

BANCO CENTRAL DE LA
REPÚBLICA ARGENTINA

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Financial Stability Bulletin

First Half 2007



FINANCIAL STABILITY BULLETIN

Central Bank
of Argentina

First Half 2007

Issue N° 7

Central Bank of Argentina

April 2007

ISSN: 1668-5164

Online edition

Reconquista 266

Capital Federal, Argentina

C1003ABF. Tel.: 4348-3500

www.bcra.gov.ar

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Preface

***Financial stability** 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 resilience of the financial sector in the face of negative shocks 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.*

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 and main topics 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 at the end of June 2007, will be on September 27, 2007, on the Central Bank website.*

Buenos Aires, March 29, 2007



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CENTRAL BANK OUTLOOK

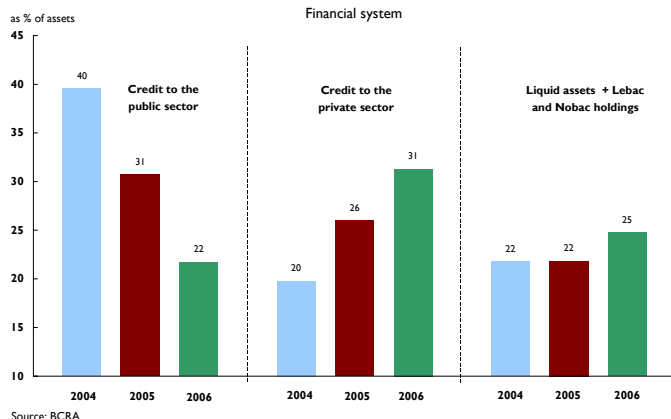
During the past two years, as a result of the new regulations adopted by the Central Bank, the domestic financial market has been exhibiting a significant consolidation, which strengthens the financial stability scenario over the short and medium term. In the second half of 2006 a sustained growth was combined with a limited balance of risks and a strengthening of solvency levels. Specifically, the financial entities continued to show a noticeable improvement, underpinned by the persistent growth of financial intermediation, a strong recovery of private credit, a significant growth of time deposits, rediscounts with the Central Bank close to disappear and by strengthening its profitability and capital position. In accordance with the prudential policy adopted by the Central Bank the developments took place in a favorable context of risks. Thus, the banking system again exhibited a substantial robustness to face the liquidity, credit, currency and market risks, while the exposure to the interest rate risk also showed an improvement.

The process of assets normalization at the financial system stands out as a Central Bank financial policy achievement. A greater exposure to the private sector was stimulated and there was progress with the scheme towards a gradual valuation of the public sector portfolio at market prices. In order to boost finance to the private sector: incentives were granted to classify debtors according to their prospects ahead rather than by past performance, the capital requirements for mortgage loans were made more flexible, the use of specific documentation (such as receipts for rental payments and utilities, among others) was encouraged as a substitute for evidence of income, screening systems and credit scoring models were adopted and the Origination Manual for mortgage loans was launched again to enhance the homogenization of the portfolio for its securitization. In this case, and through market solutions the Central Bank stimulates the banking system being complementary with the capital market.

In this manner a fall of 9.1 p.p. in the exposure to the public sector was achieved in 2006 (almost 18 p.p. in the past two years) to stand at around 21.7% of assets. The gradual amortization of loans, portfolio sales, adjustment to valuation at market prices and the collection in cash of part of the pending compensations from the National Government drove these changes. Likewise, the banking system obtained a significant success in expanding its loans to companies and households, reaching a growth of over 41% in 2006. This movement meant that the private sector crowded-out the public sector as the main debtor of the financial system, recording a share of 31% of assets at the end of 2006, 5 p.p. more than at the beginning of the year (11 p.p. in the past two years).

The expansion of private financing in 2006 was driven by both corporate and household credit lines. In the first case, although promissory notes attained the largest contribution to growth export financing stood out on its strong dynamism. On the other hand, the increase in household loans was in connection with personal loans, and to a lesser extent to credit cards. The mortgage loans, which by nature are the last lines of credit to

Chart I
Assets Normalization
Financial system

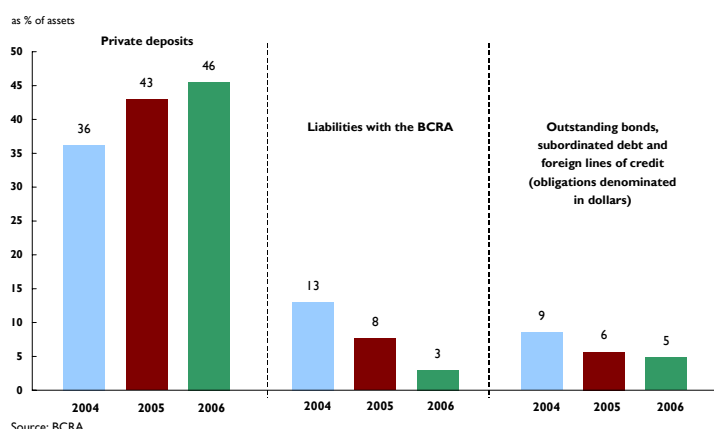




recover following a crisis, expanded by 17% in 2006 (23% annualized in the second half), to reverse the performance of the previous years. The incentives recently established by the Central Bank are expected to help to reinforce this expansion in the short term.

The process of reconstructing the credit market is being achieved together with a sustained strengthening of the financial system to face credit risk. The private sector exhibits a combination of a solid expansion in the revenues of all the productive sectors and households, with a robust financial position, explained especially by reduced debt levels and low interest rates. In this context, the financial system is granting new loans that record low levels of arrears and by establishing adequate levels of provisioning. In particular, this framework boosted the considerable improvement of the quality of the financial system's private sector portfolio, changing from non-performance levels of 18.6% of private loans in 2004 to 4.5% in 2006. This figure is a historical minimum for the domestic financial system and is already in line with what is seen in other Latin American economies. During 2006 the financial system transferred part of its portfolio into financial trusts, to take advantage of the benefits of complementation with the capital market.

Chart 2
Liabilities Normalization



The positive context of development added to a healthy private sector financial position also led the non-bank financial intermediaries (NBFI) to transfer their funds increasingly towards the private sector. In particular, the NBFI are reducing their deposits with CER adjustments in the financial system in order to place more funds on the stock market. Although this component had led the profits of the NBFI in 2006, the increased exposure to market risk could lead to a moderate increase in the volatility of their earnings.

Likewise, the success of the incentives drawn up by the Central Bank was seen in the significant liabilities normalization. Specifically, in 2006 the Central Bank adopted a number of measures that tend to extend the maturity of bank funding, helping to mitigate one of the barriers that hinder the definite take off of medium term credit. It decided that sight deposits in pesos remunerated at more than 35% of the BADLAR rate would be subject to a 100% reserve requirement. Also, it twice increased the reserves on sight deposits 2 p.p. (raising it from 15% to 19%), eliminated the remuneration of reserves on this kind of deposit (current accounts and savings accounts) and eliminated the requirement on time deposits with a remaining maturity of over 180 days. It authorized transactions with time deposits at a floating rate together with an ensured fixed minimum interest rate and expanded the range of eligible assets and indicators for time deposits with a variable remuneration (both operations at a minimum term of 180 days). In a context of a generalized increase of deposits these measures favored the migration of savings set up in sight accounts to time deposits. In addition, it decided to acknowledge perpetuities (with a minimum 30 year term) in the calculation of the capital compliance, as an incentive for the issue of this kind of long term debt instruments and again reveal the benefits of bank complementation with the capital market.



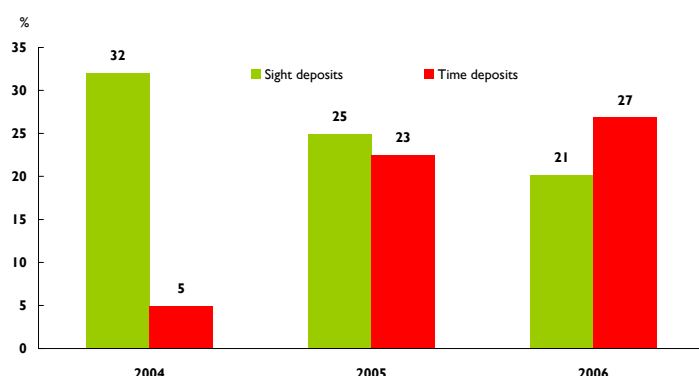
With this set of incentives, added to the gradual increase of the interest rates, for the first time since the crisis, in 2006 the financial system achieved an expansion of time deposits (27%) that was larger than the increase of sight deposits (21%). Consistently with this domestic liquidity context, banks are reducing their liabilities with the Central Bank rapidly. By March 2007, illiquidity rediscounts granted by the Central Bank in the 2001-2002 crisis had almost disappeared. At present, of the original 24 financial entities, there is only one still in the matching schedule, having cancelled 86% of the balance owed since the end of 2004. As a result, at the beginning of March there was an outstanding principal of only \$2.57 billion as matching funds.

In the past two years liquid assets has remained at adequate levels compared to the deposits to exhibiting a slight readjustment of the coverage undertaken during the 2001-2002 crisis. In addition, the banking system relies increasingly on market mechanisms which allow for a more efficient risk management. In this manner, the call and repo markets between financial entities are growing systematically. Furthermore, the development of the domestic capital market increases the possibility of selling assets, which improves the liquidity available for banks. Finally, the possibility for the Central Bank to act as a lender of last resort in specific illiquidity cases reinforces the robust context for the financial system to face liquidity risk.

The process of financial system balance sheets normalization and the expansion of the financial intermediation activity are leading the improvements of earnings. Driven by the strong performance of the financial margin, the profits accrued by the financial system in 2006 were more than double that recorded in 2005, and stood at around 15% ROE and 2% ROA. The expansion of the more stable revenue sources of the banking system, especially, powered the 2006 results: the net interest income and service income margin grew 33% and 29%, respectively, compared with 2005. The favorable international scenario for domestic debt also enhance more trading and an improvement in the prices of fixed income assets, to double the annual results from holding and trading financial assets. However, profit of the domestic financial system is still low in an international comparison. In this regard, if the sound performance of the domestic economy and the growth of financial intermediation activity persist, the bank results in 2007 are expected to be more aligned with those in other emerging economies.

Financial entities are strengthening solvency with their own funds, associated with the expansion of the activity and with external contributions. In fact, in 2006 the financial system profits consolidated as the main source of equity growth, while capital contributions continued to be significant. With a 23% growth of net worth in 2006, the banking system was able to improve its solvency levels, to remain above the capital requirements defined by the Central Bank and the international minimum recommended. Thus, capital compliance was 16.8% of the risk-weighted assets, while the excess of capital compliance was 130% of the capital requirement. The process of strengthening the solvency indicators will continue in 2007. At

Chart 3
Private Deposits
Year on year (%) - Financial system

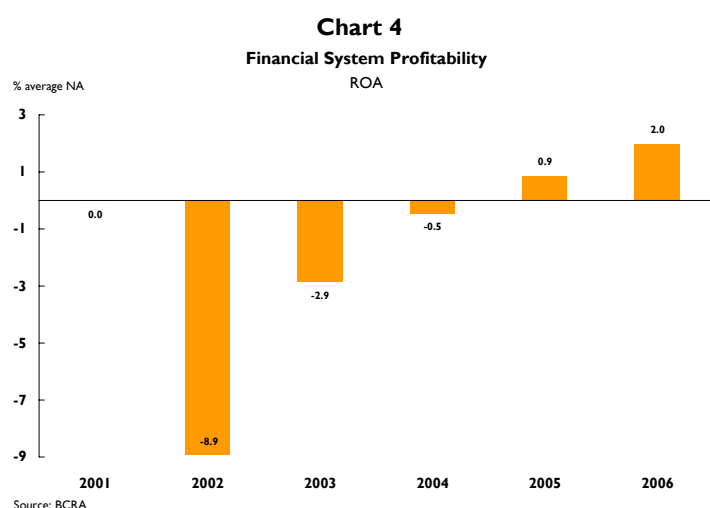


Source: BCRA



this respect, the Central Bank published the criteria applicable in order to distribute profits. This clear and predefined mechanism reflects the normalization of the financial system, facilitating and encouraging bank capitalizations.

The positive characteristics of profits and solvency growth are expanded when the increasingly competitive framework in which the financial intermediation activity takes place is analyzed. In this manner, a reduction of the intermediation spreads is observed on both household and corporate segments. The increasing competition was driven by a persistent improvement in the factor productivity levels, even more noticeable in a framework of expansion of the number of branches and the staff employed. A progressive increase in the efficiency of revenue generation is occurring, to surpass the pre-crisis levels. In 2007 these degrees of competition are expected to heighten, and thus encourage the continuity of the improvements in efficiency. This competitive framework opens the possibility of a gradual trajectory towards a consolidation of financial system structure. Furthermore, with the purpose of encouraging the competitive framework, the Central Bank made the data from the Transparency Information Regime available to the public on its web page and adjusted the methodology for publishing the total financial cost of loans, to promote more transparency in the financial system transactions.



Encouraged by the incentives defined by the Central Bank, the financial entities achieved significant progress to face their exposure to foreign currency risk. In this manner and to a large extent as a result of the lessons of the last domestic crisis, the Central Bank outlined a regulatory strategy which promotes a low exposure to foreign currency risk: applying the deposits in dollars only to loans in dollars and for debtors with revenues associated to this currency, capital requirements for foreign currency mismatch and the stimulus of markets for coverage. In addition, the success of these policies was reflected in the solidity revealed by the financial system to a foreign currency stress test. Furthermore, although in a context of more volatility in 2007, the banking system is estimated as continuing to strengthen to face market risk.

However, financial system also exhibits a number of limitations, some derived from the last domestic crisis, and others in connection with historical structural factors of the Argentine financial market. Among the first group, although with some improvements in 2006 the exposure to real interest rate risk stands out. The long maturity of the assets adjusted by CER, the persistent fall in liabilities with CER, and the lack of a counterparty on a large enough scale to arrange CER swaps with the financial entities, provide a framework scarcely favorable to mitigate this risk in 2007. Nevertheless, with the higher solvency levels the financial system is expected to be capable of reducing the impact on net worth if a negative shock of an increase in the real interest rate occurs (a scenario with a low likelihood). On the other hand, the Central Bank continues creating incentives through market solutions. In this case, as from the beginning of February 2007 the Central Bank started to take part in interest rate and maturity swaps, to encourage the market for derivative products.



Although the low credit levels are associated with historical and structural factors, the last domestic crisis increased this characteristic. At the end of 2006 the level of loans to the private sector was equivalent to about 11% of the GDP (3.2 p.p. more than the minimum recorded after the crisis), which is around half the level observed in the pre-crisis period and much lower than the international figures. To the scarce depth a reduced access to financial services is added, in both regional terms and for the lowest socio-economic strata, to become one of the major historical limitations of the local financial system. It is estimated that although improvements will be seen in 2007, in both the depth and the access of private credit, closing the gap to international levels will only be feasible in the medium term.

The Central Bank continues strengthening the measures to assist a gradual reversal of the poor access to financial services. In this manner micro-credit was encouraged: the period for installments of the loans was expanded, banks were allowed to grant an initial grace period for the payment of capital services, the limit of the installment to be paid was raised from \$200 to \$300 as coverage for a larger population range, the maximum term of loans was extended from 24 to 36 months and the amount of finance available for domiciliary infrastructure works was expanded from \$3,000 to \$6,000. Also, with the purpose of increasing the geographical coverage of the financial system capital requirements according to the regional characteristics were defined, the setting up of new credit unions is more flexible and the possibility of adopting a new form of mobile operating branch where there are no branches already operating was authorized.

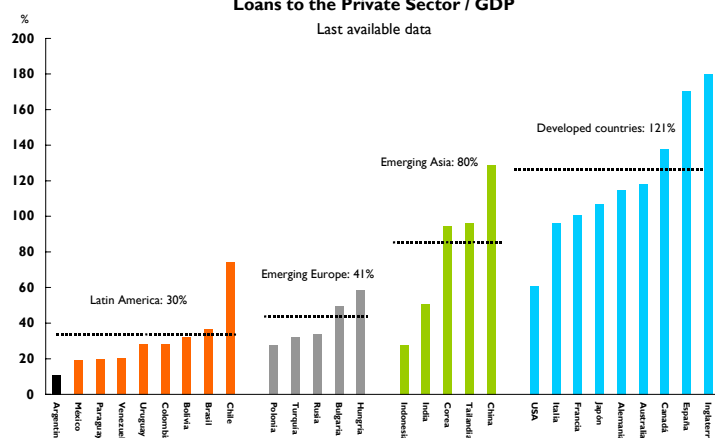
In this scenario of expansion of banking activity the Central Bank strengthens the supervisory scheme that focused on risks. This consists of an ongoing cycle that combines inspections at the financial institution offices (on-site control) with following up from a distance carried out by the SEFYC during the period between inspections (off-site control). The latter comprises tracking and analyzing the financial entities situation, including the definition of early warning indicators. The tasks of the 2006-2007 on site inspection schedule also continued, which include the communication of the CAMEL BIG ratings granted by the SEFYC to financial entities and their calculation to determine the minimum capital requirements. The Central Bank through the SEFYC carries out this procedure in a manner consistent with its Supervision Manual, which is updated constantly and bears in mind the most recent international standards.

The increased complexity and innovation of banking transactions are posing new challenges for risk management. Specifically, at both international and domestic level the relevance of undertaking oversight of the operational risk of financial entities is expanding. Following its own experience and the guidelines recommended by the Basel Committee the Central Bank defined rules for the management of operational risk related to the management and adoption of information technology. These requirements enable the financial system to have access to the technological environments at the highest level and begin to mitigate one of the dimensions of operational risk.

Chart 5

Loans to the Private Sector / GDP

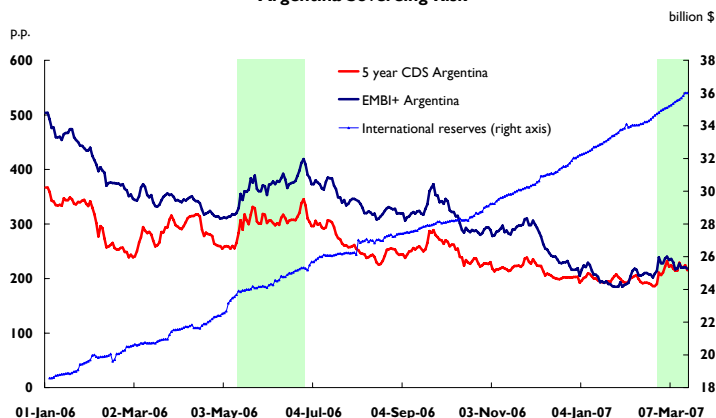
Last available data



Source: IMF, International Financial Statistics



Chart 6
Argentina Sovereign Risk



Source: BCRA y Bloomberg

The events at the beginning of the year indicate an international financial scenario for 2007 with more volatility, at least during the first half of the year. The greater turbulence in the early months of 2007 is not considered to be associated with a change in fundamentals of global economy, as it has been preceded by a period of a significant appreciation of the different kinds of assets in a context of abundant international liquidity. In this manner, the changes observed as corrections to prices reflect a temporary adjustment rather than a new trend in the financial market conditions. Nevertheless, it is worth noting that in a context of improved fundamentals, the generalized deepening of prudential mechanisms that perform as automatic stabilizers (such as the accumulation of international reserves and the counter-cyclical funds) in the region help to consider Latin America in general, and Argentina in particular, as better prepared to absorb external shocks.

In this international scenario expectation it is estimated that during 2007 the favorable domestic macroeconomic context will continue. This pattern, together with the regulatory schedule defined by the Central Bank will boost the development of financial system activity in a framework of an ever more efficient risk management with a growing level of competition. In this scenario, the Central Bank will deepen its task of monitoring the financial system to promote its sound operation with the aim of strengthening the financial stability conditions.

I. ECONOMIC AND FINANCIAL CONTEXT

Summary

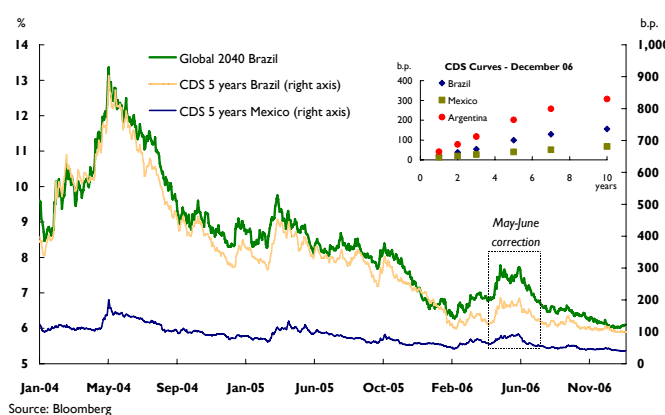
Overall, international conditions in 2006 continued to be favorable for the development and deepening of global financial activity. Despite the greater volatility witnessed since the end of February 2007 (partly due to sustained asset appreciation and narrower margins), the outlook for 2007 will remain positive as long as the economies of USA and China do not experience a sudden slowdown.

USA economy's lower growth rate was offset by growth in the Euro zone and emerging economies (Asia and Latin America). Euro zone and USA inflation fell in the second half of 2006, affected by the decrease in the price of oil. Nonetheless, core CPI inflation as well as inflationary risks have led the USA to maintain the Fed Funds rate at 5.25% since June 2006. The ECB continued the monetary policy adjustment process, while the BoJ decided last July to raise the benchmark interest rate, thus ending the zero interest rate policy of recent years. Growth in the Euro zone and Japan, as well as the slight tightening trend in their monetary policy, is expected to continue in 2007, while the slowdown projected in the USA should increase the probability of a moderate cut in the Fed Funds rate in 2007.

Commodity prices remained at high levels in the last six months of 2006, favoring Latin American economies. In Latin America, the abundant availability of international funds along with improved fundamentals and counter cyclical policies was reflected in sovereign risk spreads, which reached historic lows towards the end of the year. Commodity prices are expected to remain high during 2007 and – subject to risks in global markets – capital flows towards Latin America are expected to increase.

The domestic economy grew 8.5% in 2006, showing robust growth for the fourth year in a row. Healthy fundamentals, such as external and fiscal surpluses and consistent monetary and financial policy, contributed to the strong performance. Domestic expenditure continued to drive economic growth, and investment reached 21.7% of GDP. The downward trend in the growth of prices continued to strengthen, with consumer price inflation in the Buenos Aires metro area (GBA CPI) recording a single digit increase in 2006. The Central Bank met the guidelines set out in its Monetary Program (MP) for the fourteenth consecutive quarter. High growth is expected to continue in 2007 along with an increase in the GBA CPI consistent with the MP guidelines. This should have a favorable effect in strengthening financial stability.

Latin America Fixed Income: Benchmarks



International Reserves - BCRA

Gold, hard currencies and time deposits

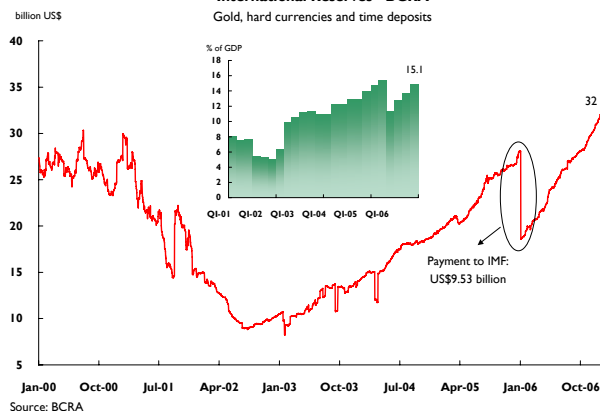
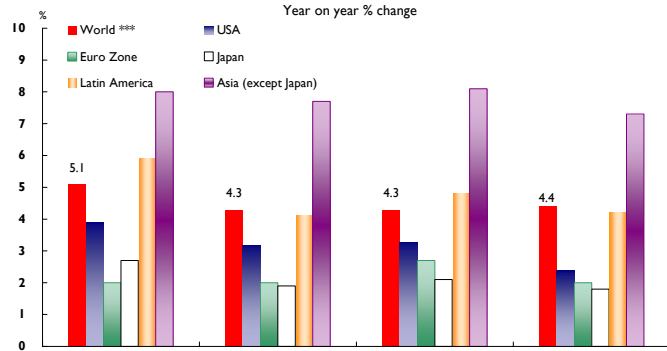




Chart I.1

GDP in Real Terms

Year on year % change

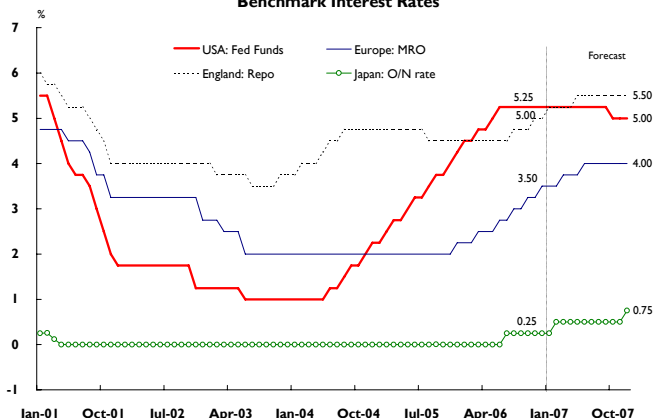


*Estimated; ** Forecast; *** Mentioned rates are calculated using purchasing power parity (PPP), while using market exchange rates it would rise to 3.4% in 2007 and 3.9% in 2006.

Source: LatinFocus Consensus Forecast and other

Chart I.2

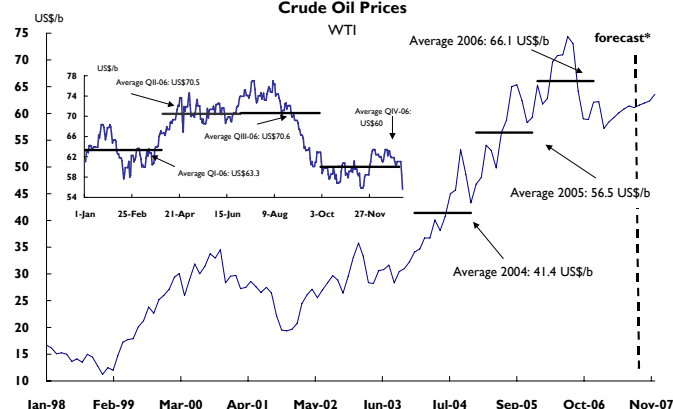
Benchmark Interest Rates



Source: Bloomberg and other

Chart I.3
Crude Oil Prices

WTI



* forecast using forward contracts

Source: Bloomberg

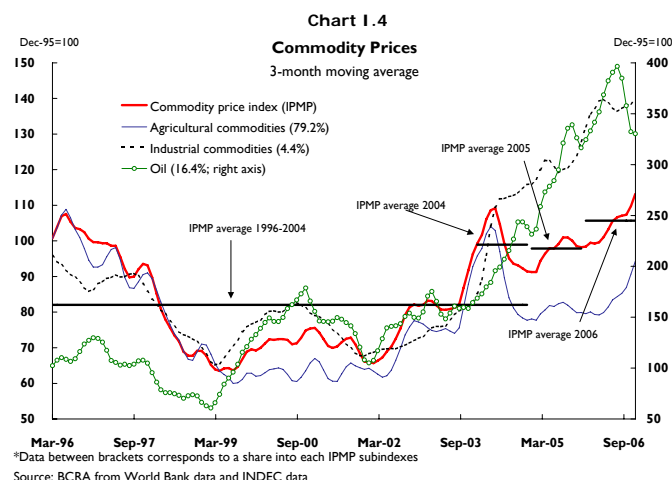
I.1 International conditions

International conditions were favorable for growth in global financial activity

The world economy continued to show a stronger, more balanced growth during the second half of 2006. The lower growth rate in USA was offset by growth in the Euro zone and emerging economies in Asia and Latin America. The world economy is expected to continue to perform favorably for the fifth consecutive year in 2007 with annual growth rates of over 4% (see Chart I.1). In particular, USA GDP grew 3.3% in 2006, mostly due to strong performance in the first quarter. As the housing market slowed down, growth decelerated since the second quarter of 2006 and the economy is now forecasted to grow 2.4% in 2007, down from the 3.1% expected a year earlier. The Euro zone continued its favorable performance, reaching in 2006 its highest growth rate in the last five years (2.7%). The region is expected to grow around 2% in 2007, the same rate as in 2004-2005. Driven by corporate growth, the Japanese economy continues to increase at rates close to 2%: GDP expanded 2.2% in 2006 and is expected to grow by 1.8% in 2007. Growth in Latin America continues to consolidate, with rates over 4%, although these are still below rates registered in emerging Asian economies (around 7%).

Euro zone and USA inflation fell in the second half of 2006 to nearly 2% year-on-year (y.o.y), affected by the decrease in oil prices. Inflation in 2007 is expected to fluctuate around this figure. Core inflation (which excludes food and energy prices) was contained within the Euro zone and ended the year at 1.5% y.o.y, while increased in USA during the second half, reaching 2.6% y.o.y in December. Core CPI inflation and persistent inflationary risks have led USA Federal Reserve to maintain the Fed Funds rate at 5.25% since June 2006, despite market expectations of a decrease in the benchmark rate in response to a weaker USA economy. The European Central Bank (ECB) continued to raise its benchmark rate (Main Refinancing Operations, MRO) to 3.5%. Lastly, in a context of lower deflation, the Bank of Japan (BoJ) decided to increase the overnight call market rate from 0% to 0.25% in July 2006, ending the zero interest rate policy of previous years. With moderate hikes expected in benchmark rates, monetary policy in the Euro zone and Japan is likely to continue its slight tightening trend going forward, while a slight cut is expected in the Fed Funds rate (see Chart I.2).

Commodity prices continued to record high values in the last half of 2006. The upward trend in agricultural commodity prices offset the fall in oil prices, from an historic maximum in the third quarter (US\$77 per barrel in June) to around US\$60 per barrel in the last months of 2006. In turn, the path of metal commodity prices was similar to that of agricultural commodities (see Chart I.3). As a result, the commodity price index (IPMP), which tracks the path of Argentina's main export commodities, ended the year at a record high (see Chart I.4). In coming months, commodity prices are expected to remain high and close to average levels in 2006. Growth worldwide, particularly in China and India with increasing food, manufacturing inputs and oil imports in order to



sustain an expanding domestic demand, should help support high price levels.

International liquidity in 2006 remained high despite the tightening of the monetary policy in the main economies

The abundant availability of international funds along with the improvement in fundamentals and the implementation of counter cyclical policies – such as the accumulation of international reserves and improved public sector debt management – were reflected in the downward path of sovereign risk spreads. This more than offset the price falls recorded during the volatile period of May-June.

The region's financial asset values improved once more in the second half of 2006, with a notably fast recovery as agents quickly responded to the undervalued assets. In many cases asset values rapidly reached higher levels than prior to the adjustment. In this context, spreads over low risk debt (such as USA Treasury securities) reached historic lows while continuing their downward trend (see Chart I.5). Interest rates for some benchmark emerging market sovereign bonds, such as the Global 2040 bond in Brazil, recorded end-of-year levels below those registered at the start of 2006 (see Chart I.6). Spreads for credit default swaps (CDS) – which reflect risk expectations for debt securities – reached historic lows in countries where these contracts exhibit ample liquidity (such as Mexico and Brazil). In the same manner, the region's risk premiums continued to decouple from the spread between USA junk and AAA-rated corporate bonds. Under this favorable context, which is expected to continue, capital flows to Latin America should increase in 2007.

Taking a broad perspective, it appears that emerging market assets are consolidating as an asset class – trading in deeper markets, with a more diversified investor base and with greater differentiation between countries. Trading in emerging market debt reached a record high in 2006, growing 20% over the previous year to US\$6.5 trillion (see Chart I.7). Investors have displayed growing interest in local debt – trading increased to 57% of total volume traded – reflecting not only greater appetite for risk but also a stronger outlook for the region. Increased trading in domestic currency assets is also consistent with the debt management policies that emerging countries have carried out in recent years with the aim of reducing foreign exchange mismatches.

Emerging country equity markets improved substantially during the second half of 2006, in line with USA equity markets. Equities reached new highs and attained lower volatility (see Chart I.8), although these trends were partially compromised by greater volatility starting February 2007. Therefore, emerging market stock indexes recovered from declines in the first half to achieve double-digit returns in 2006. The *Morgan Stanley Capital International* (MSCI) emerging market indicator increased 29% over 2006, while Latin America's regional index outdid the overall index, growing by 39% (see Chart I.9).

In this international context, financial activity in emerging economies has remained on its growth path, although new risk factors have emerged

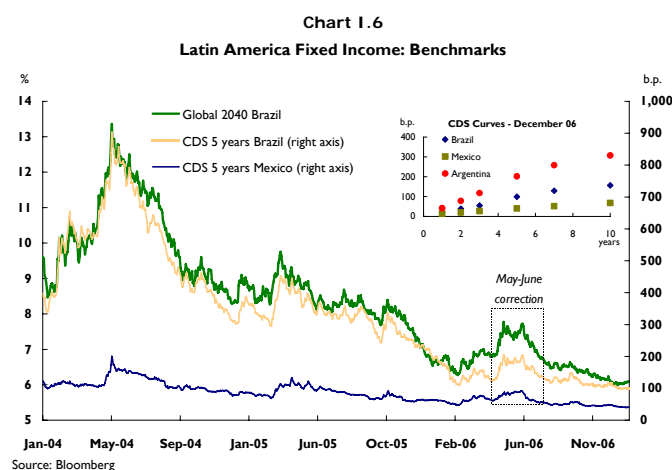
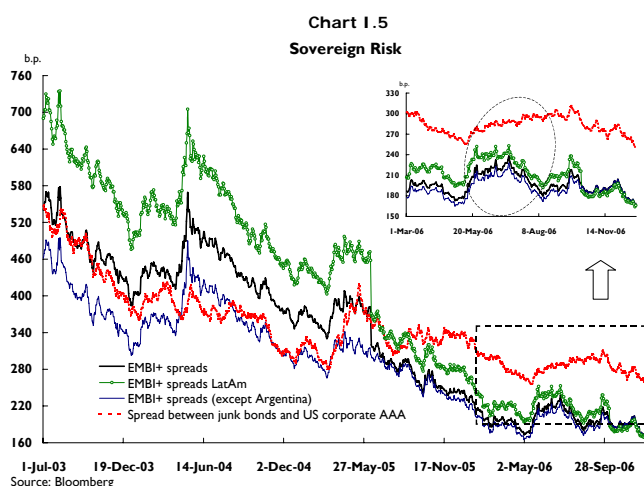
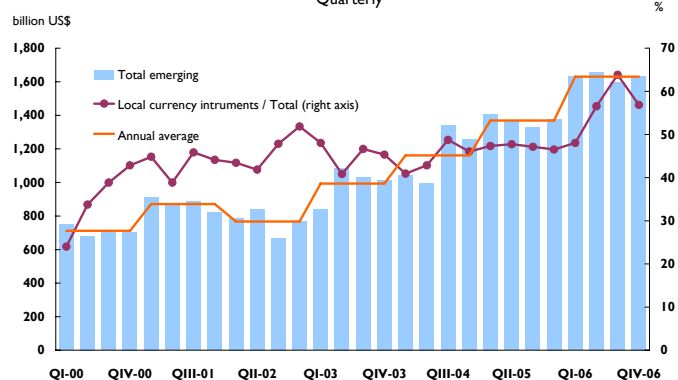


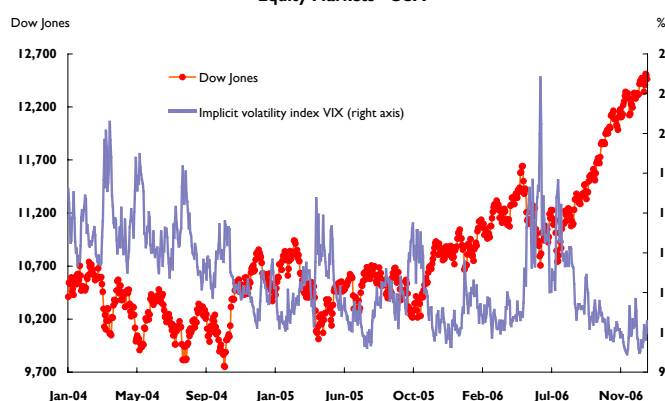


Chart I.7
Emerging Debt Instruments Trading Volume
Quarterly



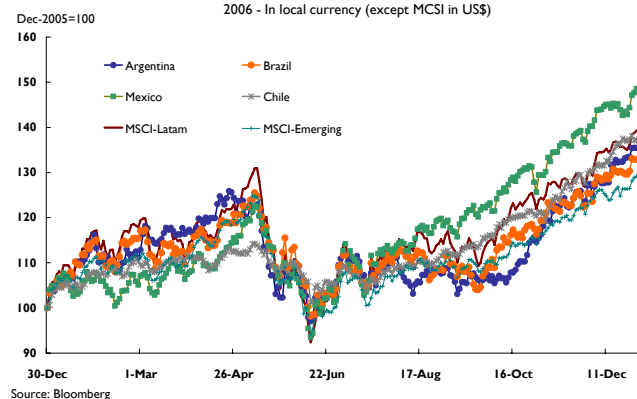
Source: Emerging Markets Trade Association

Chart I.8
Equity Markets - USA



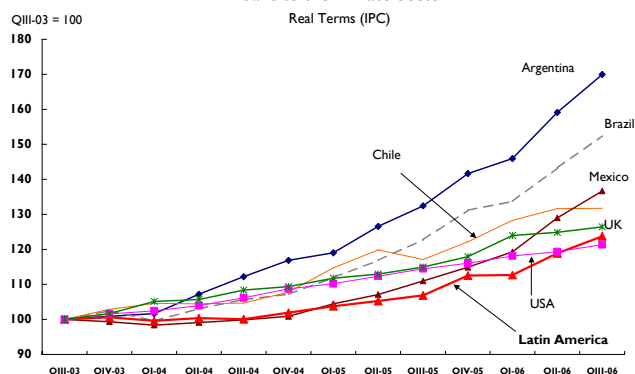
Source: Bloomberg

Chart I.9
Stock Indexes - Emerging Markets
2006 - In local currency (except MSCI in US\$)



Source: Bloomberg

Chart I.10
Loans to the Private Sector
Real Terms (IPC)



Source: BCRA from IMF data

Private sector credit continued to increase in the region during 2006 (see Chart I.10). In Latin America however, with the exception of Chile, private sector credit continues to play a relatively small role in the economy (see Chart I.11), with growth led mainly by household credit. The increase in credit took place in an environment characterized by global growth and relatively checked inflation, both factors contributing to a gradual improvement in portfolio quality – differences in portfolio quality persist, however, between emerging and developed countries. As a result, the strong performance in financial intermediation strengthened solvency levels of financial institutions in emerging economies (see Chart I.12).

There are new factors, however, which generate uncertainty regarding financial activity in emerging economies. Volatility in international capital flows is influenced by monetary policy changes of the main central banks. The initial tightening of monetary policy in Japan led to the rolling back of a substantial volume of carry trades that had been taking place in Asia over recent years. Specifically, low interest rates drove investors to take on foreign currency denominated debt (such as the Japanese yen) and invest in assets denominated in another currency to obtain higher returns. The reduction in these hedged positions introduces an additional source of uncertainty on international financial markets, as it implies greater capital flow volatility.

