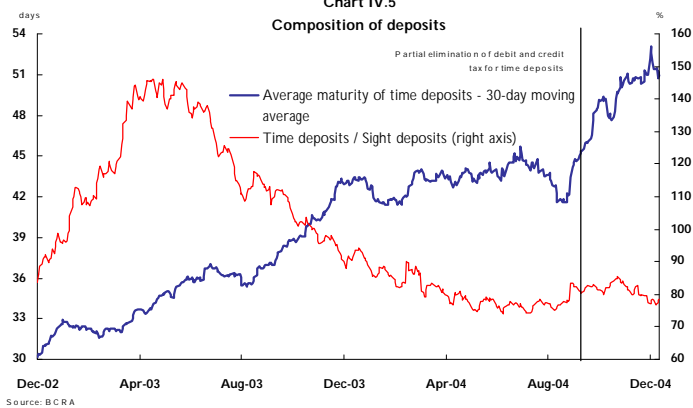
Chart IV.4
Minimum cash compliance in pesos
As % of total deposits



Source: BCRA

Although the funding structure of the financial system showed some improvement, it is still heavily weighted towards the short term, in part weakening the position of the system in relation to liquidity risk. In the second half of 2004 there was a recovery in time deposits and an increase in their average length of around 7 days (see Chart IV.5), maintaining the strength of the financial system as regards its exposure to liquidity risk. Nevertheless, significant improvement remains to be carried out in relation to the funding structure, as around 80% of deposits mature in less than one month. It is possible that in a scenario that includes the elimination of the tax on bank credits and debits on the setting up of time deposits, the conclusion of the sovereign debt exchange and a moderate rise in interest rates that would help to increase the duration of bank liabilities, there could be a strengthening of the funding structure.

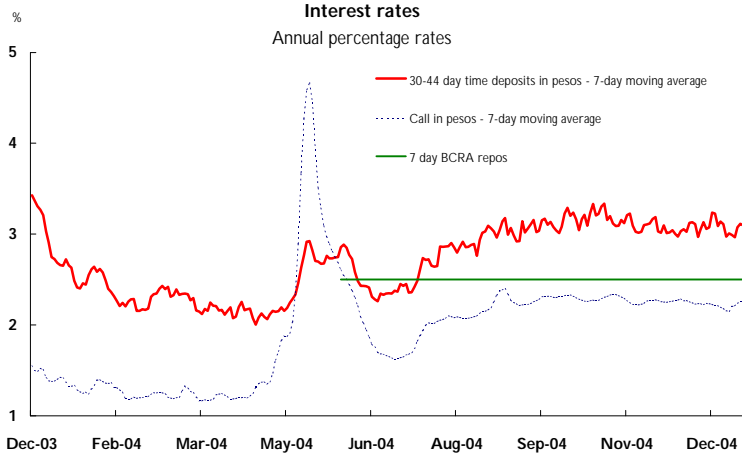
Chart IV.5
Composition of deposits



Source: BCRA

This bias towards the short term in the structure of funding had a negative impact on the take-off by medium and long-term lending. Nevertheless, after 5 consecutive years of destruction of lending to the private sector, in 2004 the financial system began to rebuild the nucleus of its traditional financial intermediation activity, applying a significant proportion of the resources gained (basically through deposits) to lending to the private sector, with signs of an acceleration in this process towards the second half of the year (see page 31 of the chapter on Structure and Activity). Liquidity surpluses held by banks, added to the good opportunities that exist for the sector in a favorable macroeconomic context are the main factors that explain this phenomenon.

Chart IV.6
Interest rates



Source: BCRA

The Central Bank has set the interest rate it pays on its repos slightly above the main short-term interest rates, causing a slight increase (see Chart IV.6). Financial institutions accompanied this movement by raising the interest rates on time deposits, improving the level of such deposits and an extension in their terms. The latter was mainly a result of the taking of time deposits adjusted according to CER (with a longer minimum term), in an environment in which depositors expected improved real yields compared with deposits not subject to adjustment.

In addition to the firm liquidity position that currently prevails, as can be seen from the levels of the main coverage indicators, the robust liquidity risk position of the financial system is based on three pillars. The first pillar is formed by the growing development of interbank money markets: call money and repos. The call market deepened notably in 2004, and in the second half of the year trading was one and a half times higher than in the first half of the year. Although this market is expected to continue to develop, there is a need for a reduction in its high level of segmentation. The deepening of this market will also require a reduction in its level of concentration: while the source of such funds is spread across the various different types of bank, takers are almost exclusively foreign banks (see Chart IV.7). The inter-bank repo market has grown gradually as from its creation in mid-2004.

In second place, the monetary authority is promoting the development of a market for repos with the Central Bank, which as well as creating the basis for a monetary policy based on interest rates, represents a mechanism that improves the liquidity position of the financial system. In view of the widespread existence of high



levels of liquidity, the Central Bank has performed few reverse repos.

The existence of an operating mechanism that is efficient and transparent and which allows the Central Bank to recover its role as a lender of last resort constitutes the third pillar. Over and above the high levels of liquidity recorded by banks and the deepening of short-term money markets, this third pillar is essential to the strengthening of the situation of the financial system in the face of exposure to liquidity risk. The possibility of gaining access to direct lines of credit in pesos from the Central Bank in times of individual liquidity shortages (experienced by solvent institutions) constitutes an effective safety net and an incentive that will help to prevent mass outflows of deposits from the system that are not related to fundamental problems. The Central Bank's policy for providing financial assistance to banks with temporary liquidity problems has been included in a fair and transparent regulatory framework that grants credibility to the handling of monetary policy.

For 2005 the basic conditions for further growth in lending are now present, both in terms of market and as regards the incentives provided by the Central Bank. This will no doubt lead to a moderate reduction in the indicators of coverage against liquidity risk. Nevertheless, market liquidity instruments are expected to gain in strength, and this, added to the powers of the Central Bank as a lender of last resort and the rising public confidence in banks, will create a framework providing significant protection to the financial system against liquidity risk, consolidating the conditions that will encourage a greater degree of financial stability.

IV.2. Credit risk

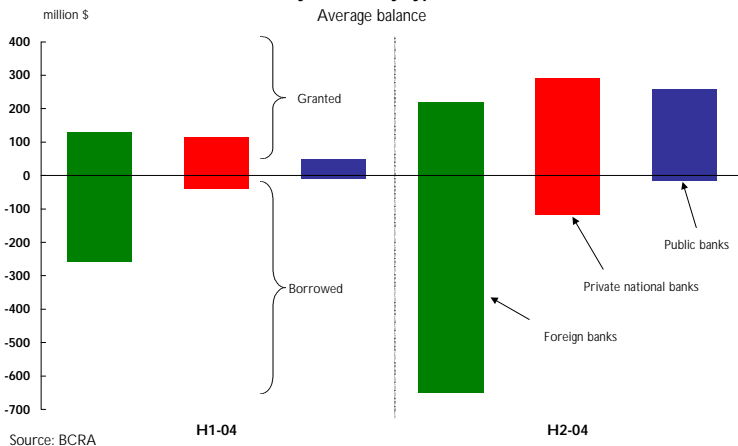
IV.2.1. Public sector

Although the exposure of the financial system to the public sector⁴ continues to decline slowly and steadily, it continues to record extraordinarily high levels as a result of the crisis in 2001-2002. As the exposure to this sector reflects the holding of long-term assets, it can be expected that correction will take place gradually.

At the end of 2004 lending to the public sector accounted for 42% of total financial system assets. This represents a 5 p.p. decline for the year (spread evenly over the whole period), and 9 p.p. in terms of the maximum level recorded in mid-2002 (see Chart IV.8). In addition, in the second half of 2004 there was a change in the composition of this exposure for the financial system, with an increase in securities in portfolio and a drop in loans, given the switch of provincial debt into government securities (BOGAR). This gradual downward trend in exposure to the public sector is a phenomenon that is being experienced by both private and public banks (see Chart IV.9).

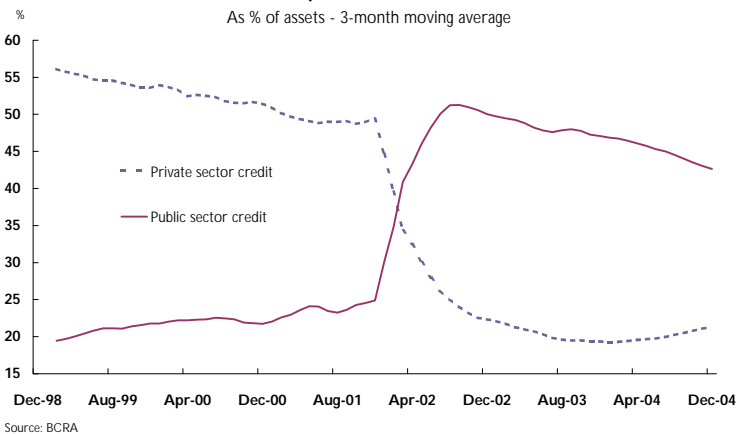
Exposure to the public sector is expected to continue to decline for various reasons. Cash flows generated by the payments on such assets are being used to make payments committed to under the so-called matching system, to increase liquid assets, or to increase lending to the private sector. In 2005 partial amortization took place of several assets with a very significant weighting in bank

Chart IV.7
Call money market by type of entities
Average balance



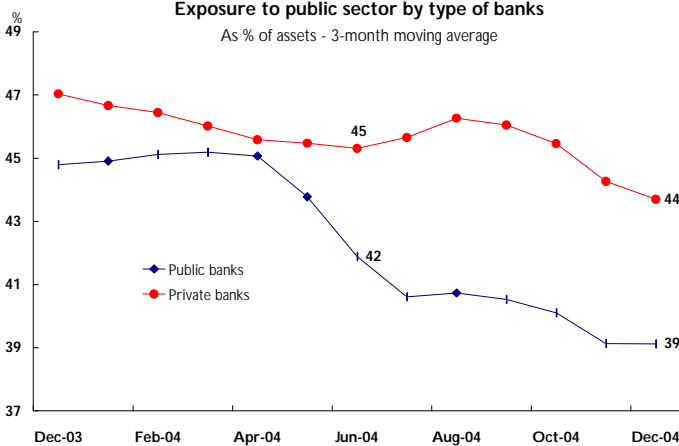
Source: BCRA

Chart IV.8
Public and private sector credit risk
As % of assets - 3-month moving average



Source: BCRA

Chart IV.9
Exposure to public sector by type of banks
As % of assets - 3-month moving average

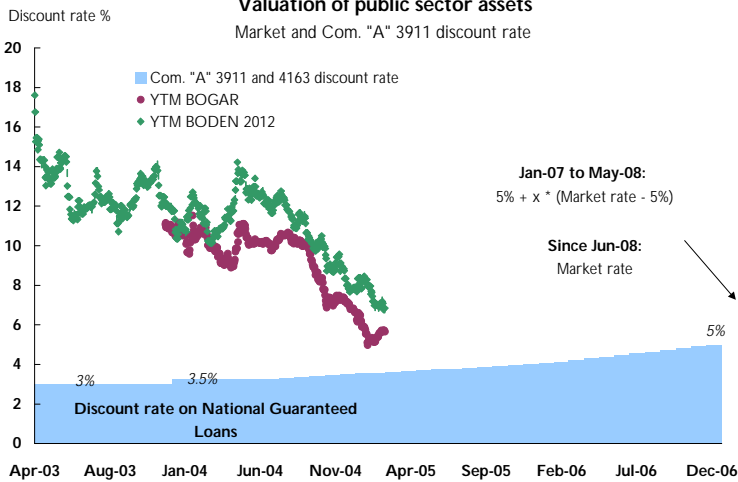


Source: BCRA

⁴ The definition of lending to the public sector adopted by the FSB (see Glossary) does not include holdings of securities issued by the Central Bank.



Chart IV.10
Valuation of public sector assets
Market and Com. "A" 3911 discount rate



Source: BCRA

portfolios, such as Secured Loans, BOGAR (paying monthly installments as from March) and BODEN 2012 (with a first annual installment payable in August).

In addition, the continuous downward adjustment to the value of public sector assets leads to predictions of a gradual decline in the exposure of banks to the national and provincial governments. This is a result of the regulations designed to gradually adjust the valuation of securities and loans to market rates⁵. As the rate used to discount these assets closes on the discount rate, banks will be in a better position to sell them (see Chart IV.10). With the imminent closing of the sovereign debt exchange, further corrections could take place in the valuation of public sector assets⁶. It should be borne in mind however that the exposure of the financial system as a whole to securities eligible to participate in the exchange is relatively low.

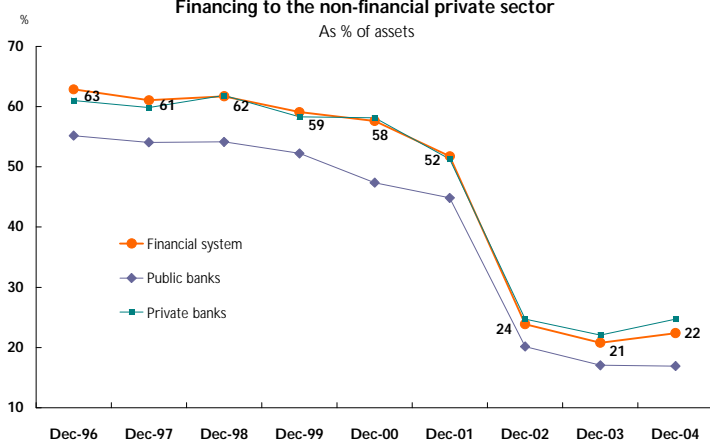
In addition to the gradual reduction in exposure to the public sector, there has been a decline in the credit risk implicit in this exposure. It is estimated that in the short and medium term public sector payment capacity will be strengthened by various factors: record revenue levels, fiscal discipline (at both national and provincial levels), an improved financial profile as a result of the debt exchange and the potential opening up of international credit markets (see chapter on Financial system debtors, page 25).

IV.2.2. Private sector

In the context of a lower repayment risk from private sector counterparts (see chapter on Financial system debtors, pages 21 and 26), banks were able to increase lending without compromising the quality of their assets. Indeed, delinquency rates benefited significantly from the increased volume of new loans⁷ (better quality lending, having been granted in a more favorable context), and from a significant drop in the volume of loans rated as non-performing. This latter factor was mainly a reflection of the steady progress made in the restructuring of corporate liabilities, the return to normal settlement of liabilities by various agents in the economy, and the elimination from balance sheets of the worst loans (either by means of write-off of balance sheet). Together with increased lending activity in a context of lower implicit credit risk, these factors led the portfolio non-performance rate to record levels similar to those in force at the end of 2001.

For the first time since 1998, lending to the private sector returned to growth in the first half of 2004. This change in trend accelerated during the second half of the year, so that by the end of 2004 loans to the private sector represented 22% of total assets: 2 p.p. higher than in the previous year (see Chart IV.11). The low current level of lending to the private sector, almost 40 p.p. below that recorded prior to the crisis, in the new macroeconomic context represents a considerable margin for growth in exposure to this sector. Any increase in this area will also provide potential for a recovery in financing margin, given the high current participation in loan portfolios of lending to the public sector and liquid assets, items with a lower relative yield.

