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Preface

Financial stability (FS) can be defined as a situation in which the financial services sector is able to channel the savings of the population and provide a nationwide payments system in an efficient manner that is sustainable over time. The proximity to (or distance from) a context in which the ability to provide these services in a lasting manner is threatened, whether by a run on banks, excessive leverage, inadequate risk management policies or distorted asset prices will define financial fragility or strength.

As with most emerging economies, in our case most financial intermediation is channeled through the banking system, so that the FS concept is centered mainly on the evaluation of the conditions that lead to the normal operation of financial institutions. In this context, in order to serve as a guide for the implementation of policy, the purpose of FS leads from an operating point of view to the adoption of measures that are basically intended to deal with market failures (market power, externalities or asymmetric information). In the context of the implementation of sound and stable macroeconomic policies, the achieving of FS requires clear rules regarding the entry and exit of financial institutions, an adequate prudential regulatory framework and safety network, effective official supervision, sufficient legal and institutional support for the control bodies, and mechanisms that encourage market discipline.

The existence of a strong link between FS and economic growth justifies its becoming a social asset that the State must seek out and protect. In addition, in terms of the implementation of policy, the influence of FS on the effectiveness of monetary policy must be borne in mind, as well as its importance to the functioning of the national payments system. Many Central Banks were in fact created to confront situations of financial instability, and at present most of them have as one of their basic functions, either directly or indirectly, the promotion of FS.

“Supervision of the proper functioning of the financial market” is one of the key roles assigned to the Central Bank of Argentina by Article 4 of its Charter. To fully comply with that legislative mandate, it is necessary to complement the standard regulatory and supervisory powers of the Central Bank with a communication strategy that is transparent and accessible to all financial system users and the public in general.

*The **Financial Stability Bulletin** presents an overall evaluation of the development of financial system stability, combining the various sources of information from the Central Bank on the matter into a single publication. Because of both its scope and its aim of reaching the general public, it can be said that the **Financial Stability Bulletin** is to financial stability what the Inflation Report is to price stability.*

*The **Financial Stability Bulletin** can be approached in two different manners, depending on the depth of detail desired by the reader. A reading of the Central Bank Outlook together with the summary of each chapter will enable the reader to capture the essence of the Bulletin. Naturally, a full reading of the report provides a broad evaluation of each of the topics dealt with, and will be further enriched by the analysis of the topics covered in the Boxes.*

*This first issue focuses on the recent past, placing special emphasis on the regulatory re-foundation and financial normalization that took place in 2003, without an understanding of which it is not possible to determine the overall state of the banking system at the start of 2004. The **Financial Stability Bulletin**, which will be published half-yearly, replaces the Bulletin of Monetary and Financial Affairs, the last number of which covered the year 2002. The next edition of the **Bulletin** will appear on the Internet in the last week of September 2004, based on a statistical cut-off at the end of the first half of the year.*

Buenos Aires, May 31, 2004



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CENTRAL BANK OUTLOOK

The year 2003 marked the end of the first stage of the stabilization of the financial system. The **liquidity** shortfalls of 2002 were transformed into significant surpluses towards the end of 2003, with liquidity ratios in the order of 24%, 8 percentage points above Central Bank requirements. **Losses**, which reached a record in 2002 and remained at dangerously high levels during the first half of 2003, disappeared towards the end of last year. **Solvency**, severely threatened by 4 consecutive years of deep recession, began to recover in the second half of 2003, as a consequence of a widespread rolling-over of 22% of liabilities (with foreign creditors and the Central Bank) and additional capital contributions equivalent to 25% of financial system consolidated net worth (NW) at the end of 2003.

The return of depositors and the greater certainty regarding net worth were essential preconditions without which the second stage begun in 2004 would not have been possible: the resurgence of the banking business. In the last five years the financial system has not only been losing relative weight in the economy, it has also been making a systematically negative contribution to its growth. Banks are lending again, but the stock of loans to the private sector of only 8% of GDP reminds us that there is a long way to go until financial institutions reach a volume of business that will allow them to achieve a lasting profitability at the same time as making a real contribution to economic development.

The role of the Central Bank in this resurgence is as important as that which it performed during the normalization stage, although it still faces significant limitations affecting its ability to move quickly towards a definitive solution of the problems inherited from the financial crisis.

Specifically, unlike the situation that existed in other countries that have recently experienced exchange and banking crises on a large scale, the Central Bank is equipped with fewer tools and only a fraction of the resources available in other latitudes to promote the re-capitalization of financial institutions. Because of the high levels of national public sector indebtedness, there are no fiscal resources available to strengthen banks, other than the government securities issued to avoid the accounting deterioration on bank balance sheets that would have been caused by the mismatched mandatory conversion into pesos (*pesificación asimétrica*) of assets and liabilities. This fiscal contribution represents a fraction of the fiscal contribution observed in the resolution of other financial crises. In a similar manner, whereas the solution of such crisis required international agencies to contribute with significant disbursements, in the case of the Argentine crisis, net disbursements were in fact negative. This shortage of resources from outside the financial system is particularly worrying because of the relative size of the Argentine crisis, double that of other financial crises during the second half of the 1990s, both in terms of liquidity – deposits fell by 42% in real terms – and solvency – financial institution consolidated net worth fell 37% in real terms.

Within this context of a scarcity of resources and instruments, the Central Bank's strategy for the stabilization of the financial system concentrated on a system of incentives based on two pillars: 1) providing institutions with time to absorb the losses caused by the

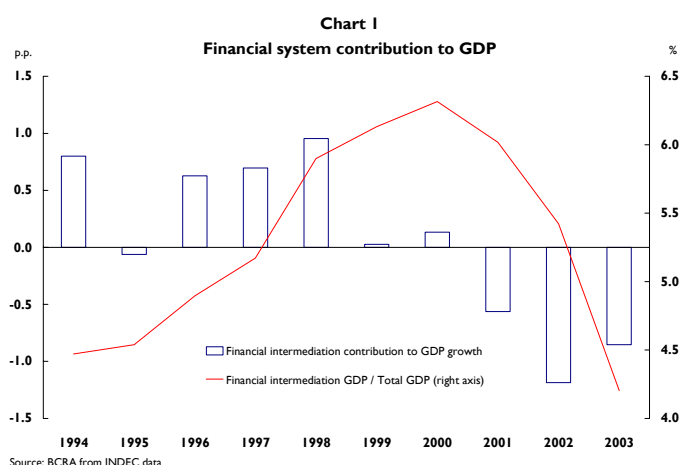




Table I
Recent crises

Country	Crisis date	Real change in deposits	Real change in NW	Fiscal contribution	FMI net disbursement (million US\$)
Mexico	'94 - '95	-15%	-64%	19%	10,670
Venezuela	'94 - '95	-43%	-6%	15%	-657
South Korea	'97 - '00	-6%	15%	31%	6,069
Indonesia	'97 - '00	-13%	-183%	57%	10,348
Thailand	'97 - '00	-2%	58%	44%	3,212
Ecuador	'98 - '01	-24%	-59%	22%	298
Turkey	'00 - '02	-27%	97%	31%	13,419
Average		-19%	-20%	31%	6,194
Argentina	'81 - '82	-36%	-9%	55%	s.d
Argentina	'02 - '03	-42%	-37%	11%	-930

nearly us\$50,000 million including US Treasury support

-us\$6,500 million considering international organization net flows

(1) from the beginning of the crisis to the through in deposits
(2) Net worth, considering a period of two years after the crisis

Source: BCRA from IMF data (IFS and "Managing Systemic Banking Crises" (IMF, 2003)), except for Argentina (BCRA)

crisis and rebuild their capital base internally, and 2) changing regulations and prudential rules so that banks can expand their business, aiming for a financial system that is not only sound but also agile.

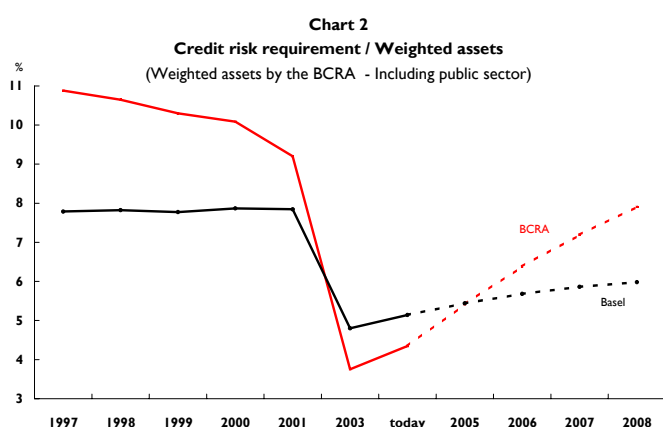
The measures aimed at building the first pillar include the following: a) allowing the deferral of losses caused by court-ordered deposit releases, permitting their gradual amortization; b) requiring a gradual convergence on market value of public sector exposure; and c) establishing of capital requirements that converge on 8% (Basel I) towards the end of 2008, with rising coefficients for the risks inherited from the crisis (exposure to the public sector and interest rate mismatching).

As far as the second pillar is concerned, the Central Bank directed its efforts to putting in place a new regulatory structure intended to rebuild the foundations for a competitive financial system. In order to do so, unlike the situation during the previous decade, the peso was set as the unit of account and equal treatment was established for all financial institutions, regardless of the composition of their equity, and for all credit applicants, regardless of their size or nature. In this context, the Central Bank a) implemented a cash reserve reduction policy, b) evened out the minimum capital requirements for new loans (increasing the margin available to finance the private sector, fundamentally for small businesses and individuals, which recorded the best compliance with their liabilities during the crisis), c) promoted access to credit for both SMEs and debtors recording non-compliance in the past but showing positive signs in terms of future cash flows, d) set limits on lending to the public sector, e) prohibited currency mismatching between debtor loans and income, and f) required all financial institutions to present medium-term business plans, to be able to count on a proactive supervision process.

