



# Financial Stability Bulletin

Second Half 2005





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# FINANCIAL STABILITY BULLETIN

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**Central Bank  
of Argentina**

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Second Half 2005

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**Issue N° 4**

Central Bank of Argentina

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November 2005  
ISSN: 1668-5164  
300 Online edition

Reconquista 266  
Capital Federal, Argentina  
C1003ABF. Tel.: 4348-3500  
[www.bcra.gov.ar](http://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 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 2005, will be on March 30, 2006, on the Central Bank website.*

Buenos Aires, September 29, 2005





## Contents

<b>Central Bank Outlook.....</b>	<b>9</b>
<b>I. Macroeconomic Context. 13</b>	
I.1. International conditions.....	14
I.2. Domestic conditions.....	15
<b>II. Financial System Debtors.....</b>	<b>21</b>
II.1. Financial system asset portfolio.....	22
II.2. Public sector.....	22
II.3. Corporations.....	23
II.4. Households.....	27
<b>III. Financial Infrastructure.....</b>	<b>29</b>
III.1. Capital market.....	30
III.2. Financial intermediaries.....	33
<b>IV. Risk Management.....</b>	<b>41</b>
IV.1. Liquidity risk.....	42
IV.2. Credit risk.....	44
IV.3. Currency and interest rate mismatch risk.....	51
IV.4. Market risk.....	53
<b>V. Solvency.....</b>	<b>53</b>
V.1. Profitability.....	54
V.2. Capital position.....	59
<b>VI. Payments System.....</b>	<b>63</b>
VI.1. Introduction.....	64
VI.2. The national payment system.....	64
VI.3. Uniform federal clearing.....	67
<b>Balance of Risks.....</b>	<b>69</b>
<b>Abbreviations and Acronyms.....</b>	<b>71</b>
<b>Index of Charts and Tables.....</b>	<b>73</b>
<b>Box 1 : Matching Mechanism: Early settlement, Anticipated Payments of Installments, and Normalization of Liabilities.....</b>	<b>36</b>
<b>Box 2 : The Development of Electronic Banking in Argentina.....</b>	<b>44</b>
<b>Box 3 : The Central Bank and its role in Consumer Protection.....</b>	<b>56</b>







## CENTRAL BANK OUTLOOK

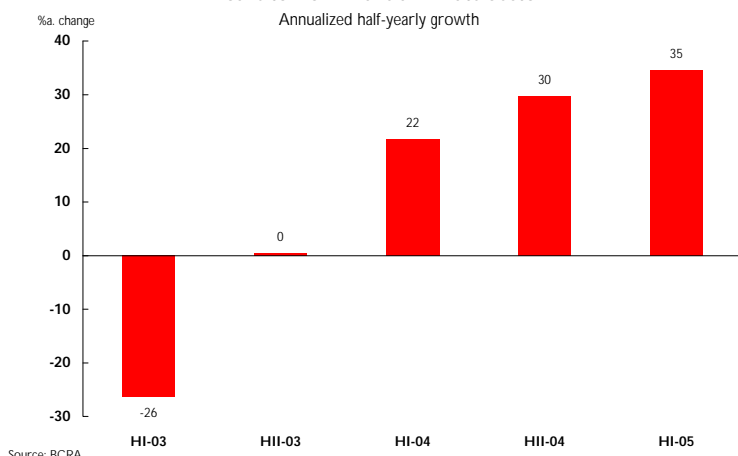
During the first half of 2005 the performance of financial markets continued to show significant progress. In particular, there has been a notable strengthening in the recovery of the banking system, where recent performance and expected developments are providing strong indications of an increasingly sound situation. The continuous growth of private sector deposits and loans, improved asset quality, recovery in profitability and the steady capitalization by financial institutions confirm this positive process. These developments within the banking system, driven by the favorable domestic and international conditions, constitute a framework of financial stability for the short and medium term.

In the first part of 2005 the effectiveness of Central Bank policies for increasing the bank credit instruments available to the private sector became evident. After increasing by 26% during 2004, the stock of loans to the private sector grew 35% a. during the first half of 2005 (\$6.2 billion). The main regulatory changes introduced by the Central Bank included: relaxation of re-financing and additional credit terms, the elimination of margins for discounted documents, extension of coverage terms of preferred class “A” guarantees, reduction of requirements for the discounting of atomized portfolios, encouragement for the use of guarantees issued by Reciprocal Guarantee Companies, raising the maximum amount for classifying a commercial loan as a loan for consumption from \$200 thousand to \$500 thousand, extending from 360 to 540 days the maximum term for arrears allowed to debtors in creditor protection until they are classified as unrecoverable, exemption from the need to require evidence of income for the granting of consumer loans for less than \$15 thousand, and the extension of foreign currency lending capacity to sectors that generate income in foreign currency.

This redirecting of financial system activity to the private sector has been seen in both the use of funds and the origin of these resources. The increase in loans to corporations and households was mainly funded from the growth of private sector deposits (\$10.3 billion or 26% a.). In addition, this phenomenon is the counterpart to the significant effort being made by the banking sector to reduce its exposure to the public sector (\$8.2 billion, 4.7 p.p. of assets). In broader terms, this positive phenomenon has also been seen in non-bank financial institutions, a sign of the increasing robustness of the whole financial market activity.

At the same time as the financial system succeeded in gradually crowding-in the private sector, it also made efforts to normalize the liabilities inherited from the crisis in 2001-2002. Thanks to the high liquidity in the system, financial institutions quickly reduced their indebtedness to the Central Bank. In addition to the payment of installments under the so-called matching system, a new mechanism was provided for the anticipated payments of installments laid down by the Central Bank and the exercise of the originally-established right to settle debt in advance. As a result, by June 2005 only 11 of the original 23 banks that had borrowed from the monetary authority still recorded debt.

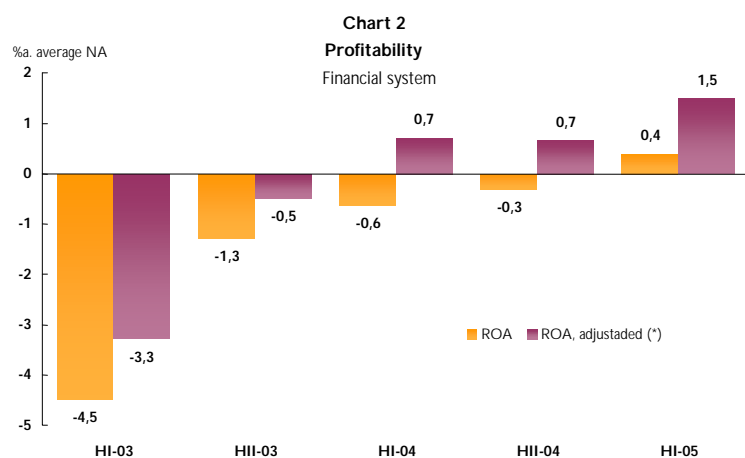
Chart 1  
Loans to Non-Financial Private Sector  
Annualized half-yearly growth





These developments took place at the same time as banks improved their risk management. The steady growth by private sector deposits at low rates, combined with favorable liquidity indicators, demonstrate an adequate level of financial system coverage in the face of liquidity risk. The development of inter-bank markets and the presence of the Central Bank in the repo market and in its recovered role as a lender of last resort have reinforced this argument.

During the first part of 2005, the financial system succeeded in strengthening its exposure to credit risk through an improvement in the quality of its assets. On the one hand, the conclusion of the sovereign debt restructuring led to a direct improvement in the quality of public sector assets, both because of the receipt of new Government securities and the strengthening of performing debt. On the other hand, the consolidation of repayment capacity by the productive sector and individuals led private sector assets quality to rise above pre-crisis levels. This situation, added to the still low exposure of banks to the private sector (23% of assets) and the prudent policy for the setting up of provisions by financial institutions, resulted in an exposure of bank net worth to private credit risk that is now at its lowest historical level.



Source: BCRA (\*) Excluding amortization of payments for court ordered releases and the effects of Com. "A" 3911.

At the same time as the financial system improved its situation regarding credit and liquidity risks, it also made gains by reducing its exposure to risk derived from the mismatching of foreign currency. This behavior is in line with the reduction of vulnerability to macroeconomic volatility that to a large extent was inherited from the crisis in 2001-2002.

In this context, financial institutions succeeded in recording profits in the first half of 2005 (\$430 million or 0.4%a. of assets) for the first time since the crisis of 2001-2002. Without taking into account the legacy of the crisis (court-ordered deposit releases and the valuation of public sector assets), these profits amount to slightly under \$1.6 billion or 1.5%a. of assets. However, financial system benefits register a greater volatility than historical records, showing the exposure to changes in macroeconomic variables and some extraordinary adjustments. Nevertheless, a notable increase in interest income has been accounting for a rising proportion of bank profits. In a scenario of declining interest rates, the increase in the volume of lending to the private sector drove the growth in results from traditional financial intermediation.

The resilience of the financial system to negative external shocks continues to improve. In addition to the favorable performance by results, capitalization was carried out by public and private sector banks for close to \$1 billion in the first half of 2005, for a total of almost \$11.3 billion in the post-crisis period. Positive expectations regarding the development of domestic economic and financial activity has mobilized this significant process of capitalization. This behavior is even more striking if it is considered that a significant part of these capital contributions was made by foreign capital banks, a sign of confidence by international institutions in the local economy. This process of capitalization will continue in coming months, with an amount of \$500 million expected to be capitalize in the short run.



Although the financial system continues to steadily deepen its process of recovery, **there are still tasks pending for the short and medium term.** Despite the fact that growth of credit to the private sector has been a feature of the financial system since early 2004, private sector loans still only amount to 9% of GDP, well below historical domestically and international levels. Banks will have to contribute their efforts and experience to increase the availability of credit to the private sector. The broad potential for growth that currently exists in the financial sector must be materialized in line with the application of adequate criteria for debtor assessment. Given that private sector lending is rising at a rate of more than 35%a., such assessment mechanisms will hold the key to the performance of the financial system in the medium term.

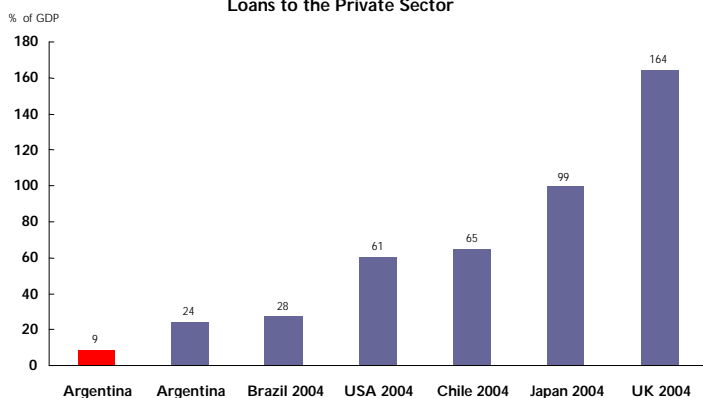
In addition to prudent growth in lending to companies and families, **financial institutions must continue to lengthen the terms of their credit offerings.** This element will be fundamental for the resurgence of lending for production and mortgage credit lines. Although the extension of deposit terms is a necessary element, the reduction in exposure to the public sector and the return of bank funding via capital markets are additional factors that will contribute to the strengthening of lending to the private sector in the mid to long term.

Financial institutions have already begun to travel some way along this road. **Although it still remains high, there has been a notable effort made to lower exposure to the public sector in the post-crisis period.** The gap between lending to the public sector and private sector financing has fallen by half, from 27 p.p. of assets (in mid-2003) to 13 p.p. by June 2005. It is expected that, as a result of actions by banks and incentives provided by the Central Bank, this trend will be maintained in the short run.

**Although the likelihood of the risk materializing are low, reduction in exposure to the risk of increases in real interest rates continues to be a problem that remains to be tackled.** During the first half of 2005 banks maintained their exposure to the risk from real interest rates unchanged. A reduction in this risk is expected to take place in coming months.

With the fundamental aim of promoting financial stability, **the Central Bank is to encourage the development of adequate market incentives to confront and reduce such vulnerabilities.** First, the Central Bank continues with its policy of supporting the revival of lending to the private sector, as well as the lengthening of its terms. To increase the availability of medium and long-term loans, the Central Bank continues **to promote an increasing term to maturity for deposits.** Measures such as the increase in the minimum term for deposits adjusted by the CER index, variable returns time deposits, deposits for a minimum of 180 days with “rewards,” and the extension of the maximum term allowed for Pension Fund (PF) deposits (a measure adopted together with the Pension Fund Supervisory Authority (PFSA) are examples of this. Nevertheless, it is considered that for the resurgence of credit in the medium and long term it will be essential for development to take place in capital markets, contributing to the broadening of the financial system’s funding horizon. **The Central Bank**

Chart 3  
Loans to the Private Sector



Source: IMF, INDEC and BCRA



**promotes and supports initiatives tending to deepen the capital markets**, such as asset securitization, the development of futures and swap markets, and the setting up of a secondary market for time deposits.

Furthermore, futures and hedging markets will provide financial institutions with an alternative to moderate the net exposure to real interest rate risk. At present the dollar futures market has begun to gain depth, but trading in BADLAR and CER markets is still at an incipient stage. **The Central Bank has promoted the launching of these term markets, and began trading on them with the aim of increasing their depth.**

Also with the aim of increasing medium and long-term lending to the private sector, **the Central Bank is encouraging a reduction in exposure to the public sector by financial institutions.** It has been established that banks may record a maximum level of lending to the public sector of 40% as from 2006. In addition, the schedule laid down for the marking to market of public sector assets continues to be implemented, improving the quality of balance sheet information and generating a decline in the portfolio from revaluation and an increased incentive to sell such assets. This latter point will also be encouraged by the ending of the payment of compensation for asymmetric conversion to pesos.

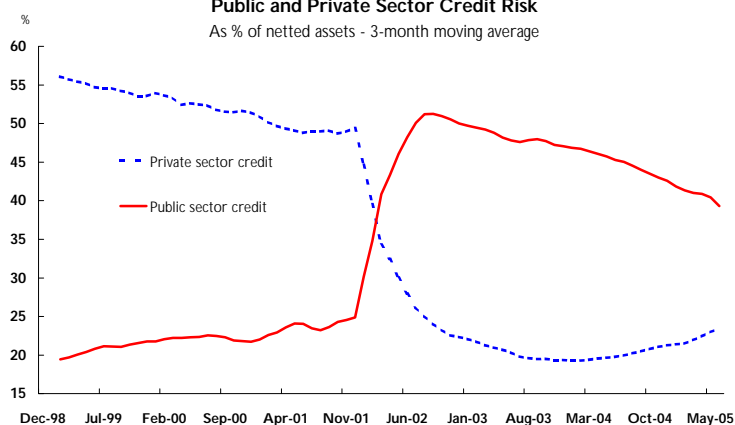
As it has been doing on a regular basis, **the Central Bank has created new incentives to promote the use of banking services by the economy and by individuals.** Savings accounts can now be opened by those aged between 18 and 21, providing an additional 1.5 million people with the opportunity to gain access to the financial services offered by the local banking system.

Furthermore, as part of this policy for promoting the use of banking services and the spread of financial services to the regions, **the Central Bank has regulated the operation of Credit Unions and modified regulations on minimum capital requirements.** In the case of the latter, regulatory changes centered on the reduction of basic minimum capital, taking into consideration the location, class and operating volume of each new financial institution. This is intended to make formal credit available in regions where banking coverage is low, boosting the supply of financial services for individuals and for micro, small and medium-size enterprises in those regions, in the context of the application of rules on prudence and Central Bank supervision.

This progress in financing activity needs to be matched by a responsible bank monitoring policy. **On this matter, there has been considerable progress with the schedule foreseen for on-site inspections for the 2004-2005 period.**

**It is estimated that in coming months the financial system will sustain the strengthening process.** As the rate of increase in the use of banking services by the economy grows, banks will continue to focus on the private sector. In the short and medium term, such behavior will be closely linked to the continuity of sound performance by local macroeconomic conditions, with an influence on both the quality of bank assets and the possibility of

**Chart 4**  
**Public and Private Sector Credit Risk**  
As % of netted assets - 3-month moving average

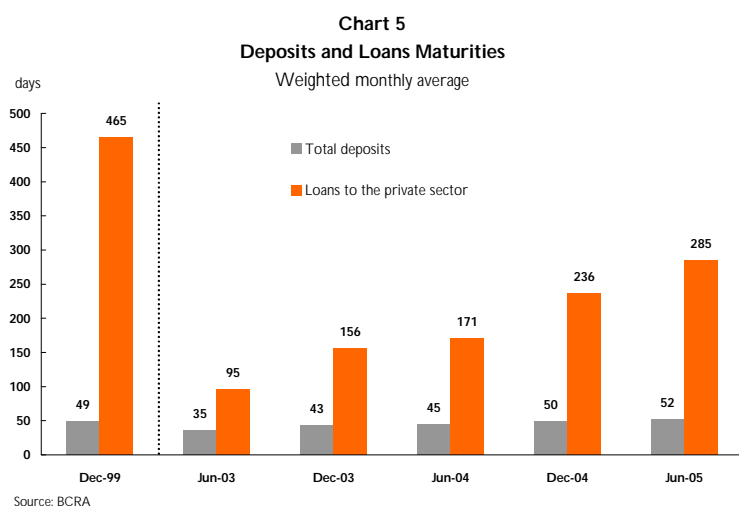


Source: BCRA



an increase in bank activity. In addition, it is expected that the reinforcing of these trends will contribute to a consolidation of the profits recorded by the financial system, with annual profits for 2005 for the first time since the crisis in 2001-2002. This positive development by profitability and the capitalization expected to take place shortly ensure that the financial system will be increasingly resilient in response to any possible negative shocks.

Furthermore, **it is expected that financial institutions will succeed in reducing their high exposure to the public sector in the medium term.** The declining portfolio of public sector credit has meant a reduction in the exposure of assets to real interest rate risk (as it mostly involves assets at fixed rates restated by CER). In the context of a reduction in the issue of debt adjusted by CER, in the second part of 2005, and in particular in 2006, there is expected to be an improvement in the exposure of the financial system to real interest rate risk. Lastly, given bank risk balance, the shrinking of the mismatching of terms derived from the reduction in exposure to the Government also ought to encourage an increase in longer-term lending to the private sector.



The Central Bank will continue to carry out its task of monitoring the sound operation of the financial system. It will continue to establish adequate incentives that will allow banks to increase their business in a context of limited risk, at the same time as they contribute to the overcoming of the outstanding matters left over from the crisis. This environment will be complemented by the full implementation of standard banking supervision practices. **The Central Bank considers that this pattern of activity and monitoring in a healthy macroeconomic climate, will form the basis for the development of conditions that will promote financial stability.**



# I. MACROECONOMIC CONTEXT

## *Summary*

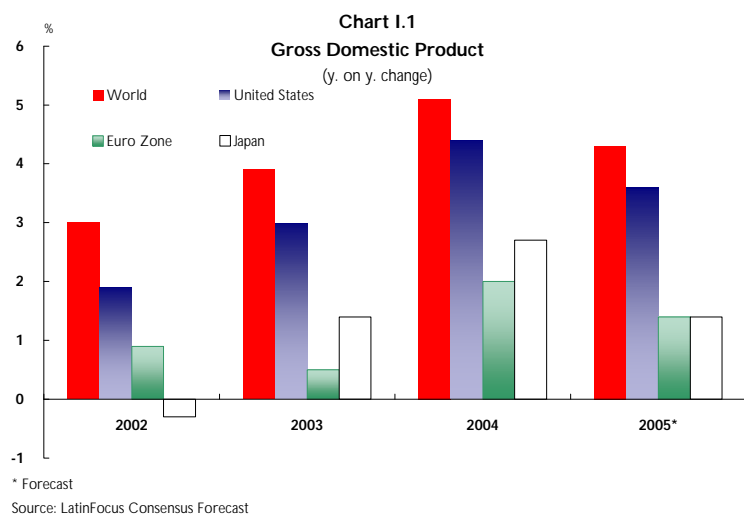
*Favorable conditions remain in place in 2005, with a positive effect on the outlook of the economies and financial systems of both developed and emerging countries. Certain risk factors must be monitored, however, as they could threaten this expected scenario. The future developments of oil prices and global imbalances are the main sources of uncertainty regarding the global economy, while the effect of US interest rates and Brazil's economic performance are the main sources of concern at the domestic and regional levels.*

*The domestic economy grew at a rate of 9.1% y.o.y. during the first half of 2005, a level of expansion that is similar to that over the previous two years. Domestic consumption and investment were the main drivers of growth. The level of output in the economy is currently starting to link up with bank credit, particularly lending to finance consumption and working capital for the business sector. For the next few months, it is expected a greater development in investment that enhance corporate credit demand.*

*Economic growth occurred together with a greater increase in prices. The Central Bank has reduced the monetary stimulus, showing a change in the bias of monetary policy. In coming months, the Central Bank's efforts will be focused on making inflation expectations converge on levels that are more consistent with price stability.*

*Current conditions of macroeconomic stability, which stem from strict fiscal discipline and responsible management of monetary policy, aided by the strong performance and positive outlook of the external sector, provide the appropriate environment for financial intermediation to develop in a healthy and stable way.*





**Table I.1**  
**Emerging Countries**  
Financial systems - Main indicators

	ROA		Non-performing loans / Total loans		Capital / Assets at Risk	
	2003	2004	2003	2004	2003	2004
Asia	1.0	1.5	11.2	10.1	15.2	14.8
Latin America	1.0	1.4	10.1	8.6	14.3	16.2
Europe	1.6	1.7	8.0	7.8	17.1	16.0

Source: Global Financial Stability Report, April 2005, IMF

## I.1. International conditions

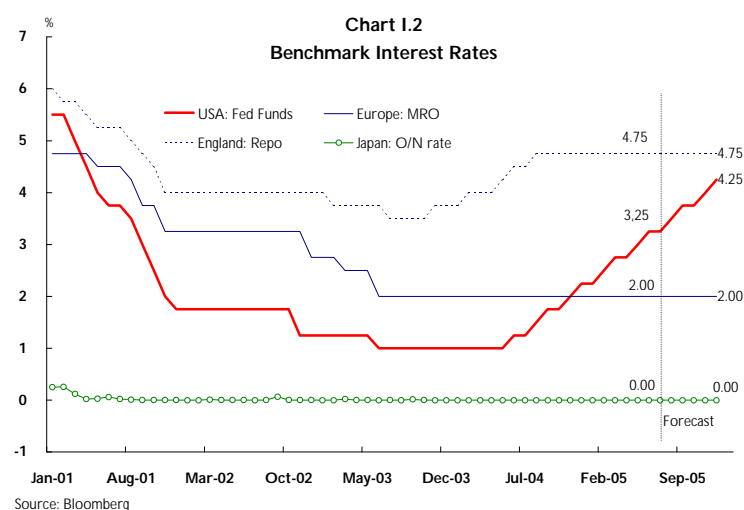
Despite certain changes to risk factors, the global scenario remains relatively favorable to financial markets in both developed and emerging economies, providing the appropriate background for the development of the domestic financial system. Outstanding growth in the world economy during 2004, as well as its momentum during the first half of this year, have set the conditions for an expected world growth of more than 4% in 2005 (see Chart I.1). Such remarkable growth and the still substantial levels of international liquidity, the low world inflation and the recent improvement in commodity prices provide a setting that encourages the gradual development of emerging economies and of their financial systems.

From a global perspective, the environment for financial intermediaries became stronger during the first half of 2005. Improvements in the payment capacity of both the corporate and household sectors explain most of the change. Under these conditions, financial institutions obtained higher levels of profitability while registering improvements in terms of liquidity management. In particular, the financial systems of emerging economies sustained a pattern of gradual improvement. Amid a context of substantial growth in credit to the private sector, there were improvements in profitability and asset quality (see Table I.1). The financial systems of emerging economies have continued to maintain capital positions above the internationally recommended minimum levels. These factors suggest a sound framework for the different financial intermediaries, which is essential in dealing with potentially negative shocks.

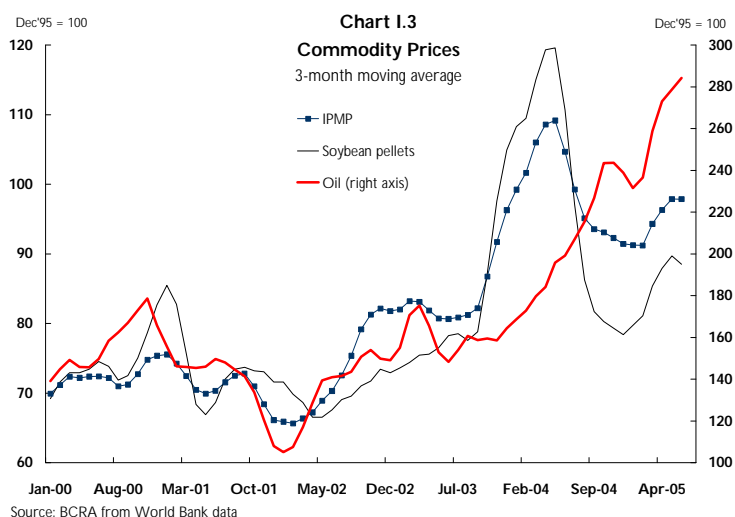
International capital flows, which are strongly influenced by US monetary policy, have a direct effect on the financial systems of emerging economies. Consequently, the lower probability of a sudden increase in US benchmark interest rates (see Chart I.2) can be taken as good news, as this outcome was seen as more likely a few months back. International financial conditions also remain positive, particularly as long-term interest rates in developed countries are at historically low levels, benefiting emerging economies.

From a regional point of view, lower economic growth in Brazil is a source of risk for the region and the domestic economy. The slowdown of Brazil's economy could partially affect the momentum of Argentina's export sector, with an influence on the remarkable growth and high quality of the associated bank credit. Despite this, the recovery in agricultural commodity prices during the first half of the year (see Chart I.3), driven by increases in international soy and corn prices, helped to improve the payment capacity of the agricultural export sector.

As mentioned in the previous edition of the **FSB I-05**, the sound growth of emerging economies continues to gain strength. This trend is mostly due to a context of increasing commodity prices, greater order in fiscal and external accounts, a greater degree of consistency in macroeconomic policies and a favorable outlook for future growth. Consistently with these fundamentals, sovereign risk premiums for these countries have drifted apart from the spread on high risk US corporate bonds (see Chart I.4). This result is expected to correlate with a growing flow in







international funds towards emerging economies in coming months, providing a new source of funds for financing the private sector.

International conditions still suggest three major sources of uncertainty for the domestic economy over the medium term, which will require close monitoring. The future path of oil prices could affect world economic growth. If the Brazilian economy were to perform below expectations there would be a negative effect on the performance of Argentina's economy and financial system. Lastly, the possibility that "global imbalances" might undergo a correction, as well as the determination of which region (Europe or Asia) would bear most of the adjustment costs, remain a substantial source of uncertainty. If this scenario were to materialize, it could affect the stability of the global financial system, and in the event of sudden stops to capital flows there would be an impact on emerging countries. However, the direct effect of this scenario on the Argentine financial system would be more reduced, given the domestic trend towards lower exposure to external lending in the post-crisis period.

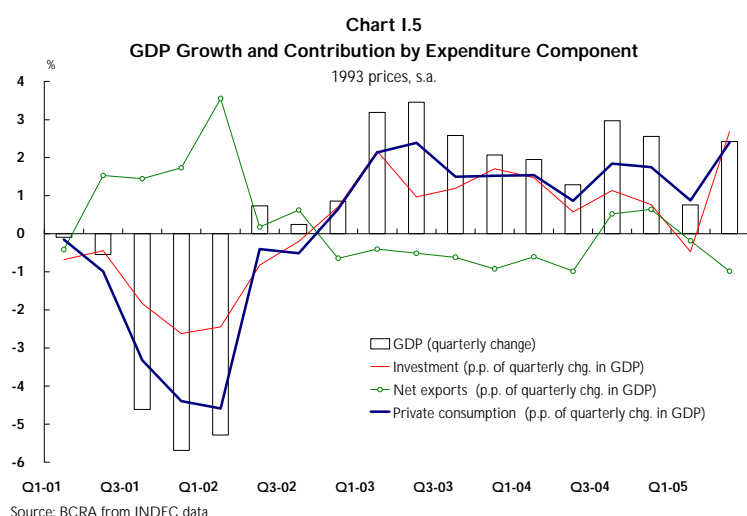
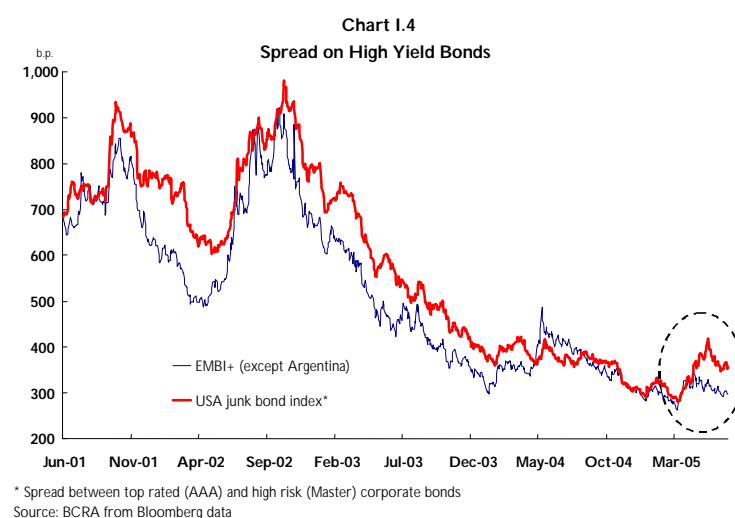
Overall, based on expected developments and remaining risk factors, international financial conditions are not expected to hinder the ongoing recovery of the Argentine financial system throughout the rest of the year.

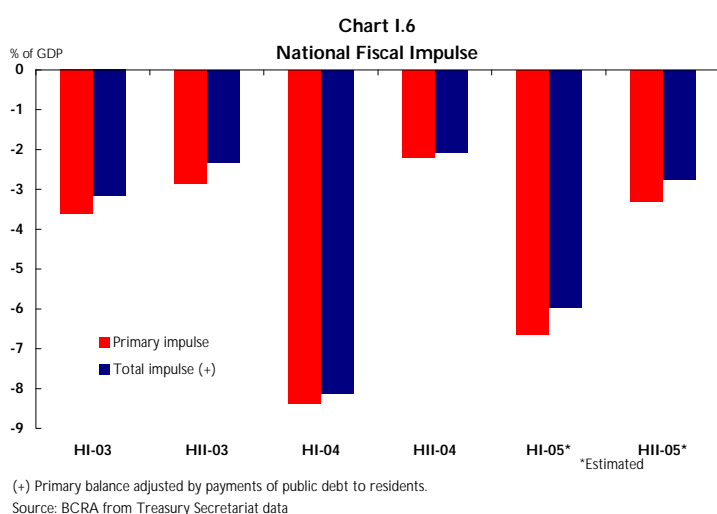
## I.2. Domestic conditions

During the first half of 2005, the economy sustained the same level of growth as in the previous two years, although the increase in prices was somewhat greater. The rise in the consumer price index (CPI) accumulated over the first half of the year was similar to that registered throughout all of 2004.

GDP increased by 9.1% y.o.y. during the first half (see Chart I.5), setting the statistical carry-over effect for the rest of the year at around 6.4%. However, the behavior of the different components of spending was not uniform over the first half. During the second quarter there was a substantial recovery in investment, which was accompanied by a greater increase in consumption, following a substantial slowdown by both components of domestic spending during the first quarter. In contrast, the negative contribution of net exports increased during the second quarter as the result of a surge in imports and a slower rate of export growth.

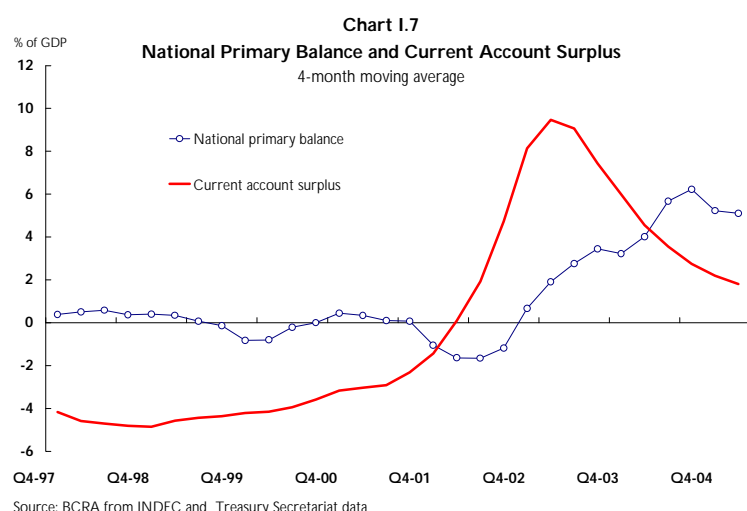
The recovery of incomes in the families will cause the wage-bill to increase, which in addition to the ongoing expansion in household credit is expected to cause greater consumption in the second half of the year. The second half of the year is also characteristically a period of high fiscal stimulus (see Chart I.6). Investment is expected to grow again following the recovery in construction and in imports of capital goods, partly as a result of a projected increase in public works projects and the effect of fiscal measures aimed at stimulating investment. Additionally, this would take place in an improved business climate, following the conclusion of the debt restructuring and given the greater momentum in credit. In this context, the BCRA sustains its growth forecast for 2005 above 7%.