Chart IV.11
Financing to the non-financial private sector
As % of assets



Source: BCRA

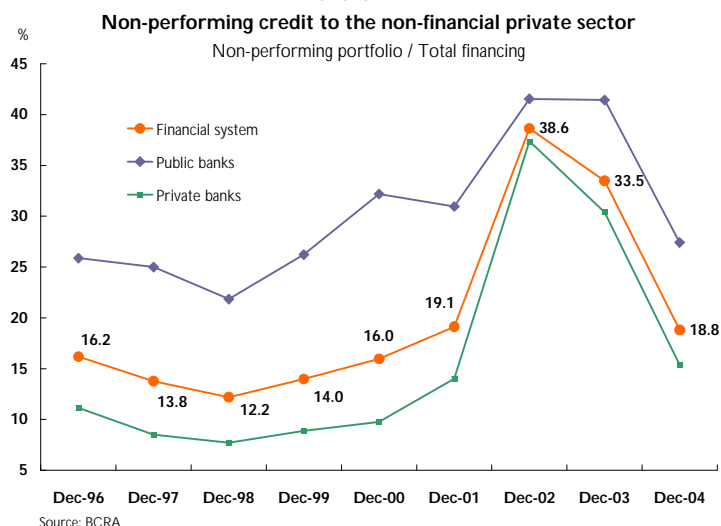
⁵ Com "A"3911 and modifying regulations.

⁶ See Com "A"4270.

⁷ The loans heading includes loans (excluding provisions), other credits from financial intermediation, assets under financial leases, and sundry credits linked to the sale of immobilized assets (see ordered text of the Debtor Classification on the BCRA website).



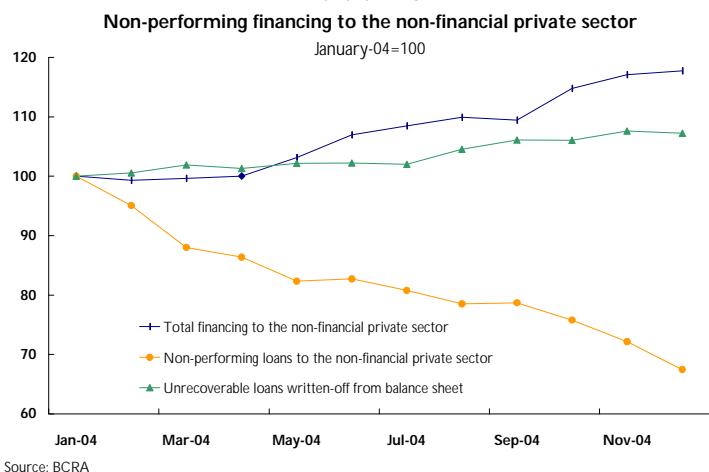
Chart IV.12



In a context in which economic activity rose at a faster rate than expected, increased exposure to the private sector resulted in an improvement in the quality of bank portfolios. In the second half of 2004 the combination of higher lending totals and a drop in non-performing totals enabled significant improvements to be made: non-performance fell to half the peak reached in mid-crisis, to a level of 18.8% for the system as a whole, slightly below the level at the end of 2001 (see Chart IV.12).

The drop in loans classified as non-performing (levels 3 to 6) was a key factor in the development of the portfolio indicator (see Chart IV.13). The fall in the impaired portfolio is explained by various factors: changes in Central Bank regulations, favorable prospects for recovery, the normalizing of payments by certain debtors, the debt restructurings that took place, sales of non-performing portfolios and the transfer to write-off of balance sheet of loans considered to be unrecoverable¹.

Chart IV.13



Analysis of the development of classification of loans in effect at the beginning of the half-year evidences significant stability (80% of loans maintained their classification). This is particularly clear in the better quality segments: of the loans rated in level 1 in June, only 2.5% recorded a deterioration in the second half of 2004 (see Table IV.1). There was a notable positive reclassification in the least severe of the non-performing categories, with 20% of loans that had originally been classified as level 3 (with problems or defective compliance) having become performing.

This improvement has taken place both in private banks (with a non-performing rate that has fallen almost 6 p.p. in the half-year to a level of 15%) and in public banks (down almost 7 p.p. to 19%). Notable progress has been recorded by private banks with a nationwide scope. These are large institutions with a significant presence in commercial lending markets, which suffered a greater relative erosion of their portfolios during the crisis. Although the portfolios of these banks continue to record a delinquency rate (17%) that is higher than that for the rest of the private bank sub-groups, their steady improvement has led the progress seen by the private bank portfolio as a whole.

Table IV.1

Transition matrix June 2004 / December 2004
Weighted by amount - In %

		December 2004								TOTAL
		1	2.a	2.b	3	4	5	6	Write off (*)	
June 2004	1	89.1	1.4	0.1	0.5	0.3	0.1	0.1	8.4	64.4
	2.a	18.1	49.7	14.9	8.3	2.2	0.1	0.1	6.7	6.9
	2.b	25.2	1.5	61.7	9.7	0.6	0.0	0.0	1.3	2.2
	3	9.1	10.7	0.4	59.3	15.3	1.2	0.1	3.8	5.3
	4	5.7	1.0	0.4	4.9	59.1	14.8	1.2	12.9	7.2
	5	2.7	0.4	0.1	0.6	0.7	73.8	0.2	21.5	12.8
	6	11.6	1.0	0.0	0.1	1.9	2.3	61.3	21.8	1.2
TOTAL	60.6	5.1	2.5	4.7	5.5	10.6	0.9	10.0	100.0	

Figures based on debtor information at the start of the exercise

(*) Includes both repaid financing and that charged-off from balance.

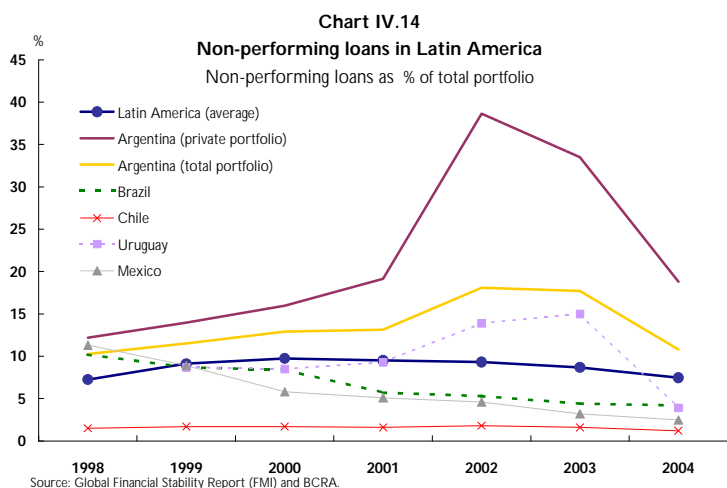
Source: BCRA

In general terms, although current non-performing levels have shown a significant recovery compared with the peaks recorded at the height of the crisis (when the non-performing level reached 40%), there are still improvements to be made if single-digit indicators are to be achieved. This would imply approaching the average non-performing rates in emerging economies: non-performing loan indicators in Latin America in recent years have remained within an average range of between 8% and 9%² (see Chart IV.14).

Private sector credit risk coverage by provisions continued to record a positive trend. The marked decline in loans classified as non-performing was far higher than the drop recorded in provision balances, taking the ratio of provisions to total non-performing

¹ Central Bank regulations require that six months after being classified as unrecoverable (provided for at 100%), loans not recording any improvement in classification must be eliminated from assets and transferred to memorandum accounts. Corrected for the transfer to write-off of balance sheet in the half-year, the non-performance of the financial system has gone from 33.5% at the end of 2003 to 20.8% one year later.

² Global Stability Report (IMF)



loans from 90% to 100% in the second half of 2004³. This behavior was seen in both private and public banks (see Chart IV.15), although in the latter group the drop in impaired loans was much more marked than the reduction in provisions, as could be seen from the coverage ration in excess of 100%.

Rising provision coverage in the context of a still low exposure to credit risk and the continued capitalization of the financial system was transformed into a lower exposure of net worth to credit risk (see Chart IV.16). Non-performing loans not covered by provisions in relation to net worth recorded a virtually zero rate at the end of 2004, having traditionally stood at close to 20%. This shows the very low rate of net worth erosion as a result of unexpected uncollectability in the non-performing portfolio.

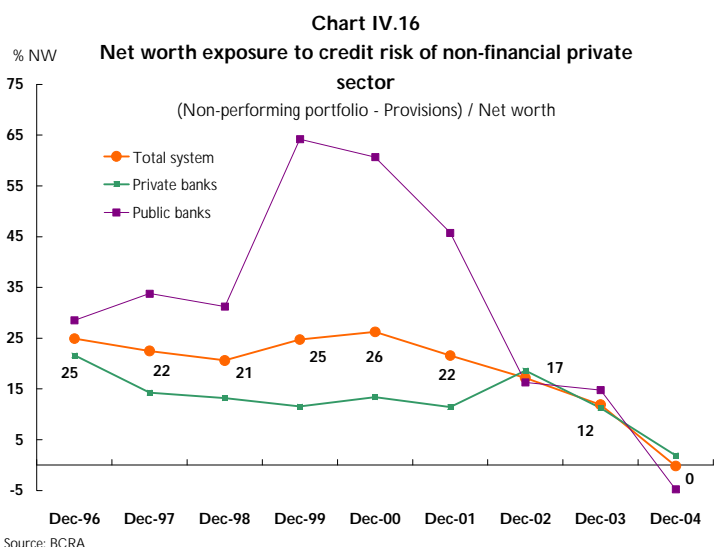
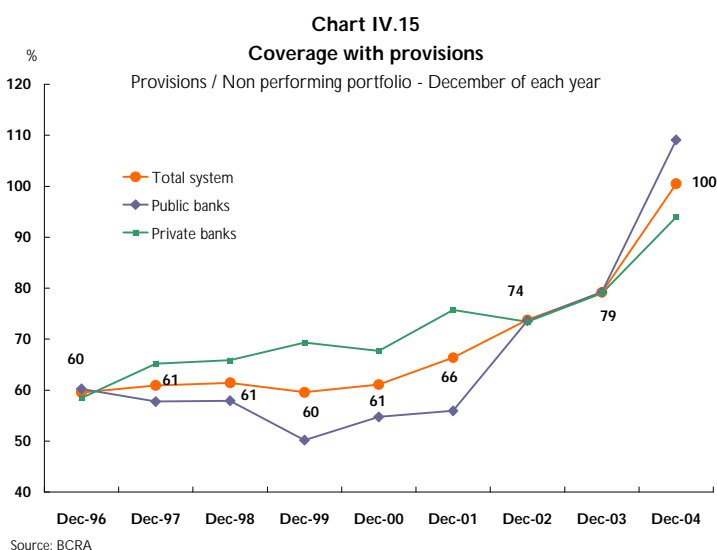
Expectations in relation to counterpart risk being faced by the financial system continue to be favorable in the case of the private sector, given the prospects that exist for a steady growth in lending in a healthier macroeconomic climate. As a result of the low risk-return trade-off, still attractive for banks, and the low level of credit in a context of rising investment needs, it is expected that banks will continue to increase their exposure to the private sector. As has been seen to date, this increased exposure, together with continued reclassification activity will ensure the positive trends in portfolio quality and yield will be maintained. The possibility of achieving a private sector loan portfolio quality in line with the level appropriate for an emerging economy will be further enhanced by additional gains in the matter of the restructuring of corporate liabilities⁴ and the positive effect on the loan market of the soon to be concluded sovereign debt exchange, enabling an increase in the loan offer with a low level of implicit risk.

Corporations

In the second half of 2004 banks continued to revitalize their lending to the corporate segment, as had been seen since the beginning of the year⁵. After reaching a turning-point in the first quarter of the year, lending to companies increased at an accelerating pace. In this new context, in which the corporate fabric is recording improved activity levels and showing signs of positive prospects for its financial position, leading to a lower counterpart risk for banks, this incipient increase in exposure to the corporate sector will lead to an improvement in bank financial margins and a continued recovery in the quality of its assets.

All sectors increased their bank borrowing (see Chart IV.17), including those that were still recording declines in the first half of the year (construction and services). Nevertheless, manufacturing industry and primary production continued to lead the increase recorded in commercial lending, in line with the recovery in activity in those sectors (see Chart IV.18).

In addition, the portfolio of lending to these two sectors currently records the best quality indicators (in both cases, the non-



³ The ratio rose from 92% in June to 101% in December if the denominator considers exclusively those loans granted to the private sector.
⁴ Com "A"4254 issued at the end of 2004 postponed until December 2005 the temporary regulation (introduced at the end of 2003 by Com "A"4060) allowing commercial portfolio debtors agreeing repayment schedules arising from duly approved in or out of court schemes of arrangement or entering into payment agreements with creditor financial institutions, or from private arrangements with the financial institution, to be reclassified as normal, as long as they count on the prior approval of the Board of the lending institution.
⁵ For purposes of analysis, loans to companies are those granted to legal persons (whatever the type of loan) and commercial credit financing granted to individuals. Data analyzed has been taken from the Debtor Status Report.



Table IV.2
Transition matrix June 2004 / December 2004 - First larger debtors
Larger debtors / Overall financing

		Dec-04								TOTAL
		1	2.a	2.b	3	4	5	6	Write off (*)	
June 2004	1	86.5	0.2	0.3	0.1	0.0	0.0	0.0	13.0	54.6
	2.a	6.9	49.5	27.3	8.8	0.6	0.0	0.0	6.9	13.3
	2.b	30.4	0.0	58.2	11.4	0.0	0.0	0.0	0.0	6.5
	3	3.2	10.7	0.0	67.2	16.1	0.0	0.0	2.9	11.6
	4	4.1	0.0	0.0	7.4	59.2	7.4	0.0	21.9	9.4
	5	0.0	0.0	0.0	0.0	0.0	92.2	0.0	7.8	2.8
	6	25.7	0.0	0.0	0.0	0.0	0.0	49.7	24.6	1.9
	TOTAL	51.3	7.9	7.6	10.4	7.5	3.3	1.0	11.1	100.0

Figures based on debtor information at the start of the exercise

(*) Includes both repaid financing and that charged-off from balance

Source: BCRA

performing rate is below 20%, after recording levels of close to 50% during the crisis). In a context of steady improvement in the payment capacity of companies, new loans represent a considerably lower credit risk, resulting in improved loan quality. This fact, added to the continued refinancing activity being carried out by large corporations, led to a marked recovery in portfolio quality indicators (Chart IV.19), reflecting the fact that increased exposure by banks to the most active sectors has been beneficial.

The impact of liability restructuring was particularly significant in the case of larger companies. Analysis of the performance of loans at June 2004 to the 100 leading debtors in the financial system shows that 12% of the loans that were non-performing improved their classification in the second half (see Table IV.2). There has also been notable stability in loans with better ratings, in part a reflection of the improved quality of new loans that already existed at the end of the first half of the year.

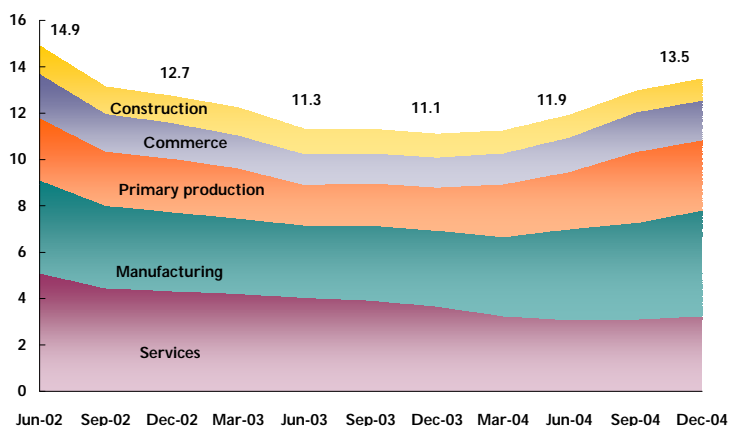
The type of lending to corporations showing the greatest dynamism during the second part of 2004 was that backed by promissory notes. As a result, this category recorded one of the largest drops in delinquency rates, together with pledge-backed loans and mortgage lending (Chart IV.20). Nevertheless, overdrafts continue to be the line with the lowest non-performance (12%). Overdrafts and lending against promissory notes, the most dynamic lines in this scenario of lower credit risk, were able to benefit in particular from the growth in good-quality lending. Future gains in non-performance by credit line will mainly be driven by the dynamism shown in each segment (as long as the credit risk remains at a low level) and in progress on the matter of the restructuring of corporate liabilities.