New financial rules, together with the strong economic recovery, led to promising results during 2003. All deposit restrictions were lifted, and totals at the end of 2003 are at a level similar to those recorded at the end of 2001, despite interest rates being at their historically lowest levels. It can therefore be said that 2003 was the year in which there was a regulatory re-foundation and liquidity recovered.

There was a change in the trend of lending to the private sector as from August 2003, with positive variations being seen in the final months, accompanied by sharp declines in lending rates for all lines and a steady drop in portfolio non-performance. It can therefore be expected that 2004 will be the year credit and the longed-for "return of financial intermediation", without which there can be no steady, lasting economic growth.

Nevertheless, there are important outstanding matters that will keep the financial system at risk until they are finally resolved, and which will require an additional regulatory and supervisory effort by the authorities. In the first place, banks still carry an excessive level of exposure to the national public sector, implying a large concentration of risk and a significant immobilization of assets that conspires against profitability and the taking of productive risks. The restructuring of sovereign debt currently in default will be a determining factor, both because of its impact on the



Growth: progressive up to a loan portfolio to GDP ratio of 20% in 2008

Source: BCRA

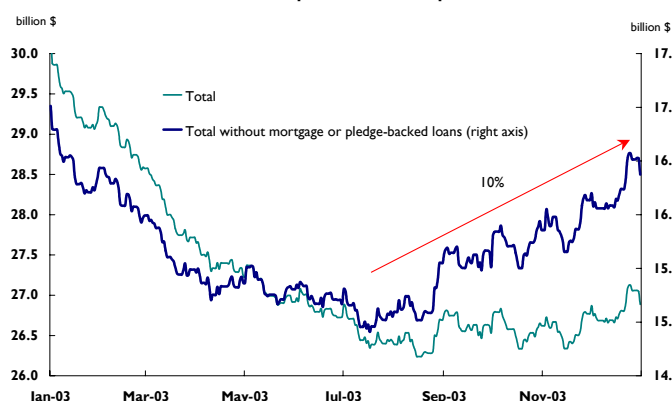


macroeconomic context and the direct consequences it will have on net worth and liquidity within the financial system.

In second place, banks are still showing significant balance sheet mismatching in interest rates, currencies and terms, as a consequence of the origins of the crisis and the particular solutions found for it. Such mismatching exposes banks to sharp variations in profitability when there are sudden movements in variables over which they have no control, and against which they are unable to protect themselves. This excessive exposure makes banks naturally unwilling to take on new risks, so that they tend to favor managing past history rather than building the future.

In addition, on top of the high exposure of banks to the public sector, the non-performance in portfolios of loans to the private sector remains high, in spite of the improvement seen in the second half of 2003, making it difficult for banks to adopt a more aggressive lending strategy.

Chart 3
Loans to private sector in pesos



Source: BCRA

The legal uncertainty regarding the treatment of the court-ordered release of deposits also has negative consequences, both on net worth (because of the stock) and on liquidity – deposit outflows arising from this source continue. To this should be added the fragile funding structure, with an exaggerated dependence on sight deposits caused by the disincentives generated by the tax on bank debits and credits. The combination of this funding structure and the mentioned mismatching make it difficult for long-term lending to return, this being the segment most in demand by borrowers.

Lastly, in spite of the notable improvement in recent quarters, customers still show signs of a high level of distrust regarding banks (especially as far as the transparency of products and charges is concerned), as a results of the situations they suffered during the crisis, which also acts to hinder the recovery of intermediation.

Aware of these subsisting weaknesses, the Central Bank is working in those areas for which it is responsible on various alternative solutions to such pending matters, so that as soon as possible, within the context of the restrictions that have been described, a lasting, genuine Financial Stability can be achieved.

I. CONDITIONS OF FINANCIAL SYSTEM DEBTORS

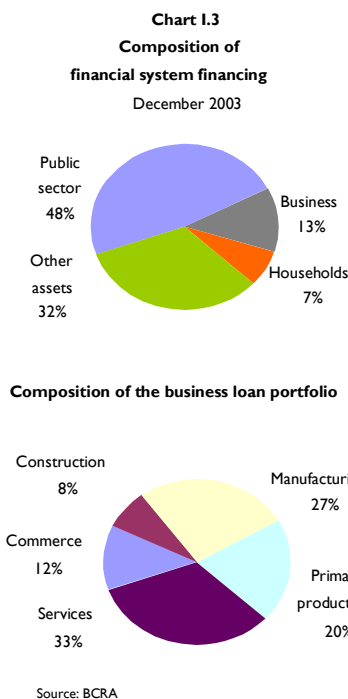
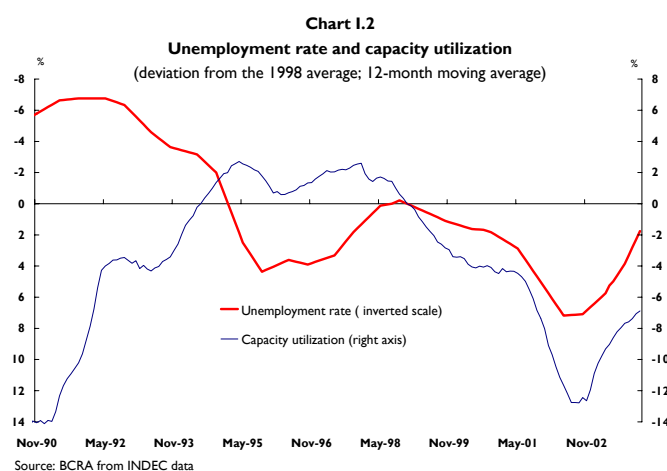
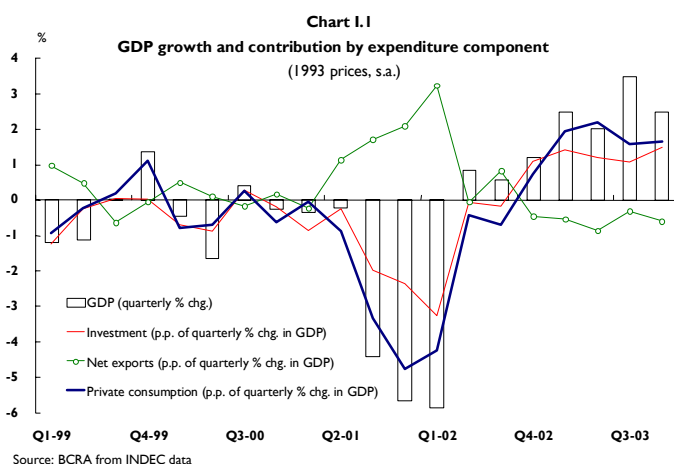
Summary

In line with positive conditions overall, the main sectors of the economy performed favorably during 2003. Both the current situation in terms of economic activity, income and profitability, as well as the financial developments observed as a consequence of the conversion of balances into pesos, the pre-payment and restructuring of private sector debt and lower interest rates have all led to a clear improvement in the financial situation of most sectors of the domestic economy, creating the conditions for a fall in credit risk.

The public sector (accounting for 48% of the assets of the financial system) saw a significant improvement in its income statement accounts in 2003, reflecting the effects of a rebuilding of its current income in line with the recovery of activity levels and changes in relative prices. This has allowed it to service its performing debt and achieve a financial surplus. During 2004 it is expected that this sound fiscal performance will be maintained, given the deepening of the process of economic recovery. There are however two factors clouding the future performance of the public sector: uncertainty regarding the results of the renegotiation of the debt and the increase in 2005 and 2006 of the servicing due on the performing debt, compared to the financial burden in 2004.

The recovery in the level of economic activity has been led by the goods-producing sector, agriculture and construction, as a result of a major change in relative prices following the devaluation of the peso, and supported by the favorable international context. By mid-2003 it was also possible to detect the beginning of a recovery in the service sector. In general terms, barring a few exceptions such as those sectors in which prices are regulated and/or which are highly indebted in foreign currency, the good prospects for the corporate sector (13% of the assets of the financial system) suggest an improvement in its debt burden.

The household sector (7% of the assets of the financial sector) recorded a significant increase in its income during 2003, as a consequence of increases in both the level of employment and real wages. These events, added to the wealth effect, have combined to explain the growth in consumption. During 2004 it is expected that there will be a further increase in employment and real wages that will underpin the rising trend in private consumption, at the same time as consumer confidence will be at a high level and lending rates will decline. These developments, added to a lower level of net borrowing, lead to estimates of a drop in credit risk for the sector.



I.1. Context¹

Below is a brief description of the main macroeconomic developments during the period, which should be understood as providing an overall reference framework for the sector by sector analysis of the economy, in terms of the leading debtors (both current and potential) of the financial system.

In 2003, growth of the local economy resulted in a rise of 8.7% in GDP. This was driven basically by the strength of domestic demand, led by private sector consumption, and in second place by investment, while net exports made a negative contribution to economic growth, after having dampened the fall in GDP in 2002 (see Chart I.1).

Manufacturing, construction and agribusiness were the most dynamic sectors explaining the rise in GDP last year. In the second half of 2003 growth also began to affect the services sector.

In the context of a lack of credit in the financial sector, the change in relative prices resulting from the devaluation of the peso caused an increase in company profitability. This was particularly the case of sectors producing tradable goods, and this factor, added to the reduction in debt burden from the conversion into pesos and the default and subsequent restructuring, ensured businesses were able to count on the means to finance their working capital. The above, together with the high level of idle capacity in the economy after 15 consecutive quarters of recession (giving rise to a 20% drop in GDP since the peak reached in 1998) and the implementation of responsible fiscal and monetary policies, generated the foundations for growth in output (see Chart I.2). In these conditions, the increase in output took place during a period of notable price stability.