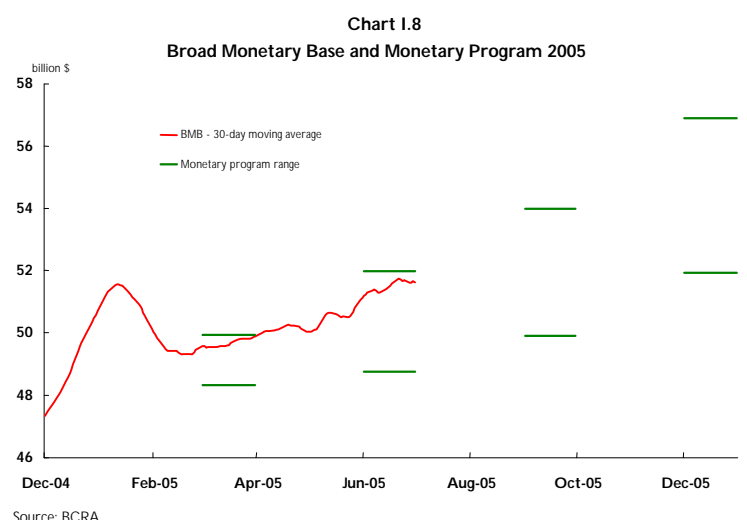


Both external and public sector accounts registered surpluses during the first half of 2005, which are expected to persist into the second half (see Chart I.7). The current account is forecast to close the year with a surplus of approximately 2% of GDP, while the consolidated public sector surplus is expected to exceed 4% of GDP. The Government had no difficulty in meeting its financial requirements, despite a limited inflow of funds from international financial institutions. It achieved this outcome partly by raising funds from capital markets, through the issue of new voluntary debt following the conclusion of the debt restructuring process.

The Central Bank has played a role in the process by which growth returned to normal, under a scenario in which the economy appears to be reaching the potential GDP level. For the eighth consecutive quarter, the Central Bank met the targets set down in the Monetary Program (see Chart I.8). The broad monetary base (BMB) came to an average \$51.6 billion, a 1.9% increase over the first half of 2005, which is about half the increase over the year-earlier period. This implied a 3.9% monetary contraction in real terms, compared to a 0.6% expansion in 2004, which is a clear sign of the change in the bias of the Central Bank's monetary policy.

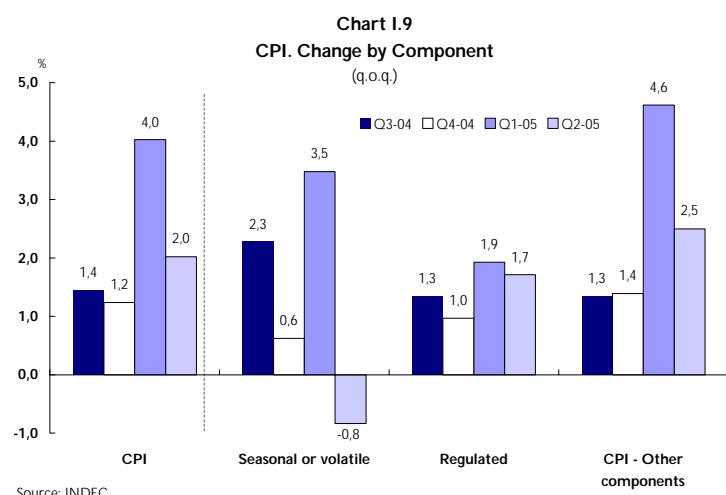


At the same time, the Central Bank seized on the opportunity afforded by conditions in the external sector to strengthen its prudential reserve accumulation policy, replicating the practice of other central banks. This strategy, which put the level of international reserves at US\$23.1 billion by the end of June (the highest level since April 2001), was carried out with care to minimize the impact from the monetization of the balance of payments on the economy while maintaining a substantial quasi-fiscal surplus. For this purpose the Central Bank used a number of absorption instruments at its disposal, including the issuance of LEBAC and NOBAC, repo transactions with the Central Bank, early settlements of rediscounts (see Box 1) and open market operations with sovereign bonds. Interest rates adjusted upwards under these policies, with the repo market's interest rate corridor shifting from 2.75-3.25% at the end of March to 4.25-5.25% at the end of June, while LEBAC rates increased by 2.4 percentage points (p.p.) for the shortest-term bills and 1.6 p.p. for one-year bills.



Prices increased by more than expected during the first six months of 2005 (6.1%), with most of the build-up occurring between January and March. After increasing by 4% over the first quarter, the CPI increased by barely 2% over the following three months (see Chart I.9).

Although the economy has started to grow at a more moderate rate and the essential economic variables are in equilibrium, it is unlikely that the inflation rate will be below 8%. Faced with this scenario, the Central Bank's efforts over coming months will be focused on making medium-term inflation expectations converge on levels that are more consistent with price stability. Although inflation expectations for 2005 are above the year's indicative target, the REM market consensus survey forecast declines again for the year-ahead period, to a lower level that is closer to Central Bank forecasts.



Economic activity in future periods is expected to be closer to its sustained growth path. Fiscal and monetary discipline, as well as a strong performance by the external sector, therefore outline a favorable environment for the sound and stable development of financial intermediation.



## II. FINANCIAL SYSTEM DEBTORS

### *Summary*

*During the first half of 2005 the favorable economic and financial performance by bank debtors in general significantly improved the quality of the financial system's portfolio. In the context of growing macroeconomic stability, positive developments in both the public sector and in the case of companies and families contributed to this improvement.*

*The successful completion of the sovereign debt restructuring process enabled the public sector to place the payment of its liabilities on a regular footing, at the same time as significantly improving the sustainability of public sector debt. This fact, added to the sustained fiscal discipline imposed by the Government, encouraged a gradual return by the public sector to capital markets. Both the normalization of the debt and the sound fiscal performance have established a positive framework for the development of public sector payment capacity.*

*In the first half of 2005, companies continued to improve their solvency levels, following growth in output across all economic activities, and the steady improvement in their financial profiles. Given current levels of indebtedness, a large part of the growth forecasted for coming months could be financed by local banks without this implying any weakening of company repayment capacity. Nevertheless, although as a result of the macroeconomic context and business actions foreign indebtedness has been cut, there are still traces of the effects of the crisis in 2001-2002, particularly in companies that recorded higher relative levels of foreign borrowing prior to the crisis.*

*The restoring of wage levels, growth in employment, high consumer confidence and notably low levels of consumer indebtedness constitute a positive framework for the financial performance of individuals. As a result, it is expected that the anticipated growth in consumption will be strongly linked to the increase in purchasing power by families and the taking of new loans. In addition, it is considered that the margin for borrowing by families will enable consumer lending to be financed without undermining its financial profiles.*



Chart II.1

## Financial System Asset Portfolio

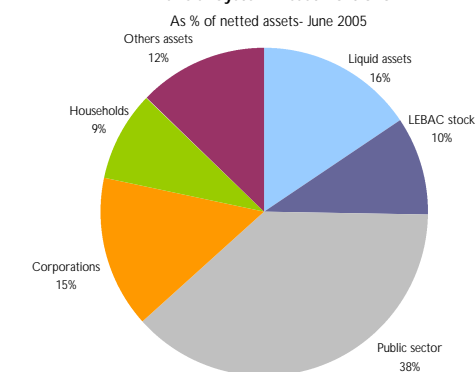


Chart II.2

## National Fiscal Accounts\*

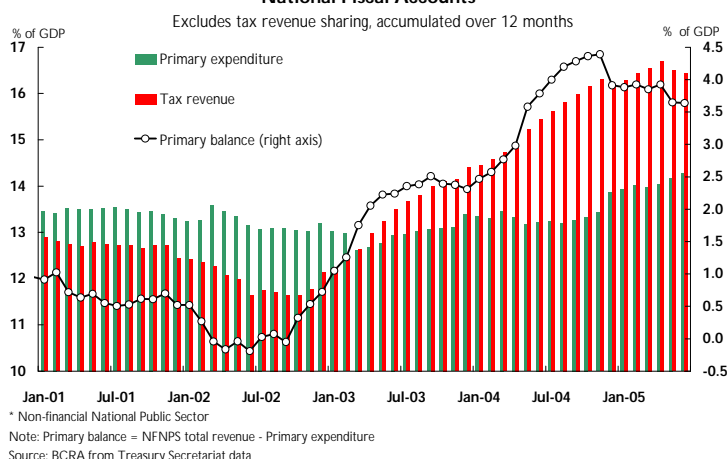


Chart II.3

## Share in National Tax Revenue

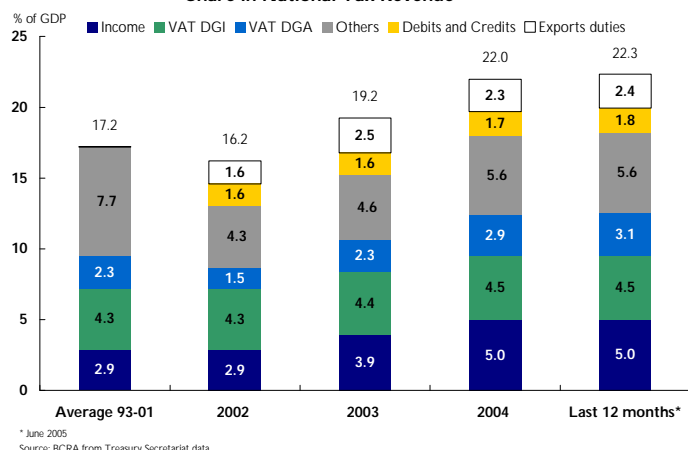
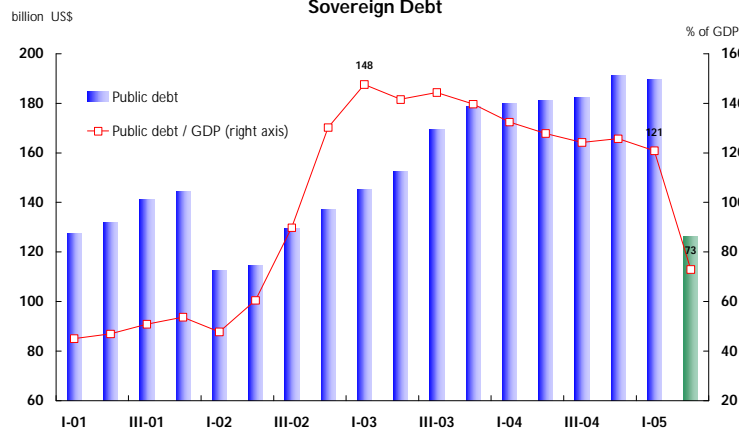


Chart II.4

## Sovereign Debt



## II.1. Financial system asset portfolio

In addition to being closely linked to domestic macroeconomic performance, like all other productive activities, financial intermediation is directly exposed to the economic and financial performance of its debtors.

At present, as a consequence of the crisis in 2001-2002, financial institutions still record a high, if declining, exposure to the public sector (see Chart II.1). By the beginning of 2004, banks had started to increase their lending to the private sector. Low levels of corporate and household indebtedness provide an ample margin for the financial system to promote economic growth without assuming excessive risk.

## II.2. Public sector

## II.2.1 Fiscal situation

During the first half of 2005 the Government again had no trouble meeting all its performing debt commitments, even though fund inflows from International Financial Institutions remained limited. Following the completion of the restructuring of public debt, the Government gradually returned to the capital market for its financing, placing issues in both pesos and dollars.

In the first half of 2005 Non-Financial Public Sector accounts continued to record positive results (see Chart II.2), although the primary surplus has shrunk compared with 2004. Provincial accounts have performed in a similar manner to national accounts, with an expected consolidated primary surplus (Nation and Provinces) in excess of 4% of GDP in 2005, slightly above the level forecast in the 2005 Budget (3.9% of GDP).

Fiscal results continued to be based on the performance of tax income, which rose by 18% in the June 2004-2005 period, and is expected to end the year with an increase of approximately 16%, reaching 22.5% of GDP. Growth was due mainly to increased value-added tax income, social security receipts, and income tax (see Chart II.3). Primary spending rose again during the first half of 2005, a behavior that is expected to be maintained for the rest of the year.

## II.2.2 Public debt

The stock of National Public Debt totaled US\$189.8 billion at the end of the first quarter of 2005 (121% of GDP). Nevertheless, preliminary information indicates that following the restructuring of the debt in default, the public debt now stands at US\$126.6 billion<sup>1</sup> (see Chart II.4).

In line with the debt restructuring schedule, the term for submitting offers ended on February 25, 2005, the definitive results were announced in March, and the exchange took place in the first days of June. The transaction was widely accepted, with an overall participation of 76.15% or US\$62.3 billion of the total US\$81.8 billion in eligible debt. The issue of new securities for US\$35.3 billion was broken down as follow: US\$15 billion

<sup>1</sup> The eligible debt not participating in the exchange has been considered at the maximum reference value for such liabilities in accordance with the terms of the Restructuring Prospectus (US\$6.6 billion).



Table II.1  
Public Debt Indicators  
In %

	Dec-01	Apr-05
Interest Services / Exports	38	9
Public Debt / Exports	544	364
Public Debt in foreign currency / Exports	527	228
Interest Services / International liquid reserves	70	15
Interest Services / Tax Revenue	22	10
Interest Services / GDP	8	2
Debt / GDP	113	72
Capital and interest payments / Total Debt *	88	45

\* Next 5 years. Excludes Bogar, Boden Provincial Cuasimonies and Temporary Advances

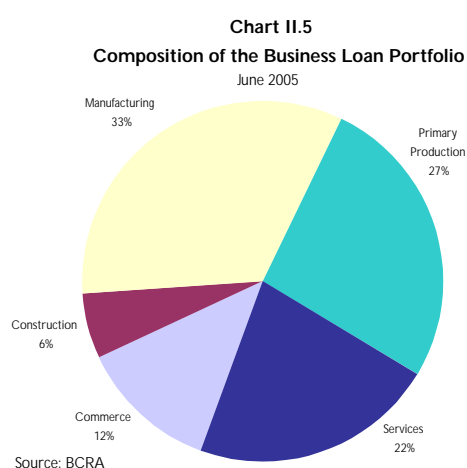
Source: Economy Ministry

in Par bonds, US\$11.9 billion in Discount bonds, and US\$8.3 billion in Quasi-par bonds.

As a result of the exchange, the sustainability of the sovereign debt improved significantly (see Table II.1). The post-exchange stock of public debt totals 73% of GDP, with 37% of the debt denominated in pesos, interest servicing having been cut from 8% to only 2% of GDP. Although the balance of public debt in relation to output remains high by international standards, the financial conditions of the new bonds (low interest rate coupons and a lengthy maturity profile) have meant that the average maturity of the debt has been considerably extended. As a result, the successful completion of the public debt restructuring process and the gradual return to capital markets have sharply improved the Government's payment capacity.

### II.3. Corporations

The financial system gradually continues to increase its lending to the productive sector. Any evaluation of the outlook for financial institutions should include consideration of the economic and financial performance of companies. The development of manufacturing industry in particular provides valuable information when assessing levels of financial stability (see Chart II.5). The primary sector and services also affect the performance of the financial system. On the other hand, banks record low exposure to the payment capacity of debtors in the commerce and construction sectors.



Despite the improvement in investment in recent years, the sharp growth in levels of production has continued to drive a narrowing of the output gap, so that the economy is at close to its potential output level. Increased investment was largely focused on improvements to manufacturing processes and the efficiency of production. As a result, various sectors still require larger volumes of investment to be able to increase their output. At present, installed capacity restrictions are affecting sectors such as gas, electricity, oil refining and basic metals industries. Demand for medium-term financing by these sectors is expected to rise, and will in part be met by the domestic financial system.

Following the significant financial imbalance that the devaluation of the peso generated for firms (because of its high levels of dollar borrowing), the corporate sector achieved a steady improvement in its financial profile (see Chart II.6). Although the level of external corporate debt is still higher than it was in the period prior to the crisis, liabilities to the financial system have decreased considerably. At present, however, this trend is showing signs of reversing, with a year-on-year growth (March 2004-2005) in bank lending to companies of 1.1 p.p. of GDP, at the same time as there has been a year-on-year reduction of 6.6 p.p. of GDP in debt abroad.

This improvement in financial profile in the post-crisis period has been most notable in the group of companies with the best access to capital markets during the pre-crisis period (see Chart II.7). As these corporations reduce their debt, it is expected that new investment will begin to rely more on bank financing or capital markets.

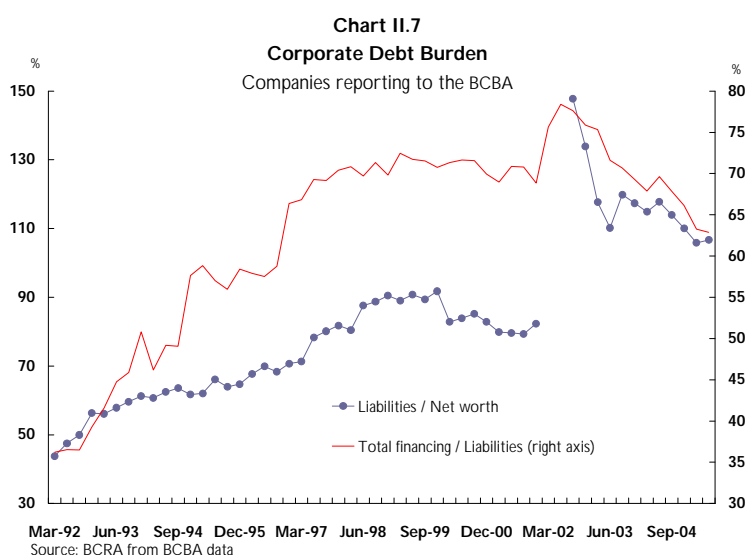
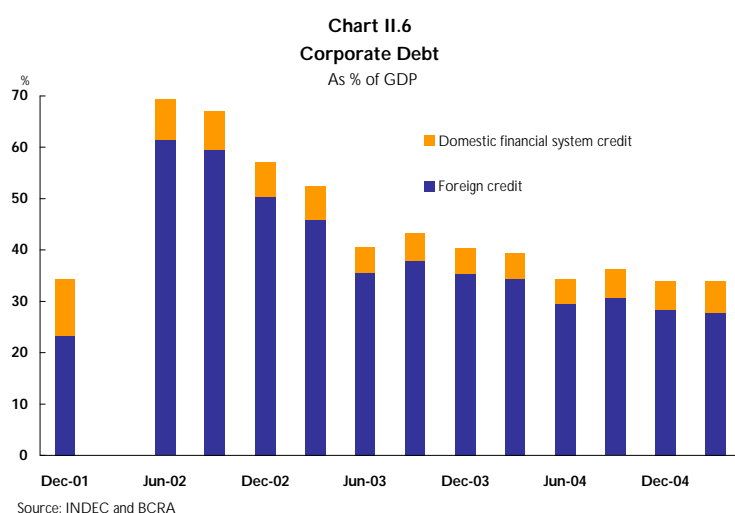
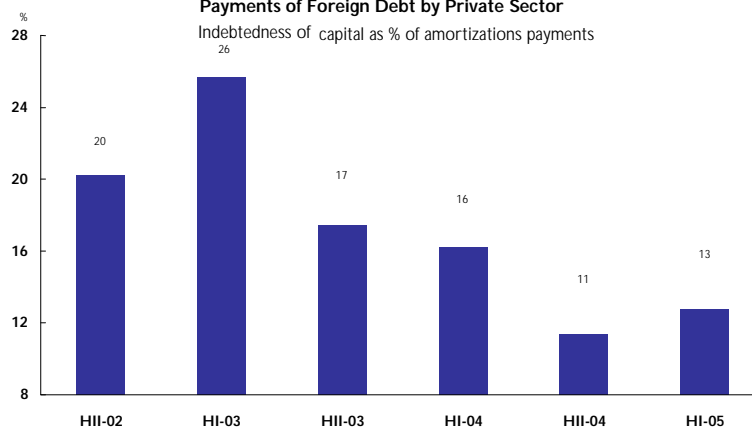






Chart II.8

Payments of Foreign Debt by Private Sector  
Indebtedness of capital as % of amortizations payments



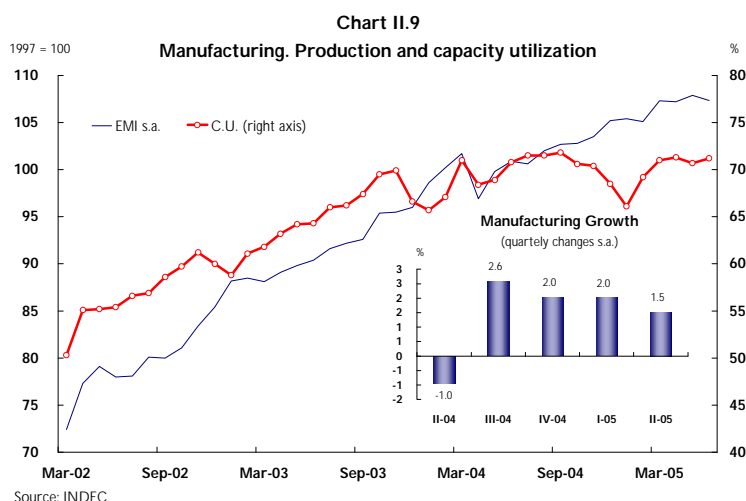
Source: BCRA

The steady improvement in the solvency of companies in the post-crisis period, at a time when many are renegotiating with their creditors, has been reflected in the gradual strengthening of foreign debt repayment capacity. The current level of non-performance stands around 10% of maturities, whereas two years ago this delinquency indicator was twice as high (see Chart II.8).

In coming months it is expected that the demand for bank credit for productive purposes will come from companies with a relatively lower foreign debt. These include small and medium-size enterprises, which in a strong growth context, and having borrowed less in foreign currency in the pre-crisis period, currently record a greater borrowing capacity.

### II.3.1. Manufacturing

The manufacturing sector continued to grow in the first half of 2005, reaching record output levels (see Chart II.9), driven mainly by vehicle manufacturing and production of non-metallic minerals (linked to the growth in construction).



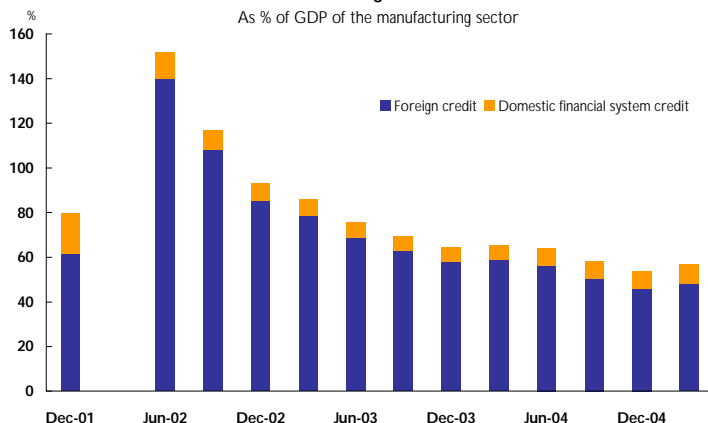
Source: INDEC

Although new investment was recorded that increased the stock of productive assets in certain sectors (such as food and beverages and the production of rubber and plastic, among others), the use of installed capacity in the manufacturing sector rose to 71% by the end of the first half of 2005. This process took place in the context of significant differences between sectors. Some specific areas, such as basic metal industries and oil refining, are operating at the limit of their capacity.

The manufacturing sector showed notable efforts to improve its solvency in the post-crisis period (see Chart II.10). By means of the restructuring of foreign debt and repayments of principal, it was able to reduce its foreign exposure to below the levels recorded in the pre-crisis years. In addition, it almost halved the use of banking credit in carrying out its production. These two elements help to confirm the margin currently shown by the manufacturing sector in relation to its ability to take on new debt for productive purposes, positioning goods producers as a solvent segment in the short and medium term.

Chart II.10

Manufacturing Sector Debt  
As % of GDP of the manufacturing sector



Source: INDEC and BCRA

Prospects for growth in the manufacturing sector continue to be favorable, and it is expected that for the third year in succession the increase in the level of manufacturing activity will be higher than the average for the economy as a whole. In addition, it is expected that third party finance for the manufacturing sector, which holds the key to growth in certain sectors, will be increasingly provided by the domestic financial system, at the same time as foreign indebtedness will be cut back. Bank lending has already gained ground in the last year (March 2004-2005), growing by 2.3 p.p. of manufacturing sector GDP.

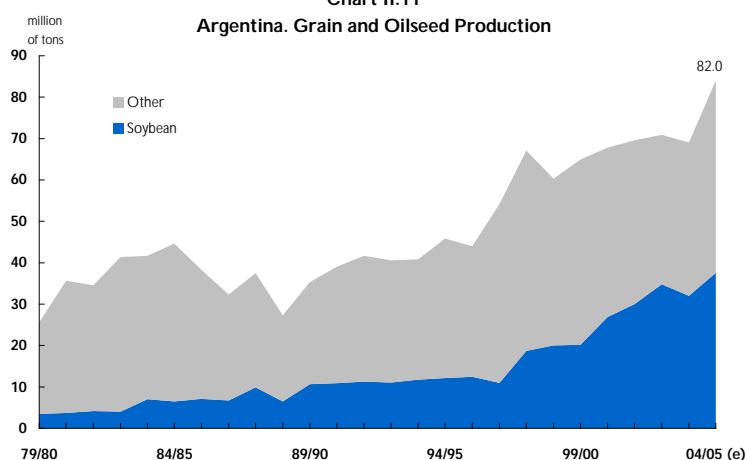
### II.3.2. Primary sector

The primary sector recorded a significant increase in its level of activity in the first half of 2005, mainly as a result of the strong increase in agricultural harvests. The livestock sector also contributed to this behavior, mainly as a result of the good exporting performance at a time when domestic consumption





Chart II.11  
Argentina. Grain and Oilseed Production



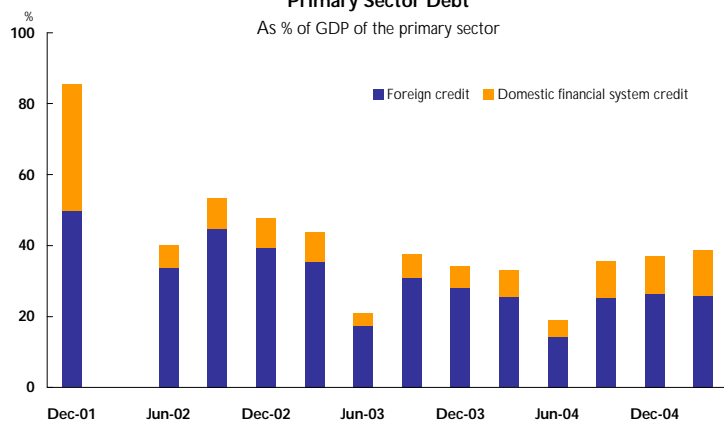
Source: BCRA from SAGPyA data

was down and international prices were higher. The oil and gas sector, on the other hand, recorded a drop in the first half of 2005.

The farming harvest was a record 84.1 million tons (see Chart II.11), gaining from the favorable weather and increased investment in technology. The increase of almost 21% in production was centered mainly on soybean, corn and wheat, a factor that was accompanied by a recovery in prices of primary products.

The livestock sector showed faster growth in the second quarter of 2005, with increased cattle sales. Exports, with a year-on-year increase of around 37% at June 2005, benefited from the reopening of the important Chilean market, and increased demand from Russia.

Chart II.12  
Primary Sector Debt  
As % of GDP of the primary sector

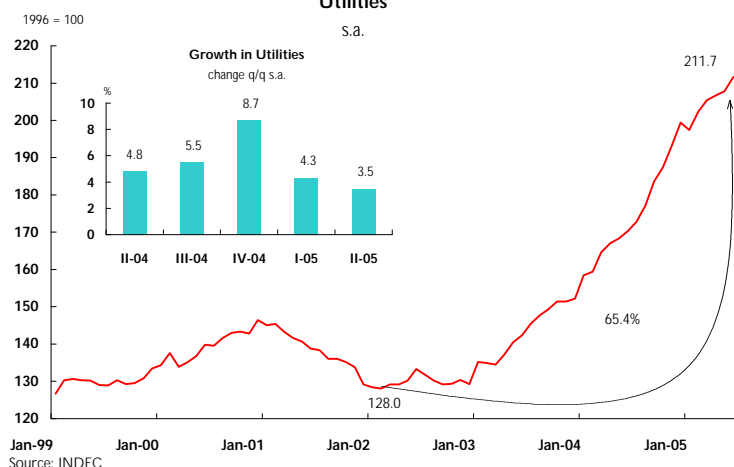


Source: INDEC and BCRA

The macro-economic situation during the post-crisis period was favorable to the primary sector, and companies involved in such activities were able to significantly strengthen their financial profiles. The sharp increase in output was driven by capital contributions from the companies themselves, at the same time as they achieved a significant reduction in indebtedness both in relation to the local financial system and banks abroad (see Chart II.12). This combination of sound economic and financial performance has ensured a suitable risk profile for companies in the primary sector. As a result, there is growing interest by local financial institutions in such companies, with bank lending to primary production having risen in the period March 2004-2005 5.4 p.p. of sector GDP.

Looking forward, there is expected to be further development by primary production, which could be boosted by the possible opening up of the market in China. Faced by new investment needs, companies in the primary sector present a sound financial position, on the basis of which they will be able to obtain third-party financing, while preserving their repayment capacity.

Chart II.13  
Utilities  
S.A.



Source: INDEC

### II.3.3. Services

Service sectors continued to expand in the first half of 2005, although there was a slowing in the rate of growth. Lower growth by public utilities (see Chart II.13) has been partly to blame, together with the gradual maturing of the cell-phone market and operating limitations on increased services in some sectors.

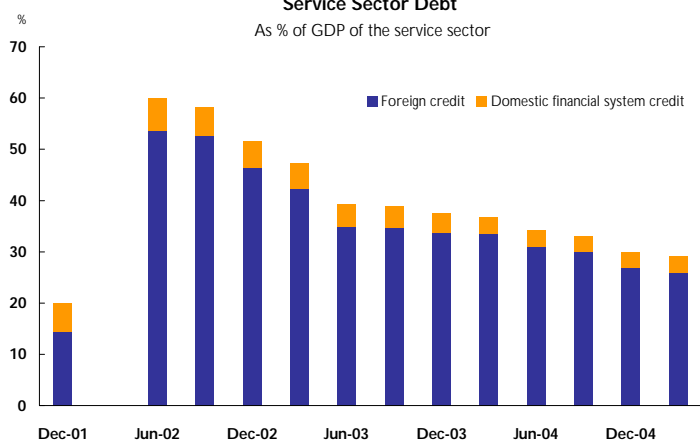
In the first half of 2005 the Government speeded the pace of its contract negotiations with privatized utilities, determining a partial rate increase for this year (basically for wholesale users), with a definitive tariff recovery announced for the coming year.

Although not yet having reached pre-crisis solvency levels, service companies have been strengthening their financial position (see Chart II.14). This sector has been noted in the past for its low levels of indebtedness, and is again showing signs of being in a position to assume debt without weakening its payment capacity.



Chart II.14  
Service Sector Debt

As % of GDP of the service sector



Source: INDEC and BCRA

Several major contract renegotiations must be concluded during the rest of 2005 and in early 2006. Progress on this front will enable impediments to investment to be lifted, at the same time as encouraging greater growth for the sector. This scenario is consistent with an increase in the financing needs of public utility companies once comprehensive accords have been signed, without implying any excessive rise in the sector's indebtedness.

### II.3.4. Commerce

Retail sales continued to rise in the first half of 2005, boosted by a recovery in real wage levels and a gradual increase in the availability of consumer credit.

In the first six months of the year the increase in supermarket sales was over 7% y-o-y in real terms, while mall sales recorded a rise of over 12% y-o-y (see Chart II.15). Household appliance sales were up 48% y-o-y in real terms in the first quarter of 2005, and durable goods purchasing intentions were at their highest ever levels.

Companies in the commerce sector currently record low levels of indebtedness, particularly in relation to the domestic financial system. Although in the pre-crisis period these corporations were financed in almost equal parts by local banks and funds from abroad, given the current macroeconomic context, it is likely that growth in this sector will be supported by domestic credit. This phenomenon is developing very slowly: bank lending increased its participation in commercial activity by 1.5 p.p. of sector GDP in the period March 2004-2005.

### II.3.5. Construction

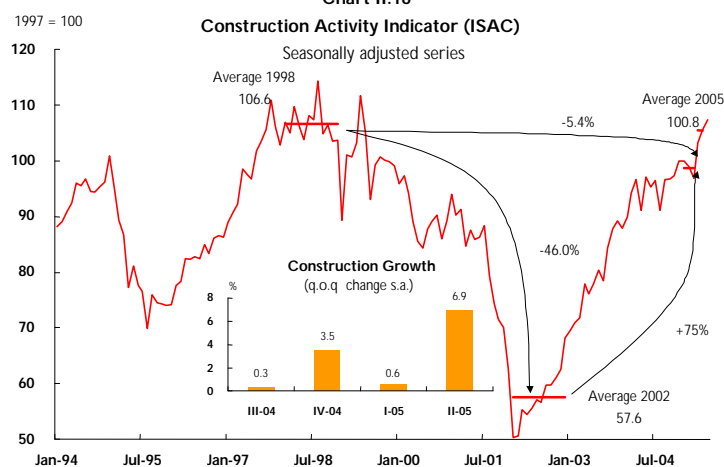
The construction industry recorded growth once again in the first half of 2005, although the rise was uneven. After having remained almost unchanged in the first three months of the year, between April and June growth reached 6.9% s.a., the highest level since the first quarter of 2004 (see Chart II.16). This spurt was caused mainly by a rise in oil industry construction and housing, sectors that had recorded declines in the first quarter of the year.

Private real estate developments have boosted housing starts, thanks to higher property prices. Public housing construction grew at a faster rate in the first half of 2005, while construction in the oil and gas sectors also increased. New investment and the continuation of projects begun at the end of 2004 in the manufacturing, agriculture and commerce sectors have ensured that the non-housing construction segment has continued to grow.