Lower credit risk and declining delinquency, together with the liquidity prevailing in the market, were reflected in a certain downward trend in interest rates paid by the corporate sector: the spread between such interest rates and the cost of funding⁶ at the end of 2004 was almost half that seen one year earlier in the case of current account overdrafts. This downward trend continued into the second half of 2004, although at a slower rate than in previous six-month periods (Chart IV.21).

Lending to related parties remains at a low level, with delinquency levels that were much lower than the corporate average (Chart IV.22). At the end of 2004 lending to related companies continued to account for only 1% of lending to corporations, while the non-performance indicator (close to 8%) recorded a slight fall with regard to its level in mid-year. As a consequence of the prudential regulations in force, there are limits to the amount such lending can increase⁷, with the aim of preventing distortions in decision-making by banks that might result in critical situations for individual institutions that could spread to the system as a whole.

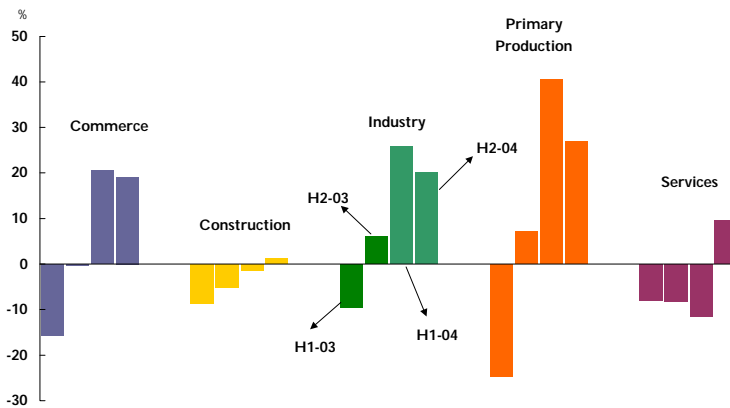
The outlook for coming months as regards credit risk remains positive. In view of the favorable prospects for the business sector, its payment capacity will not be threatened in the short and medium term. As a result, given the still low exposure of the financial system to the business sector, it is expected that it will increase

Chart IV.17
Bank exposure to economic sectors
Financing to legal entities / Assets



Source: BCRA

Chart IV.18
Changes in financing by economic sector



Source: BCRA

⁶ Taking as an approximation the interest rate on time deposits for periods of 59 days, adjusted by the reserve requirement.

⁷ Com "A"2140 and modifications.



steadily, on the basis of the various factors affecting supply and demand of credit.

Demand for credit is expected to continue to recover, given the favorable expectations for the development of the economy, the consequent improvement forecast in profitability, and the favorable conditions for borrowing in pesos. Nevertheless, greater demand will be achieved only slowly, and own funds will continue to provide the main source of financing for the private sector (see Chart IV.23). This is a phenomenon that gained strength during the latest crisis, in an environment noted for changes in relative prices, ample liquidity in many sectors, a cessation of payments by many companies and a decline in financial intermediation.

The outlook for supply is also favorable in view of factors such as the gradual return to normal of bank financial positions, improved corporate payment capacity (which translates into lower perceived credit risk), and the policy implemented by the Central Bank to encourage medium and long-term lending. As regards this latter factor, there are additional measures under study to promote a longer-term funding structure for banks, including the creation of new financial instruments and the recovery of other existing mechanisms.

In addition, the gradual recovery in public confidence in the financial system and the conclusion of the sovereign debt exchange will lower the uncertainty affecting the decision-making horizon. These two factors lead to moderately optimistic prospects in terms of growth in the supply and demand for credit.

Lastly, the progress made in the capitalization of financial institutions will also have a positive influence on the capacity of banks to increase their stock of lending to the private sector. Increased contributions of capital will enable a diversified growth of lending for productive purposes without compromising the solvency of the system (see chapter on Solvency, page 56).

Households

In the second half of 2004, exposure to the household sector remained at the levels reached in the middle of the year, at around 8% of assets (see Chart IV.24). Nevertheless, there has been an encouraging growth in lending to individuals through specific lines such as consumer loans and credit cards. As consumer confidence has risen, these lines have recorded significant growth, and they have gained a larger weighting in terms of overall lending to households. At the end of 2004 these lines accounted for slightly less than 45% of such lending, 7 p.p. more than in mid-year and 12 p.p. more than at the end of 2003. New mortgage transactions remained weak, with repayments exceeding the volume of new loans granted, with negative variations that have meant that total lending to households has declined slightly (see Chart IV.25).

The still low exposure to the household sector in relative terms represents a particularly attractive potential for growth, given the gradual improvement recorded in the sector's repayment capacity. Implicit credit risk has been gradually reduced as a result of the steady gains in terms of employment and wages, leading to a continuous fall in the interest rate differential between consumer

Chart IV.19
Non-performance by economic sector
Non-performing portfolio / Total financing

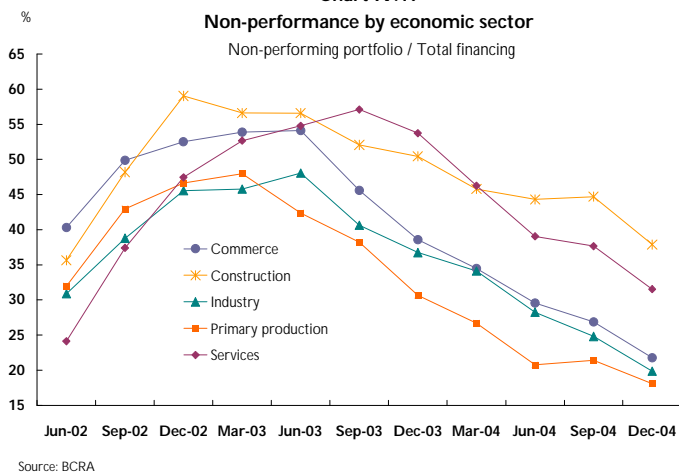


Chart IV.20
Non-performance by type of financing
Lending to business

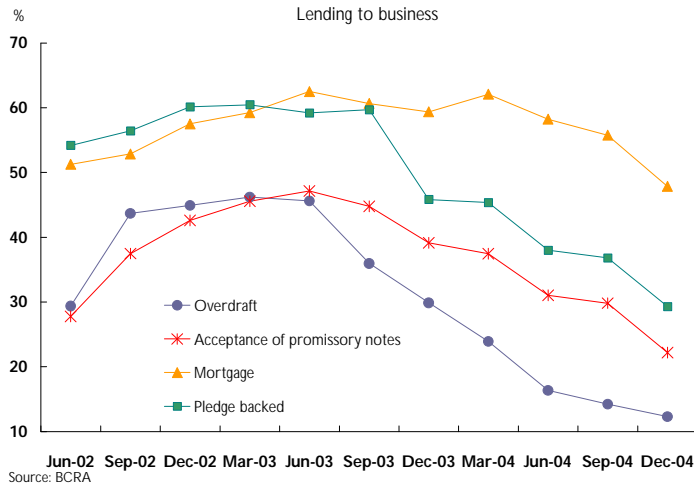
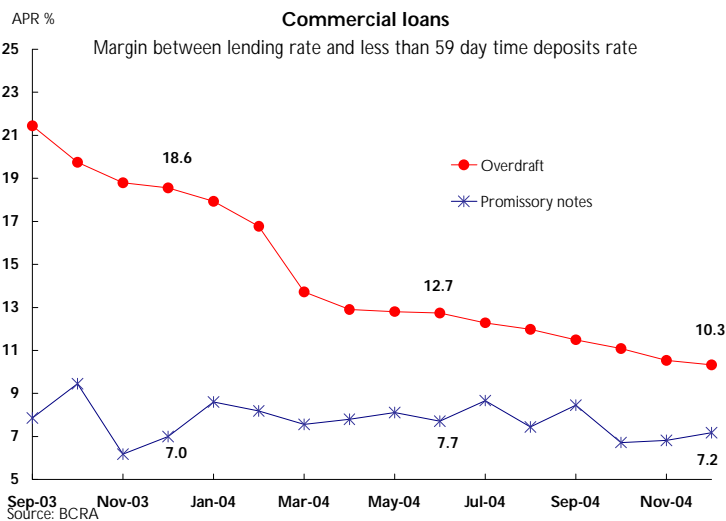
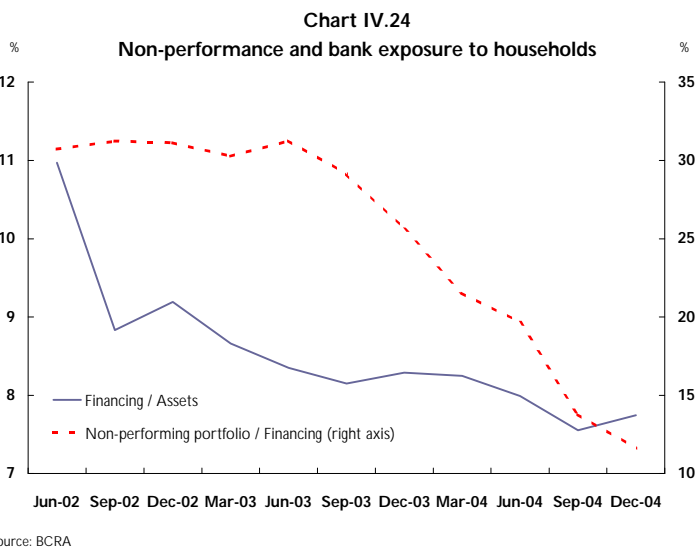
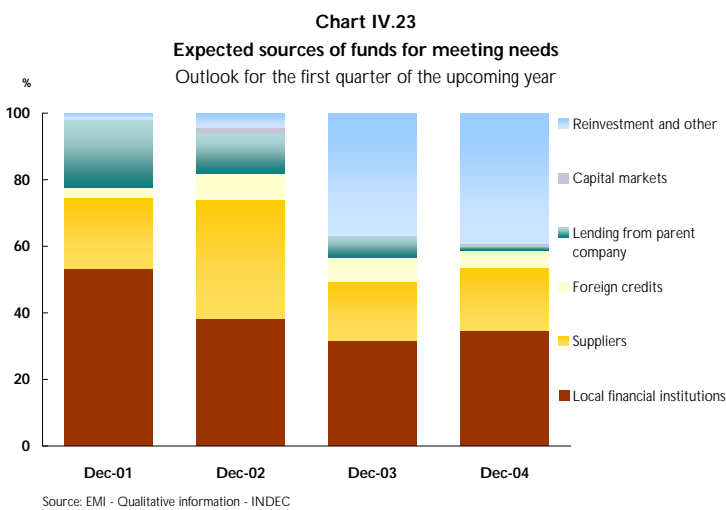
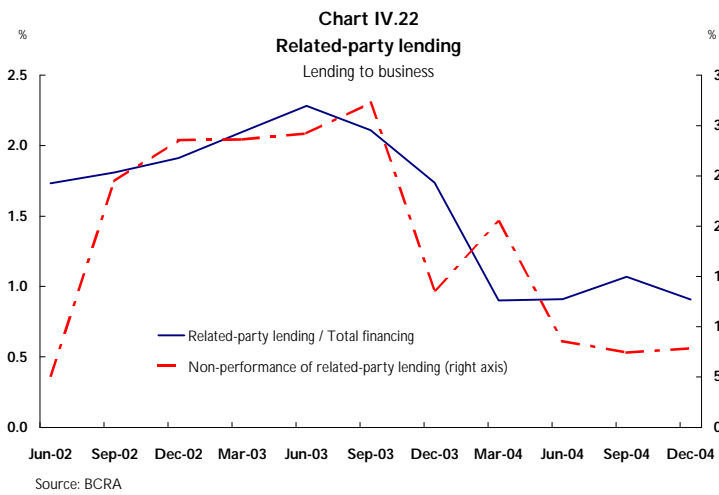


Chart IV.21
Commercial loans
Margin between lending rate and less than 59 day time deposits rate





lending lines (currently the most dynamic) and the cost of bank funding (see Chart IV.26).

Portfolio quality indicators have been able to recover, following the increase in new lending and the steady improvement in household payment capacity. Household loan delinquency at the end of 2004 was very close to 10%, almost half the level of six months earlier and one third of the peak reached at the height of the crisis.

There has been a particularly notable drop in non-performance in the case of the lines currently showing the greatest dynamism. consumer loans and credit cards addressed to households record delinquency rates of 7% and 4% respectively (see Chart IV.27). Mortgage and pledge-backed loans, with a declining non-performing rate of close to 15%, currently show indicators that are a significant improvement on those recorded during the recent crisis. This has resulted in the household sector becoming particularly attractive to the banking system, in view of the risk-return profile from lending to this segment.

In a scenario in which the potential for losses derived from lending to the household sector is declining steadily, it is expected that the supply of such lending will evolve in a positive manner in 2005, still headed by shorter-term consumer loans, which are most likely to increase at present and which have the greatest potential as the use of banking services increases. These lines are associated with one of the most significant developments in capital markets during 2004, the revival of rust funds that have enabled an improved administration of the risks implicit in such transactions. Supplies of longer-term credit will depend on the ability of banks to gain access to long-term funding. The issue of mortgage certificates during 2004 was a positive step in this regard.

In the case of demand for credit, prospects are also favorable, particularly in the in the short and medium term segments, in view of the dynamism shown by consumption. Demand for longer-term credit will only be able to strengthen gradually, as the gap between wage levels and property prices narrows.

Lending to households will also benefit from general aspects such as the end of the sovereign debt restructuring (which will provide greater dynamism to longer-term funding), and renewed confidence in banks.

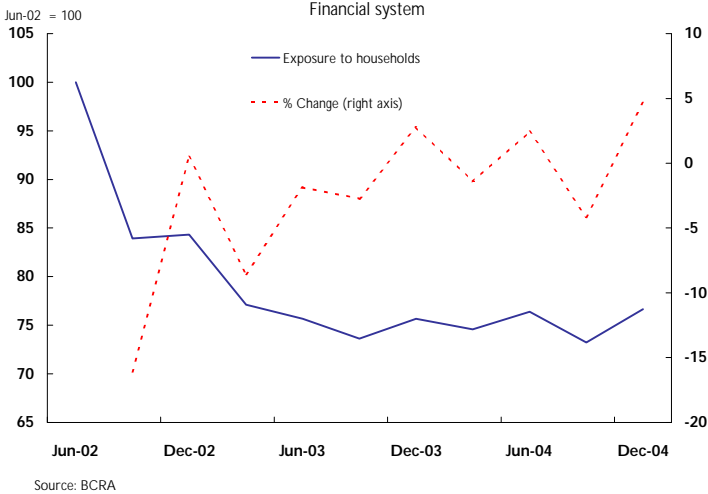
IV.3. Currency and interest rate mismatch risk

Although the financial system has been steadily strengthening its position as regards the principal intrinsic risks from financial intermediation (liquidity and credit), it still has a long way to go to improve the situation as regards the risk from currency and interest rate mismatching risks. Nevertheless, in the second half of 2004 the financial system achieved a relative improvement in its exposure to foreign currency risk, by narrowing the gap between assets and liabilities denominated in that currency.