I.2. Economic conditions and the financial system

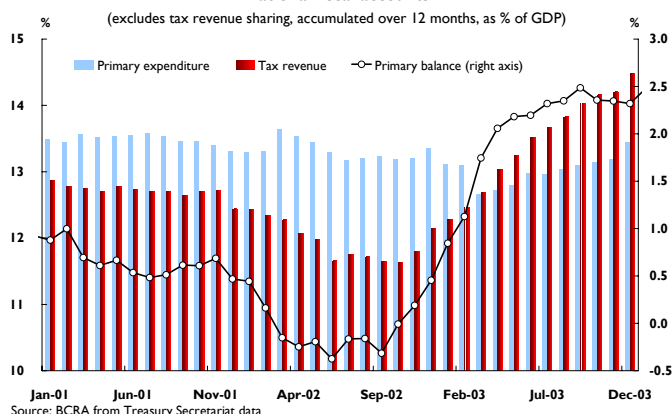
Credit risk is one of the most significant risks faced by the financial system as it carries out its intermediation role. Monitoring the financial conditions of the leading groups of financial system debtors is essential to be able to determine the ability to repay loans, the main determinant of credit risk. For the purposes of the analysis carried out in this Bulletin, the description of the credit risk behavior of each sector is related to the net exposure of the banking system to it. This is detailed in the Risk management section, in order to provide an overall approximation of the repayment risk to net worth and the opportunities to increase lending in the various sectors.

There follows an analysis of the credit risk for the main groups of debtors in the local financial system, monitoring borrowing levels and the debt servicing burden and analyzing the main real and financial variables, including income, profit margins, profitability, debt and implicit rates of interest. From a methodological point of view, sectors have been grouped into public sector, household and corporate. The latter group is broken down into the main industries for further analysis. In terms of the relative importance of each group in the portfolio of assets in the financial system, it should be

¹ For a detailed analysis regarding the behavior of the main macroeconomic variables, see the Inflation Reports for the Fourth Quarter of 2003 and the First Quarter of 2004.



Chart I.4
National fiscal accounts



noted that at December 2003 the public sector accounted for over half of such assets, while the private sector (corporate and household), represented almost one fifth of the total. Of loans granted to corporations (13%), one third of the total was directed at the service sector, while only 8% was in the form of assistance to the construction sector (see Chart I.3).

I.3. Public sector

Fiscal conditions²

Fiscal accounts recorded a positive result in 2003, ensuring an over-performance of the fiscal targets in the 2003 Budget and in the agreement with the IMF signed in September of the same year. The large primary surplus allowed the government to comply with all the payments that became due on the performing public sector debt, and even enabled it to build up a fiscal surplus.

As a result, there was a consolidation of the improvement in public finances seen in the last quarter of 2002 for both the national and provincial governments. The National Non-Financial Public Sector recorded a primary surplus of \$8.677 billion (2.3% of GDP), exceeding the target of \$7.790 billion (2.1% of GDP) established in the agreement signed in September with the IMF (see Chart I.4). The significant primary surplus enabled the administration to pay interest on the performing public sector debt, which includes the National Guaranteed Loans (PGN), Provincial Secured Bonds (BOGAR), the BODEN Optional National Government Bonds and the liabilities with international financial institutions (IFIs). The first three account for 85% of the financial system's total exposure to the public sector.

This improvement in accounts has been mainly due to the effects of an increase in public revenue. Primary spending has remained in line with 2003 budget estimates.

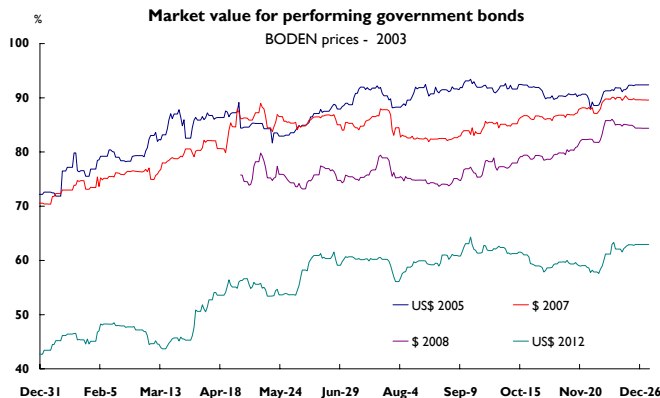
It is expected that the sound fiscal performance seen in 2003 will be possible again this year, backed by a continued recovery in output. The national fiscal surplus would therefore exceed 2004 budget forecasts (2.4% at federal level and 0.6% from the provinces), and this, together with the continuity of the IFI financing program, will allow the government to comply with its payments on performing public debt, for which banks have a relatively greater exposure.

The positive performance in the value of performing sovereign debt shows an improvement in the image of the government in terms of meeting future commitments (see Chart I.5).

Public debt

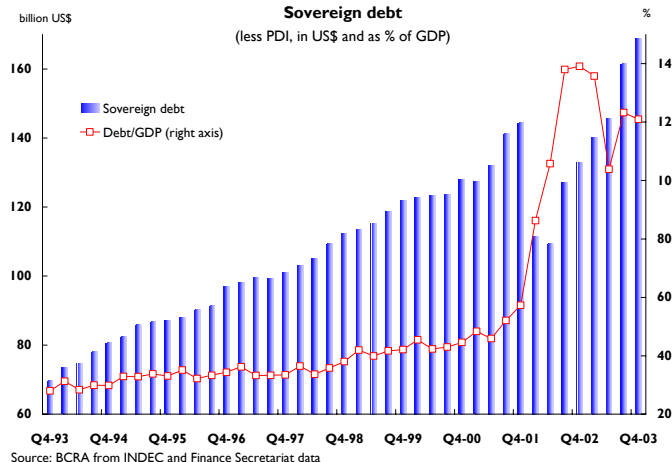
At December 31, 2003 the public debt amounted to approximately 120% of GDP (US\$178.8 billion, see Chart I.6). While 43% of this debt is not in default, Global bonds held by private and institutional investors in Argentina, Italy, the United States, Japan, Germany and elsewhere account for the bulk of the debt to be restructured (see Table I.1).

Chart I.5
Market value for performing government bonds
BODEN prices - 2003



Sovereign debt

(less PDI, in US\$ and as % of GDP)



² For a detailed analysis of public sector income and spending, see the Inflation Reports for the Fourth Quarter of 2003 and the First Quarter of 2004.



Table I.1
National public sector debt as of December 31, 2003
(million US\$)

	Without arrears	Arrears	Total	As % of total
TOTAL	150,805	28,015	178,821	100.0
<i>Medium-and long-term</i>	<i>148,279</i>	<i>28,015</i>	<i>176,295</i>	<i>98.6</i>
Notes and bonds	87,022	25,782	112,804	63.1
Peso denominated	9,676	5,957	15,633	8.7
BODEN	4,602	-	4,602	2.6
Denominated in foreign currencies	77,346	19,825	97,171	54.3
BODEN	13,059	-	13,059	7.3
Loans	61,258	2,233	63,491	35.5
NGL	14,100	-	14,100	7.9
IFIs	32,118	-	32,118	18.0
Bilateral agencies	4,571	1,895	6,466	3.6
BOGAR	9,679	-	9,679	5.4
Commercial banks	522	303	825	0.5
Other	267	36	303	0.2
<i>Short term</i>	<i>2,526</i>	<i>-</i>	<i>2,526</i>	<i>1.4</i>
BCRA temporary advances	2,526	-	2,526	1.4

Source: Finance Secretariat

The PGN arose from the debt swap that took place in 2001, while the BODEN bonds arose from swaps carried out with financial system depositors, compensation paid to banks, the redemption of quasi-monies and from certain other items. The BOGAR bond was a component of the program for the reorganization of provincial public finances promoted by the federal government. The federal government acts as the guarantor for such transactions, at the same time as it withholds up to 15% of federal tax-revenue sharing (corresponding to the provinces that opted for this debt swap) to make service payments on the bond. As this is the leading security in financial institution portfolios, the above has strengthened the situation of the financial system as far as public sector exposure is concerned.

Following an increase in 2005, in subsequent years a declining trend is anticipated in performing sovereign debt maturities, easing the future financing burden to be faced by the public sector (see Chart I.7).

At the annual meeting of the IMF in Dubai on September 22, 2003, the government presented the outlines of its defaulted debt restructuring proposals and defined the action plan to be followed. This plan contemplated the setting up of a bank syndicate to assist in the drafting of the restructuring proposal and the placement of the new bonds to be issued, as well as a schedule of meetings with consultative groups. In addition, it was estimated that the submission of the formal restructuring proposal would take place between June and August (see Table I.2).

Therefore, one of the main sources of potential risk for the economy in general (given the rising amortization schedule) and the financial system in particular (given its high exposure), is linked to the development of the process of restructuring of the public debt in default.

I.4. Corporations

During 2003 the economic recovery continued to be led by industry, agriculture and construction. As from the second half of 2003 signs also began to be seen of a recovery in most service sectors.

The goods-manufacturing sector benefited most in terms of profitability. This was because of the change in relative prices after the devaluation in the case of domestic market businesses (via import substitution) and those manufacturing for export. This enabled a recovery of output, making use of the significant idle capacity in the economy caused by the recession and the previous structure of domestic prices that had not been conducive to the development of certain industries while the convertibility regime was in place (see Chart I.8).