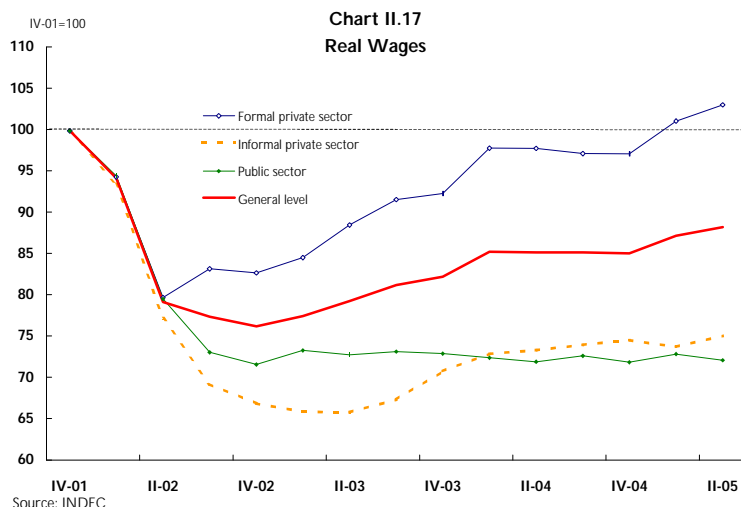
The level of indebtedness recorded by companies in the construction sector is the lowest of all economic activities. Although the liabilities of the sector are currently spread between local bank creditors and foreign debt, in the pre-crisis period construction companies obtained most of their financing from the domestic market. As from the crisis in 2001-2002, this sector cut the share of bank debt in terms of sector output to less than half its pre-crisis level.

Chart II.16  
Construction Activity Indicator (ISAC)

Seasonally adjusted series



Source: INDEC



Businesses in the sector are positive regarding the outlook, particularly in the case of companies building public works. This growth in activity could take place within the framework of increased third-party financing without this implying any reduction in the payment capacity of companies in the sector.

#### II.4. Households

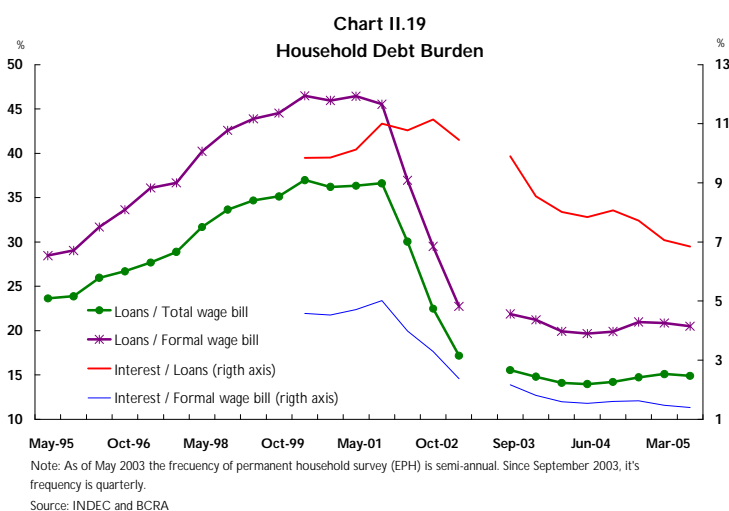
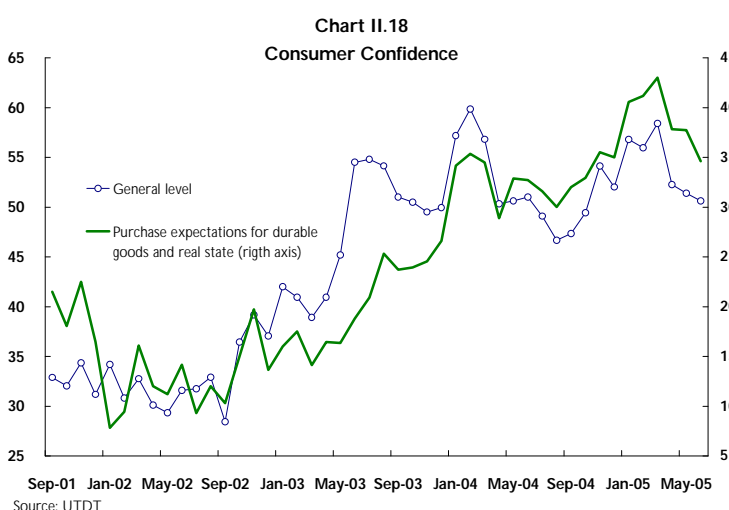
In the first six months of 2005, households maintained their sound payment capacity, thanks to a recovery in wage levels and an increase in the level of employment, record levels of consumer confidence and low personal indebtedness levels.

Household consumption returned to strong growth in the second quarter of 2005, after having risen during the first quarter at a lower rate than had been seen in the last two years. Once the circumstantial factors that affected its performance at the beginning of the year, such as the seasonal decline in employment and additional fiscal pressure from the deferral on income tax due dates, had been overcome, consumption patterns in the second quarter reflected the improvement in the real income of workers.

This improvement in wages was driven by remunerations in the private formal sector, which rose above real wage levels in the pre-crisis period (see Chart II.17). The above, added to the increase in employment, notably strengthened the source of household income. Furthermore, although there was a reduction in the final months of the first half, consumer confidence and expectations regarding the purchase of durable goods and property remained well above historical levels (see Chart II.18).

The burden of household debt in terms of the amount of interest paid is well below that seen in the pre-crisis period (see Chart II.19), benefiting from both low levels of indebtedness and lower interest rates payable by consumers. Households therefore show an adequate repayment capacity in relation to their current liabilities, as well as broad potential for taking on new debt.

The purchasing power of the population will continue to improve in 2005 on the basis of negotiated wage agreements and the Government's wages policy, which includes improving public sector wages and pensions, as well as because of the recovery in employment that began in the second quarter. Furthermore, as part of the increase in consumption will be financed by local banks, households are expected to increase their levels of indebtedness without compromising their medium-term repayment capacity. Accordingly, 2005 will end with growth in private sector consumption similar to that of the economy.





### III. FINANCIAL INFRASTRUCTURE

#### *Summary*

*Completion of the sovereign debt exchange has led to more encouraging prospects for the development of the domestic financial infrastructure. In the first half of 2005 the domestic capital market began to show dynamism, driven mainly by the recovery in the fixed income sector, where there has been greater liquidity coupled with lower spreads. The market for Central Bank securities has continued to deepen, with large trading volumes on secondary markets. The stock market recorded some volatility in the first part of the year, ending the first half with a slight negative variation. In the corporate debt market, \$900 million was raised by means of new bond issues during the first six months, while financial trusts were created for over US\$1.5 billion.*

*There was increased activity by financial institutions and non-bank financial intermediaries in the first half of 2005. The latter consolidated their growth trend, in the context of increased diversification of their assets. Rising numbers of contributors led to growth in pension funds, while the encouraging macroeconomic context strengthened the development of the insurance market and mutual investment funds.*

*Banking sector activity continued its path towards normal levels. At the same time as exposure to the public sector declined, investment in Central Bank securities and the channeling of resources towards lending to the private sector (15%, 36%a.) were the main activities of financial institutions during the first half. Commercial credit lines led growth in lending to the private sector (27%, 61%a.).*

*In the case of liabilities, the settlement of debt with the Central Bank and growth in private sector deposits (12%, 26%a.), led the return to normal. This latter trend is a clear sign of increased public confidence in the financial system, in particular as it is taking place in the context of relatively low interest rates. For its part, the Central Bank continues to promote the extension of deposit terms as one of the requirements for a take-off in lending to the private sector in the mid to long term. This, together with the efforts made by financial institutions, has resulted in growth of almost 50% in the average term of transactions. Following the debt exchange, the continuity of the process of reduction in exposure to the public sector and the development of capital markets will be fundamental elements providing an impulse to the availability of bank financing in the medium and long term.*



Chart III.1

## Yield Curve of CER Adjusted Bonds in Pesos

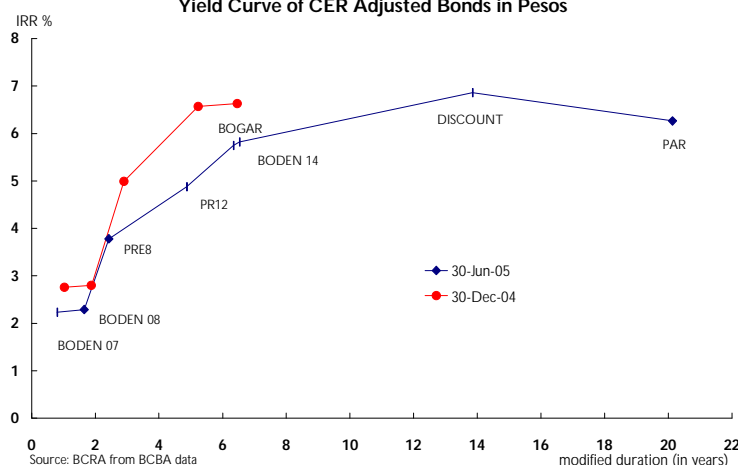


Chart III.2

## Traded Volume of Public Bonds

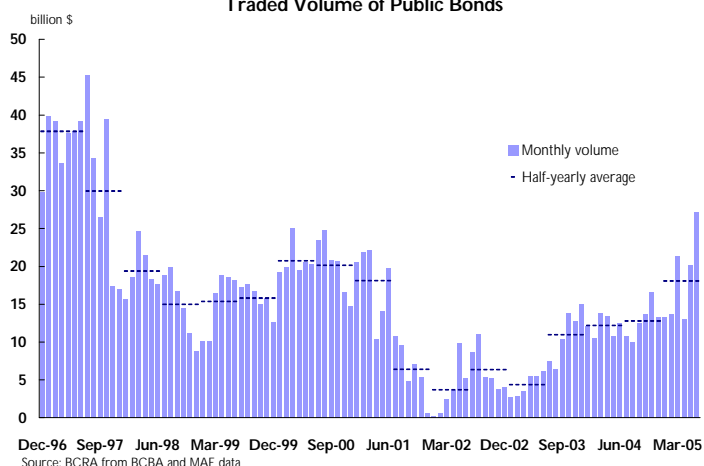
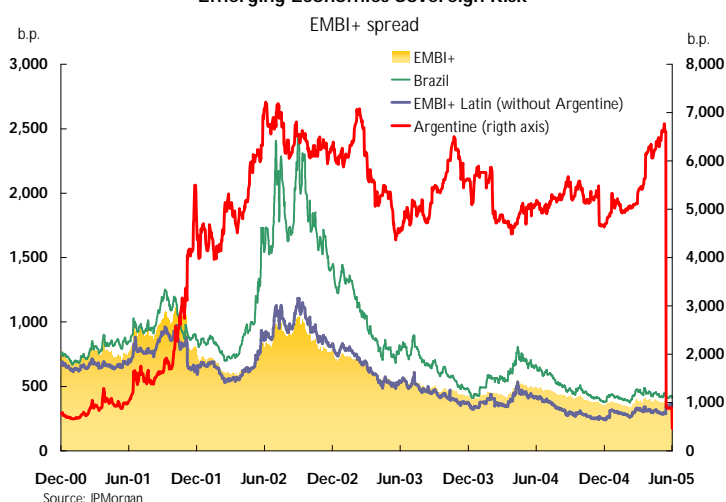


Chart III.3

## Emerging Economies Sovereign Risk



## III.1. Capital market

In a highly favorable international context for emerging economies, the good performance of the domestic economy (both recent and projected) has helped provide the capital market with increased dynamism. During the first half of 2005 one significant event that helped to lower uncertainty and improve the business climate was the conclusion of the sovereign debt exchange. This revitalized the capital market, particularly as regards levels of activity, as reflected in rising trading volumes and a return to bond issuing by the Federal Government. Although a favorable scenario prevailed in the first months of the year, development was less uniform in the case of prices, reflecting the impulse to investor expectations provided by the imminent pulling out of default.

The volatility of domestic markets in the first half of 2005, a feature shared by most emerging markets, was a reflection of various factors, such as the expectations for a sharper increase in the US base rate and the delay that took place in the handing over of the new debt certificates once the exchange had been completed. In addition, towards the end of the first half there were factors such as the uncertainty generated by the measures announced to discourage inflows of funds of a speculative nature (Decree 616/05) and the expectations regarding the possibility of reaching an agreement with the IMF.

Domestically, the conclusion of the sovereign debt exchange had a more notable impact on the bond market. The exchange<sup>2</sup> ensured that the demand for Government securities (especially those in local currency) continued to gain strength. As a result, despite the volatility recorded over the course of the half-year, improvements were recorded in the prices of the more liquid bonds, more marked in the case of bonds restated on the basis of the CER index (see Chart III.1). Progress was particularly notable in terms of trading volume, with levels in June being similar to those traded in the period prior to the crisis in 2001-2002 in real terms, with an average monthly amount almost 34% greater than that recorded during the second half of 2004 in real terms (see Chart III.2) or 40% in nominal terms.

Given the exposure of local financial institutions to the public sector, these fixed income markets have a particular impact on the portfolio quality and the solvency of the financial sector. Improved prices and greater liquidity were particularly relevant in the case of the performance recorded by banks, enabling several financial institutions to make progress with their strategy for disposing of public sector assets in order to lower their high exposure to that sector.

The conclusion of the debt exchange and the favorable economic and fiscal prospects have helped ease the way for an eventual return by the country to international financial markets. The country risk indicator is now back at normal levels. After beginning the year at close to 4,700 basis points (b.p.) in the case of domestic debt, the EMBI+ spread for Argentina at the end of June was approximately 460 b.p.<sup>3</sup> (see Chart III.3). At the

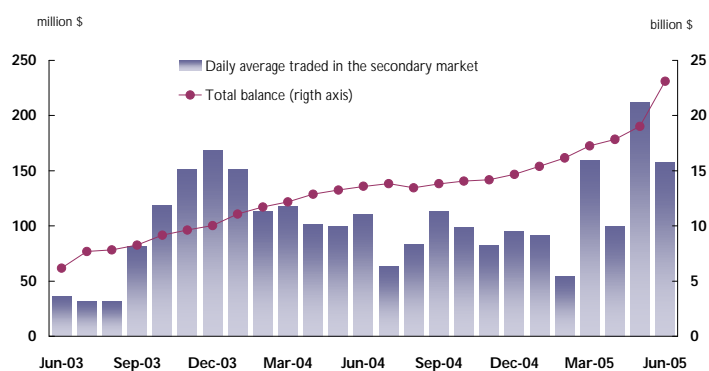
<sup>2</sup> Applications were accepted until the end of February. The new bonds began to be listed as from June.

<sup>3</sup> In mid-June the index was adjusted to take into account the restructuring of Argentine debt. The index currently incorporates two bond types, Par and Discount in dollars.





Chart III.4  
LEBAC in Circulation and Secondary Market Transactions



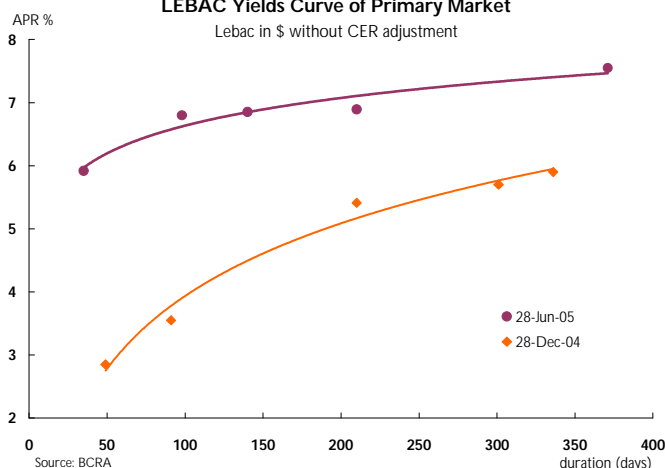
same time, international rating agencies adjusted their ratings for Argentine bonds, removing them from the defaulted category and in certain cases improving the rating of performing bond series. The spread of EMBI+ for the rest of the countries in Latin America halted the recovery, however (partly reflecting the negative influence of the political situation in Brazil), although it still stands at a historically low level.

In May, once the sovereign debt exchange was over, the Government was again able to make voluntary debt placements, after almost four years during which the market had been closed to it. That month the first tender of BODEN 2014 in pesos adjusted by CER took place, with offers almost doubling the \$1 billion that had been expected.

Given the existing levels of liquidity in the local market, and in line with the monetary policy implemented (see Page 16), the market for Central Bank securities continued to deepen. The total stock of assets in circulation (LEBAC and NOBAC) at the end of June 2005 was close to \$23 billion, almost \$8.4 billion more than the total at December 2004. This increase, together with the greater demand, had a positive impact on the secondary market, with a marked increase in volumes traded, which exceeded the maximum levels recorded during 2003 (see Chart III.4).

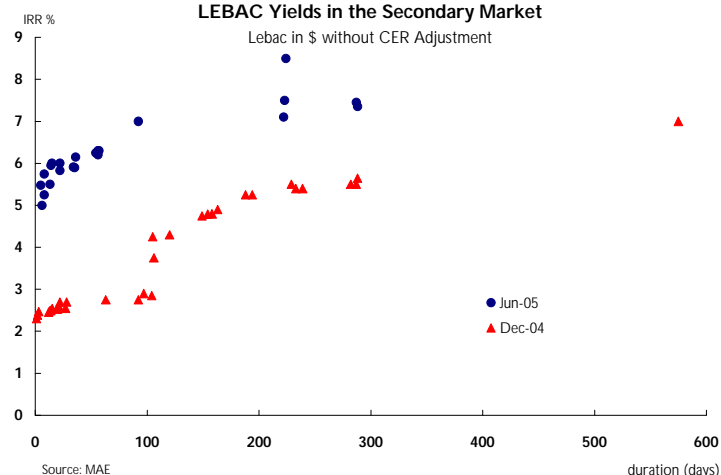
In addition, contrary to the situation that had been observed until then, in the first part of 2005 the Central Bank implemented a policy for a gradual increase in interest rates. The increase in cut-off rates was more pronounced in the shorter segments, implying a progressive flattening of the yield curve (see Chart III.5). This behavior was also reflected in the secondary market for Central Bank securities (see Chart III.6). At the end of the six months under review, the policy followed by the Central Bank through its LEBAC tenders has shown two significant changes: a trend towards a lengthening of the term for which funds were taken and the halting of issues of assets restated according to CER.

Chart III.5  
LEBAC Yields Curve of Primary Market  
Lebac in \$ without CER adjustment



The corporate debt market continued to record activity well below levels posted in the previous decade, although in this half there were some signs of recovery, with bond issues being made for almost \$900 million. Almost half this amount related to new issues, the rest being a result of debt restructuring. This is an improvement on 2004, when only around 20% of issues corresponded to genuine raising of new funds. On secondary markets prices continued to reflect a differentiation between those companies that had to restructure their liabilities and those that duly complied with their obligations. In the specific instance of debt issued by financial institutions, prices recorded a slight improvement during the six months, a sign of improved soundness and the better outlook for the banking sector (see Chart III.7).

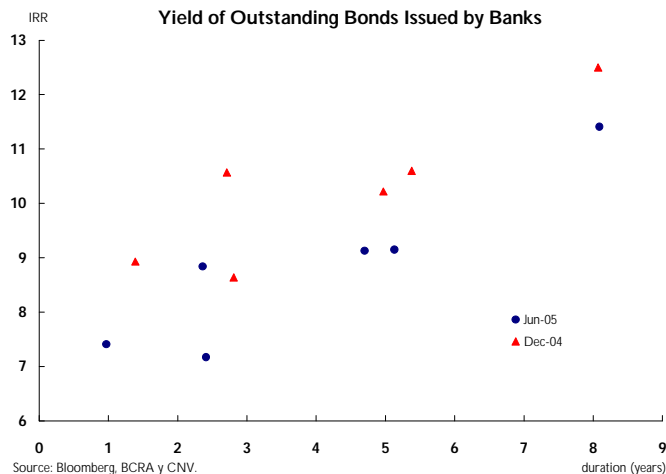
Chart III.6  
LEBAC Yields in the Secondary Market  
Lebac in \$ without CER Adjustment



There continued to be significant activity in the issuance of financial trusts, in part driven by the financial system itself. In the first half of the year financial trusts were issued for more than \$1.5 billion, based on the securitization of personal loans, credit card lending and mortgage loans.

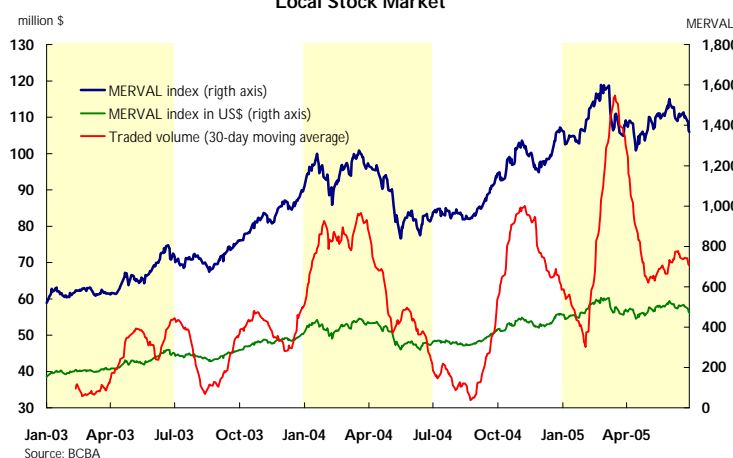


Chart III.7  
Yield of Outstanding Bonds Issued by Banks



The share market was affected by considerable volatility in 2005. After reaching a record 1,600 points at the end of February (at the time of the closing of the sovereign debt subscription), the Merval index performed erratically (see Chart III.8). At the end of June the index stood at around 1,400 points, with a slightly negative variation for the six months (-0.6%). In dollar terms the six-monthly change in the Merval was positive, close to 2%, with a less favorable performance than that of other emerging market exchanges. The gain in dollars on the stock markets of Chile, Brazil and Mexico was between 8% and 10% in this six-month period (see Chart III.9). The volatility seen in the local market was a reflection of the same macroeconomic effects experienced by the remaining markets, to which were added certain factors specific to the stock-exchange environment, such as the filing in May of healthy balance sheets by listed companies.

Chart III.8  
Local Stock Market

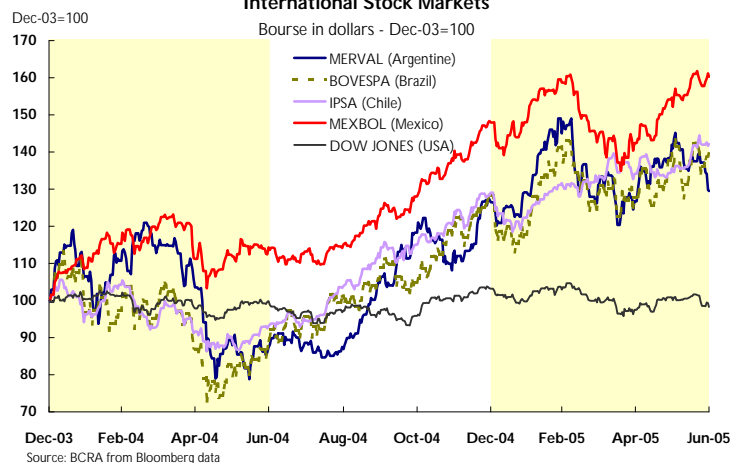


Despite the volatility in prices, there was some progress as regards market capitalization and in trading volumes. Stock market capitalization went up 19% on average compared with the previous six months, although recording certain fluctuation (rising until February and declining subsequently), reflecting the movement by prices. Bank stock market capitalization recorded a similar trend, having posted a notable upward trend in recent periods (see Chart III.10).

Share volumes traded were up 20% and 30% compared with the same period of the previous year and the immediately preceding half-year.

During the first half of 2005, markets for financial futures centered their activity on currency trades, in particular the US dollar, although transactions began to grow in reals and euros. In addition there was an incipient increase in other hedge markets, such as futures on BADLAR (see Chart III.11), launched at the end of 2004. These contracts are especially useful for banks, as they allow covering the mismatch generated by the taking of short-term funds for lending over longer periods. Although the number of futures contracts on BADLAR varied and is still at a low level, there were signs of interest from banks, while the expectations for this product remained optimistic. Future contracts on the CER index have not yet achieved a significant market volume.

Chart III.9  
International Stock Markets  
Bourse in dollars - Dec-03=100



It is expected that in coming months the capital markets will continue to develop gradually, keeping pace with the growth of the financial system and the real economy. These expectations are based on various factors, such as the stability of the macroeconomic context, business growth and the appearance of new investment projects. The prevailing levels of liquidity will also contribute, as well as the growing demand for assets suitable for covering different risks. In addition, the existence of an expanded yield curve (following the recent debt exchange) has been another significant factor, as it serves as a benchmark for the analysis of investments for longer terms. Furthermore, it is expected that the growing development of the capital market will stimulate the availability of medium and long-term financing for the productive sector, at the same time as providing the necessary complementation for the financial system.





Chart III.10  
Stock Market Capitalization

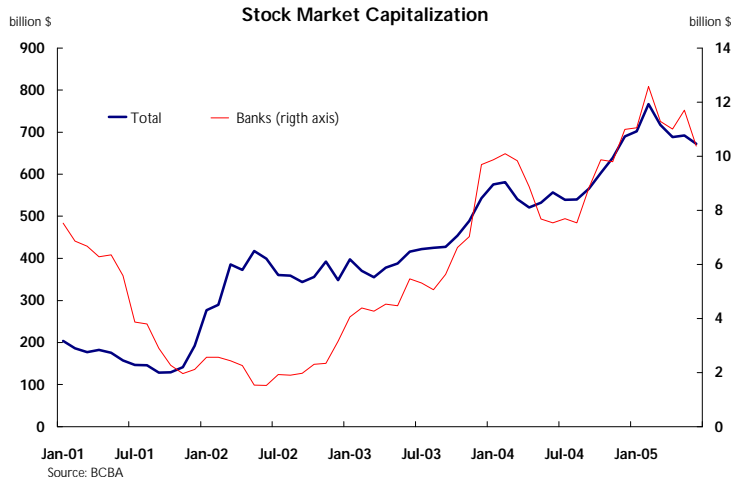


Chart III.11  
Forward Markets - Volume Traded

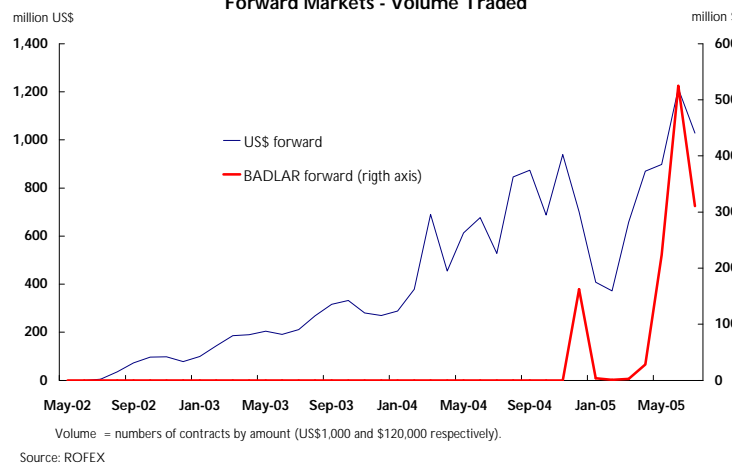
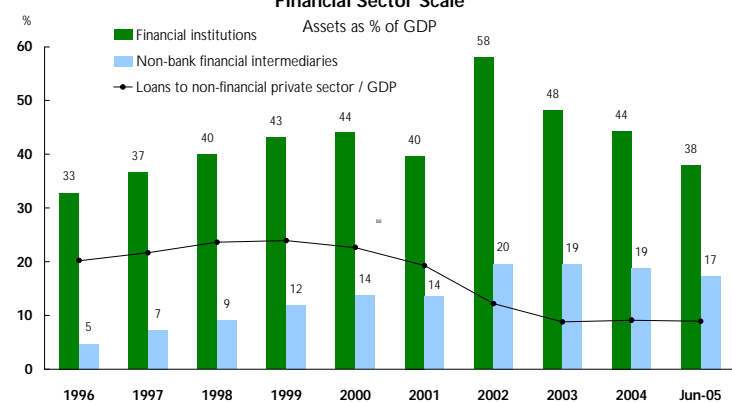


Chart III.12  
Financial Sector Scale



### III.2. Financial intermediaries

To provide an overall view of the financial intermediation process, with a particular focus on the prevailing stability, this section evaluates the development and performance of financial intermediaries, both banking and non-bank financial intermediaries (NBFI). While the former are banks, the NBFI are mainly pension and retirement funds (PF), mutual investment funds (MF) and insurance companies (IC). The low relative size of the NBFI, both in terms of the size of local banks (see Chart III.12) and when compared with other countries in the region (in Brazil and Chile they account for over 50 and 110% of output respectively), could be considered as indicative of their high development potential.

It should be noted that often ownership of NBFI and banks is centered on so-called financial conglomerates. The existence of such conglomerates means that their component parts can carry out transactions among themselves, which can act both to the benefit of consumers or represent a source of additional cost for consumers and for financial stability. Benefits include the advantages of lower costs from volume of production and the unification of activities (including those of administration and sales), with a direct effect on the efficiency of the financial sector. In addition, institutions in one financial segment with a sound reputation and knowledge of their customers will be in a position to provide them with new services, being faced with lower selling and monitoring costs.

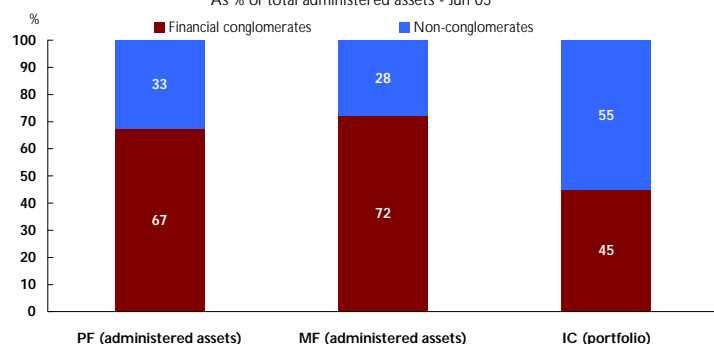
Nevertheless, there are also risks from the providing of such services by conglomerates. For example, conglomerates can find ways to avoid certain regulatory requirements when switching between financial segments with differing regulations, and can take advantage of regulatory voids generated by specialized regulatory entities. In view of these potential effects and their relevance to the system, financial conglomerates represent a phenomenon that requires monitoring in order to preserve financial stability.

In Argentina, many banks have invested in PF, IC or MF managers, while others participate in NBFIs indirectly through related companies or through the financial group to which they belong. Out of the 90 financial institutions present locally, 24 record investments (whether direct or indirect) in one or more NBFI segments and/or other banks. Of this group of institutions, 13 hold investments in an NBFI or in another bank, 6 have a presence in two areas of business, 3 in three, while 2 financial institutions cover the entire universe of activities.

The impact of local conglomerate activity increases when the size of the institutions involved is considered. If account is taken only of the assets administered by the NBFI, more than 60% is handled by conglomerates (see Chart III.13). As larger banks are the main institutions linked to NBFIs, this level rises to 80% when analyzing financial intermediaries as a whole (see Chart III.14). At local level, the creation of the PF market as from 1994, and the arrival on the scene of large foreign financial groups in the second half of the 1990s, encouraged the growth of this phenomenon. Nevertheless, conglomerate activity is not linked to one type of entity in particular. Private domestic

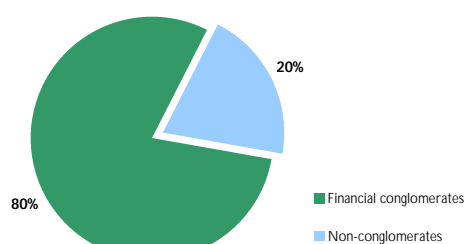


**Chart III.13**  
**Conglomeration in Non-banking Financial Intermediaries**  
As % of total administered assets - Jun 05



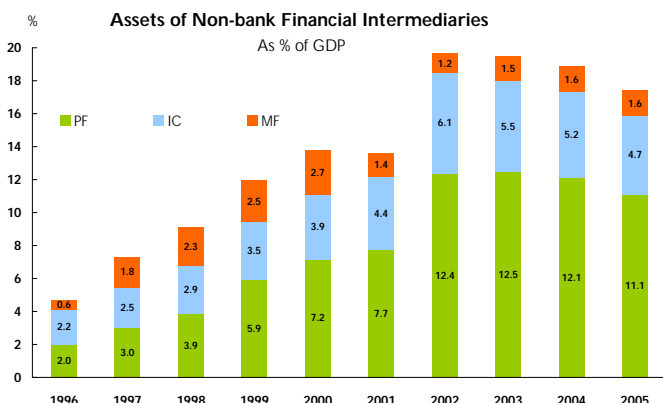
Financial conglomerates: Banks which participate, directly or indirectly, in other NBFIs. Pension Funds and Mutual Funds administer third-part funds. Insurance companies: last information as of March 2005.  
Source: BCRA from BCRA, SAFJP, SSN and Cámara Argentina de FCI

**Chart III.14**  
**Conglomeration in Financial Intermediaries**  
Banking Institutions, MF, PF and IC  
As % of administered assets - Jun 05



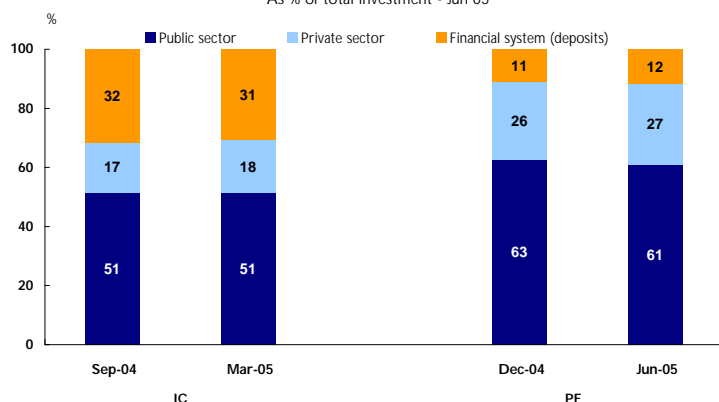
Insurance companies: last information as of March 2005.  
Source: BCRA from BCRA, SAFJP, SSN and Cámara Argentina de FCI

**Chart III.15**  
**Assets of Non-bank Financial Intermediaries**  
As % of GDP



Note: Data at December of each year. Insurance companies: last information as of March 2005.  
Source: BCRA from BCRA, SAFJP, SSN and Cámara Argentina de FCI

**Chart III.16**  
**Non-bank Financial Intermediaries Portfolio Composition**  
As % of total investment - Jun 05



Source: BCRA from BCRA, SAFJP y SSN

institutions, foreign and public ones administer 25%, 42% and 33% respectively of total conglomerate assets.