It is estimated that at the end of 2004, financial system assets adjusted according to CER totaled \$32 billion more than the liabilities subject to the evolution of that coefficient, 42% more than total bank net worth (see Chart IV.28). In addition, bank balance



Chart IV.25
Bank exposure to households
Financial system

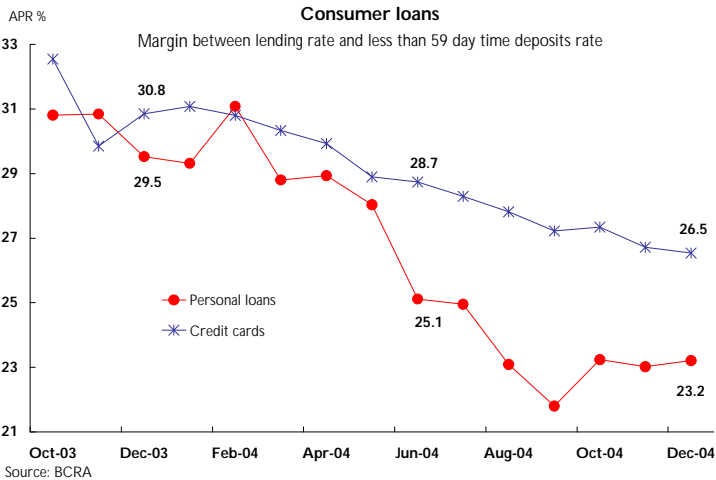


sheets record more than US\$3.2 billion of total assets denominated in foreign currency (mainly US dollars), above their total funding in foreign currency, equivalent to 41% of their net worth.

The main difficulty encountered by the financial system in lowering the balance sheet imbalance from CER adjustment lies in the nature of the items that make it up. On the one hand, almost all the assets adjusted by CER consist of lending to the public sector, which has a relatively long average life. On the other, most CER-adjusted liabilities are made up of bank debt owed to the Central Bank. The balance of these lines declines gradually in line with the funds generated by the servicing of the public sector assets delivered in guarantee, under a scheme known as matching.

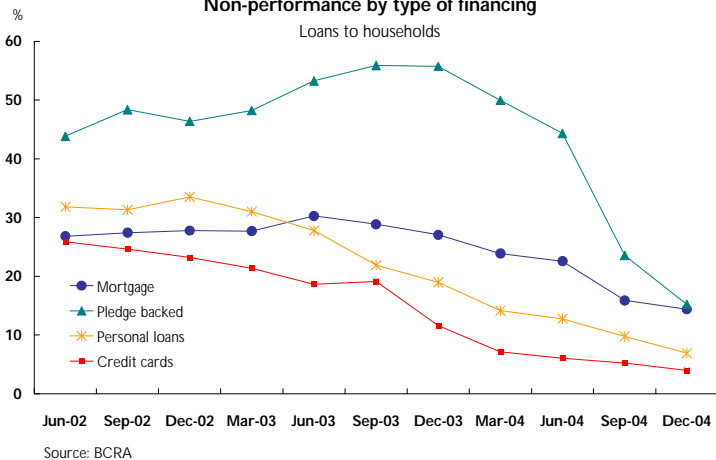
In the current context of low real rates of interest, the asset position in CER-adjusted items has a positive effect on the profitability of the system as a whole. In 2004 the financial system earned 1% in terms of assets as a result of the net adjustment or CER items. However, this mismatching is precisely one of the sources of potential volatility in financial system results in the face of changes in price levels, and particularly in the real rate of interest (see Chart IV.29). CER-adjusted assets earn interest at a fixed real rate of interest, whereas bank funding in general accrued variable rates of interest that follow market conditions. As a result, the profitability of the financial system is particularly influenced by the evolution of real interest rates.

Chart IV.26
Consumer loans
Margin between lending rate and less than 59 day time deposits rate



During the second half of 2004 there were no significant changes in the exposure of the financial system to interest rate risk mismatching. The taking of time deposits adjusted by CER (which reduced the mismatching), the increase in the holding of Central Bank CER-adjusted securities (which increases the mismatching), and the settlement of CEDRO certificates (also increasing the mismatching), among other transactions, explain the mentioned behavior. In addition, the settlement in installments of liquidity assistance under the matching mechanism helped to ensure the mismatching remained unchanged, as banks realized assets (from the public sector) and liabilities (rediscounts) adjusted by CER in the same amount. In addition, in the face of a slight increase in the likelihood of a rise in the real rate of interest, even if the CER-adjusted position were to remain unchanged, there would be an increase in the risk to private bank net worth from this type of mismatching.

Chart IV.27
Non-performance by type of financing
Loans to households



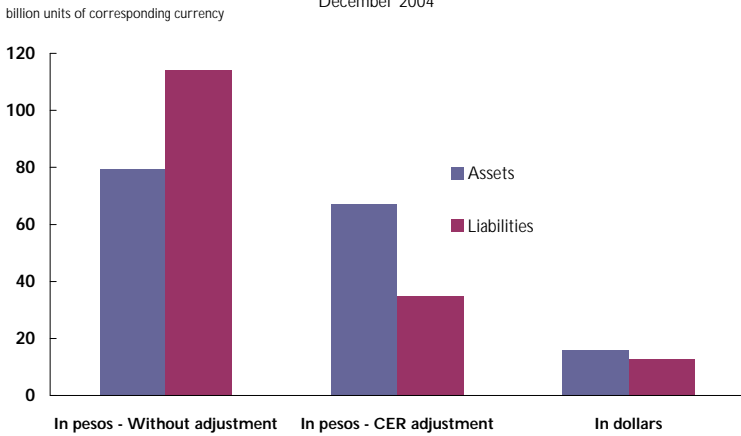
The aggregate financial system still records a significant balance sheet mismatch from foreign currency items. This means that the performance of financial institutions as a whole is closely linked to the development of the peso-dollar exchange rate. As a result, after a slight nominal depreciation of the peso against the dollar, in 2004 the impact on net worth of the mismatch was positive, with the recording of accounting income for 0.4% of assets. In view of the potential variability from this imbalance on bank net worth, and because of the lack of any lender of last resort in dollars, the Central Bank reinforced regulations on foreign currency transactions¹⁵.

In the second half of 2004 notable progress was made on the reduction of exposure to exchange rate risk. Foreign currency mismatching measured in terms of net worth fell 9 p.p. over the six

¹⁵ See page 43 of FSB II-04, available at www.bcra.gov.ar



Chart IV.28
Currency mismatch
December 2004

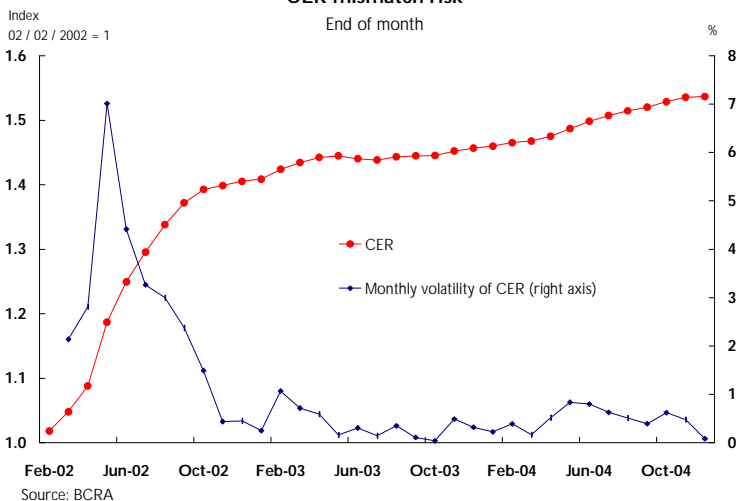


Source: BCRA

months. Despite the settlement of foreign debt, this result was a consequence of lower balances of government securities and liquid portfolio assets denominated in dollars and an increase in net worth. In view of the lower exposure, reduction in the volatility of the peso-dollar exchange rate helps to reduce the risk to net worth derived from foreign currency mismatching (see Chart IV.30).

The Central Bank is promoting market mechanisms to help mitigate both currency and interest rate mismatches. In the second half of the year, markets for financial instruments began to gain in depth. The daily amount of dollar futures trades increased steadily, with a sharp rise in the second half of 2004, when the monthly average was 50% higher than the average for the first half of the year (see Chart IV.31). In addition, at the end of 2004 CER term and interest rate swap markets were created. Although few transactions have been traded to date, the deepening of these markets will enable banks to hedge their real interest rate risks.

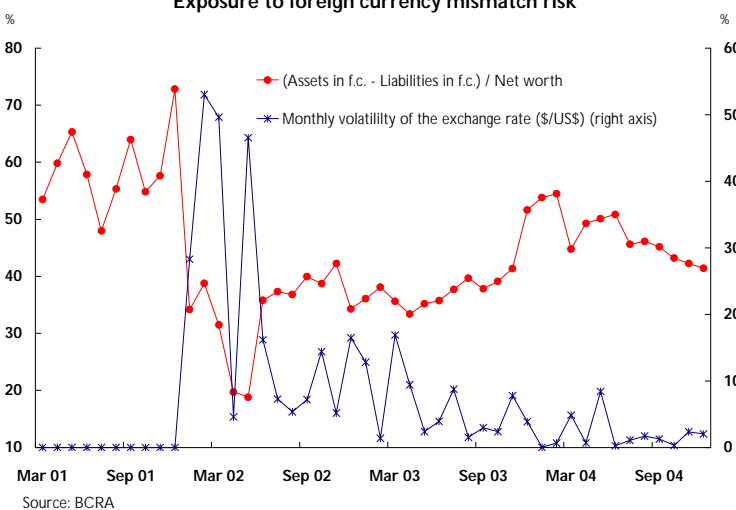
Chart IV.29
CER mismatch risk
End of month



The outlook for 2005 includes a reinforcing of the trend in the second half of 2004. On the one hand, the exposure of the financial system to the risk of mismatching for CER and interest rate will increase slightly, while the risk from exchange rate changes will decline. The main factors impacting in this regard are: the long duration of public sector assets, the positive evolution expected for CER, the outcome of the sovereign debt exchange and the advances and accelerated repayment of installments under the matching mechanism. On factor that could moderate these developments might be the continued rise in adjustable time deposits, if the rising trend seen in recent months is maintained.

In early 2005 the Central Bank introduced a mechanism that enables banks to tender for advanced repayment of the installments planned under the matching mechanism. This will help banks to improve their financial situation and thus their credit ratings, with a consequent benefit from lower funding costs. Although the use of this mechanism will strengthen the financial system, it will have a secondary effect, as it lowers the amount of CER-adjusted liabilities. This means there will be a rise in the risk from exposure to the real rate of interest.

Chart IV.30
Exposure to foreign currency mismatch risk



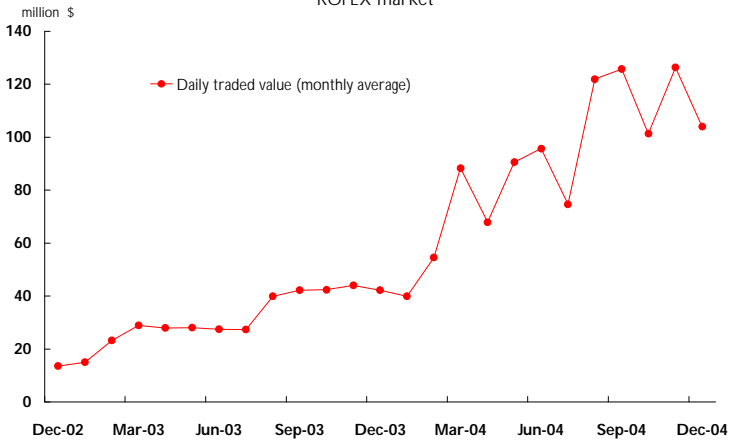
In turn, the result of the sovereign debt exchange will lead to a marginal increase in the average duration of assets, with a moderate impact on net worth sensitivity to changes in interest rate. The delivery of government securities in foreign currency in exchange for securities in pesos at a fixed rate adjusted by CER will increase the level of CER mismatching.

Nevertheless, the financial system could focus its efforts on lowering its exposure to CER and real interest rate risk. If the upward trend recorded in recent months were to persist, one tool could be the taking of time deposits adjusted by CER. The acceleration in the growth of these deposits at the end of 2004 indicate the possibility of a deepening of this market in the short term. In addition, the Central Bank is working on the possibility of banks issuing corporate bonds adjusted according to CER, which represent an improvement on time deposits in at least two regards, as they have both longer terms and a secondary market.

In addition, it is estimated that there will be a gradual deepening of hedge markets, which will begin to reduce and/or neutralize the

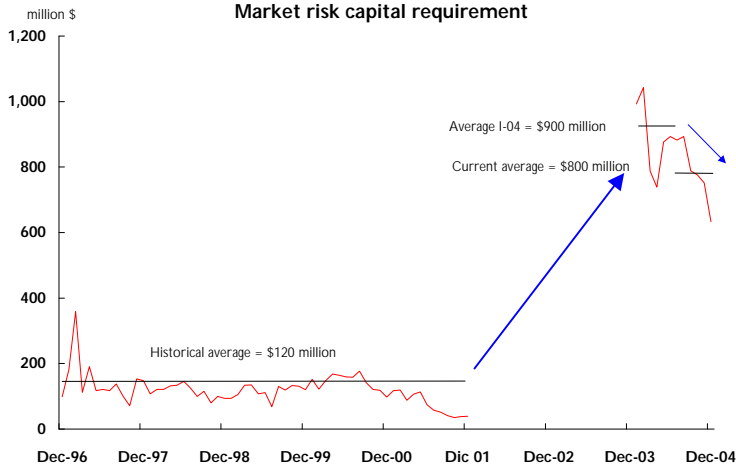


Chart IV.31
Dollar future trading
ROFEX market



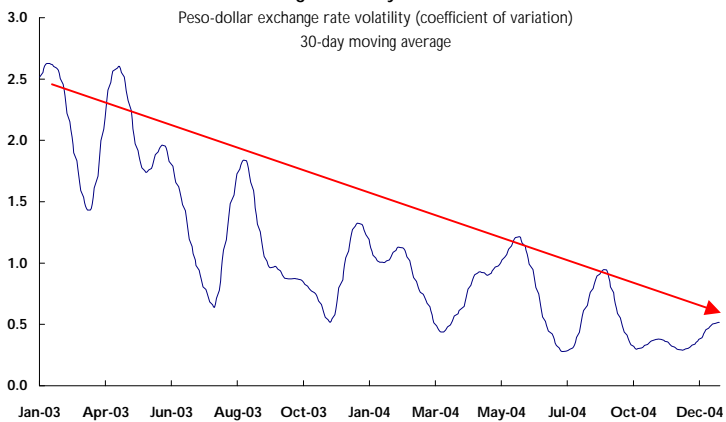
Source: Rosario Futures Exchange

Chart IV.32
Market risk capital requirement



Source: BCRA

Chart IV.33
Foreign currency market risk
Peso-dollar exchange rate volatility (coefficient of variation)
30-day moving average



Source: BCRA

potential affect on equity of the volatility generated by the price of the dollar, inflation, and interest rates, contributing to increased financial stability.

IV.4. Market risk

Exposure to market risk of financial institution balance sheets remained at levels notably above those of the pre-crisis period (see Chart IV.32). This can partly be explained by the incorporation, following the abandoning of the currency board mechanism, of peso-dollar exchange rate volatility to the risks faced by banks.

In the second half of 2004, capital requirements for market risk recorded a slight drop compared with the previous half. The fall in the volatility of the rate of exchange, added to the lower holding of foreign currency assets, were the main factors leading to this drop in the capital requirement for capital risk, which fell by an average 11% (see Chart IV.33). This capital requirement remains low in relation to overall capital requirement, as it accounts for only 10% of the total.

One factor that will have an influence on the capital requirements for banks to face market risk is the carrying out of the sovereign debt exchange. Capital reserves held by banks will enable them to face possible net worth variations associated with the debt exchange. It is expected that the effect of the exchange on the government security portfolio will be minimal, because of the methodology for the booking of the eligible bonds and for the post-exchange bonds to be issued.