Since the collapse of convertibility and the conversion into pesos of corporate liabilities, the financial position of businesses suffered severe distortion. On the one hand, producers of tradable goods obtained an increase in their income in pesos, improving their repayment capacity. Within this group, those borrowing through the local banking system (converted into pesos) gained an additional benefit from the reduction in liabilities in real terms. On

Chart I.7
Service payments on performing national public debt

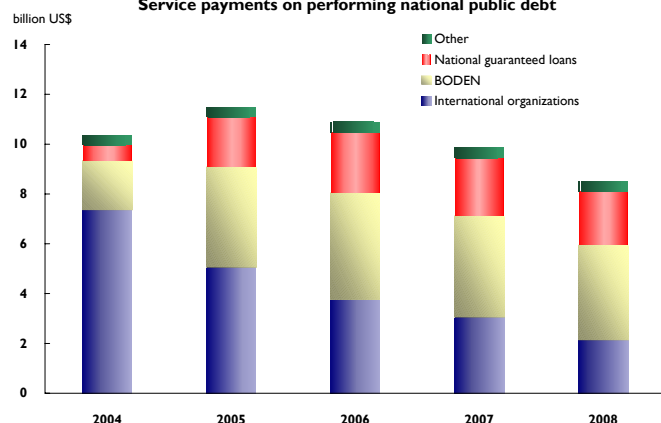


Table I.2
Main features of the new bond issues

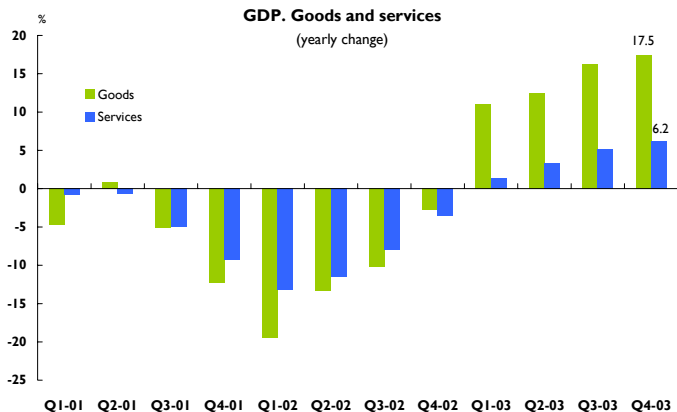
Bond menu	Haircut % (*)	Coupon		Average life
		Type	Range (%)	
Discount bond	75	incremental	1-5	8-32 years
Par bond	0	fixed	0.5-1.5	20-42 years
Quasipar bond	30	fixed	1-2	20-42 years

(*) according to an overall reduction of 75% on the nominal stock of eligible debt

Source: Finance Secretariat, Consultative group meeting, October 2003



Chart I.8
GDP. Goods and services
(yearly change)

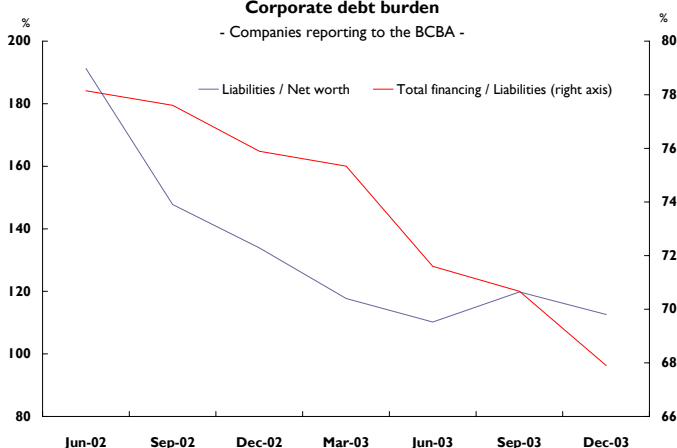


Source: BCRA from INDEC data

the other, businesses specializing in non-tradable goods did not experience any significant impact on their profitability. Businesses that borrowed domestically benefited from the conversion into pesos, and improved their financial position following increased economic activity. A different situation was experienced by corporations which saw their liabilities rise in line with the rate of exchange while their income continued to depend on the domestic market. Most of these companies defaulted on their debt, but a steady increase has occurred in private sector debt restructuring agreements as from the second half of 2003.

Although there have been differences between sectors, on the whole the conversion into pesos, early payment and restructuring of private debt and lower market interest rates have meant that by the end of 2003 there has been a clear improvement in the financial position of the corporate sector, and in particular in the debt burden (see Chart I.9). This has been driven by the gradual recovery in income and profitability and an encouraging outlook for overall and sector by sector real output. These elements have led to an improvement in the payment potential of corporations, which account for 13% of the assets of the financial system.

Chart I.9
Corporate debt burden
- Companies reporting to the BCBA -



Source: BCRA

Services

Public services finally returned to growth, reaching levels of close to their historical high point thirteen months after recording a trough (see Chart I.10). This strengthens the financial system, as the services sector is the non-financial sector with the highest level of bank borrowing. The financial system's exposure to this sector totaled 4% of total assets (32% of corporate financing).

During 2003 output in the public utilities sector increased by 8.1% year on year (y.o.y.), as a result of the recovery in all its component activities, particularly cargo transport, electricity, gas, water and telephone services.

The rise in domestic consumption and employment while services prices remained mostly unchanged since the end of convertibility gave rise to an increase in demand, and this trend is expected to continue during the current year, despite adjustments to some utility rates.

In addition, a recovery can be expected in investment in the sector following the renegotiation of concession contracts by the government, especially in the gas, water and electricity sectors.

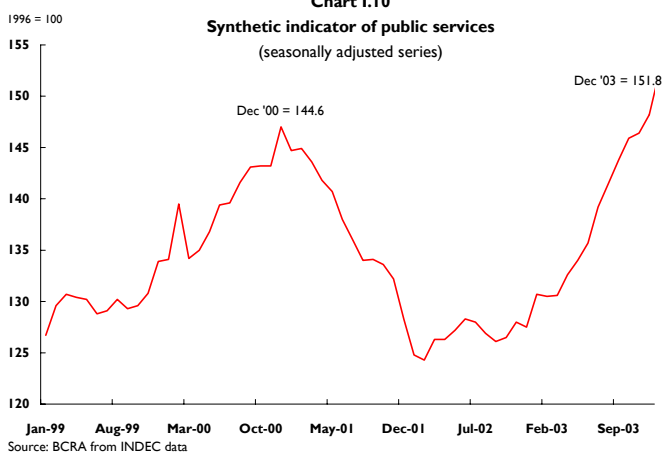
Strong growth in the consumption of public services is expected in 2004, led by the telecommunications, cargo transport and toll-road sectors, as a consequence of the higher forecast levels of economic activity.

Manufacturing

Manufacturing also recorded sharp growth during 2003 (16.2% y.o.y.) although performance in the previous year had been irregular (see Chart I.11).

Having started the year with strong growth in the first quarter, the rise in manufacturing was halted in the second quarter because of difficulties experienced by exporting activities (at a high level of

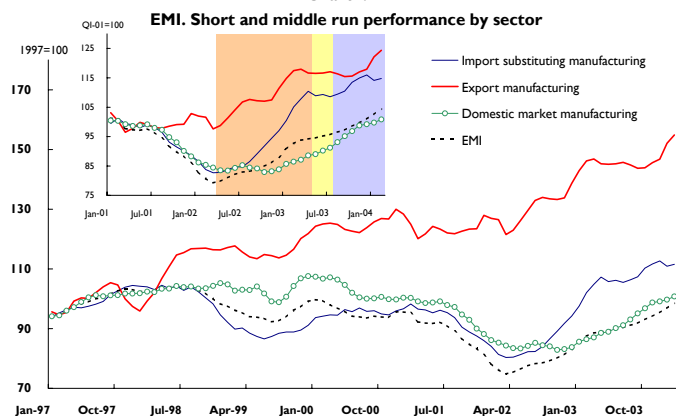
Chart I.10
Synthetic indicator of public services
(seasonally adjusted series)



Source: BCRA from INDEC data



Chart I.11



installed capacity utilization) and a slow-down in import substitution manufacturing. The latter took place because of an increase in exportable surpluses in Brazil following the recession in that economy. Nevertheless, there was a strong return to growth in the second half, boosted by the domestic market and the economic recovery in Brazil. This helped improve the performance of those sectors most closely linked to domestic demand, such as manufacturers of non-metallic minerals, the fabricated metals sector and auto manufacturing (see Chart I.12).

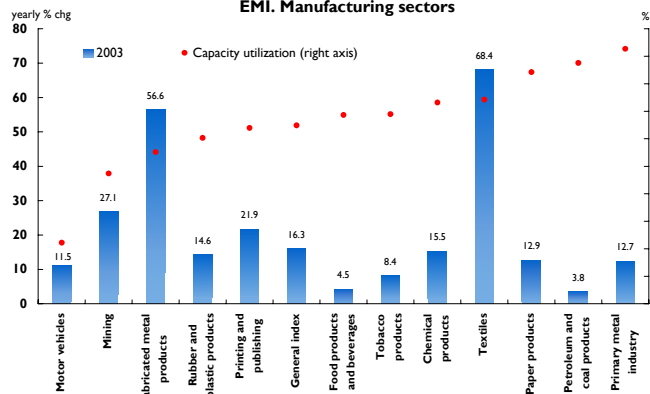
Utilization of installed capacity in manufacturing was uneven across the various categories, with sectors with a very low level of utilization, such as the auto industry, and others very close to maximum levels, such as basic metal industries and oil refining. An increased demand for financial system lending is expected from the latter in particular in 2004.

Manufacturing will record a high level of growth in 2004, driven by expansion in domestic consumption, especially consumer durables, and greater demand for manufactured goods following the recovery by the Brazilian economy. This outlook will help the strength of the financial system in terms of credit risk. Lending to this sector is equivalent to 3.3% of total financial system assets (27% of lending to corporations). Nevertheless, a slow-down is expected in the rate of year-on-year growth because of the higher levels from which it took off and the appearance of bottlenecks in some sectors that are expected to become more significant in 2005.