### III.2.1. Non-bank financial intermediaries

At June 2005 NBFIs assets totaled approximately \$92 billion, equivalent to more than 17% of GDP (see Chart III.15). Analyzing the behavior of NBFIs portfolios, a widespread increase in private sector financing can be observed, driven by a greater diversification of assets.

The balance of PF portfolio assets recorded a positive variation of 8% in the first half of the year, explained by increased worker contributions (because of a higher number of contributors) and the profitability of the system. PF financing of the public sector fell 1.6 p.p. in the period, to almost 61% of total assets (see Chart III.16). This took place in the context of the delivery of new Government securities (Quasi par and Discount) arising from the sovereign debt exchange and the favorable prospects for their performance. Furthermore, PFs increased their exposure to the private sector to 27% of their total portfolio, a behavior explained by the increased holding of shares by these institutions. The share accounted for by deposits in the total assets of PFs rose 0.6 p.p. in the period, with CER adjusted deposits accounting for almost three-quarters of the total.

MFs gained in strength in the first part of the year, growing by close to 17%, accumulating a net worth of \$8.0 billion<sup>4</sup>. This performance was in line with the favorable macroeconomic prospects and the good domestic business climate. MF growth was mainly driven by the dynamism of fixed income funds (which went up 80%), accounting for half the increase for the sector during the first half. Equity funds grew by 25%, accounting for 40% of the growth in MFs during the period. As a result, the net worth of bond and equity funds accounted for almost half of all MFs during the period. Growth in time deposits and money funds slowed during the last six months. The relatively low returns on time deposits and the increased attractiveness of Government securities following the conclusion of the debt exchange had an impact in this regard.

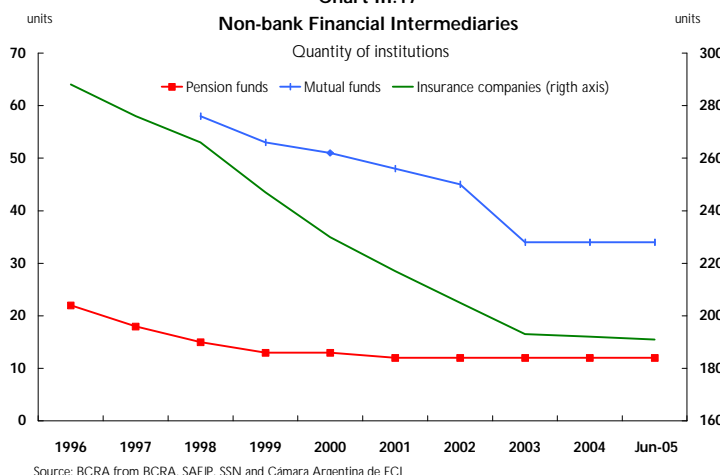
At March 2005 insurance companies (IC) recorded assets for close to \$25 billion, almost 8% more than in the previous half. This gain has been in line with the recovery seen in insurance underwriting. In the first half of 2005, IC investment portfolios recorded a slight decline in their exposure to the public sector, although it remains high. The share accounted for by investments in the private sector went up 1.6 p.p. in the period, while there was a drop in IC deposits held in the financial system.

In the first half of the year there were no signs of significant changes in the number of NBFIs (see Chart III.17), an indication that the adjustments in the sector following the crisis in 2001-2002 is virtually at an end. The number of PFs and MF managers remained unchanged, while the number of IC dropped by one. However, one of the three largest PFs (in terms of assets), which had been owned by a foreign institution, was acquired by an economic group that was already active in the social security

<sup>4</sup> Including peso and dollar funds.



Chart III.17  
Non-bank Financial Intermediaries  
Quantity of institutions



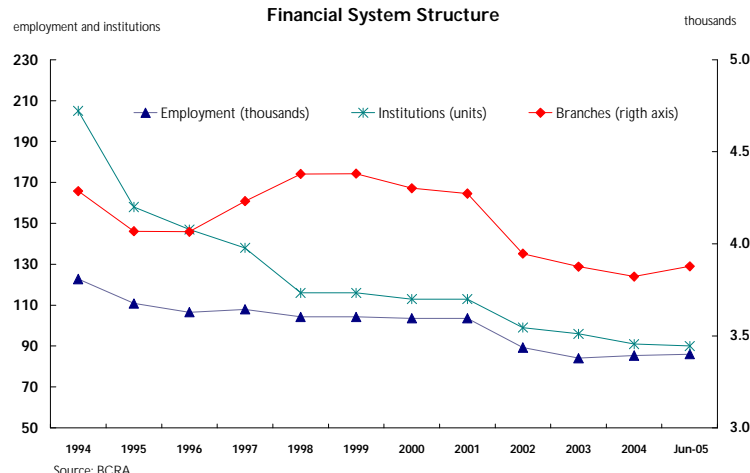
segment. A merger can therefore be expected in the second half of 2005, with increasing consolidation in the sector.

### III.2.2. Financial institutions

During the first half of 2005 the structure of the financial system continued to show signs of gradual recovery after the crisis in 2001-2002. Employment in the sector rose by almost 620 in the period (see Chart III.18), driven mainly by the private sector. In addition, the negative trend that had been seen in the number of bank branches since 1999 has been reversed, with a rise of 56 units in the period.

The increase in employment did not prevent an improvement in the productivity of the labor factor which recorded a further improvement in this half, consolidating the trend seen since the beginning of 2003, in the context of continued advances in both the scale of the financial intermediation business and in technology (see Chart III.19). Nevertheless, the still low levels of private sector lending mean that further effort is still required to reach pre-crisis levels.

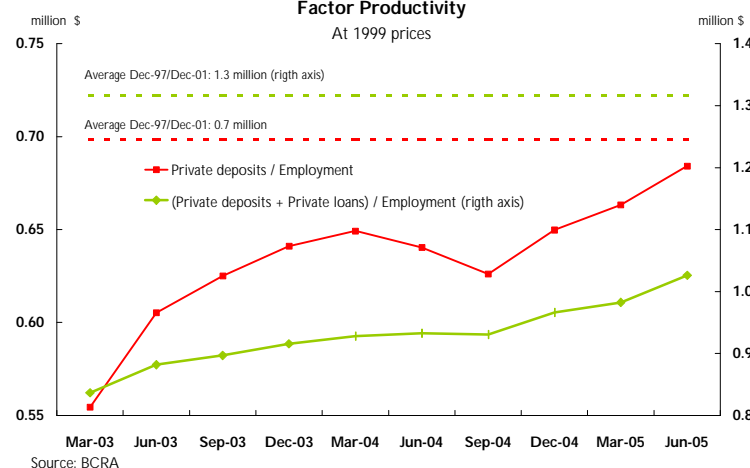
Chart III.18  
Financial System Structure



Although increased consolidation of the banking sector can be expected in the medium term, this adjustment will be gradual and will depend on market conditions. In the first half of 2005 only one small entity pulled out of the market, after three years noted for a process of downsizing. Despite the reduction, there was a further decline in the level of concentration of deposits in private banks, in a similar manner as in the whole banking system (see Chart III.20). The limited presence of large banks with the same owner means that there has been no significant change when analyzing the system taking into account the definition of financial conglomerates.

In addition, the process of post-crisis adaptation of the financial system in terms of market share continued. As pointed out in previous issues of the FSB<sup>5</sup>, in recent years some foreign banks pulled out of the market and others were sold to local investors. In the first half of 2005 one foreign bank passed into local hands, and furthermore the deposits held by private domestic banks increased in relative terms (see Chart III.21). Nevertheless, foreign capital banks still account for approximately 38% of private sector deposits in the financial system.

Chart III.19  
Factor Productivity  
At 1999 prices



Financial intermediation volume continued to increase in the first half of 2005, although at a slower rate than in 2004. While financial system assets (netted and consolidated<sup>6</sup>) in the financial system rose approximately 0.7% (1.4% a.), in real terms<sup>7</sup> they recorded a decline of almost 4.9% (-10% a.) (see Chart III.22). In this context there was an increase in loans (35% a.) and private sector deposits (26% a.).

The trading of Central Bank securities and the channeling of funds to private sector lending represented the main activities of the financial system in the first half of 2005 (see Table III.1). Liquidity has declined to levels more appropriate to the less

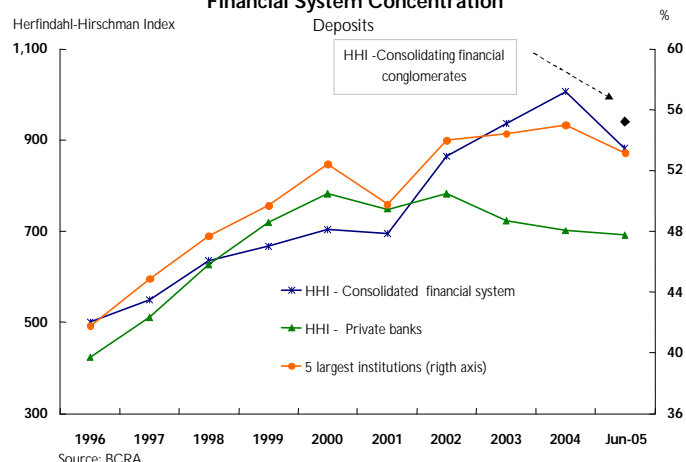
<sup>5</sup> See page 30 of FBS I-05.

<sup>6</sup> Assets net of the accounting duplications generated by repo, term sale and unsettled spot transactions. Consolidated for transactions between financial institutions.

<sup>7</sup> Restated on the basis of the CPI.



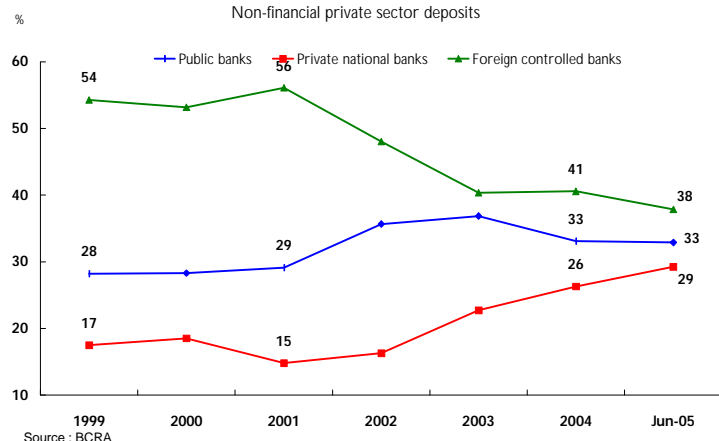
Chart III.20  
Financial System Concentration



uncertain macroeconomic outlook, and more in line with the levels existing in the financial systems of the leading emerging economies (see page 42). In addition, as part of the gradual individual adjustment to regulatory limits on exposure to the public sector (40% of total assets), the system was able to reduce its public sector assets (to 35% of total assets at the end of the half-year). These developments are consistent with an improvement in the solvency of the financial system.

Financial system lending to the private sector grew by more than 16% (35% a.) in the first half of 2005, in the context of economic growth and improved business prospects. Consumer and commercial lines grew at similar rates (57% a. and 61% a., respectively), although the latter accounted for two-thirds of total growth. In year-on-year terms, however, consumer lines continue to record greater growth (see Chart III.23). Collateralized loans began to record positive year-on-year changes at the beginning of the year.

Chart III.21  
Breakdown by Type of Institution  
Non-financial private sector deposits

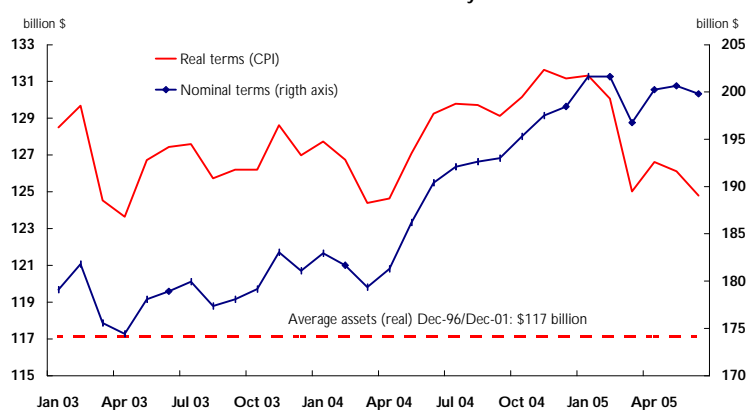


During the first half of 2005 commercial lines were boosted by current account overdrafts (30% or 69% a.). This mechanism is used mainly by companies needing short-term working capital that make use of authorized overdraft facilities granted by the banks with which they operate. Because no security is required and availability is immediate, interest rates are generally high. Nevertheless, during the first half of the year overdraft costs fell 1 p.p. to a level of approximately 14.5%.

In the case of consumer credit, personal loans recorded an increase of 29% (66% a.) in the six months. These loans, granted to households for relatively short periods on an unsecured basis, received a strong impulse from the increase in lending to holders of payroll accounts. They have also benefited from recent alliances between banks and the leading durable household goods chains, and the slight decline seen in their interest rates.

In the case of collateralized credit, in the first half of 2005 pledge-backed loans increased by 16% (34% a.), while mortgage lending recorded a drop of 0.8% (-1.6% a.). Although the granting of new mortgage loans accelerated in the second quarter, it has not yet been sufficient to compensate for the volume of mortgage repayments.

Chart III.22  
Netted Assets of Financial System



Growth in lending to the private sector was widespread and uniform across all groups of banks (see Chart III.24), in the context of a general increase in lending activity. Nevertheless, private banks continue to account for almost two-thirds of the market, in a segment in which foreign banks are particularly strong.

As a result, the first six months of 2005 have demonstrated the effectiveness of the Central Bank's policy aimed at increasing bank financing mechanisms available to the private sector. The main advances in terms of Central Bank regulations have centered on adapting the deteriorated situation of the financial system left behind by the crisis to the current favorable macroeconomic context, promoting the financing of small and medium-size companies and broadening the base of potential borrowers.





Table III.1  
Balance Sheet  
Consolidated system total - % of netted assets

	Jun-04	Dic-04	Jun-05	Half-yearly change HI-05 (%)
<b>Assets</b>	100	100	100	1
Liquid Assets	18	17	16	-9
LEBAC / NOBAC	5	6	10	56
Lending to the private sector (*)	18	20	23	16
Lending to the public sector	45	42	38	-10
Other asset	14	15	14	-2
<b>Liabilities + Net Worth</b>	100	100	100	1
Public sector deposits	15	16	16	0
Private sector deposits	39	41	47	13
CEDRO with CER	2	1	1	-41
Liabilities with the BCRA	14	14	11	-18
Outstanding bonds, sub. Debt and for. Credit	11	9	7	-26
Other liabilities	8	7	7	-4
Net Worth	10	11	12	6

(\*) Total loans do not include provisions

Source: BCRA

As part of this process, and given the favorable business prospects for companies that had been affected by the local crisis, regulations on loan refinancing and additional lending were relaxed. In addition, it was decided to extend from 360 to 540 days the maximum arrears allowed for debtors under creditor protection before banks are required to classify them as unrecoverable (for further detail see Box 1 in **FSB I-05**).

In addition, incentives were established to encourage lending to small and medium-size enterprises (SMEs), such as the elimination of margins for trade bill discounts, the extension to one year of the cover provided by preferred class “A” guarantees, reduced requirements for the discounting of atomized loan portfolios, an increase in the amount of the guarantee that Reciprocal Guarantee Companies can grant to an SMEs (from \$500 thousand to \$1.25 million), and the raising of the maximum for the classifying of a commercial credit line as for consumption purposes from \$200 thousand to \$500 thousand.

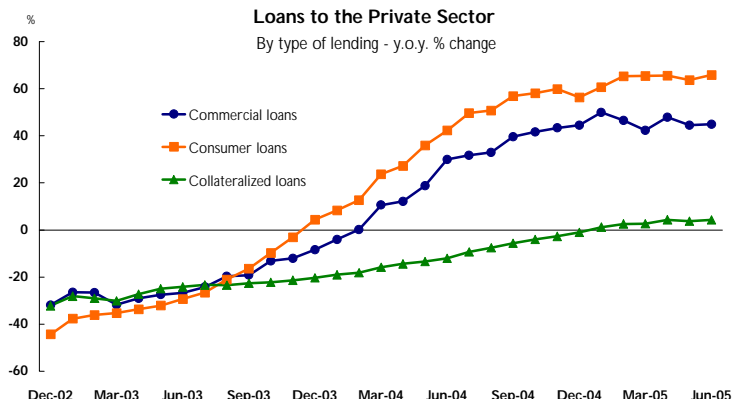
Lastly, the Central Bank has encouraged the broadening of the base of potential new borrowers. The main measures in this regard have included the waving of income confirmation documents for the granting of loans for less than \$15 thousand and the expansion of foreign currency lending capacity to sectors generating income in foreign currency.

On the matter of financial institution liabilities, the significant growth in excess of 12% (26%a.) in private sector deposits during the half-year (see Chart III.25) was a clear indication of the gradual recovery in public confidence in the local banking system. This growth was led by an increase in sight deposits and a larger volume of time deposits (in both cases the rise was 14%, 30%a.). Unlike the situation in the previous half, public sector deposits declined slightly, as a result of the increased disbursements by the Government because of the normalizing of payments on its foreign liabilities.

In the case of time deposits, those adjusted by the CER index grew by almost 22% (48%a.) in the first half of 2005, although as from March they posted a slight decline. The rise by these deposits was mainly linked to the PFs, as they channeled resources into such longer-term instruments with an inflation hedge because of the lengthier horizon existing for their liabilities.

In part as a result of Central Bank encouragement, banks succeeded in lengthening the average term of deposits by almost 50% in the last 2 years (see Chart III.26). Gradually, after the blow suffered from the crisis in 2001-2002, individual and corporate confidence is returning to banks, implying an extension of the maturity of loans.

Chart III.23  
Loans to the Private Sector  
By type of lending - y.o.y. % change



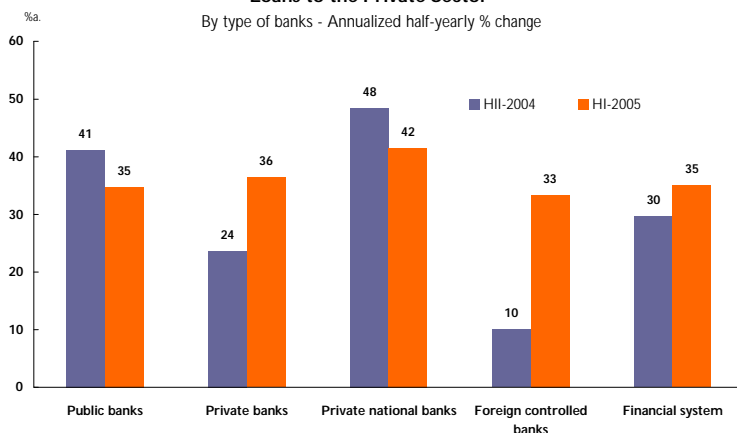
Commercial loans include overdraft, acceptance of promissory notes and export credit.

Consumer loans include credit card and personal loans.

Collateralized loans include pledge-backed loans and mortgages.

Source: BCRA

Chart III.24  
Loans to the Private Sector  
By type of banks - Annualized half-yearly % change

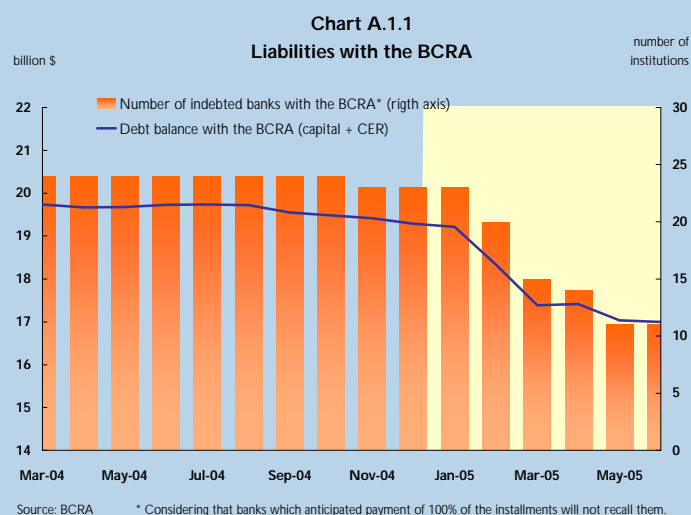


Source: BCRA



### BOX 1 : MATCHING MECHANISM: EARLY SETTLEMENT, ANTICIPATED PAYMENT OF INSTALLMENTS, AND NORMALIZATION OF LIABILITIES

Once the pressure on liquidity was over, and in line with the process for a gradual restructuring of their balance sheets, during the first half of 2005 banks adopted a strategy for curtailing their liabilities with Central Bank debt (see Chart A.1.1). The reduction of these debts (incurred during the 2001-2002 crisis) in excess of the normal repayment of installments originally laid down under the system known as *matching* has taken place by means of two types of operation: early settlement and anticipated payments of future installments.



Whereas early settlement was already contemplated under the *matching* mechanism (Decree 739/03 and Com. “A” 3941), the possibility of bringing forward payments was introduced by the Central Bank at the end of 2004. According to the methodology established (Com. “A” 4268 and 4282), by means of periodic tenders banks were allowed to submit offers for the installments they intended to bring forward, specifying the nominal interest rate they were willing to pay for the right to anticipate the payment. The first tender, called at the end of January, was followed by a further two (in February and April). New tender processes are planned for the second half of the year.

In designing this anticipated payments scheme an effort was made to incorporate additional mechanisms to soften the monetary expansion impact, and incentives were established so that banks would intensify their efforts to increase their lending to the private sector<sup>8</sup>. In addition, under this scheme, financial institutions were able at any time to opt to recover the amounts advanced that had not yet been applied to the settlement of specific installments, paying a premium on the basis of the most recent LEBAC cut-off rates. As a result, in this case, the securities assigned in guarantee are not to be released at the time the advances are paid, but once the corresponding amounts have been applied at the due date of each installment.

In view of existing liquidity levels, and because of the rising financial cost implicit in such borrowing<sup>9</sup>, financial institutions expressed strong interest in bringing forward the payment of installments or directly settling them in advance. During the first half of 2005 the principal of the borrowings from the Central Bank in connection with liquidity assistance dropped 17% to a level of close to \$15 billion by June 2005 (\$17 billion including CER). Almost two-thirds of this reduction arose from the early settlement of installments and the bringing forward of payments of future installments (see Chart A.1.2). Furthermore, the number of borrowing banks, which at the end of 2003 totaled 23, fell to a total of 11 over the course of the six months, considering that the banks that anticipated payments for the full amount of their borrowing will not request the return of these funds (3 institutions).

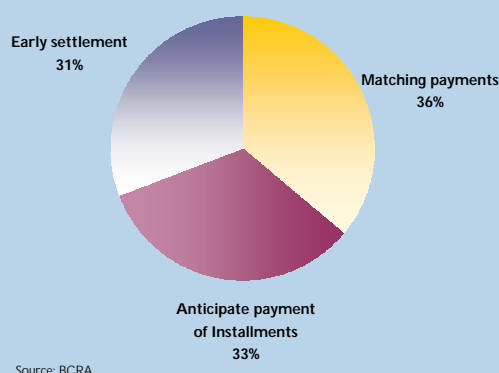
<sup>8</sup> It was established that the percentage of indebtedness for which anticipated payment offers could be made was linked to the growth in the portfolio of loans to the private sector in the 12 months prior to each tender.

<sup>9</sup> Debts under the *matching* scheme accrue interest at an annual rate of 3.5% on a balance restated according to the CER index.



This drop in indebtedness helped keep bank financial expenditure stable at a time when the cost of funding was on the rise. In addition to lowering the CER accrual payable, there was a drop in the interest due on the debt to the Central Bank. Whereas during the second half of 2004 such interest accounted for 27% of all interest costs, as of June 2005 this weighting was 21%. In addition to lowering financial costs, the shrinking of the debt with the Central Bank has made progress possible on the correction of the distortions caused by the crisis in 2001-2002 on the structure of financial system liabilities. With better-structured balance sheets, financial institutions should be able to earn improved credit ratings, facilitating access to cheaper sources of funding, with a positive impact on the availability of credit.

Chart A.1.2  
Accumulated Payments to BCRA  
H1-05 - Liabilities from rediscounts



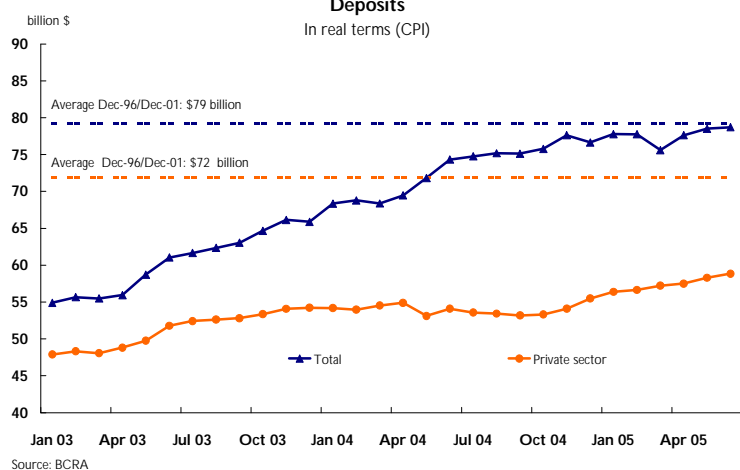
On the other hand, these transactions reduce the funding maturity, affecting the mismatch imbalance of maturities of terms inherited from the 2001-2002 crisis. This immediate effect can be reversed in the medium term, when access to market funding has become easier. In addition, the improvement that takes place in terms of solvency from the reduction in debt restated according to CER (based on the lower cost of funding), is partially offset as a result of the increase in the asset position in adjustable instruments in the financial system (real interest rate imbalance). In this latter case, the effect is immediate and can be quickly reversed. In the specific instance of early settlements, when the assets provided as collateral<sup>10</sup> were released, various banks were able to develop their strategy for lowering their exposure to the public sector, significant sales of Government securities and Secured Loans having taken place during the half-year. Although in many cases this had a negative effect on current profitability (as these assets had a market value that was lower than their book value), the transaction improved the quality of the balance sheets of the banks involved, leading to a sounder equity base for the sustained recovery of traditional financial intermediation.

<sup>10</sup> The order of precedence defined at the time the collateral was established was: first Secured Loans, then BOGAR, followed by BODEN. Priority was to be given to the imposition in first place of assets restated on the basis of CER. The release of the guarantees was to take place in inverse order of precedence.



Chart III.25  
Deposits

In real terms (CPI)



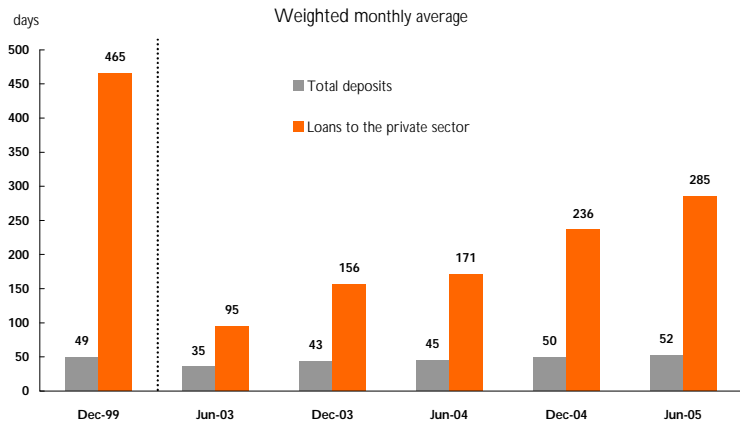
Source: BCRA

Despite these developments, the mismatching of terms inherited from the crisis, in particular because of the receipt of long-duration public sector assets and the drop in other sources of finance with a longer term (such as corporate bonds and foreign credit lines), is conditioning the horizon for the offer of credit to the private sector. The reduction in the level of exposure to the public sector, particularly strong during the first half of 2005, will encourage banks to finance longer-term investment projects. In addition, the expected deepening of the local capital market will allow banks to make use of longer-term funding tools, assisting in this regard.

The process of normalization of financial institution liabilities has been reflected in both the drop in foreign liabilities and in those outstanding with the Central Bank. The foreign currency debt of financial institutions fell during the half, explained by the acceleration in the settlement of liabilities and a series of actions leading to capitalization. In the aggregate, these lines fell 26% during the period, to less than 7% of total financial institution funding. In addition, in early 2005 three auctions were held for the anticipated payments of installments for payment under the so-called “matching” scheme (see Box 1). These auctions, together with voluntary early settlement by several banks and the regular payment of installments, led to significant growth in the use of funds to settle part of the inheritance from the crisis in 2001-2002. In this context, the share of total funding of financial institutions accounted for by borrowing from the Central Bank dropped 3 p.p. during the six months.

Chart III.26  
Deposit and Loan Maturities

Weighted monthly average



Source: BCRA

In coming months it is expected that financial intermediation activity will continue to recover, particularly in the framework of rising lending to the private sector. In addition, the receipt in cash of part of the compensation outstanding because of the conversion of balances into pesos could lead to a further drop in exposure to the public sector, stimulating the availability of investment credit. In the case of liabilities, some banks have begun to restrict the taking of CER-adjusted deposits, and this could affect the total balance of such deposits. Lastly, in the case of the matching mechanism, it is expected that the process of normalization of bank liabilities will continue, both by means of auctions for the anticipated payments of installments and voluntary early settlement by banks.



## IV. RISK MANAGEMENT

### *Summary*

*In addition to strengthening the resilience of the financial system to the risks inherited from the crisis 2001-2002, in the first half of 2005 the system prudently managed the new risks it assumed. Risk management policies led financial institutions to lower their exposure to liquidity, credit, foreign currency and market risks. Nevertheless, improvements still need to be made in the short and medium term, in line with the reduction of exposure to the public sector, lengthen the duration of liabilities and the reduction of the high exposure to an increase in real interest rates.*

*Gradually, the financial system is succeeding in restoring its links with its customers. This has been evident from the steady increase in private sector deposits, combined with the low rates of interest paid. Nevertheless, the need to increase the maturity of deposits is a matter that must still be resolved. In the first half of 2005, with the aim of normalizing their portfolios, financial institutions adjusted their liquidity levels to figures more in line with the context of financial stability and the requirements of the Central Bank. The Central Bank for its part is promoting market solutions that will enable risks to be transferred in an efficient manner. Inter-bank money markets, such as the call-money market and repo transactions between private sector parties, are two of the most important of such mechanisms. In addition, the market for repos with the Central Bank and its recovered function as a lender of last resort help shore up the system against any negative liquidity shock.*

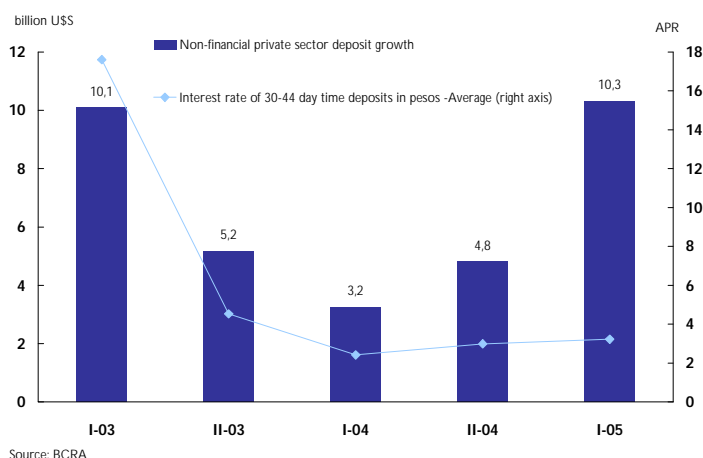
*In the early months of 2005 the financial system succeeded in strengthening its position in terms of credit risk. On the one hand, there was a significant reduction (4.7 p.p. of assets) in exposure to the public sector, as well as an improvement in the Government's payment capacity. In addition, the private sector continued to steadily lower its implicit risk, with a drop in non-performance beneath pre-crisis levels. Although financial institutions are increasing their lending to the private sector at a significant rate (35%a.), the low starting point (9% of GDP) and the prudence shown by the lending policies adopted, mean that it is possible to argue that this increase does not imply excessive risk-taking by the banking sector.*

*In addition to strengthening its position in the face of liquidity and credit risk, the financial system reduced its vulnerability to the active mismatching of foreign currency, mainly through a reduction in its assets denominated in dollars. In turn, this led to a reduction in exposure to market risk, moderating the impact on bank solvency of daily fluctuations in the peso-dollar exchange rate.*

*Despite the unfavorable context for any reduction in the risk from a rise in real interest rates, the financial system succeeded in holding its position steady. In the short and medium term it will be necessary to gradually reduce this risk. The Central Bank will promote market solutions that will contribute hedge mechanisms to protect against the risk from the real rate of interest.*



Chart IV.1  
Flow of Private Funds to the Financial System

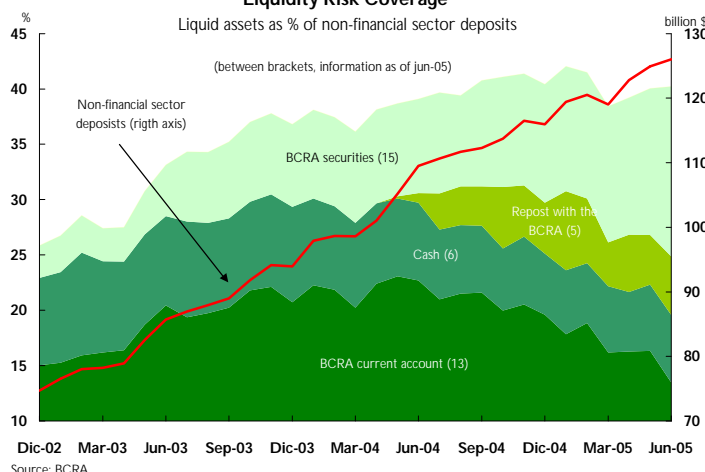


#### IV.1. Liquidity risk

The financial system is strengthening its access to funds through the private sector. In the first half of 2005, banks recorded a net inflow of funds from private sector deposits for an amount of close to \$10.3 billion, equivalent to a half-yearly increase in their balances of 26%a. (see Chart IV.1). This performance was achieved in coordination with low interest rates, both in historical terms and on the basis of comparison with other countries, reinforcing the idea that there has been an improvement in the perception of banking system health by depositors.