Nevertheless, it is expected that the bonds to be received shortly in exchange will reduce market risk through the value at risk from the foreign currency position. This will be modified because in many cases bonds in foreign currency will be exchange for bonds in local currency, implying a reduction in the exposure to foreign currency assets, and therefore a reduction in market risk.

V. SOLVENCY

Summary

In the second half of 2004 the financial system managed to reduce its losses considerably, in line with the pattern of progressive recovery of its indicators of profitability. Still under the influence of the effects of the crisis, throughout 2004 it accumulated a loss of almost \$760 million (0.4% of assets), a figure significantly less than that recorded in 2003 (\$5.3 billion, 2.9% on assets). If, in order to obtain a proxy for the ongoing profitability conditions of the banking business, headings related to the gradual recognition of the effects of the crisis (amortization of court ordered payments and adjustments to the valuation of public sector assets), the 2004 accounting year closed with a profit of \$1.4 billion (0.7% ROA).

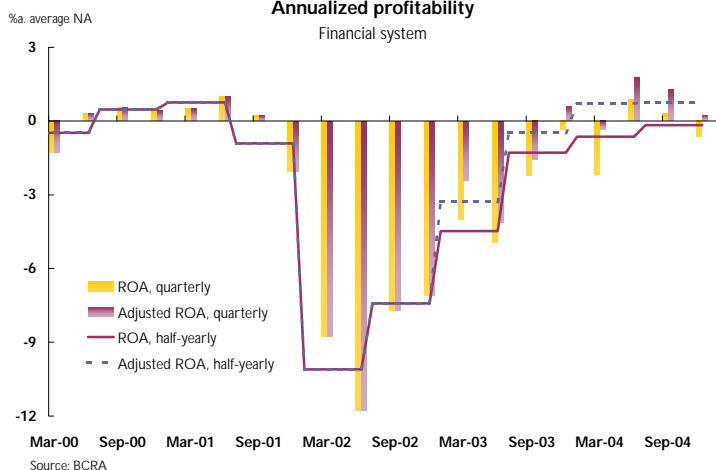
Together with the growth in net interest income, the financial margin showed an important recovery in 2004. This was linked to the increase in credit to the private sector, in a context of falling lending interest rates. As regards 2005, given the potential margin for growth in credit to the private sector, in the present scenario of reduced counterparty risk, a major expansion in credit for production and consumption is expected, with the resulting effect on the financial system's net income. On the cost structure side, in 2004 fewer losses for non-collectibles were posted, due to the solid performance of fundamental variables of the domestic economy and favorable prospects for economic activity during 2005.

This frank improvement in the results of the financial system adds to the procedures for capitalization of various financial institutions, both locally and foreign owned (together, in the second half of 2004 alone the total was \$2.3 billion, almost 11% of equity), marking a framework of continued strengthening of the financial system. At present, the Argentine financial system registers an aggregate regulatory capital compliance adequate to meet requirements set by the Central Bank. In the framework of normalization of prudential regulation, there are commitments for fresh contributions by financial institutions. The latter are especially relevant, given the expectations about the favorable evolution of financial intermediation, to the path of gradual growth in capital requirements that respond to the prudential scheme that was redesigned as from the 2001-2002 crisis.

It is estimated that in the medium term financial institutions will find in the strengthening of profits (higher levels and less volatility) the principal mechanism to face situations of unexpected losses, consolidating the conditions that promote a greater degree of financial stability.



Chart V.1
Annualized profitability
Financial system

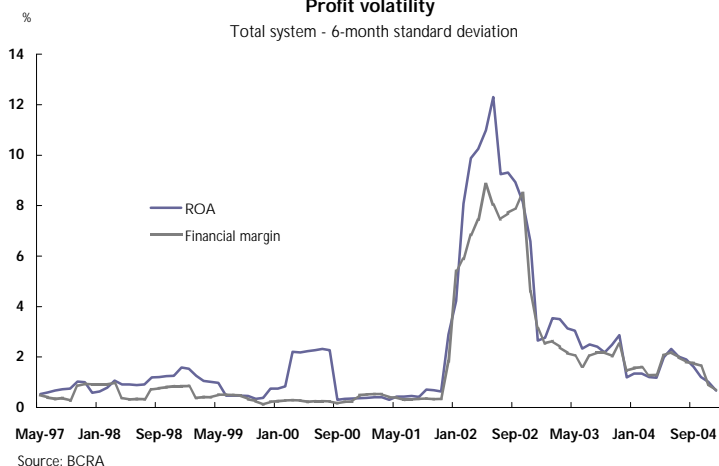


V.1. Profitability

The financial system closed the second half of 2004 with a significant reduction in its losses, thus advancing in the progressive recovery of its indicators of profitability (see Chart V.1). This pattern of reinforcement of results constitutes the basis for a continued recovery of the solvency financial system.

Losses in the second half totaled about \$170 million or 0.2% annualized (p.a.) of assets. This result implies an important advance compared with the losses of the previous quarter (-0.6% a. of assets) and those of the same period of 2003 (-1.3% a.). Furthermore, if for the purpose of having an approximation to current profitability items related to the gradual recognition of the effects of the 2001-2002 crisis are excluded (amortization of court-ordered payments and adjustments in valuation of public sector assets) the result increases to a profit of 0.8% a. on assets. This level is already in line with terms usual in emerging economies and with the values domestically. The 2004 accounting year closes with a loss of around \$760 million (0.4% of assets), way below that posted during the previous year (\$5.3 billion at 2.9% of assets). By excluding the amortization of court-ordered payments and valuation adjustments a profit of almost \$1.4 billion (0.7 % of assets) is obtained for the full year 2004.

Chart V.2
Profit volatility
Total system - 6-month standard deviation



The profitability of the financial system continues to show declining volatility, although the variability remains higher than was seen before the crisis (see Chart V.2). The persistent volatility occurs mainly as a result of the mismatches that exist on bank balance sheets (see page 46 of the chapter on Risk Management) and the adjustments of a non-current nature that are being carried out, including the corrections made in compensations to be received. In both cases, these are factors linked to the 2001-2002 crisis and to measures undertaken in that context.

Table V.1
Profitability structure - Total system
In annualized terms - As % of average assets

	2002	2003	2004	H2-03	H1-04	H2-04
Financial margin	6.5	1.1	3.2	2.8	3.3	3.2
Net interest income	-1.7	-0.5	0.9	0.1	0.8	1.1
Restatement by CER and CVS	3.9	1.3	1.0	1.2	1.2	0.8
Gains on securities	1.7	1.1	0.9	1.1	0.9	1.0
Foreign exchange price adjustments	2.7	-0.5	0.4	0.7	0.6	0.3
Other financial income	-0.1	-0.3	-0.2	-0.1	-0.2	-0.2
Service income margin	1.9	1.9	2.0	1.9	2.0	2.1
Operating costs	-4.4	-4.2	-4.1	-4.2	-4.1	-4.2
Loan loss provisions	-4.7	-1.1	-0.7	-1.0	-0.7	-0.8
Adjustments to the valuation of government securities (*)	0.0	-0.4	-0.2	0.0	-0.3	-0.1
Tax charges	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Income tax	-0.2	-0.2	-0.1	-0.1	-0.3	0.0
Amortization payments for court-ordered releases	0.0	-0.6	-0.9	-0.8	-0.9	-0.9
Other	-1.8	0.9	0.8	0.3	0.6	0.9
Monetary results	-5.8	0.0	0.0	0.1	0.0	0.0
ROA	-8.9	-2.9	-0.4	-1.3	-0.6	-0.2
ROE	-59.2	-22.7	-3.5	-10.7	-5.6	-1.5
Adjusted ROA (**)	-8.9	-1.9	0.7	-0.5	0.7	0.8

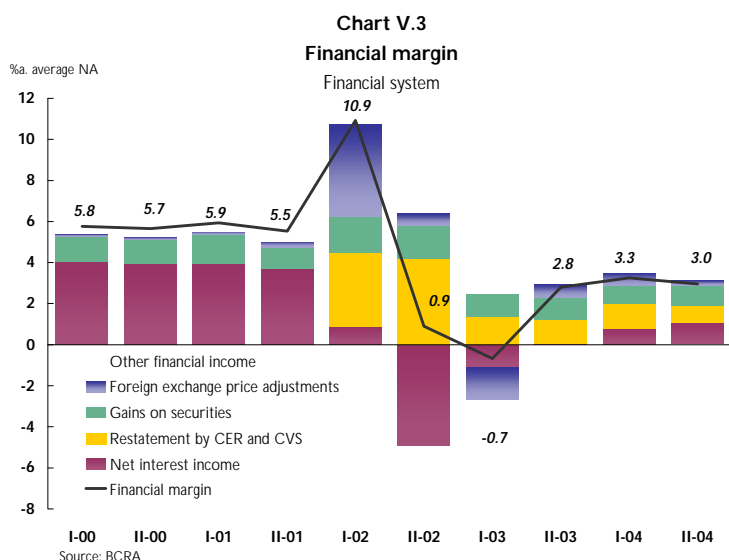
(*) Com. "A" 3911 and complementary communications.

(**) excluding amortization of payments for court ordered releases and the effects of Com "A" 3911 and complementary communications.

Source: BCRA

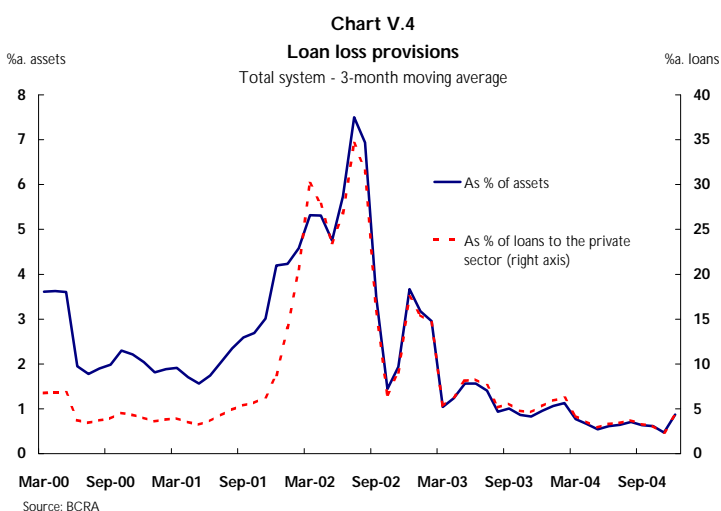
In the second half of 2004 the banks managed to sustain the recovery of the financial margin attained during the earlier semesters, while profits from services maintained a rising trend (see Table V.1). The cost structure did not show significant changes, with a slight rise in operational outlays and bad loan charges. In this context the half-yearly change in profitability was led by an increase in sundry profits, a fall in adjustments to public sector assets and a smaller accrual of income tax.

The financial margin was maintained at around 3% a. of assets (see Chart V.3) during this half year. This is a significant advance when compared with the negative levels recorded until the first half of the previous year. However, during the second half some changes in the composition of the margin were observed: an increase in profit from interest and a smaller restatement for the price-indexed Reference Stabilization Coefficient (CER), although the sum of both headings remained stable compared with the first half of the year (at around 2% a. of assets). Indeed, banks were able to offset the fall in adjustments by CER accrual (as a consequence of a context of lower inflation) with the fruits of their efforts to expand credit to the private sector.

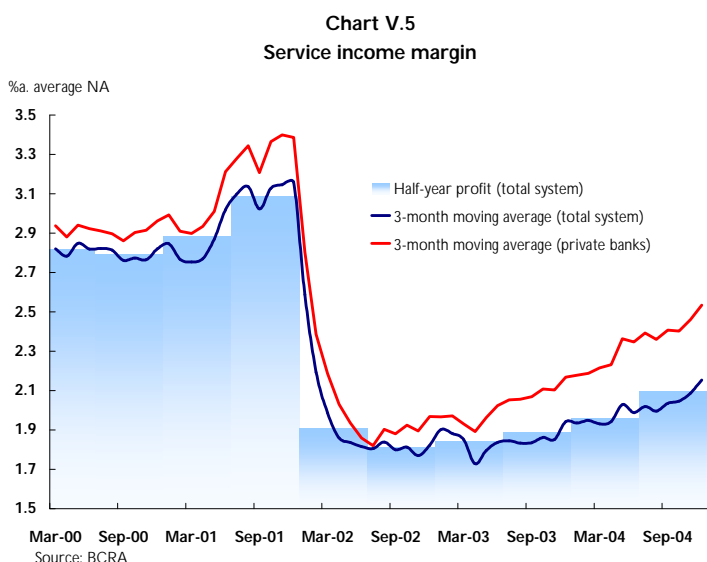


The increase in revenues from interest in this half was much higher than the growth of the respective outlays. In a context of falling interest rates on loans, the growth in interest revenue was due to the increase in outstanding loans. This contrasts with the improvement shown during previous periods, when gains were mobilized by the fall in the cost of obtaining deposits, in a scenario of normalization of the financial system and the recovery of liquidity. In a manner consistent with the sustained increase in private credit¹⁶ in a context where the total balance is still low in terms of GDP, the growth of interest revenue is expected to continue leading the progressive recovery of financial margins.

The slight increase from the first half in gains from securities, that reached 1%a. of assets, also spurred the financial margin. This advance was led by greater profits from government securities, consistent with the sustained recovery of fixed income assets, although the heading also reflected the negative impact of various adjustments to the valuation of portfolio assets. In addition, the increase in results from securities was partly offset by a fall of the yield on transitory holdings. The larger return on assets allowed to compensate in part for the fall foreign exchange adjustment. Due to changes in exchange rates during the second half of the year and the positive net holdings of securities in foreign currency denominations of the financial system (see page 46 of the chapter about Risk Management), smaller profits were posted for revaluation of accounts. The differences in exchange rates were further impacted by corrections carried out on estimated compensations.



The increase of credit in a context of more solid fundamentals for the real economy not only had favorable repercussions on interest revenue, but also allowed costs associated with provisions to remain at low levels when compared with recent experience (see Chart V.4). Indeed, charges for non-collectibles rose very slightly, to 0.8%a. on assets; which means an advance when compared with the same period a year earlier (with charges above 1%a. of assets) and are already far from the extraordinary levels posted during 2003 (almost 5%a. of assets). The lesser need for current provisions occurs in the context of sustained improvement in the quality of the private finance portfolio, due to the continued progress in restructuring private-sector commercial debts and facing a scenario of more limited credit risk. In terms of improvements in the financial position of the diverse components of the private sector (see pages 21 and 26 of the chapter about Financial System Debtors) efforts for provisions are not expected to grow in the medium term.



Services income margin, which have been gaining a growing role after the crisis (especially in the case of private sector banks), continued exhibiting growth. This heading attained a level of 2.1%a., maintaining the 0.1p.p. semi-annual growth over the past two years (see Chart V.5). These increases reflect gains in terms of efficiency. Measured in terms of the volume of deposits and loans to the private sector, a record level of service income is observed (see Chart V.6), allowing for an increased coverage of operational expenditure. The persistence of this trend is particularly beneficial for the financial system, in so far as it

¹⁶ In the framework of the 2005 Monetary Programme growth in credit to the private sector is estimated at over 20%. The expectations prevailing on the market (as evidenced by the REM) are also close to this figure.



represents a revenue flow with low volatility, helps towards building loyalty of the client base and enables the sustained improvement of the financial margin by cross-selling of different products¹⁷. Expectations are also favored as the outcome of the sovereign debt swap is faced. The imminent closure of the principal factor of local uncertainty, allows for estimates of more activity on the domestic capital market which could result in a growth in the demand for related services.