Demand for financing by small and medium-size enterprises is also expected to increase, to meet higher demand for working capital and the execution of small investment projects that had been put on hold due to the greater macroeconomic uncertainty in previous periods. For this reason, the financial system is shifting towards a rising use of funds to finance SMEs.

Chart I.12

EMI. Manufacturing sectors



Primary sector

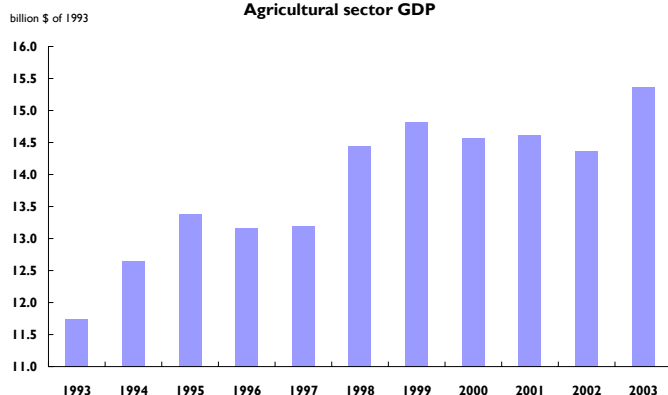
In 2003 the added value generated by the livestock, agriculture, hunting and forestry sector recorded an increase of 6.9% compared to the same period of the previous year (see Chart I.13). This performance was driven mainly by the increase in volumes harvested and the increased slaughter of beef cattle. The agricultural sector achieved an increase of 2% in the 2002/2003 harvest, mainly thanks to soybean totals, reaching a record level (70.8 million tons), at a time when international prices were rising.

In such a context, this sector used the large profits it obtained to prepay loans from the financial system and make heavy investment in machinery and improved sowing methods. Even after the settlement of bank loans that has taken place, the primary sector accounts for 2.5% of the assets of the financial system (20% of lending to the corporate sector).

The volume of the 2003/2004 harvest is expected to be slightly lower, because of worse weather conditions during the sowing and harvesting periods. In spite of this, the sharp rise in international commodity prices that accelerated in the last quarter of 2003 will more than compensate for the drop in volumes. It is estimated that the rise in profitability will enable new investments in fixed assets

Chart I.13

Agricultural sector GDP





and infrastructure (roads, ports and silos) to be made for \$13.9 billion.

Commerce

Retail sales recorded a positive trend as a result of increased spending by households, particularly in the lower income brackets. Amid a favorable macroeconomic context, the increase in the wage bill was strongly directed towards consumption. The gradual return of credit for this purpose also made the purchase semi-durable goods easier, sales of which had been severely depressed in recent years.

On the other hand, the supermarket sector posted a drop in sales in real terms in 2003, caused by a change in household consumption patterns, as they switched part of their purchases to other distribution channels such as self-service stores and neighborhood grocers. In spite of this, sector sales in nominal terms recorded an increase of 9.6% in 2003 because of the average increase in sector prices. Notwithstanding the drop in volumes sold, supermarket profit margins were unaffected, in fact recording a slight rise, as a result of the lower increase recorded by some of their costs (wages, services, rentals) compared to the rise in their prices to the consumer. The return of supplier credit also contributed to improved profitability (see Chart I.14).

Shopping mall sales also recorded a sharp rise (in nominal and real terms), benefiting from increased tourism and higher consumption by sectors with a greater purchasing power. This boost ensured that the level of store occupancy increased to 91%, similar to that recorded for commercial premises throughout the main commercial districts of the city of Buenos Aires (see Chart I.15).

Retail sale activity is expected to rise during the current year, as long as consumer credit available increases and real wages recover. This will improve the position of banks, which record an exposure to the commerce sector of 1.5% of their assets (12% of lending to the corporate sector).

Construction

Construction stood out as one of the most dynamic sectors backing economic recovery. The increase of 37.8% recorded by the construction activity indicator (ISAC) raised it to a level similar to that of 2001, but is still 19% below the peak in 1998 (see Chart I.16).

Housing construction was the sub-category that led growth during 2003. In conditions featuring a shortage of credit, the generation of a wealth effect accentuated this trend through the channeling of domestic savings into such real assets. This took place because of the effects of the depreciation of the peso on that part of the population that held savings in foreign currency, at the same time as construction costs were low (compared to the cost of housing itself). The drop in the opportunity cost generated by low yields on the remaining investment alternatives also contributed to this process. As a result, funds flowing into construction came largely from the private sector, bypassing the financial system. Nevertheless, the system has an exposure to the construction sector of 1% of its assets (8% of corporate lending), which is

Chart I.14

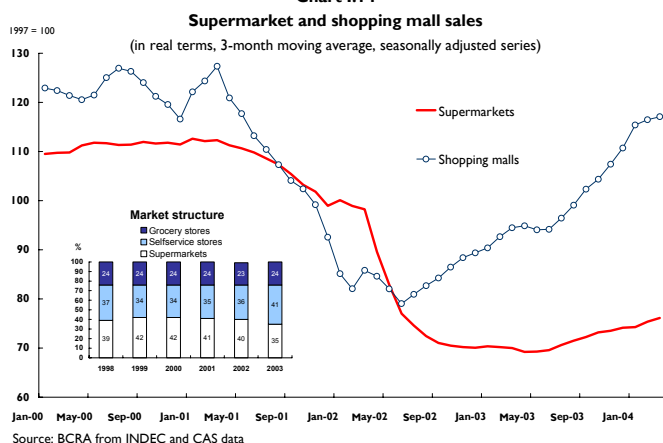


Chart I.15

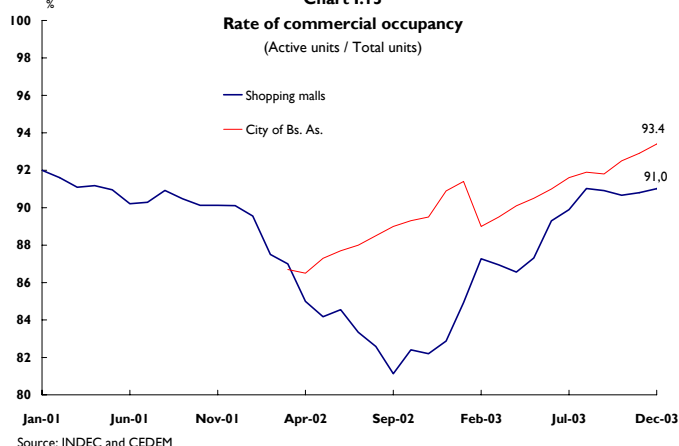


Chart I.16

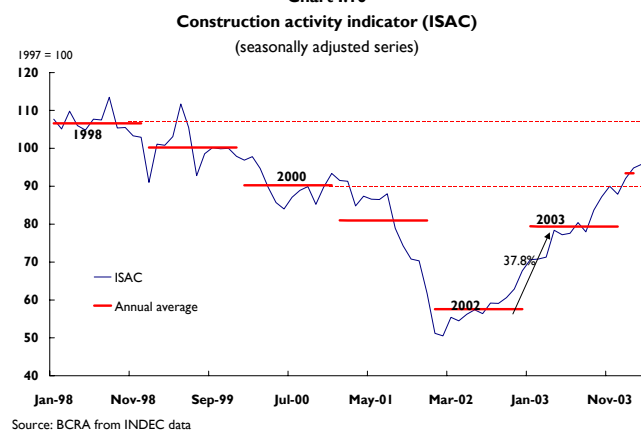
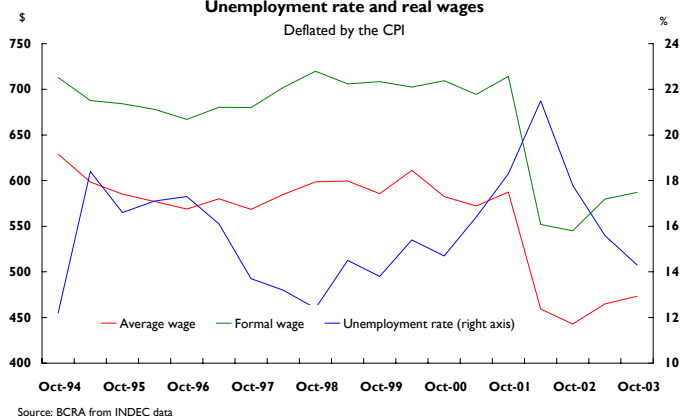




Chart I.17
Unemployment rate and real wages
Deflated by the CPI



consistent with the historically low weighting of this sector in bank lending.

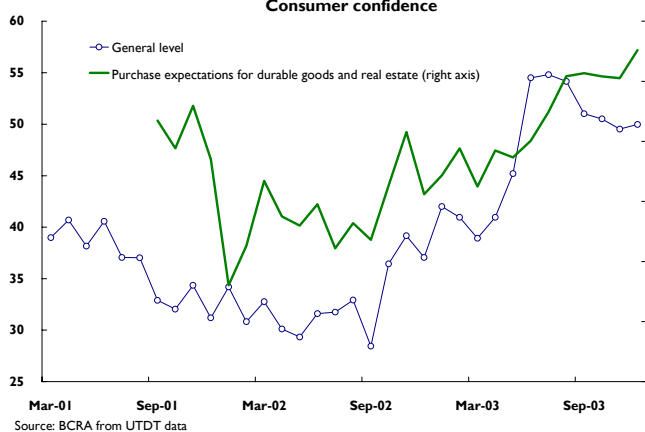
In 2004 it is expected that in the short term there will be continued activity in construction and remodeling as a result of work already begun, provided with an additional impulse from the renewed availability of credit. It is therefore expected that in the current year there will be an increase in mortgage lending, reversing the trend that has been in place over the last 3 years.