As a result, financial institutions have been able to allocate more resources to market instruments with a greater associated yield, at the same time as repaying certain liabilities (in particular those due to the Central Bank). As anticipated in FSB I-05, in the first half of 2005 the financial system lowered its reserves of liquid assets, using funds to acquire financial assets (in particular Central Bank securities) and to grant lines of credit for the private sector (see Pages 33 and 34).

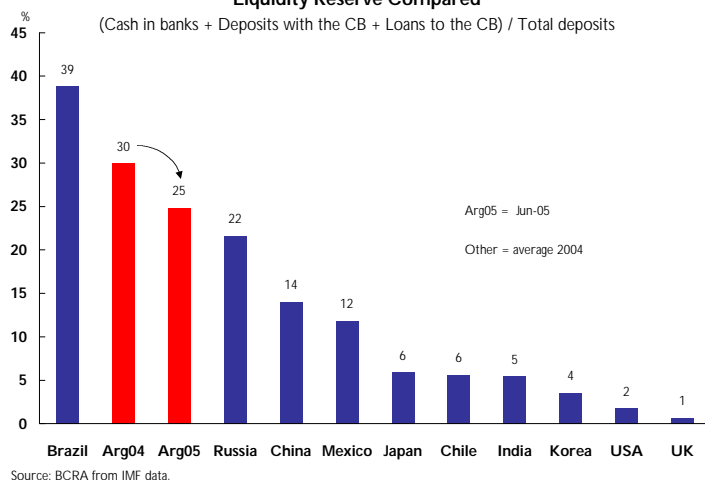
Chart IV.2  
Liquidity Risk Coverage



The financial system was therefore able to achieve a moderate reduction in its liquidity indicators without this implying an increase as in its liquidity risk exposure. The liquidity level (cash, Central Bank current account and repo transactions with the Central Bank), measured in terms of non-financial sector deposits, dropped from 30% to 25% in the first half of 2005 (see Chart IV.2). Nevertheless, if holdings of Central Bank securities are considered within the indicator for coverage in the face of liquidity risk, the ratio stands at around 40% of the deposits of the non-financial sector.

This declining trend in the high levels of liquidity characteristic of a post-crisis period is leading financial institutions to regularize their assets portfolios. As a result, although levels are still high in international terms, the financial system has begun to bring its liquidity indicators into line with those seen in emerging economies (see Chart IV.3).

Chart IV.3  
Liquidity Reserve Compared

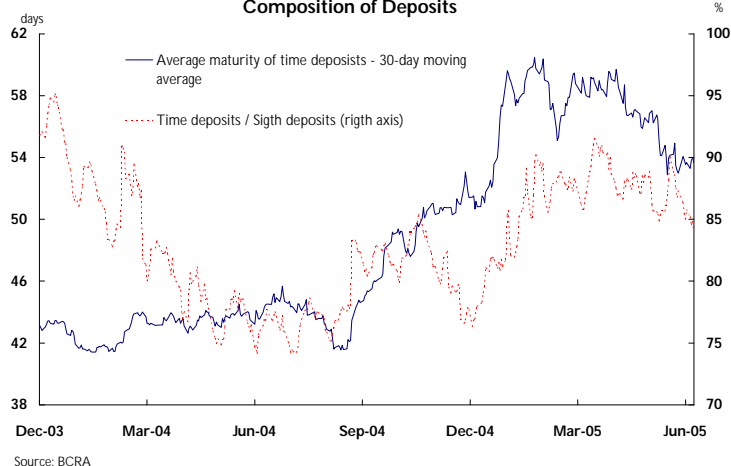


Although financial institutions are opting for instruments with increased yield and lower liquidity, such investments are made taking into account the Central Bank's liquidity requirements. Excess reserve compliance, which at the end of 2004 stood at close to 1.7% of deposits, dropped to 0.3% in June 2005. For banks, this has implied a more efficient use of resources in terms of solvency (see Page 58).

The financial system was able to fund itself in the private sector at relatively low interest rates, thus rebuilding its liquidity levels. Nevertheless, compared with the situation observed in the last half of 2004, during the first half of 2005 financial institutions have been only moderately successful in increasing the average length of deposit terms. Gains achieved in the early months of 2005 were reversed towards the end of the six months, so that the average term to maturity rose by a slight 3 days (see Chart IV.4). This performance was partly influenced by CER-adjusted time deposits, which rose sharply at the beginning of the year only to decline gradually subsequently.



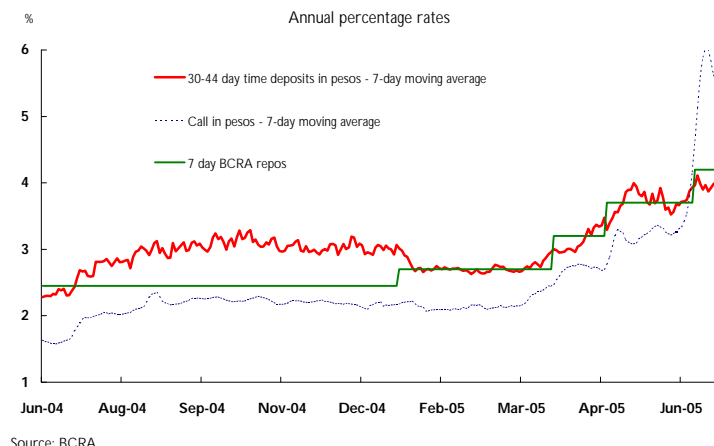
**Chart IV.4**  
**Composition of Deposits**



The short-term nature of deposits continued to be one of the main weaknesses of the financial system in the face of liquidity risk. Financial institutions have reacted accordingly: faced by short-term funding they apply most of such funds to relatively short-term assets, avoiding any growth in the maturity mismatch that was inherited from the local crisis in 2001-2002.

In the face of a rise in prices higher than had been estimated for 2005, the Central Bank began to reduce the monetary stimulus (see Page 16), increasing interest rates (both in the repo market and LEBAC and NOBAC issues). Banks responded to this by adjusting their interest rates upward, while the interbank money market also followed the Central Bank's lead (see Chart IV.5). As a result, in the first part of 2005 the financial system succeeded in doubling the volume of private sector funds it recorded in the last half of 2004. In particular, in the first quarter of the year deposit-taking centered on CER-adjusted deposits, while in the second quarter it reflected the impact of the increase of almost one third in the interest rate paid on time deposits.

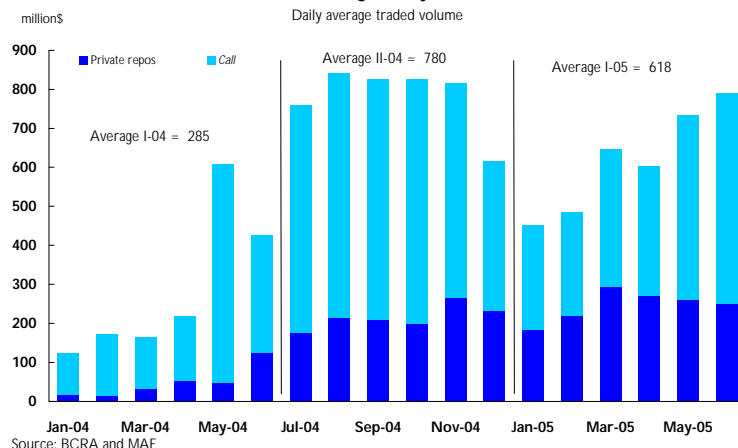
**Chart IV.5**  
**Interest Rates**  
Annual percentage rates



In addition to the favorable liquidity situation of the financial institutions themselves, the strength of the financial system in the face of unexpected deposits withdraw rests on three basic pillars. First, the Central Bank continues with its policy for the encourage of market solutions that make it possible to transfer risks in an efficient manner. These include the incipient interbank and repo money markets. Although they still lack depth (see Chart IV.6), the gradual reduction in liquid asset levels will enhance their growth.

For the interbank market to operate smoothly it will be particularly important for there to be a reduction in its high segmentation and its levels of concentration. In the case of the latter, there is an accumulation in the amounts taken by foreign entities that reach to 80% of the total (see Chart IV.7). In turn, the granting side is shared between domestic private banks and foreign bank, with only a small participation by public sector institutions.

**Chart IV.6**  
**Interbanking Money Market**  
Daily average traded volume

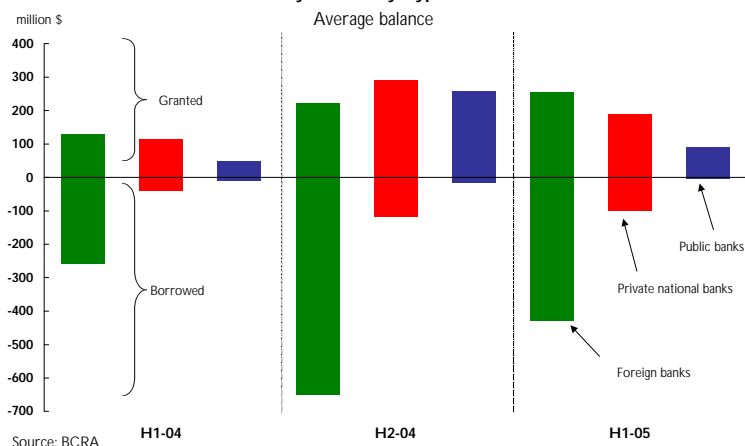


Second, the development of the repo market with the Central Bank represents a significant source of funds in the event of a specific liquidity requirement. During the first half of 2005, the high levels of liquidity in the local economy, added to the increase (from 2.50% to 4.25%) in the interest rates on Central Bank repos, led financial institutions to increase their participation in this market. As a result, the increase in average volumes traded for the six months reached 34%, with an average monthly trading volume of almost \$1.4 billion.

The third pillar underpinning the strength of the financial system in the face of liquidity risk is the capacity of the Central Bank to act as a lender of last resort. Financial institutions with particular liquidity needs can call on the monetary authority to be able to cover their shortfalls. This mechanism acts in two dimensions: it helps to eliminate specific liquidity problems, and it dissuades depositors from taking part in runs on banks, helping to prevent systemic crises not related to fundamental aspects. In this instance the Central Bank has established a regulatory



Chart IV.7  
Call Money Market by Type of Entities



framework that is transparent and equitable and grants credibility to the administration of monetary policy.

It is expected that in the next six months the robustness of the financial system will remain firm in the face of its exposure to liquidity risk. At the same time, the process of financial intermediation will deepen, with a switch of liquidity into financial assets and lending to the private sector. Liquidity indicators are likely to fall slightly, to more normal financial system levels.

Banks will continue to obtain funding from private sector deposits, while the lengthening of maturity will pose a significant challenge. Given the guidelines laid down in the current Monetary Program, the Central Bank will continue to reduce the monetary stimulus to ensure inflation expectations in the medium term converge on a level more consistent with price stability.

Although such a situation will mean an improvement in terms of the maturity of deposits, it will also represent a partial restriction on the ability of financial institutions to obtain funds from the Central Bank, whether through the rediscount window or through reverse repos. The monetary effect of these lines will have to remain in consistency with the guidelines established by the Monetary Program. In turn, the Central Bank will continue to promote the development of interbank and private sector repo markets.

## IV.2. Credit risk

### IV.2.1. Public sector

In the first part of 2005 the financial system significantly strengthened its position in the face of the risk of exposure to the public sector<sup>11</sup>. This was explained by the large drop in portfolio exposure and the increase in the payment capacity of the Government. The conclusion of the public debt restructuring process had a positive repercussion on banks, both because of the normalizing of payments and the improved outlook for the securities arising from the exchange, as well as because of the positive impact on performing bonds. This improved quality of public sector assets was reinforced by the regular surpluses being reported by the sector at all levels.

By June of 2005 lending to the private sector accounted for 35% of total financial system assets<sup>12</sup>, 4.7 p.p. less than at the end of 2004 (see Chart IV.8). Although the Government remains the banking sector's leading debtor, the gap with the private sector has narrowed significantly (see Chart IV.9). In mid-2003 this gap reached a high of 27 p.p. of assets, dropping steadily until reaching 13 p.p. by June 2005. This trend, observed for the financial system, gained in strength once the Government securities arising from the debt exchange were received, and banks began to move towards compliance with regulations on the limits for exposure to the sector (40% of total assets) that will come into force at the beginning of 2006. These developments, which are consistent with individual strategies tending to

Chart IV.8  
Exposure to Public Sector by Type of Banks

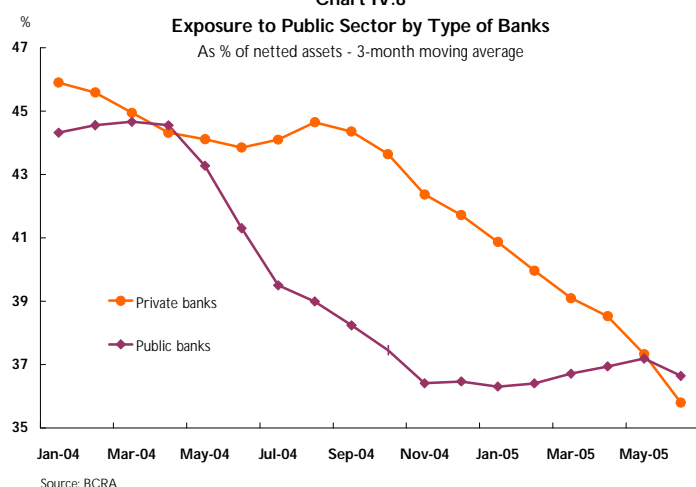
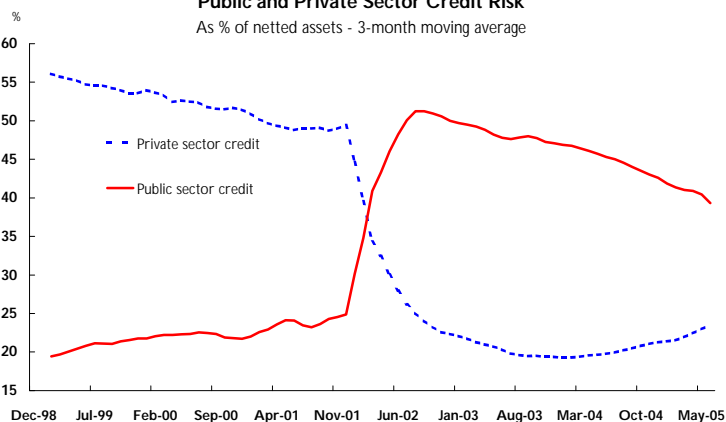


Chart IV.9  
Public and Private Sector Credit Risk



<sup>11</sup> The definition of lending to the public sector adopted by the FSB (see Glossary) does not include holdings of securities issued by the Central Bank.

<sup>12</sup> In terms of consolidated financial system netted assets, this figure is 38%.



improve risk to return profiles, reflect the widespread behavior of both private and public banks (see Chart IV.10).

The ending of the debt exchange in February 2005 improved the quality of bank assets. The normalization of payment flows and the encouraging performance of the prices of the resulting bonds were two of the direct effects of the exchange. In addition, the exchange of sovereign debt had a positive effect on the prices of existing performing bonds. This ensured that book values of Government securities moved closer to market values, facilitating their sale. In addition, this trend towards the normalization of financial system assets was reinforced by the gradual adjustment to the valuation of public sector securities according to the regulation that sets a schedule for valuing holdings to market<sup>13</sup> (see Chart IV.11).

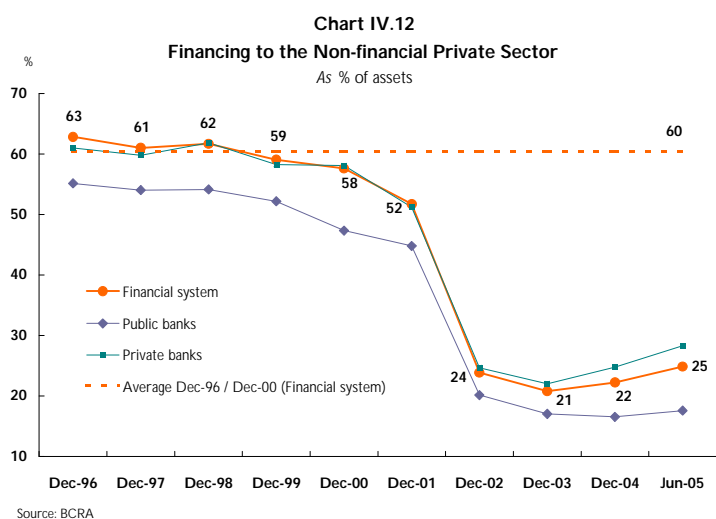
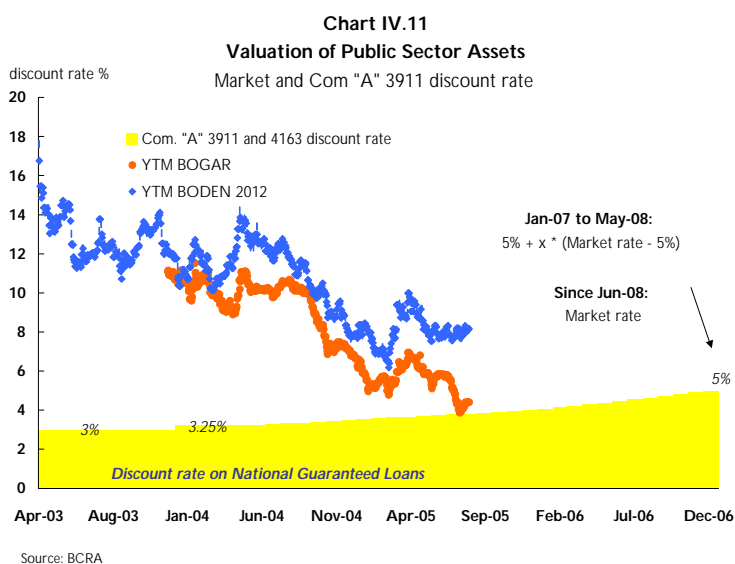
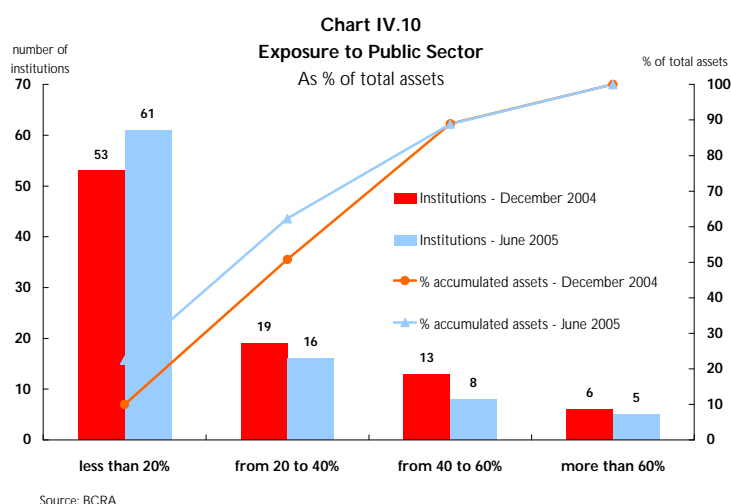
Looking forward, it is expected that the financial system will continue to lower its exposure to public sector risk, enabling an increase in credit lines for the private sector. If economic growth levels remains, orderly macroeconomic policies and the favorable international context for emerging economies are maintained, Government securities will continue to record a positive performance and will be reflected in improved bank net worth. Public sector results are expected to continue positive, increasing repayment capacity (see page 20), with direct effect on the sector's counterpart risk and therefore on the quality of bank assets.

#### IV.2.2. Private sector

As banks continue to show signs of a steady consolidation of their strength in the face of the private sector risk, they have been boosting their lending lines to companies and households. The positive performance of the local economy, added to a prudent lending of banks and the good prospects for new business, are behind this trend.

In a manner similar to that mentioned in **FSB I-05**, the continuous improvement in the quality of lending to the private sector was mainly due to the drop in non-performing loans<sup>14</sup> (in situations 3 to 6) and to the lower risk represented by the new loans granted.

During the first half of 2005, the exposure of the financial system to the private sector maintained the upward trend that began in early 2004. At June 2005, bank lending to the private sector reached a level of almost 25% of total assets, 2.6 p.p. more than at the end of 2004 (see Chart IV.12). Although the levels reached were far from pre-crisis levels, the encouraging growth in lending to the private sector in recent years, the current prospects for economic growth in 2005-2006, the drop in the cost of loans, and the availability of liquid resources in banks have come together to provide a very encouraging context for a prudent growth in lending to the private sector. A sound debtor base will pave the way for future financial system robustness in relation to private sector credit risk.



<sup>13</sup> Com. "A" 3911 and modifying regulations.

<sup>14</sup> The loans heading includes loans (without excluding provisions), other credits from financial intermediation, assets under financial leases, and sundry credits linked to the sale of immobilized assets (see ordered text of the Debtor Classification on the Central Bank website).



**BOX 2 : THE DEVELOPMENT OF ELECTRONIC BANKING IN ARGENTINA**

The development of information technology and communications in recent years has had a broadly positive impact on various productive sectors despite the individual characteristics of each country. The financial sector in Argentina has not been immune to this development and has incorporated e-banking services to its service options. Although still at an incipient stage (it is estimated that only 12% of the 10 million Internet users make use of such services), it is expected that this new information and banking service distribution channel will see significant development in future, with a consequent redefinition of the business models and risk profiles in the sector. In such a context, the Central Bank, through the Superintendence of Financial and Exchange Institutions, has been operating an e-banking Commission, since 2001 with initial the objectives included the analysis of the developments taking place internationally and the regulations issued on sound practices and control over the activity.

E-banking is a phenomenon in constant evolution, and consists of a group of facilities provided by financial institutions to their customers by various electronic channels, so that they can gain remote access to the services offered. By these means, banks are able to provide increased convenience to their customers, PN of parallel achieving a significant reduction in their operating costs. The range of products and services provided by institutions through electronic channels varies in content, capacity, sophistication, and the medium enabling them. Although financial institutions have used electronic channels for many years, the advent of Internet has extended their use to the receipt of instructions and the delivery of products and services to their customers. At present there are various electronic channels that enable links between a bank's information technology environment and its customers. These include automatic tellers, Internet Banking, PC Banking, Telephone Banking and PoS (point of Sale). In addition there are other means with lower degrees of development, such as: intelligent cards ("electronic wallets"), EDI (electronic data interchange), mobile (m-banking) and Video kiosks.

An understanding of the various e-banking *products* in the market enables the identification of the inherent risks involved. On the one hand are the so-called information services. This is the basic level of electronic banking, providing information through various elements. If the medium used is Internet, the mechanism is similar to the provision an institutional brochure. The risk is relatively low, as in general the information system does not compromise the internal systems of the financial system. Nevertheless, the server and/or web site of the institution or service provider could be susceptible to intrusion, so that controls are required to prevent unauthorized alterations to them.

Then there are the information exchange services, involving a certain degree of interaction by means of e-mail, customer balance requests, loan applications, updating of information for changes in address, etc. As information is accessed via the institution's internal network, the risk is greater. The control of virus and intrusion thus becomes a critical factor in such an environment. In addition, transactional services involve another level of products that allow customers to perform monetary transactions queries. In this case stricter controls are required, as such transactions include the payment of utility services, access to accounts, funds transfers and others. Lastly, the deepest level of e-banking involves virtual banking. In this segment, traditional banking is abandoned with the adoption of a strategy for performing transactions exclusively using Internet. In this instance, new tools and procedures must be developed to protect against a wide range of vulnerabilities and risks behind an open means of communication.

Rapid growth in the use of Internet as a distribution channel for bank services raises significant challenges for financial institutions, especially in the area of *risk management*, and therefore for the regulatory agencies. At present there are certain situations that could have an impact on the bank risk profile, including: a) an increase in competition through the appearance of new products and services; b) limited experience of e-banking risk management in the case of the boards and managements of institutions; c) potential for increased fraud because of the limited development of a sound business practices scheme; d) lack and/or ambiguity in rules and in terms of application and jurisdiction of the activities involved in e-banking; e) storage of significant volumes of customer data that could impact on confidentiality policies. These are just some of the points that could affect the balance risk of banks. In general, such factors are related to strategic, operational, reputation and legal risks.



At present, almost two thirds of *Argentine financial institutions* (57) operate some sort of e-banking system via Internet, but only a few banks have implemented exactly the same business alternatives on the Web as they offer in their traditional branches (see Table A.2.1). Nevertheless, the growth that has been observed in both volume and diversification of alternative electronic channels within the financial system has been very significant in recent years. This phenomenon can be seen in the increase recorded in the number of users of Internet in general, as well as in the development of knowledge by users and potential banking service customers. In addition, it is expected that the development of alternative channels will rise as the cost of existing technology declines and new portable devices appear with the ability to connect to financial institution technology infrastructure appear.

Tabla A.2.1  
Development of e-Banking in Argentina

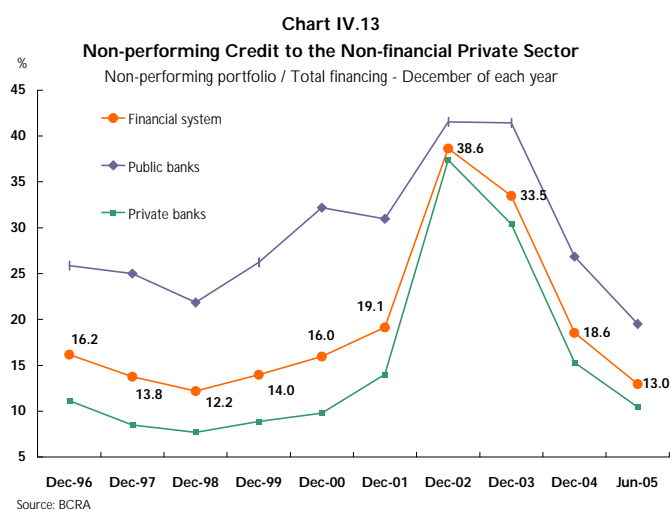
Type of service of e-Banking by Internet	June 2001		June 2005		
	Number	Share (%)	Number	Share (%)	Share of deposits (%)
Without presence	70	63	33	37	1
In construction	3	3	0	0	0
Informative site	15	13	14	16	3
Transactional site	24	21	43	48	96
Banking only by Internet	0	0	0	0	0
Total of entities	112	100	90	100	100

Source: BCRA

In general terms, distance banking in Argentina is used to complement traditional distribution channels. Services usually offered are: a) bank balance enquiries; b) utility service payments (e-payment); c) payment of credit cards; d) transfer between accounts of the same customer; e) placing of time deposits; f) requests for check-books; g) consultation, simulation and/or initiating of loan applications; and h) purchase of bonds, shares or other securities.

Given that the offered services via Internet (e-banking) are still at an early stage of development, the Central Bank considers that it is not appropriate to recommend broad *regulatory standards* that could potentially restrict technological innovation. Consequently, the strategy of the Central Bank has been to maintain basic regulations on operating requirements that must be followed by the I&T information and technology areas of financial institutions, carrying out appropriate monitoring of the latest developments in the sector. Future actions will be aimed at facilitating continued analysis and dialogue that will eventually lead to the development of supervision tools for e-banking activities.





Following two consecutive years of improvement in the quality of the private sector credit portfolio, in mid-2005 a level of non-performance of 13% was reached, lower than the average recorded in the second part of the 1990s (see Chart IV.13). This drop was mainly a result of the decline in loans classified as non-performing and the growth of lending to the private sector. This behavior was driven by the normalizing of payments by certain debtors in arrears, the transfer to memorandum accounts of loans classified as unrecoverable<sup>15</sup> and the improved business outlook for debtors. The regulatory impulse by the Central Bank with the aim of facilitating the granting of new loans has also helped in this regard.

In the first half of 2005 there was an improvement in the quality of existing loans: 93.1% maintained their rating, while 3.6% (almost \$1.4 billion) improved, exceeding the 3.3% (\$1.25 billion) of loans that recorded a deterioration in their quality. Of the top-quality loans (in situation 1) at the end of 2004, approximately 2.8% experienced deterioration in their classification over the six months (see Table IV.1). There was a notable improvement in the non-performing segment: approximately 14% of the loans classified in situation 3 at June 2005 had shown a worse classification six months earlier.

**Table IV.1**  
Transition Matrix December 2004 / June 2005  
Weighted by amount - In %

		June 2005								TOTAL
		1	2.a	2.b	3	4	5	6	Write off (*)	
December 2004	1	88.9	1.5	0.4	0.4	0.2	0.3	0.0	8.3	74.9
	2.a	22.8	65.2	1.7	4.3	1.1	0.9	0.1	3.8	4.0
	2.b	0.2	0.0	83.1	0.9	4.0	0.0	0.0	11.8	1.8
	3	7.1	5.6	1.2	69.1	6.0	1.8	0.1	9.1	3.8
	4	3.6	3.2	0.0	13.4	67.8	2.5	0.2	9.2	4.9
	5	0.7	0.1	0.0	0.3	6.7	68.1	0.3	23.9	9.7
	6	3.8	0.3	0.0	0.4	0.6	1.9	65.7	27.4	0.8
TOTAL		68.1	4.1	1.9	3.8	4.5	7.1	0.6	9.9	100.0

Figures based on debtor information at the start of the exercise

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

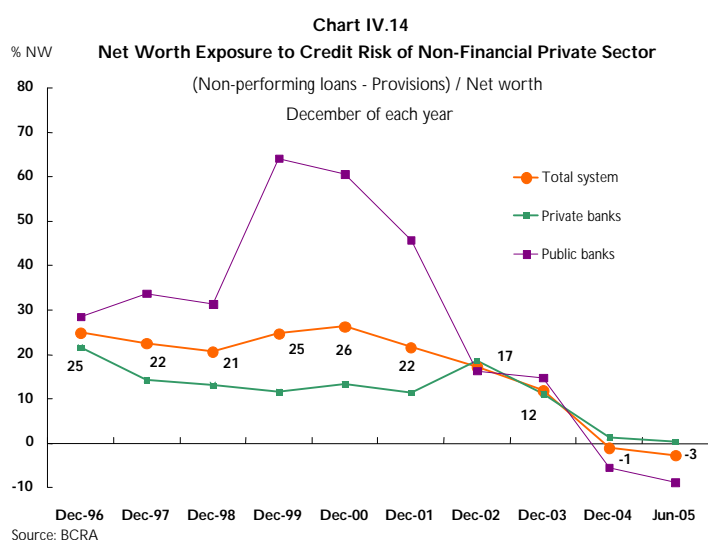
Source: BCRA

The half-year reduction in non-performing credit portfolio was more marked in the case of official banks (where it fell 7.3 p.p. to a level of 19.5%). Nevertheless, these banks continue to record low levels of portfolio quality, especially when compared to private banks. The latter posted a further drop in their non-performing level in the six months (4.9 p.p. to 10.5% of the loan portfolio), closing on pre-crisis levels. The drop in private bank non-performance was led by major institutions with branches nationwide.

Exposure of net worth to private sector credit risk continued to fall in the first half of 2005 (see Chart IV.14), in the context of an increase in the coverage by provisions and a steady recovery in the net worth of the financial system. The excess provisions in relation to the non-performing portfolio transformed the ratio of net worth exposure of the financial system into a negative figure. This is an indication of the notably cautious strategies by financial institutions in providing in advance for expected losses from unrecoverable.

In coming months it is expected that financial institutions will continue to promote the placing of new loans to the private sector, in a situation in which there will be availability of resources and an attractive risk-return profile for lending lines. This impulse will be reinforced by the new commercial strategies adopted by banks, as they compete for a larger share of the loan market.

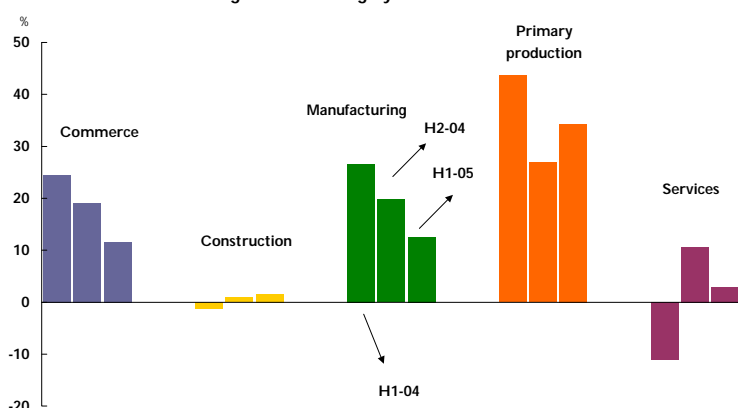
The rising financing needs of the various sectors of the economy, in line with the appearance of profitable new businesses, lead to a favorable outlook for the continued growth in the demand for credit from the domestic financial system. This impulse is expected to be accompanied by an improvement



<sup>15</sup> Central Bank regulations require that six months after being classified as unrecoverable (provided for at 100%), loans not recording any improvement in classification must be eliminated from assets and transferred to memorandum accounts. Corrected for the transfer to memorandum accounts in the half-year, non-performance of the financial system has dropped from 19.4% at the end of 2004 to 14% in June 2005.