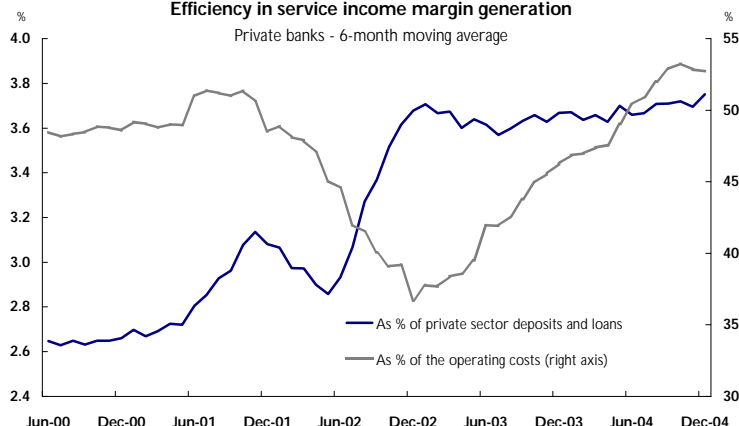
Despite the expansion of banking activity, banks were able to contain the increase in their cost structure: operational expenditure grew very slightly in the second half of the year, reaching a level of 4.2% a. of assets. This rise was due to more payroll payments in a context of gradual recovery of wages, and was also consistent with the greater sales efforts carried out by the larger institutions. These changes offset the gain that stemmed from a lower level of depreciations. On the other hand, the coverage of spending with revenues¹⁸ remained at around 120%; with a slight drop from the previous half (see Chart V.7). In the medium term a steady positive trend in efficiency terms is foreseen; although the expected expansion banking activity may lead to larger management spending, this would be more than compensated by a larger flow of revenues. In addition, certain gains are expected to be seen as a consequence of the greater consolidation observable in the sector (see page 29 of the chapter on Structure and Activity).

Part of the improvement in profitability is explained by an increase in sundry items, which is one of the most volatile headings. In fact, these results represented a gain of 0.9% a. in the second half of 2004, with a semi annual growth of 0.3 p.p.. The positive change in this case was due to the joint effect of lower charges for other provisions, an increase in loan recovery and an improvement in foreign affiliates. The changes mentioned were able to compensate for some fall in released provisions, which had been particularly high during the first half of the year.

Finally, part of the half yearly progress in results is associated with a fall in the amount accrued as income tax, reflecting the deferral to 2005 granted by the Executive Branch. On the other hand, items associated with a gradual recognition of the costs of the 2001-2002 crisis showed some decrease: although the amortization of court ordered payments still represents 0.9% a. of assets (some \$140 million per month), adjustments to the valuation of public sector assets fell 0.2 p.p. to a level of 0.1% a.. It is not expected that these items of the costs structure will show significant changes over the medium term, due to the regulatory schedules¹⁹.

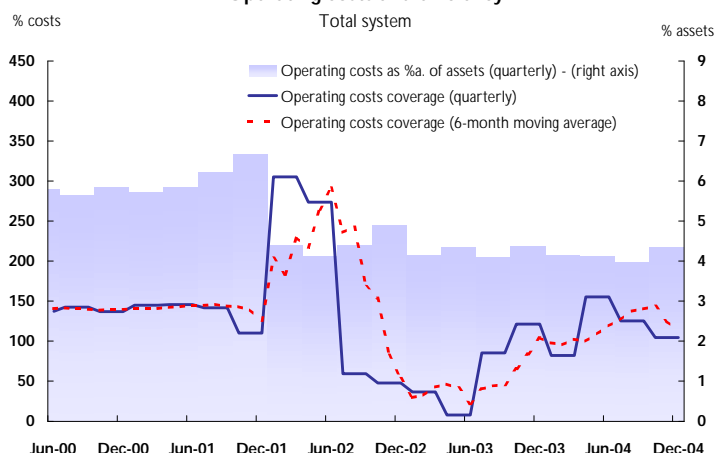
A large share of results in the second half of 2004 was explained by the performance of public sector banks, that posted profits of almost \$350 million (0.9% a.), a clear advance compared to the losses of the previous half (-0.3% a.). The private sector banks, on the other hand, showed some stability in their results, due to

Chart V.6
Efficiency in service income margin generation
Private banks - 6-month moving average



Source: BCRA

Chart V.7
Operating costs and efficiency
Total system



Source: BCRA

¹⁷ An example is the strong activity of some banks in terms of the expansion of insurance and personal loans, due to the crossed sale to users of transactions services (payroll accounts).

¹⁸ Financial margin and fee income.

¹⁹ Communication "A" 3916 for amortization of court-ordered payments, and Communication "A" 3911 with subsequent changes for valuation adjustments.



Table V.2
Profitability structure - Private banks
 In annualized terms - As % of average netted assets

	2002	2003	2004	H2-03	H1-04	H2-04
Financial margin	7.6	2.3	3.0	4.2	3.4	2.6
Net interest income	-0.2	0.1	1.0	0.3	0.9	1.2
Restatement by CER and CVS	1.1	0.9	0.8	1.1	1.0	0.6
Gains on securities	2.5	1.7	0.9	2.0	0.8	0.9
Foreign exchange price adjustments	4.4	-0.3	0.6	0.9	0.9	0.2
Other financial income	-0.1	-0.2	-0.3	-0.1	-0.3	-0.3
Service income margin	2.0	2.0	2.4	2.1	2.3	2.4
Operating costs	-4.8	-4.6	-4.6	-4.6	-4.5	-4.7
Loan loss provisions	-5.0	-1.3	-0.9	-1.0	-0.9	-0.9
Adjustments to the valuation of government securities (*)	-	-0.6	0.0	0.0	-0.1	0.0
Tax charges	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3
Income tax	-0.2	-0.3	-0.2	-0.1	-0.4	0.1
Amortization payments for court-ordered releases	-	-0.7	-0.9	-0.8	-0.9	-1.0
Other	-3.0	1.0	0.7	0.0	0.7	0.8
Monetary results	-7.5	0.0	0.0	0.0	0.0	0.0
ROA	-11.3	-2.5	-0.9	-0.5	-0.9	-0.9
ROE	-79.0	-19.1	-7.2	-3.7	-7.1	-7.3
Adjusted ROA (**)	-11.3	-1.2	0.3	0.3	0.6	0.0

(*) Com. "A" 3911 and complementary communications.

(**) excluding amortization of payments for court ordered releases and the effects of Com "A" 3911 and complementary comuni

Source: BCRA

adjustments carried out to close the 2004 accounting year: a second half loss of \$530 million or 0.9%a. of assets (see Table V.2). Nevertheless, excluding the impact of amortization of court ordered payments and public sector assets; the private banks recorded an adjusted profit of \$10 million, at almost breakeven point in terms of their assets.

Among the private banks there was a mixed performance (see Table V.3). In particular, the subgroups which were already posting profits (regional and specialized retail banks) continued to do so. Unlike the retail banks with national coverage, the retail banks that cater for more limited market niches rely on a higher financial margin (with greater profits from interest and on securities) with a lesser burden of amortization of court ordered payments. In the case of retail banks with national coverage profitability still has the negative impact of non-recurrent adjustments to compensations made to balance sheets (although the way these adjustments were recorded was heterogeneous, in general they affected gains from securities and foreign exchange price adjustments). It may also be observed among government owned banks that the positive results were obtained due to a lower burden of their cost structure (management spending and bad loan charges), a lower share of amortization of court orders and a slightly larger financial margin (with more accrual by CER and better return on assets), allowing for compensation of the lower share of profits from services compared to private banks.

Table V.3
Profitability structure by type of bank - Second half -2004
 In annualized terms - as % of netted assets

	Public banks	Private banks				Wholesale
		Total	National coverage	Regional coverage	Specialized	
Financial margin	3.4	2.4	1.5	5.4	19.1	6.3
Net interest income	0.7	1.1	0.7	1.9	15.4	2.7
Restatement by CER and CVS	1.2	0.6	0.6	0.6	-0.3	0.2
Gains on securities	1.1	0.9	0.5	2.5	2.4	1.4
Foreign exchange price adjustments	0.3	0.1	0.0	0.5	1.7	2.1
Other financial income	0.0	-0.3	-0.4	-0.1	0.0	0.0
Service income margin	1.5	2.5	2.3	3.0	1.9	2.4
Operating costs	-3.2	-4.5	-4.0	-5.9	-17.0	-7.8
Loan loss provisions	-0.5	-0.9	-0.7	-1.3	-4.1	-0.9
Adjustments to the valuation of government securities (*)	-0.3	0.1	0.1	0.0	0.0	-0.1
Tax charges	-0.2	-0.3	-0.3	-0.5	-0.9	-0.4
Income tax	0.0	0.1	0.2	-0.2	-0.8	-1.2
Amortization payments for court-ordered releases	-0.7	-1.0	-1.1	-0.4	-0.4	-0.1
Other	0.9	0.8	0.6	1.2	2.4	1.8
Monetary results	0.0	0.0	0.0	0.0	0.0	0.0
ROA	0.9	-0.9	-1.5	1.2	0.2	0.1
ROE	10.6	-8.3	-14.7	8.0	0.7	0.3
Adjusted ROA (**)	1.8	0.0	-0.4	1.7	0.7	0.3
Weight in total assets (%)	39.1	57.5	45.6	11.3	0.5	2.6

(*) Com. "A" 3911 and complementary communications.

(**) excluding amortization of payments for court ordered releases and the effects of Com "A" 3911 and complementary communications.

Source: BCRA

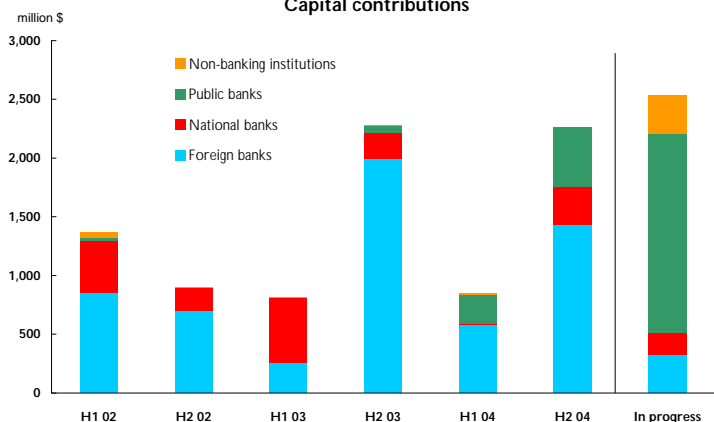
The outlook for profits remains favorable, due to the prevailing trends and in terms of the expected presence of different factors with a positive character over the short and medium term: an improvement in the financial intermediation margin, more profits from services and a reduction of the extraordinary adjustments. It is estimated that the improvement of the financial margin will be the principal engine to reinforce the profits of the financial system, together with the expansion of credit and the sustained improvement in the quality of finance. In terms of the growth expected in the outstanding balance of loans to the private sector, the system should be able to eventually face some increase in the cost of its funding. In terms of the cost of funding over the next few months the positive impact of the anticipated payment of installments to repay debts owed to the Central Bank as part of the matching scheme²⁰. This means an improvement of balance sheets would be reflected in better credit rating of the financial institutions and a fall in their financing costs.

Furthermore, the progressive improvement of transactional activity and the possible recovery of the capital market would also cooperate towards the achievement of a stable and rising profit margin, sustaining the positive trend in terms of service earnings. Although some increasing pressure on operational outlays is expected, the completion of improvements due to the rearrangement of the system's structure should not be underestimated. In terms of these prospects, the continued restoration of profit margins would continue contributing to an improvement in solvency, binding the foundations of a stable financial system.

²⁰ See Communications "A" 4268 and 4282 and Communications "P" 48174 and 48196.

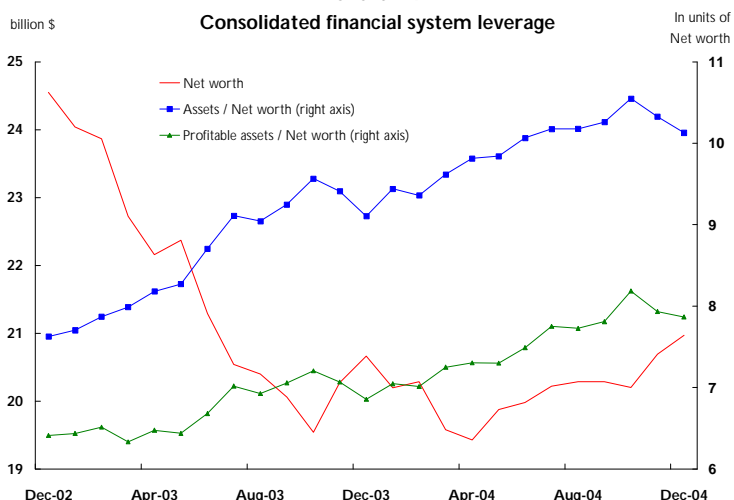


Chart V.8
Capital contributions



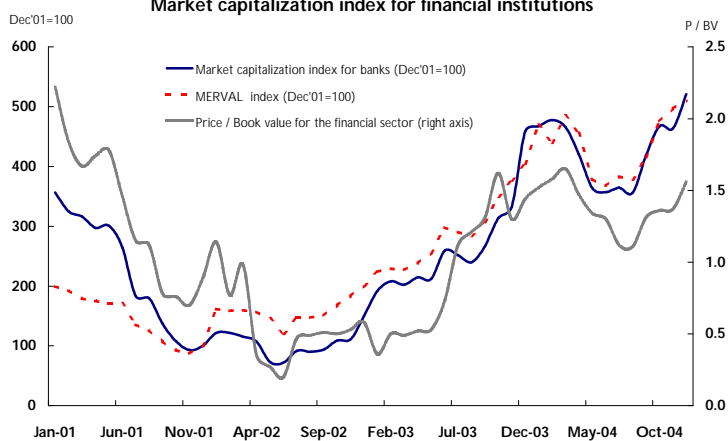
Source: BCRA

Chart V.9
Consolidated financial system leverage



Source: BCRA

Chart V.10
Market capitalization index for financial institutions



Source: BCRA from BCBA data

V.2. Capital position

The soundness of the financial system continued to improve during the second half of 2004, mainly due to the growth of capitalizations carried out and committed to by financial institutions and the trend of recovery of systemic profitability. The indicators of leverage and market signals acted in this direction.

Throughout 2004 the encouraging prospects for local financial activity, associated with a favorable macroeconomic context, stimulated both capitalization decisions of various financial institutions and plans to capitalize in the future. During the second part of the year, these capitalization processes led to a greater degree of solvency of the financial system (equity grew 6.1%). Over the medium term, it is expected that the gradual strengthening of profitability of the financial system will lead to a mainly endogenous growth process for bank capital, reinforcing the direct contributions to capital as a means to strengthen solvency.

The new capital contributions totaled some \$8.0 billion in the period from the beginning of 2002 until 2004 (see Chart V.8), which represented a 38% growth from initial equity. In the second half of 2004 the financial system received capital injections of almost \$2.3 billion, expanding capital by 11%²⁵. Although until the first half of 2004 capitalization of liabilities owed to head offices was the most frequently used mechanism, in the latter half of the year capital injections in cash rose to almost half of new capitalizations.

Foreign owned private banks received almost two thirds of capitalizations carried out in the second half of 2004, which is an evidence of their strategy to expand the presence in the country. On the other hand, national banks also maintained an important share of the new capital injections, in the context of their growing share of the domestic market (see page 31 of the chapter on Business Structure).

Furthermore, a significant volume of capital contributions is still pending exercise, approximately \$2.9 billion, of which almost two thirds pertains to capitalization in installments that began during the second half of 2004. In these processes the public sector institutions are of special relevance.