I.5. Households

Private sector consumption became the most dynamic component of demand in terms of its contribution to growth in GDP. On average during 2003 it contributed with over 6 p.p. to the growth of the economy, a trend that accelerated towards the second half of the year as the recovery gained strength.

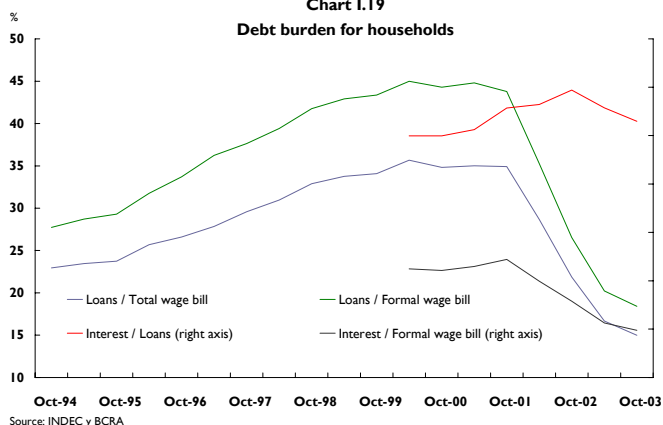
The increase in the wage bill in 2003, due to the drop in unemployment and the increase in real wages, together with the wealth effect (from reduced uncertainty regarding future income), were the main reasons for the performance by consumption (see Chart I.17). The improved development and outlook for household income has been reflected in a strengthening of the financial system.

Chart I.18
Consumer confidence



Consumer confidence recorded a significant improvement over the course of last year, especially once the presidential election was over (see Chart I.18). In addition, expectations regarding the purchase of consumer durables and real estate remain high, and are currently at levels similar to those recorded at the beginning of 1998, when the economy was showing signs of overheating, prices of durable goods compared to wages were significantly lower than at present, and consumer credit (mortgage, pledge-backed, consumer loans and credit cards) was rising at an annual rate of 24%. Despite the improvement in the expectations for durable goods purchases, there are still certain restrictions, as explained in the following chapter, that prevent significant growth in the demand for credit with this purpose, given the decline recorded in real wages in recent years.

Chart I.19
Debt burden for households



It is expected that private consumption will grow by around 9% in 2004, faster than GDP. This will be due to improvements expected in the wage bill (following a further decline in unemployment and a rise in wages in excess of 10%), the mentioned high levels of consumer confidence, and the drop expected in lending rates.

In the last two years there has been a sharp reduction in the debt burden for the sector. The household sector became increasingly leveraged during the 90s, reaching a turning point during the crisis in 2001. The combined effect of a drop in financial liabilities (backed by the early repayment of debt as a result of the conversion into pesos and the preference for avoiding CER and CVS adjustment) and the rise in household income reduced household leverage. The drop in interest rates also contributed to alleviate the debt burden (see Chart I.19).

II. PRUDENTIAL POLICY: REGULATORY RE-FOUNDATION

Summary

The recession that began in 1998 and grew into a depression in 2001-2002 gradually eroded the quality of financial system assets. Lending to the private sector fell steadily as business profitability declined, while rising unemployment brought lack of job security and falling wages. When the impact affected the quality of public sector debt, a run on deposits led to a freeze on deposits and the collapse of convertibility.

The crisis in the Argentine financial system has therefore had very different origins from those of the crises seen in the 90s in emerging nations in both Latin America and Asia. Lending to the private sector, far from booming, had undergone a continuous decline, to a level of only 8% of GDP in mid-2002. The public sector was in default and only issued new debt to compensate banks for the difference between amounts paid to depositors and the rates collected from debtors; at the same time international lending agencies, which had strongly increased their exposure to Argentina in the 90s, became net receivers of funds after the crisis. The result of this was the predominance of exposure to the public sector over the private sector in the case of bank assets, and a lack of local public funds or external official funds that could be used to capitalize the system. Additionally, the system had already adapted to such low levels of activity, both in terms of the number of institutions (down by half following the crisis in 1995) and in the use of resources (closing of branches and reduction in employment between 1999 and 2002).

From this diagnosis, the Central Bank designed the strategy for its policy, considering that adjustments to system costs had already been carried out and that improvement in the macroeconomic situation and growing bank balance sheets following new lending and services to the private sector would gradually rebuild profitability. This approach, added to the restructuring of sector liabilities, was the only realistic option for the recapitalization of the system. Time thus became fundamental in two aspects: 1) to quickly separate the past from the future in terms of the profound changes in the economy following the collapse of convertibility; 2) to allow institutions to absorb the impact on their net worth that could not be corrected with public funds.

The Central Bank's prudential policy during 2003 had two aims in particular: restoring the financial system to normal and carrying out a re-foundation of the regulatory framework. Whereas the former was intended to restore the financial system to health after the banking system crisis, the latter was aimed at establishing prudential regulatory guidelines to act as a foundation for the development of a stable financial system, without losing sight of the fact that a crisis had taken place. The lengthening of the average life for banking foreign debt and of liabilities to the Central Bank contributed to the opening up of the so-called "corralón" restrictions on deposits. In addition, the Central Bank established the possibility of using extended amortization to soften the impact of the losses caused by deposit releases under court orders, and promoted a change in the valuation methodology of financial institution assets. In particular, it established a gradual convergence of the book value of lending to the public sector on its market value. In addition, given the high exposure of the financial system to the public sector, the Central Bank imposed limits on such lending.

A series of measures were also taken to encourage the granting of sound loans to the private sector. To this end, Central Bank policy aimed at improving the mass of available resources and increasing the channels for their use, promoting a process of financial re-intermediation. Restrictions on the granting of new loans were lifted, with greater weight being given to favorable prospects rather than the past situation of companies that had suffered during the crisis, and debt refinancing processes were made easier. Lastly, the Central Bank re-established the guidelines for minimum capital requirements, adapting them to international standards and eliminating the higher requirements over some debtors that had caused an erroneous bias in lending in pre-crisis years.



II.1. Context

The local banking crisis in 2001-2002 had origins that were very different from those observed during the 90s in emerging countries: a) absence of any prior surge in private sector lending, and the existence of a public sector in default, and b) IFIs, which had sharply increased their exposure to Argentina in the 90s, became net receivers of funds after the crisis. The result of this was the predominance of bank exposure to the public sector over the private sector, and subsequently a lack of local public funds or external official funds that could be used to capitalize the system. In view of these conditions, the Central Bank considered that the only realistic option for system “re-capitalization” was to rebuild profitability, which would return together with an improvement to the macroeconomic situation and the search for new business, at the same time as liabilities were restructured. The time variable thus became fundamental in two dimensions: 1) to quickly separate the past from the future in terms of the profound changes in the economy following the collapse of convertibility; 2) to provide institutions with time to absorb the impact on their net worth that could not be fixed through the use of public funds. The Central Bank’s prudential policy during 2003 aimed to restore the financial system to normal and carry out the re-foundation of the regulatory framework. Whereas the former was intended to restore the financial system to health after the banking system crisis, the latter was aimed at establishing prudential regulatory guidelines to set the basis for the development of a stable financial system.

II.2. Normalization of the financial system

In mid-2003 regulations were issued on the repayment of liquidity assistance granted by the Central Bank to financial institutions during the crisis. For those opting for the system, a schedule of interest rates and repayments was established that was similar to that of the assets secured as collateral for this assistance (mostly lending to the public sector), with repayment in a maximum of 70 installments and at an annual interest rate of 3.5% on balances adjusted according to the CER index (see Chart II.1). This mechanism, known as *matching*, required banks to first regularize the situation of the commitments arising from their foreign liabilities at the end of 2003.

This mechanism, added to the restructuring of foreign banking liabilities, enabled a sharp reduction in the average term for financial system liabilities, thus making it possible to relax the *corralón* deposit restrictions. In April and May 2003, holders of CEDRO certificates could opt to exchange them in full or in part for various alternatives, depending on the original currency of the deposit. Holders of deposits originally in pesos could request the partial or total settlement of their certificates by means of the credit of their technical value to sight accounts. Holders of deposits in foreign currency could request the technical value of the CEDRO certificates be credited to sight accounts or time deposits (depending on the amount), as well as receiving BODEN 2013 for the exchange rate difference (see Box 1).