Towards the end of February 2007 there was a new period of volatility, with a global fall in equity values, deterioration of emerging market debt, appreciation of currencies frequently employed in carry-trades and flight to USA Treasuries. This new adjustment period was triggered by the combination of several factors, including the sudden drop in Chinese stock markets (due to rumours of a future tightening in regulations to curb speculative trades), concerns over USA economy (including a slowdown in the sub prime mortgage market) and mounting geopolitical risks. This period of greater volatility was not linked to any changes in fundamentals and should therefore be assessed taking into account substantial prior appreciation due to the abundance of international liquidity.

The effect of geopolitical conflicts on oil prices makes them intrinsically volatile adding uncertainty to inflation levels and, therefore, in the benchmark rates of the main economies. Additionally, the extent to which the slowdown in USA housing market will affect the rest of the economy still remains unclear. Although commodity prices are expected to remain high in upcoming months, these need to be tracked closely. The adjustment process to global imbalances also remains an outstanding source of uncertainty.

Finally, the effects from the failure of the Doha Round of multilateral trade negotiations – such as a potential wave of greater protectionism – should be taken into account. With the exception of oil prices, the probability of occurrence for other risks remains relatively low.



BOX 1: SUB PRIME MORTGAGES IN USA

Problems in the sub prime mortgage market (lax underwriting conditions, increasing non-performance, lenders with financial difficulties) fueled concerns regarding USA housing sector slowdown and its eventual effects on the rest of the economy. These concerns, along with other factors, resulted in a significant increase in the volatility of international financial market during the last part of February 2007

Concerns over the increasing fragility of USA sub prime mortgage market grew during the second half of 2006. These fears were one of the main drivers behind the global volatility observed since the end of February 2007. This sector has received increasing attention in a context of a weakening USA housing market, and has in turn generated significant uncertainty regarding its ultimate effect on consumption and activity levels.

The sub prime mortgage market encompasses high-risk debtors, including those with limited records or records featuring default or non-performance. This greater credit risk is reflected in higher interest rates. The sector has expanded rapidly in recent years (with yearly growth rates of up to 25%), driven by real estate appreciation up to 2006 and the rise in securitization and the use of credit derivatives¹ (see Chart B.1.1.)

Chart B.1.1
Mortgage Backed Debt in USA

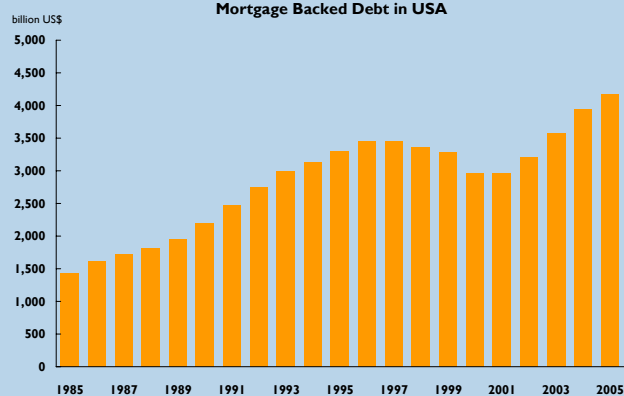
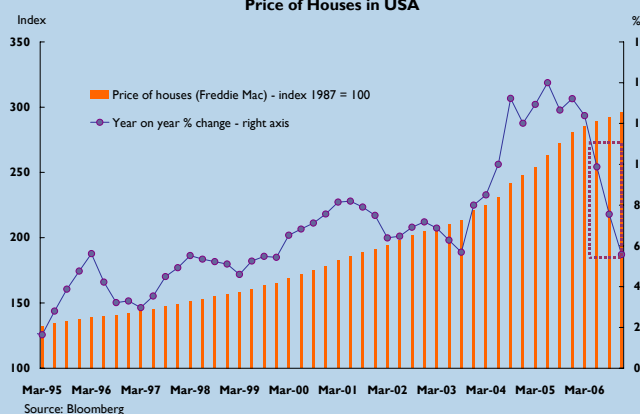


Chart B.1.2
Price of Houses in USA



In a context of strong demand for assets with this type of collateral by banks and institutional investors (following the low returns in more developed markets), lending institutions have increased efforts to sustain growth. This has translated into an easing of credit standards: increased gearing, a broader debtor base (including higher relative risk sectors), etc². Higher interest rates and weakening real estate prices, combined with easing credit standards, have jeopardized debtors' repayment capacity. The sub prime market in particular was especially affected by the slowdown in real estate prices since 2005 (see Chart B.1.2.), as debtors with financial difficulties faced limited refinancing and house sale possibilities. Loan portfolio non-performance therefore increased in the second half of 2006, following record lows over the past two years. Non-performance in the sub prime sector reached nearly 13% (driven by variable rate loans), compared to 10.3% in 2004, although levels are still 2 p.p. below the peak levels of June 2002 (see Chart B.1.3.). Despite the fact that non-performance in the prime sector has also increased, the rise seems to be contained.

These difficulties were also reflected in the closure and sale of sector-specific firms and business units. Nearly 20 specialized firms are estimated to have left the market in 2006. Concerns over this phenomenon intensified in February 2007, when several lenders reported greater than expected losses for the sub prime segment while some banks tried to sell their sub prime mortgage units³. Rumors spread at the start of 2007 that New Century (the largest independent sub prime lender in USA) was at the edge of bankruptcy⁴. At the same time, concerns over the sector led Freddie Mac, one

¹ Loans are sold and used as underlying assets for bonds (mortgage backed securities or other types of structured products) which are mostly purchased by institutional investors.

² The industry is currently attempting to implement stricter underwriting condition, while regulators are trying to define tighter standards for mortgages.

³ Corporations in this sector displayed alarming signs: growing losses in subprime operations, growing loan-loss provisions, downsizing and freezes on the issuing of new credit, among others.

⁴ The firm, under criminal investigation for problems discovered in their asset operations (suspected insider trading) and accounting, had begun to show serious liquidity problems.



of the biggest debt purchasers in USA, to announce in the first quarter of 2007 that it would no longer buy several types of sub prime debt⁵, fuelling further fears regarding the sector's performance going forward.

Chart B.1.3

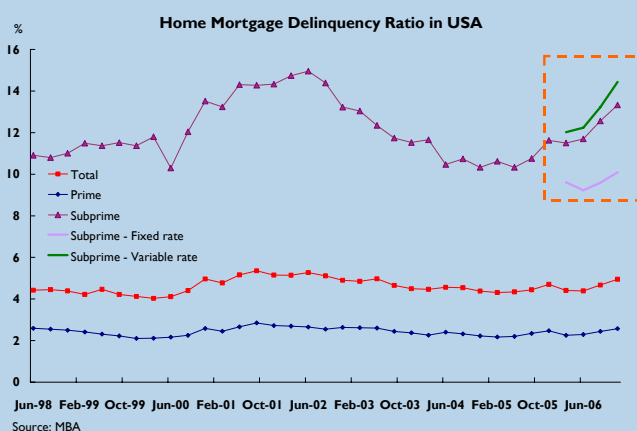
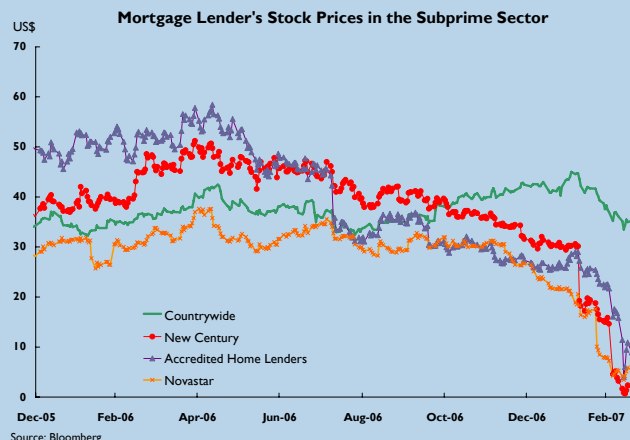


Chart B.1.4



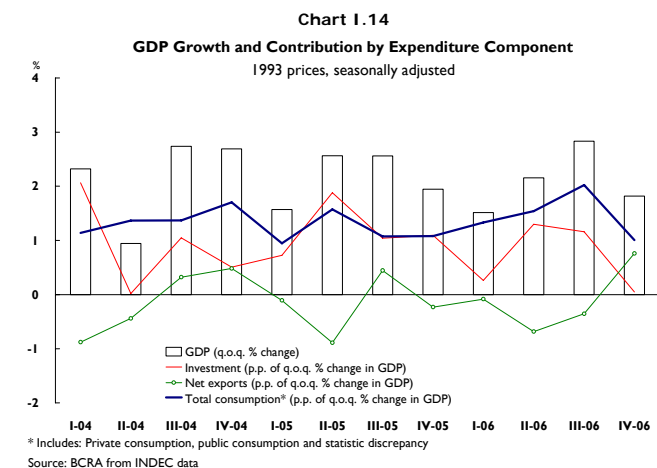
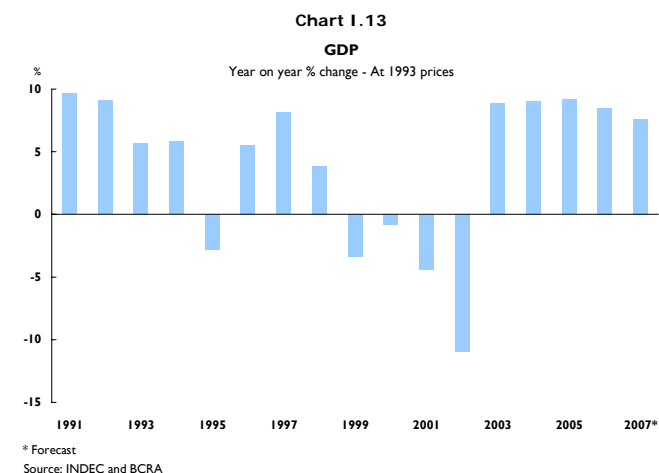
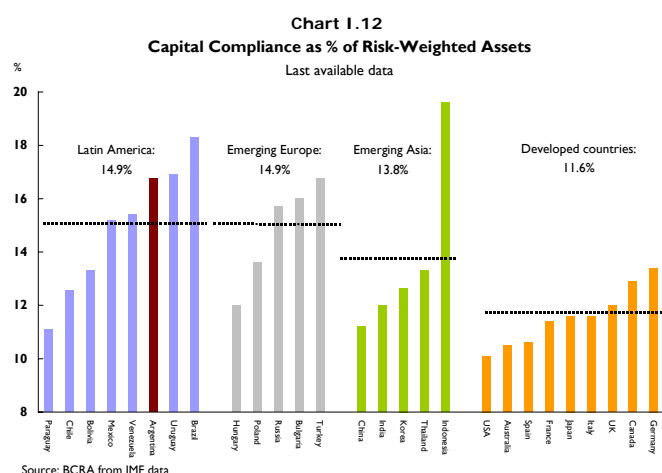
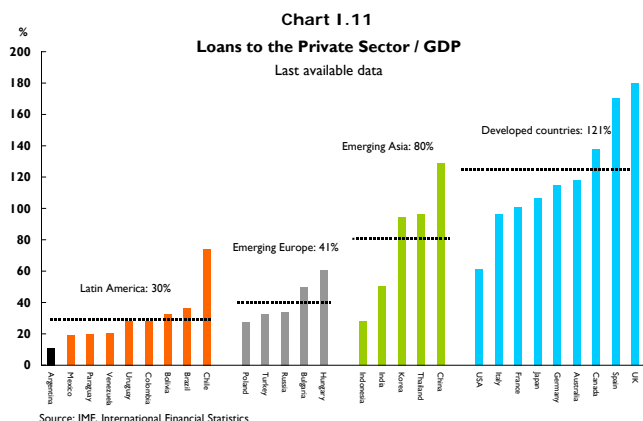
In this context, asset value volatility for the sub prime mortgage market increased in 2007 (see Chart B.1.4). Equity prices for firms in this sector fell considerably (especially those firms in critical situations such as New Century). The price of bonds linked to sub prime mortgages started to fall, while spreads on credit default swaps widened. For example, one of the benchmarks used to assess perceived risk in this sector, the ABX-HE BBB⁶ index, registered a broad-based decline in February. However, tranches linked to the loan portfolio granted in 2006 performed relatively worse, reflecting concerns over the relaxation of credit standards.

With regards to financial stability, although the sub prime sector represents a relatively small portion of USA mortgage market (around 10-20%), its worsening should be treated cautiously, as it could signal the start of a more generalized slowdown, including the prime market. If this were the case, credit conditions could tighten (eventually leading to a credit crunch) and could affect the level of economic activity. Concerns over this sector are also motivated by its eventual impact on larger financial firms. Sudden price declines among these assets may also force investors (such as hedge funds) to divest other types of risky assets (including junk bonds and emerging markets assets).

Nonetheless, the problem is perceived to be limited to this specific segment of the mortgage market (with non-performance in the prime sector below 2001-2002 levels) and a spillover effect that would significantly affect fundamentals for the mortgage market in general as well as the other financial markets is not expected.

⁵ For example, so-called "2-28" loans which had a fixed rate for the first two years, which later becomes adjustable.

⁶ The index tracks the market price of a portfolio of CDS covering the default risk of high-liquidity sub prime mortgages. There are different tranches to the index, depending on the date on which benchmark transactions were initiated.



I.2 Domestic conditions

The economy's performance continues to strengthen domestic financial stability

Domestic economic activity grew once more in the second half of 2006, driven by performance in most of the economy's productive sectors. GDP grew on average by 8.5%, slightly below the previous three years' rates (see Chart I.13).

Domestic expenditure continued to drive economic growth in 2006. Private expenditure was the most important contributing factor to GDP growth during the whole year, increasing by an average 8% y.o.y. This was fuelled by growth in wages, pensions and credit, in a context of high consumer confidence. Investment continued to grow in the second half of 2006, although at a lower rate than in the first half, as a result of decelerating growth in construction expenditure. In spite of this, investment in 2006 grew by an average 18% y.o.y, nearly doubling the economy's growth and increasing its share of GDP to 21.7%. Lastly, net exports continued to contribute negatively to GDP growth in 2006, with imports growing at a higher rate than exports (see Chart I.14).

The strong growth rate is expected to continue for the fifth consecutive year in 2007. Consumer spending and investment will continue to drive economic activity.

Fiscal and current account surpluses, combined with a consistent monetary and fiscal policy, contributed to the marked strengthen of the domestic economy

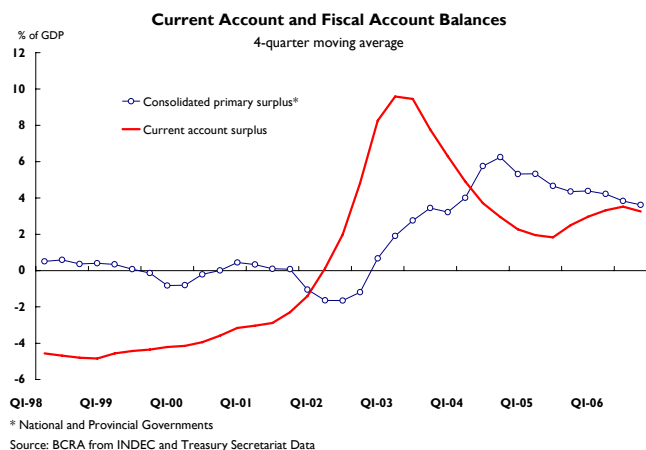
Current account surplus in 2006 grew mainly as a result of an increased trade surplus, as well as lower foreign exchange outflows in the services account, and a decrease in net rental investment deficit. The current account surplus accounted for 3.4% of GDP, 0.4 p.p. more than in 2005. This was mostly due to the trade surplus, which responded to growth in exports, reaching an historic US\$46.6 billion (see Chart I.15). External accounts are expected to remain strong in 2007.

The non financial public sector (NFPS) continued to show a favorable performance. The primary surplus reached 3.5% of GDP in 2006, similar to last year's figure (3.7%) and in excess of budget guideline of 3.3%. Net of interest payments, the financial surplus accounted for 1.8% of GDP.

The Central Bank continued to accumulate international reserves during the second half of 2006, as an insurance mechanism against future external shocks (see Chart I.16). Reserves reached nearly US\$32 billion, US\$4 billion above the level registered towards the end of 2005, prior to the settlement of the entire stock of debt with the International Monetary Fund (IMF). This policy of accumulating reserves was carried out without neglecting the monetary market – monetary expansion was sterilized through the use of several instruments, including rediscount debt settlements, the issuing of Lebac and Nobac, repo operations and changes in cash reserve ratios.



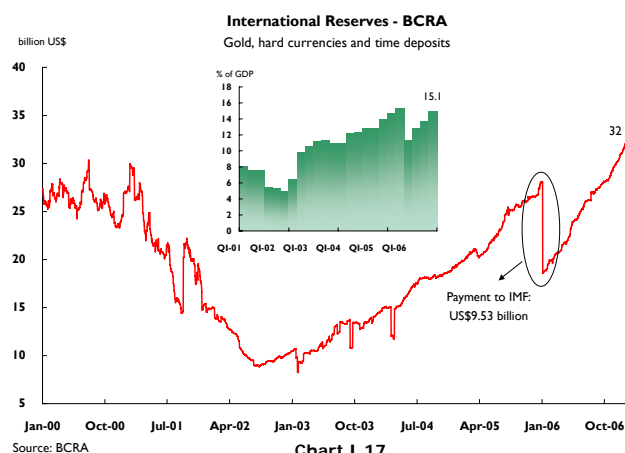
Chart I.15



The BCRA met the guidelines set out in its Monetray Program (MP) for the fourteenth consecutive quarter in 2006 (see Chart I.17). There was a sustained slowdown in the y.o.y growth rate of M2 in 2006, which fell nearly 6 p.p. to 18.9% in December (nearly 3 p.p. less than the estimated increase in nominal GDP). Overall, the Central Bank will continue to control the growth of monetary aggregates in 2007, and especially in M2, where the upper as well as lower bound set out in the MP will imply a lower y.o.y. growth rate than in 2006.

Towards the end of 2006, growth in GBA CPI continued along the downward trend registered in the first half, allowing the year to end with a single digit increase

Chart I.16



The CPI increased 9.8% (see Chart 1.18) in 2006, below market expectations in the previous months and inflation in 2005 (12.3%). The deceleration in the general level of retail prices was bolstered by the CPI Other components, a proxy for core inflation that accumulated a 10.2% y.o.y increase in 2006, 4 p.p. less than in 2005. Despite these improvements, the deceleration in the growth of consumer price inflation in the Buenos Aires metro area (GBA CPI) was limited to specific headings, and the scale as well as the spread and persistence of overall price increases remained high, suggesting that the Central Bank must continue to pursue efforts to curb inflation. The increase in GBA CPI in 2007 is expected to be in line within the range set forth in the MP (between 7% and 11%).

Chart I.17

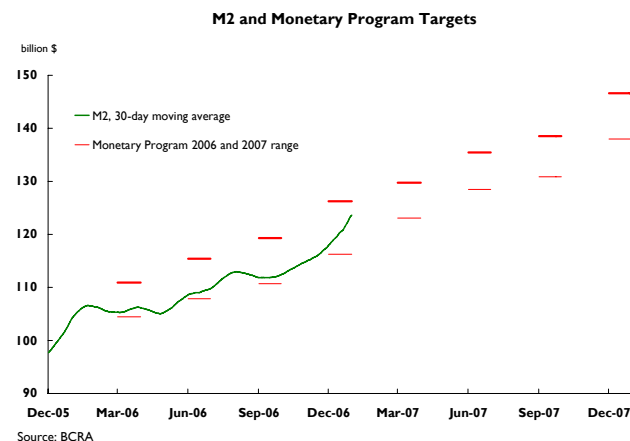
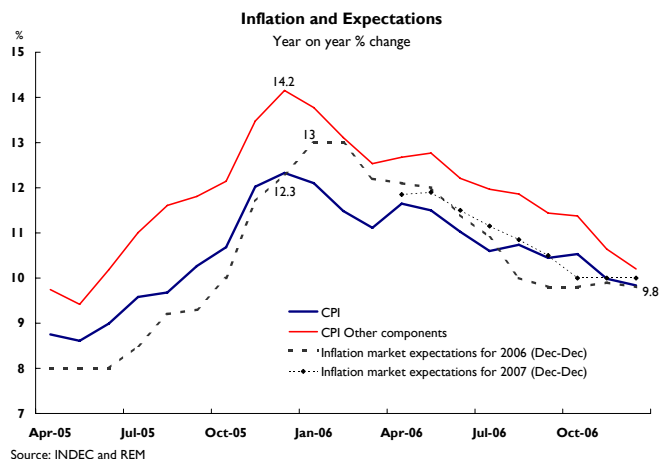


Chart I.18



II. CAPITAL MARKETS

Summary

With a less uncertain outlook and lower volatility, and given the persistence of solid domestic fundamentals, in the second half of 2006 the reversal of the falling trend observed in May-June consolidated. Accordingly, an overall rise in the prices of domestic financial assets took place, supported by growing traded volumes, albeit in many cases still below the levels observed earlier in the year. Nevertheless, early 2007 volatility in international financial markets resulted in a climate of uncertainty for the rest of the year.

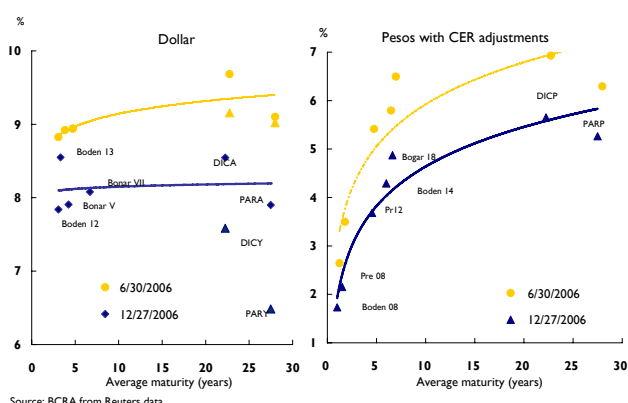
For dollar-denominated Public Sector debt, the rise in prices reduced the spreads to all-time lows, while CER-adjusted securities decline in yields fell short of first quarter minimum records. Lower risk-aversion reflected on flatter yield curves on both cases. In the primary market, the National Government conducted private placements of Boden 12 and auctioned Bonar V and Bonar VII. At the auctions, the financing cost decreased persistently, in line with falling yields in the secondary market.

The BCRA, in line with its Monetary Program, continued to auction Lebac and Nobac. Floating rate notes maintained a favorable reception, with spreads over Badlar falling in both the primary and secondary markets. Traded volumes of BCRA bills and notes kept growing and so did the share in total traded volumes.

Private sector debt also exhibited great dynamism. As most corporate debt restructuring processes with their origins in the 2001-2002 crisis conclude, new, genuine corporate debt issuance picked up. Furthermore, traded volumes in secondary markets of corporate debt exhibit an increase in both domestic and foreign markets. In the second half of 2006, the growth in issuance of financial trusts consolidated, with the share of consumption financing as the underlying asset rising. Trading of deferred-payment checks keeps growing, thus becoming a relevant financial source for SME. Nevertheless, daily traded volumes still remain, in relative terms, comparatively low.

With regards to equities, the MERVAL index hit an all-time high at the end of 2006, taking advantage of the rise in banking sector stocks towards the end of the year. Even when traded volumes in the second half of 2006 were smaller than in the first half, activity levels picked up significantly in the last months of the year. Besides, derivatives markets keep deepening, albeit still based in currency futures and forwards.

Argentina Yield Curves



Traded Volume of BCRA Bills and Notes

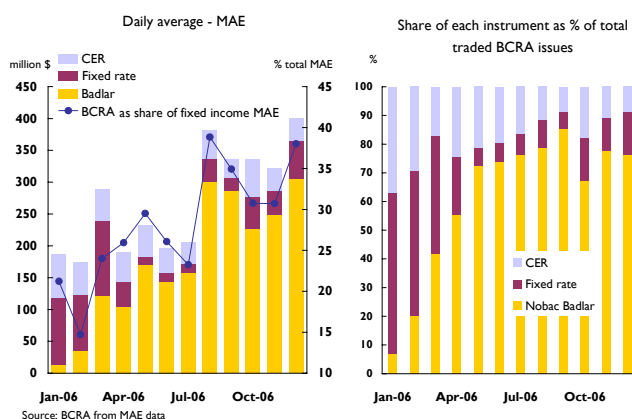
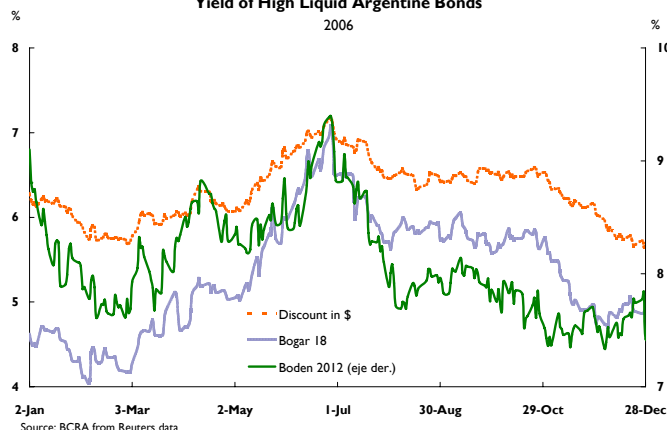




Chart II.1

Yield of High Liquid Argentine Bonds
2006

II.1. Public sector fixed income

Public sector debt prices resumed their rising trend following the May-June correction, outperforming other countries in the region

The trend in prices of Argentine fixed income assets was again positive, as from the very beginning of the second half of 2006. This was mainly due the easing of inflation expectations in the U.S., which had formerly supported expectations of further rises in the Fed funds target rate and prompted a significant correction in prices of risky assets during May and June. Emerging markets' fixed income assets (including Argentine Public Sector debt) were subsequently supported as fears of a housing-led pronounced deceleration in the U.S. economy receded. With commodity prices still elevated, plenty of global liquidity, and solid fundamentals, demand for emerging assets remained steady.

Chart II.2

Argentina Yield Curves

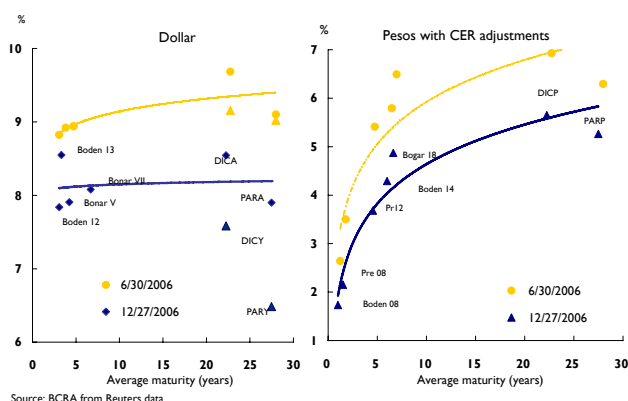
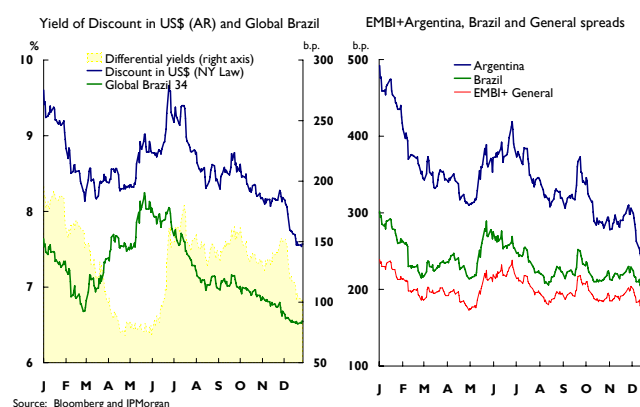


Chart II.3

Fixed Income Relative Values - Year 2006



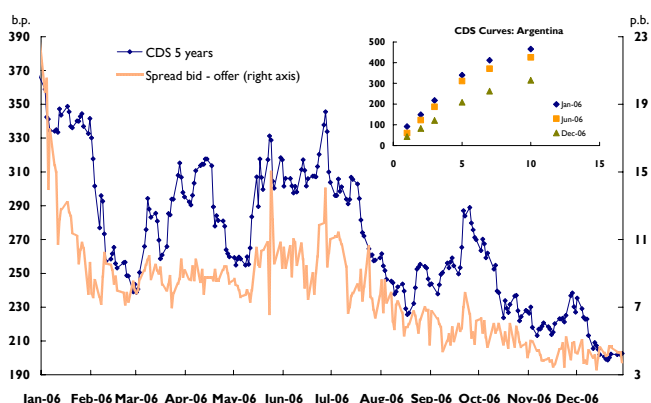
Local macroeconomic variables, which did not weaken in the context of increased uncertainty of the first half of 2006, continue to reflect the strength of the economy. In this regard, by the end of the 2006 Argentine fixed income assets outperformed those of other comparable countries in the region. The spread between the Argentine dollar-denominated Discount bond and the Brazilian Global maturing in 2034 fell from the six-month period high of 178 b.p. (on July 2006) to 100 b.p. In addition, the EMBI+ Argentina reached all-time lows, trimming down the spread against the Brazilian equivalent (see Chart II.3), while Argentine 5 year CDS spreads exhibit historically low levels and more liquidity (see Chart II.4).

Even when a positive trend for Argentine public sector debt prices is anticipated for 2007 (in line with the overall positive outlook for fixed income assets in emerging markets), the persistence of a certain degree of volatility can not be ruled out, given the recent appreciation and the historically low spreads against other less risky assets. As a matter of fact, in late February 2007 volatility in the global markets rose sharply (see Page 16), and this should have a negative transitory effect on emerging assets in general, resulting in falling Argentine fixed income assets and equity prices.

The National Government financing policy still pivots on local dollar-denominated issuance with maturities of less than ten years, where yields exhibit a falling trend

⁷ By means of this strategy, an investor earns a spread by borrowing in a low-yielding currency (like the Japanese yen or the Swiss franc) and investing the proceeds in a high-yielding currency. Currency risk is assumed.

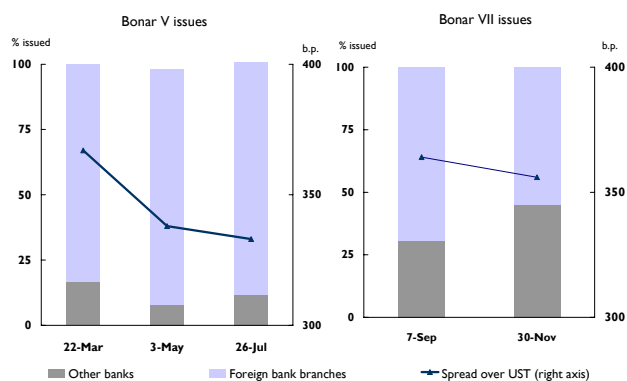
Chart II.4
Credit Default Swaps: Argentina



Between June and December, the National Government placed locally dollar-denominated debt, this time around for a total of US\$2.1 billion⁸. About 32% of this grand total was obtained by means of private placements with the Venezuelan Government (Boden 2012), while the rest came from auctions of Bonar V (with maturity in 2011) and Bonar VII (with maturity in 2013). Foreign investment banks participation fell successively to account for only 54% of the total at the last placement of the year. In this manner, the trend reverted from what had happened in the first half of the year, when these institutions accounted for almost 80% of the total⁹. Furthermore, yields and spreads over Treasuries for both issues fell (see Chart II.5), in line with developments in secondary market trading during the period under review.

Interest in floating-rate BCRA notes remained strong, which reflected in the rise in traded volumes in the domestic markets and the fall in spreads over Badlar

Chart II.5
Bond Issued by Public Auctions - 2006

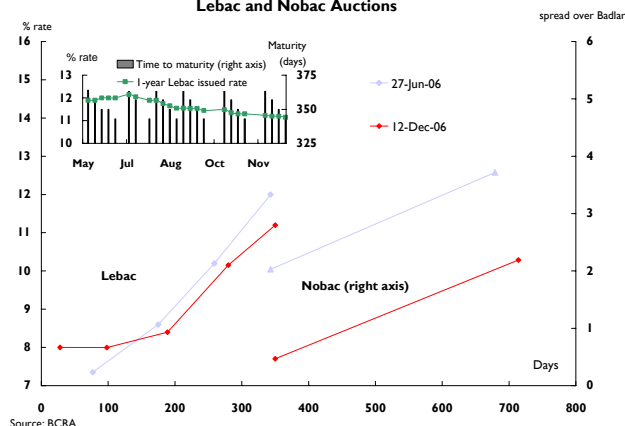


Source: BCRA from Secretariat of Finance - Ministry of Economy and Production

The BCRA auctioned Lebac and Nobac on a regular basis, in line with the current Monetary Program. By December 2006, the outstanding stock of assets issued by the monetary authority totaled approximately \$40.9 billion. Over the second half of the year, floating-rate Nobac (spread over Badlar rate) issuance remained more dynamic: their share in total outstanding grew to 61% from 41% in June (as at December 2005, this ratio was only 12%). At year-end, the duration of the portfolio of outstanding BCRA debt was 357 days, 11 days longer than six months ago and 110 more than a year earlier.

Yields of BCRA bills and notes in primary and secondary market trading fell in the second half of the year (see Chart II.6). As for floating-rate notes (Nobac), falling yields came along with tighter spreads against the underlying Badlar rate. This trend started to revert in the last month of the year, at a time when Badlar was rising (see Chart II.7).

Chart II.6
Lebac and Nobac Auctions



Source: BCRA

As a consequence of a growing outstanding stock, and significant interest from investors, traded volumes in secondary markets of Central Bank bills and notes kept rising. As a matter of fact, not only did nominal volumes rise, but also their share in total traded volumes grew to an annual record of 39% in August (see Chart II.8).

The positive trend in traded volumes of Central Bank bills and notes is foreseen to persist into the future. This is based on the growing appetite of domestic financial entities for this kind of assets as they offer an efficient hedge against rising funding costs from depositors. In addition, financial entities make active use of these instruments to manage their liquidity positions.

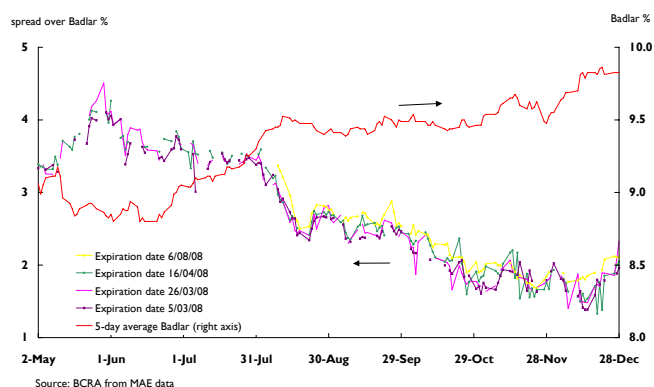
Total traded volumes of fixed income assets in foreign markets grew, driven by rising volumes in domestic debt instruments

Traded volumes of Public Sector debt (both Government- and Central Bank-issued) in domestic markets grew over the second

⁸ In net proceeds (face value times price).

⁹ These placements are not subject to the 30% withholding deposit for capital inflows, as primary public offers of securities that trade in open markets are exempt from it.

Chart II.7
Variable Rate Nobac Yields



half of the year, recovering from the contraction experienced during the first half. Actually, the average daily trading volume of fixed income assets fell from US\$442 million in the first half of the year to US\$424 million in the July-December period. Separately, in foreign markets (where traded volumes usually exceed those of domestic markets), traded volumes of fixed income assets grew. To some extent, this rise was fostered by an increase of close to 70% in domestic fixed income assets trading in 2006 (see Chart II.9).

II.2. Private sector fixed income assets

As most corporate debt restructuring processes with their origins in the 2001 crisis conclude, new, genuine corporate debt issuance picked up

In the second half of 2006, the recovery in genuine¹⁰ corporate debt issuance (see Chart II.10) increased its pace. This happened in the backdrop of a favorable international setting for fixed income assets (with yields at historical lows and growing appetite for emerging risk), with the additional support from solid fundamentals for the local economy. At the same time, most corporate debt-restructuring processes have come to an end (only a few minor cases remain unsettled). As a matter of fact, genuine issuance of corporate debt (ON) in the July-December period totaled US\$3.2 billion, rising about 70% from the total issued in the first half of the year (close to US\$1.9 billion). It should be noted that in 2005 almost 90% of new issuance was related to corporate debt-restructuring processes.

The financial sector led the issuance of genuine debt (ON) in terms of amount, maturity, and currency, setting the benchmark for renewed access to global capital markets. In April 2006, a bank conducted the first relevant (US\$250 million) medium-term (10 year) local placement not linked to a debt-restructuring process. The very same institution was the first one to place a 5 year note for US\$150 million in the global market, after concluding the restructuring of its debt. In June, a consumer finance firm (related to a local bank) concluded the first placement of peso-denominated securities in the global market. By November, this same firm had placed further peso-denominated debt in the global market at a fixed rate and with a 5 year maturity. In December, another financial entity placed an additional US\$150 million of 30-year debt at a rate of 9.75%.

In the domestic secondary market, traded volumes picked up sharply in the last month of the year, but as in the case of public sector debt, the average daily traded volume still remained below that of the previous half. Even when traded volumes of corporate debt rose 92% year-on-year, this is still equivalent to only 1% of traded volumes of Public Sector debt. The limited liquidity in this segment of the market is essentially linked to the participation of institutional investors, which usually purchase these assets to hold them to maturity. In foreign markets, a gradual recovery in traded volumes can be observed; posting an increase in excess of 100% during 2006 (see Chart II.9).

Chart II.8
Traded Volume of BCRA Bills and Notes

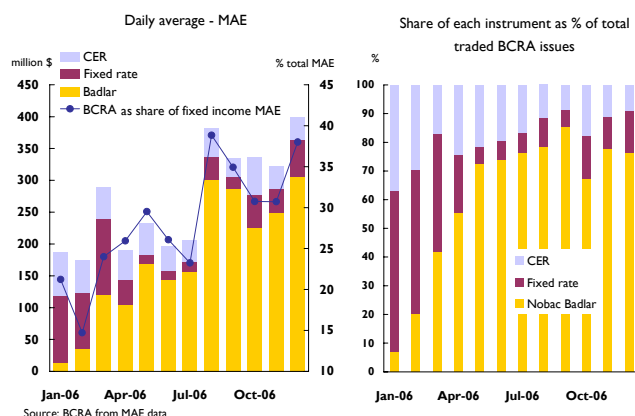
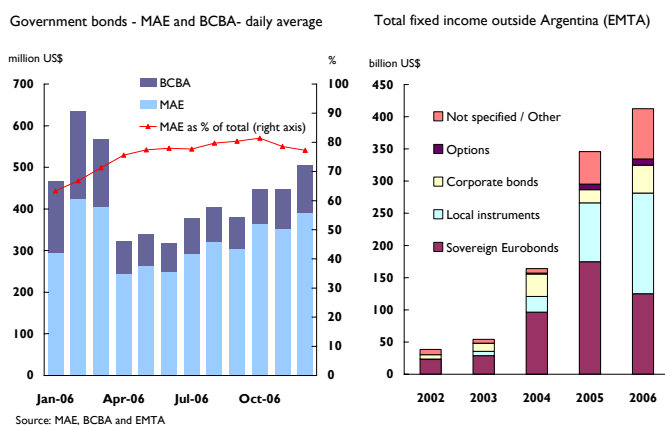


Chart II.9
Traded Volume of Fixed Income

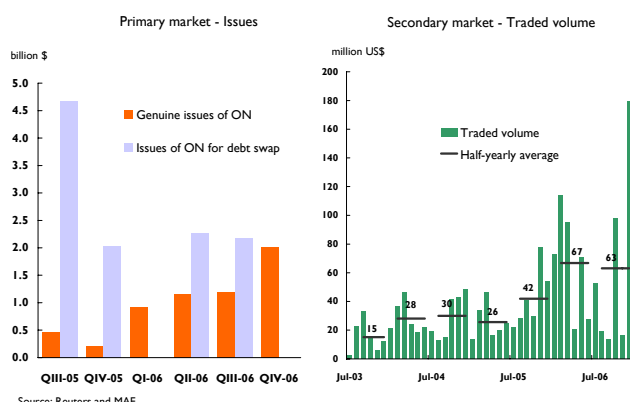


¹⁰ Excluding issuance related to corporate debt-restructuring processes.