In line with the growth of capitalization processes and the increase of the assets of institutions in the second half of 2004, the financial system recorded a stable leverage ratio (assets compared to equity) of over 10 units (see Chart V.9). Likewise, the consolidation of the financial system was reflected in the principal market indicators (see Chart V.10). These showed a growing trend in the past months, together with: better

²⁵ In addition, there are other factors such as equity adjustments, variation in profit reserves and non-allocated results, which influenced the equity of the financial institutions.



BOX 3: THE DEPOSIT INSURANCE SYSTEM AND THE ROLE OF SEDESA

The Mexican crisis in the mid 1990s had severe consequences for the Argentine financial system that led to a number of advances in the policy of bank regulation and supervision. Among these, the deposit guarantee insurance system²¹ that was established in 1995 was, at the time, a fundamental tool for the smaller depositors to restore their confidence in local banks. These systems had already been extensively used at a worldwide level for some time. In USA they exist since 1933, while the principal European markets began to use them from the 1980s.

The success or failure of a deposit insurance system is fundamentally dependent on its design. Thus, the institution that manages it, the type of funding and the liabilities it covers are key factors when it comes to obtaining a favorable cost-benefit relationship. On one hand, differences appearing in an international comparison show differences in the nature of the body managing the fund: at times in the public sector, and in other cases in private hands. On the other, the obligatory nature of contributions by the financial institutions, the amounts and maximum interest rate coverage and contributions in contingency cases, are other crucial points on which the different design schemes differ.

In the Argentine case, the private company Sociedad de Depósitos Sociedad Anónima (SEDESA) manages the Deposit Guarantee Fund (DGF). The DGF is owned by the national government, and is made up with the obligatory contributions that are paid monthly by financial institutions. In its role as administrator of the DGF, SEDESA is in charge of handling cases of closure of institutions, paying the insurance on deposits. Under certain conditions, this system sterilizes the credit risk that depositors face due to the probability that the financial institution will be unable to face up to its obligations. In this sense, the insurance acts in two dimensions: by means of its actual actions, by allowing the return of deposits to the savers, and by persuasion, by avoiding other individuals fearing for their deposits, acting as a herd and leading to runs on banks. With this as its purpose, SEDESA was designed to cater for specific situations at banks with solvency problems and not systemic crisis, taking an active part in restructuring institutions.

The guarantee on deposits has a limited scope in Argentina. It covers the refund of the principal deposited together with the interests accrued up to the date the authorization to operate of the institution is withdrawn, for an amount not over \$ 30,000 per person, adding up all that person's accounts. On the other hand, term deposits and balances of sight accounts whose interest rates exceed the reference rate published by the Central Bank are excluded from the guarantee. Neither is there coverage for those deposits entitled to incentives or prizes in addition to the contractual interest rate, in whatever form these are granted (raffles, insurance, services, among others). Finally, transferable term deposits acquired by endorsement are also excluded from the coverage.

In order to make the deposit insurance operative, SEDESA has the following mechanisms:

- Make cash payments to depositors of the amounts covered by the guarantee.
- Carry out capital subscriptions, non-refundable contributions or loans to financial institutions.
- Carry out sales option contracts of assets transferred in favor of the institutions that acquire these assets or make payment of deposits of the original institution.
- Absorb deposits that belong to suspended banks.
- Contract liabilities on account of the DGF.
- Establish repo programs with foreign banks that promote the stability of the financial system.

In its role as manager of the DGF, SEDESA does not receive any compensation. For its operations, outlays must be faced solely with the revenues of the DGF. This is made up with obligatory monthly contributions of financial institutions. The “normal” monthly contribution is 0.015%²² of the average of daily balances of deposits in pesos and in foreign currency.

As a complement, there is a differential “additional” contribution, which results from the various factors that define the implicit risk of each institution²³.

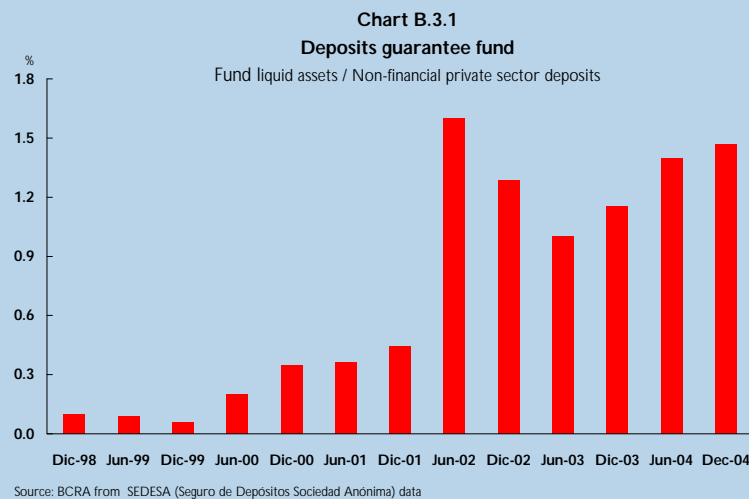
²¹ Law 24.485, Decree 540/95 and modifications

²² The contribution was reduced twice during the second half of 2004, from 0.03% to its current value (Communications “A” 4206 and “A” 4271).

²³ The normal contribution is corrected by means of an index between 1 and 2, to obtain the additional contribution. This weighs three factors: the quality of the assets portfolio, the excess compliance of primary capital requirements (RPC), and when available, the CAMEL grading assigned to the institution by the Superintendency of Financial and Exchange Institution (SEFyC).



The success of the system was such that, despite the severe domestic crisis, in all cases the restructuring of depository institutions in which SEDESA had a part 100% of the deposits were placed at the disposal of their owners. Given the menu of operating instruments available for restructuring cases, SEDESA's mandate is to act with the procedure that generates the "least-cost solution". In particular, SEDESA has participated in many cases in which it has acquired assets or made contributions in order to make restructuring feasible, without it being necessary to pay out the amount of the guarantees. In fact, the most common means of intervention has been the purchase of trust funds, a mechanism used in 60% of the cases. Although to a lesser extent, it has also acquired deposits and made non-refundable contributions. 1998 and 2002 were the years of most assistance on behalf of the DGF, with over 50% of the amounts granted since the regime began. During 2004 SEDESA made no contributions in any of the five cases of closure or absorption of institutions²⁴. At the end of the year, the available balance of the DGF was over \$1.2 billion, which constituted a relatively large amount in terms of total deposits (see Chart B.3.1).



It is necessary to mention that although the system has benefits, especially to smaller depositors, it also has costs. The use of these mechanisms originates moral hazard problems. This is the possibility that the guarantee will undermine incentives for savers to monitor the activities of the bank, allowing the latter to venture into activities with higher risk, benefiting the weaker institutions and generating more risk at a systemic level. This situation leads to a larger need of a regulatory framework and agile and efficient supervision.

In order to cushion these negative effects of insurance on market monitoring, the Central Bank set limits to amounts and interest rates. The limit of amounts is an incentive for larger and more sophisticated investors to carry out tracking the banking operations, while the caps on interest rates punish the financial institutions that exhibit a relatively higher associated risk.

Lastly, in the framework of building up a solid collective safety net for financial institutions, this deposit insurance scheme is supplemented by the Central Bank's faculty to act as a lender of last resort, as mechanisms designed to face solvency and liquidity problems respectively.

²⁴ In January 2005 capitalization of \$188 million in a bank by SEDESA was approved, with the purpose of making the bank meet Central Bank requirements.



Table V.4
Minimum capital by group of banks
 December 2004 - In %

Group of banks	Surplus capital / Capital requirement (*)	Capital / Assets at risk (**)
Public banks	288	10
Private banks	182	15
National coverage	174	13
Regional coverage	170	21
Specialized	121	39
Wholesale	311	40
Non-bank institutions	138	47
Total	199	14

(*) Includes capital requirements arising from credit risk, interest rate risk, market risk additional requirements and forebearances.

(**) Assets weighted by credit risk

Source: BCRA

expectations about bank profits, the virtual increase in capital flows after the government debt swap, and gradualism in the rise of international interest rates.

Added to the context of gradual strengthening of the financial system, is the compliance of prudential rules about minimum capital requirements set by the Central Bank. In the second half of 2004, financial institutions attained a capital compliance of 14% of risk-weighted assets, a level higher than required locally. All groups of institutions surpassed the minimum capital requirements (see Table V.4), with the private sector institutions, in particular specialized and wholesale institutions, those showing the greatest leeway²⁶.

The situation observed at the end of 2004, with high systemic capital integration levels, and a prospect of continuing to increase the solvency of the financial system, is in accordance with various fundamental facts. Firstly, both the expected growth of intermediation activity during 2005, as also the emergence of new opportunities in the scenario following the public sector debt swap, spur the growth in bank capital. In addition, due to the schedule of attenuation of capital requirements laid down by the Central Bank, financial institutions will require a capital increase. It is worth noting that the Central Bank has required that banks submit their business plans, which induces them to prepare coherent budgets in relation to their activities planned for the future, including paths in accordance with their levels of capitalization.

²⁶ It should be noted that, in relation to the effects of the 2001-2002 crisis on the sector, the Central Bank set a scheme for convergence of the valuation of government securities with market values and a schedule for adjustment over time of the requirements for credit risk exposure to the public sector and interest rate risk (see page 21 of Financial Stability Bulletin 1-04).

VI. PAYMENTS SYSTEM

Summary

A safe and efficient payments system is a necessary condition to attain a situation of sustained growth of the economy. The exposure to intrinsic risks and the possibility that a crisis situation could spill over to all the economy make the institutional development and monitoring systems of payment of special interest for central banks. In general terms, the National Payments System in Argentina develops in an environment that observes the main guidelines which have been established as international standards, placing it in an advanced position among emerging economies. The Central Bank continues producing significant advances to make the National Payments System more efficient, granting it national coverage.

In the domestic economy, although at present the principal means of payment is cash, the continued technological change and the growing process of bank usage is generating a diversification process for payment instruments, deepening the use of checks, transfers and both credit and debit cards. In particular, based on the favorable macroeconomic context and despite the Tax on Debits and Credits in Bank Accounts (IDCCB), the use of checks is growing strongly and the level of returned items is at a historical minimum and with better performance than other countries in the region. The growing share of movements by large firms in making use of this means of payment stands out, and is partly due to the effect of the IDCCB.

The Central Bank, by means of an agreement with the financial institutions, has managed to start implementing the project known as Uniform Federal Clearance. This scheme is designed to increase the speed of transactions at a national level and optimize the clearance of values by using electronic registers instead of physical means. In this way, the Central Bank is contributing, like the principal central banks in developed economies, to promote the process of digitalization of payments systems. A clear example of this progress is the expansion of check truncation (the physical document remains at the bank where it has been deposited and only electronic information is transmitted to the institution it is drawn on) to almost all operations at a national level. These improvements will make it possible to both reduce risks and to shrink the costs of using the system of payments.



VI.1. Introduction

The set of instruments, processes and channels through which the funds that make up the system of payments are transferred constitutes a necessary tool for the development of economic activity. According to the institutional arrangements and the particular operating characteristics, systems of payment, in general, tend to generate a significant exposure to different risks (liquidity, credit, operations, etc.) for the different agents involved, which, by their nature, can spread rapidly to all the economy. In general, it is cause for special interest by central banks in setting the conditions to have on hand agile, safe and efficient payment systems. This task acquires greater relevance to the extent that they assume the responsibility for ensuring financial stability.

The Central Bank, together with the Interbank Commission for Means of Payment in Argentina (CIMPRA), is carrying out different tasks to develop a National Payments System (NPS) that covers all the country's geography in a fair and efficient manner. In particular, with the purpose of moving towards the optimization of NPS operations, it has resumed the tasks related to carrying out the stages pending from the Means of Payment Clearance Model that began in 1997, whose final purpose is to achieve the full operation of the Uniform Federal Clearance (UFC).

VI.2. National Payments System

Given the pace of technological progress, and led by both supply and demand factors, economies develop different instruments that operate as commonly accepted means of payment. Although with more emphasis in developed than emerging economies, electronic means of payment are taking the place of traditional physical instruments. Gradually, and tracking world growth and the greater depth and stability of financial systems, it is seen that emerging economies are migrating to regimes in which electronic means of payment achieve an increasing share in the total volume of transactions.

At present, in the domestic economy, cash is the most used means of payment (Chart VI.1). However, the strong growth in bank usage during 2004 highlighted the importance of the use of the financial system as a supplier of means of payment, surpassing pre-crisis levels. Looking forward to 2005 the impact of the bank tax (IDCCB) will be the main disadvantage that the use of the financial system as a means of payment will have compared with cash. Nevertheless, the good growth prospects for 2005, together with a recovery of the level of employment, will boost the use of banks in the economy.

In 2004 the greater solidness of the financial system promoted the use of banks as both a supplier of financial services as a depositary for family savings (Chart VI.2). The above is reflected clearly in the firm growth of private deposits in current accounts (21%) and in savings accounts (42%). In this way, the good health of the financial system boosts the means of payment most commonly used after cash: checks and transfers from bank accounts.

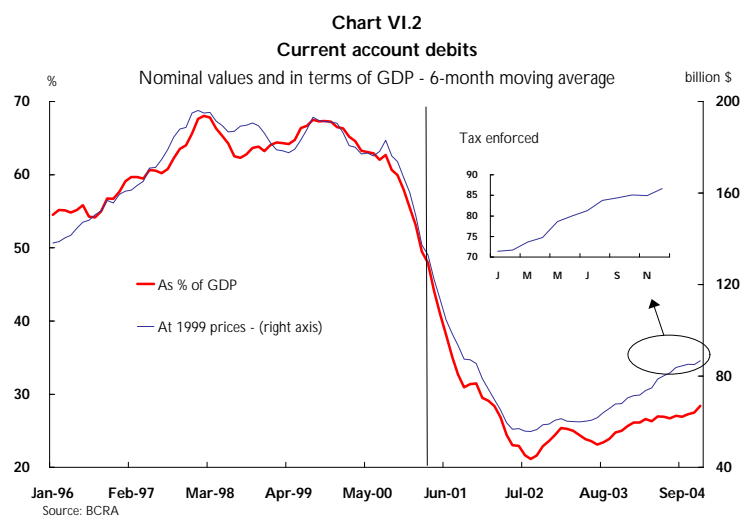
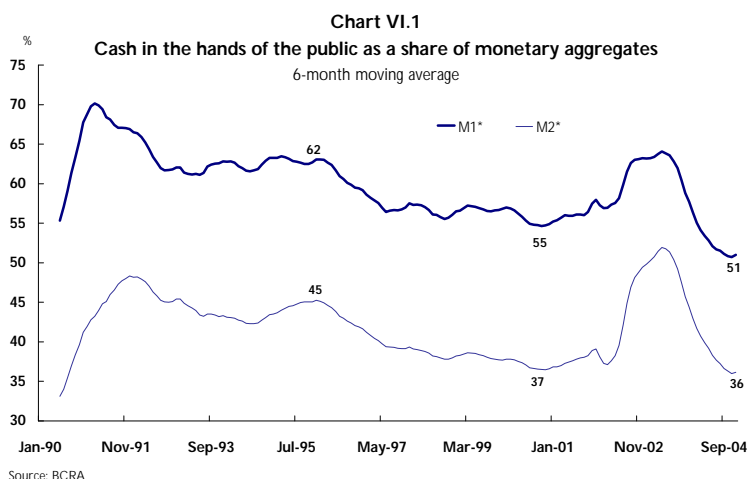
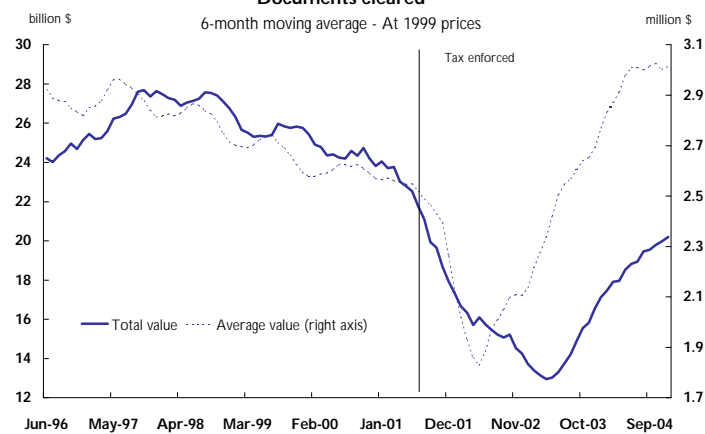