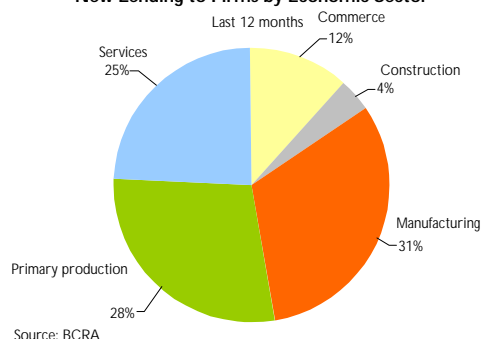


Chart IV.15  
Changes in Financing by Economic Sector



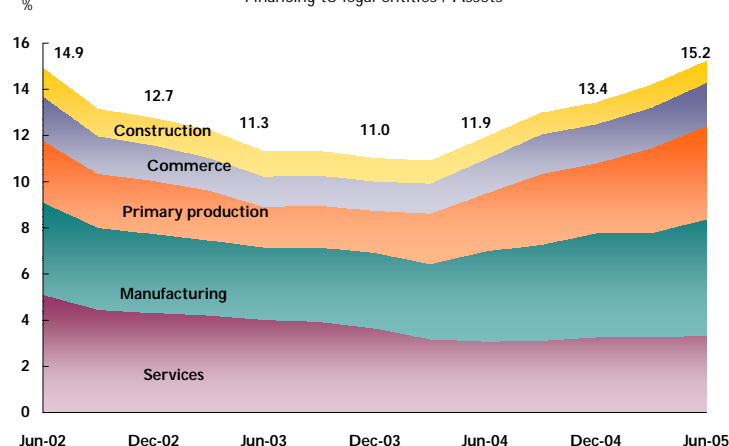
Source: BCRA

Chart IV.16  
New Lending to Firms by Economic Sector



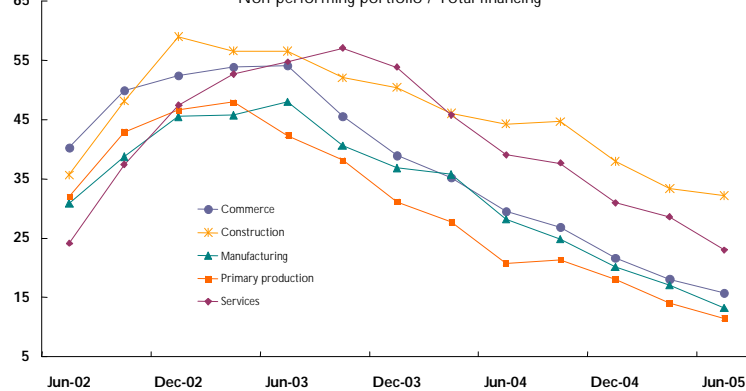
Source: BCRA

Chart IV.17  
Bank Exposure to Economic Sectors



Source: BCRA

Chart IV.18  
Non-Performance by Economic Sector



Source: BCRA

in the quality of the private sector loan portfolio, given the prudence observed to date in policies for lending to the private sector in the context of the latter's increased repayment capacity. (see pages 21 and 25).

### Corporations

In the first half of 2005 financial system lending to the corporate segment continued to rise<sup>16</sup> (14.3% or 31% a.). Increased needs for financing in the local manufacturing sector, given the continuity of the upward economic cycle, and the increased dynamism of the exporting sector reinforced this trend.

In line with the demand for credit in the first part of 2005, the portfolio of loans to companies granted by the financial system grew almost exclusively in the two segments recording the lowest repayment risk in the post-crisis period: manufacturing industry and primary production (see Chart IV.15). New local market business opportunities, and increasingly those on international markets, continued to drive lending growth to those sectors. Almost two-thirds of new loans to companies in the last year have been made to manufacturing industry and the primary production sectors (see Chart IV.16). Growth in lending to the primary sector contributed to the diversification of the portfolio (see Chart IV.17).

Although manufacturing industry and primary production continue to absorb bank lending, they remain the sectors with the best financial system ratings (see Chart IV.18). This declining delinquency trend was matched by the remaining sectors of the economy. The low non-performance recorded by newly-granted loans is a sign of increased financial system monitoring of debtors. Only 2.9% of all new loans made in the last year were granted to companies that had or developed payment problems during the year.

Unlike the situation seen in 2004, in the first half of 2005 the lines assigned to large companies<sup>17</sup> led growth (see Chart IV.19). This growth was consistent with the relatively low level of non-performance recorded by the credit lines for large companies (see Chart IV.20). Lending to small companies continued to show an improvement in quality. The gradual opening up of new niches in local and export markets will lead to improved repayment quality for smaller companies.

The prudent behavior of financial institutions was also in line with the risk represented by each of the different credit lines. Although all types of lending to companies recorded an improvement in their credit quality (see Chart IV.21), banks concentrated on those with a lower implicit risk: current account overdrafts. This type of borrowing, increasingly used by companies for short-term working capital requirements, continues to be the credit instrument recording the lowest level of non-performance (under 7%).

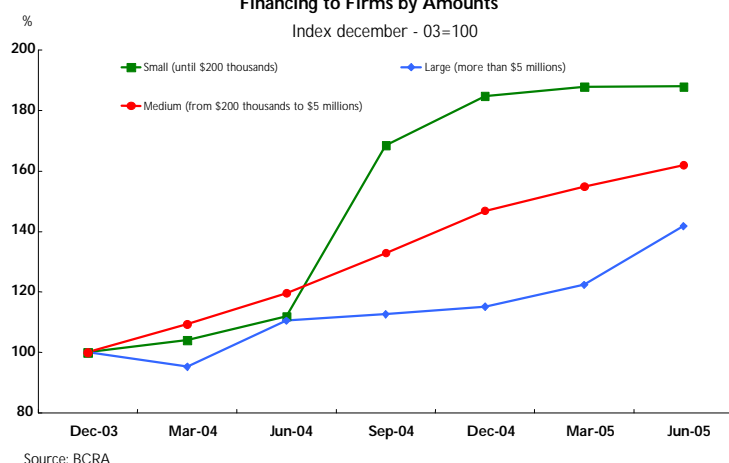
In recent months the ample lending capacity of banks, combined with declining company credit risk, ensured that rates of interest

<sup>16</sup> For purposes of analysis, loans to companies are those granted to legal persons and commercial credit financing granted to individuals.

<sup>17</sup> In this instance, company size is defined by size of their borrowing, with a distinction being made between small companies (up to \$200 thousand), medium-size companies (from \$200 thousand to \$5 million) and large companies (over \$5 million).



Chart IV.19  
Financing to Firms by Amounts  
Index december - 03=100



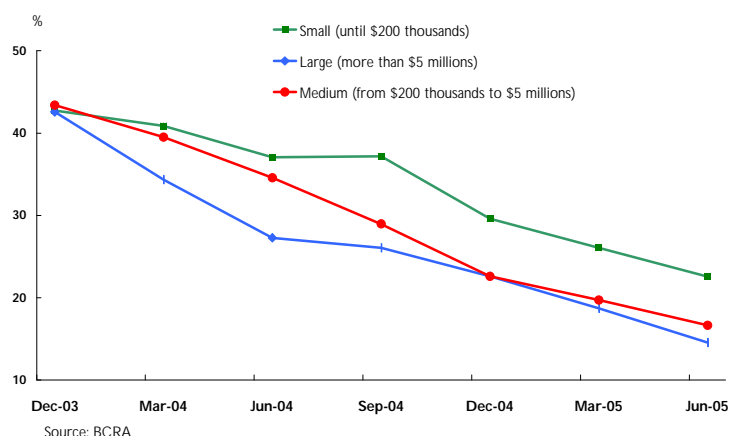
paid by the corporate sector remained at relatively low levels (see Chart IV.22).

In coming months there is expected to be a gradual reversal of the still low levels of utilization of sources of bank financing by companies, in a context of declining interest rates. Growth in the demand for bank financing will be gradual, given the persistent use by companies of their own resources to finance their activities (see Chart IV.23). The appearance of new business, on both domestic and export markets, will continue to drive the demand for credit from the local financial system.

At the same time, credit offering will continue to increase, in a context of bank liquidity and attractive risk to return ratios for corporate lending. Private sector credit risk will continue to decline, driven mainly by encouraging prospects for new business in the business sector. Active involvement by banks in the search for new customers and market niches will be responsible for this trend.

#### Households

Chart IV.20  
Non-Performing by Dimension of Firms



Lending to households went up 13.6% (29%a.) in the first half of 2005, generating an increase in financial system exposure to risk from individuals to almost 9% of assets (see Chart IV.24). During the period there was a marked increase in pledge-backed loans to households, although they still represent only 5% of all lending to the sector. Furthermore, there has been a steady increase in personal loans and credit card lending, lines that are being promoted by banks, accounting for half of all lending to households. Although the granting of new mortgage loans continues to increase (particularly following the stimulus provided by a small group of large banks), the total stock continues to decline because of the effect of a significant volume of repayment.

Gradually rising levels of formal employment, higher wages and a steady increase in the labor stability horizon generated the conditions for an improvement in the financial profile of families. These factors, added to the strategies of banks directed at increasing lending to this sector (atomizing their loan portfolios and thus spreading the counterpart risk), in the context of growing competition for the better debtors, led to a steady decline in interest rate costs (see Chart IV.25).

The decline in interest rates is consistent with the reduction in the implicit risk of lending to households. This latter aspect can be seen from the improvement in portfolio quality indicators. Non-performance totaled almost 7%, 4 p.p. less than in the previous half, and almost 12 p.p. less than one year earlier.

While the quality of pledge-backed loans is rising sharply, credit card and personal loan lines continue to make up the portfolio of lending to households recording the lowest non-performance rates (see Chart IV.26). As a result of sound financial institution lending policy, less than 4% of the loans granted to households over the last 12 months were made to debtors that recorded, or began to record, payment problems during the period.

Chart IV.21  
Non-performance by Type of Financing  
Lending to business

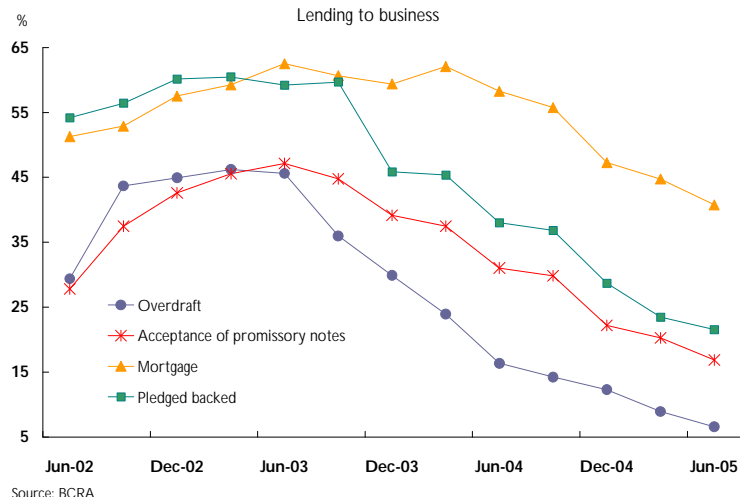
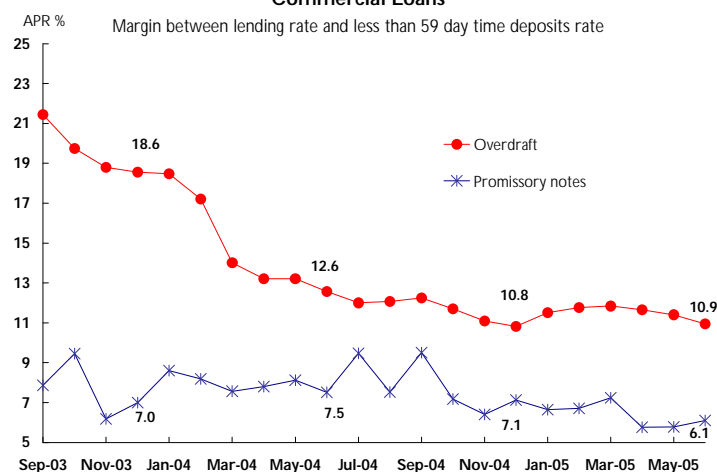




Chart IV.22  
Commercial Loans



Source: BCRA

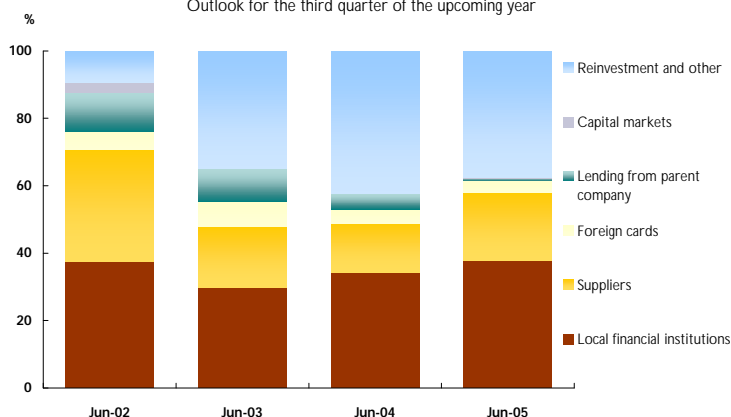
The favorable prospects for economic growth in the second half of the year, as well as for 2006, lead to an encouraging outlook for the recovery in levels of lending to households. Demand will rise as a result of improvements in the labor market that will allow households to bring forward decisions on consumption through the use of bank loans. Meanwhile, the supply of credit to households will remain firm, encouraged by the sound liquidity position of banks and the prospects for a good risk to return ratio for lending to households.

### IV.3. Currency and interest rate mismatch risk

In the first half of 2005, the financial system was able to continue to gain strength in the face of foreign currency risk, at the same time as it succeeded in ensuring there was no increase in its vulnerability to real interest rate volatility, despite the adverse context.

The financial system has been showing a steady improvement in its exposure to the peso-dollar exchange rate. In mid-2005, the asset equity imbalance derived from dollar-denominated items amounted to US\$3.7 billion (US\$ 2.5 billion if branches abroad are excluded). This amount is equal to 43% of financial system net worth, close to 23 p.p. lower than the level recorded one year earlier (see Chart IV.27).

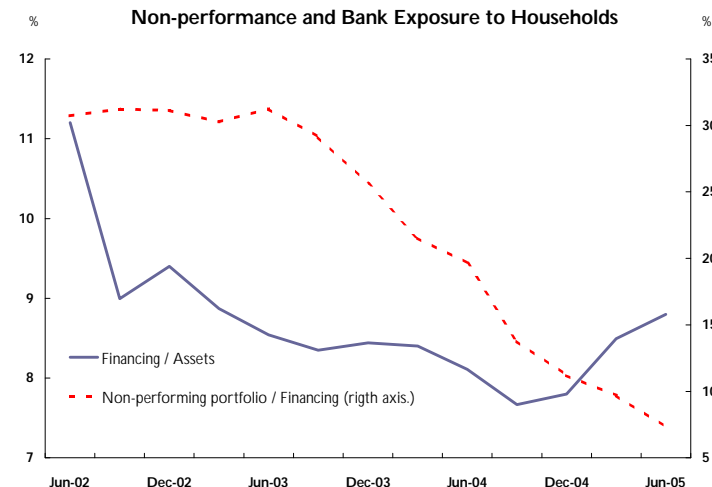
Chart IV.23  
Expected Sources of Funds for Meeting Needs  
Outlook for the third quarter of the upcoming year



Source: EMI - Qualitative Information - INDEC

This encouraging trend being recorded by the financial system is in line with the combined efforts of financial institutions and the Central Bank. After the crisis in 2001-2002, the monetary authority imposed restrictions on foreign currency lending<sup>18</sup>, preventing increases in foreign currency mismatching. As a result, in the first half of 2005, the financial system granted loans in foreign currency to debtors with repayment capacity in that currency, using resources in that same currency. In addition, banks sold part of their dollar-denominated Government security portfolios, simultaneously reducing foreign currency mismatching and exposure to the public sector (see page 42).

Chart IV.24  
Non-performance and Bank Exposure to Households



Source: BCRA

Compared with the same period of the previous year, in the first half of 2005 the declining peso-dollar exchange rate led the financial system to erase gains from exchange rate adjustments (see page 55). Whereas in early 2004 banks gained 0.6%a. of assets from the increase in the peso-dollar exchange rate, in the first part of 2005 these gains disappeared. As a result, thanks to the reduction in exposure to the dollar, the financial system avoided recording losses from the adjustment to the valuation of items denominated in foreign currency.

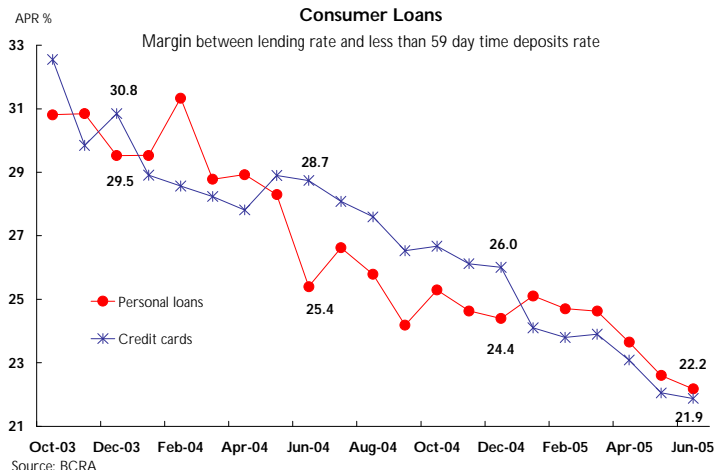
The financial system succeeded in moderating the pressures for an increase in the exposure to real interest rate mismatching. Banks ended June 2005 with a stock of CER-adjusted assets that was around \$34 billion higher than adjusted liabilities (see Chart IV.28). Driven by financial institution capital increases, the strength of the banking system in the face of CER mismatching remained at levels similar to those at the end of 2004. At the end of the first half of 2005, the financial system recorded a CER mismatching of close to 137% of net worth.

<sup>18</sup> See page 49 of FSB II-04, available at [www.bcra.gov.ar](http://www.bcra.gov.ar)





Chart IV.25  
Consumer Loans



As anticipated in **FSB I-05**, during the early months of 2005 it was difficult for banks to improve their CER mismatching. The lengthy term to maturity of public sector assets, the impact of the sovereign debt exchange (with an increase in CER-adjusted securities), and the accelerated settlement of installments under the matching mechanism all contributed to increasing exposure. Nevertheless, the taking of CER-adjusted deposits and the payment in cash of part of the compensation due to banks helped offset these effects.

At present, the impact of holding more assets than liabilities adjusted by CER has been beneficial for financial institutions. During the first six months of 2005 the positive evolution by the CER index (see Chart IV.29) compared with nominal interest rates, led to the accrual of profits for 1.6%a. of assets, close to 0.4 p.p. more than the amount recorded in the same period of 2004. Nevertheless, this asset position held by financial institutions means that they are exposed to an increase in real interest rates.

In accordance with the prudential regulations laid down by the Central Bank, financial institutions must comply with a capital requirement for interest rate risk (including the risk from the real interest rate). At June 2005, this capital requirement represented slightly over 13% of total capital requirement (including credit risk and market risk)<sup>19</sup>.

In the medium term, the financial system must focus its efforts on lowering the risk from the real interest rate. In view of the local macroeconomic and monetary context expected for the medium term, the Central Bank's policy for reducing the monetary impulse will increase the probability of a scenario with more stable price levels (see page 16), generating incentives for a reduction in such mismatching in the short term.

In turn, the Central Bank is promoting market solutions so that financial institutions can obtain hedging for their exposure to the dollar, CER, and real interest rates. In this regard, it has been noted that the market for dollar futures is becoming gradually deeper, although in the first half of the current year there has been no improvement on the second half of the previous year. In addition, at the end of 2004 CER futures and interest rate swap markets were set up. However, so far the amounts traded on these markets have not been significant.

In the next six months it is expected that financial institutions will continue to gradually reduce their exposure to currency risk and the risk from the real rate of interest. Continued payment of outstanding compensation, the lengthening maturity of deposits without adjusted by CER and the capitalization by banks will be the main drivers behind this process.

Lastly, it is expected that the adaptation of banks to the regulations restricting public sector lending to 40% of total assets (as from January 2006) will lead some banks to sell their portfolios of Government securities (most of which are in pesos plus CER or dollars), reducing their mismatching.

Chart IV.26  
Non-performance by Type of Financing

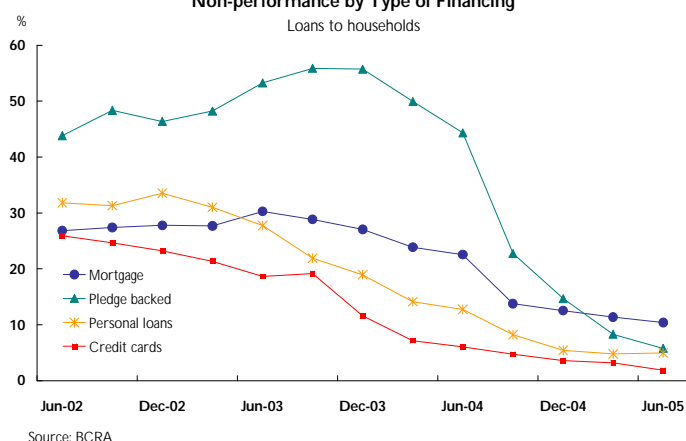


Chart IV.27  
Exposure to Foreign Currency Mismatch Risk

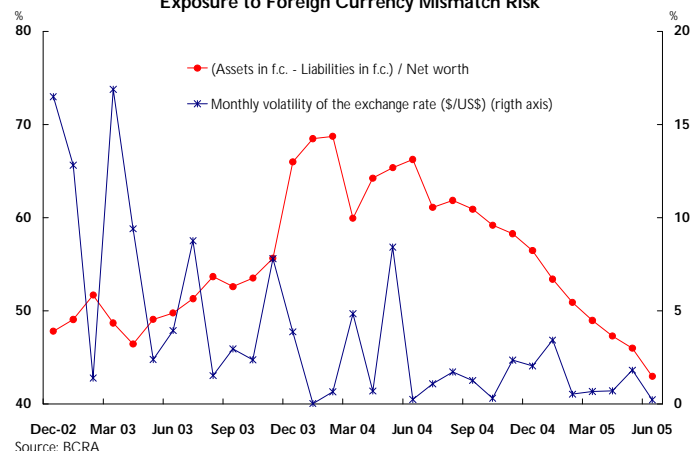


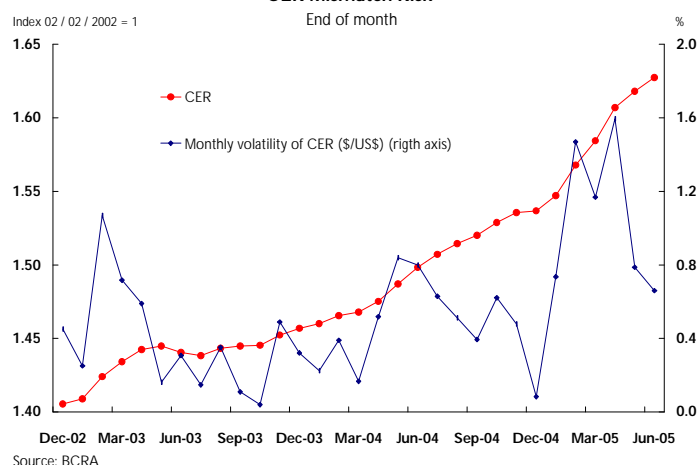
Chart IV.28  
Currency mismatch



<sup>19</sup> To soften the impact of the 2001-2002 crisis on capital requirements, current regulations have established ratios that gradually increase interest rate risk requirements (alfa2), reaching a ratio of one by early 2007.



Chart IV.29  
CER Mismatch Risk  
End of month



#### IV.4. Market risk

Bank exposure to market risk (measured according to the value at risk of the portfolio of assets marked to market) fell during the first part of 2005, although it remains at historically high levels (see Chart IV. 30). This change in level (compared with the previous decade) reflects the incorporation of the risk derived from exposure to the volatility of the dollar.

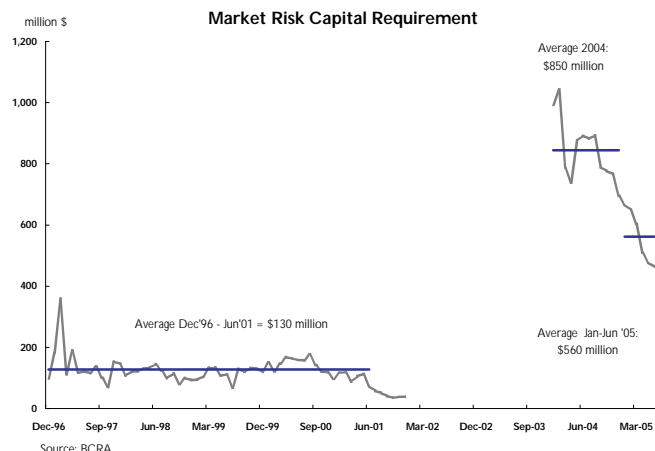
Current prudential regulations require minimum capital on the basis of the value at risk of the portfolio of listed securities (both domestic and foreign), including bonds, shares and foreign currency positions<sup>20</sup>. Calculation of the capital requirement is made on the basis of the positions of each institution in each of the listed assets, measured in terms of current prices. Of the total portfolio of public and private sector securities (close to \$60 billion at June 2005) a minimum of 65% corresponds to securities excluded from the market risk requirement<sup>21</sup>. The market risk requirement thus accounts for a marginal proportion of total capital requirement: close to 5% in mid- 2005.

In the case of financial assets with a regular listing in foreign currency, the risk of both positions is considered: the exposure to risk of changes in the price of the asset<sup>22</sup> and risk derived from the volatility of its currency. In view of this regulatory framework, and on the basis of the composition of the aggregate balance of the financial system, the value at risk of the position in foreign currency is currently one of the principal components of the market risk requirement, as well as being the principal determinant of the variations in that requirement (see Chart IV.31). The drop in the exposure of foreign currency assets in a context of reduced exchange rate volatility (see Chart IV.32) translated into a marked reduction in capital requirement for market risk (30% compared with the previous quarter).

This performance was linked mainly to three factors. On the one hand, the recent exchange of sovereign debt, which implied a reduction in foreign currency exposure (a large part of the transaction consisted of the exchange of bonds in foreign currency for bonds in local currency). Furthermore, in many cases the process of recapitalization of banks has taken place by means of the settlement of liabilities in dollars with their head offices. In addition, in the first half of 2005 certain banks sold significant quantities of foreign currency assets, in line with their strategy for reducing exposure to the public sector.

It is expected that this downward trend in exposure to market risk will persist in coming months, based on forecasts for a lower foreign currency position and a limited volatility in the exchange rate. This trend will also benefit from the policy for a steady reduction in exposure to the public sector and more stable prices in the bond markets.

Chart IV.30  
Market Risk Capital Requirement



Chapter IV.31  
Market Risk Capital Composition  
Financial system

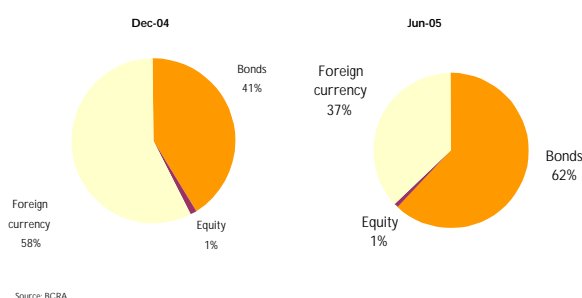
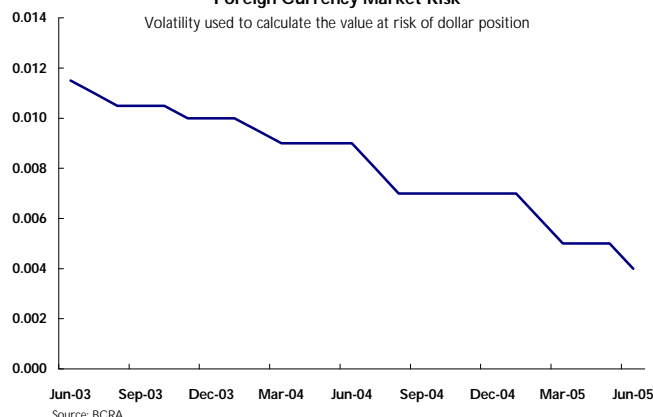


Chart IV.32  
Foreign Currency Market Risk



<sup>20</sup> For further information, see the Ordered Text on Minimum Capital for Financial Institutions, available at [www.bcr.gov.ar](http://www.bcr.gov.ar).

<sup>21</sup> These securities not considered for the market risk requirements have been included in the requirement for interest rate risk or credit risk.

<sup>22</sup> Volatilities published by the Central Bank for assets are calculated on the basis of their price in the currency of origin.





## V. SOLVENCY

### *Summary*

*The trend towards the construction of a more robust financial system gained a firmer foothold during the first half of 2005, based on higher profitability and a steady flow of capital contributions. Financial institutions as a group obtained profits over a six-month period for the first time since the domestic crisis in 2001-2002, strengthening the process of gradual recovery in profitability. A profit of close to \$430 million (0.4%a. of assets) was registered over the first half, a marked improvement compared to losses in previous six-month periods. The improvement is sustained even if amortizations of court-ordered releases and adjustments to the valuation of public-sector assets are not computed, producing an adjusted result that is closer to current profits. This result came to approximately \$1.6 billion, or 1.5%a. of assets, almost double that obtained in the two previous six-month periods.*

*The improvement was driven by the financial margin: an increase in net interest income and CER-adjustments more than offset some declines in the gains from securities and foreign exchange price adjustments headings. These developments were linked to the healthy and steady expansion in credit to the private sector and a policy to reduce exposure to the public sector, factors that are expected to stay in place during the second half of 2005. The strengthening of financial intermediation in an environment of lower credit risk also produced a decline in loan loss provisions. With an increasing financial margin and growth in service income, the coverage of costs with revenues gained strength, helping efficiency indicators reach pre-crisis levels.*

*This gradual improvement in earnings and the carrying out of several capital contributions have led to a sustained improvement in the financial system's solvency. Financial institutions received capitalizations for over \$1 billion during the first half, causing net worth to increase by 6.2% and leverage ratios to decline. Capital compliance increased to 14.2% of risk-weighted assets, broadly exceeding local requirements.*

*Over coming months, the favorable outlook for financial activity suggests encouraging forecasts for profitability and new capital contributions (with almost \$500 million already committed). The strength of the financial sector is therefore expected to continue to increase, helping to reinforce an environment of financial stability.*



### V.1. Profitability

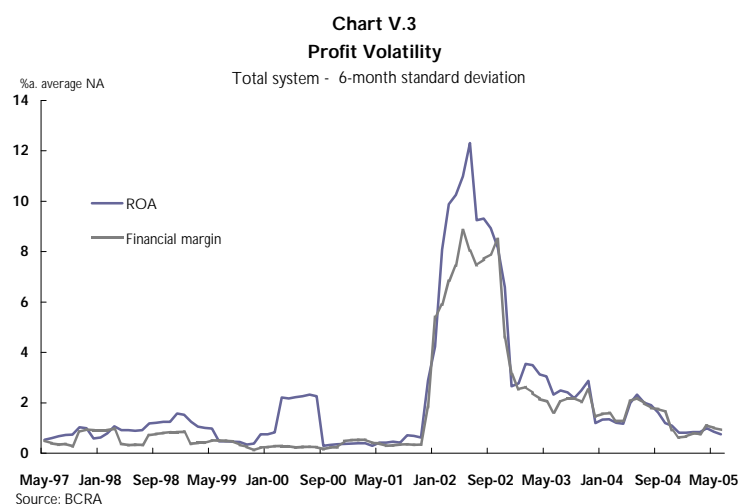
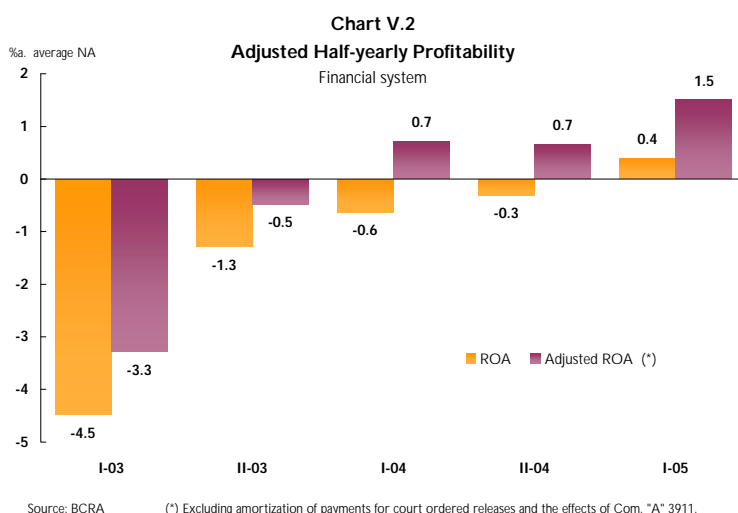
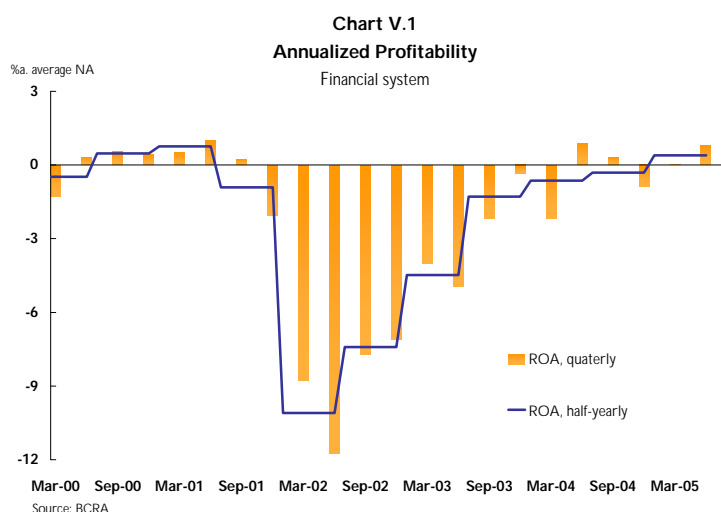
During the first half of 2005 –and for the first time since the 2001-2002 crisis– the financial system obtained net profits over a six-month period, a result that confirms that a pattern of gradually recovering profitability is underway (see Chart V.1). The ongoing recapitalization process, the fact that the context of generalized losses is being left behind and the positive outlook in terms of profitability allow the financial system to gain in terms of solvency, making it more resilient to potentially negative shocks.