Chart II.10

Primary and Secondary Markets of Corporate Bonds (MAE)



Corporate debt yield curves also fell in the period, in line with the overall behavior of fixed income assets. In the case of the banking sector, the yield curve seems to be more representative as the number of issues is larger and yields seem less dispersed (see Chart II.11). In perspective, corporate debt issuance is foreseen to keep growing and yields to keep falling in 2007. This is of singular importance for the banking system, as longer-dated funding will permit longer-dated lending.

Growth in financial trusts issuance and traded volumes consolidates

Issuance of asset backed securities grew briskly in the second half of the year, with 124 new issues for a total of \$4.4 billion. This implies a 26% growth as compared with the same period of 2005 (see Chart II.12). In this manner, in 2006 there were 205 new issues for a total of \$7.5 billion, posting a 50% increase over a year ago.

This sustained expansion is based on the rate of economic growth and the performance of consumption, as more than 60% of the amount issued in 2006 (FV of \$4.5 billion) was backed by receipts on personal loans and credit card coupons (44% and 19%, respectively), in line with the trend observed since the end of the last crisis (see Chart II.13).

Additionally, substantial issuance was backed by national guaranteed loans (PGN). These assets drew particular market interest as the underlying CER-adjustable assets lack secondary market¹¹ trading. Accordingly, secondary market trading of asset backed securities grew markedly, mainly driven by these securities backed by national guaranteed loans, which accounted for closely 50% of the volumes traded.

Chart II.11

Yields of Outstanding Bonds Issued by Banks

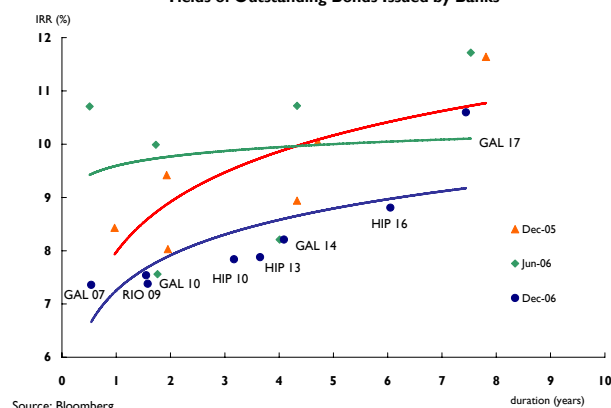
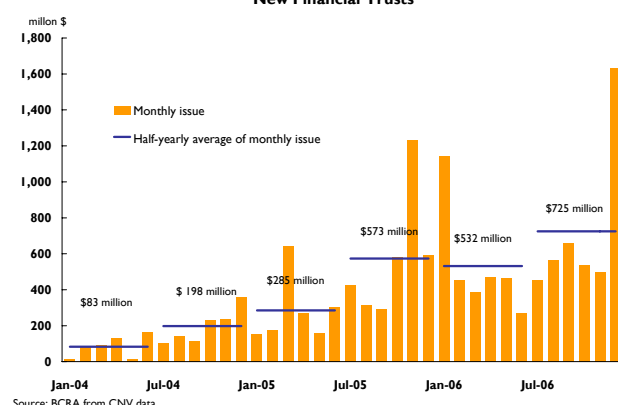


Chart II.12

New Financial Trusts



In December, the novel Gas I Trust was issued, by means of which AFJPs started financing infrastructure projects. Total issuance was \$588 million and the proceeds will be applied to the expansion of gas pipelines managed by Transportadora Gas del Norte (TGN) and Transportadora Gas del Sur (TGS). AFJPs subscribed 35% of the issue and participation of foreign investors was significant at 52% of the total.

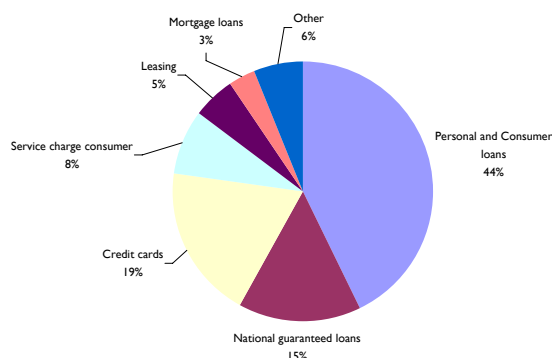
Financial trusts are strongly dominated by the domestic currency, which accounts for 95% of the outstanding. With regards to maturities, 40% of the amounts issued in the second half of 2006 have maturities of less than two years.

Trading of deferred-payment checks at the Stock Exchange still reflects intense activity in this segment of the market, that materialized in volumes increasing 33% in the July-December period and more than 100% in the year 2006 (see Chart II.14). Significant dynamism in this asset class is expected for 2007, so that together with growing bank lending would further consolidate the access to credit by the SME sector.

¹¹ Guaranteed loans are not traded publicly and trades must be conducted before a notary public.



Chart II.13
Securitization by Underlying Assets
2006



Source: CNV

Chart II.14
Trading of Differed-Payment Checks

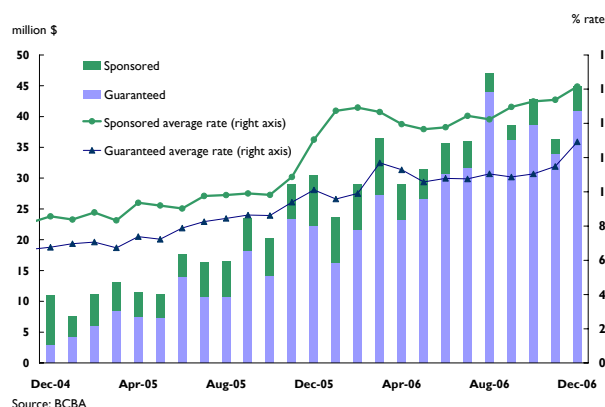
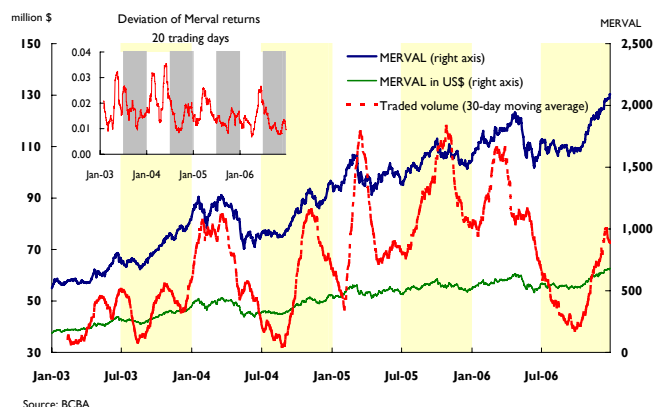


Chart II.15
Local Stock Market



II.3. Equities

The Merval stock index hit an all-time high. Traded volumes recovered, but still remain at low absolute levels

During the second half of 2006, stock indices in the region experienced a significant recovery. While the Dow Jones Industrials index hit new all-time highs and emerging market stock indices reflected on this positive trend, the Merval stock index closed the year with a record 2,094 points. This level is compatible with an increase of 22% over the previous six-months and 35% for the year (as measured in pesos). Computing the dollar return would yield similar results, as the peso experienced only a modest depreciation over the period. With a yearly 33% gain in dollars, the Merval ranks among the best performers in 2006. The recovery of the index in the second half of the year was simultaneous with an environment of lower volatility (see Chart II.15).

Furthermore, a change in the relative performance of the stocks that make up the index can also be observed. On top of Tenaris' positive performance (the stock with the largest weight in the index and whose price is highly correlated with the price of oil), stocks in the banking industry posted solid recoveries (see Chart II.16). More precisely, banking and utilities stocks seem more relegated and exhibit the greater potential for appreciation in 2007. As a matter of fact, in the first months of 2007 banking stocks already posted sizeable gains that were partially reverted by the late February turbulences in global markets.

Traded volumes in the stock exchange fell from a daily average of \$85 million in the first half of the year to \$52 million in the July-December period. As November and December readings were among the highest in the second half of the year, this figure is projected to climb back to early 2006 levels of \$100 million. Beyond this recovery in volumes traded at the BCBA, in 2006 they were 19% lower than in 2005 and remain well below those of other stock exchanges in Brazil, Mexico, and to a lesser extent, Chile and Colombia.

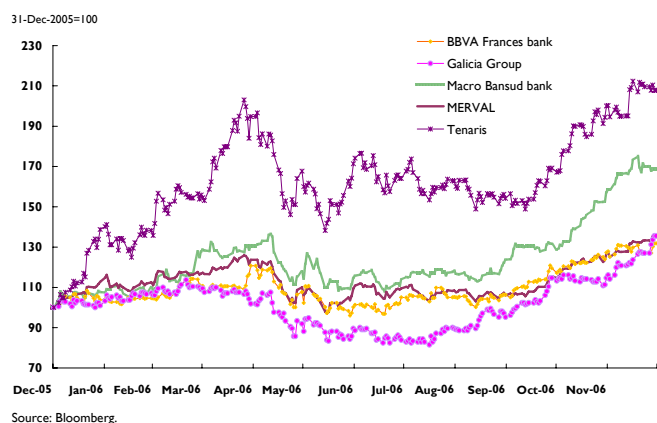
Lastly, the opening of a dedicated panel to stocks of SME will mean an additional source of financing for this kind of firms. In this regard, the applications of two firms have already been authorized.

II.4. Derivatives

Derivative markets still concentrate their activity in dollar futures and forwards

In the foreign exchange derivatives markets (MAE and ROFEX) traded volumes maintained their growing trends (see Chart II.17), posting rises of 16% in the previous six months and 52% in the year. Even when yearly rates of growth have been decreasing, the elevated rates of growth are still typical of a market in its early stages of development, as opposed to more mature markets where traded volumes tend to be more stable over time.

Chart II.16
Banks, Tenaris and Merval Stock Indexes

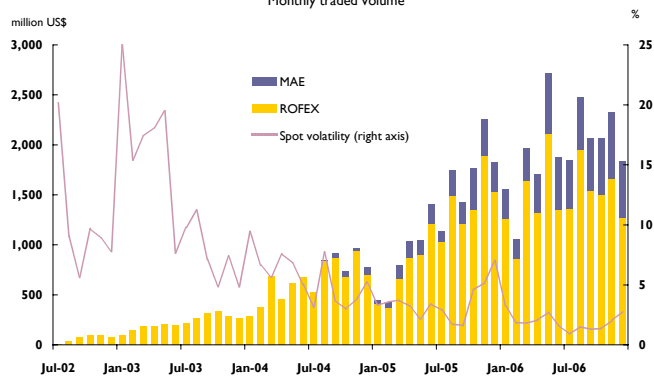


Notwithstanding the growth in volumes traded in the second half of the year, the highest reading in the year occurred in May 2006, when the volatility of the spot exchange rate peaked. In this sense, the ongoing expansion of the futures market is of singular importance as it offers a hedge for foreign currency positions and, at the same time, provides a benchmark for the expectations of the future path of the currency.

With regards to other futures contracts, those linked to the Badlar rate, which were thinly traded in 2005, were virtually not traded at all in 2006.

In perspective, traded volumes of currency futures are expected to exhibit significant dynamism in 2007, beyond any changes in the volatility of the spot price. Furthermore, significant advances in matters of derivatives trading would be observed as of the first quarter of 2007, in connection with the interest rate swap transactions conducted by the BCRA as well as the management of the maturity profile of its liabilities.

Chart II.17
Currency Derivatives
Monthly traded volume



III. FINANCIAL SYSTEM DEBTORS

Summary

During 2006 the financial system was able to strengthen its lending to the private sector, pushing public sector financing into second place. This positive qualitative change in bank credit portfolios is in line with the encouraging economic context. Over the course of 2007 it is expected that economic activity will continue to record a strength growth rate, improving the payment capacity of the main financial system debtors.

The fiscal result for the national public sector has been positive, being reflected in both declining levels of indebtedness and the successful debt issuances that were made during the year. This scenario, combined with the achievement of financing resources for 2007 in advance, reinforces the perception of lower public sector credit risk, consistent with the favorable development of sovereign debt CDS spreads, with a positive repercussion on the credit portfolio of the local financial system.

All productive sectors recorded a positive performance in 2006. These improvements, added to the reduction in external company indebtedness, continue to strengthen the financial situation of the corporate sector. Although foreign currency debt levels are still considerable, manufacturing industry is gradually reducing these liabilities, improving its situation in order to be able to borrow locally. From lower levels, the other areas of economic activity also show a reduction in dollar indebtedness, leading to a sounder credit situation. During 2007 it is likely that the dynamism of local lending will partly compensate for the reduction in company foreign currency liabilities, within the framework of rising credit needs aimed at increasing productive capacity. Taking advantage of the solid fundamentals of the domestic economy and certain international appetite for emerging country debt, it is estimated that some local companies could begin to seek funds on capital markets.

Although loans to households have been growing at a faster rate than income, low levels of indebtedness and positive prospects for income and employment (the latter increasingly in the formal sector of the economy) constitute a situation in which family financial positions are being strengthened. As a result, the sector records a low relative credit risk, leading to forecasts of an increase in the level of bank exposure to families in 2007.

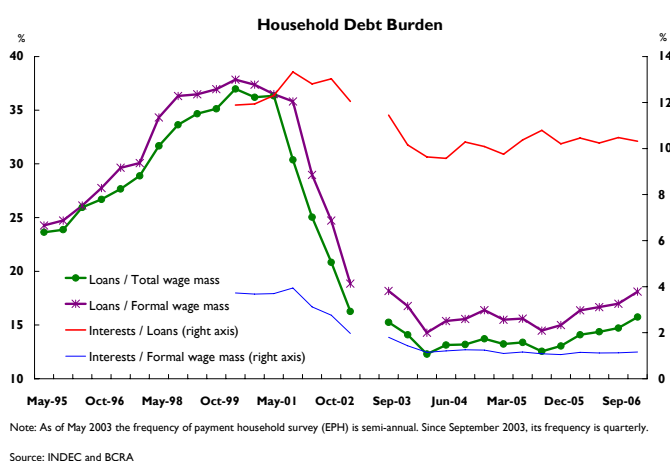
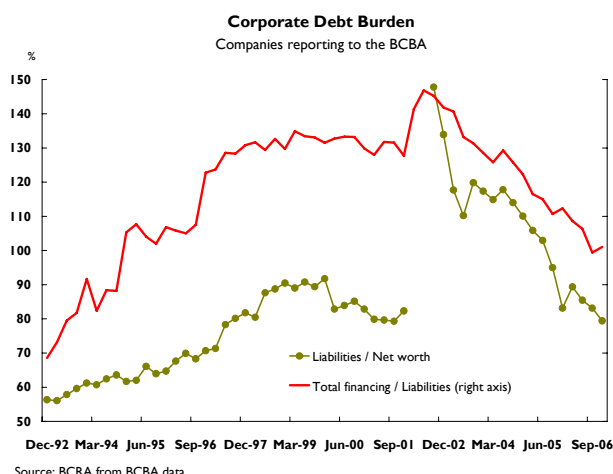
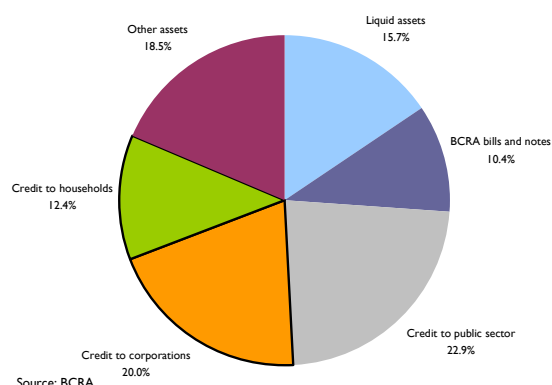




Chart III.1
Financial System Asset Portfolio
As % of netted assets - December 2006



III.1. Financial system assets portfolio

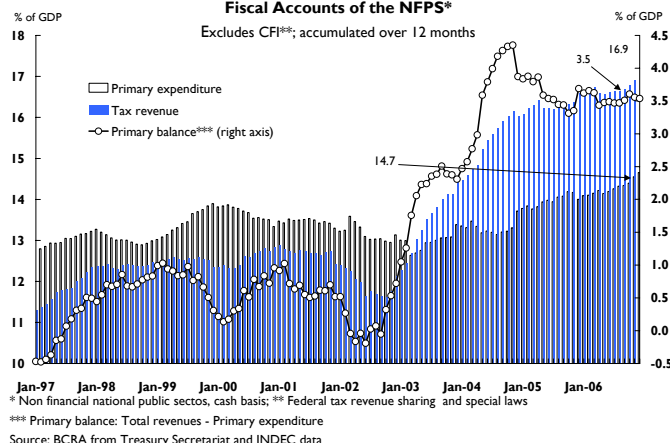
The private sector has become the main financial system debtor

During the course of 2006, and for the first time since the crisis in 2001-2002, bank lending to companies and households has risen above exposure to the public sector (after growing 41%) (see Chart III.1). For the medium-term development of counterpart risk, this rising lending to private sector activities should take place in association with adequate evaluation of credit performance, both in the case of lending to the business sector and to households. Special monitoring should be made of the behavior of new loans to both new and previously-existing borrowers.

In addition, it is expected that the public sector asset portfolio will continue to decline gradually during 2007, in an encouraging macroeconomic scenario that will continue to promote the financing of investment and household consumption needs.

Chart III.2

Fiscal Accounts of the NFPS*
Excludes CFI**; accumulated over 12 months



III.2. Public sector

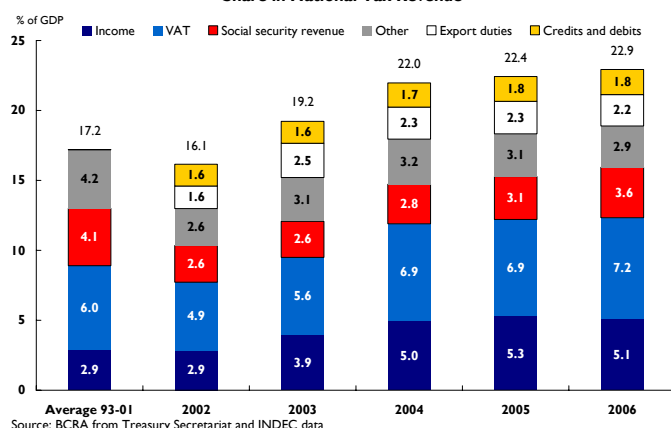
National public accounts evolved favorably during 2006¹², reducing the sector's counterpart risk

In 2006 the Non-Financial National Public Sector (NFPS) posted a primary surplus of 3.5% of GDP, showing a slight decline compared with the previous year, when it amounted to 3.7% of GDP (see Chart III.2). In nominal terms the primary result totaled close to \$23.2 billion, an increase of more than \$3.5 billion compared with the previous year, influenced by the good performance of national tax revenue, which totaled \$150 billion in 2006 (equivalent to 23% of GDP), recording growth of almost 26% in 2006 (see Chart III.3). Total spending also rose by 26%, driven mainly by primary spending. In an economic growth context, it is expected that revenue and primary spending will continue to show an upward trend, so that the primary surplus in terms of GDP will record a further decline, in line with the guideline foreseen in the 2007 National Budget (PN 2007), to 3.1% of GDP.

Interest payments increased 13% in 2006, and included the first payment of servicing on the GDP-linked coupons issued as part of the public debt restructuring process for a total of close to US\$390 million. As a result, the NFPS financial result totaled 1.8% of GDP, remaining virtually unchanged in relation to 2005.

As foreseen, in 2006 the fiscal results of the provinces fell, mainly because of the increase in primary spending. The primary and financial results from the provincial public sector in particular are expected to be below the forecast for 2006 in the PN 2007¹³. As a result, in 2006 the consolidated public sector (Nation and Provinces) would have recorded a primary surplus

Chart III.3
Share in National Tax Revenue



¹² For a more detailed analysis of Public Sector income and expenditure, see the Inflation Reports for the fourth quarter of 2006 and the first quarter of 2007.

¹³ The 2007 National Budget planned for 2006 primary and financial surpluses by the provincial public sector of 0.4% of GDP and 0.1% of GDP, respectively.

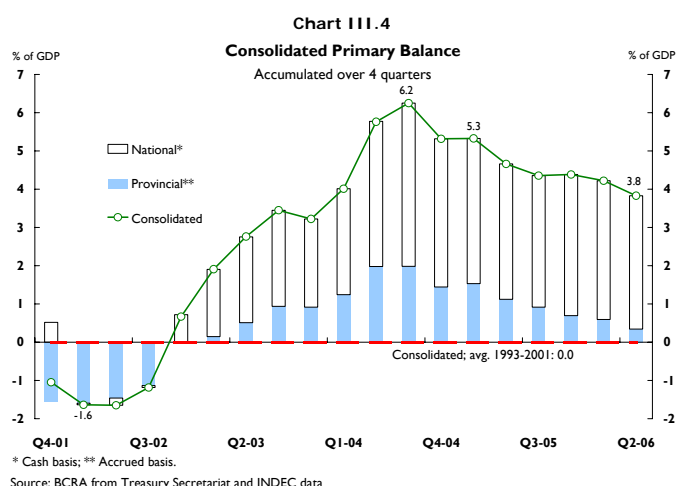


Table III.1
Bond Issues in 2006

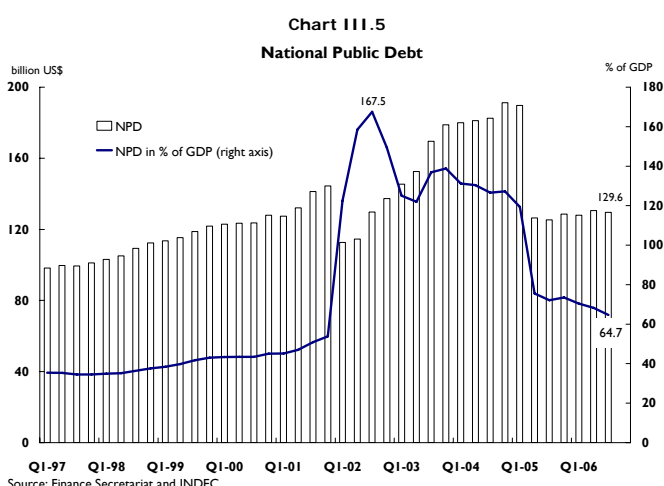
Bond	Auction Date	Total Issue ¹	Issue Price ²	Yield ²	US Treasury Bond Spread ³
Boden 2012*	19-Jan-06	312	80.0	8.5	418
Boden 2012*	27-Jan-06	308	81.1	8.3	381
Boden 2012*	14-Feb-06	308	81.1	7.8	311
Boden 2012*	21-Feb-06	307	81.4	7.6	298
Bonar V	22-Mar-06	500	94.5	8.4	367
Bonar V	03-May-06	500	96.4	8.1	338
Boden 2012*	09-May-06	239	83.7	7.5	253
Boden 2012*	07-Jun-06	243	82.5	8.3	334
Boden 2012*	27-Jun-06	245	81.6	9.1	393
Boden 2012*	17-Jul-06	482	83.0	8.6	348
Bonar V	26-Jul-06	500	97.3	8.3	333
Bonar VII	07-Sep-06	500	92.7	8.4	364
Boden 2012*	31-Oct-06	420	71.5	7.4	272
Bonar VII	30-Nov-06	500	96.3	8.0	356
Total 2006		5,365			

(1) Nominal value, in million; (2) In %; (3) In basis points

(*) Private award.

Note: In 2006, National Public Debt bond issues were in dollar.

Source: Secretariat of Finance



of less than 4% of GDP (it had been 4.4% in 2005) and it is estimated that it will continue to decline in 2007, although it will still be high in historical terms (see Chart III.4).

In 2006, the public sector succeeded in lowering its indebtedness level

In the context of its 2006 debt issuance program, the National Government issued bonds in dollars for a face value (FV) of US\$5.4 billion, of which slightly over half corresponded to direct placements with Venezuela¹⁴. In the second half of the year issues totaled FV US\$2.4 billion, including the first two issues of BONAR VII¹⁵ (2013) for FV US\$500 million each. In addition, two direct placements were made with Venezuela of BODEN 2012 for a total of FV US\$902 million, as well as the final issue of BONAR V for FV US\$500 million¹⁶. At a time of improvement in the international financial scene following the volatility seen in May and June, the spread in relation to USA Treasuries dropped to an average of close to 340 b.p. (see Table III.1). Consequently, bond issues in dollars, together with the financial surplus and the net use of temporary advances (TA) from the Central Bank, enabled the National Treasury to cover its financial requirements for 2006 and bring forward part of the borrowing needed for the early months of 2007.

As a result, despite new debt issues in dollars to meet principal maturities, and the increase in peso liabilities, mainly because of CER adjustments, positive fiscal account results and economic expansion lowered public debt levels. During 2006 the National Public Debt dropped 8.9 p.p. of GDP, reaching almost 65% at the end of September 2006 (see Chart III.5). Public sector payment capacity continued to show improvement, a trend consistent with the historically low spreads on Argentine CDS currently being recorded (see Page 22).

In addition, at the beginning of 2007 further progress was made on the settlement of arrears in public debt servicing. Towards the end of January the Government agreed with the Spanish authorities on the repayment to that country of a debt for US\$983 million, arising from a loan granted in 2001. It is intended to repay the liability over six years, with increasing amortization of principal, at a LIBO rate plus 140 b.p.. Following this agreement, at present over 95% of the total stock of National Public Debt is in a normal payment situation¹⁷.

III.3. Corporate sector

In a context of low relative indebtedness level, foreign liabilities still show the greatest weighting, although local borrowing continues to increase in importance

Over the course of 2006 banks increased their lending to the corporate sector, at a time of increasing levels of production and

¹⁴ All national public debt issues in 2006 were in dollar-denominated bonds.

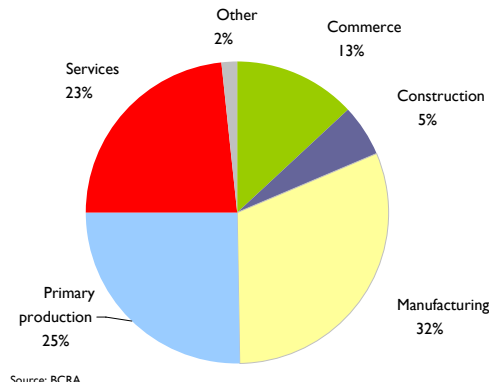
¹⁵ See Joint Resolution No. 230/2006 and 64/2006 issued by the Treasury and Finance Secretariats. The total authorized amount for the issue was FV US\$2 billion.

¹⁶ In accordance with Joint Resolution No. 88/2006 and 18/2006 issued by the Treasury and Finance Secretariats, the total authorized amount for the issue was FV US\$1.5 billion.

¹⁷ To make this calculation, the total of bonds not submitted for swap (holdouts) amounting to FV US\$25.3 billion, has been excluded.



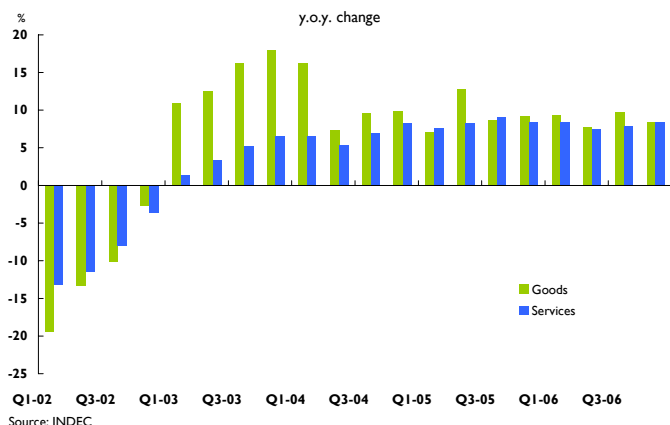
Chart III.6
Banking Financing to Companies by Economic Sector
December 2006 - In %



improved prospects for business in the medium term. The most dynamic economic activities, manufacturing industry and primary production of goods, continue to account for the largest share (almost 57%) of bank lending to companies (see Chart III.6). Resources allocated to services and commerce also achieved significant shares, while lending to the construction sector remains at low levels.

In the second half of 2006 the economy continued to record a high growth rate in both the services and goods-producing sectors (see Chart III.7). There was a particularly notable performance by manufacturing industry and services connected with transport and communications. In general terms, these improvements in productive activities continue to be reflected in the consolidation of the financial position of the corporate sector, reducing the risk of lending to companies. Corporate indebtedness abroad continues to decline (see Chart III.8), increasing the relative share of funds from the domestic financial system, in a context of reduced volatility of the peso-dollar exchange rate.

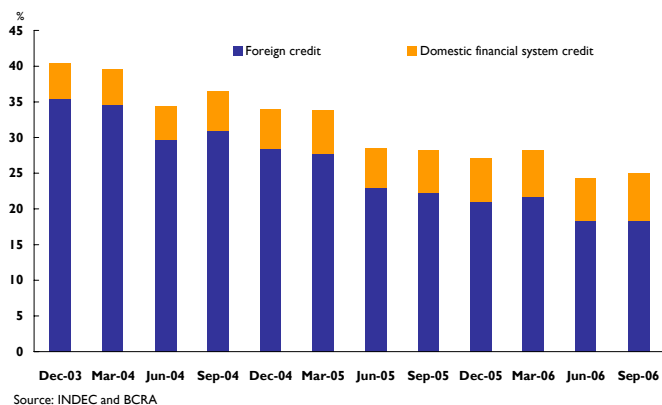
Chart III.7
GDP, Goods and services
y.o.y. change



This trend towards the normalization of financial position in the corporate sector is also evident in the financial statements of companies that have access to the domestic capital market (mostly larger-size companies). This corporate sector records levels of leverage and share of bank lending that are lower than those that prevailed in the pre-crisis period, with a declining trend (see Chart III.9). This movement is matched by greater solvency levels, in line with the steady increase in domestic economic activity and sound prospects for the exporting sector.

In coming months there is expected to be widespread balanced growth across producers of goods and providers of services, leading to further expansion in aggregate activity levels, a trend that will strengthen the financial position of corporations and encourage new investment. This will provide an encouraging scenario for increased bank lending to the productive sector, within the framework of good company repayment potential.

Chart III.8
Corporate Debt
As % of GDP



III.3.1. Manufacturing

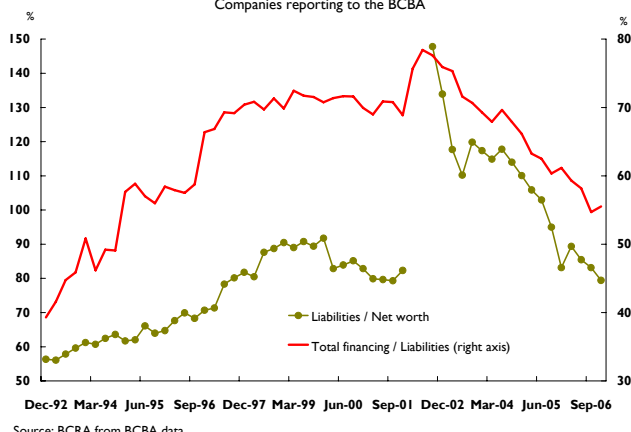
Companies in the sector continue to strengthen their financial position

In the final part of 2006 manufacturing industry continued to evolve in a positive manner, benefiting from the rising trend in demand, both internal and external. The sector expanded by 8.3% y.o.y. during 2006, totaling five consecutive years of growth and continuing to evidence an encouraging outlook for 2007 (see Chart III.10). Increased manufacturing activity was seen in all sectors, although those making the greatest contribution were the vehicle industry, the food sector and the manufacture of chemical products, which accounted for two thirds of the growth in the sector.

This favorable performance by manufacturing industry was matched by a slight increase in the use of installed capacity, which in 2006 was 0.8 p.p. higher than in 2005. Rising industrial



Chart III.9
Corporate Debt Burden
Companies reporting to the BCBA

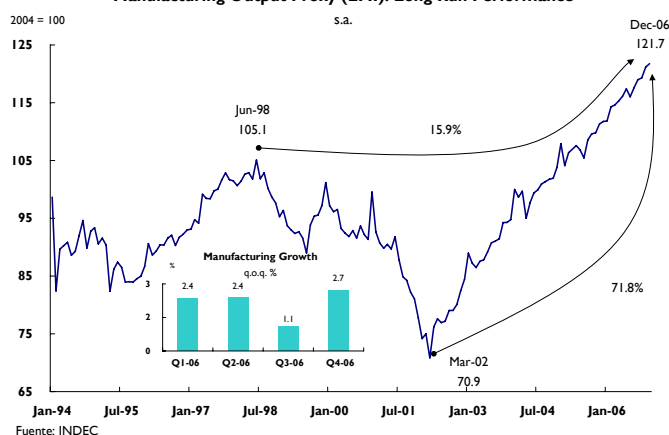


output has been based on increased production facilities and the incorporation of new workers, in a context of greater labor productivity (see Chart III.11).

Manufacturing industry indebtedness levels have shown signs of growth, with a gradual increase in the use of local financing (see Chart III.12), while borrowing abroad continues to show a greater weighting. It can be expected that the encouraging prospects for the sector in coming years will promote demand for the financing of new investment. This situation leads to forecasts for steady increases in domestic financing for manufacturing industry in coming years.

In 2007 domestic and external demand is expected to remain firm, and this, added to the statistical carry-over of 3.2% inherited from 2006 growth, makes it possible to forecast a further year of economic expansion. Output is expected to increase by over 7% in 2007. Once again, the manufacturing sector will be driven by the same activities that led manufacturing industry growth in 2006, together with rising levels of activity by basic metal industries, particularly in the second half, once investments under way to increase productive capacity have matured. This expected positive performance will strengthen the financial position of industry.

Chart III.10
Manufacturing Output Proxy (EMI). Long Run Performance

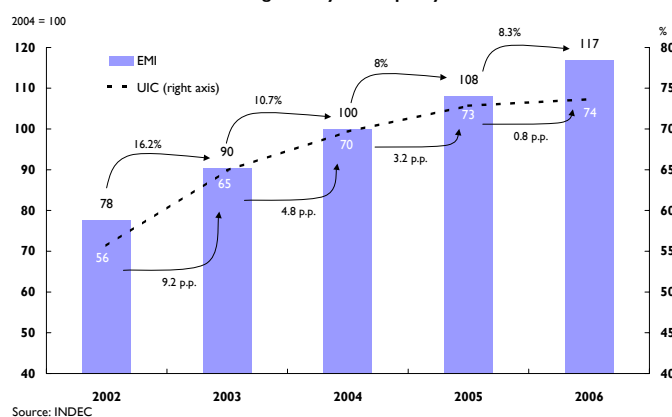


III.3.2. Primary sector

Outstanding performance by the primary sector in 2006, in part driven by international prices, contributes to a reduction in repayment risk

Favorable weather conditions recorded during the growth of leading crops, and the high prices for agricultural production, will contribute for a record harvest in the 2006/07 season. As a result, agriculture is expected to make a positive contribution to GDP growth, despite the modest performance of the livestock sector.

Chart III.11
Manufacturing Activity and Capacity Utilization

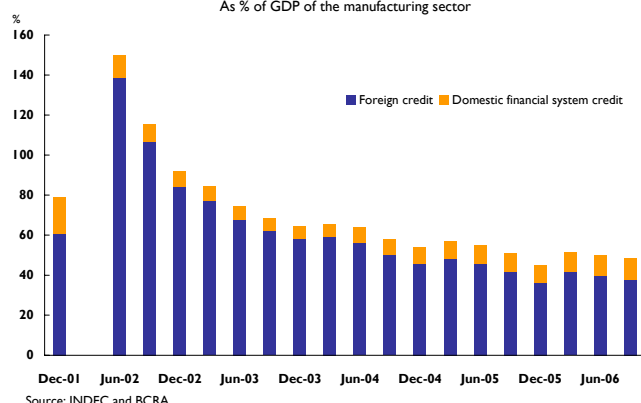


The 2006/07 harvest is expected to reach a new record of close to 90 million tons, well in excess of initial estimates and 6% above the previous record in the 2004/05 season. Given an impulse from the addition of almost 2 million hectares in extra area for sowing (6.5% y.o.y.) and an improvement estimated at around 10% in crop yields, production is expected to be 17.5% higher than in the 2005/06 season, with increased production of both cereal and oilseed crops (see Chart III.13 and Table III.2). As a result, and thanks to increases in international prices, the value of the exportable surplus of the agro-industrial sector will be 30% above that obtained in the 2005/06 harvest, totaling close to US\$16 billion.

In the livestock sector, during the second half of 2006 there was a reduction in beef slaughter of close to 2% y.o.y., mainly because of lower export volumes. Nevertheless, export values in 2006 were higher than in the previous year, benefiting from improved international prices. In 2007 it is expected that supply will be restricted because of the lower investment in the sector, so that production volumes could post a further drop.



Chart III.12
Manufacturing Sector Debt
As % of GDP of the manufacturing sector



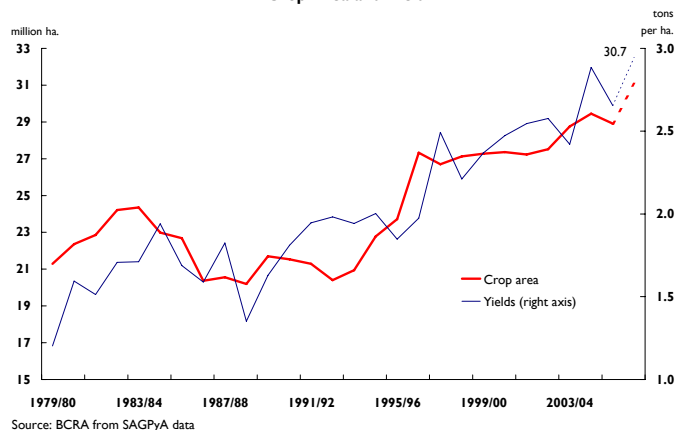
In line with the positive aggregate performance by the primary sector, companies continue to show reduced levels of indebtedness. In particular, the share of debt in foreign currency continues to decline in comparison with the rising levels of domestic borrowing. It is expected that the outlook for the primary sector will remain favorable, contributing to an improvement in the financial condition of companies in the sector, which will have an impact by lowering their credit risk, encouraging the use of bank credit.

III.3.3. Services

Service companies continue to perform notably well, contributing to consolidate their payment capacity

Service sectors continued to make a positive contribution to economic growth in the second half of 2006. Transport, storage and communications services in particular recorded a positive performance, driven by tourism, the farming sector and the increased use of telephone services, especially cell-phones, which grew by 27% y.o.y. in the second half of 2006 (see Chart III.14).

Chart III.13
Crop Area and Yield



Electricity, gas and water supply levels also increased, benefiting from greater industrial output and strong residential sector demand, leading to record levels towards the end of 2006. In the second half, energy supplies were 5.5% up on the level in the same period of the previous year, and announcements were made with the aim of increasing capacity in the medium term. Output capacity from Yacypetá is expected to rise over the course of the year, and new electricity generation equipment will be incorporated during the year that will come into service in 2008. New financial trusts have been set up to finance expansion of the gas carrying system, and at the same time new medium-term investment projects in the sector have begun to be evaluated, based on incentives granted for their development, such as the setting of differential rates or additional charges.