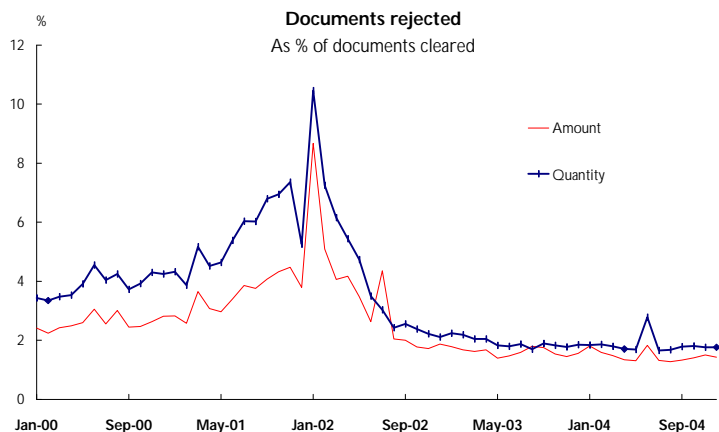
Chart VI.3
Documents cleared



Source: BCRA

The use of checks as a means of payment has been recovering gradually (Chart VI.3). In 2004, an increase of 13% in the number of checks cleared was observed, which meant a rise, in real terms, of 31% in the value cleared. It is worth noting that the increase mentioned fundamentally reflects the performance of transactions in accounts associated with large firms, in so far as the average value of each check cleared has grown significantly in recent years. However, there is still a long way ahead to reach the pre-crisis level of check usage: in 2004 cleared checks were 67% of those registered in 1998, and the value, in real terms, was 28% lower. For 2005, the economic growth forecast, the strengthening of the financial system, expectations about the transitional nature of the IDCCB and the low and stable level of check rejections, will provide a favorable scenario for the future development of checks as a means of payment.

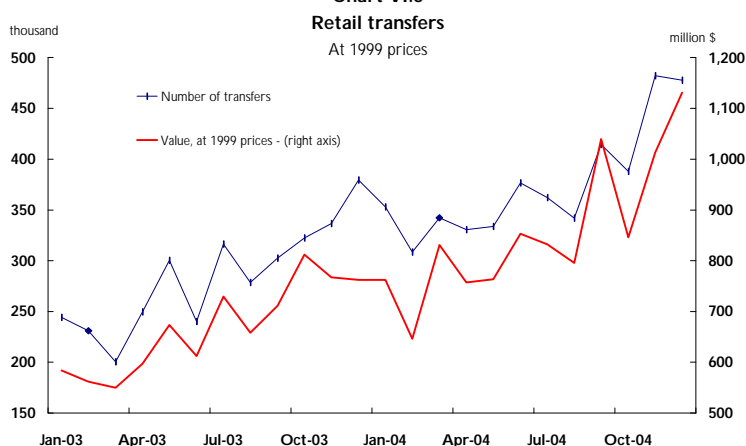
Chart VI.4
Documents rejected



Source: BCRA

As regards the latter, the amount of checks rejected during the second half of 2004 was less than 1.8% of the documents cleared (Chart VI.4). This level, which has shown a gradually decreasing trend since 2003, shows the notable performance of the check as a payment instrument in the domestic economy. On one hand, a share of rejections far below pre-crisis figures is seen. Also, check rejections in the Argentine economy are less than in other countries in the region (over 5% in Brazil). These elements are consistent with a relative efficiency of checks as a means of payment in the domestic economy.

Chart VI.5
Retail transfers



Source: BCRA

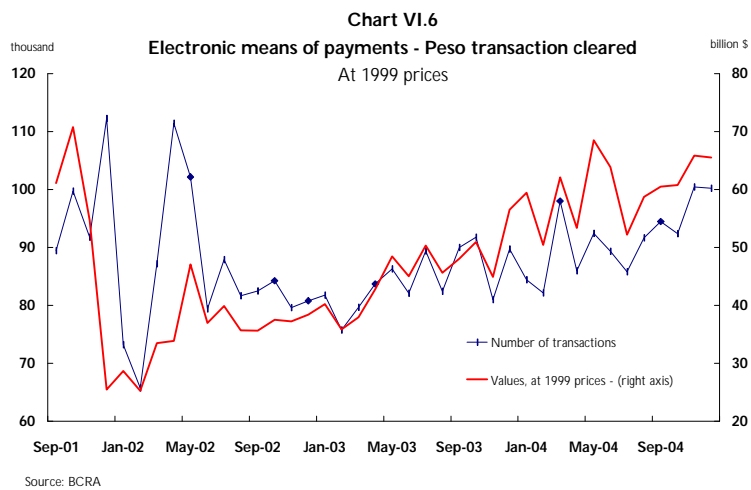
Although to a lesser extent than cash and checks, transfers between bank accounts are another commonly accepted means of payment. The number of transfers rose strongly in the second half of 2004 (21%) which involved a real growth of 23% in the value transacted (Chart VI.5).

During 2004 the use of credit and debit cards as means of payment grew. The number of credit cards issued rose almost 8% to over 8 million plastic cards, while debit cards expanded 3%, to a total 12 million cards in circulation. It is expected that this trend will continue in the short and medium term, based on the optimistic growth expectations together with the continuity of the process of growing use of banks in the economy.

In 2004 the number of transactions and the amounts operated by electronic means also expanded (Chart VI.6). Transactions channeled through Electronic Means of Payment (MEP) grew 8% over the year, while in real terms the amounts transacted rose 32%. This has been the experience since the beginning of 2003 and is expected to continue growing, largely boosted by the expansion of economic activity and the greater use of electronic channels for financial transactions.

VI.3. Uniform Federal Clearing

The Central Bank, together with financial institutions, has agreed to implement Uniform Federal Clearing (UFC), seeking to make the supply of financial services smoother nationwide. This means that transactions are carried out faster and at less cost, irrespective of the geographical location. It is estimated that



these improvements will have positive effects for both individuals and regional productive sectors.

These measures tend towards the optimization of the operations of the NPS in terms of both electronic transfers and clearance of securities. Already at the beginning of 2005 the time for retail transfers throughout the country has been reduced to 24 hours. As well as shortening the time of the transaction, this improvement allows for lowering the transaction costs of transfers.

Furthermore, the mechanics of clearing securities is optimized, fostering the use of electronic records instead of physical instruments. It is estimated that in the Argentine economy every month an average of around 7 million checks are transacted. This situation is evidence of the potential advantages of the proposed changes, promoting the shorter times, diminishing the implicit risks and minimizing of the costs involved in physical transport.

As part of the principal measures adopted is the increase of the maximum amount for check truncation (the physical document remains at the bank where it is deposited and only electronic information is transmitted to the institution where it has been drawn), extending the mechanism to all the country. Thus, almost all the documents transacted at a national level will remain within the system. These advances are in line with standards used in the principal developed economies.



BALANCE OF RISKS

Due to the severe local crisis of 2001-2002 and the establishment of a new macroeconomic scenario, there has been a virtual obstruction in the task of quantitatively evaluating the overall risk for financial stability. In light of the important difficulties in being able to approximate behavior equations and probability distributions associated with that methodology, **the BCRA has opted to present a qualitative appreciation of the general status of conditions leading to short-term financial stability in this section of the Financial Stability Bulletin.** In particular, this evaluation brings together analyses carried out in relation to possible changes in macroeconomic context and to recent and expected financial system behavior, both with respect to its net worth exposure to different types of risk and to its solvency position. The normalization of the financial system is allowing for the commencement of work on the development of quantitative evaluation models of risk to financial stability conditions.

In the overall evaluation, in recent observed behavior as well as in expected evolution in the short term, we uphold that **the financial system continues to show encouraging signs in the context of the recovery process begun following the 2001-2002 crisis.** There is a consolidation in the presence of the main trends highlighted in the risk balance in the previous edition of the FSB: **a favorable change in the overall configuration of financial system risks and a gradual improvement in its solvency position.** Notwithstanding this, it is worth pointing out that the permanency of important currency and interest rate mismatches, together with a slight change in the most likely short-term macroeconomic scenario configuration, lead to a moderation of expectations as regards the sector's pace of improvement and to a need to increase the watch over those factors which still act as a potential source of instability.

The financial system aggregate displays an acceptable balance between exposure and coverage before the main risks inherent to the activity of financial intermediation: liquidity risk and credit risk. The evolution of the main liabilities (which notes increasing confidence in banks), high liquidity indicator levels, the expansion of interbank currency markets and the behavior of the BCRA (both in the repo market and in its role of lender-of-last-resort in pesos) recreate a context which make it unlikely to consider a short-term scenario with systemic liquidity problems for the banking system.

The foreseen potential net worth impact on the financial system from the lack of loan recoverability from the private sector appears substantially reduced. The main factors behind this result are: the steady progress in the different debtors' financial position (based on improved income and profitability conditions and the restructuring

of liabilities), continued portfolio diversification, and conservative policies with respect to provision coverage on the part of banks, as well as the regulatory changes adopted by the BCRA in order to encourage healthy credit to the production sector.

Following the 2001-2002 crisis, the financial system evidenced a sharp mismatch in currency and interest rates. While it is expected that the positive gap between assets and liabilities in foreign currency decrease in the short term (within the framework of the regulatory limitations existing and derived from the public debt exchange), **a clear trend cannot be defined for the CER asset position.** On the side of coverage, it is worth pointing out that the dollar futures market has recently begun to deepen and that CER term and interest rate swap markets were launched at the end of 2004. There is no doubt a long way to go, in terms of participation and depth in these markets, for these to provide instruments adequate to lessening the impact of the currency and real interest rate risk to which the financial system is exposed. **In the short term, the combined behavior of inflation, the peso-dollar nominal exchange rate and interest rates will define the share of those risks in the overall configuration of financial system risks.**

Looking ahead to 2005, the end of the public debt exchange process eliminates one of the most important of the uncertainty factors which have been weighing on the financial system and on the economy in general. The lengthening time horizon for investors and the strengthening of the public sector's payment capacity are the main positive effects of the debt exchange's outcome. Notwithstanding this, **the new post-exchange scenario begins to delineate the main elements to monitor in the short term.** Firstly, good medium- and long-term opportunities ought to stimulate greater foreign investment. Likewise, the post-exchange scenario poses a higher likelihood of interest rate hikes. Here, **a consistent and mild movement in economic and financial variables should be considered positively in order to continue along a path of activity level expansion with decreased inflation, the only macroeconomic context that sets the bases for steady growth in the financial system's operating level.**

In 2004, the financial system continued with the significant capitalization process seen in the last few years. **For 2005, trends with respect to the flow of capitalizations and increase in financial system profitability are expected to continue,** the latter of these as of the continued growth in private credit (with a good risk-profitability relation) and of financial services in general. **These developments have been recouping the sector's ability to resist adverse shocks and increase the appreciation of greater financial stability.**



In conclusion, taking into account the developments expected in the financial system in upcoming months, we believe that **the path toward the consolidation of those conditions necessary for financial stability should present no major obstacles.** It merits underlining that given a background context in which financial intermediation activity exhibits a relatively good potential for development in the medium and long term, **the BCRA will continue on with its monitoring of the main sources of risk. The Central Bank thus looks to direct its actions towards the aim of consolidating the sector's progress and thereby improve its contribution to steady economic growth.**



ABBREVIATIONS AND ACRONYMS

\$. Argentine pesos.

APR: Annual percentage rate

BCB: Central Bank of Brazil.

BCBA: *Bolsa de Comercio de Buenos Aires*. Buenos Aires stock exchange.

BCRA: *Banco Central de la República Argentina*. Central Bank of Argentina.

BMB: Broad monetary base. Defined as money in circulation plus current account deposits in pesos by financial institutions in the BCRA plus the stock of quasi-monies.

BODEN: *Bonos Optativos del Estado Nacional*. Optional federal bonds.

BOGAR: *Bonos Garantizados*. Guaranteed bonds.

CAMEL: Capital, Assets, Management, Earnings and Liquidity.

CAS: *Cámara Argentina de Supermercados*. Argentine Supermarket Chamber

CCI: Construction cost index.

CEDEM: *Centro de Estudios para el Desarrollo Económico Metropolitano*.

CEDRO: *Certificado de Depósito Reprogramado*. Rescheduled deposit certificate.

CER: *Coeficiente de Estabilización de Referencia*. Reference stabilization coefficient.

CPI: Consumer price index.

CVS: *Coeficiente de Variación Salarial*. *Wage variation coefficient*.

EB: Executive branch.

ECB: European Central Bank.

EMBI: Emerging markets bond index.

FS: Financial stability.

FSB: Financial stability bulletin.

FOMC: Federal Open Market Committee (USA).

FUCO: *Fondo Unificado de Cuentas Corrientes Oficiales*. Unified Official Current Account Fund.

GDP: Gross domestic product

HHI: Herfindahl-Hirschman index.

IDCCB: *Impuesto a los Débitos y Créditos en Cuentas Bancarias*. Tax on current account debits and credits.

IFI: International financial institutions: IMF, IADB and WB.

IFS: International financial statistics.

IMF: International Monetary Fund.

INDEC: *Instituto nacional de estadísticas y censos*. National Institute of Statistics and Censuses.

ISAC: *Índice Sintético de Actividad de la Construcción*. Construction activity index.

LEBAC: *Letras del Banco Central de la República Argentina*. BCRA bills

M0: Banknotes and coins

M1: M0 plus peso and US dollar current accounts net of FUCO.

M2: M1 plus peso and US dollar savings accounts (at 50% of their balance).

M3: M2 (with US dollar savings accounts at 100% of their balance) plus peso and US dollar time deposits including CEDRO with CER.

m.a.: Moving average

MAR: Minimum application of resources in pesos.

MC: Minimum cash.

MR: Market rate.

MERVAL: *Mercado de Valores de Buenos Aires*. Executes, settles and guarantees security trades at the BCBA.

NA: Netted assets.

NDA: Net domestic assets.

NIR: Net International Reserves, which are the difference between the BCRA's gross international reserves and liabilities with the IMF.

NOBAC: *Notas del Banco Central*. BCRA notes.

NW: Net worth

p.p.: Percentage point.

PGN: *Préstamos Garantizados Nacionales*. National guaranteed loans.



PS: Price stability.

PV: Par value.

REM: BCRA Market expectation survey.

ROA: Return on assets.

ROOA: Ordinary return on assets.

RPC: *Responsabilidad Patrimonial Computable*.
Adjusted stockholder's equity, calculated towards
meeting capital regulations.

s.a.: Seasonally adjusted.

SEFyC: Superintendence of Financial and Exchange
Institutions.

SME: Small and medium enterprises.

SIOPEL: *Sistema de operaciones
electrónicas*. Trading software used on the
over-the-counter market.

TD: Time deposits.

US\$: United States dollar.

USA: United States of America.

UTDT: Universidad Torcuato Di Tella.

VaR: Value at risk.

VAT: Value added tax.

WPI: Wholesale price index.

y.o.y.: Year-on-year.

YTM: Yield to maturity.



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