An accounting profit of close to \$430 million – 0.4% of assets in annualized terms (a.) – was registered during the first half of the year. This implies a significant improvement compared to the losses registered in the previous six-month periods (-0.6% a. and -0.3% a. of assets during the first and second half of 2004)<sup>23</sup>. Removing the effect of court ordered releases and adjustments to the valuation of public sector assets (which are linked to the gradual acknowledgement of the effect of the past crisis) obtains a profit of almost \$1.6 billion (1.5% a.) is obtained for the first half of 2005. This adjusted profitability –a more representative measure of the banking business current profitability– also improved substantially: during the first half of 2005 it was more than double that calculated for the two previous six-month periods (see Chart V.2).

Despite the improvement in achieved levels, the volatility of profitability is still above the minimum values recorded before the crisis (see Chart V.3). This is to a large extent due to the persistence of certain mismatches (in foreign currency and in CER-adjusted securities). Volatility also arose from some adjustments of a non-recurring nature, including the following: adjustments to the valuation of assets delivered as collateral for liabilities with the Central Bank, accounting of accumulated (and unaccrued) CER-adjustment and the accounting effect of substantial sales of public sector assets. In perspective, these adjustments are part of a return to normal conditions in banking activity. As balance sheets are gradually rid of the effects of the past crisis, and as mismatches continue to decline, accounting results are expected to become increasingly stable.

The financial margin drove profits during the first half (see Table V.1). As financial intermediation gained momentum, both interest accrual and CER-adjustments increased. This was only partly offset by a decline in gains from securities and from foreign exchange valuation adjustments. An upward trend in service income margin also helped boost revenues. On the other hand, the cost structure contracted: a cutback in loan-loss provisions offset a slight increase in operating costs and income tax accrual.

Banks made progress in rebuilding their financial margin, which increased by almost one percentage point over the first half (see Chart V.4). This picks up the effect of increases in the two components that currently represent the core of financial margin: net interest income and restatement by CER. Net interest income remained on an upward trend, increasing by 0.3 p.p. to 1.3% a. of



<sup>23</sup> Based on the latest information available. Figures may differ from those reported in previous editions of the FSB due to balance-sheet corrections made by banks.



Table V.1  
Profitability Structure - Total System  
In annualized terms - As % of average netted assets

	2002	2003	2004	I-04	II-04	I-05
Financial margin	6.5	1.1	3.1	3.3	3.0	3.9
Net interest income	-1.7	-0.5	0.9	0.8	1.0	1.3
Restatement by CER and CVS	3.9	1.3	1.0	1.2	0.8	1.6
Gains on securities	1.7	1.1	1.0	0.9	1.1	0.9
Foreign exchange price adjustments	2.7	-0.5	0.4	0.6	0.3	0.0
Other financial income	-0.1	-0.3	-0.2	-0.2	-0.2	0.1
Service income margin	1.9	1.9	2.0	2.0	2.1	2.2
Operating costs	-4.4	-4.2	-4.1	-4.1	-4.2	-4.3
Loans loss provisions	-4.7	-1.1	-0.8	-0.7	-0.9	-0.6
Adjustments to the valuation of government securities (*)	0.0	-0.4	-0.2	-0.3	-0.1	-0.2
Tax charges	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Amortization payments for court-ordered releases	0.0	-0.6	-0.9	-0.9	-0.9	-1.0
Other	-1.8	0.9	0.8	0.6	0.9	0.9
Monetary results	-5.8	0.0	0.0	0.0	0.0	0.0
Income tax	-0.2	-0.2	-0.1	-0.3	0.0	-0.2
<b>ROA</b>	<b>-8.9</b>	<b>-2.9</b>	<b>-0.5</b>	<b>-0.6</b>	<b>-0.3</b>	<b>0.4</b>
<b>ROE</b>	<b>-59.2</b>	<b>-22.7</b>	<b>-4.2</b>	<b>-5.6</b>	<b>-2.8</b>	<b>3.5</b>
<b>Adjusted ROA(**)</b>	<b>-8.9</b>	<b>-1.9</b>	<b>0.7</b>	<b>0.7</b>	<b>0.7</b>	<b>1.5</b>

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

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

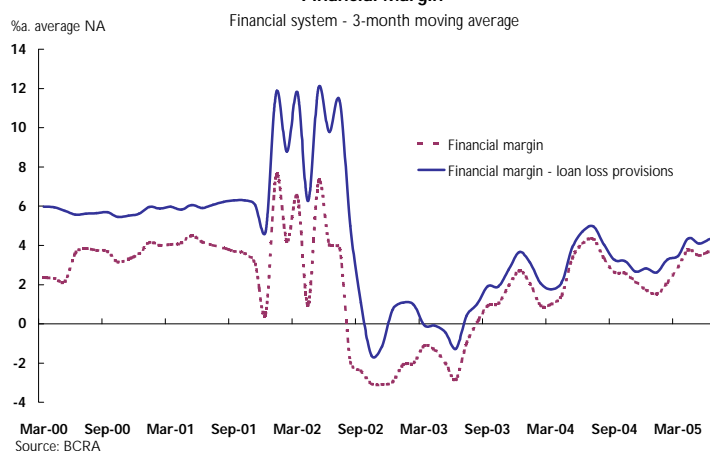
Source: BCRA

assets, as accrued interest on loans increased further than interest paid on deposits (see Chart V.5) due to the larger volume of intermediation. While changes in interest rates were not uniform over different credit lines, there was a marked increase in the amounts granted in the relatively higher-yield lines (such as overdrafts, promissory note acceptances and personal loans). Given the steady improvement in loan portfolio quality, this led to an increase in interest income that more than offset the increase in payments made on deposits –where both interest rates and balances have been on the rise, although with a substantial share of the latter made up by sight deposits-. Interest payments on liabilities with the Central Bank also declined, as a result of advanced payments and prepayments of the installments arising from the so called *matching* framework (see Box 1).

The accrual of CER adjustments almost doubled during the first half (see Chart V.6). This was mostly explained by the performance of the index itself, which increased by 5.9% over the period, following an increase of 2.6% during the second half of 2004. The greater level of accrual is also due to the persistence of balance sheet corrections of a non-recurring nature –i.e. recognition of non accrued CER adjustment-. Lastly, advanced payments and the prepayment of installments from the matching framework contributed by reducing adjustments due, which was partly offset by increases in adjusted time deposits. CER accrual is expected to decline in the future, under the most likely scenario that changes to the price level will diminish and non-recurring adjustments will involve declining amounts.

The greater accrual of interest and CER adjustment, in addition to an increase in “other financial results”<sup>24</sup>, made up for the contraction arising from the gains from securities and foreign exchange price adjustments headings. Gains from securities declined from 1.1%a. to 0.9%a., as certain banks divested themselves of part of their bond portfolios. As the gap between the market value of Government securities and their accounting value narrowed (helped by recovering prices in fixed-income securities), there were greater incentives for banks to take action in reducing their exposure to the public sector, following current regulatory constraints. Two previously unavailable factors enabled banks to sell-off securities: the acceptance of securities for compensation receivable, and the program for advances on installments of debt with the Central Bank, which implied the release of assets that had previously been placed as collateral.

Chart V.4  
Financial Margin



<sup>24</sup> This heading increased by 0.3 p.p. over the first half, mostly due to a decline in provisions after a large bank sold a substantial amount of guaranteed loans during the second half of 2004, with the aim of purchasing US dollar securities to refund excess compensation it had previously received.



### BOX 3: THE CENTRAL BANK AND ITS ROLE IN CONSUMER PROTECTION

Debate has gained ground in recent years over the role of central banks in fostering the development of institutions aimed at protecting consumers of financial services. One of the pillars of this type of regulation is extending the quantity and quality of information available to the consumer, with the aim of providing the best possible conditions for decision-making. Facilitating comparisons across institutions not only protects the consumer's interest over the short-run, but also strongly encourages the overall efficiency of the financial market by promoting greater competition over the medium term.

In line with developments at the international level, and particularly driven by the need to help rebuild bank-client relationships that were damaged following the 2001-2002 crisis, an interest appeared at the domestic level to promote consumer protection for users of financial services, and both the Central Banks and the banking sector have been working towards this objective. In particular, financial institutions have composed a "Código de Buenas Prácticas" (Code of Good Practices), in effect as from September 2005. The code urges banks to deal with clients transparently and attentively, stressing the importance of communicating information in an appropriate and timely manner. The Central Bank believes that this proposal is a step forward in terms of improving the institutions that protect users of financial services. However, the Central Bank considers that the code needs to be developed further, as it must be open to best practices and the demands of financial service users.

The Central Bank had already started to encourage consumer protection, launching the so-called "Régimen Informativo de Transparencia" (Information Transparency Regime - ITR) jointly with the "Subsecretaría de Defensa de la Competencia y Defensa del Consumidor" (Anti-trust and Consumer Protection Office) during the second half of 2004. The service provides bank clients with qualitative and quantitative information by financial institution (available from the Central Bank's website at [www.bcra.gov.ar](http://www.bcra.gov.ar)), facilitating the comparison of maintenance and usage costs for the main products and services offered by banks, such as: credit cards, savings accounts, electronic transfers and mortgage and personal loans. The ITR provides easy access to information of different financial products and services, pooling together a broad range of relevant, up to date and comparable information for each product, making available alternatives known and encouraging market discipline.

Additionally, in mid-2005 the Central Bank made a firm commitment in consumer protection by creating an internal body called the "Comité de Transparencia" (Transparency Committee), which is composed of Central Bank officials and technical staff. The Committee's aim is to safeguard transparency in the information supplied by banks to clients, encouraging the elimination of the information asymmetries that are typical in the commercial relationships between the financial system and its clients.

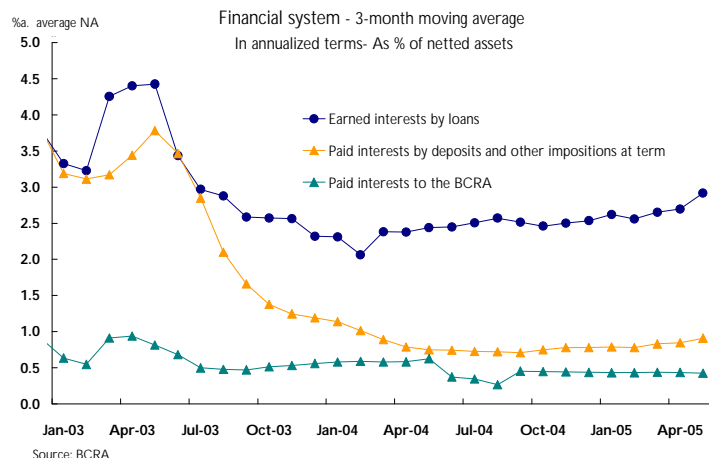
Among the main responsibilities assigned to the (Transparency Committee), some of the most important include making information on the goods and services offered by financial institutions available to the public in general, the setting up of procedures to deal with queries and complaints from bank users in an appropriate and timely manner and the drive to educate clients in terms of encouraging a responsible culture in the use of financial products and services. In line with its role in supervising financial institutions, the Central Bank (through its Transparency Committee) will also monitor institutions' compliance with the regulations and policies set forth in this regard. Additionally, the Committee is mandated to encourage the adoption of new financial products and services, encouraging the spread of information regarding the use and costs of these new products. This is part of the Central Bank's effort to improve relations between banks and their clients. Hopefully, the summed efforts of the Central Bank, the ITR and the Transparency Committee will help to increase the use of bank services in the economy, by means of an increase in competition and in the efficiency of the financial system.

In the short and medium term, the Central Bank will continue to work to improve the mechanisms that must protect consumers of financial services, driving the increase in bank service use, efficiency and competition, which are key elements in strengthening the conditions that lead to financial stability. The Central Bank is currently assessing the possibility of broadening the set of products and services covered by the ITR, as well as improving the quality of the database in general.



Chart V.5

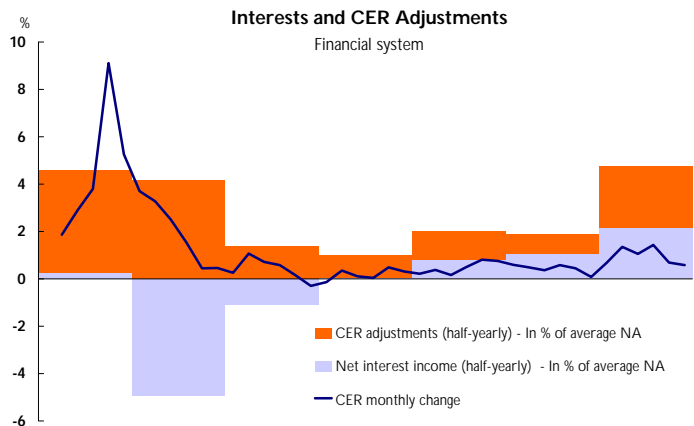
**Main Lines of Net Interest Income**  
Financial system - 3-month moving average  
In annualized terms - As % of netted assets



Source: BCRA

Chart V.6

**Interests and CER Adjustments**  
Financial system

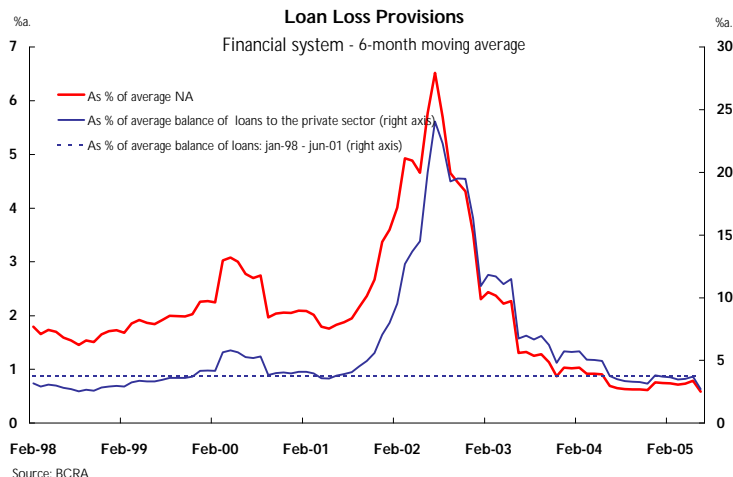


Source: BCRA

Chart V.7

**Loan Loss Provisions**

Financial system - 6-month moving average



Source: BCRA

Regarding foreign exchange price adjustments, the combined effect of the revaluation of assets and liabilities in foreign currency (due to the path followed by the exchange rate) and results from trading in foreign currency were almost zero in terms of assets over the first half.

Favorable macroeconomic conditions reinforced the downward trend in loan loss provisions. These provisions accounted for 0.6% a. of assets during the first half, 0.3 p.p. below the level recorded during the previous half and 0.1 p.p. below the year-earlier period (see Chart V.7). Loan losses amounted to 2.7% a. of the balance of loans to the private sector during the first half of 2005, 1.1 p.p. less than in the year-earlier period and already in line with average values before the crisis. Delinquency is expected to remain relatively low by historical standards, as a result of sustained improvement in portfolio quality and an environment of declining credit risk (see page 46). Provisions may increase to some extent towards the second half of the year, however, as part of adjustments usually made while closing the fiscal year<sup>25</sup>.

Service income increased by about the same rate as in previous six-month periods, up 0.1 p.p.. Although private banks had previously provided most of the momentum in service income, its growth during the first half of 2005 was driven to a large extent by public banks (see Chart V.8). Analysis of these figures should also take into account that the heading was positively affected during the first half by commissions accrued by banks for acting on behalf of clients in the sovereign debt swap, as well as from keeping the newly issued bonds in custody. A greater volume of capital market activity is expected to follow the end of the swap, leading to greater sales of investment banking services that may allow to prop up the growth already in place in terms of transactional banking.

Put in perspective, the upward trend in service income stems from a generalized growth in the different components included under this heading (see Chart V.9), given the efforts made by banks to bolster their income base in an environment in which traditional intermediation activity is still recovering. Charges on liabilities (basically from sight deposit accounts) are still the main source of commissions. These are highly relevant to bank's profitability structures, not only because they provide a steady source of income but also as they are linked to other activities that allow banks to strengthen other sources of income. Managing deposit accounts allows banks to obtain better information on the repayment capacity of potential credit recipients, allowing a greater access to credit and/or the offering of more attractive interest rates. An example of this is the current increase in overdrafts. Something similar occurs with the increase in personal loans, as in many cases these imply sales made to people whose wages are deposited in accounts with the same bank.

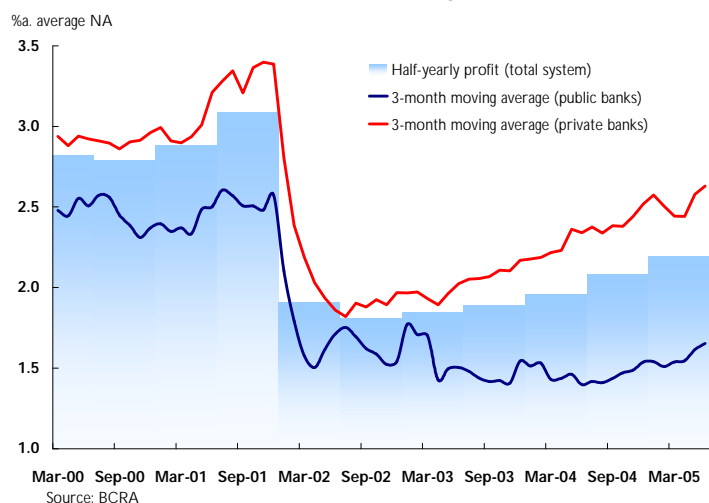
Growth in the activity of the financial system has also affected the level of expenditures. In fact, as structures are showing signs of expansion—several institutions are reassessing their regional coverage and the staff required for growth in their businesses—

<sup>25</sup> Although remarkable changes to provisions are made at the close of every quarterly balance sheet, they tend to be more pronounced during the last quarter of the year, which is when most institutions close the fiscal year.





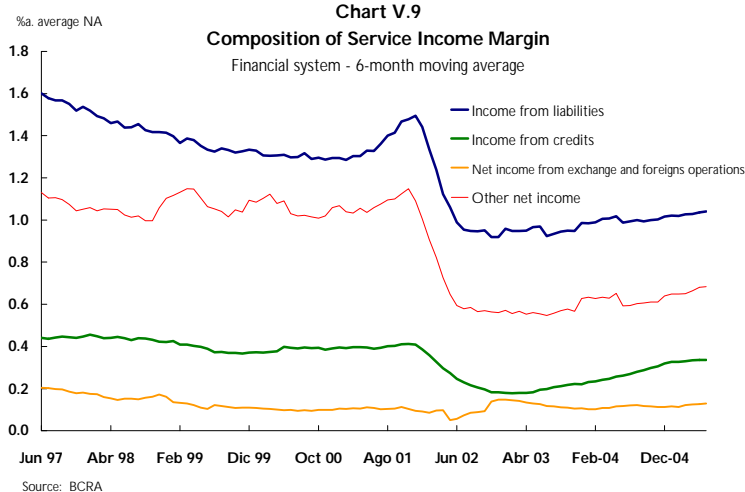
Chart V.8  
Service Income Margin



and wages are gradually gaining lost ground, operating costs have been on a slight upward trend<sup>26</sup>. These costs increased by 0.1 p.p. during the first half of 2005, similar to the rate of growth over the previous six months, to a level of 4.3%a. of financial system assets.

Since income is also on the rise, the increase in costs did not imply a loss in efficiency. The ratio of operating costs covered by income<sup>27</sup> stood at 142% during the first half of 2005, whereas during the previous two six-month periods it had remained at about 125%. Although the ratio is almost at its average value before the crisis (see Chart V.10), it is expected to remain on the rise, allowing the sector to eventually reach the levels that were common in the years before the crisis (about 150%). Additionally, as mismatches in the financial system continue to decline it is expected that the ratio will behave with less volatility than in the present.

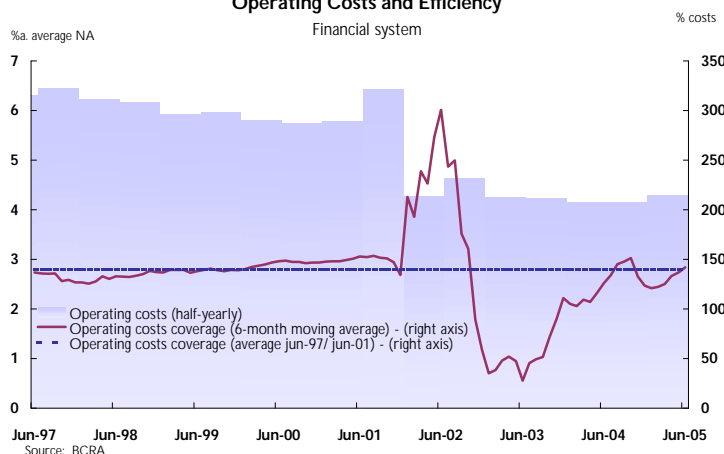
Chart V.9  
Composition of Service Income Margin  
Financial system - 6-month moving average



In accordance with regulations currently in place, the financial system continues to gradually accrue the remaining costs of the 2001-2002 crisis. Adjustments to the valuation of public sector assets increased slightly over the first half. As a result, the valuation of the Government security portfolio is gradually approaching market values (see page 43). Amortization payments for court-ordered releases increased by 0.1 p.p. to 1%a. of assets. The effect of amortization of court-ordered releases is particularly concentrate in larger institutions (private retail banks with a national coverage and, to a lesser extent, public banks).

Public banks still accounted for most of the profits in the financial system, accruing profits of \$350 million, or 0.9%a. of assets, during the first half. This increases to 2%a. if amortization of court-ordered releases and adjustments to valuation of public sector assets are not computed. ROA for public banks was sustained thanks to growth in accrual of CER-adjustment (public banks' long position in CER-adjusted instruments is the largest of any bank subgroup). Adding the effects of a larger volume of intermediation in a context of lower loan loss provisions, this helped offset losses from foreign exchange price adjustments, a cutback in gains from securities, and an increase both in amortizations of court-ordered payments and income tax.

Chart V.10  
Operating Costs and Efficiency  
Financial system



The main highlight during the first half of 2005 was the improved performance by private banks, as they obtained positive profits over a six-month period for the first time since the end of the crisis (see Table V.2) – a total \$60 million (0.1%a.), or \$730 million (1.2%a) excluding court-ordered releases and valuation adjustments. Progress in this case was also led by an improvement in the financial margin thanks to an increase in net interest income and CER-adjustments, added to a cut-back in loan loss provisions as the quality of this bank group's portfolio improved consistently. However, there is a degree of disparity in the performance of the different subgroups of private banks (see Table V.3). The group with the largest

<sup>26</sup> It should be taken into account that part of the increase over the first half was originated in adjustments of a non-recurring nature: several banks made substantial payments linked to the dismissal of staff in senior positions. This effect could also be linked to changes in the structure of the system, as transfers between institutions take place.

<sup>27</sup> Financial margin and service income margin.



**Table V.2**  
**Profitability Structure: Private Banks**  
In annualized terms - As % of average netted assets

	2002	2003	2004	I-04	II-04	I-05
Financial margin	7.6	2.3	2.9	3.4	2.5	3.6
Net interest income	-0.2	0.1	1.0	0.9	1.2	1.4
Restatement by CER and CVS	1.1	0.9	0.8	1.0	0.6	1.1
Gains on securities	2.5	1.7	0.8	0.8	0.8	0.7
Foreign exchange price adjustments	4.4	-0.3	0.6	0.9	0.2	0.2
Other financial income	-0.1	-0.2	-0.3	-0.3	-0.3	0.1
Service income margin	2.0	2.0	2.4	2.3	2.5	2.5
Operating costs	-4.8	-4.6	-4.6	-4.5	-4.7	-4.8
Loans loss provisions	-5.0	-1.3	-0.9	-0.9	-0.9	-0.6
Adjustments to the valuation of government securities (*)	-	-0.6	0.0	-0.1	0.1	-0.1
Tax charges	-0.4	-0.3	-0.3	-0.3	-0.3	-0.4
Amortization payments for court-ordered releases	-	-0.7	-1.0	-0.9	-1.0	-1.0
Other	-3.0	1.0	0.7	0.7	0.8	0.9
Monetary results	-7.5	0.0	0.0	0.0	0.0	0.0
Income tax	-0.2	-0.3	-0.2	-0.4	0.1	-0.1
<b>ROA</b>	<b>-11.3</b>	<b>-2.5</b>	<b>-1.0</b>	<b>-0.9</b>	<b>-1.1</b>	<b>0.1</b>
<b>ROE</b>	<b>-79.0</b>	<b>-19.1</b>	<b>-8.1</b>	<b>-7.1</b>	<b>-9.2</b>	<b>0.7</b>
<b>Adjusted ROA(**)</b>	<b>-11.3</b>	<b>-1.2</b>	<b>0.2</b>	<b>0.6</b>	<b>-0.1</b>	<b>1.2</b>

(\*) 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

weighting (private retail banks with a nationwide coverage) managed to curtail losses (-0.5% a. of assets) to a third of those in the previous six-month period. This is the group for which the amortization of court-ordered releases implies the heaviest relative burden (1.2% of assets). Private retail banks with a regional coverage continued to perform outstandingly well, with ROA at 2.3% a.. Enhanced balance sheets (declining exposure to the public sector, higher quality of private sector loan portfolios, lower effect from amortizations of court-ordered payments) allow these banks to generate income more effectively.

In view of the pattern of recovery seen in the financial system's results so far, and given the current conditions of greater stability in economic variables, the outlook for profitability remains positive. The financial margin is expected to continue gaining in strength, in hand with the sustained expansion in lending to the private sector and the persistent improvement in the quality of this portfolio (there has been progress in restructuring corporate liabilities and to settle overdue debts). Additionally, with the country putting the restructuring of sovereign debt behind, the deepening of capital markets becomes possible and the trend towards a recovery in prices on fixed-income markets together with an increase in security trading should produce an improvement in gains from securities<sup>28</sup>.

A gradual improvement in the return on banks' asset portfolios (as more funds are allocated to private sector lending), and a continuous recovery in transactional activity (producing higher service income) are expected to stimulate an expansion in the income base. This will put banks in a better position to face potential increases in their funding costs, or an upward trend in their operating costs. A stable macroeconomic environment should help keep loan loss provisions at relatively low levels, despite possible once-only corrections or seasonal patterns.

**Table V.3**  
**Profitability Structure by Type of Bank - First Half 2005**  
In annualized terms - As % of average netted assets

	Public	Private				
		Retail				Wholesale
		Total	National coverage	Regional coverage	Specialized	
Financial margin	4.1	3.6	2.8	5.4	16.9	6.1
Net interest income	0.8	1.4	1.1	2.0	15.0	1.7
Restatement by CER and CVS	2.2	1.1	1.2	1.3	-0.7	0.2
Gains on securities	1.2	0.7	0.3	1.8	2.3	3.1
Foreign exchange price adjustments	-0.2	0.2	0.2	0.2	0.3	1.0
Other financial income	0.1	0.1	0.1	0.1	0.0	0.2
Service income margin	1.6	2.5	2.5	2.9	2.6	1.7
Operating costs	-3.3	-4.8	-4.2	-5.6	-17.1	-7.6
Loans loss provisions	-0.5	-0.6	-0.5	-0.6	-3.2	-0.9
Adjustments to the valuation of government securities (*)	-0.2	-0.1	-0.2	0.0	0.0	-0.1
Tax charges	-0.2	-0.4	-0.3	-0.4	-0.9	-0.4
Amortization payments for court-ordered releases	-0.9	-1.0	-1.2	-0.4	-0.4	-0.1
Other	0.8	0.9	0.6	1.8	4.0	0.5
Monetary results	0.0	0.0	0.0	0.0	0.0	0.0
Income tax	-0.4	-0.1	0.0	-0.5	-0.9	-0.5
<b>ROA</b>	<b>0.9</b>	<b>0.1</b>	<b>-0.5</b>	<b>2.3</b>	<b>1.0</b>	<b>-1.1</b>
ROE	8.3	0.7	-4.4	15.9	3.1	-3.7
<b>Adjusted ROA (**)</b>	<b>2.0</b>	<b>1.2</b>	<b>0.9</b>	<b>2.8</b>	<b>1.4</b>	<b>-0.9</b>
Weight in total assets (%)	39.1	60.1	44.5	12.4	0.6	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

## V.2. Capital position

The improvement in financial system solvency during the first half of 2005 derives both from the substantial recovery in profitability and from capital contributions carried out and committed to by financial institutions. During the first half of the year, in a macroeconomic context that remains encouraging for domestic financial activity, the financial system received capital contributions of close to \$1 billion (see Chart V.11). As in previous periods, the most important mechanism in carrying out capitalizations was the use of debt-to-equity swaps with parent companies. However, there were a number of smaller contributions through cash injections, as well as a contribution from SEDESA to a bank under restructuring. Capital contributions received by banks between 2002 and June 2005 add up to about \$11.3 billion, more than half the initial net worth. Over the next few months, given the commitments adopted by a set of institutions with the Central Bank, there should be further capital contributions of about \$500 million.

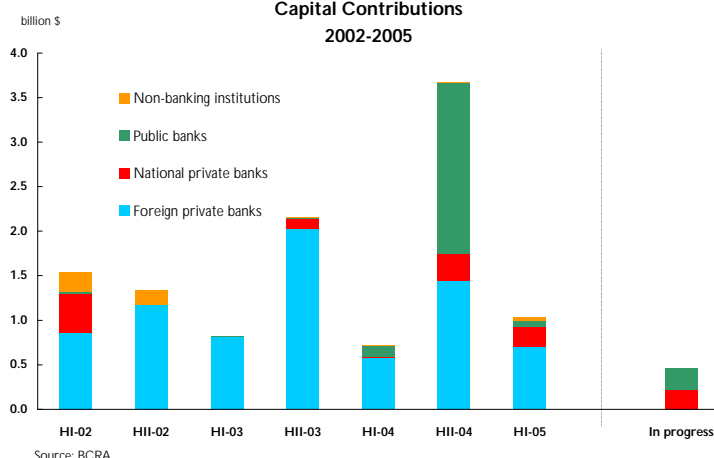
Foreign-controlled banks accounted for almost three fourths of capitalizations over the first half of 2005. Additionally, several

<sup>28</sup> It is worth noting that certain institutions could be driven to make substantial new sales in order to satisfy limits to the exposure to public sector assets in effect as from 2006 (40% of total assets) potentially causing once-only losses.





Chart V.11  
Capital Contributions  
2002-2005



domestic private institutions received capital contributions from their shareholders, while different sub-national Governments capitalized their respective banks<sup>29</sup>. Some of these capital contributions were made in the context of financial institution strategies to reduce exposure to the public sector, thereby improving their business profile in a way that is fully compatible with the regulatory incentives put in place by the Central Bank (see page 42). In these cases, the capital injections offset the negative effect of acknowledging the market valuation of public debt securities.

Capital contributions and the recovery of profits caused the increase of the net worth of the financial system by 6.2% over the first half of 2005. In line with this behavior, the leverage ratio<sup>30</sup> for the financial system aggregate declined from 9.1 units to 8.6 between December 2004 and June 2005 (see Chart V.12). Despite this trend, the main market indicators for the financial system were to some extent volatile over the past six months, in line with the overall performance of the stock market (see Chart V.13). The trend was affected by institution-specific factors (although a large set of financial institutions posted earnings), while at the global level most resources were allocated to the Government securities issued following the sovereign debt restructuring.

During the first half of 2005, the financial system continued to obtain improvements in terms of compliance with the Central Bank's prudential minimum capital regulations<sup>31</sup>. As of June 2005, financial institutions attained a level of capital compliance of 14.2% of risk-weighted assets (0.1 p.p. above the value for the previous semester), broadly surpassing the requirement for credit risk (a minimum of 8%). A breakdown of financial institutions into uniform subgroups shows all of them above the required minimum, particularly wholesale and specialized banks (see Table V.4).

Regarding the regulatory framework, the Central Bank modified the basic capital requirements for financial institutions in June 2005<sup>32</sup>, setting up criteria according to geographical regions. The aim is to ease the incorporation of new institutions to the financial system, particularly in areas with lower bank coverage. The regions were set up according to competition and financial service coverage indicators for the different areas of the country, reducing basic capital requirements in the areas where these indicators were lower.

Analysis of the aggregate surplus capital position in terms of regulated minimum capital requirements (excess compliance as a fraction of the total regulatory capital requirement) must take into account a collection of factors at play. As part of the general strategy with which the Central Bank dealt with the crisis in 2001-2002, it set up certain changes to valuation and prudential regulations, setting up certain forbearances and gradual adjustments. In particular, financial institutions must meet a schedule of gradual adjustments to requirements for public sector credit and interest rate risk. Expected growth in lending to

Chart V.12  
Consolidated Financial System Leverage

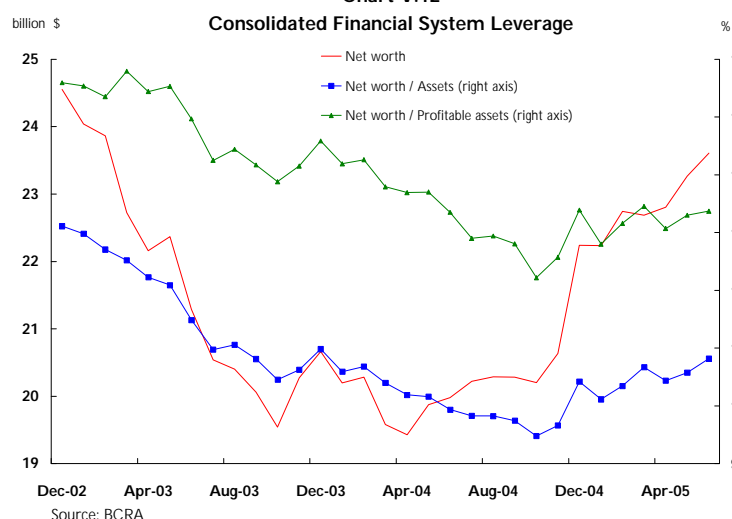
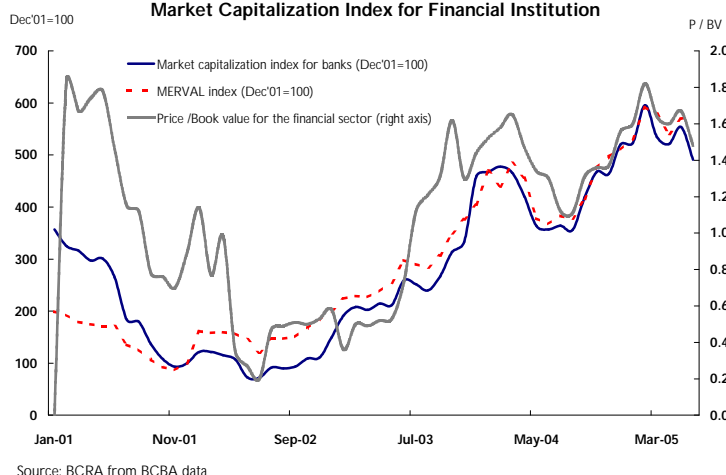


Chart V.13  
Market Capitalization Index for Financial Institution



<sup>29</sup> In some cases, within the framework of programs setting up contributions in installments.