In this context, steady reduction in the foreign liabilities of utility companies will continue to strengthen their financial position. In mid-2006 borrowing levels recorded by these companies were lower than those in the pre-crisis period. Local bank lending resources to this sector have seen significant growth in recent periods, in the context of encouraging prospects for this activity in the medium term.

Table III.2
Grain and Cotton Production

	2004-05		2005-06		2006-07 (estimated)		Chg. 2006-07 / 2005-06	% chg. 2006-07 / 2005-06
	million tns	%	million tns	%	million tns	%		
Cereals	41,858	49.3	31,433	41.0	40,517	45.0	28.9	9,084
Corn	20,483	24.1	14,500	18.9	21,000	23.3	44.8	6,500
Wheat	15,970	18.8	12,575	16.4	14,000	15.6	11.3	1,425
Grain sorghum	2,894	3.4	2,090	2.7	2,800	3.1	34.0	710
Rice	956	1.1	1,175	1.5	1,210	1.3	2.9	35
Brewing barley	886	1.0	796	1.0	1,000	1.1	25.6	204
Oat	536	0.6	227	0.3	400	0.4	76.3	173
Rye	92	0.1	33	0.0	61	0.1	84.3	28
Others	41	0.0	37	0.0	47	0.1	27.0	10
Oilseeds and oleaginous fruits	42,658	50.2	44,750	58.4	48,669	54.1	8.8	3,920
Soybean	38,300	45.1	40,500	52.9	44,000	48.9	8.6	3,500
Sunflower	3,800	4.5	3,821	5.0	4,064	4.5	6.4	243
Peanut	445	0.5	347	0.5	508	0.6	46.4	161
Others	113	0.1	82	0.1	97	0.1	18.9	15
Cotton	448	0.5	418	0.5	800	0.9	91.4	382
Total	84,964	100.0	76,601	100.0	89,987	100.0	17.5	13,386

Source: BCRA from SAGPyA and USDA data

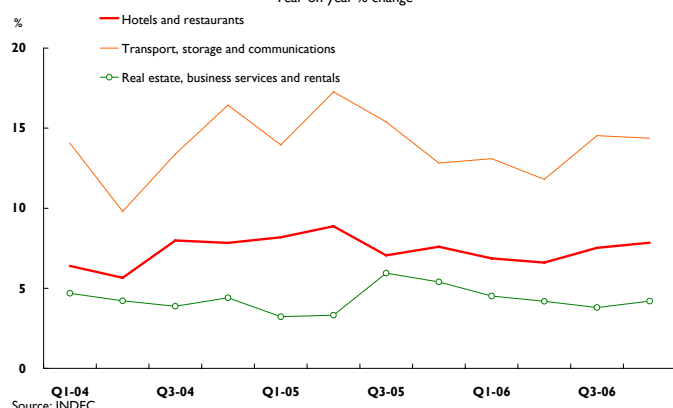
III.3.4. Commerce

The robust financial position of this sector has enabled it to increase investment, making use of domestic bank credit

Retail trade has continued to evolve favorably. In the second half of 2006 retail sales saw an acceleration in their growth rate, in line with the increase in household spending. Supermarket sales went up by an average of close to 12% y.o.y. in the second half, exceeding the rate of increase in recent years, while sales by shopping malls increased by 9% y.o.y. in the same period (see Chart III.15). Over 2006 as a whole, sales were up 9.3%



Chart III.14
GDP Services
Year on year % change



Source: INDEC

y.o.y. in the case of supermarkets and 10.9% y.o.y. in shopping malls.

The rise in the real wage mass, together with better levels of consumer credit, boosted retail sales, especially those of consumer durables. Both car sales and those of household appliances grew at a rate of close to 30% y.o.y. in the second half of 2006.

Given the encouraging prospects for consumer spending and the high level of store occupancy, new retail outlets are planned, supermarkets and shopping malls in particular. These investments are being carried out in part with resources obtained from the domestic financial system. This behavior is in line with the moderate levels of indebtedness shown by companies in this sector, a situation that reinforces their repayment capacity.

III.3.5. Construction

Bank lending to construction remains low, despite the attractiveness of the sector, given its low level of indebtedness and good performance

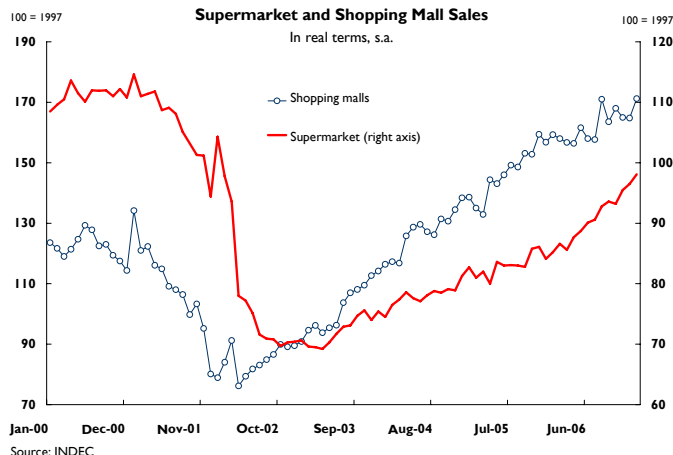
After strong first-half growth, construction evolved at a more moderate rate in the second half of 2006. The sector posted growth of 10.7% y.o.y. in the second half, showing signs of deceleration, although on average in 2006 the sector grew 15.5% y.o.y., making it one of the most dynamic sectors of the economy (see Chart III.16).

During the course of 2006 private sector house-building made a significant contribution to the sector's performance. In addition, the rise in economic activity, especially in manufacturing industry, commerce and tourism, encouraged industrial plant expansion and greater investment in hotel, shopping mall and supermarket construction. Infrastructure and highway works continued to grow at a good rate, benefiting from a greater Government investment in public construction.

A gradual change is being noted in the nature of construction, with medium-term projects being developed to increase the availability of simple dwellings (rather than the luxury ones), at the same time as projects are taking place over a wider geographical area. Greater availability of mortgage lending will make it possible to increase the potential demand for homes. The construction business continues to be largely financed from outside the financial system, with resources provided either by the construction companies or direct investors (both resident and non-resident). The low levels of indebtedness recorded by construction companies, combined with the still positive prospects for the sector, will improve the capacity of the sector to obtain credit lines.

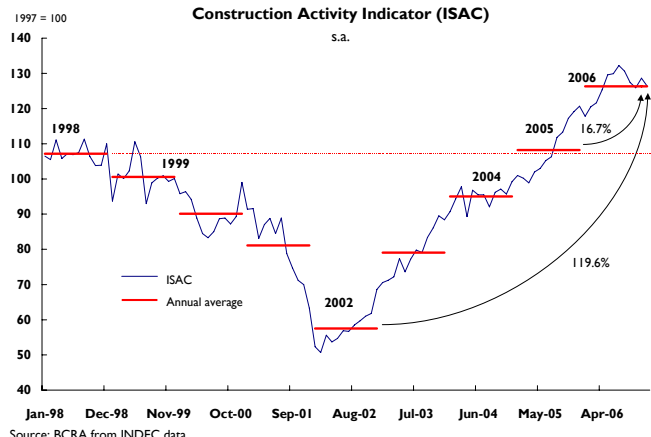
Growth will continue in the sector in 2007, although probably at a lower rate. Despite increased costs and stability in sales and rental values, an optimistic outlook by business leaders in the sector, added to a rise in construction permit areas and the favorable development of the economy, make it possible to forecast another growth year for the construction sector.

Chart III.15
Supermarket and Shopping Mall Sales
In real terms, s.a.



Source: INDEC

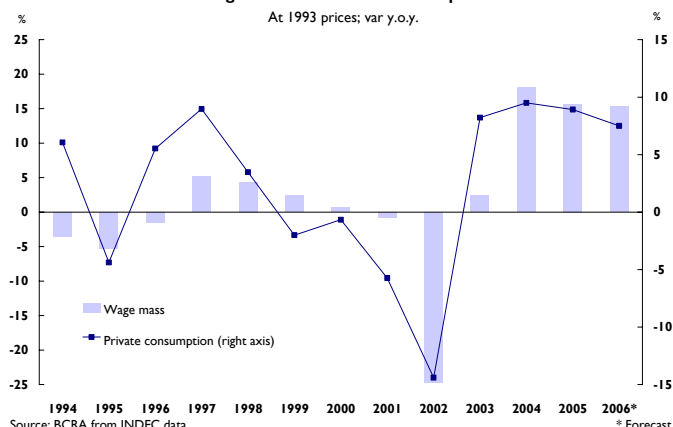
Chart III.16
Construction Activity Indicator (ISAC)
s.a.



Source: BCRA from INDEC data



Chart III.17
Wage Mass and Private Consumption
At 1993 prices; var y.o.y.

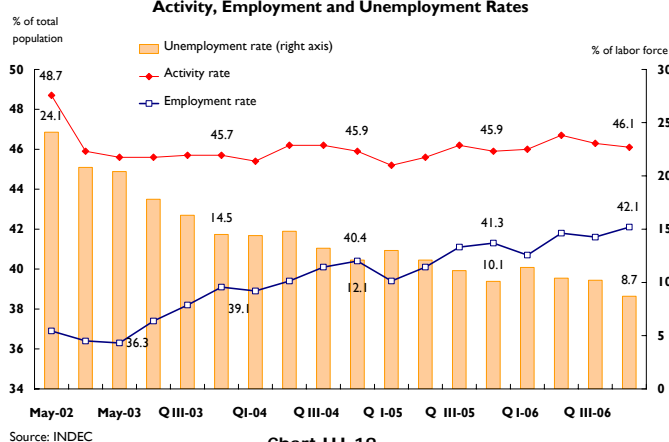


III.4. Household sector

Household bank borrowing levels remain low, although showing signs of an upward trend, supporting the perception that credit risk of this sector continues at a low level

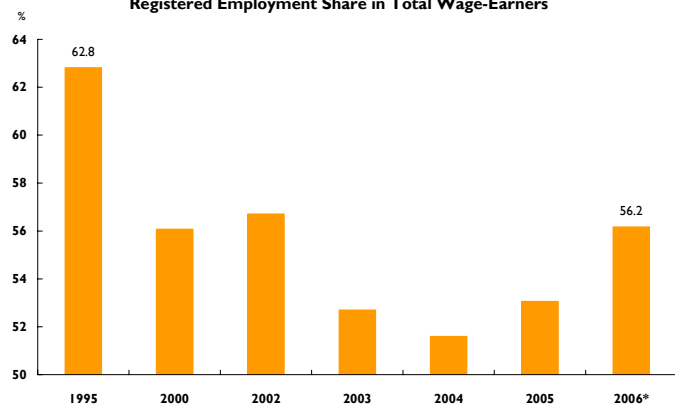
Household spending levels continued to rise during the second half of 2006, although the annual growth rate was slightly below the average for the economy. The increase was a result of higher disposable income, mainly because of the rise in real wages, and increased household indebtedness, in a context in which consumer confidence, in particular for the purchase of durable goods, continues to record historically high levels (see Chart III.17).

Chart III.18
Activity, Employment and Unemployment Rates



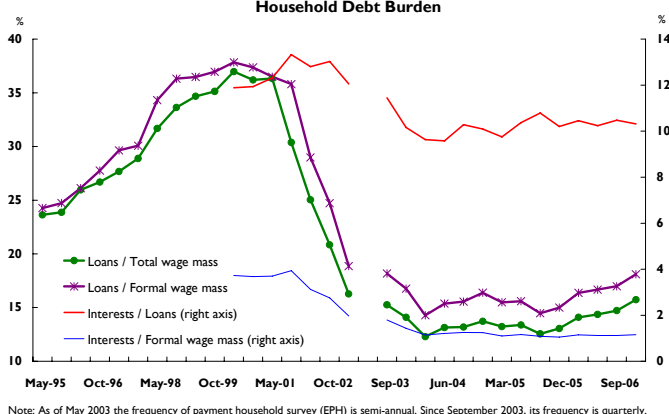
Employment conditions continued to improve in the second half of 2006. Job creation has enabled a steady drop in the unemployment rate, which at the end of the year stood at 9% of the economically active population (PEA; see Chart III.18). Increased employment was accompanied by an improvement in the quality of new jobs. Employment in the official sector of the economy continued to rise, reaching close to 57% of total employment in the third quarter of 2006, 3 p.p. above the level recorded in the same period of the previous year (see Chart III.19).

Chart III.19
Registered Employment Share in Total Wage-Earners



This performance took place in a context in which formal sector employment continued to rise at a rate in excess of 12% y.o.y., while unregistered employment remained practically constant. Improved job quality should be translated into improved household payment capacity, as formal employment implies a lower probability of dismissal. As a result, consumer lending lines record low levels of credit risk, encouraging active placement of such loans by banks. This development, combined with household financing requirements and the good prospects for future income, is reflected in a steady increase in the indebtedness level of the sector, higher than the rise in the wage mass (see Chart III.20). Despite this dynamic, household indebtedness stands at below pre-crisis levels, in a context in which interest rates have remained relatively stable.

Chart III.20
Household Debt Burden



It is expected that the outcome of new wage bargaining processes in the private sector, together with increases that have been announced in pensions and family allowances, will stimulate a further increase in household consumption during 2007.

IV. FINANCIAL INTERMEDIARIES

Summary

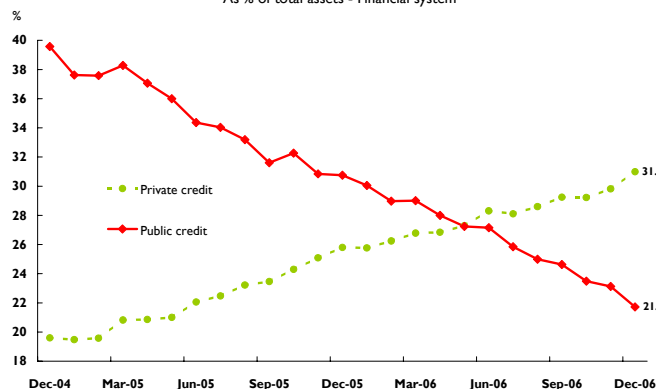
During 2006 the expansion of domestic financial intermediaries deepened. The non-bank financial intermediaries (NBFIs), in particular, managed to gain share in the local financial market and simultaneously increased the weighting of the private sector in their portfolio. Influenced by a favorable macroeconomic context, pension funds, insurance companies and mutual funds expanded in 2006.

The financial entities closed their best post-crisis year, exhibiting persistent progress in their equity structure in quantitative and qualitative terms. This progress was reflected in a strong growth of traditional financial intermediation. In an encouraging economic scenario, credit to the private sector exceeded the exposure to the public sector, a performance driven by the incentives that the Central Bank proposed. In addition, the measures adopted by the Central Bank promoted long term finance in order to add momentum to productive investment. As a result, among the new credit lines granted to corporations those at longer terms increased slightly, while the mortgage loans exhibited a 17% increase in 2006. For this it was fundamental to secure the extension of the maturity of deposits. During 2006, for the first time since the 2001-2002 crisis, private time deposits grew more than sight deposits.

In addition, as a result of the cancellations in advance of debts with the Central Bank, rediscounts tended to disappear, leaving behind one of the characteristics of the crisis and transforming the intermediation process, fundamentally targeted to the private sector.

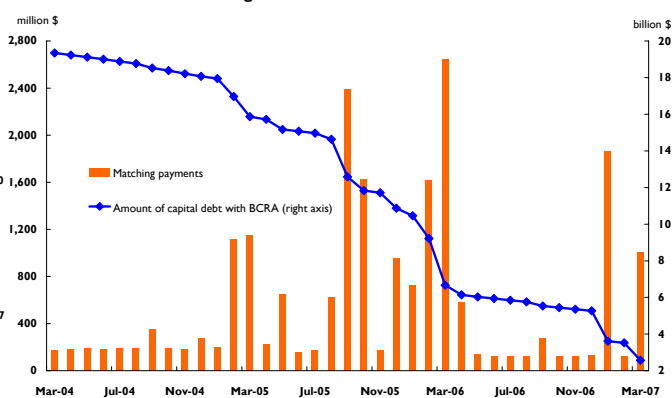
Overall, considering the progress observed during 2006, and due to the expected framework of solid economic activity, the prospects for 2007 are encouraging, with the process of expansion and consolidation of the local financial intermediaries expected to continue.

Public and Private Sector Exposure
As % of total assets - Financial system



Source: BCRA

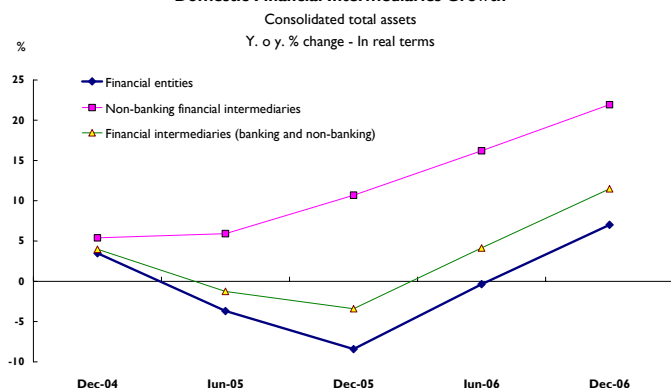
Matching Schedule Liabilities with BCRA



Source: BCRA

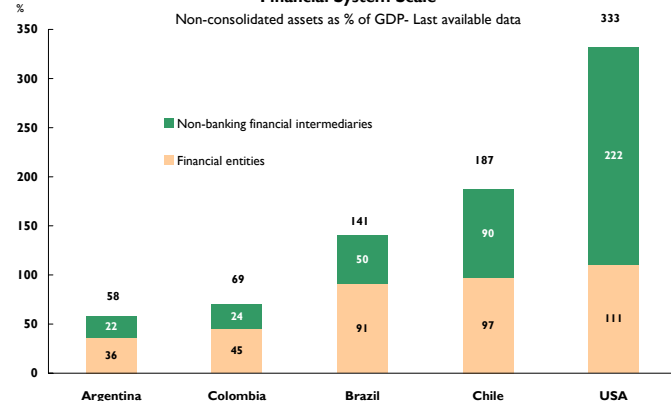


Chart IV.1
Domestic Financial Intermediaries Growth



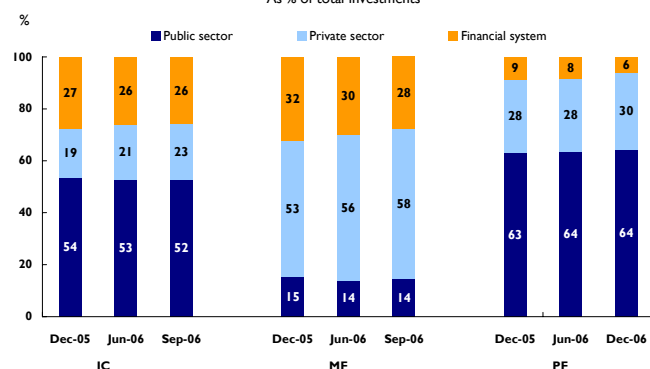
Note: Sep-06 is the last information for MF.
Source: BCRA, SAFF, SSN and Cámara Argentina de FCI

Chart IV.2
Financial System Scale



Source: BCRA from Suprintendencies, Central Banks and IMF

Chart IV.3
Non-Banking Financial Intermediaries Portfolio Composition



Note: Sep-06 is the last information for MF.
Source: BCRA from SAFF, Cámara Argentina de FCI and SSN

IV.1. Non-bank financial intermediaries

In 2006 the domestic financial intermediaries grew more than the GDP. Nevertheless, the potential for growth is still significant

During 2006 a growth of 11% (in real terms) of the consolidated assets of the local financial intermediaries was seen (see Chart IV.1). The sound performance of the sector was in the framework of a favorable context, noticeable by the momentum of the domestic economic activity and the performance of the international financial markets. The expansion of financial intermediaries on aggregate even accelerated during 2006. For the first time since the 2001-2002 crisis the activity of financial intermediaries grew at a faster pace than the national economy. The momentum of the non-bank financial intermediaries (NBFI) was crucial in this process. However, it is worth noting that there is still a strong growth potential existing in the sector, especially when compared with its scale in other emerging economies (see Chart IV.2).

The NBFI gained share within the financial market, exhibiting a shift towards the private sector

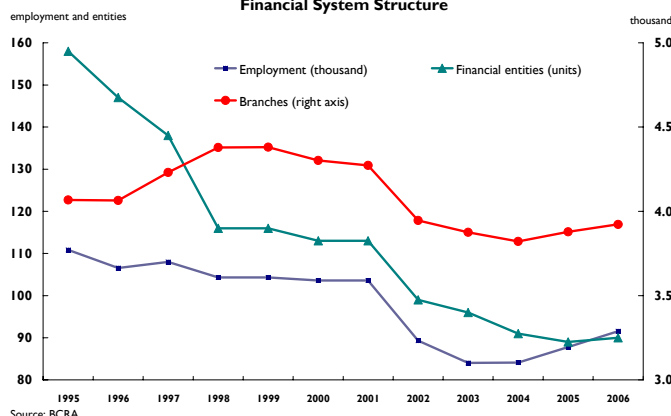
The consolidated assets¹⁸ of the NBFI totaled \$133 billion in 2006, to exhibit a 20% growth in real terms. The NBFI thus gained ground within the market and already account for more than 50% of the bank assets, 6 p.p. more than at the end of 2005. More than half this increase was explained by the inherent momentum of pension funds (PF).

Driven by this expansion of the NBFI, the investment portfolio of the pension funds totaled almost \$90 billion in December 2006, growing more than 20% in real terms in the year. This increase was fundamentally due to the outstanding development of the prices of financial assets. In addition, albeit a second order effect on the portfolio, the number of contributors and the average taxable income also increased.

In 2006 there was a readjustment of the pension fund portfolios that increased their exposure to market risk. In fact, during 2006 the PF exhibited an increase in their financing of the private sector through equity instruments, an event that was generalized among the NBFI (see Chart IV.3). In fact, during the second half of the year among the private investments of the PF the shareholdings stood out, in line with the sound performance of the stock exchanges (see Page 26), while an expansion of their positions in mutual funds was also seen. At the same time the PF slightly increased their share of sovereign instruments in portfolio (Bonar VII, Par and Discount bonds in pesos, GDP-units and financial trusts that have national guaranteed loans – PGN- as underlying assets). Part of the origin of these funds was the cancellation of deposits in the financial system (both CER adjustable time deposits and those arranged at a fixed interest rate).

¹⁸ In order to avoid duplications, the pension fund, insurance company and mutual fund portfolios are consolidated.

Chart IV.4
Financial System Structure

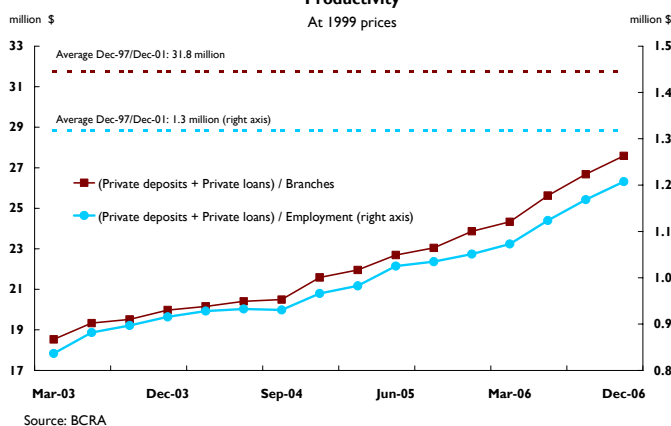


Looking ahead at 2007 an element to monitor in the pension fund sector is the social security reform, which among other changes grants the workers the possibility of returning from the AFJPs to the pay-as-you-go system. This might affect the number of contributors and the size of the future portfolio. At the same time in January 2007 Decree Nbr. 22/07 was issued which maintains the rate for personal contributions for wage-earning workers at 7%, postponing a 2 p.p. projected increase.

On the other hand, in 2006 the insurance companies assets totaled \$35 billion, growing 11% in real terms in 2006, with those specialized in retirement standing out, which allows for the time horizon of the insurance company investments to be broadened. In 2006 the share of the investment portfolio targeted at the private sector increased, at the expense of the public sector share and of deposits.

Likewise, the net worth of the mutual funds (MF) totaled about \$19 billion in 2006, exhibiting a 57% increase in real terms during the year. The MF increased the share of finance for the private sector by 5 p.p., reducing their exposure to the government and their deposits in the financial system, mainly due to their smaller holdings of deposits adjustable by CER. The estimate is that a gradual recovery of the mutual fund sector will be seen and a consolidation of the insurance sector.

Chart IV.5
Productivity
At 1999 prices



IV.2. Financial entities

The financial system ended its best post-crisis year. Both staff and the number of branches grew, while productivity increased

Following the resizing caused by the 2001-2002 crisis, the sound prospects for the financial activity are generating a sustained growth in staff and the number of branches. In fact, the employment level increased 4.3% in 2006 (see Chart IV.4).

In the context of increasing competition, the financial system managed to continue its expansion, achieving improvements in the productivity of its factors, and at the same time the increase in the number of productive services employed (see Chart IV.5). In fact, if the rising trend in the levels of intermediation observed in the past two years is maintained, by the end of 2007 the productivity levels registered prior to the crisis might be surpassed.

Meanwhile, the favorable environment was a factor for an increasing number of financial entities to make their business grow, expanding financial intermediation activity to more participants. In fact, loans granted to the private sector are increasing constantly, and show a fall in the business concentration in 2006 (see Chart IV.6).

In addition, a more uniform distribution among the different groups of financial entities was noted (see Chart IV.7). National private banks have been gaining ground within the market and for the first time surpassed the public banks holdings of private deposits. On the other hand, foreign owned financial entities since 2003 have held approximately 40% of the private sector deposits, with a slight increase in 2006.

Chart IV.6
Financial System Concentration

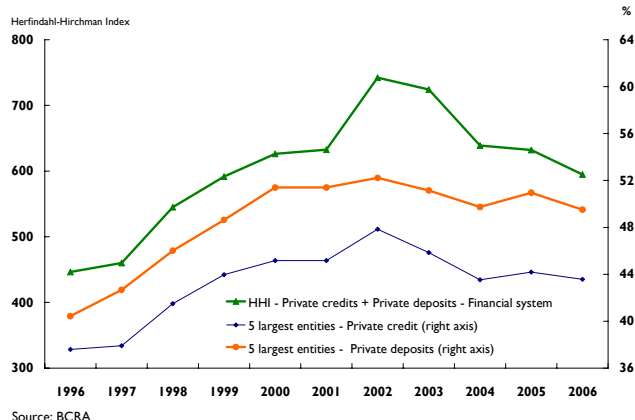
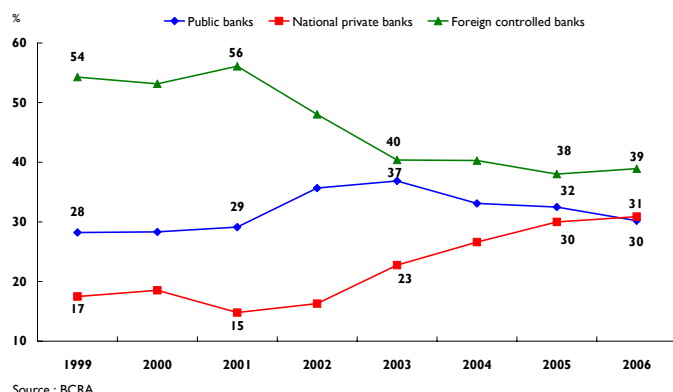




Chart IV.7
Breakdown by Type of Entity
Non-financial private sector deposits



The financial system is exhibiting an improvement in its balance sheet structure in both quantitative and qualitative terms

In accordance with the trend towards the recovery of banking activity, during 2006 the financial entities continued increasing their intermediation levels. This performance was reflected in a progressive increase of the private sector deposits in real terms (11% in 2006) and of loans to the private sector (28% in 2006). In this scenario of expansion of financial intermediation, the assets of the financial system grew 7% in real terms during 2006 (see Chart IV.8).

At the same time the process of normalization of the assets structure was deepened. Driven by the Central Bank regulations, the bank exposure to the public sector fell by 9 p.p. of total assets in 2006 (see Chart IV.9) to a 21.7% level (22.9% of netted assets), freeing up financial resources for corporations and families. This change was the fruit of different strategies the financial entities carried out to adjust their assets, driven in particular by the regulations adopted by the Central Bank. Specifically the gradual convergence to market prices of the government securities was introduced, the application from January 2006 of a maximum cap of 40% of assets as individual exposure, changing to 35% from July 2007 and the capital requirement on public sector assets.

Associated with the reduction of the exposure to the public sector, another sign that the normalization of assets has deepened in the past two years is the significant fall in the stocks of compensations from the national government still pending. At the end of 2006 they represented only 0.3% of the total assets of the financial system, while in December 2002 they had been 9.1%.

This regularization process together with the expansion of activity towards the private sector, has meant that for the first time since the crisis in 2006 the weighting of credit to the private sector in the banking system assets exceeded its exposure to the government. Since the end of 2004 the share of public sector assets was reduced almost 18 p.p., while the loans to the private sector grew 11 p.p.. This generates a financial system that is independent from the government financial needs. Meanwhile, the nominal growth of credit to the private sector was more than 41% in 2006, resulting in the main growth engine of financial system assets (see Table IV.1). Private banks led the growth of loans to the private sector.

Recent regulations introduced by the Central Bank contributed to promote longer term financing

The improvement of the revenues of the different productive sectors and families, combined with the positive prospects of the banking activity, were reflected in both the expansion of private credit and in the extension of the maturity terms of the new loans granted. At the end of 2006 the duration of the new private loans was somewhat more than 3.1 years on average (see Chart IV.10), almost four months more than in the same period of 2005. In

Chart IV.8
Netted Assets of Financial System

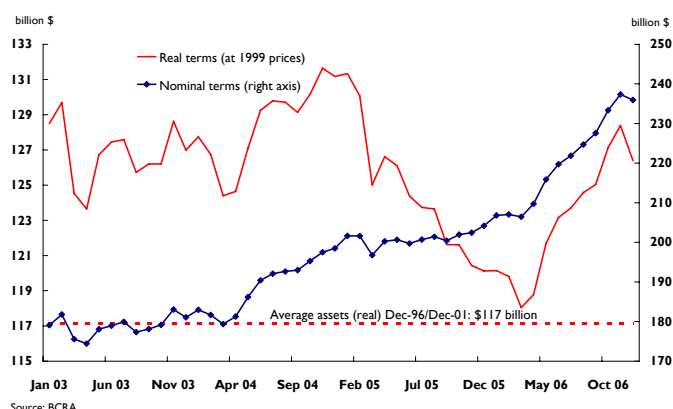


Chart IV.9
Public and Private Sector Exposure
As % of total assets - Financial system

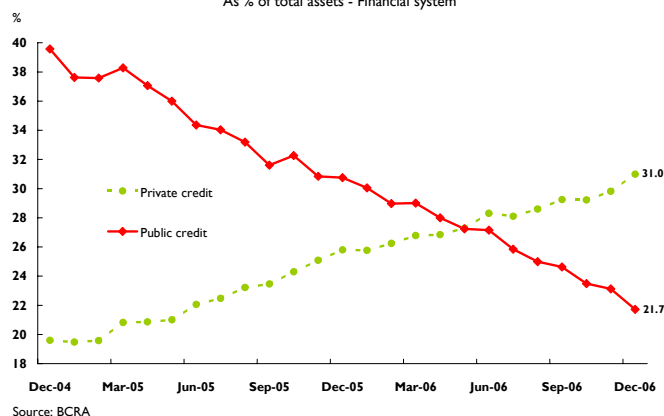


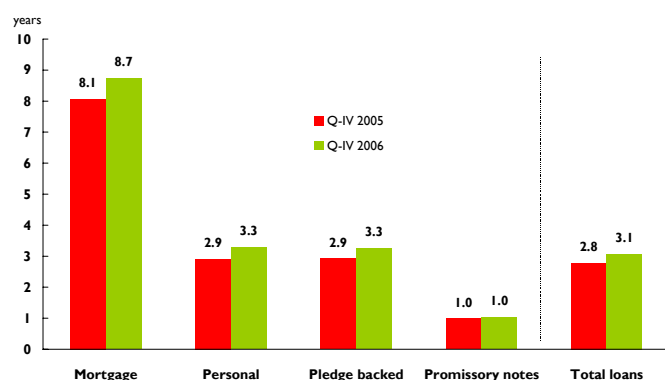


Table IV.1
Balance Sheet
Financial system - % of netted assets

	Dec-05	Jun-06	Dec-06	Half-yearly change II-06 annualiz. (%)	y. o y. change 2006 (%)
Assets	100	100	100	17.7	17.5
Liquid assets	13.2	16.1	15.7	11.6	39.6
Lebac / Nobac	10.1	9.7	10.4	35.8	21.4
Credit to the private sector	26.7	29.2	32.0	40.9	41.1
Credit to the public sector	32.8	28.8	22.9	-25.3	-17.8
Other assets	17.2	16.1	18.9	65.2	30.5
Liabilities + Net Worth	100	100	100	17.7	17.5
Public sector deposits	16.4	18.0	18.6	25.6	33.7
Private sector deposits	48.8	50.0	50.8	21.7	22.4
Liabilities with the BCRA	8.2	5.1	3.1	-54.8	-54.8
Outstanding bonds, subordinated debt and foreign credit	6.1	5.5	5.1	0.3	-1.0
Other liabilities	7.7	8.2	8.8	34.9	33.9
Net worth	12.9	13.2	13.6	24.0	23.3

Source: BCRA

Chart IV.10
Lending to the Private Sector
Average maturity weighted by amounts



Note: Excludes overdraft and credit cards
Source: BCRA

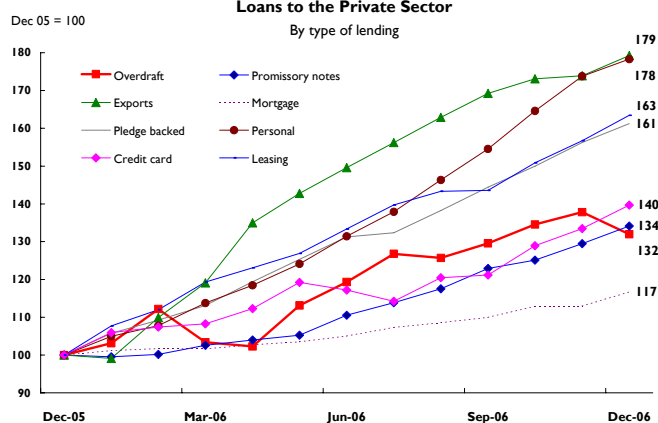
particular, the loans to families extended their average duration to maturity by seven months to 4.4 years.

During 2006 the Central Bank adopted a number of measures to extend the maturity of bank funding, and thus gradually relaxing one of the restrictions so that the financial system can grant longer term loans. In particular, it seeks to boost the purchase of housing in the family case and to carry out longer term investment projects in the productive sector case. Specifically, it decided that the sight deposits in pesos with a remuneration of over 35% of the BADLAR rate will be subject to a 100% minimum cash reserve requirement. It also twice increased by 2 p.p. the minimum reserves requirements on sight deposits (from 15% to 19%), eliminated the remuneration of reserves and the reserve requirement for the time deposits with a 180 days term remaining. These measures favored the migration of savings set up in sight accounts to time deposits. Furthermore, in order to stimulate the long term funding the BCRA promoted the perpetuities (with a minimum of 30 years) by the adjustment to the minimum capital compliance.

The Central Bank also stimulated mortgage credit by making the capital requirement for these loans more flexible (provided they are applied to single family housing for permanent occupancy) of up to \$200,000, allowing for finance of 100% of its value and 90% when the amount is between \$200,000 and \$300,00. In addition, the financial entities were also encouraged to include in the assessment of the payment capacity of the debtors their rental receipts, utility payments, among others, in line with the recommendation to adopt screening systems and credit scoring models to assess the process of granting loans. In the final quarter of 2006 the mortgage loans were granted for 8.7 years on average, almost eight months longer than in the same period of 2005.

With these advances, for the first time since the crisis a generalized increase in all loan lines was observed, in a context of growing competition

Chart IV.11
Loans to the Private Sector
By type of lending



Source: BCRA

Among the loan lines associated with commercial activities, during 2006 the expansion of export finance and pre-finance stood out (see Chart IV.11). On the other hand, both the overdrafts and the promissory notes grew during the year. In 2006 bank leases for corporations also increased by 62% to reach a stock of \$2.2 billion. The services and manufacturing industry led this change, recording increases of 63% and 67% respectively, in their finance through this mechanism. As regards the loan lines for family consumption, an outstanding performance was seen in personal loans and credit cards.

Furthermore, the sound prospects within the business led to a healthy competition between the financial entities to gain new customers. This broadened the number and range of financial products, leading to a fall in the financial intermediation spread for almost all the credit lines (see Chart IV.12). Overall, the spread was reduced by both an increase in the borrowing rates and a slight decline of the lending rates.



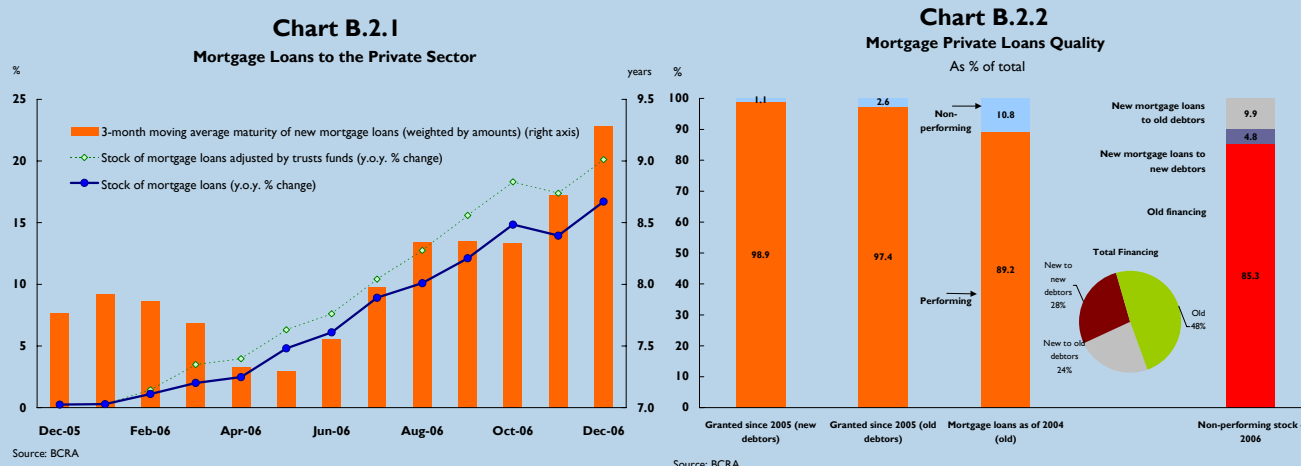
BOX 2: THE DOMESTIC MARKET FOR MORTGAGE LOANS

In line with the incentives defined by the Central Bank, during 2006 the stock of mortgage loans grew for the first time since the crisis. Although supply is still concentrated at a few banks and its development is only beginning, the prospects for 2007 are encouraging

In a favorable economic context, marked by a robust growth that is based on solid macroeconomic fundamentals, bank credit to the private sector completed its third year of expansion, with the longer term lines beginning to gain momentum.