In addition, it was established that exchange rate losses derived from compliance with court-ordered releases of deposits in their original currency could be booked as assets to be amortized over

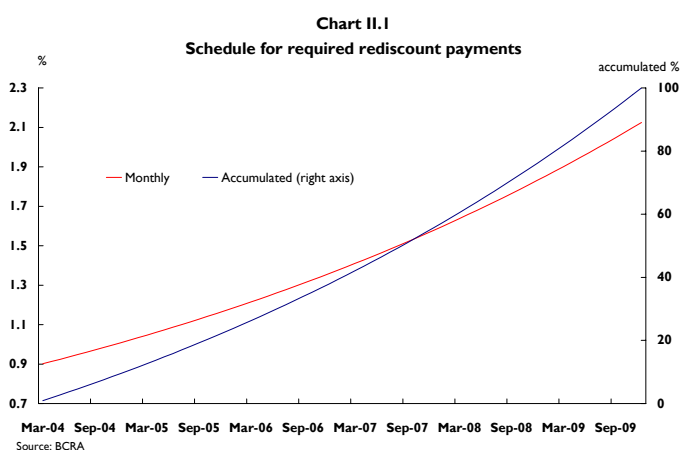
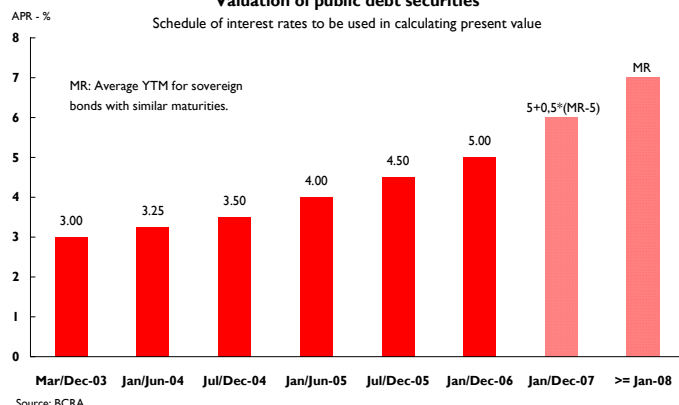




Chart II.2
Valuation of public debt securities



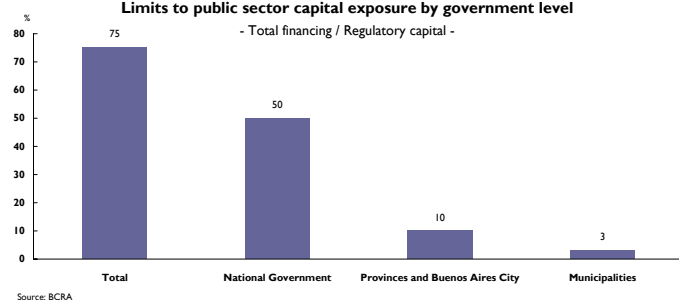
60 months. This measure did not imply the granting of compensation of any kind, and was intended as a uniform accounting treatment that spread losses over several fiscal years.

To have the book value of bank assets converge with their market value, the Central Bank laid down parameters for their valuation and limits on lending to the public sector. The aims of these changes were twofold: to ensure accounting uniformity and to gradually move valuations closer to market value. A valuation mechanism was established as from March, according to which such assets were to be valued at the lower of their present or technical values. An increasing schedule of discount rates was established to determine their present value – starting from an annual 3% – which will reach the average market interest rate in January 2008 (see Chart II.2).

On the matter of restrictions on exposure to the public sector, as from April 2003 the portfolio of national government securities (except those issued by the Central Bank) was made subject to maximum lending limits. The setting of a limit on the total arises from recognition of the high correlation in portfolio quality of the various jurisdictions and institutions in the public sector at times of financial stress. In turn, the required parameters reflected recognition by the Central Bank that the current high share of bank lending accounted for by the public sector is a consequence of the domestic crisis (see Chart II.3). Furthermore, it was established that as from January 2006 public sector lending (with the exception of transactions with the Central Bank) will not be able to exceed 40% of assets for the previous month. Lastly, as from 2003 it is no longer permitted to book government securities at their par value (except for the compensation bonds received under the terms of sects. 28 and 29 of Decree 905/02).

II.3. Regulatory re-foundation

Chart II.3
Limits to public sector capital exposure by government level
- Total financing / Regulatory capital -



During 2003 the Central Bank modified its Minimum Cash regulations, linking them more closely to the terms of liabilities, at the same time as encouraging a recovery in lending and meeting unexpected movements in the demand for real balances resulting from the final lifting of restrictions on time deposits. As from March, the residual maturity criterion has been applied for term deposits (with reserves set based on the number of days to maturity). In addition, CEDROs have been included among the items subject to liquidity reserves, with the same coefficients as those for the remaining time deposits and debt securities. On several occasions during 2003 the Central Bank decided to lower the reserve requirements rate (see Table II.1).

In addition, to assist in the normalization of the financial system the Central Bank approved a series of measures to facilitate the transformation of surplus liquidity into new loans to the private sector, as well as mechanisms for the refinancing of borrowings from the financial system:

- In April – on a temporary basis through to the end of 2003 – the Central Bank modified the classification criteria for commercial debtors. Companies with debt of less than \$5 million within the system could be classified with a criterion based only



Table II.I

Minimum cash requirements and minimum application of resources coefficients

Type of liability	En force as from					
	Dec-02*	Mar-03**	Apr-03	Jul-03	Nov-03	Dec-03
MC						
Sight deposits	22	22	18	13	23	20
Sight deposits by mutual funds	100	100	100	80	80	80
Time deposits						
up to 29 days	14	12	11	9	18	18
from 30 to 59 days	14	9	8	7	14	14
from 60 to 89 days	14	8	7	5	10	10
from 90 to 179 days	14	6	5	5	5	5
from 180 to 365 days	14	4	3	3	3	3
over 365 days	14	0	0	0	0	0
foreign lines of credit	0	0	0	0	0	0
Minimum application of resources						
Sight deposits	18	18	17	12		
Time deposits						
up to 29 days	12	12	11	9	Regulation repealed	
from 30 to 59 days	12	12	11	7		
from 60 to 89 days	12	12	11	5		
from 90 to 179 days	12	0	0	0		
from 180 to 365 days	12	0	0	0		
over 365 days	12	0	0	0		
Total (MC + MAR)						
Sight deposits	40	40	35	25	23	20
Sight deposits by mutual funds	100	100	100	80	80	80
Time deposits						
up to 29 days	26	24	22	18	18	18
from 30 to 59 days	26	21	19	14	14	14
from 60 to 89 days	26	20	18	10	10	10
from 90 to 179 days	26	6	5	5	5	5
from 180 to 365 days	26	4	3	3	3	3
over 365 days	26	0	0	0	0	0
foreign lines of credit	0	0	0	0	0	0

* Rescheduled deposits were not under the requirement. As from March, they were made subject to the same regulation as term deposits.

** Residual term was included in minimum cash requirements and minimum application of resources coefficients.

Note: All through 2003, non-bank institution current accounts, special dollar accounts as collateral for futures and options transactions and special sight accounts in foreign currency were subject to an 100% requirement, while judicial escrow accounts were subject to a 10% requirement.

Source: BCRA

on the arrears recorded in their debt servicing. This measure recognized that the application of normal classification criteria, based on projected cash flows, could generate a considerable disparity in classification from one bank to another, given the context of unusual uncertainty in macro and microeconomic forecasts. Also, only a third of the total number of days in arrears were computed for the period between the imposing of *corralito* restrictions and April 1, 2003, as this was the time during which the economy underwent the worst of the liquidity crisis.

- The requirements for promissory notes to be considered as preferred class “A” guarantees were eased, and in view of the legal impediments to the foreclosure of mortgage debtors, the term during which mortgages for loans in situation 4 or 5 can be maintained as preferred guarantees was lengthened by 18 months.
- The increase in the limit for equity interests that can be taken as creditor protection (from 12.5% to 20% of the capital or votes of the issuing company) was extended until the end of 2004.
- The percentages of new lending that banks can grant to companies classified in categories from 2 to 5 were increased, assigning these increases the same provision level as that required for performing loans (1%) (“additional lending”).
- To facilitate credit availability for companies with a highly favorable outlook but significantly damaged net worth due to the crisis, it has been allowed for loans implying new disbursements of funds through to June 30, 2005 to exceed the limit in force of 300% of the debtor’s net worth.
- Credit assistance to new customers classified as non-performing by other banks was allowed, without this requiring the setting up of provisions from a “carry-over” effect.
- Guidelines were adapted for the classification of commercial debtors entering into formal payment agreements with creditors during the period from June 30, 2002 to December 31, 2004. These debtors shall be able to be reclassified as performing on the basis of their repayment capacity (measured by means of future cash flows under the agreement, company prospects, and the outlook for the sector to which the company belongs), instead of using the general rule, based on the percentage of repayment of the refinanced principal.
- Provisions were eased in the case of losses posted for haircuts on principal, in view of the improvement deemed to exist in the collectibility of the remaining loan balance.

Complementing the above measures, and taking into account the lessons learnt in 2001, at the beginning of 2002 the Central Bank began to promote sound lending policies. It established a mandatory requirement for the application of resources obtained in foreign currency to debtors with a repayment capacity in the same currency. However, it was not until 2003 that the Central Bank was able to significantly improve the scope of this regulation, aiming at the normalization of the financial system while not abandoning the supervision of possible net worth inconsistencies. The purposes already approved for such lending were expanded to include corporate bonds and trust share certificates (where the underlying assets are export pre-finance and finance) and loans to producers or processors of export goods.