<sup>30</sup> Defined here as the ratio between netted assets and net worth.

<sup>31</sup> For further detail, see **FSB I-04**.

<sup>32</sup> Com. "A" 4368.



**Table V.4**  
**Minimum Capital by Group of Banks**  
 June 2005 - In %

Group of banks	Surplus capital / Capital requirements(*)	Capital / Assets at risk (**)
<b>Public banks</b>	<b>190</b>	<b>10</b>
<b>Private banks</b>	<b>148</b>	<b>16</b>
National coverage	140	14
Regional coverage	168	21
Specialized	110	34
Wholesale	192	39
<b>Non-bank institutions</b>	<b>141</b>	<b>47</b>
<b>Total</b>	<b>157</b>	<b>14</b>

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

(\*\*) Assets weighted by credit risk.

Source: BCRA

the private sector, given the encouraging outlook for new business, drives banks to increase their capital levels to fulfill Central Bank requirements. It should also be taken into account that the crisis produced balance sheet mismatches, linking bank results to the volatility of certain macroeconomic variables. This causes banks to hold a cushion of additional capital for precautionary reasons.

From a general point of view, the solvency of the domestic financial system is expected to continue gaining in strength in 2005-2006, within a framework of sensible macroeconomic policies. Although the capitalization process is expected to continue over time, it is also expected that further expansions in banking solvency levels will be to a great extent determined endogenously – that is, based on the sector's capacity to ensure that financial intermediation results remain on a positive trend over the medium term.



## VI. PAYMENTS SYSTEM

### *Summary*

*The design and monitoring of the payment system are of particular relevance to economic and financial stability, because they affect crucial dimensions like the efficiency achieved in carrying out day to day transactions, the availability of liquidity and its mobility, and the effective application of monetary policy.*

*As occurs in other emerging economies, for Argentina the use of bank or electronic money (debit and credit cards, transfers, direct debits) is becoming increasingly intensive, together with a growing level of bank usage. However, the more traditional means of payment (such as cash and, to a lesser extent, checks) maintain their dominant position, unlike what is observed in developed economies.*

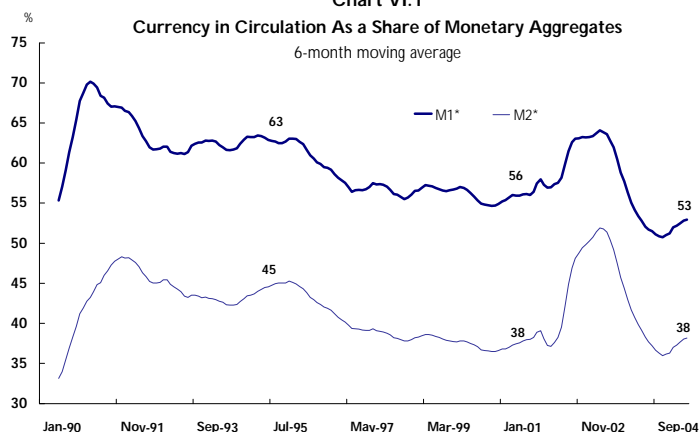
*Consistent with the expansion of economic activity and of the financial system, the large value payment systems also show an increasing level of activity. The volume transacted through the Electronic Means of Payment (MEP) grew 11% in real terms during the first part of 2005.*

*In the framework of the adoption of the Means of Payment Clearance Model, that was initiated in Argentina in 1997, finally in mid 2005 a significant advance was carried out: the full operation of Uniform Federal Clearing (CFU). Employing the method known as truncation, clearance of documents of less than \$5,000 was extended throughout all the national territory. In 2006 this amount is expected to be increased in order to include practically all checks. This brings with it an important collection of benefits, of which the following stand out: a more efficient payments system for individuals and firms, lower operating costs for the financial system and a reduction of the operational risks associated with clearing activity.*



Chart VI.1

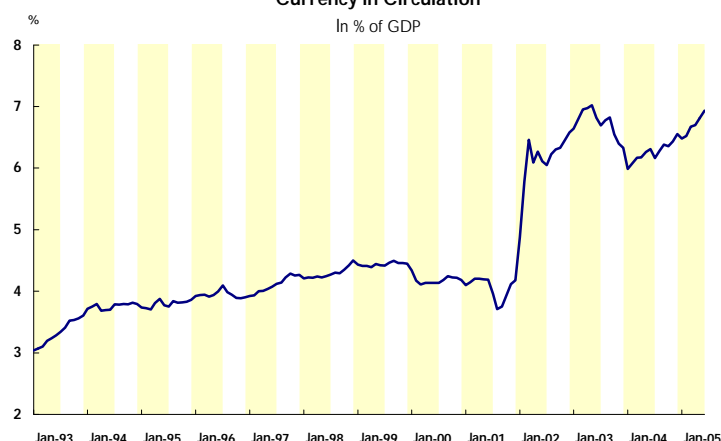
Currency in Circulation As a Share of Monetary Aggregates  
6-month moving average



Source: BCRA

Chart VI.2

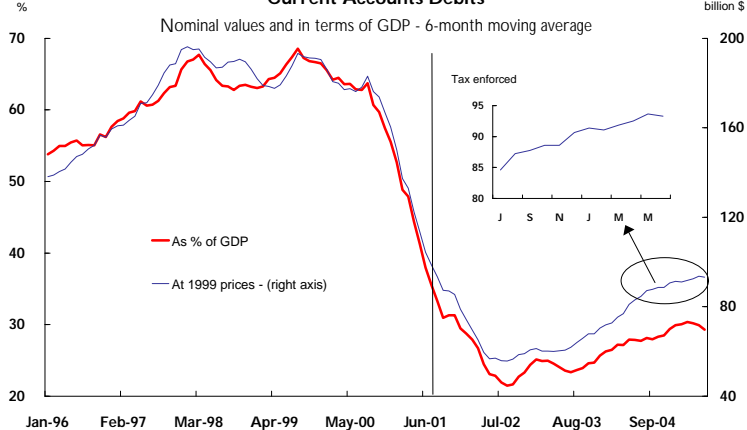
Currency in Circulation  
In % of GDP



Source: BCRA

Chart VI.3

Current Accounts Debits



Source: BCRA

## VI.1. Introduction

The design and monitoring of the payment system of an economy is of vital importance to central banks. On one hand, in so far as the customary trade in goods and services requires instruments of payment, the payment system has a direct impact on the development of different economic activities, and affects the degree of efficiency that they attain. Also, the systems of payment are relevant in terms of the management of the liquidity of markets and, in this sense, for the effectiveness of monetary policy. In addition, by interconnecting the different financial markets, the payment system is a keystone in terms of the soundness and the stability of the aggregate financial system.

In order for the payments system to inspire confidence among economic agents, and thus allow for progress in the development and deepening of financial markets, central banks regulate and monitor liquidity, credit and operational risks inherent to their everyday activity. In recent years these payment system risks have been the focus of a growing interest by the makers of monetary and financial policy. Changes in technology and the financial innovation process, with effects on the instruments available and the volumes of transactions, explain a large share of the relevance of these risks. In addition, disturbances of a previously unknown character (like the Y2K problem, or the impact of terrorist attacks) have forced the reassessment of the role of uncertainty, with an impact on the design of contingency plans.

As regards the domestic National Payments System (NPS), the implementation of the so called Means of Payment Clearance Model began in 1997. After the recent crisis, efforts have been made to advance towards the implementation of the pending phases to attain a fully functioning Uniform Federal Clearance (UFC). This scheme finally started to operate at the end of July 2005, allowing all financial institutions to clear documents electronically, in a simultaneous fashion.

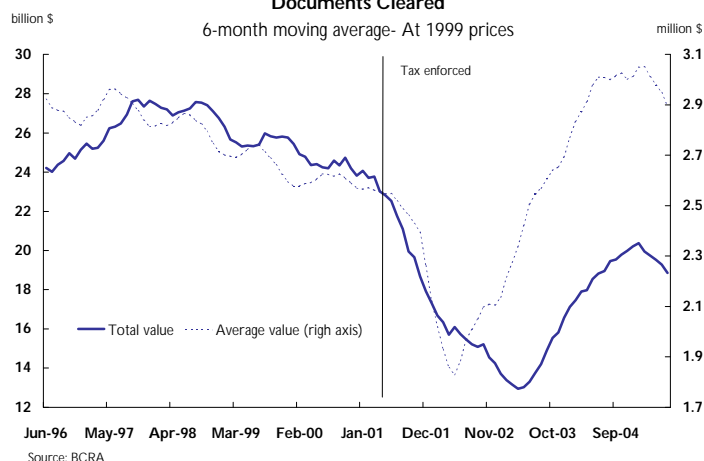
Although the NPS already meets the minimum standards observed at an international level, there are still differences in its development compared with that observed in central economies. This means that there is a need to carry out growing efforts to continue progress in terms international best practices.

## VI.2. The National Payment System

Following international trends, in recent years the National Payments System (NPS) has registered a profound transformation, notable as regards the instruments used to channel the different types of transactions. Although, as occurs in all developing economies, in Argentina cash is still the prevailing means of payment, at present a significant growth of substitute means of payment is observed. The use of so called "bank", "plastic" or "electronic" money (debit and credit cards, transfers and direct debits) is increasingly widespread, as reflected by the growing issuance of instruments and the rising volume of transactions. However, the relevance of these more modern means of payment continues to be less marked than what is exhibited by developed economies, so that it is expected



Chart VI.4  
Documents Cleared

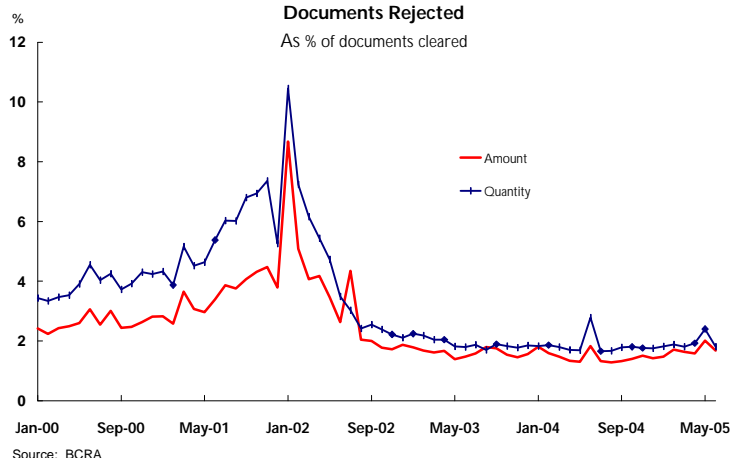


that their use will continue to expand on the domestic market, in line with the growing level of economic activity.

The leading role for the use of cash was maintained in the first half of the year, as a rising trend in their use was registered hand in hand with economic activity growth (see Chart VI.1). The average amount of bills and coins in circulation (in the hands of the public and at financial institutions) during the first half of 2005 was around \$34.0 billion, 27% more than the same period last year in nominal terms (17% in real terms). Currency also continued to grow in terms of GDP, rising from 6.5% to almost 7% of GDP (see Chart VI.2).

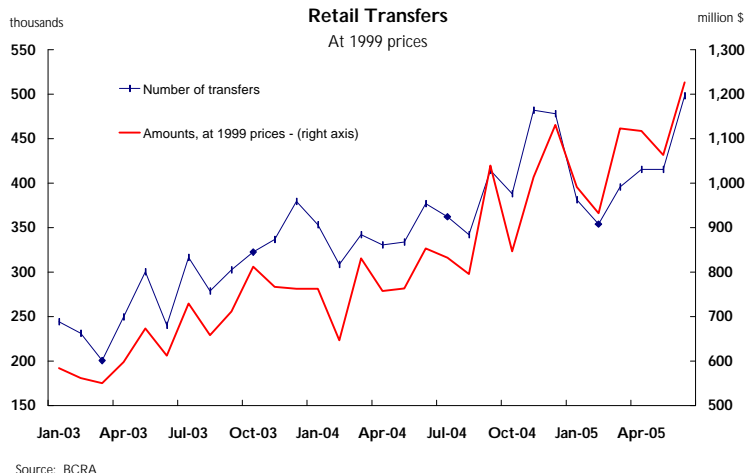
At the same time the progressive revitalization of the public's confidence in the financial system, the growing level of economic activity and the gradual recovery of wages were reflected in a rising balance of sight accounts at banks. As of June 2005 current accounts showed a level that was 24% more than the same period a year ago, while in savings accounts a growth of 27% was recorded. This allowed for a more intensive use of associated means of payment, such as checks, transfers and direct debits (see Chart VI.3), despite the impact of the IDCCB ("bank debit and credit tax") that is still applicable. It is expected that this kind of transactions, which are channeled through the low value clearing houses, will sustain their expansive trend in future, in a manner that is consistent with the prospects of the momentum of economic activity, to which the gradual growth in bank usage and shifts to the formal economy are added.

Chart VI.5  
Documents Rejected



In addition, together with the increasing use of sight accounts, the use of cards on the domestic market continues to intensify. The number of debit cards grew 1% in the past six months<sup>33</sup> (to 11.8 million) while the amount of credit cards rose 7% (to 8.7 million). In particular, the use of debit cards became widespread in recent years, along with several factors, among which the collection of wages and pension benefits in savings accounts<sup>34</sup> stands out, as well as the payments made to certain beneficiaries of social plans by this means. Other relevant factors were the programs undertaken to provide incentives for consumption, like the promotional discounts granted by major retail chains or the reimbursement of part of the Value Added Tax (VAT) when paid with cards. In the case of credit cards, the generalization of promotions with interest free instalments is another additional incentive for their use.

Chart VI.6  
Retail Transfers

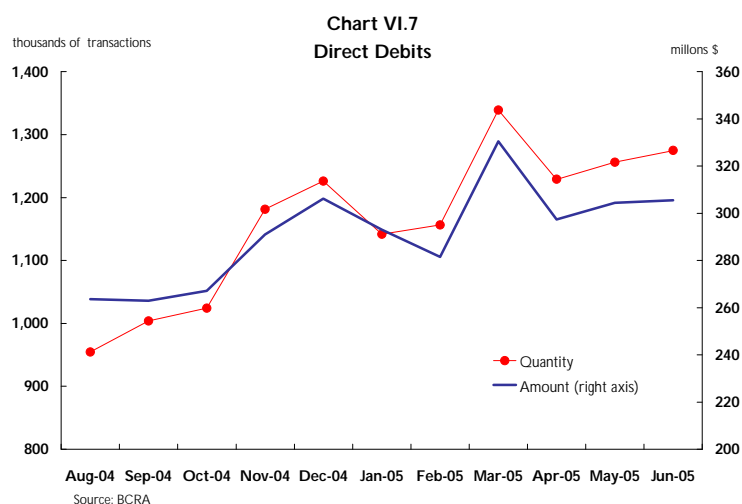


In the case of checks, the per capita amount issued in Argentina is significantly larger than that observed in developed countries like Japan, Germany or Switzerland (where other means of payment have already consolidated their position), but seems to be lower than that exhibited in other emerging economies (like Brazil or Chile, where in general signs of a larger use of the different means of payment associated with the banking system are observed). After their use in the domestic market fell sharply between 1998 and mid 2003 (a negative trend that was accelerated by the introduction of the Bank Debit and Credit Tax in the first half of 2001), as from 2004 some recovery was recorded that faded out in the first half of 2005 (see Chart VI.4).

<sup>33</sup> Data to March 2005.

<sup>34</sup> The number of accounts in which wages are paid grew 10% between March 2004 and the same month of 2005, to a total of about 5.2 million accounts.





In this half the number of checks cleared grew 4% compared to the same period in 2004, while the amount cleared remained practically stable in real terms. At the same time, the average value of checks in real terms, which towards the end of 2004 had exceeded the levels prior to the crisis (reflecting a more concentrated among larger firms) during this half showed a slight negative variation.

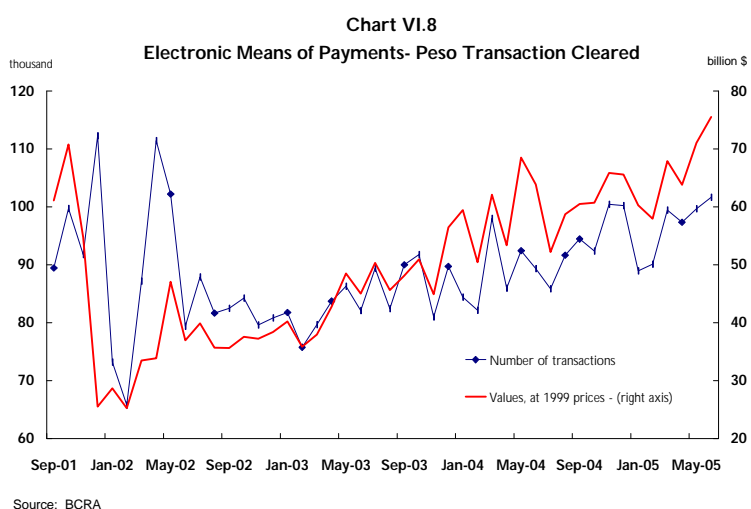
As regards rejected documents, during this six month period they stood at a level of 1.9% of the monthly average of checks cleared, to show a stable performance during the period (see Chart VI.5). The rejection of documents at present exhibits levels lower than those seen at the beginning of the decade, that in parts reflects the heavier weighting in their use by large firms, compared to the advances in alternative means of payment for smaller value transactions.

Although the volume of money channelled as retail transfers still remains less than that routed through other means, for example as checks, an important growth in recent years is observable. Transfers, that have exhibited sharp oscillations since 2001 (during the full application of restrictions on cash withdrawals), acquired a more stable profile towards the end of 2003. During the first half of 2005 the average number of transfers was 410,000 per month. In line with the trend towards a greater use of means of payment in a context of recovery of economic activity, a growth of 20% compared to the number of transfers in the first half of 2004 was observed, while the amounts thus transacted rose 40% in real terms (see Chart VI.6).

The growing use of electronic means of payment is also reflected in direct debits (previously agreed on with corporations in order to pay various services, such as electricity utilities, cable television or membership fees of institutions), which continue to show a markedly rising pattern. In the first half of 2005 a total of 7.4 million transactions were cleared, for a total amount of approximately \$1.8 billion (see Chart VI.7). The monthly average was 1.2 million transactions, 25% above the level recorded in 2004.

Finally, as regards the large value payment systems, the transactions by means of Electronic Means of Payment (MEP) sustained their growth path (see Chart VI.8), which reflects the increasing banking nature of transactions<sup>35</sup>. The MEP, which has been operating since 1997, was developed and is operated by the Central Bank, financial institutions and Electronic Clearing Houses (ECH). It is a real time gross settlement system, that uses the current accounts that financial institutions hold at the Central Bank. Through this system inter-bank transactions are carried out, together with operations initiated by their customers, international transfers, the settlement of net balances of the clearing process, and the settlement of repos with the Central Bank, among others. The net compensation operated by the two large value clearing houses approved by the Central Bank are also channelled through the MEP.

During the first half of 2005 approximately 577,000 transactions in pesos were routed through the MEP, with a total value of



<sup>35</sup> With the purpose of promoting the use of the MEP system, the Central Bank does not charge commissions for the services it provides through this market.





about \$624 billion, a figure 11% larger in real terms than that recorded in the same period last year. A considerably smaller amount was recorded for transactions in U.S. dollars, although in this case a positive trend was also observed. Due to the close links between activity in the MEP and the dynamics of financial markets, it is expected that over time the volume of operations through this channel will continue to grow.

### VI.3. Uniform Federal Clearing

At the end of July 2005 the Uniform Federal Clearing (UFC) or “Federal Clearing” began to operate. This schedule allows for electronic and simultaneous clearing of signed documents (checks, drafts and certificates of deposit, among others) between all financial institutions. Once the UFC took full effect, 48 hour clearing of checks was extended to documents (checks and postal orders) of less than \$5,000, making the chain of payments more dynamic for individuals and business. During 2006 the amount is expected to be raised to include practically all checks. In addition the task of transmitting the images of these documents began, together with their electronic registration, a phase forecasted for the first four months of 2006.

The shorter terms for clearing documents of up to \$5,000 was due to these being truncated (only the relevant data for them to be credited sent by electronic means), to also allow for a reduction in the operating costs of banks and to limit the risk incurred in the physical transport of documents. Truncation has been operational since 1999 but only for the city of Buenos Aires and its metropolitan area. At present, almost 90% of the checks issued are eligible to be channelled through this system, while those that exceed the amount set as a limit continue to be channelled in the customary manner (sending the physical instrument to the drawer’s bank).

These changes imply a substantial added value for the customers of the financial system, by optimizing the development of processes, reducing operational risks and the costs of transactions and by interconnecting all markets in Argentina in a more efficient manner in a single clearance session. The mechanism allows for the instruments to be credited in a single and uniform term, irrespective of where they are issued, to make commercial exchange easier and allow for increasing bank usage. Because the funds are available in a shorter (and more reliable) time frame, the holder of the document has less incentive to endorse it in order to cancel economic obligations.

In order to make truncation of the instruments easier, the Central Bank is setting minimum security and standardization regulations for their designs. Thus, it seeks to provide a higher quality to the securities issued by the customers, especially in the case of checks, for which the different financial institutions are required to obtain prior approval. Similar procedures are at currently being analyzed for certificates of time deposits, bank drafts and bank payment orders.





## BALANCE OF RISKS

The financial system is gradually overcoming the problems that stemmed from the crisis in 2001-2002. In this manner, although there are still some remnants of the crisis, a new map of the risks that are managed by the financial institutions is emerging. In this context, **the Central Bank is focussing its efforts on monitoring both the complete normalization of the banking system and the direction towards which the new developments in financial services are leading.**

In a macroeconomic framework where the current trends of growth with low levels of inflation are maintained, it is estimated that **over the short run the financial system will continue to exhibit a position strengthened by a global assessment which bears in mind the principal inherent risks. The banking system also shows a growing level of resilience in the event of possible negative shocks, which have a small probability of occurring.** The combination of both elements lead to the belief that the progress in the domestic financial activity will enable completion of the normalization plan in a context in which the principal conditions that make for financial stability will prevail.

During the first half of **2005 the financial system managed to improve its overall balance of risks.** In this regard, the principal change during the period was the reduction in the exposure to the public sector and the increased exposure to the private sector. This improved the risk profile of the banking system, due especially to the diversification of portfolios and the contraction of the mismatch in the maturities of assets and liabilities.

On the other hand, **the financial system shows a relatively strong position as regards the liquidity risk.** The sustained recovery in the confidence of depositors, the high levels of liquid reserves and the deepening of money markets are signs of the good coverage that banks have to face liquidity risk. In addition, and within a transparent regulatory framework, the Central Bank, by deepening the repo market and in its function as the lender of last resort, has induced a **sharp reduction in the probability that an adverse individual liquidity shock will be transformed into a systemic problem.**

In the first half of 2005 **the financial institutions increased their soundness in the event of credit risk.** Although the financial system still exhibits an important exposure to the public sector, the conclusion of the debt restructuring and the sustained fiscal discipline mean that **the most probable scenario over the medium term will be the strengthening of the payment capacity of the public sector.** Likewise, the improvement in the quality of the private portfolio, added to a prudent policy of provisioning, **led the financial system to show a full coverage of the losses expected from non performing loans to the private sector.** At the same time, the reduced levels of corporations and families debt and the low exposure of the

banking system to these, allow for the statement of a **minimal probability of a negative credit shock and on its limited impact on capital.** In line with the above, during the first half of 2005 **the banking system carried out a prudent policy in granting private credit.** For example, the expansion of new private credit to companies, with an adequate financial position, reflects the increase in the exposure to credit risk on a sound basis.

On the other hand, the financial system has achieved few advances in reducing its exposure to real interest rate risk. However, **the possible scenario that includes increases in real interest rates that began to have some impact on the solvency of the financial system has a very small probability of occurring.**

These developments in the financial system, and the probabilities assigned to each of these scenarios, are consistent with a scenario in which a positive macroeconomic performance is maintained. In this regard, both monetary discipline and the continuity of fiscal responsibility will be the keypoints that will define the total normalization and healthy expansion of financial activity.

The financial institutions have been recovering their levels of profits at a sustained pace during the post crisis period. In the first half of 2005, for the first time after the crisis, the banking system registered half year profits. **The continued progress in terms of results, added to the sustained process of capitalizations carried out by financial institutions, make up a framework of a sustained solvency margin, increasing its resilience negative shocks.**

For the next few months **the most probable scenario in which the financial system may operate will boost the consolidation of the recovery of financial institutions, while promoting the conditions of financial stability.** However, the financial system should focus its efforts on the continued recovery of its portfolio of assets and in lessening the mismatch in real interest rates. Carrying out these challenges will contribute greatly to the strengthening of the financial system. For this purpose, the Central Bank is promoting market mechanisms to support the financial institutions that overcome these weaknesses, by providing an optimistic framework for the short and medium terms.





## ABBREVIATIONS AND ACRONYMS

**\$:** Argentine pesos.

**APR:** Annual percentage rate

**BCB:** Central Bank of Brazil.

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

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

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

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

**BOGAR:** *Bonos Garantizados*. Guaranteed bonds.

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

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

**CCI:** Construction cost index.

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

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

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

**CPI:** Consumer price index.

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

**EB:** Executive branch.

**ECB:** European Central Bank.

**EMBI:** Emerging markets bond index.

**FS:** Financial stability.

**FSB:** Financial stability bulletin.

**FOMC:** Federal Open Market Committee (USA).

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

**GDP:** Gross domestic product

**HHI:** Herfindahl-Hirschman index.

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

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

**IFS:** International financial statistics.

**IMF:** International Monetary Fund.

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

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

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

**M0:** Banknotes and coins

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

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

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

**m.a.:** Moving average

**MAR:** Minimum application of resources in pesos.

**MC:** Minimum cash.

**MR:** Market rate.

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

**NA:** Netted assets.

**NDA:** Net domestic assets.

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

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

**NW:** Net worth

**p.p.:** Percentage point.



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

**PS:** Price stability.

**PV:** Par value.

**REM:** BCRA Market expectation survey.

**ROA:** Return on assets.

**ROOA:** Ordinary return on assets.

**RPC:** *Responsabilidad Patrimonial Computable*.

Adjusted stockholder's equity, calculated towards meeting capital regulations.

**s.a.:** Seasonally adjusted.

**SEFyC:** Superintendence of Financial and Exchange Institutions.

**SME:** Small and medium enterprises.

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

**TD:** Time deposits.

**US\$:** United States dollar.

**USA:** United States of America.

**UTDT:** Universidad Torcuato Di Tella.

**VAR:** Value at risk.

**VAT:** Value added tax.

**WPI:** Wholesale price index.

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

**YTM:** Yield to maturity.





## INDEX OF CHARTS AND TABLES

### Chart index

1.	Loans to Non private sector.....	7
2.	Profitability.....	8
3.	Loans to the Private Sector.....	9
4.	Public and private sector credit risk.....	10
5.	Deposits and Loans maturities by Amount Bracket.....	11
I.1.	Gross domestic product.....	14
I.2.	Benchmark interest rates .....	14
I.3.	Commodity prices.....	15
I.4.	Spread on High Yield bonds.....	15
I.5.	GDP. Growth and contribution by expenditure component .....	15
I.6.	National fiscal impulse.....	16
I.7.	National primary balance and current account surplus.....	16
I.8.	Broad monetary base and monetary program 2005.....	16
I.9.	CPI. Change by component.....	17
II.1.	Financial system asset portfolio.....	20
II.2.	National fiscal accounts.....	20
II.3.	Share in national tax revenue.....	20
II.4.	Sovereign debt.....	20
II.5.	Composition of the business loan portfolio.....	21
II.6.	Corporate debt.....	21
II.7.	Corporate debt burden.....	21
II.8.	Payment of foreign debt by private sector.....	22
II.9.	Manufacturing. Production and capacity utilization.....	22
II.10.	Manufacturing sector debt.....	22
II.11.	Argentina. Grain and oilseed production .....	23
II.12.	Primary sector debt.....	23
II.13.	Utilities.....	23
II.14.	Service sector debt.....	24
II.15.	Supermarket and shopping mall sales.....	24
II.16.	Construction activity indicator (ISAC).....	24
II.17.	Real wages .....	25
II.18.	Consumer confidence.....	25
II.19.	Household debt burden .....	25
III.1.	Yield curve of CER adjusted bonds in pesos.....	28
III.2.	Traded volume of public bonds.....	28
III.3.	Emerging economies sovereign risk.....	28
III.4.	Lebac in circulation and secondary market transactions.....	29
III.5.	Lebac yields of primary market.....	29
III.6.	Lebac yield in the secondary market.....	29
III.7.	Yield of outstanding bonds issued by banks.....	30
III.8.	Local stock market.....	30
III.9.	International stock markets.....	30
III.10.	Stock market capitalization.....	31
III.11.	Forward markets – volume traded.....	31
III.12.	Financial sector scale.....	31
III.13.	Conglomeration in non banking financial intermediaries.....	32
III.14.	Conglomeration in financial intermediaries banking institutions, MF, PF and IC.....	32
III.15.	Assets of non-banking financial intermediaries.....	32
III.16.	Non-bank financial intermediaries portfolio composition .....	32
III.17.	Non-bank financial intermediaries.....	33
III.18.	Financial system structure.....	33
III.19.	Factor productivity.....	33
III.20.	Financial system concentration.....	34
III.21.	Breakdown by type of institution.....	34
III.22.	Netted assets of financial system.....	34
III.23.	Loans to the private sector.....	35
III.24.	Loans to the private sector.....	35
A.1.1.	Liabilities with the BCRA.....	36
A.1.2.	Acumulated payments to BCRA.....	37
III.25.	Deposits.....	38
III.26.	Deposits and loan maturities .....	38



IV.1.	Flow of private funds to the financial system.....	40
IV.2.	Liquidity risk coverage.....	40
IV.3.	Liquidity reserve compared.....	40
IV.4.	Composition of deposits.....	41
IV.5.	Interest rates.....	41
IV.6.	Interbanking money market.....	41
IV.7.	Call money market by type of entities.....	42
IV.8.	Exposure to public sector by type of banks.....	42
IV.9.	Public and private sector credit risk.....	42
IV.10.	Exposure to public sector.....	43
IV.11.	Valuation of public sector assets.....	43
IV.12.	Financing to the non financial private sector.....	43
IV.13.	Non-performing credit to the non-financial private sector.....	46
IV.14.	Net worth exposure to credit risk of non financial private sector.....	46
IV.15.	Changes in financial by economic sector.....	47
IV.16.	New lendings to firms by economic sector.....	47
IV.17.	Bank exposure to economic sectors.....	47
IV.18.	Non-performance by economic sector.....	47
IV.19.	Financing to firms by amounts.....	48
IV.20.	Non-performing by dimension of firms.....	48
IV.21.	Non-performance by the type of financing.....	48
IV.22.	Commercial loans.....	49
IV.23.	Expected sources of funds for meeting needs.....	49
IV.24.	Non-performance and bank exposure to households.....	49
IV.25.	Consumer loans.....	50
IV.26.	Non-performance by type of financing.....	50
IV.27.	Exposure to foreign currency mismatch risk.....	50
IV.28.	Currency mismatch.....	50
IV.29.	CER mismatch risk.....	51
IV.30.	Market risk capital requirement.....	51
IV.31.	Market risk capital composition.....	51
IV.32.	Foreign currency market risk.....	51
V.1.	Annualized profitability.....	54
V.2.	Adjusted half-yearly profitability.....	54
V.3.	Profit volatility.....	54
V.4.	Financial margin.....	55
V.5.	Main lines of net interest income.....	57
V.6.	Interests and CER adjustments.....	57
V.7.	Loan loss provisions.....	57
V.8.	Service income margin.....	58
V.9.	Composition of service incoming margin.....	58
V.10.	Operating costs and efficiency.....	58
V.11.	Capital contributions.....	60
V.12.	Consolidated financial system leverage.....	60
V.13.	Market capitalization index for financial institution.....	60
VI.1.	Currency in circulation as share of monetary aggregates.....	64
VI.2.	Currency in circulation.....	64
VI.3.	Current account debits.....	64
VI.4.	Current cleared.....	65
VI.5.	Documents rejected.....	65
VI.6.	Retail transfers.....	65
VI.7.	Direct debits.....	66
VI.8.	Electronic means of payment – peso transaction cleared.....	66

### Table index

I.1.	Emerging countries.....	14
II.1.	Public debt indicators.....	21
III.1.	Balance sheet.....	35
A.2.1	Development of e-banking in Argentina.....	45
IV.1.	Transition matrix December 2004/ June 2005.....	46
V.1.	Profitability structure: Total system.....	55
V.2.	Profitability structure: Private banks.....	59
V.3.	Profitability structure by type of bank – first half 2005.....	59
V.4.	Minimum capital by group of banks.....	61