Specifically, for the first time since the crisis, in 2006 the mortgage loans granted to the private sector exceeded cancellations, to show a 17% growth in its stock. This expansion occurred simultaneously with an extension of maturities for the transactions, partly associated with an improvement of the mismatch of maturities on the financial entity balance sheets (see Chart B.2.1). The recovery of mortgage loans in the post-crisis period is extraordinary when compared with experiences in other countries, which show that this kind of loan lines, like other medium term ones, are the last to reappear following a crisis period. The development of the market was accompanied by a growing generation of financial trusts with mortgage portfolios, to take advantage of the benefits of the complementarities between the financial system and the capitals market. In this manner, considering these transactions the growth of mortgage credit totaled 20% in 2006.

The granting of new mortgage loans in 2006 was divided into practically equal shares for the public and private banks, with both groups exhibiting the possibility of lending for a medium term. Among the borrowers, almost two thirds of the new loans were granted to families and the remainder to corporations. The main uses the families made of these loans were for the construction of housing to live in and to purchase used properties. Among the corporations the most dynamic heading was services, followed by the primary industry, in line with the momentum that these sectors show.



The expansion of the market occurred in a context of limited private sector risk (see Page 53). Specifically, the ratio of non-performing loans with mortgage guarantees recorded a 6.3 p.p. fall in 2006 to stand at 6.2%. Due to the long maturity of this kind of loans, the total portfolio includes loans from before the crisis, which reflect its remaining effects. Therefore, if only the new loans are considered (for example, those granted as from January 2005), the non-performance ratio is 1.8%, significantly less than that recorded for the total mortgage portfolio. Furthermore, within the new portfolio, the performance of the new debtors to the financial system (with a 1.1% non-performance) is much better than for old debtors (with 2.6% non-performing), which reveals the sound payment capacity evidenced by the possible borrowers who are entering the financial system (see Chart B.2.2).

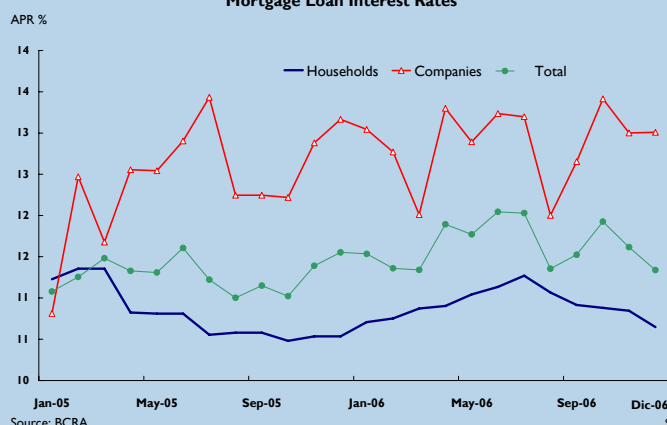
The market growth, the low counterparty risk and the macroeconomic stability scenario enabled the interest rates on the mortgage loans to remain stable in 2006 in a range of 11% to 12% per year (see Chart B.2.3), with higher and more volatile rates for corporate loans. However, the total financial cost (TFC) included an average of about 200 b.p. over the interest rate (exhibiting a large dispersion) when management outlays and insurance costs are added. In this manner, seeking more transparency and competition between the financial entities by trying to make it easier to compare alternative deals, the Central Bank has required the correct publication of the TFC by the financial entities and has made the data of the Transparency Regime available to the public on the Central Bank web page.



However, the degree of market development is still low, exhibiting a certain degree of concentration. More than 90% of the increase of mortgage loans was accounted for by only six financial entities, of which four are private and two are public. In general these banks seek to recover an important niche for their business, because over time they have held a significant market position (at present they hold 60% of the stock of mortgage loans, and before the crisis it was more than 50%). At the same time, in line with the incentives proposed by the Central Bank almost all these financial entities have been extending the maturity of their funding, opening up the possibility of granting longer term lines.

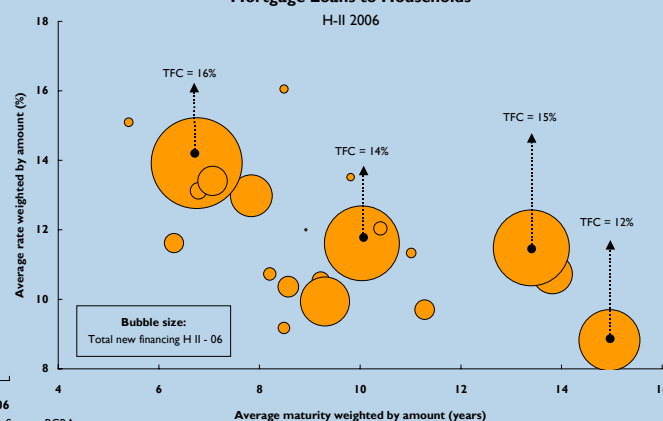
The financial entities which at present dominate the market for family mortgages show a considerable dispersion in the characteristics of the lines they grant. Specifically, the average maturity of the deals are seen to be in a broad range of 7 to 15 years. On the other hand, although some dispersion in the average interest rates of the transactions (and in the TFC), part of these differences may be accounted for by the existence of a greater or lesser share of loans at fixed or variable rates (see Chart B.2.4).

Chart B.2.3
Mortgage Loan Interest Rates



Source: BCRA

Chart B.2.4
Mortgage Loans to Households
H-II 2006



Source: BCRA

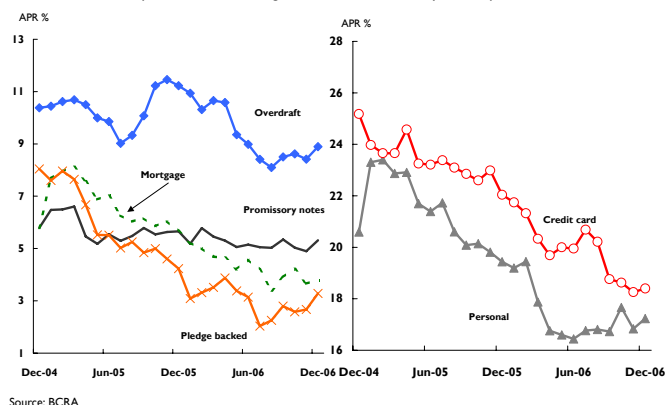
The Central Bank has been setting incentives to develop the mortgage market. With this purpose it has flexibilized the capital requirement for these loans, encouraged the financial entities to include the documentation that substitutes for income receipts to assess the payment capacity and is making progress on an Origination Manual to make it easier to homogenize the mortgage loans for securitization later, among other measures. This last incentive aims precisely at exploiting the benefits of the complementarities of the financial system and the capitals market, which in 2006 began to gain in importance. In fact, during the year financial trusts were set up with mortgage loans as underlying assets for some \$300 million. In this manner, the financial system manages to offload risks on the capital market, acting as a generator of loans and a forum where the risks are valued and traded, respectively.

To sum up, the development prospects of the market are positive, especially when it is considered that at present mortgage loans are only 13% of the bank credit to the private sector and 1.5% of the GDP, whereas before the crisis they had been more than triple the latter level. As well as the budding development of the financial system activity, the deepening of the capital market, the correct incentives proposed by the Central Bank and the encouraging economic context are forecasts of the continuity of growth of the mortgage market in 2007.



Chart IV.12
Interest Rates

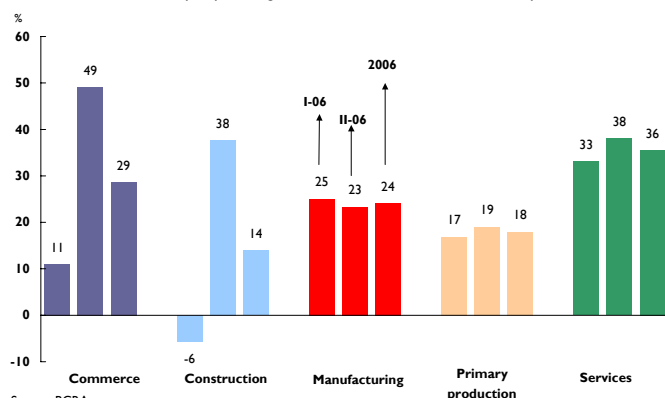
Spread between lending rates and less than 59-day time deposit rate



Source: BCRA

Chart IV.13
Lending by Economic Sector

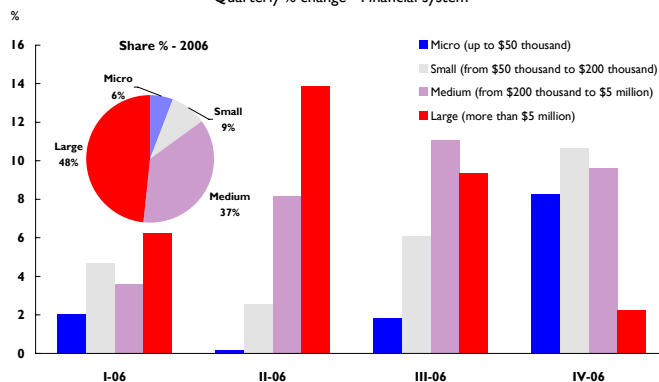
Real half-yearly % change - Annualized and total annual - Financial system



Source: BCRA

Chart IV.14
Lending to Companies by Amount Range

Quarterly % change - Financial system



Source: BCRA

Manufacturing industry and services drove the expansion of bank lending to corporations during 2006

In fact, after its fifth consecutive year of expansion, favored by the growth of demand (domestic and foreign) and by new investments, the manufacturing industry led in borrowing loans. Meanwhile, the persistent growth of service output, especially for the telephone services, was reflected by a strong increase in the demand for credit by this sector (see Chart IV.13). Funds targeted at primary production showed an increase, as did those for commerce and for construction. In this framework, manufacturing and primary goods production are the sectors that concentrate more than half the total corporate finance (32% and 25%, respectively). During 2007 it is estimated that loans for the different sectors will continue to expand contributing towards an increase of economic growth (see Page 56).

Meanwhile, the increase in loans for firms in 2006 occurred in all credit tranches (see Chart IV.14): lines of over \$5 million (mainly targeted at large corporations) grew to account for almost half the total finance. On the other hand, loans of up to \$200,000 (small business and micro-undertakings) increased strongly, with an outstanding momentum in the second part of the year favored by the pro-SME measures adopted by the Central Bank. A substantial share of the loans for small and medium enterprises (SMEs) was channeled as bank leasing.

While a substantial growth of private sector credit was achieved, during 2006 the financial entities also increased their liquid assets

During the year the liquid assets grew almost 40% (see Table IV.1). This performance was partly because throughout the year the Central Bank decided on increase in its minimum cash reserve requirements. In addition, the Central Bank decided to allow the requirements to be achieved with 67% of the cash held by banks, whereas until August 100% could be used. These measures became an additional instrument to stimulate the more efficient use of cash by the banks. At the same time the Central Bank measures were successful in extending the terms of the deposits, in order to reduce the mismatch that usually exists between accepting the deposits and granting medium and long term loans, which are ultimately those that can feed productive investment.

Liabilities also accelerated their normalization process: private sector deposits grew more than the transactional ones and rediscounts from the Central Bank almost disappeared

During 2006 the deposits in the financial system grew 14% in real terms, to exceed the figures prior to the crisis (see Chart IV.15). Meanwhile, the private sector deposits continued on their growth path, reaching almost 60% of total liabilities and 51% of assets (see Table IV.1).

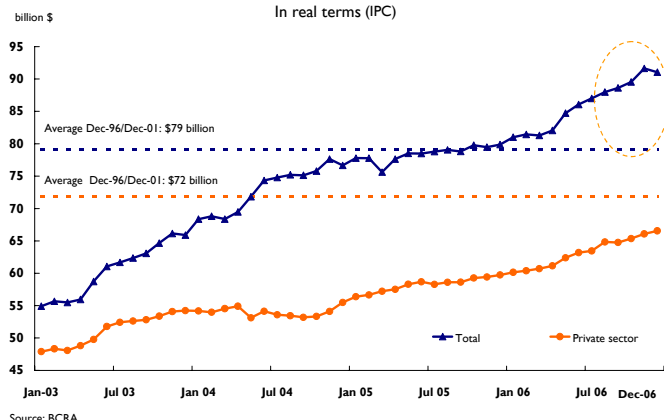
A growing preference for longer term deposits was noticeable. During 2006 the stock of private sector time deposits grew 27%, surpassing the 21% growth of private sight deposits (see Chart IV.16). However, among the time deposits, a slower rate of expansion of the long term deposits was recorded, which was



Chart IV.15

Deposits

In real terms (IPC)



partly associated with the decline of deposits adjustable by CER, in connection with the smaller NBFI investment in these instruments (see Page 38).

Likewise, despite the sound performance of the time deposits, looking ahead the momentum of long term credit will depend on the financial instruments used by the banks to fund themselves on the capital markets. It should be noted that in December 2006 and January 2007 a financial entity placed issues on the international financial markets. Taking advantage of the complementarities between the financial system and the capitals market will be crucial for the maturity of the credit supply to grow, in order to achieve a more efficient risk management.

The financial system continued reducing its debts with the Central Bank through the matching schedule. The debts with the Central Bank in March 2007 were only 1% of bank liabilities, 8 p.p. less than at the end of 2004 (see Chart IV.17). Until now the cancellation of debts with the Central Bank assumed a strong application of funds which in the near future will practically disappears. Since the beginning of the scheme, two thirds have been payments in advance, which accelerated during 2006. At present only one bank still registers debts under the matching scheme and only 14% of the original debt is still outstanding.

Chart IV.16

Private Deposits

Y. o y. % growth - Financial system

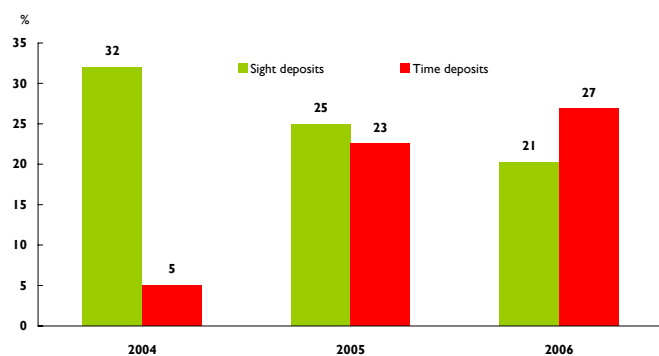
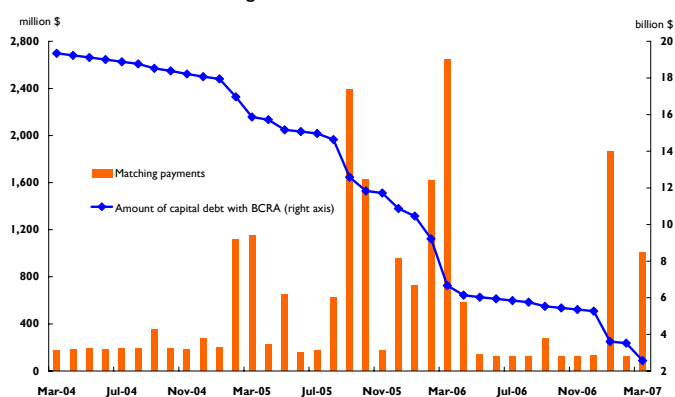


Chart IV.17

Matching Schedule Liabilities with BCRA

V. RISK MANAGEMENT

Summary

In a macroeconomic context that favors expansion of its financial intermediation activity, the financial system holds appropriate risk management policies. Incentives established by the Central Bank by means of market solutions continue to be effective in mitigating financial system risks through deepening interbank liquidity markets, reducing exposure to the public sector, strengthening the financial system in the face of private sector credit risk, and lowering the foreign currency and interest rate risks. Although some market volatility is expected in 2007, it is projected that the domestic economy will continue along a growth path, providing a suitable framework for the financial system to consolidate the trends observed in 2006.

In the context of appropriate macro-prudential policies, including strategies for the accumulation of international reserves, the financial system demonstrates a sound position in the face of liquidity risk. With current holdings of liquid assets and interbank money markets that are continuing to grow, financial entities already enjoy a range of alternatives for hedging against liquidity risk. In 2007 it is expected that liquidity levels will remain stable, at the same time as interbank markets continue to deepen. Banks have reduced their exposure to the public sector, and the favorable performance by fiscal accounts with Government's declining level of indebtedness represent a reduction in its credit risk. Although exposure to the private sector continued to increase, rising family income levels, falling unemployment, improved business prospects and low levels of indebtedness contributed to lowering its credit risk. As a result, private sector non-performance stands at a historically low 4.5%, with provisions that exceed the total portfolio in arrears. Despite the expected increase in private sector indebtedness levels, it is hoped that this sound performance will continue during 2007.

The reduction in exposure to foreign currency risk and the reduced volatility of the peso-dollar exchange rate contributed to mitigate the potential effect from this risk. Stress tests indicate improved resistance to this risk; in an extreme situation, the immediate effect would be limited, and the financial system would maintain its levels of solvency in line with local requirements and international recommendations. Market risk registered an increase associated with the financial turbulence in May and June, and the higher proportion of bonds marked to market. It is estimated that this trend towards higher market risk will persist in 2007, with a likelihood of further acceleration by 2008.

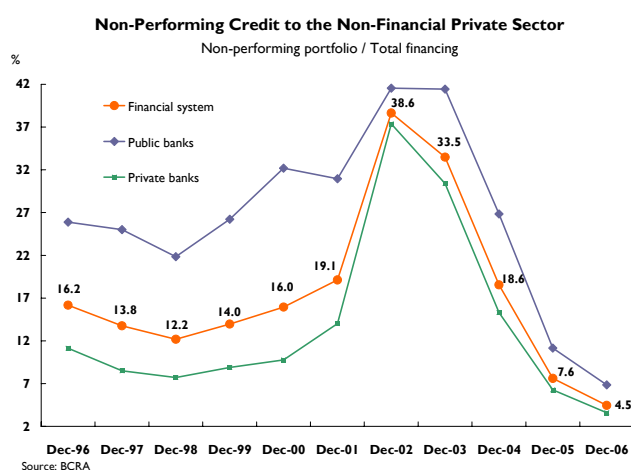
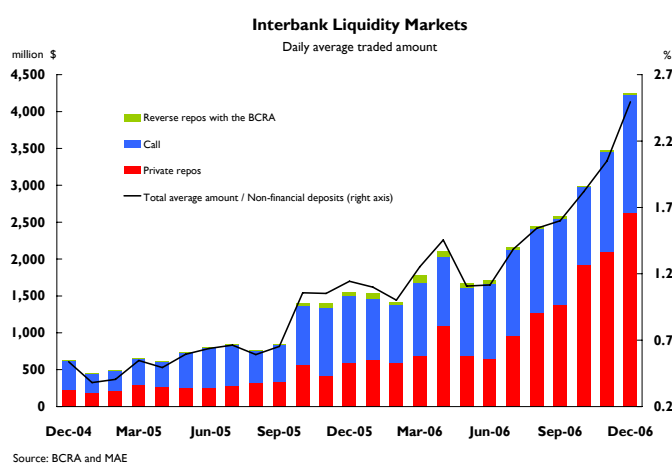
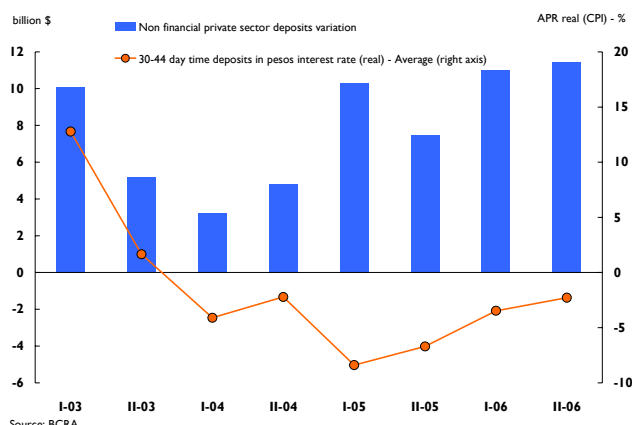


Chart V.1

Flow of Private Funds to the Financial System

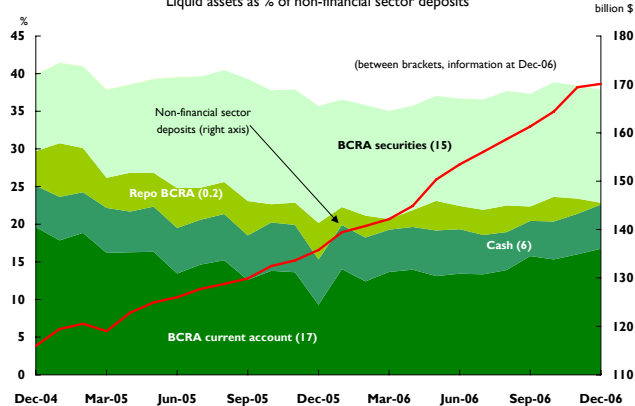


Source: BCRA

Chart V.2

Liquidity Risk Coverage

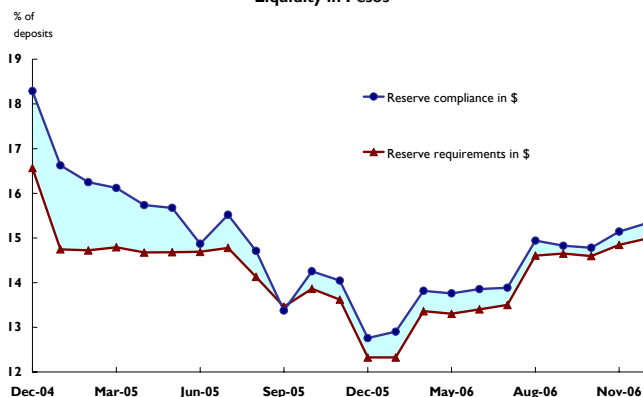
Liquid assets as % of non-financial sector deposits



Source: BCRA

Chart V.3

Liquidity in Pesos



Note: The data of Dec-06 corresponds to the quarterly average Dic-06 to Feb-07. Quarterly data are estimated.
Source: BCRA

V.1. Liquidity risk

Protection against liquidity risk continues to gain strength

In line with the increasing use of banking services for day-to-day household and company transactions, and given the increased channeling of savings into the domestic financial system, funding by means of private sector deposits has shown an expansive dynamic. Private sector deposits ended 2006 with an annual increase of \$22.6 billion (22%, 11% in real terms¹⁹) (see Chart V.1). Although still negative, interest rates in real terms show a trend towards neutral territory, encouraging the channeling of savings into the financial system.

Over the course of 2006 banks continued to make progress with the normalization of their traditional financial intermediation activity (see page 40). Both the increase in private sector deposits and the resources derived from the steady decline in exposure to the public sector contributed to meeting the increased credit needs of agents in the private sector. This trend also enabled financial entities to bring forward settlement of pending liabilities under the matching scheme, and to gradually increase their liquidity.

In this liquidity context, the holding by banks of liquid assets (cash, current account at the Central Bank and repos with the Central Bank) recorded a slight increase in terms of non-financial sector deposits, ending 2006 with an indicator of close to 23% (see Chart V.2). If holdings of Central Bank bills are included among the assets considered to be most liquid, this indicator also shows a moderate increase, to 38% of the deposits of the non-financial sector in 2006.

These indicators are compatible with an adequate compliance with the liquidity requirements in pesos established by the Central Bank, at the same time as banks have continued to narrow the precautionary gap that exists between compliance levels and the liquidity requirement (see Chart V.3). In August 2006, the Central Bank adjusted its minimum cash requirements and its means for compliance²⁰, with the aim of promoting an extension of the average term for deposits, encouraging the migration of savings in sight deposits towards time deposits (see page 44).

The domestic financial system records liquidity levels that are slightly above the average for Latin America and are notably higher than those in developed economies (see Chart V.4). The greater intrinsic risk of emerging economies (generally reflected in the prudential regulations of each financial system), added to the still incipient progress by interbank and capital markets, partly explain this phenomenon. In addition, a combination of a low probability of occurrence of a liquidity shock and the existence of market alternatives to hedge against liquidity problems in the case of financial systems in developed economies, enables them to manage this risk more efficiently.

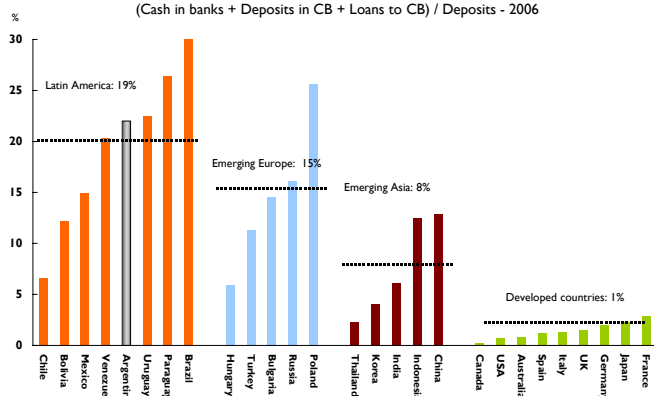
¹⁹ Deflated by CPI.

²⁰ Communication "A" 4549 dated June 2006 established as from August an increase of 2 p.p. in the reserve requirement on sight deposits in pesos (to 19%), the elimination of the reserve requirement on time deposits in pesos for residual terms of over 180 days, and the suppression of the use of certain cash items (cash in the bank, in transit and in security carriers) for the determination of reserve requirement compliance.

Chart V.4

Liquid Assets International Comparison

(Cash in banks + Deposits in CB + Loans to CB) / Deposits - 2006

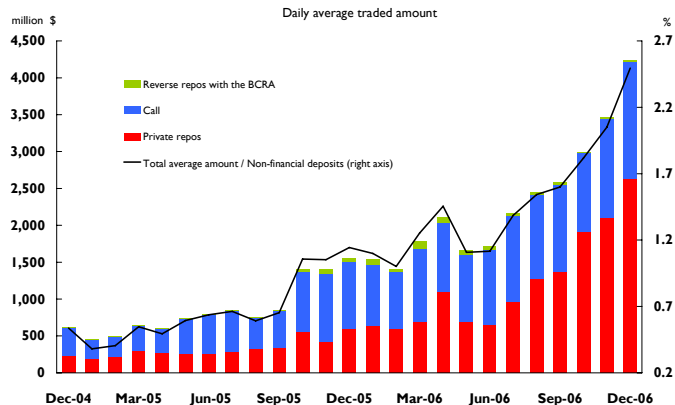


Source: BCRA from IMF data

Chart V.5

Interbank Liquidity Markets

Daily average traded amount

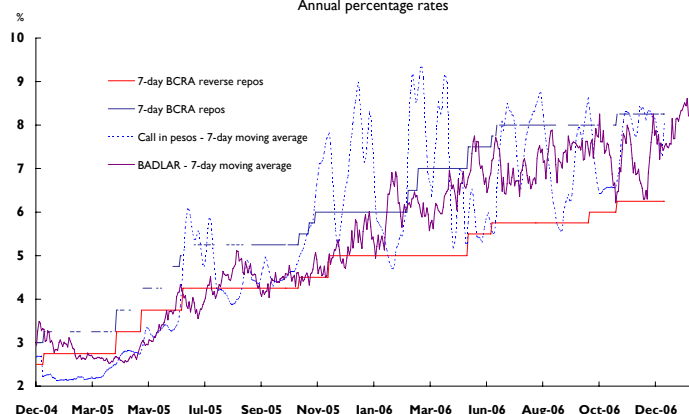


Source: BCRA and MAE

Chart V.6

Interests rates

Annual percentage rates



Source: BCRA

Bank foreign currency liquidity indicators continued to return to normal over the course of 2006, helped by deepening of the export credit market (see page 44). At the end of 2006 banks held liquid assets in dollars for almost 20% of deposits in that currency²¹.

Interbank repos and the call market have shown greater dynamism, increasing the range of bank liquidity hedging instruments

The role of the interbank liquidity market has gained strength as an additional tool for liquidity risk management. Repo operations between financial entities increased threefold on average in the second half of the year compared with the same half of the previous year, while amounts traded on the call market almost doubled in the same period (see Chart V.5). This development of the interbank liquidity market is consistent with the reduced volume of reverse repos between banks and the Central Bank. As a result, amounts traded on interbank markets continue to grow in terms of deposits, reaching close to 2.5% at the end of 2006, a sign of improved administration of financial system liquidity.

Interest rates have been following a steady upward path, a trend that in part reflects increases in Central Bank repo rates (see Chart V.6) and strict control of monetary aggregates under the Monetary Program. This has served to encourage a reduction in the short-term deposit bias of financial system funding derived from the recent crisis, at the same time as promoting an increase in saving in banks.

In this scenario, the financial system has been gradually increasing the maturity of its liabilities: the ratio of time deposits to sight deposits reached 86% at the end of 2006, slightly more than 4 p.p. above the level in the previous year (see Chart V.7). During 2006 the average maturity of time deposits remained relatively stable at around 50 days. In this context, financial entities pursued a consistent credit strategy, generating credit lines compatible with the duration of their funding.

The sustained recovery of the local fixed income market represents a further pillar in liquidity risk hedging. The increase in volumes traded and in the value of government securities in portfolio (observing the current valuation schedule), has made it possible for banks to quickly realize these positions in the case of specific liquidity requirements. In addition, the setting up of financial trusts using bank assets (both public and private) is another tool that financial entities have begun to deepen, to be able to improve the management of their resources.

Liquid assets will gradually be reassigned, although developing interbank markets will provide coverage in the face of liquidity risk

It is estimated that during 2007 the growing channeling of financial resources towards companies and households will

²¹ Half-yearly changes were influenced by one specific transaction by a public bank, and a change in the dollar liquidity requirement by the Central Bank (Com. "A" 4602).



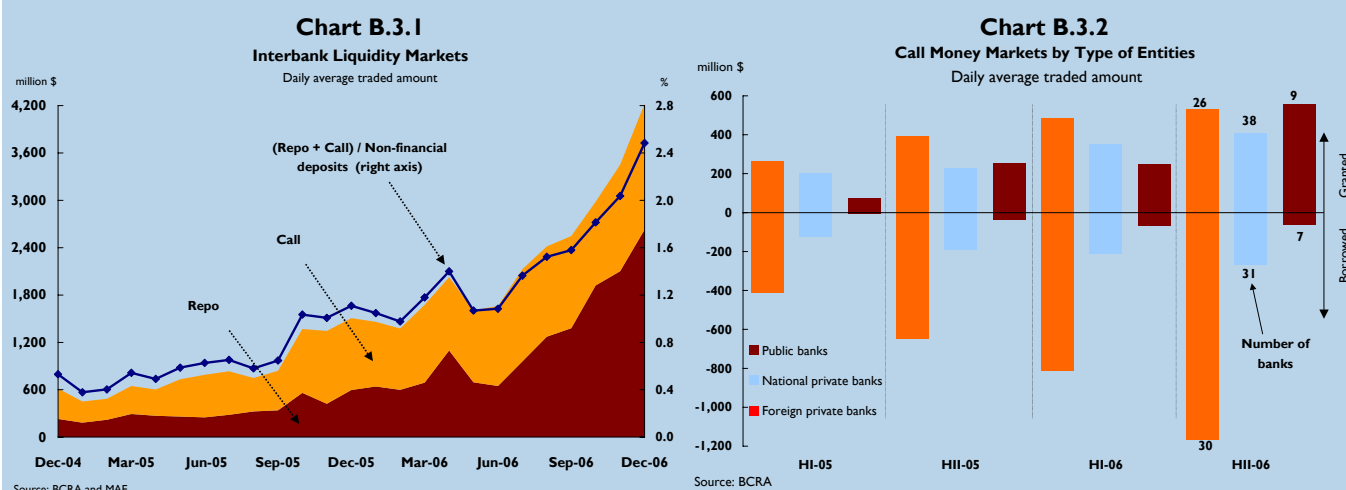
BOX 3: INCREASED DEPTH IN INTERBANK MARKETS

Following the crisis in 2001-2002 the financial system was able to achieve reasonable levels of liquid assets, strengthening protection against liquidity risk. Together with proactive Central Bank policies intended to provide market solutions, interbank liquidity markets began to evolve. In particular, in the last two years there has been notable development in the interbank repo and call markets, broadening the range of tools available to the financial system to obtain a more efficient coverage in the face of liquidity risk

In part because they make it possible to reduce the holding of liquid assets, the deepening of interbank and capital markets provides a more efficient hedge against liquidity risk. Emerging economies that have experienced banking crises (with certain similarities to the local crisis in 2001-2002), subsequently recorded high liquidity levels. This was a sign intended to lower the risk perceived by the private sector, making it possible to re-establish traditional financial intermediation channels. Following such crisis events, liquid asset levels are expected to gradually adapt to less uncertain circumstances, and liquidity risk management should increasingly be dealt with by means of instruments available in the market.

Furthermore, a wide range of tools have been introduced with the aim of mitigating this risk. The existence of a Central Bank able to act as a lender of last resort provides a tool that enables a solution to be assigned to specific liquidity problems, while international regulatory frameworks establish additional requirements to cover this type of risk. In addition, the rise of interbank markets helps strengthen hedging against liquidity risk, providing market solutions in the event of requirements for funds. In developed economies these markets achieve considerable depth. Banks and other non-bank financial intermediaries with excess resources place them for short periods with other financial entities that need them, setting a price for the liquidity that is reflected in the interest rates agreed.

Although on a lower scale, emerging economies are developing their own interbank markets. In Argentina, the dynamism of private sector financing, combined with measures adopted by the Central Bank, are beginning to encourage the development of interbank liquidity markets. In particular, whereas in 2004 the daily average traded in repos between banks in the financial system was approximately \$130 million, it totaled \$330 million and \$1.2 billion in 2005 and 2006, respectively (see Chart B.3.1). In addition, in recent years financial entities have been behind an accelerated expansion of the call market: the average daily amount traded on this market totaled \$1.1 billion in 2006, twice the total in 2005. As a result, the amounts traded on these interbank markets have been gaining as a proportion of deposits, rising from 0.7% on average during 2005 to 1.5% over 2006.



The various types of bank show an uneven interbank liquidity market performance. Public banks tend to allocate their main liquidity excesses to call transactions, showing a markedly net lender position in recent years (see Chart B.3.2). Although to a lesser extent, private domestic financial entities also tend to show a net lender position for call transactions, while foreign banks are net borrowers of these lines.

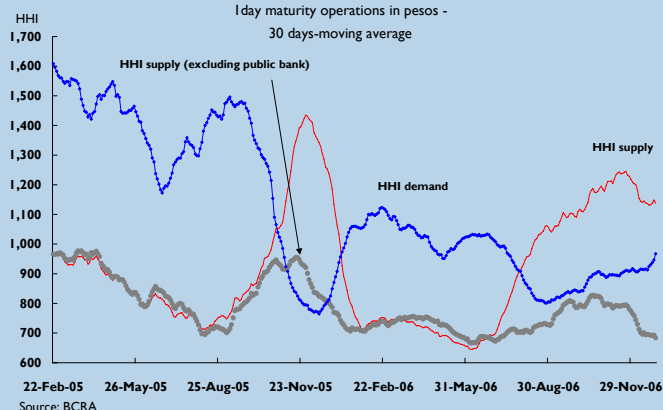
The gradual decline in levels of concentration and the low segmentation scenario are signs of the gradual development of the local call market. In particular, there has been a relative decline in the levels of concentration of the amounts traded by banks bidding for call money (see Chart B.3.3). On the side of those offering call money funds, the greater concentration is explained by one large official bank. Nevertheless, if this bank is excluded, the concentration of



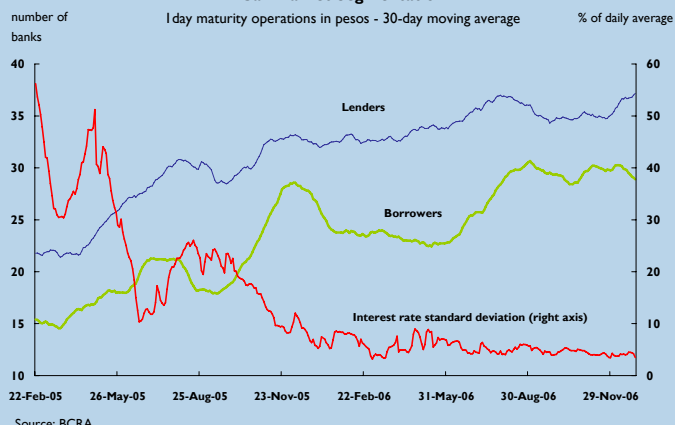
offering banks takes on a slightly downward trend. In this context, call operations form a map in which there is a growing diversity of crossed trading among participants, a sign that the market is showing declining levels of segmentation. The narrowing of the differences between the interest rates agreed, and the steady increase in the number of participants (bid and offered), confirm this position (see Chart B.3.4).

Chart B.3.3**Call Market Concentration**

1 day maturity operations in pesos -
30 days-moving average

**Chart B.3.4****Call Market Segmentation**

1 day maturity operations in pesos - 30-day moving average



The steady deepening of the local capital market provides a framework for the development of additional tools to efficiently cover the risks taken on by banks. Increasingly, financial entities will be able to invest in financial assets with secondary markets that are sufficiently liquid, obtaining both a hedge against liquidity risk and a yield on their placements. As a result, there will be a gradual increase in the benefits of complementariness between the financial system and the local capitals market.

In a context in which an intensifying of bank financing for companies and households is forecasted for 2007, financial entity liquidity levels will gradually be adapted, with interbank markets being assigned a greater role in liquidity risk hedging. With the deepening use of these market instruments, a greater number of financial entities will begin to operate in interbank markets, strengthening the position of the financial system in terms of liquidity administration and thus improving conditions consistent with a scenario in which financial stability prevails.



continue, generating an adjustment to bank liquid assets. The rapid spread of the use of interbank financing instruments, in addition to the recovery by the Central Bank of its role as a lender of last resort in specific instances, have helped reinforce the strength of the financial system in the face of liquidity risk. In addition, the robustness of the banking system when confronted by liquidity shocks is based on appropriate prudential policies, such as the accumulation of international reserves.

Furthermore, the sustained dynamism of the local fixed income market, and the possibility of obtaining liquid resources from the setting up of financial trusts with bank assets will widen the options for the financial system in order to satisfy potential additional liquidity demands.

V.2. Credit risk

V.2.1. Public sector²²

Declining exposure to the public sector, accompanied by sound fiscal accounts, strengthen bank financial situation in the face of the sectors credit risk

Central Bank incentives in relation to public sector credit demonstrated their effectiveness at the end of 2006. Bank exposure to the public sector dropped more than 9 p.p. in 2006, to a level of 21.7% of total assets (22.9% of netted assets), reinforcing the trend seen in the last 2 years (a drop of close to 18 p.p.). Private sector financial entities led this process, showing a drop of close to 12 p.p. of their total assets in 2006, to a level of 16%.

The significant reduction in the weighting of Government assets in bank portfolios is related to the incentives introduced by the Central Bank and the increasing private financing alternatives with better risk to yield relations. Already by mid-2006 the combination of these factors generated a significant qualitative change in the composition of financial system assets: for the first time since the crisis, the private sector became the principal debtor of the financial system.

Banks have been able to count on various channels by means of which to moderate their exposure to the public sector. Dynamic growth by fixed income markets in emerging countries, including Argentina, generated an increased incentive to realize these securities, bringing their book value closer to their market value, or by the setting up of financial trusts. In addition, the receipt partly in cash of pending compensation from the Government, as well as scheduled amortization of sovereign debt, reinforced this trend. The schedule established by the Central Bank for the marking of the public sector portfolio to market also contributed to lowering exposure to the public sector (see Chart V.8). Lower exposure to the public sector makes it possible to reinforce lending for investment, by gradually reducing the term mismatch between bank assets and liabilities.

Chart V.7

Time Deposits

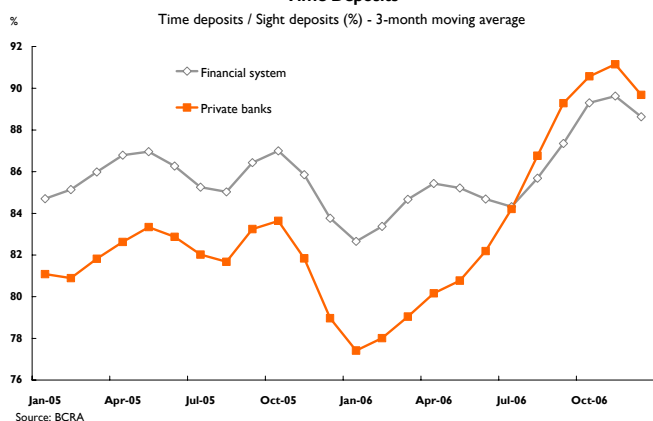
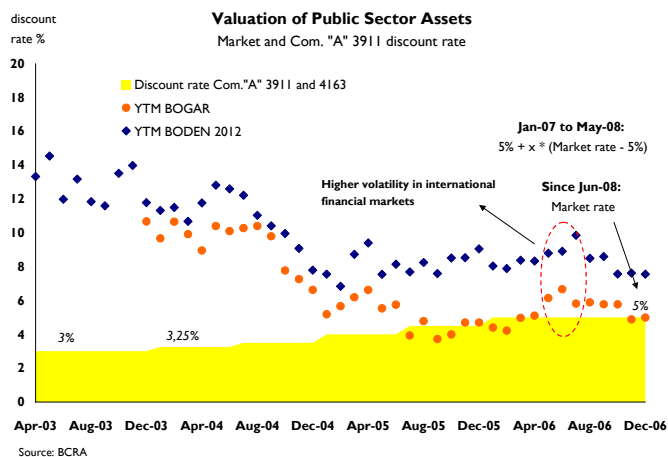


Chart V.8

Valuation of Public Sector Assets

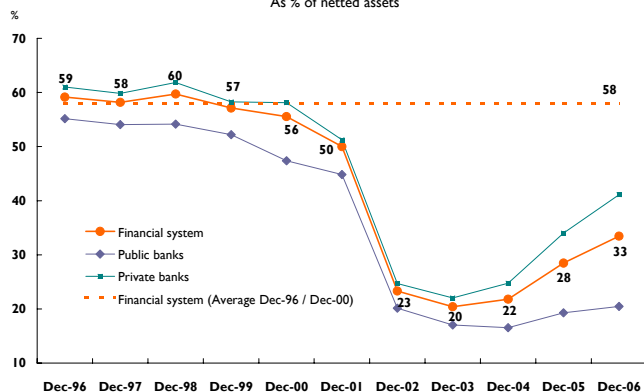
Market and Com. "A" 3911 discount rate



²² The concept of credit to the public sector used in the FSB (see definition in the Glossary) excludes the holding of securities issued by the Central Bank.

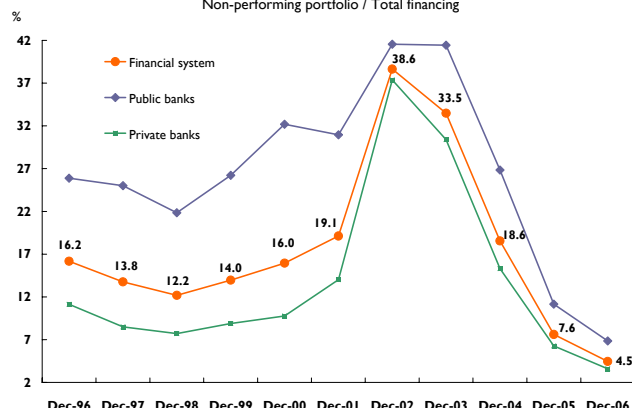


Chart V.9
Financing to the Non-Financial Private Sector
As % of netted assets



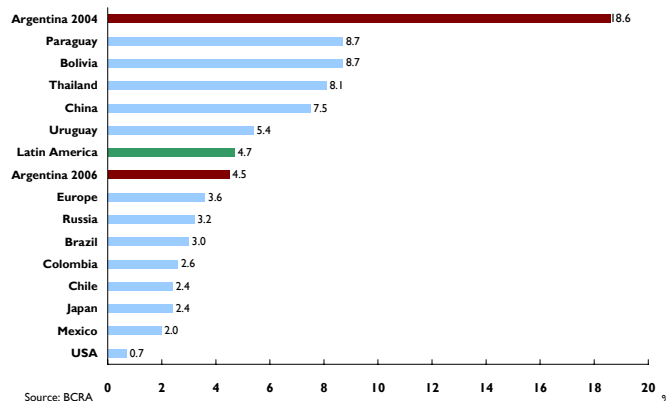
Source: BCRA

Chart V.10
Non-Performing Credit to the Non-Financial Private Sector
Non-performing portfolio / Total financing



Source: BCRA

Chart V.11
Non-Performing Private Portfolio
Non-performing portfolio / Total financing - Last available data



Source: BCRA

This adaptation of bank exposure to the public sector continued to take place at the same time as a declining credit risk for this sector. The 2006 national primary surplus (see page 30), the strength of the results expected for 2007, and the confidence of investors reflected in the latest debt placements provide support to this statement.

Reduced exposure, added to sound fiscal accounts, lead to forecasts of increased strength in the face of public sector credit risk in 2007

The decline in public sector assets held in financial entity portfolios is expected to continue in 2007, a trend that will probably be driven by portfolio sales, bond principal amortization payments, the still pending adjustment to new exposure limits in force as from July 2007 by a small group of banks, and growing levels of financial intermediation. At the same time, growing demand for credit by households and companies will continue to encourage banks to allocate a greater proportion of their resources to the private sector, thus cutting back on their lending to the Government.

In an expected scenario of sustained economic growth, declining exposure to the public sector will take place in the context of healthy fiscal accounts and lower levels of Government borrowing. This performance will therefore result in a sounder financial position for the sector, with an increase in its repayment capacity, thus improving the quality of financial entities portfolios.

V.2.2. Private sector

The dynamism of lending to companies and households is accompanied by lower private sector credit risk

In line with the process of growth in lending to companies and households that gained strength as from 2005, in the second part of 2006 banks increased their exposure to the private sector, in the context of its lower repayment risk. Improved financial prospects for households (higher wages and declining unemployment) and companies (increases activity in all productive areas) in a situation in which indebtedness levels are still low, continue to encourage the granting of new credit resources with a low intrinsic risk, and making it possible to recover non-performing debts. Banks have therefore been meeting the rising need for resources by the private sector, without losing sight of the guidelines of an adequate allocation of credit.

Over the course of the second half of 2006, the private sector became the principal debtor of the banking sector, exceeding exposure to the public sector. This achievement was in part made possible by the measures implemented by the Central Bank, which simultaneously discouraged lending to the Government and stimulated the increased granting of resources to the private sector. As a result, at the end of 2006 lending to the private sector reached a level of close to 32% of total assets (33% of netted assets) (see Chart V.9), almost 5 p.p. more than at the end of 2005. In 2006, private banks increased their exposure to the

Chart V.12
Non-Performing Private Loans Classified by Debtor
Non-performing loans / Total loans

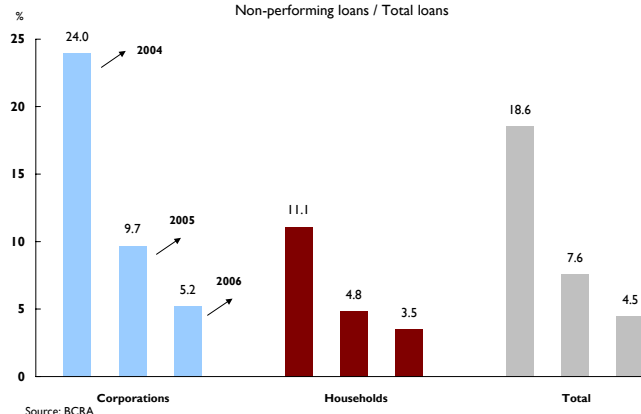


Table V.1
Transition Matrix June / December 2006
Weighted by amounts - In %

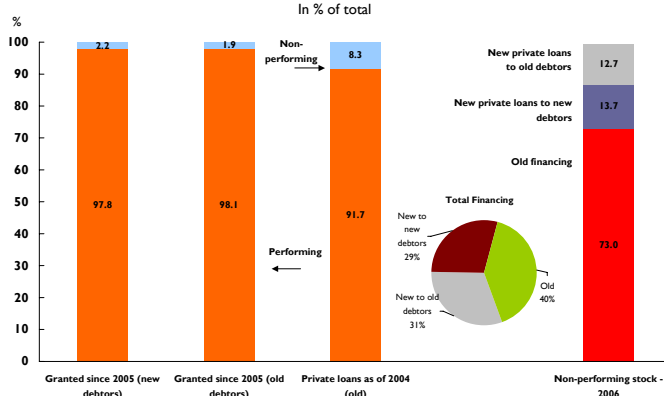
		December 2006								TOTAL
		1	2.a	2.b	3	4	5	6	Write off (%)	
June 2006	1	92.5	0.4	0.2	0.0	0.0	1.0	0.0	6.0	91.5
	2.a	27.1	5.0	9.0	0.4	0.0	52.0	0.2	6.2	2.2
	2.b	6.9	0.0	45.1	13.1	0.0	0.2	31.1	3.7	0.8
	3	12.5	52.6	19.8	1.6	0.0	8.7	0.1	4.6	1.5
	4	5.8	2.8	58.2	19.6	0.1	0.7	0.1	12.6	1.8
	5	2.8	1.9	1.5	66.0	0.2	0.3	0.2	27.2	2.1
	6	6.5	0.1	0.2	1.3	64.2	0.4	0.0	27.3	0.2
TOTAL		85.6	1.4	2.1	1.9	0.1	2.2	0.3	6.5	100.0

Figures based on debtor information at the start of the exercise

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

Source: BCRA

Chart V.13
Credit to the Private Sector Quality
In % of total



private sector by 6 p.p. of total assets, to 39%, while public banks registered growth of almost 2 p.p., to approximately 20% of total assets.

Private sector portfolio quality continued to improve in the second half of 2006, reaching historically low delinquency levels, even by international standards. This trend, combined with increased higher-quality lending to companies and households, is reflected in the strengthening position of banks in the face of private sector repayment risk.

The decline in private sector portfolio non-performance slowed at the end of 2006, registering a drop of 1 p.p. in the second half of 2006 to a level of 4.5% (see Chart V.10), below that of other emerging countries (see Chart V.11). Although starting from a higher non-performing level, loans to companies have led the way in financial system credit quality improvement (see Chart V.12).

Unlike the previous half, in the second half of 2006 the drop in non-performance was led by private banks, which reduced their delinquency by 1.2 p.p. during the period, to 3.6%. Official banks recorded a slight improvement in the quality of their private sector loan portfolio, to a non-performing level of 6.8% at the end of 2006. The combined effect of a smaller non-performing portfolio and an increase in loans has been behind the mentioned improvement.

In the second half of 2006, 85% of loans maintained their ratings, while 5.1% improved them and only 3.3% of loans worsened their rating²³ (see Table V.1). Top-quality loans (in situation 1), currently accounting for almost 92% of the total stock, deteriorated by a slight 1.6% in the second half of the year. There was also a drop in non-performing loans, as almost 48% improved to performing, and close to 16% were repaid or moved to memorandum accounts.

In the last two years, during which the revival in lending to the private sector gained strength, new loans have demonstrated high credit quality. Almost 98% of the new lines granted to both debtors already participating in the financial system and new borrowers remain in a normal repayment situation (see Chart V.13). In the current context of prudential regulation, this favorable performance is a consequence of both the positive economic scenario and the credit strategies implemented by banks.

Approximately 92% of loans to the private sector in force in 2004 are in a regular situation. As a result, three-quarters of the delinquency ratio at the end of 2006 is attributable to loans granted prior to 2004, with the rest corresponding to new credit lines.

The good performance by the private sector portfolio, added to the ample coverage by provisions set up by banks and the capitalization of the financial system, has led net worth exposure to the private sector to remain at historically low levels (see Chart V.14). Whereas in the pre-crisis period the financial

²³ The remainder corresponds to settlements in the period.



system had compromised an average of one quarter of its net worth in the event of uncollectibility of its non-performing portfolio, currently non-performing portfolio loan losses are fully provided for.

During 2007 it is expected that the strength of the financial system in the face of private sector credit risk will continue to be reinforced

At the beginning of 2007, the persistence of positive domestic macroeconomic conditions will marginally strengthen the improvement in bank loan portfolios. This development will be supported by steady growth in new credit lines with a still low level of associated counterpart risk, added to the reduction in loans in arrears. In this scenario, it is expected that there will be an increase in the still low exposure of banks to the private sector.

Availability of bank lending capacity in a context of an attractive risk-return ratio for private sector lending activity should encourage dynamism in both traditional lending lines and the search for new market niches that have yet to be fully explored, such as the development of micro-credit. Lastly, this development is expected to take place in a framework of growing competition among financial entities, with the increased stimulation provided by the regulations introduced by the Central Bank.

Corporations

The positive economic scenario strengthens the position of banks in the face of credit risk from productive sectors

In the final part of 2006 corporate repayment risk continued to decline, reflecting the robust increase in output and the healthy financial situation of the sector. Driven by increased demand, manufacturing industry, services, commerce and the agricultural sector recorded notable growth in the second half of the year (see pages 32 to 35), movements that were accompanied by significant expansion in the flow of credit resources to these sectors²⁴. After significant growth by the construction sector in recent years, there was some slowdown at the end of 2006.

Corporate credit requirements to finance working capital and increase their production capacity in the medium term were the main reasons for the increased exposure of banks to credit risk from this sector. At the end of 2006, close to 20% of bank netted assets consisted of lending to corporations, almost 2 p.p. more than in mid-year. Currently, manufacturing industry and primary goods production are the sectors accounting for over half of corporate lending (see page 32), although services recorded notable dynamism in 2006.

Growing exposure to credit risk from corporations has continued to develop in a context of lower delinquency, falling 1.4 p.p. in the half to 5.2% of total corporate lending. Increased lending continues to be channeled mainly to the most dynamic sectors

Chart V.14

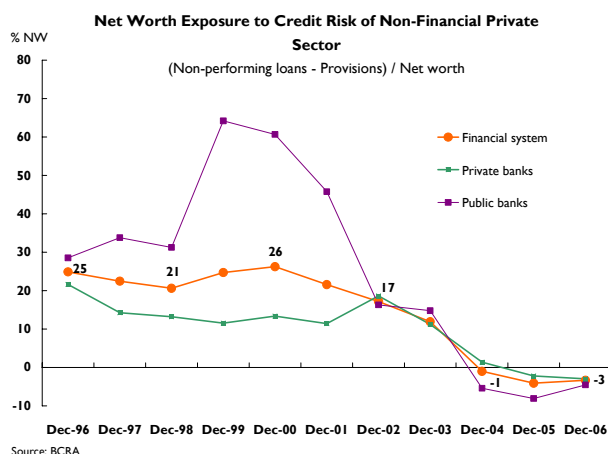
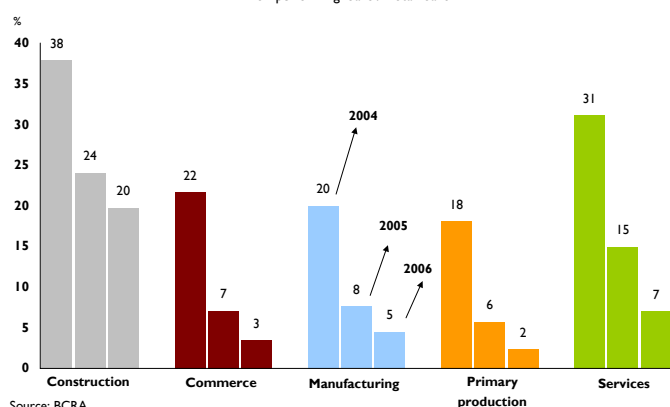


Chart V.15

Non-Performing Loans by Economic Sectors
Non-performing loans / Total loans



²⁴ Chapter III includes a detailed description of bank lending by activity.



with a better repayment capacity. While manufacturing industry showed a non-performance rate of 4.5% (see Chart V.15), 1.3 p.p. below the level in the first half of the year, primary goods production and commerce reached delinquency levels of 2.3% and 3.4% respectively, also showing signs of a declining trend.

New corporate credit lines show notable credit quality

Non-performance in the various segments of lending to companies is gradually converging. In line with the development seen in recent years, lines for larger amounts have shown a notable growth during the period, a trend accompanied at the end of 2006 by the loan segment traditionally associated with small and medium-size enterprises (see page 44). Repayment risk for lower credit amounts has thus situated below that for the remaining lines. While non-performance in lending segments for amounts in excess of \$5 million and for those between \$200 thousand and \$5 million stood at around 5.4% at the end of 2006 (almost 0.6 p.p. and 1.9 p.p. less than in the middle of the year) (see Chart V.16), the small loan segment (from \$50 thousand to \$200 thousand) and the micro segment (less than \$50 thousand) recorded delinquency levels of 4.6% and 4.1%, respectively (with drops of 2.3 p.p. and 2.6 p.p. for the period).

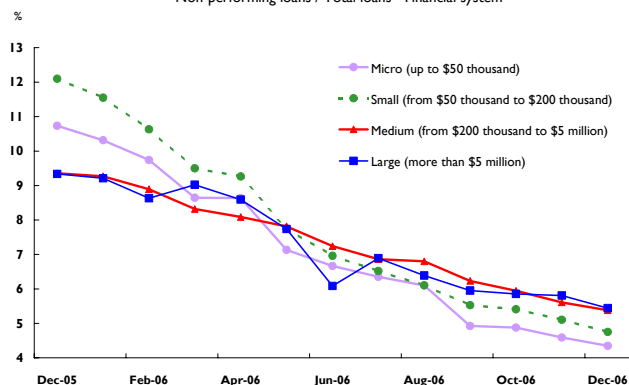
In the context of a steady increase in lending to companies, banks have lowered their interest rate spread (see Chart V.17), a sign of both increased competition for borrowers and their lower repayment risk. While overdrafts continue to record the lowest non-performing rate (2.3%), mortgage loans recorded a notable improvement in their quality (delinquency dropped 7 p.p. to 10.4%) (see Chart V.18). Furthermore, in the last two years, companies have developed into low-risk borrowers: almost 99% of new loans granted are in a regular payment situation. In particular, new pledge-backed loan non-performance stands at a level of only 0.5%, and 1% in the case of overdrafts and promissory notes. Approximately 11% of the loans outstanding at the end of 2004 are classified as in arrears, explaining three-quarters of the corporate non-performance ratio.

In 2007 it is expected that growth in corporate lending will continue, in a context of limited repayment risk

Growth is being forecasted for the various goods and service-producing sectors for 2007, driving further growth in aggregate activity. Companies will continue to increase their demand for bank financing, with a lower use of own funds, and a probable increase in their reliance on suppliers' credit (see Chart V.19). As a result, companies will continue to boost their production, at the same time as their investments to increase installed capacity reach maturity.

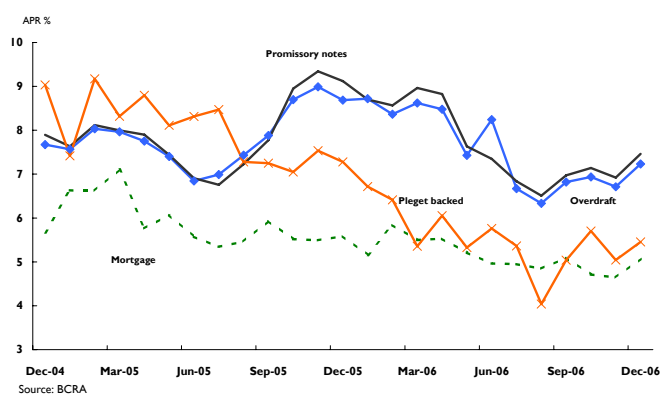
It is expected that bank credit resources will continue to be deployed in those sectors with the most favorable business prospects. In a domestic and international scenario that continues to be favorable, corporate financial strength will continue to advance, resulting in an improved position for banks in the face of corporate repayment risk.

Chart V.16
Non-Performance Portfolio by Amount Range
Non-performing loans / Total loans - Financial system



Source: BCRA

Chart V.17
Financial Intermediation Spread - Corporations
Spread between lending rate and less than 59 days time deposits rate



Source: BCRA

Households

Steady reduction in household repayment risk encourages greater bank exposure

In line with the trend seen in the last two years, household consumer loans continued to increase steadily in 2006, reflected in an increase in bank exposure to credit risk from that source (to 12.4% of netted assets). This growth has taken place in the context of a larger real wage mass, lower levels of unemployment, and still low levels of household indebtedness reflected in their lower credit risk: delinquency stood at 3.5%, lower than in the previous year.

At the end of 2006, growth in lending to households was led by personal and credit card loans, lines that register non-performance ratios of 3.6% and 1.9% respectively at the end of the year (see Chart V.20). Given the improved outlook for households, enabling longer-term planning, pledge-backed loans and mortgages recorded declining delinquency levels (0.9% and 4%, respectively).

This dynamic has taken place in the context of lower loan spreads during 2006 (see Chart V.21), a development consistent with the reduction in the implicit risk from households. In effect, approximately 97% of new loans granted show normal repayment, while almost 96% of previously-existing loans are in a normal situation. As a result, the stocks of non-performing loans at the end of 2006 was shared in similar proportions between old and new loans.

Expected growth in the wage mass, higher levels of formal employment, and low levels of household borrowing help explain the strength of banks in the face of household lending risk in 2007

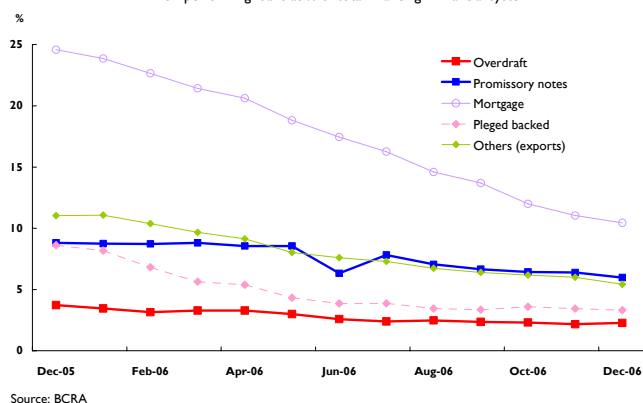
Encouraging prospects for economic growth in 2007 augur continued consolidation of household lending, in a context of limited repayment risk. Credit demand will be driven by improved prospects for employment and wages, allowing households to project financing for longer terms, particularly for remodeling or home acquisition, and car purchases.

Growing availability of bank lending resources in the context of increasing competition for the best market niches will become evident in a greater supply of credit. Banks will continue to develop their main strategies for the gaining of suitable borrowers, such as agreements with leading household appliance chains, benefits on purchases with debit and credit cards, the granting of loans to individuals who receive their salaries through banks, etc. Evolution of consumer loan portfolio credit quality will depend on the strategy for placement and monitoring carried out by financial entities.

V.3. Currency risk

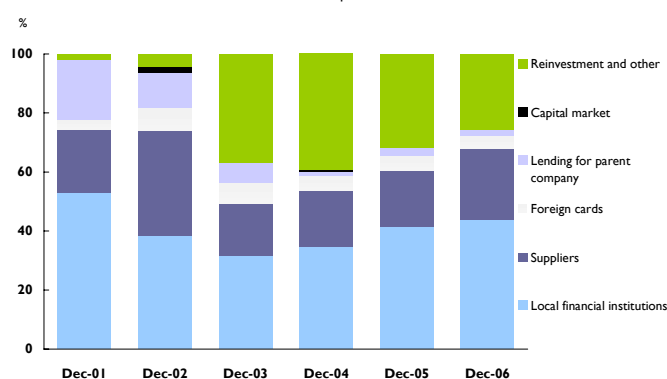
During 2006 banks continued to consolidate their position in the face of the risk from foreign currency

Chart V.18
Non-Performing Lending to Business by Type of Financing
Non-performing loans as % of total financing - Financial system



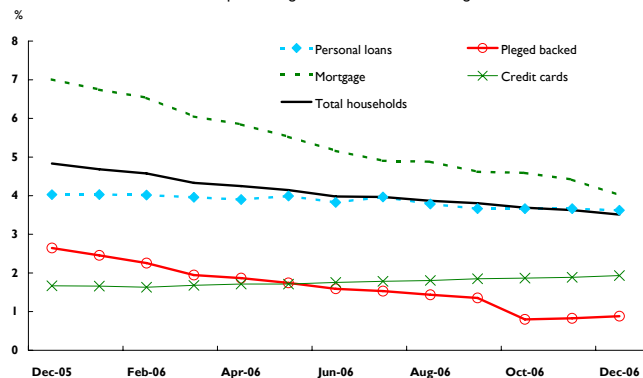
Source: BCRA

Chart V.19
Expected Sources of Funds for Financing
Outlook for the first quarter of 2007



Source: EMI - Qualitative information - INDEC

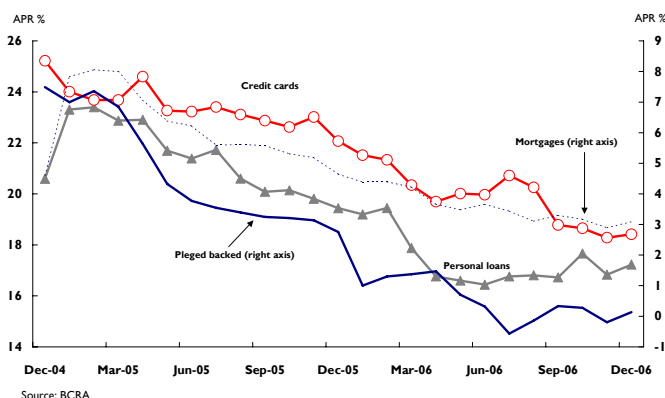
Chart V.20
Non-Performance Loans to Households by Type of Financing
Non-performing loans as % of total financing



Source: BCRA



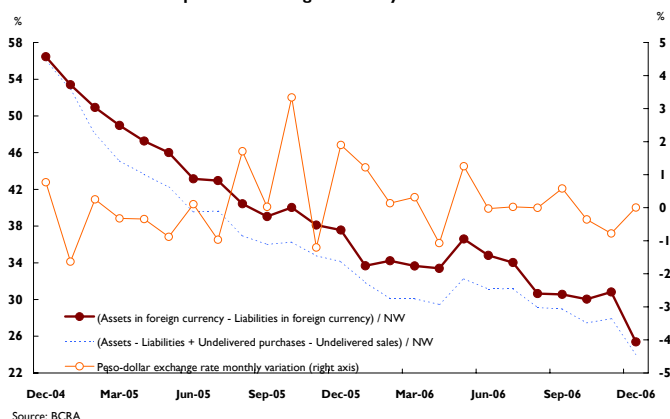
Chart V.21
Financial Intermediation Spread - Households
Spread between lending rate and more than 59 days time deposits



The Central Bank continues to closely monitor foreign currency mismatching risk, within the framework of prudential regulatory requirements, with adequate incentives to minimize the effects of peso-dollar exchange rate movements on bank financial positions. As a consequence of the recent crisis, foreign currency credit lines can only be granted to those whose income is related to the peso-dollar exchange rate, and loans must be funded in the same currency. This lowers the risk to bank net worth, protecting the currency of origin of depositor transactions.

Over the course of 2006 banks reinforced their position in the face of foreign currency risk. This trend continues to be driven by the drop in mismatching between foreign currency assets and liabilities, which totaled slightly over US\$2.7 billion at the end of the year, almost US\$600 million and US\$1.8 billion less than at the end of 2005 and 2004, respectively. This trend, combined with the steady consolidation of bank solvency, has been reflected in a significant 12 p.p. decline in balance sheet exposure to currency risk in 2006, falling to almost 25% of bank net worth (see Chart V.22). In addition, the financial system has been strengthened against foreign currency risk because of the reduction in exchange rate volatility in 2006.

Chart V.22
Exposure to Foreign Currency Mismatch Risk

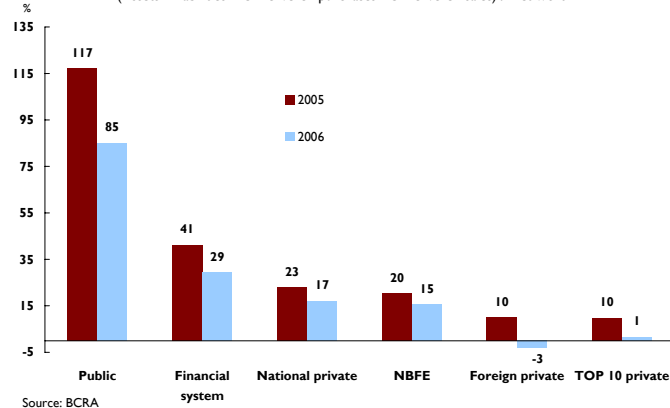


Public banks show the largest foreign currency mismatch (reaching 85% of net worth at the end of 2006). Nevertheless, a notable improvement was noted in 2006, with declining levels of exposure (see Chart V.23). National private banks and non-bank financial entities show low levels of foreign currency mismatching, while foreign banks have a slight foreign currency liability position. Futures markets continue to expand (see page 26), encouraged by the Central Bank, providing banks with a more efficient tool to manage this risk.

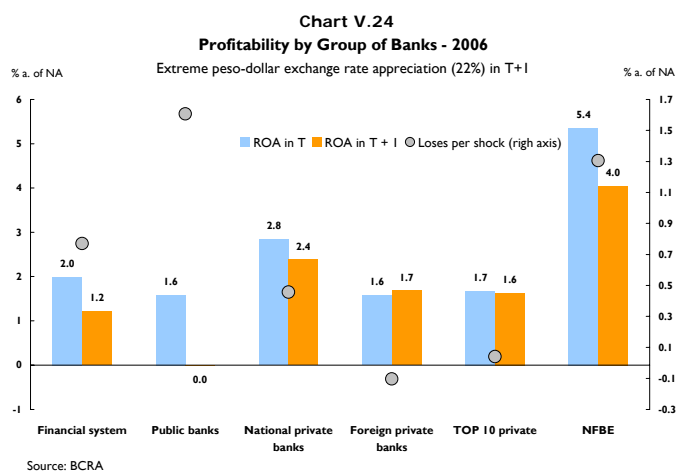
Stress test exercises show that the financial system possesses adequate strength to be able to face foreign currency risk

As in the previous issue of the FSB, a hypothetical shock to the peso-dollar exchange rate has been introduced into a stress test to evaluate the impact on bank financial position. Taking the current foreign currency position, a nominal 22% appreciation of the exchange rate has been introduced as an extreme case (with a low probability of occurrence) for both Argentina and the leading economies in the region in recent decades. This tests the effect on profitability, and therefore on the solvency of the various groups of banks. The analysis reflects the instantaneous impact on balances at the end of 2006, disregarding cash flow effects and the subsequent adjustments to bank portfolios.

Chart V.23
Open Position in Foreign Currency
(Assets - Liabilities + Undelivered purchases - Undelivered sales) / Net worth



Given their high asset position in foreign currency (approximately 85% of net worth), the greatest adverse effect will be reflected in public bank income statements, which would record no profit for the year (see Chart V.24). The second largest negative impact would be felt by national private banks, with profitability in 2006 that would be 2.4%, 0.4 p.p. below the level actually recorded. Non-bank financial entities would also post lower results, although they would remain at a high level, while foreign private banks are fully hedged against this risk. As a result, financial system profitability in 2006 would fall 0.8 p.p. to 1.2%, still a considerably positive value.



Notwithstanding the extreme hypothetical shock, the financial system would maintain capital compliance levels in excess of internationally recommended levels (see Chart V.25). Public banks, which are most vulnerable to this risk, would achieve a level of solvency of approximately 11% of risk-weighted assets, in an extreme exchange rate appreciation situation. The financial system would show a drop of less than 1 p.p. in its capital compliance, which would remain at a level of close to 16% of assets at risk. It can therefore be indicated that the financial system as a whole, and the various uniform bank groups individually, show an extremely robust situation in the face of foreign currency risk, evidence of the efficacy of the measures implemented by the Central Bank in this regard.

V.4. Interest rate risk

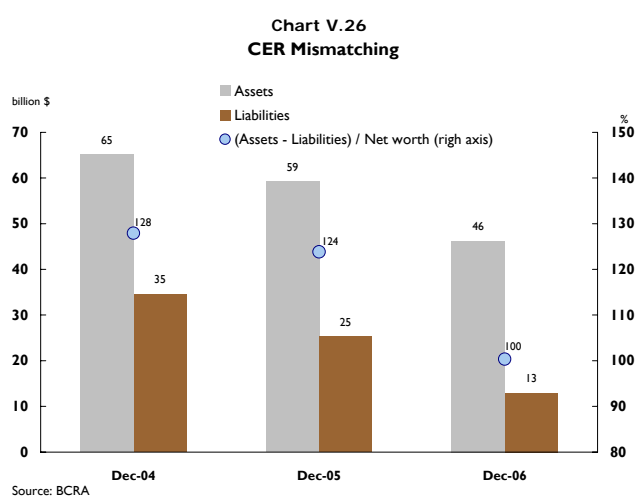
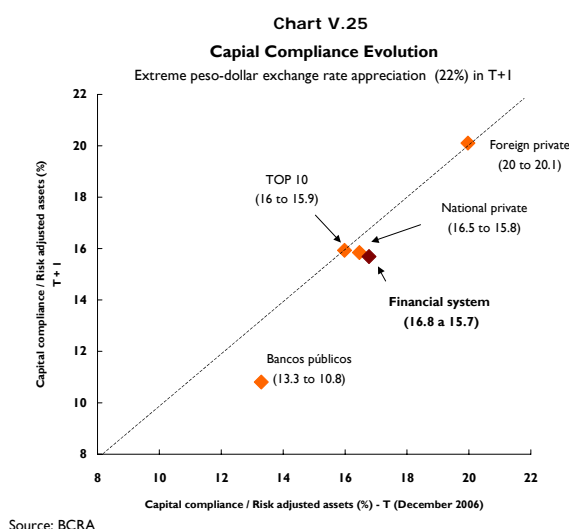
Gradual reduction in bank exposure to interest rate risk

The financial system continues to reduce its exposure to interest rate risk. Decline of public sector assets is leading to a drop in the term to maturity of total assets, while the dynamic of time deposit is increasing the maturity of liabilities. These behaviors are gradually narrowing the significant term mismatching that had its origins in the 2001-2002 crisis, thus reducing the exposure of the financial system to increases in interest rates.

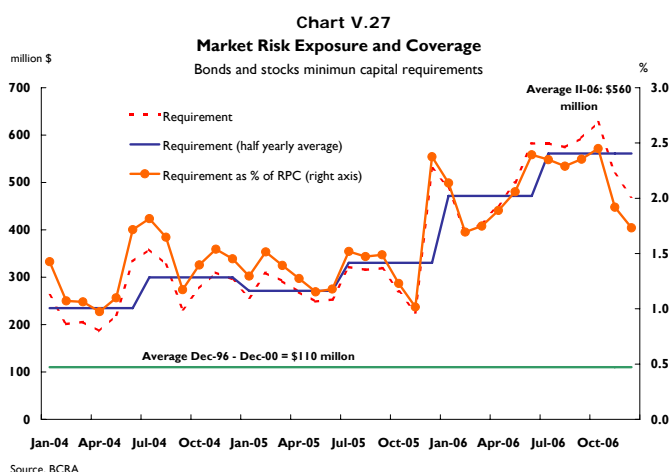
The financial system is exposed to a risk derived from increases in interest rates in excess of the rise in CER. The difference between asset and liability items adjusted by CER (at a fixed rate) leads the banks exposure to the real interest rate risk. This mismatching recorded a drop of 24 p.p. over the course of 2006 (see Chart V.26), reaching a value close to that of bank net worth (approximately \$33 billion) by the end of the year.

During 2006 there was a significant drop in bank adjustable assets (almost \$13 billion) and liabilities (over \$12 billion). Given the similar size of these two declines, there has been a moderate decline in mismatching in nominal terms. In the case of assets, banks continued to reduce their stock of Government securities adjustable by CER (national guaranteed loans and Bogar, among others), in the context of the adaptation to the public sector exposure limits set by the Central Bank. In addition, bank holdings of Central Bank Lebac and Nobac fell, in line with their gradual amortization. Early repayment of liquidity rediscounts (totaling \$5.1 billion for the year²⁵) and the reduction in time deposits with adjustment clauses, gave an impulse to the contraction of liabilities in this currency.

The Central Bank continues to make progress in the provision of solutions for efficient hedging of bank risks. In particular, work is being carried out on the deepening of CER futures markets and interest rate swaps. In early 2007 the Central Bank implemented a notes swap session, making it possible to exchange securities with different terms and rates. One of its main challenges will be to achieve high liquidity levels for this market, consistent with the aim of enabling certain large financial entities to reduce their exposure to this risk.



²⁵ Includes principal and CER adjustments.



Looking ahead to 2007, the decline in exposure to the interest rate risk faced by banks will probably be moderate. This will be due to the fact that a large majority of banks are currently observing the 35% limit on exposure to the public sector, reducing incentives to dispose of such adjustable securities that enable the accrual of profits. In the case of liabilities, in the early months of 2007 there has been significant early repayment of rediscounts, and these obligations will probably show a further large drop in the remaining months of the year. In this scenario, consolidation of solvency will continue to have a significant role in the process of reducing bank exposure to this risk.

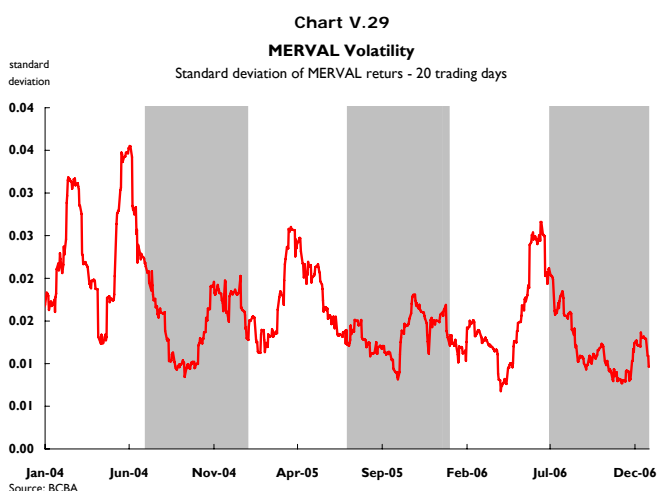
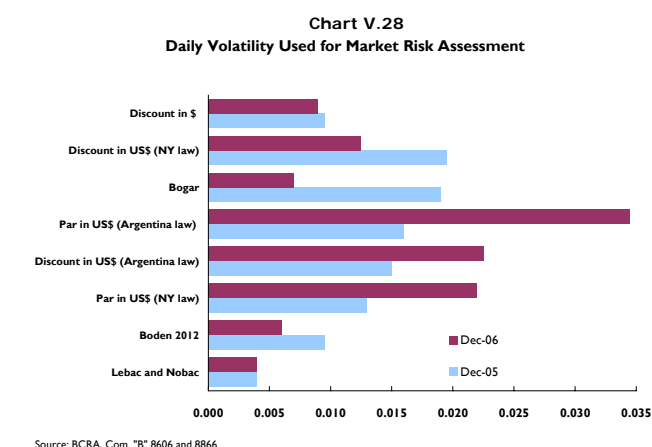
V.5. Market risk²⁶

In 2006 the banking sector recorded low levels of exposure to market risk from both the holding a fixed income assets and equities; nevertheless, certain volatility is expected for 2007

Over the course of 2006 the financial system recorded a moderate increase in its average exposure to market risk (see Chart V.27). This movement was caused in part by the growing share of marked to market securities held in bank portfolios, at a time of certain turbulence in financial markets towards the middle of the year. Notwithstanding this trend, there was a notable decline in the last two months of the year, in view of the reduction in financial market uncertainty.

The composition of market risk exposure remained relatively stable following the crisis, with a significant participation by government securities (approximately 98%). Average exposure from fixed income assets increased during the year, in a context of certain unevenness in the evolution of volatility for such financial assets (see Chart V.28). Exposure caused by equities continues to rise, in a context of declining volatility in Merval yields (see Chart V.29).

Looking ahead to 2007, the risk from the holding of fixed income assets will reflect the effect of gradually increasing holdings of such assets in portfolios that have been marked to market. Nevertheless, the financial system records capital levels that are comfortable able to confront any possible materialization of market risk.



²⁶ In this section, market risk will include the impact on financial position of price volatility associated with both bonds and shares.

VI. SOLVENCY

Summary

The significant expansion of the volume of financial intermediation in 2006, together with the favorable perspectives for the sector, were reflected by a sharp increase in the profits of the financial entities and the receipt of fresh capital contributions. The financial system thus continued improving its solvency. In 2006 banks accrued profits of 2% of netted assets and 15% of net worth, which more than doubled the 2005 figures.

During the second half of 2006 the positive results were driven by the increase of profits for holding and negotiating financial assets and by higher service results. In a more stable macroeconomic context with less inflation and a slight fall in the peso-dollar exchange rate, the decline of CER adjustments and in exchange rate differences explained the slight drop in the financial margin in the second half of 2006. The operating costs of the banks continued with their gradual increase, in a framework of growing financial activity and higher levels of employment and wages in the financial sector.

The larger profits and the new capital contributions received by the banks increased their degree of strength to face possible adverse shocks. The fresh capitalizations totaled almost \$950 million in the second half of 2006, a change mostly accounted for by national private banks. For all 2006 the capitalizations totaled \$2.4 billion, while the cumulative figure in the post-crisis period was over \$15 billion. In 2006 the banking system exhibited the fastest growth rate of net worth in the post-crisis period (23%), while it noticeably improved its quality. On the other hand, at the end of 2006 the capital compliance of the financial system was 16.8% of the risk weighted assets, far higher than the local minimum requirements and those internationally recommended.

For 2007 the current favorable conditions of the financial system are expected to be sustained. In particular, the growing volume of financial intermediation is expected to have positive repercussions on the profitability of banks, especially through the larger interest and service revenues. The cost structure will continue to accompany this growth context, while the high levels of provisions and the solidness to face credit risk will maintain loan loss provisions at historical low levels. Meanwhile, the international scenario that expects more volatility in 2007 will lead to some uncertainty about the performance of the results associated with security transactions. In this framework, it is said that the profitability of the banking system should continue to strengthen the solvency of the sector, and thus contributing to the financial stability conditions.

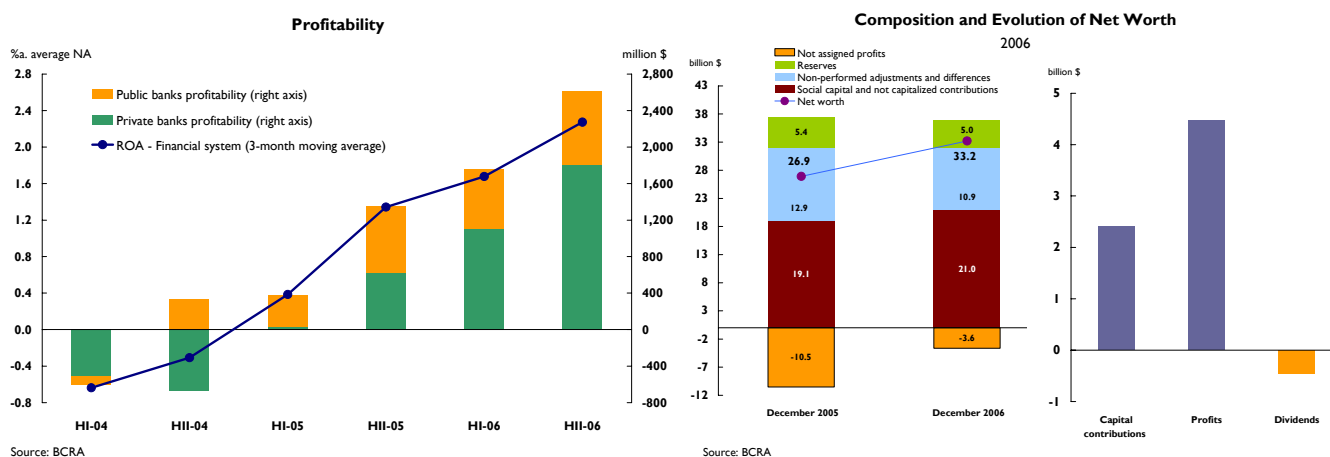




Chart VI.1
Profitability

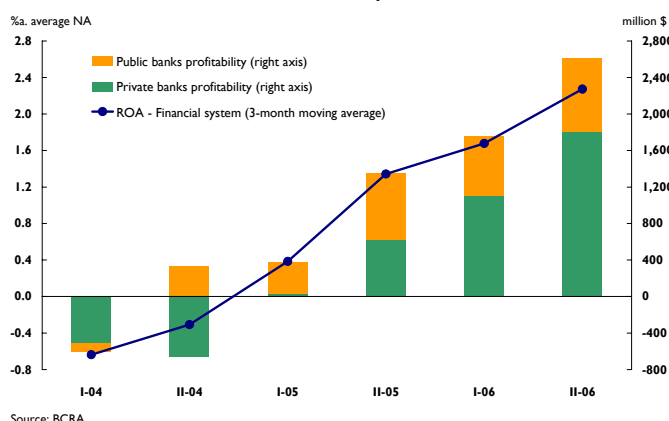


Chart VI.2
ROE International Comparison
Last available data

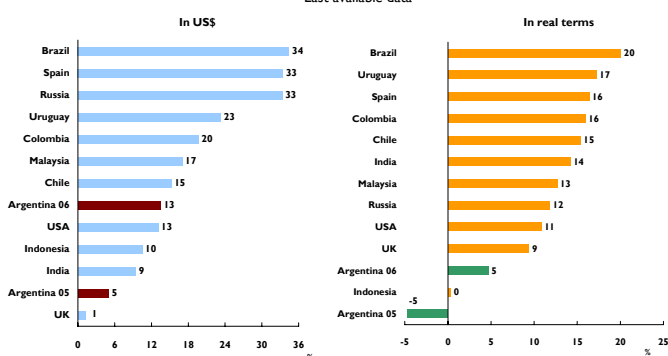
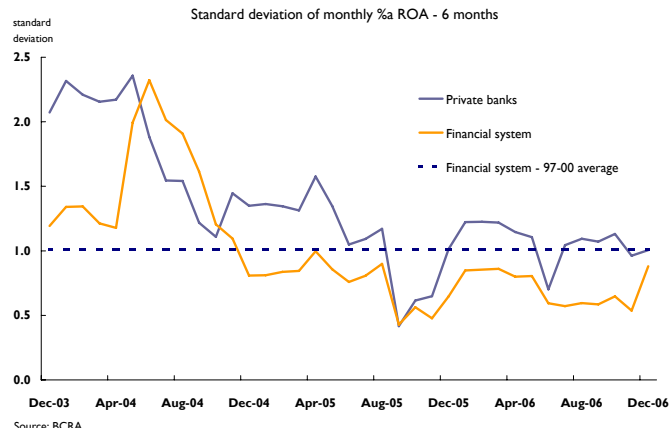


Chart VI.3
Volatility of Financial System Profitability
Standard deviation of monthly % ROA - 6 months



VI.1. Profitability

Banks continued to strengthen their profits in the second half of the year, to close 2006 with a profit level that more than doubled 2005

As a result of the deepening of the traditional financial intermediation activity, banks ended the year with a profit rate that was more than double the year before: ROE of 15% and ROA of 2%²⁷. The larger profitability of the banking system came in the second half of 2006 (see Chart VI.1). In line with the guidelines the Central Bank had set regarding the capitalization of the financial entities, profits resources consolidated as the principal pillar strengthening the solvency of the sector.

Throughout 2006 profitability in real terms (deflated by the CPI) attained positive values. Thus, while in 2005 the ROE in real terms had stood at negative values (-4.7%), during 2006 it totaled 4.7%, above the pre-crisis level (2.6%). However, this indicator is still lower than the figures recorded in other economies in the region and in developed countries (see Chart VI.2).

The higher level of profits in the financial system came in a context of reduced volatility. The least stable headings of the banking system profit and loss statement (the gains on securities, the CER adjustments and exchange rate differences) exerted a limited influence on the dispersion of profits, with their volatility remaining at similar levels to those attained in the pre-crisis period (see Chart VI.3). In parallel, the relative importance of the more stable revenue sources of the financial system increased in importance: interest and service incomes.

The strengthening of the capitals market sustained the financial margin

The financial margin of the banking system recorded a slight fall in the second half of the year (see Table VI.1), a shift associated with the lesser momentum of the CER adjustments and the profits on exchange rate differences. On the other hand, the significant increase in the profits for holding and negotiating financial assets had this heading become the main driver of the financial margin. The service results exhibited their highest level in the post-crisis period, while in a context of higher employment and wage levels in the financial sector, operating costs persisted on their growing trend. Finally, reversing the trend in previous periods, the sundry results expanded sharply.

In a context in which inflation recorded the lowest growth rate in the past two years and the banking system exhibited a small CER mismatch, in the second half of 2006 the CER adjustments fell by 0.5 p.p. of assets, to 1.1%a. (see Chart VI.4). On the other hand, the profits from exchange rate differences exhibited a decline of 0.2 p.p. of assets to 0.3 %a., mostly reflecting the slight drop in the nominal peso-dollar exchange rate between the ends of the period (\$0.02 per dollar), change that reversed the

²⁷ Unless otherwise indicated, during the rest of Chapter VI the concept of assets net of accounting duplications generated by repo transactions, term sales and unsettled spot transactions is used.

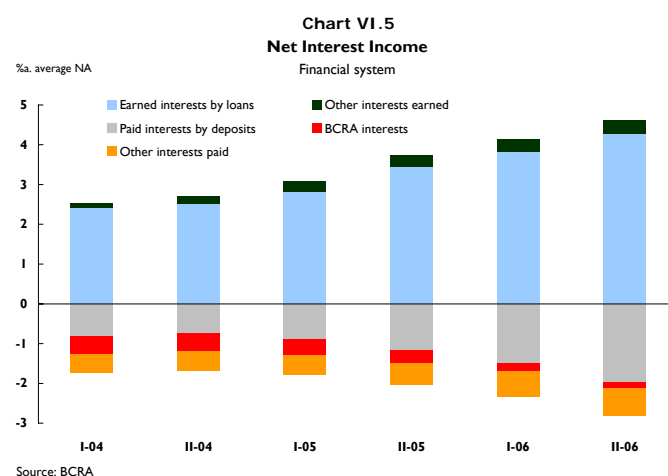
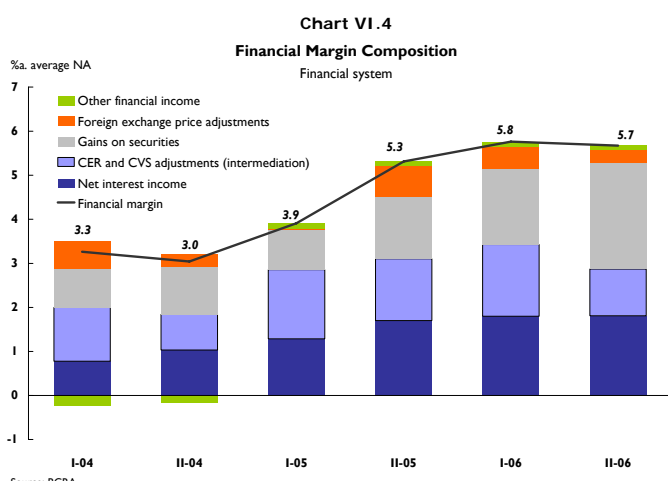


Table VI.1
Profitability Structure: Financial System
In annualized terms - As % of average netted assets

	2003	2004	2005	2006	II-05	I-06	II-06
Financial margin	1.1	3.1	4.6	5.7	5.3	5.8	5.7
Net interest income	-0.5	0.9	1.5	1.8	1.7	1.8	1.8
CER and CVS adjustments	1.3	1.0	1.5	1.3	1.4	1.6	1.1
Gains on securities	1.1	1.0	1.2	2.1	1.4	1.7	2.4
Foreign exchange price adjustments	-0.5	0.4	0.4	0.4	0.7	0.5	0.3
Other financial income	-0.3	-0.2	0.1	0.1	0.1	0.1	0.1
Service income margin	1.9	2.0	2.3	2.7	2.5	2.6	2.8
Operating costs	-4.2	-4.1	-4.6	-5.1	-4.9	-5.0	-5.1
Loans loss provisions (%)	-1.1	-0.8	-0.6	-0.5	-0.6	-0.6	-0.5
Adjustments to the valuation of gov. securities (%)	-0.4	-0.2	-0.2	-0.3	-0.2	-0.4	-0.3
Tax charges	-0.3	-0.3	-0.4	-0.5	-0.4	-0.4	-0.5
Amortization payments for court-ordered releases	-0.6	-0.9	-0.9	-0.7	-0.9	-0.8	-0.7
Other	0.9	0.8	0.8	1.0	0.9	0.8	1.2
Monetary results	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Income tax	-0.2	-0.1	-0.3	-0.3	-0.3	-0.4	-0.3
ROA	-2.9	-0.5	0.9	2.0	1.3	1.7	2.3
ROE	-22.7	-4.2	7.0	15.0	10.6	12.7	16.9
Adjusted ROA (**)	-1.9	0.7	2.0	3.0	2.4	2.8	3.3

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

Source: BCRA



past year's trend. The gradual fall of the bank active position in foreign currency will reduce the weighting of these results in the coming months.

After the fall in May-June the capitals market showed a sharp recovery in the second half of 2006, driven by the recovery of the prices of sovereign bonds. The financial entities reflected this trend, accruing profits on their government bond positions valued at market prices. In this manner the gains on securities became the principal component of the financial margin, to record an increase of 0.7 p.p. of assets in the second half of 2006, to 2.4%a.

In the second half, the interest results remained stable at 1.8%a. of assets. In particular, in a context of strong growth of loans to the private sector and the heterogeneous development of the lending rates on the new lines granted, interest accrual grew by 0.5 p.p. of assets in the second half of 2006, to 4.3%a. (see Chart VI.5). On the other hand, the larger stock of time deposits, combined with an increase in the borrowing rates, originated an increase of 0.5 p.p. on assets of the interest outlays, to 2%a.. Meanwhile, the accelerated cancellation of financial entities' debt with the Central Bank led the interest payment on this account to fall significantly in its weighting.

Improved service results and fewer loans loss provisions

The service results, one of the most stable components of the bank profitability structure, increased 0.2 p.p. of assets in the half year period, to 2.8%a., the highest value achieved since 2002. Although the revenues associated with liabilities (mainly generated by deposits) were the principal component of service revenues, those related to loans were the fastest growing line of this heading (see Chart VI.6).

In a scenario with a sharp improvement in the portfolio quality of private loans, the expected bad loan losses continued declining gradually in the second half of 2006, to reach historically low levels (see Chart VI.7). In particular, the loan loss provisions were 0.5%a. of assets, while in terms of the private sector loans they continued to fall to stand at 1.6%a..

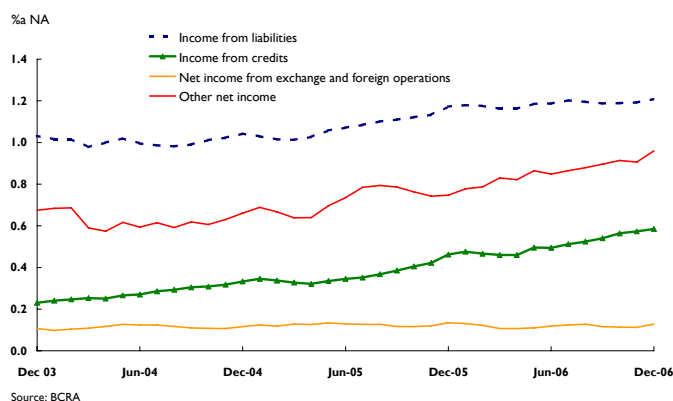
The operating efficiency levels of the private sector banks are recovering

In a context of higher employment levels (see Page 36) and wages in the financial system, operating costs remain on a gradual growth trend. In fact, the management outlays of the banks increased by 0.1 p.p. of assets in the second half of 2006 to 5.1%a. (see Chart VI.8). In this context the coverage of operating costs with revenues (financial margin and service results) remained stable in the period.

On the other hand, the efficiency of the labor factor at banks remained unchanged in the period, although lower than the values achieved prior to the crisis (see Chart VI.9). Nevertheless, the performance was heterogeneous between bank groups: while the private sector financial entities gradually improved their efficiency, the public sector banks exhibited a poorer performance. In line with the expansion of the levels of financial



Chart VI.6
Service Income Margin Composition
Financial system - 3-month moving average



intermediation expected in 2007, the efficiency of the financial system should remain on its positive trend.

All groups of private banks exhibited positive results in the second half of 2006

In 2006 private banks recorded a ROE of 15.3% and a ROA of 2.2% (see Table VI.2). The increasing results earned in the second half of 2006 were associated with an increase in the profits for holding financial assets and the expansion of the sundries headings²⁸ (which grew 0.9 p.p. and 0.8 p.p. of assets, respectively). On the other hand, in the framework of a sharp increase in the intermediation level, the service results expanded 0.2 p.p. of assets to 3.4%.

All groups of private banks posted profits in the second half of 2006. Retail private banks with a national scope, the most important group in terms of assets, exhibited an increase of 0.4 p.p. of assets in their profits to 1.8%a. (see Table VI.3). The sundry results and gains on securities were the most dynamic components in their earnings. Regional private retail banks exhibited a significant improvement in the second half of the year: their profits grew by 2.6 p.p. of assets to 6%a.. This development was accounted for by the same factors that gave momentum to the private banks of national scope. Finally, associated with the greater service results and lower operating costs, the specialized banks increased its profits by 1.6 p.p. of assets to 3.7%a..

Public banks showed returns equivalent to 14.3% of net worth and 1.6% of netted assets in 2006 (see Table VI.4). These results exhibited an expansion compared with those recorded in 2005, driven by the higher gains on securities and the reduction in losses from court payment orders.

Larger volumes of financial intermediation will boost the banking system results in 2007

In a scenario of economic growth and a larger volume of financial intermediation for 2007, the profitability of the financial system is expected to continue expanding. The greater credit demand of families and firms, in particular, will have positive impacts on the interest and service results. Meanwhile, if, as expected, the volatility of the markets is lower in the second half of 2007, a consolidation of gains on securities should be seen.

Likewise, the solid financial position of the private sector agents will maintain the non-performance loan ratio of the banking system at reduced levels, so that the loan loss provisions will exhibit a slight increase due to the momentum inherent in the expansion of the financial intermediation activity in 2007. The share of CER adjustments on assets is expected to continue to fall, largely associated with the smaller CER mismatch of the financial system and the reduction of the inflation levels. On the other hand, the larger deposit and loan stocks will be reflected by a strengthening of the service results, which are already at

Chart VI.7
Loan Loss Provisions
Financial system - 6-month moving average

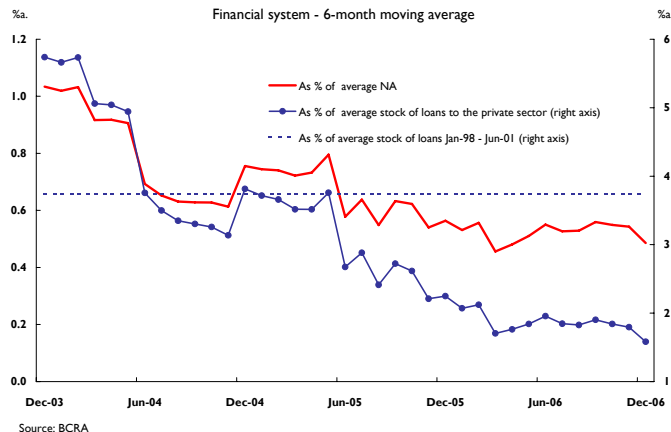
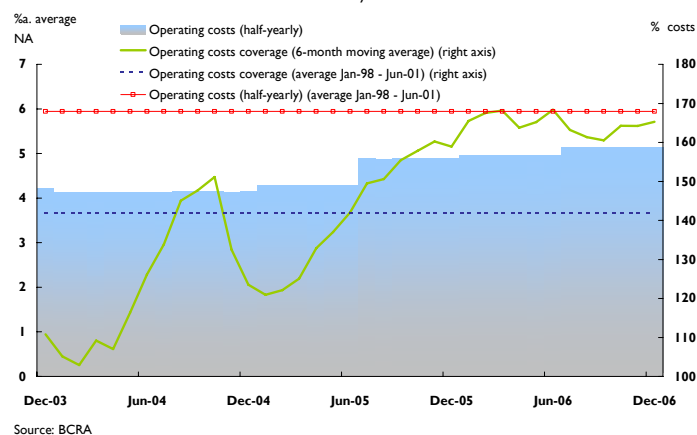


Chart VI.8
Operating Costs and Efficiency
Financial system



²⁸ Mainly associated with the profits for shareholdings in other corporations, sale of loan portfolios that were in memorandum accounts and freeing up provisions on loans.



Chart VI.9

Efficiency

Employment costs / (Private deposits + Private loans) - ln %

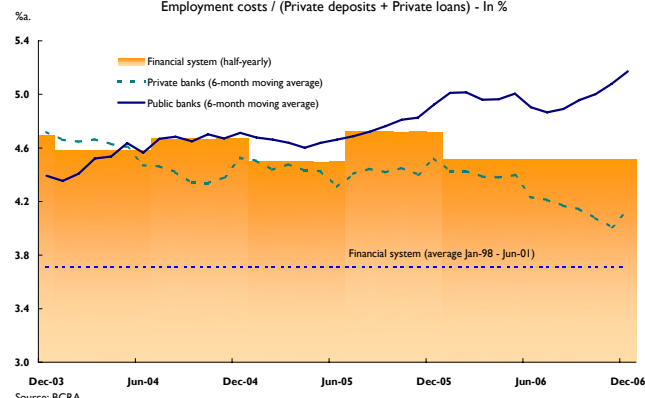


Table VI.2

Profitability Structure: Private banks

In annualized terms - As % of average netted assets

	2003	2004	2005	2006	II-05	I-06	II-06
Financial margin	2.3	2.9	4.3	5.8	5.0	5.6	6.0
Net interest income	0.1	1.0	1.7	2.1	2.0	2.1	2.1
CER and CVS adjustments	0.9	0.8	1.0	0.6	0.8	0.8	0.5
Gains on securities	1.7	0.8	1.0	2.4	1.3	1.9	2.8
Foreign exchange price adjustments	-0.3	0.6	0.5	0.5	0.7	0.7	0.5
Other financial income	-0.2	-0.3	0.1	0.1	0.1	0.1	0.1
Service income margin	2.0	2.4	2.7	3.3	2.9	3.2	3.4
Operating costs	-4.6	-4.6	-5.1	-5.8	-5.5	-5.6	-5.9
Loans loss provisions (*)	-1.3	-0.9	-0.6	-0.5	-0.6	-0.5	-0.6
Adjustments to the valuation of gov. securities (*)	-0.6	0.0	-0.2	-0.1	-0.2	-0.2	-0.1
Tax charges	-0.3	-0.3	-0.4	-0.6	-0.5	-0.5	-0.6
Amortization payments for court-ordered releases	-0.7	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9
Other	1.0	0.7	0.9	1.2	1.0	0.8	1.6
Monetary results	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Income tax	-0.3	-0.2	-0.2	-0.3	-0.2	-0.2	-0.4
ROA	-2.5	-1.0	0.5	2.2	1.0	1.8	2.6
ROE	-19.1	-8.1	4.1	15.3	7.6	12.3	18.0
Adjusted ROA (**)	-1.2	0.2	1.6	3.2	2.2	2.8	3.6

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

Source: BCRA

Table VI.3

Profitability Structure by Type of Bank: Second Half 2006

In annualized terms - As % of average netted assets

	Private				
	Retail				Wholesale
	Total	National coverage	Regional coverage	Specialized	
Financial margin	5.8	5.1	8.1	16.0	9.2
Net interest income	2.2	1.9	3.0	12.2	-0.2
CER and CVS adjustments	0.5	0.6	0.2	-0.1	0.0
Gains on securities	2.5	2.0	4.3	3.5	8.5
Foreign exchange price adjustments	0.4	0.4	0.3	1.1	1.2
Other financial income	0.2	0.2	0.2	-0.7	-0.3
Service income margin	3.5	3.5	3.4	5.6	2.5
Operating costs	-5.8	-5.5	-6.2	-14.6	-7.4
Loans loss provisions (*)	-0.6	-0.5	-0.6	-3.4	-0.2
Adjustments to the valuation of gov. securities (*)	-0.1	-0.1	0.0	0.0	0.0
Tax charges	-0.6	-0.6	-0.6	-1.0	-0.4
Amortization payments for court-ordered releases	-0.9	-1.0	-0.6	-0.3	0.0
Other	1.6	1.3	3.3	2.3	0.4
Monetary results	0.0	0.0	0.0	0.0	0.0
Income tax	-0.3	-0.2	-0.8	-1.0	-1.4
ROA	2.6	1.8	6.0	3.7	2.5
ROE	18.8	14.1	35.6	15.6	9.6
Adjusted ROA (**)	3.7	3.0	6.6	4.0	2.6
Weight in total assets (%)	55.1	44.3	10.0	0.7	2.9

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

Source: BCRA

pre-crisis levels. The increasing and gradual readjustment of operating costs, driven by the recovery of employment levels and of wages in the sector, will not erode the efficiency gains originated in the sustained consolidation of the traditional financial intermediation channel.

VI.2. Capital position

The financial system increases its net worth, strengthening its position in the face of possible negative shocks

The expansion of the financial system profits, together with the fresh capitalizations carried out in the second half of 2006, favor the consolidation of the sector solvency. In a context of sustained economic growth that stimulates the dynamics of financial intermediation, the capitalizations totaled \$950 million in the second half of 2006 (see Chart VI.10), to accumulate \$2.4 billion in the year. In perspective, since the beginning of 2002 the capital injections have been over \$15 billion, while there are contributions pending of about \$100 million. In this scenario, the financial entities have a greater solidness level to face possible adverse shocks.

Private sector banks led the increase in fresh capital contributions in the second half of the year. National private financial entities accounted for almost all the new capitalizations in the period²⁹. On the other hand, foreign and public owned banks received a smaller capital inflow compared with previous periods. However, in the past five years foreign banks accounted for 57% of all the capitalizations that were carried out.

The net worth of the banking system in 2006 exhibited its largest increase of the post-crisis period. In the second half of the year, in particular, the net worth of the financial system expanded \$3.4 billion, to stand 11% higher than the stock in mid-2006 (see Chart VI.11). Unlike the previous half-year, private banks accounted for almost three quarters of this expansion. In perspective, in 2006 banks recorded the fastest growth rate for their net worth since the crisis (23%). Meanwhile, in terms of assets their net worth grew 0.3 p.p. in the final six months of the year, to reach a level of 13.6% at the end of 2006.

Pari passu with the net worth expansion, in 2006 the financial system recorded a sharp improvement in its composition. On one hand banks absorbed more than \$6.8 billion in losses they had accumulated in previous accounting years (mainly originated by the crisis), which reflected a year on year fall of 65% of the non-assigned results. In addition, the corporate capital grew \$1.92 billion (10%), a change accompanied by a decline of \$2.5 billion (14%) in adjustments and reserves. This qualitative change in bank capital was led by the profits earned in 2006, the capital contributions received during the period and, to a lesser extent, by the dividends distributed (about \$460 million)³⁰ (see Chart VI.12).

²⁹ For further details see Report on Banks, August 2006.

³⁰ In the first nine months of the year.



Table VI.4
Profitability Structure: Public banks
In annualized terms - As % of average netted assets

	2003	2004	2005	2006	II-05	I-06	II-06
Financial margin	-0.9	3.3	4.9	5.2	5.5	5.7	4.8
Net interest income	-1.7	0.5	0.9	1.0	1.0	1.0	1.0
CER and CVS adjustments	1.8	1.4	2.3	2.4	2.3	2.9	1.9
Gains on securities	0.1	1.3	1.3	1.6	1.5	1.4	1.9
Foreign exchange price adjustments	-0.7	0.2	0.2	0.2	0.6	0.3	0.1
Other financial income	-0.4	-0.1	0.1	0.0	0.1	0.1	0.0
Service income margin	1.5	1.5	1.6	1.7	1.7	1.7	1.8
Operating costs	-3.4	-3.2	-3.5	-3.8	-3.7	-3.7	-3.8
Loans loss provisions (*)	-0.9	-0.6	-0.5	-0.4	-0.5	-0.5	-0.3
Adjustments to the valuation of gov. securities (*)	-0.1	-0.4	-0.3	-0.6	-0.3	-0.6	-0.5
Tax charges	-0.1	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3
Amortization payments for court-ordered releases	-0.5	-0.7	-0.9	-0.6	-0.8	-0.6	-0.5
Other	0.7	0.7	0.6	0.6	0.5	0.6	0.6
Monetary results	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Income tax	0.0	-0.1	-0.4	-0.3	-0.5	-0.6	-0.1
ROA	-3.5	0.3	1.3	1.6	1.8	1.5	1.7
ROE	-31.8	3.9	12.4	14.3	16.3	13.6	15.0
Adjusted ROA (**)	-3.0	1.4	2.4	2.7	2.9	2.8	2.7

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

Source: BCRA

The main indicators for banks that trade on the Argentine stock exchange registered a very favorable development in the second half of the year (see Chart VI.13), together with an overall improvement of share prices. The higher profit and solvency levels, together with a normalization of the assets and liabilities of the financial entities were reflected by both an increase in the volumes traded and by the rise in share prices. In the first two months of 2007 this positive trend continued, while in March these indicators recorded a fall, as a result of the unfavorable situation on the stock market.

In 2006 the financial system reached levels of regulatory capital that exceed the minima required domestically and those internationally recommended. The excess of capital compliance, in particular, was equivalent to 136% of the capital requirement, while the compliance of the financial system grew by 0.3 p.p. of the risk-weighted assets in the second half of the year, to reach a level of 16.8% in December 2006 (see Chart VI.14). Even without including the temporary measures, the capital compliance of the financial system remains above than the domestic minimum requirement (and that recommended internationally) and the excess of capital compliance remains in positive terrain.

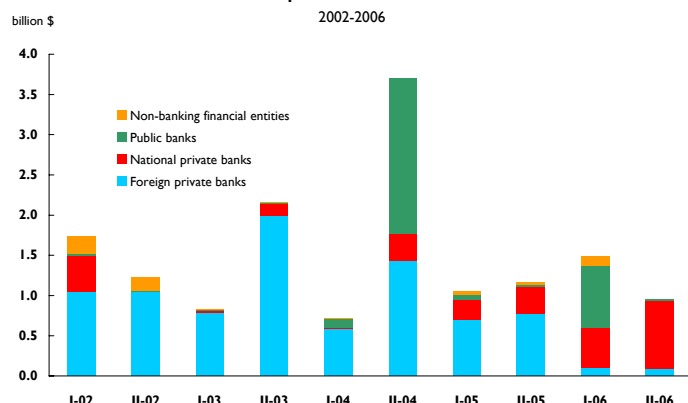
The improvement of the solvency indicators in 2006 was mainly led by public banks. Private banks performance was heterogeneous: while banks with a regional scope recorded increases in their capital compliance compared to their assets at risk, the wholesale, specialized and private with a national scope exhibited slight declines (see Table VI.5). Specifically, although private banks with a regional scope received a large share of the capitalizations and earned significant positive results in the period, these developments were partly offset by the major expansion in their traditional financial intermediation activity.

Driven by the new regulation adopted by the Central Bank, the financial entities continued strengthening their soundness ratios, contributing to a financial stability context. With the purpose of stimulating the capitalization of the financial system, the Central Bank decided that as from October 2006 securities representative of subordinated long-term debt (so called perpetuities) would be included as part of the capital compliance (RPC)³¹. By December 2006 one financial entity had issued a 30-year debt security of US\$150 million at a 9.75% rate, which is further evidence of the complementarities of the financial system with the capital markets.

In 2007 the financial system is expected to continue increasing its solvency levels

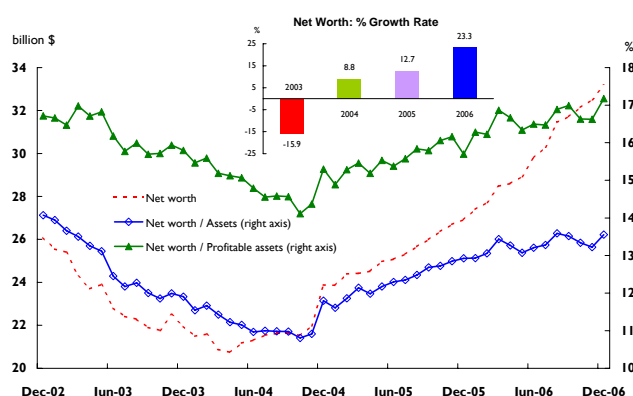
For 2007, a scenario in which a sharp growth in the volume of financial intermediation is projected, the financial system is expected to continue consolidating its robustness. In this case, it is estimated that profitability will be the driving momentum of solvency. On the other hand, in the framework of the Central Bank regulations banks are expected to continue holding adequate levels of capital compliance, to meet the schedule of

Chart VI.10
Capital Contributions
2002-2006



Source: BCRA

Chart VI.11
Financial System Leverage



Source: BCRA

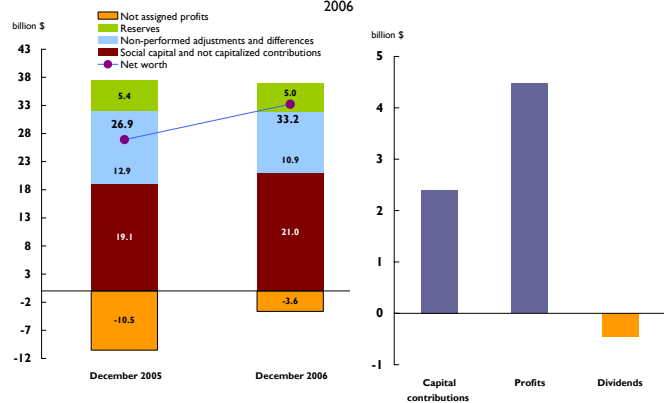
³¹ See Communication "A" 4576.



requirements for public sector credit risk and the interest rate risk.

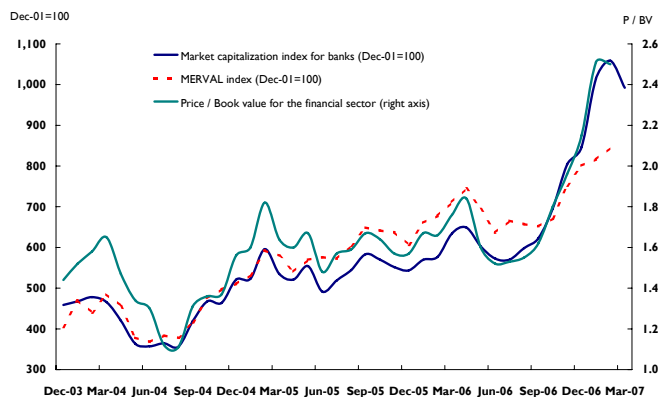
Given the degree of exposure to liquidity, loan, market and interest rate risk, it is worth noting that in general the stress tests show that although the instantaneous effects of a shock would lead to lower profits, it is estimated that such shocks would not lead to a weakening of the capital compliance of the financial system.

Chart VI.12
Composition and Evolution of Net Worth



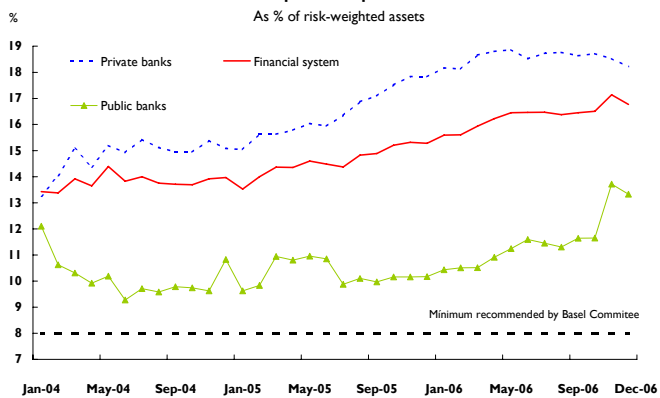
Source: BCRA

Chart VI.13
Market Capitalization Index for Financial Entities



Source: BCRA from BCBA data.

Chart VI.14
Capital Compliance
As % of risk-weighted assets



Source: BCRA

Table VI.5
Capital Requirements by Group of Banks

Group of banks	Capital in excess / Capital requirements (*)		Capital compliance / Assets at risk (**)	
	Dec-05	Dec-06	Dec-05	Dec-06
Public banks	209.8	185.9	10.2	13.3
Private banks	155.0	116.0	17.8	18.2
National coverage	142.9	95.9	16.2	16.0
Regional coverage	156.7	168.3	20.0	24.5
Specialized	262.2	173.6	33.0	26.5
Wholesale	287.1	258.3	39.0	38.1
Non-bank institutions	400.6	214.2	47.0	39.7
Financial system	173.5	136.3	15.3	16.8

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

(**) Assets weighted by credit risk

Source: BCRA



BALANCE OF RISKS

During 2006 the financial system continued with its progress towards the consolidation of a more limited global risk position, in a favorable domestic economic context combined with an adequate regulatory framework and bank supervision by the Central Bank. The persistent deepening of the traditional financial intermediation activity drives the normalization of bank net worth, reflected by higher profit and solvency levels. Therefore, the financial system attains **a greater degree of resilience to face feasible adverse shocks**. In particular, it is estimated that although some decline in profit levels may exist, the liquidity, credit, currency and interest rate shocks (with a low probability of them happening) would not lead to a weaker capital compliance of the financial system.

In line with the Central Bank financial policy, in 2006 the private sector has recovered its role as the main debtor of the financial system. This shift occurs **in a context of reduced credit risk assumed by the banks, due to the better economic and financial perspectives of the private sector**. In a scenario of a persistent increase in financial intermediation expected in 2007, the ample **current levels of provisions provide the banks with a robust resilience to face possible bad loan shocks**. The adequate monitoring of the new loans will be crucial to manage credit risk, although the as yet low debt levels back the thinking that a margin exists to include new debtors with a relatively solid payment capacity in the financial system.

On the other hand, **the exposure of the banking system to the public sector risk continues to fall**. On one hand, the weighting of this portfolio in total bank assets is dropping. On the other hand, this sector is seeing a reduction in the implicit counterparty risk, based on both the solidness of the primary surplus results and the declining levels of public sector indebtedness.

The coverage to face the liquidity risk of the financial system keeps strengthening. Banks have an adequate position in liquid assets, relying on market tools which enable them to carry out a more efficient management of their funds. The steady development of the interbank liquidity markets and the sustained deepening of the domestic capital market reinforce this line. The coverage to face liquidity risk is completed by the Central Bank capacity to act as a lender of last resort for specific illiquidity cases.

Banks strengthen their position to face possible effects of foreign currency mismatches. Both the reduction of these mismatches and the scenario of a reduced volatility in the peso-dollar exchange rate consolidate this trend. In this line, **the stress tests reveal reduced adverse effects on balance sheets when facing an extreme shock which have a small likelihood of occurring**. Furthermore, the current financial policy of the Central Bank stimulates a contraction of the credit risk associated with the possible debtors of loans denominated in a currency different from their revenues.

Gradually, one of the main risks that the financial system inherited from the crisis is reduced. **The exposure of the financial system to the real interest rate risk exhibited a decline in 2006**. In this line, the effects of a rise in the real interest rate are estimated to be limited, and not affect the financial stability framework. Although this risk is an aspect that requires further progress by banks, the Central Bank keeps monitoring it, while it continues to favor market tools that allow for more coverage.

During 2006 the exposure of the financial system to market risk increased. The growing number of financial entities that value their holdings of public securities at market prices, in a scenario which exhibited some increase of volatility, led this momentum. However, it is worth noting that **this risk continues to exhibit a small weighting in the financial system balance of risks**.

The path of rapid normalization of balance sheets, which the financial system is involved in, is reflected by both the higher levels of results and in an improvement in solvency. Thus, in 2006 the banks more than doubled their profitability, to become, together with the receipt of fresh capitalizations, the main pillars for the recovery of their strength. **The adequate solvency levels**, which amply exceed the domestic requirements and international recommendations, **enable them to have resources to face the possible adverse scenarios that the risks assumed could present**.

In a scenario of solid monetary and fiscal policies, **it is estimated that during 2007 the domestic financial intermediation will continue to deepen. A framework of healthy bank risk management policies** is a necessary condition to reach a sustainable path to deepen the degree of financial intermediation. This element will be fundamental in the medium term, when the marginal investments will possibly be more risky. In this context, **the Central Bank will move ahead with a financial policy that aims at consolidating the development of the financial intermediaries in a financial stability framework**.



STATISTICS ANNEX: FINANCIAL SYSTEM

Chart 1: Financial Soundness Indicators

As %	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
1.- Liquidity	22.3	26.1	23.1	25.0	23.4	19.6	22.8	29.1	29.6	20.1	22.5
2.- Lending to the public sector	16.9	16.2	16.2	18.0	17.3	23.0	48.5	46.5	39.6	30.8	21.7
3.- Lending to the private sector	50.8	47.7	48.4	44.9	39.9	42.7	20.8	18.1	19.6	25.8	31.0
4.- Private non-performing loans	16.2	13.8	12.2	14.0	16.0	19.1	38.6	33.5	18.6	7.6	4.5
5.- Net worth exposure to private sector	24.9	22.5	20.6	24.7	26.2	21.9	17.3	12.4	-1.0	-4.1	-3.3
6.- ROA	0.6	1.0	0.5	0.2	0.0	0.0	-8.9	-2.9	-0.5	0.9	2.0
7.- ROE	4.1	6.3	3.9	1.7	0.0	-0.2	-59.2	-22.7	-4.2	7.0	15.0
8.- Efficiency	141.8	135.7	138.2	142.5	147.4	143.3	189.1	69.3	124.8	151.1	166.7
9.- Capital compliance	23.8	20.8	20.3	21.0	20.1	21.4	-	14.5	14.0	15.3	16.8
10.- Excess capital compliance	64	73	49	54	58	54	-	116	185	173	136

Source: BCRA

Chart 2: Balance Sheet

In million of current pesos	Dec 00	Dec 01	Dec 02	Dec 03	Dec 04	Dec 05	Jun 06	Dec 06	Change (%)	
									Half yearly	Inter annual
Assets	163,550	123,743	187,532	186,873	212,562	221,962	239,137	258,396	8.1	16.4
Liquid assets ¹	20,278	13,005	17,138	27,575	29,154	20,819	29,669	37,992	28.1	82.5
Public bonds	10,474	3,694	31,418	45,062	55,382	66,733	66,300	64,422	-2.8	-3.5
Lebac/Nobac	0	0	-	-	17,755	28,340	27,791	29,091	4.7	2.6
Portfolio	0	0	-	-	11,803	21,067	21,949	25,581	16.5	21.4
Repo	0	0	-	-	5,953	7,273	5,842	3,510	-39.9	-51.7
Private bonds	633	543	332	198	387	389	800	813	1.6	108.7
Loans	83,277	77,351	84,792	68,042	73,617	84,171	92,080	103,649	12.6	23.1
Public sector	15,164	22,694	44,337	33,228	30,866	25,836	23,012	20,857	-9.4	-19.3
Private sector	64,464	52,039	38,470	33,398	41,054	55,885	65,841	77,830	18.2	39.3
Financial sector	3,649	2,617	1,985	1,417	1,697	2,450	3,228	4,962	53.7	102.5
Provisions over loans	-6,907	-6,987	-11,952	-9,374	-7,500	-4,930	-4,249	-3,996	-5.9	-18.9
Other netted credits due to financial intermediation	42,361	21,485	39,089	27,030	32,554	26,721	26,349	26,073	-1.0	-2.4
Corporate bonds and subordinated debt	794	751	1,708	1,569	1,018	873	815	773	-5.1	-11.4
Unquoted trusts	2,053	2,065	6,698	4,133	3,145	3,883	4,545	4,915	8.1	26.6
Compensation receivable	0	0	17,111	14,937	15,467	5,841	5,150	763	-85.2	-86.9
Other	39,514	18,669	13,572	6,392	12,924	16,124	15,840	19,622	23.9	21.7
Assets under financial leases	786	771	567	397	611	1,384	1,846	2,262	22.5	63.4
Shares and participation	2,645	2,688	4,653	4,591	3,871	4,532	4,719	6,378	35.2	40.7
Fixed assets and miscellaneous	4,939	4,804	8,636	8,164	7,782	7,546	7,491	7,604	1.5	0.8
Foreign branches	1,115	1,057	3,522	3,144	3,524	3,647	3,832	2,788	-27.2	-23.5
Other assets	3,950	5,334	9,338	12,043	13,180	10,950	10,299	10,411	1.1	-4.9
Liabilities	146,267	107,261	161,446	164,923	188,683	195,044	209,339	225,212	7.6	15.5
Deposits	86,506	66,458	75,001	94,635	116,655	136,492	155,072	170,904	10.2	25.2
Public sector ²	7,204	950	8,381	16,040	31,649	34,019	40,493	45,410	12.1	33.5
Private sector ²	78,397	43,270	59,698	74,951	83,000	100,809	111,799	123,437	10.4	22.4
Current account	6,438	7,158	11,462	15,071	18,219	23,487	24,376	26,900	10.4	14.5
Savings account	13,008	14,757	10,523	16,809	23,866	29,078	33,348	36,444	9.3	25.3
Time deposit	53,915	18,012	19,080	33,285	34,944	42,822	48,359	54,338	12.4	26.9
CEDRO	0	0	12,328	3,217	1,046	17	16	13	-18.4	-23.3
Other netted liabilities due to financial intermediation	55,297	36,019	75,737	61,690	64,928	52,072	47,605	46,032	-3.3	-11.6
Call money	3,545	2,550	1,649	1,317	1,461	2,164	2,983	4,579	53.5	111.6
BCRA lines	102	4,470	27,837	27,491	27,726	17,005	11,434	7,686	-32.8	-54.8
Outstanding bonds	4,954	3,777	9,096	6,675	7,922	6,548	6,762	6,603	-2.3	0.8
Foreign lines of credit	8,813	7,927	25,199	15,196	8,884	4,684	4,461	4,240	-5.0	-9.5
Other	37,883	17,295	11,955	11,012	18,934	21,671	21,966	22,924	4.4	5.8
Subordinated debts	2,255	2,260	3,712	2,028	1,415	1,381	1,243	1,642	32.1	18.9
Other liabilities	2,210	2,524	6,997	6,569	5,685	5,099	5,419	6,635	22.4	30.1
Net worth	17,283	16,483	26,086	21,950	23,879	26,918	29,797	33,184	11.4	23.3
Memo										
Netted assets	129,815	110,275	185,356	184,371	202,447	208,275	225,630	244,799	8.5	17.5
Consolidated netted assets	125,093	106,576	181,253	181,077	198,462	203,391	219,738	235,925	7.4	16.0

(1) Includes margin accounts with the BCRA; (2) Does not include accrual on interest or CER.

Source: BCRA

Methodological note (chart 1):

1.- (Cash compliance according to BCRA + Other cash holdings + Central Bank repos) / Total deposits; **2.-** (Public bonds position (without LEBAC and NOBAC) + Loans to the public sector + Compensation receivable) / Netted assets; **3.-** (Loans to the private sector + Leases) / Netted assets; **4.-** Non-performing loans to the non-financial private sector / Loans to the non-financial private sector; **5.-** (Total non-performing loans - Provisions) / Net worth. The non-performing loans includes loans classified in situation 3,4,5 and 6; **6.-** Accumulated annual results / Average monthly netted assets - % Annualized; **7.-** Accumulated annual results / Average monthly net worth - % Annualized; **8.-** (Financial margin (Net interest income + CER and CVS adjustments + Gains on securities + Foreign exchange price adjustments + Other financial income) + Service income margin) / Operating costs; **9.-** Capital compliance (Responsabilidad Patrimonial Computable) / Risk - adjusted assets according to the regulation of BCRA about Minimum Capital Compliance; **10.-** (Capital compliance minus requirements, included forbearances) / Capital requirements.



Chart 3: Profitability Structure

In millions of current pesos	Annual								Half year			% change	
	1999	2000	2001	2002	2003	2004	2005	2006	II-05	I-06	II-06	II-06 / II-05	II-06 / I-06
Financial margin	6,967	7,291	6,943	13,991	1,965	6,075	9,475	12,973	5,483	6,234	6,738	23	8
Net interest income	5,396	5,106	4,625	-3,624	-943	1,753	3,069	4,097	1,756	1,948	2,149	22	10
CER and CVS adjustments	0	0	0	8,298	2,315	1,944	3,051	3,022	1,449	1,760	1,262	-13	-28
Foreign exchange price adjustments	227	185	268	5,977	-890	866	751	928	711	561	368	-48	-34
Gains on securities	1,112	1,481	1,490	3,639	1,962	1,887	2,371	4,703	1,450	1,849	2,853	97	54
Other financial income	232	519	559	-299	-480	-375	233	223	117	116	106	-9	-8
Service income margin	3,623	3,582	3,604	4,011	3,415	3,904	4,781	6,162	2,538	2,819	3,343	32	19
Loan loss provisions	-2,565	-3,056	-3,096	-10,007	-2,089	-1,511	-1,173	-1,173	-582	-595	-577	-1	-3
Operating costs	-7,432	-7,375	-7,362	-9,520	-7,760	-7,998	-9,437	-11,477	-5,047	-5,377	-6,099	21	13
Tax charges	-497	-528	-571	-691	-473	-584	-737	-1,080	-410	-479	-602	47	26
Income tax	-421	-446	-262	-509	-305	-275	-581	-728	-333	-402	-326	-2	-19
Adjustments to the valuation of gov. securities ²	0	0	0	0	-701	-320	-410	-690	-246	-383	-307	25	-20
Amortization payments for court-ordered releases	0	0	0	0	-1,124	-1,686	-1,867	-1,697	-896	-819	-879	-2	7
Other	617	535	702	-3,880	1,738	1,497	1,729	2,227	880	817	1,410	60	72
Monetary results	0	0	0	-12,558	69	0	0	0	0	0	0	0	0
Total results	291	3	-42	-19,162	-5,265	-898	1,780	4,516	1,386	1,816	2,701	95	49
Adjusted results ³	-	-	-	-	-3,440	1,337	4,057	6,904	2,528	3,017	3,887	54	153
Annualized indicators - As % of netted assets												change in p.p.	
Financial margin	5.6	5.7	5.7	6.5	1.1	3.1	4.6	5.7	5.3	5.8	5.9	0.6	0.2
Net interest income	4.3	4.0	3.8	-1.7	-0.5	0.9	1.5	1.8	1.7	1.8	1.9	0.2	0.1
CER and CVS adjustments	0.0	0.0	0.0	3.9	1.3	1.0	1.5	1.3	1.4	1.6	1.1	-0.3	-0.5
Foreign exchange price adjustments	0.2	0.1	0.2	2.8	-0.5	0.4	0.4	0.4	0.7	0.5	0.3	-0.4	-0.2
Gains on securities	0.9	1.2	1.2	1.7	1.1	1.0	1.2	2.1	1.4	1.7	2.5	1.1	0.8
Other financial income	0.2	0.4	0.5	-0.1	-0.3	-0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Service income margin	2.9	2.8	3.0	1.9	1.9	2.0	2.3	2.7	2.5	2.6	2.9	0.5	0.3
Loan loss provisions	-2.1	-2.4	-2.6	-4.7	-1.1	-0.8	-0.6	-0.5	-0.6	-0.5	-0.5	0.1	0.0
Operating costs	-5.9	-5.8	-6.1	-4.4	-4.2	-4.1	-4.6	-5.1	-4.9	-5.0	-5.4	-0.5	-0.4
Tax charges	-0.4	-0.4	-0.5	-0.3	-0.3	-0.3	-0.4	-0.5	-0.4	-0.4	-0.5	-0.1	-0.1
Income tax	-0.3	-0.3	-0.2	-0.2	-0.2	-0.1	-0.3	-0.3	-0.3	-0.4	-0.3	0.0	0.1
Adjustments to the valuation of gov. securities ²	0.0	0.0	0.0	0.0	-0.4	-0.2	-0.2	-0.3	-0.2	-0.4	-0.3	0.0	0.1
Amortization payments for court-ordered releases	0.0	0.0	0.0	0.0	-0.6	-0.9	-0.9	-0.7	-0.9	-0.8	-0.8	0.1	0.0
Other	0.5	0.4	0.6	-1.8	0.9	0.8	0.8	1.0	0.9	0.8	1.2	0.4	0.5
Monetary results	0.0	0.0	0.0	-5.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
ROA	0.2	0.0	0.0	-8.9	-2.9	-0.5	0.9	2.0	1.3	1.7	2.4	1.0	0.7
ROA adjusted ³	-	-	-	-	-1.9	0.7	2.0	3.0	2.4	2.8	3.4	1.0	0.6
ROE	1.7	0.0	-0.2	-59.2	-22.7	-4.2	7.0	15.0	10.6	12.7	17.7	7.2	5.1

(1) Information in currency of december 2002. (2) Com. "A" 3911. Adjustments to the valuation of government unlisted securities according to Com. "A" 4084 are included under the "gains on securities" heading.

(3) Excluding amortization of payments for court-ordered releases and the effects of Com. "A" 3911 and 4084.

Source: BCRA

Chart 4: Portfolio Quality

As percentages	Dec 00	Dec 01	Dec 02	Dec 03	Dec 04	Dec 05	Sep 06	Oct 06	Nov 06	Dec 06
Non-performing loans (overall)	12.9	13.1	18.1	17.7	10.7	5.2	3.8	3.7	3.5	3.4
Non-performing loans to the non-financial private sector	16.0	19.1	38.6	33.5	18.6	7.6	5.0	4.8	4.7	4.5
Commercial portfolio (*)	14.9	20.7	44.0	38.0	22.8	9.3	5.7	5.5	5.3	5.1
Consumption and housing portfolio	17.3	17.5	31.4	28.0	11.0	4.8	3.8	3.7	3.6	3.5
Provisions / Total non-performing loans	61.1	66.4	73.8	79.2	102.9	125.1	131.5	131.8	134.4	130.6
(Total non-performing - Provisions) / Overall financing	5.0	4.4	4.7	3.7	-0.3	-1.3	-1.2	-1.2	-1.2	-1.0
(Total non-performing - Provisions) / Net worth	26.2	21.6	17.2	11.9	-1.0	-4.1	-3.7	-3.7	-4.0	-3.3

(*) Include commercial loans treated as consumer loans for classification purposes.

Source: BCRA

Chart 5: International Indicators

	GDP	Liquid assets / Private deposits	Private loans / Total assets	Non-performing loans to the private sector	Provisions / Non-performing loans	ROA	ROE	Real ROE	Capital compliance / APR
2005/2006: latest information available	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Argentina	212	31.1	30.8	4.5	130	2.0	15.0	4.7	16.8
Australia	1,327	0.8	87.1	-	198	1.8	25.5	22.1	10.5
Brazil	927	8.7	38.4	3.0	145	2.3	24.5	20.1	18.3
Chile	142	8.3	84.8	2.4	181	1.4	18.6	15.4	12.5
Spain	1,231	1.6	77.0	1.3	253	1.0	19.8	16.4	10.6
USA	13,245	0.6	57.6	0.7	160	1.4	13.1	10.8	10.1
Japan	4,365	1.9	54.8	2.4	49	0.5	12.6	13.4	11.6
Mexico	815	15.7	23.2	2.0	232	3.1	25.1	20.1	15.2
UK	2,374	1.5	45.4	1.0	81	0.8	11.8	9.4	12.0

Source: BCRA; International Financial Statistics (July 2006) and Global Financial Stability Report (September 2006) - International Monetary Fund.

Methodological note (chart 5):

1.- GDP 2006 – in billion of US\$; 2.- Cash in banks plus deposits in the monetary authority / Private deposits (%); 3.- Loans to the private sector / Total assets (%); 4.- Non-performing loans to the private sector / Total loans to the private sector (%); 5.- Provisions / Non-performing loans (%); 6.- Total results / Netted assets (%); 7.- Total results / Net worth (%); 8.- Total results / Net worth (%) (deflated by CPI); 9.- Capital compliance / Risk - adjusted assets (%).



STATISTICS ANNEX: PRIVATE BANKS

Chart 6: Financial Soundness Indicators

As %	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
1.- Liquidity	23.6	26.9	22.8	24.3	24.1	23.6	24.8	27.6	29.2	21.5	23.7
2.- Lending to the public sector	13.5	13.7	13.6	16.1	14.7	20.8	49.4	47.1	41.2	28.0	15.9
3.- Lending to the private sector	51.0	46.7	47.6	44.6	38.4	45.4	22.4	19.9	22.5	31.1	37.9
4.- Private non-performing loans	11.1	8.5	7.7	8.9	9.8	14.0	37.4	30.4	15.3	6.3	3.6
5.- Net worth exposure to private sector	21.6	14.3	13.2	11.5	13.4	11.4	18.6	11.2	1.9	-2.2	-3.0
6.- ROA	0.6	0.7	0.5	0.3	0.1	0.2	-11.3	-2.5	-1.0	0.5	2.2
7.- ROE	4.1	6.3	4.3	2.3	0.8	1.4	-79.0	-19.1	-8.1	4.1	15.3
8.- Efficiency	143.9	135.0	138.9	146.0	151.9	150.9	168.1	92.6	115.0	136.5	158.6
9.- Capital compliance	15.9	15.4	14.6	18.9	18.0	17.6	-	14.0	15.1	17.8	18.2
10.- Excess capital compliance	33	47	27	60	49	43	-	88	157	155	116

Source: BCRA

Chart 7: Balance Sheet

In millions of current pesos	Dec 00	Dec 01	Dec 02	Dec 03	Dec 04	Dec 05	Jun 06	Dec 06	Change (%)	
									Half yearly	Inter annual
Assets	119,371	82,344	118,906	116,633	128,065	129,680	136,557	152,395	11.6	17.5
Liquid assets ¹	13,920	10,576	11,044	14,500	15,893	14,074	17,555	22,228	26.6	57.9
Public bonds	7,583	1,627	19,751	22,260	24,817	29,966	28,729	27,663	-3.7	-7.7
Lebac/Nozac	0	0	-	-	8,359	15,227	14,019	15,952	13.8	4.8
Portfolio	0	0	-	-	5,611	12,899	12,998	14,231	9.5	10.3
Repo	0	0	-	-	2,749	2,328	1,021	1,721	68.5	-26.1
Private bonds	563	451	273	172	333	307	692	683	-1.3	122.5
Loans	56,035	52,319	51,774	47,017	50,741	56,565	61,028	69,294	13.5	22.5
Public sector	8,172	13,803	25,056	23,571	21,420	15,954	12,341	10,036	-18.7	-37.1
Private sector	45,103	36,636	26,074	22,816	28,213	39,031	46,584	55,632	19.4	42.5
Financial sector	2,760	1,880	644	630	1,107	1,580	2,103	3,626	72.5	129.5
Provisions over loans	-3,248	-3,957	-7,463	-5,225	-3,717	-2,482	-2,240	-2,227	-0.6	-10.3
Other netted credits due to financial intermediation	36,600	13,037	27,212	22,148	25,753	16,873	16,374	18,399	12.4	9.0
Corporate bonds and subordinated debt	724	665	1,514	1,394	829	675	644	618	-4.0	-8.5
Unquoted trusts	1,609	1,637	6,205	3,571	2,362	2,444	2,947	2,982	1.2	22.0
Compensation receivable	0	0	15,971	13,812	14,657	5,575	4,883	760	-84.4	-86.4
Other	34,267	10,735	3,523	3,370	7,905	8,179	7,900	14,039	77.7	71.7
Assets under financial leases	776	752	553	387	592	1,356	1,780	2,126	19.4	56.8
Shares and participation	1,651	1,703	3,123	2,791	1,892	2,416	2,578	4,042	56.8	67.3
Fixed assets and miscellaneous	3,225	3,150	5,198	4,902	4,678	4,575	4,536	4,677	3.1	2.2
Foreign branches	75	112	-109	-136	-53	-148	-122	-139	13.7	-6.1
Other assets	2,190	2,574	7,549	7,816	7,137	6,178	5,648	5,649	0.0	-8.6
Liabilities	107,193	70,829	103,079	101,732	113,285	112,600	118,194	131,456	11.2	16.7
Deposits	57,833	44,863	44,445	52,625	62,685	75,668	83,487	94,096	12.7	24.4
Public sector ²	1,276	950	1,636	3,077	6,039	6,946	6,951	7,029	1.1	1.2
Private sector ²	55,917	43,270	38,289	47,097	55,384	67,859	74,820	85,715	14.6	26.3
Current account	4,960	7,158	8,905	11,588	13,966	17,946	18,236	20,604	13.0	14.8
Savings account	9,409	14,757	6,309	10,547	14,842	18,362	20,366	23,165	13.7	26.2
Time deposit	39,030	18,012	11,083	18,710	22,729	27,736	32,327	38,043	17.7	37.2
CEDRO	0	0	9,016	2,409	798	3	2	1	-42.1	-50.9
Other netted liabilities due to financial intermediation	46,271	22,629	49,341	42,367	45,083	32,349	30,283	31,750	4.8	-1.9
Call money	2,293	1,514	836	726	1,070	1,488	2,123	3,384	59.4	127.5
BCRA lines	83	1,758	16,624	17,030	17,768	10,088	7,072	3,689	-47.8	-63.4
Outstanding bonds	4,939	3,703	9,073	6,674	7,922	6,548	6,762	6,413	-5.2	-2.1
Foreign lines of credit	5,491	4,644	15,434	9,998	5,444	2,696	2,478	2,249	-9.3	-16.6
Other	33,466	11,010	7,374	7,939	12,878	11,530	11,847	16,014	35.2	38.9
Subordinated debts	1,668	1,700	3,622	1,850	1,304	1,319	1,183	1,642	38.8	24.5
Other liabilities	1,420	1,637	5,671	4,890	4,213	3,264	3,242	3,968	22.4	21.6
Net worth	12,178	11,515	15,827	14,900	14,780	17,080	18,363	20,940	14.0	22.6
Memo										
Netted assets	88,501	73,796	117,928	115,091	121,889	123,271	130,290	143,784	10.4	16.6

(1) Includes margin accounts with the BCRA; (2) Does not include accrual on interest or CER.

Source: BCRA

Methodological note (chart 6):

1.- (Cash compliance according to BCRA + Other cash holdings + Central Bank repos) / Total deposits; **2.-** (Public bonds position (without LEBAC and NOBAC) + Loans to the public sector + Compensation receivable) / Netted assets; **3.-** (Loans to the private sector + Leases) / Netted assets; **4.-** Non-performing loans to the non-financial private sector / Loans to the non-financial private sector; **5.-** (Total non-performing loans - Provisions) / Net worth. The non-performing loans includes loans classified in situation 3,4,5 and 6; **6.-** Accumulated annual results / Average monthly netted assets - % Annualized; **7.-** Accumulated annual results / Average monthly net worth - % Annualized; **8.-** (Financial margin (Net interest income + CER and CVS adjustments + Gains on securities + Foreign exchange price adjustments + Other financial income) + Service income margin) / Operating costs; **9.-** Capital compliance (Responsabilidad Patrimonial Computable) / Risk - adjusted assets according to the regulation of BCRA about Minimum Capital Compliance; **10.-** (Capital compliance minus requirements, included forbearances) / Capital requirements.



Chart 8: Profitability Structure

	Annual								Half year			% change		
In millions of current pesos	1999	2000	2001	2002 ¹	2003	2004	2005	2006	II-05	I-06	II-06	II-06 / II-05	II-06 / I-06	
Financial margin	5,176	5,441	5,282	10,628	2,575	3,415	5,253	7,673	3,031	3,545	4,128	36	16	
Net interest income	3,819	3,598	3,519	-304	107	1,214	2,069	2,774	1,200	1,330	1,444	20	9	
CER and CVS adjustments	0	0	0	1,476	1,082	900	1,215	854	511	498	357	-30	-28	
Foreign exchange price adjustments	213	160	256	6,189	-312	666	576	725	436	412	313	-28	-24	
Gains on securities	908	1,232	962	3,464	1,892	959	1,259	3,132	813	1,219	1,913	135	57	
Other financial income	236	450	546	-197	-195	-322	134	187	70	86	102	45	19	
Service income margin	2,598	2,554	2,598	2,782	2,341	2,774	3,350	4,379	1,789	2,016	2,363	32	17	
Loan loss provisions	-1,872	-2,173	-2,464	-6,923	-1,461	-1,036	-714	-711	-358	-326	-386	8	18	
Operating costs	-5,326	-5,263	-5,224	-6,726	-5,310	-5,382	-6,303	-7,598	-3,370	-3,565	-4,034	20	13	
Tax charges	-368	-379	-418	-512	-366	-393	-509	-759	-287	-343	-417	45	21	
Income tax	-386	-393	-216	-337	-295	-202	-217	-363	-130	-107	-256	97	139	
Adjustments to the valuation of gov. securities ²	0	0	0	0	-665	-51	-201	-170	-118	-102	-68	-42	-33	
Amortization payments for court-ordered releases	0	0	0	0	-791	-1,147	-1,168	-1,161	-575	-539	-622	8	15	
Other	447	307	615	-4,164	1,178	846	1,156	1,623	639	528	1,094	71	107	
Monetary results	0	0	0	-10,531	-20	0	0	0	0	0	0	0	0	
Total results	269	93	174	-15,784	-2,813	-1,176	648	2,912	621	1,109	1,803	191	63	
Adjusted results ³	-	-	-	-	-1,357	252	2,016	4,243	1,313	1,749	2,494	90	43	
Annualized indicators - As % of netted assets													change in p.p.	
Financial margin	6.1	6.2	6.4	7.6	2.3	2.9	4.3	5.8	5.0	5.6	6.3	1.3	0.7	
Net interest income	4.5	4.1	4.3	-0.2	0.1	1.0	1.7	2.1	2.0	2.1	2.2	0.2	0.1	
CER and CVS adjustments	0.0	0.0	0.0	1.1	0.9	0.8	1.0	0.6	0.8	0.8	0.5	-0.3	-0.2	
Foreign exchange price adjustments	0.3	0.2	0.3	4.4	-0.3	0.6	0.5	0.5	0.7	0.7	0.5	-0.2	-0.2	
Gains on securities	1.1	1.4	1.2	2.5	1.7	0.8	1.0	2.4	1.3	1.9	2.9	1.6	1.0	
Other financial income	0.3	0.5	0.7	-0.1	-0.2	-0.3	0.1	0.1	0.1	0.1	0.2	0.0	0.0	
Service income margin	3.1	2.9	3.2	2.0	2.0	2.4	2.7	3.3	2.9	3.2	3.6	0.7	0.4	
Loan loss provisions	-2.2	-2.5	-3.0	-5.0	-1.3	-0.9	-0.6	-0.5	-0.6	-0.5	-0.6	0.0	-0.1	
Operating costs	-6.3	-6.0	-6.4	-4.8	-4.6	-4.6	-5.1	-5.8	-5.5	-5.6	-6.2	-0.6	-0.5	
Tax charges	-0.4	-0.4	-0.5	-0.4	-0.3	-0.3	-0.4	-0.6	-0.5	-0.5	-0.6	-0.2	-0.1	
Income tax	-0.5	-0.4	-0.3	-0.2	-0.3	-0.2	-0.2	-0.3	-0.2	-0.2	-0.4	-0.2	-0.2	
Adjustments to the valuation of gov. securities ²	0.0	0.0	0.0	0.0	-0.6	0.0	-0.2	-0.1	-0.2	-0.2	-0.1	0.1	0.1	
Amortization payments for court-ordered releases	0.0	0.0	0.0	0.0	-0.7	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9	0.0	-0.1	
Other	0.5	0.4	0.7	-3.0	1.0	0.7	0.9	1.2	1.0	0.8	1.7	0.6	0.8	
Monetary results	0.0	0.0	0.0	-7.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
ROA	0.3	0.1	0.2	-11.3	-2.5	-1.0	0.5	2.2	1.0	1.8	2.8	1.7	1.0	
ROA adjusted ³	-	-	-	-	-1.2	0.2	1.6	3.2	2.2	2.8	3.8	1.7	1.0	
ROE	2.3	0.8	1.4	-79.0	-19.1	-8.1	4.1	15.3	7.6	12.3	19.2	11.6	6.9	

(1) Information in currency of december 2002. (2) Com. "A" 3911. Adjustments to the valuation of government unlisted securities according to Com. "A" 4084 are included under the "gains on securities" heading.

(3) Excluding amortization of payments for court-ordered releases and the effects of Com. "A" 3911 and 4084.

Source: BCRA

Chart 9: Portfolio Quality

As percentages	Dec 00	Dec 01	Dec 02	Dec 03	Dec 04	Dec 05	Sep 06	Oct 06	Nov 06	Dec 06
Non-performing loans (overall)	8.3	9.9	19.8	15.7	8.9	4.4	3.2	3.1	2.9	2.9
Non-performing loans to the non-financial private sector	9.8	14.0	37.4	30.4	15.3	6.3	4.1	4.0	3.7	3.6
Commercial portfolio (*)	8.4	15.4	44.7	39.0	18.2	7.3	4.4	4.3	3.9	3.8
Consumption and housing portfolio	11.9	12.4	26.0	17.2	10.0	4.2	3.5	3.3	3.3	3.2
Provisions / Total non-performing loans	67.7	75.7	73.4	79.0	95.7	114.6	125.7	126.6	129.7	129.6
(Total non-performing - Provisions) / Overall financing	2.7	2.4	5.3	3.3	0.4	-0.6	-0.8	-0.8	-0.9	-0.9
(Total non-performing - Provisions) / Net worth	13.4	11.4	18.6	11.2	1.3	-2.2	-2.8	-2.9	-3.1	-3.0

(*) Include commercial loans treated as consumer loans for classification purposes.

Source: BCRA



ABBREVIATIONS AND ACRONYMS

\$: Argentine pesos.

%a.: annualized porcentaje.

a.: annualized.

AFJP: *Administradora de Fondos de Jubilaciones y Pensiones.*

ANSES: *Administración Nacional de Seguridad Social.* National Social Security Administration.

APE: *Acuerdos Preventivos Extra-judiciales.* Preliminary out-of-court agreements.

APR: Annual Percentage Rate.

b.p.: basis points.

BADLAR: Interest rate for time deposits over one million pesos between 30 and 35 days for the average of financial entities.

BCBA: *Bolsa de Comercio de Buenos Aires.* Buenos Aires Stock Exchange.

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

BIS: Bank of International Settlements.

BM: Monetary Base. Defined as money in circulation plus current account deposits in pesos by financial entities in the BCRA.

Boden: *Bonos del Estado Nacional.* Federal Bonds.

Bogar: *Bonos Garantizados.* Guaranteed Bonds.

BoJ: Bank of Japan.

Bonar: *Bonos de la Nación Argentina.* Argentine National Bonds.

BOVESPA: São Paulo Stock Exchange.

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

Cdad. de Bs. As.: *Ciudad de Buenos Aires.* Buenos Aires City.

CDS: Credit Default Swaps

CEC: *Cámaras Electrónicas de Compensación.* Electronic Clearing Houses.

CEDEM: *Centro de Estudios para el Desarrollo Económico Metropolitano.* Study Center for Metropolitan Economic Development.

CEDRO: *Certificado de Depósito Reprogramado.* Rescheduled Deposit Certificate.

CER: *Coeficiente de Estabilización de Referencia.* Reference Stabilization Coefficient.

CIMPRA: *Comisión Interbancaria para Medios de Pago de la República Argentina.*

CNV: *Comisión Nacional de Valores.* National Securities Commission

CPI: Consumer Price Index.

CPI Others: *CPI excluidos los bienes y servicios con alta estacionalidad, volatilidad o los sujetos a regulación o alto componente impositivo.* CPI excluded goods and services with high

seasonal and irregular components, regulated prices or high tax components

Credit to the public sector: includes the position in government securities (excluding LEBAC and NOBAC), loans to the public sector and compensation receivable.

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

DGF: Deposit Guarantee Fund.

Disc: Discount bond.

EB: Executive Branch.

ECB: European Central Bank.

EMBI: Emerging Markets Bond Index.

EMI: *Estimador Mensual Industrial.* Monthly Industrial Indicator

EPH: *Encuesta Permanente de Hogares.* Permanent Household Survey.

Fed: Federal Reserve of USA.

FOMC: Federal Open Market Committee (USA).

FS: Financial Stability.

FSB: Financial Stability Bulletin.

FT: Financial trust.

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

FV: Face value.

GDP: Gross Domestic Product.

HHI: Herfindahl-Hirschman Index.

IADB: Inter-American Development Bank.

IAMC: *Instituto Argentino de Mercado de Capitales.*

ICs: Insurance Companies.

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.

IndeR: *Instituto Nacional de Reaseguros.* National Institute of Reinsurance.

IPMP: *Índice de Precios de las Materias Primas.* Central Bank Commodities Price Index.

IPSA: *Índice de Precios Selectivo de Acciones.* Chile Stock Exchange Index.

IRR: Internal Rate of Return.

ISAC: *Índice Sintético de Actividad de la Construcción.* Construction Activity Index.

ISDA: International Swaps and Derivates Association.

ISSP: *Índice Sintético de Servicios Públicos.* Synthetic Indicator of Public Services.



Lebac: <i>Letras del Banco Central de la República Argentina</i> . BCRA bills.	P / BV : Price over book value.
LIBOR: London Interbank Offered Rate.	p.p.: Percentage point.
m.a.: Moving average.	Par: Par bond.
M2: Currency held by public + quasi-monies + \$ saving and current accounts.	PGN: <i>Préstamos Garantizados Nacionales</i> . National Guaranteed Loans.
M3: Currency held by public + quasi-monies + \$ total deposits.	PF: Pension Funds.
MAE: <i>Mercado Abierto Electrónico</i> . Electronic over-the-counter market.	PPP: Purchasing power parity.
MAS: Mutual Assurance Societies.	PPS: Provincial public sector.
MC: Minimum cash.	PS: Price Stability.
MEC: Electronic Open Market.	PV: Par Value.
MECON: Ministerio de Economía y Producción. Ministry of Economy and Production.	q.o.q: quarter-on-quarter % change.
MEP: <i>Medio Electrónico de Pagos</i> . Electronic Means of Payment.	REM: BCRA Market expectation survey.
MERCOSUR: <i>Mercado Común del Sur</i> . Southern Common Market.	ROA: Return on Assets.
MERVAL: <i>Mercado de Valores de Buenos Aires</i> . Executes, settles and guarantees security trades at the BCBA.	ROE: Return on Equity.
MEXBOL: <i>Índice de la Bolsa Mexicana de Valores</i> . México Stock Exchange Index.	Rofex: Rosario Futures Exchange.
MF: Mutual Funds.	RPC: <i>Responsabilidad Patrimonial Computable</i> . Adjusted stockholder's equity, calculated towards meeting capital regulations.
MIPyME: <i>Micro, Pequeñas y Medianas Empresas</i> . Micro, Small and Medium Sized Enterprises.	RTGS: Real-Time Gross Settlement.
MOA: <i>Manufacturas de Origen Agropecuario</i> . Manufactures of Agricultural Origin.	s.a.: Seasonally adjusted.
MOI: <i>Manufacturas de Origen Industrial</i> . Manufactures of Industrial Origin.	SAFJP: <i>Superintendencia de Administradoras de Fondos de Jubilaciones y Pensiones</i> . Superintendency of Retirement and Pension Funds Administrations.
MP: Monetary Program.	SAGPyA: <i>Secretaría de Agricultura, Ganadería, Pesca y Alimentos</i> . Secretariat for agriculture, livestock, fisheries, and food.
MR: Market rate.	SEDESA: <i>Seguro de Depósitos Sociedad Anónima</i> .
MRO: <i>Main refinancing operations</i> .	SEFyC: Superintendence of Financial and Exchange Institutions.
MSCI: Morgan Stanley Capital International.	SIOPEL: <i>Sistema de Operaciones Electrónicas</i> . Trading software used on the over-the-counter market.
NA: Netted assets.	SME: Small and Medium Enterprises.
NACHA: National Automated Clearinghouse Association.	SSN: <i>Superintendencia de Seguros de la Nación</i> .
NBFE: Non-Bank Financial Entities (under Central Bank scope)	TA: <i>Adelantos transitorios del BCRA al Tesoro</i> . Temporary advances.
NBFI : Non-Bank Financial Intermediaries (out of Central Bank scope)	TD: Time Deposits.
NDP: National public debt.	TFC: Total financial cost.
NFPS: Non-financial national public sector's.	TGN: <i>Tesorería General de la Nación</i> . National Treasury
Nobac: <i>Notas del Banco Central</i> . BCRA notes.	UFC: Uniform Federal Clearing.
NPS: National Payments System.	UIC: Use of Installed Capacity.
NW: Net worth.	UK: United Kindom.
O/N: Overnight rate.	US\$: United States dollar.
OCT : <i>Operaciones Compensadas a Término</i> . Futures Settlement Round.	USA: United States of America.
OECD: Organization for Economic Co-operation and Development.	UTDT: Universidad Torcuato Di Tella.
ON: <i>Obligaciones Negociables</i> . Corporate bonds.	VaR: Value at Risk.
OS: <i>Obligaciones Subordinadas</i> . Subordinated debt.	VAT: Value added Tax.
	WB: World Bank.
	WPI: Wholesale Price Index.
	y.o.y.: year-on-year.



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