Given the need to re-establish the parameters for the evaluation of financial institution capitalization, the Central Bank redefined its



Table II.2

The new regulation for bank capital:
Maximum financing for each peso of capital

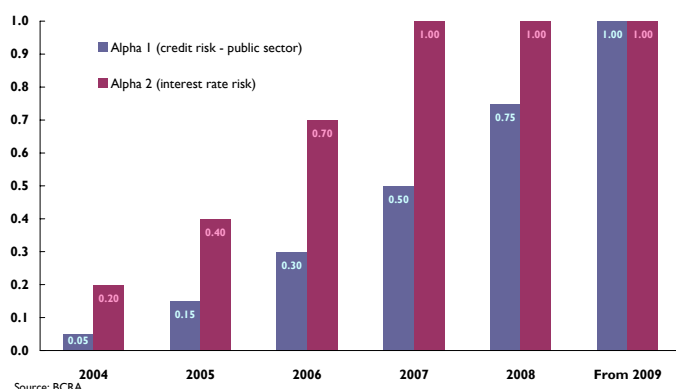
Loans to	Capital	Before ¹	Currently	Change
Public sector	\$ 1.0	\$ 25.0	\$ 12.5	-50%
Corporation	\$ 1.0	\$ 8.7	\$ 12.5	44%
SMEs	\$ 1.0	\$ 7.0	\$ 12.5	79%
Individuals	\$ 1.0	\$ 5.0	\$ 12.5	150%

¹ Including IR indicator (Basel plus)
Source: BCRA

Minimum Capital regulations to adapt them to the new economic context. The main changes effective as from January 2004 are as follows:

- A capital requirement of 8% (the same as the international standard set by the Basel Committee) has been set for private sector assets at risk, with an equal percentage required for holdings of public sector assets, covering both bonds and loans (see Table II.2).
- An additional requirement was established for the risk of mismatching between inflation and market interest rates.
- The risk from volatility in the exchange rate for the dollar has been included within the market risk requirements.
- An adjustment has been made to risk weighting factors in line with the changes made in March 2003 regarding collateral and the treatment granted to public sector assets.
- The application of the incremental requirement based on the interest rate on loans has been suspended.
- The application of the corrective factor based on the CAMEL rating (*Capital, Assets, Management, Equity, Liability*) assigned by the Superintendence of Financial and Exchange Institutions (SEFyC) normally assigns to financial institutions was temporarily suspended.
- Coefficients were set that temporarily lower both the capital requirements on loans granted to the public sector until May 31, 2003 (the alfa1 coefficient) and the capital requirements on interest rate risk (the alfa2 coefficient). At the same time, a schedule was established for the convergence of these ratios to parity by 2009 (see Chart II.4). The definition of these coefficients took into account the changes in bank portfolios and their exposure to the various risks experienced since the end of 2001, as well as current international standards.

Chart II.4
Coefficients of gradual adequacy to capital requirements



Furthermore, transparent criteria were established for the automatic granting of new financial assistance to banks by the Central Bank. The liquidity ratio of the bank must be lower than 25%, the amount to be granted must not lead to a liquidity ratio in excess of 35%, or exceed the drop in the bank's deposits in the last month, or 20% of the constraint laid down for such assistance in the monetary program. If these criteria are not met, the request will have to be approved by the Board of the Central Bank, always within the limits established by article 17 of the Central Bank Charter.

Future changes in regulations will include improvements and fine tuning of the fundamental rules that have recently been introduced, keeping pace with market developments.

III. BUSINESS STRUCTURE

Summary

Following the severe structural adjustment experienced during the crisis in 1995, the financial system embarked on a gradual readjustment of its architecture. The process of financial disintermediation that began towards the end of 1998 and the economic depression in Argentina during 2001-2002 encouraged this gradual correction. A sign of this process was the systematic drop in loans after the crisis in Russia and the decline in deposits as from 2001. The number of institutions fell, while banks that avoided closing did so by adapting their distribution channels and payroll to the shrunk volume of banking business. By 2003 bank failures had been contained. This situation resulted from the decision by the Central Bank to evaluate banks according to their prospects, promoting a forward-looking approach to economic analysis. From the standpoint of the Central Bank, there is too little business rather than too many banks. The positive macroeconomic climate is to be the driving force behind the re-intermediation process.

In 2003 the situation inherited from the crisis in 2001 forced banks to focus their efforts on stabilizing their financial situation and cutting costs, limiting their capacity to rebuild their asset portfolio and increase their income. The positive macroeconomic context and the Central Bank's prudential policy contributed to stabilizing the condition of banking liabilities that had become severely distorted as a result of that crisis. The improved performance of the financial system in 2003 was a result of the broadening of the traditional funding through deposits, an abrupt reduction in the threat represented by CEDRO certificates, an improvement in the profile of foreign debt, and a matching of the rediscount due dates to those of the assets put up as collateral.

By the second half of 2003, short-term credit to the private sector had begun to grow. Based on the sound macroeconomic context and active measures taken by the Central Bank, it is expected that during 2004 this trend will be extended from short-term to longer term lines.



III.1. Size

The long crisis had a strong impact on the economy in general, and naturally the financial system was no exception. The crisis became evident in declining levels of intermediation, which implied an unavoidable need for an adjustment to the business structure to adapt it to the recession environment. The depression in 2001 did not represent a deepening of the historical downward trend in the structure of the financial system. In this instance there were notably fewer bank failures than during the tequila crisis. A feature of the crisis in 2001 was that the financial system adapted to shrinking business by optimizing its distribution channels and personnel, so that the reduction in branches and employment was slightly higher than that which took place in the 1995/1996 period (see Chart III.1).

During 2002 the financial system received assistance from the Central Bank within the framework of its recovered role as a lender of last resort, which rescued institutions with severe liquidity difficulties. The prudential policies of the Central Bank were aimed at softening the impacts inherited from the crisis, avoiding more serious consequences on intermediation levels and the payment cycle.

Based on positive market expectations, current performance and the prospects for the business show potential for a significant recovery in the level of financial intermediation, with an overall improvement in productivity levels. These circumstances are currently setting the conditions for a context within which there should be no further episodes of significant bank failures.

Economic growth improves the prospects for the lending business in general, as well as creating opportunities for the development of new related products. Examples include:

- Export finance for SMEs
- Deepening of futures markets
- Transactional banking
- Sovereign debt and foreign currency trading
- Trust management
- Company cash management
- Check discounting
- Credit cards

A substantial reduction in the rate of the tax on bank debits and credits (IDCCB) towards the second half of 2004 would generate forecasts for improved levels of transaction business for the financial system, because it would lead to a return to the formal payments system of much of the economic activity that is currently saving on the use of cash to avoid the tax (see Chart III.2). Lastly, growing confidence in the financial system suggests that the demand for credit and transaction services derived from output growth would be channeled through financial institutions.

Notwithstanding the above, and excluding crisis-related factors, the size of the financial system undergoes changes due to its very nature. To begin with, there is a component of uncertainty regarding the global policies of multinational banks, which have a

Chart III.1
Financial system structure

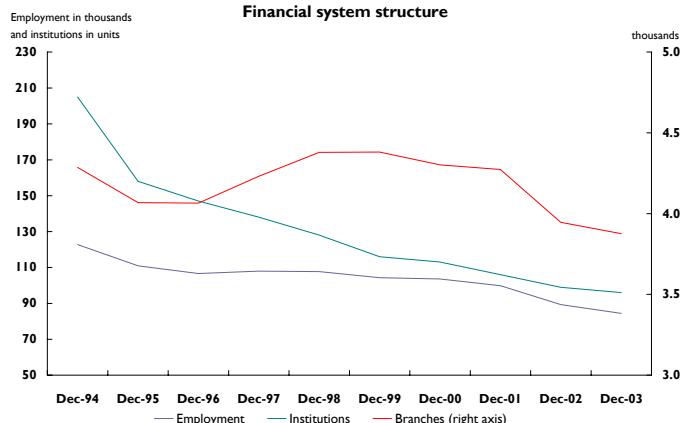


Chart III.2
Private sector current account debits as % of GDP

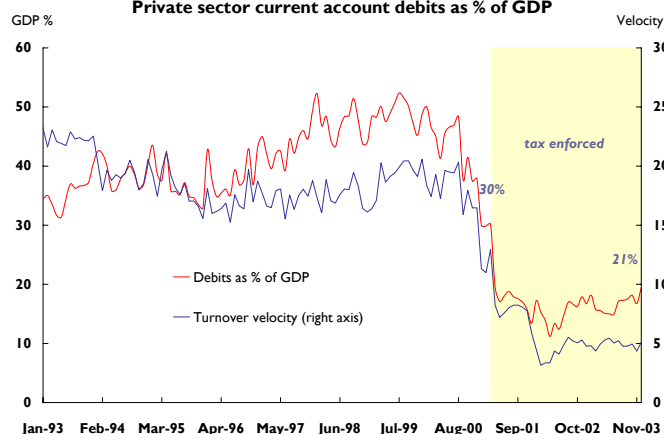


Chart III.3
Financial system concentration
- Total deposits -

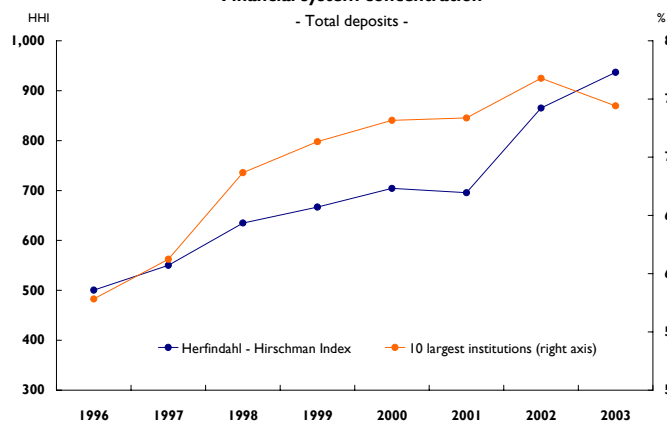




Chart III.4
Assets of financial institutions

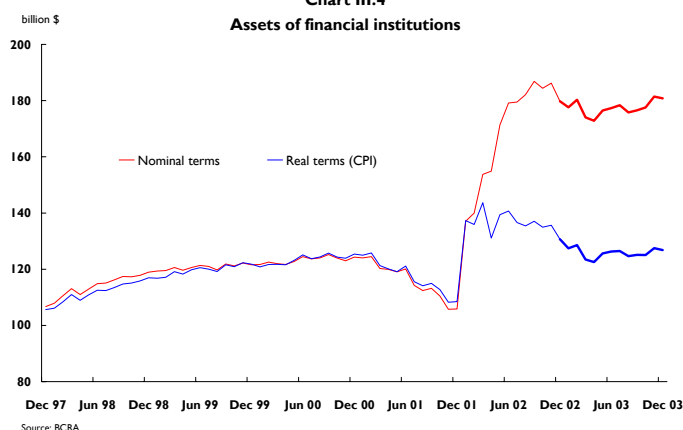


Chart III.5
Deposits of financial institutions

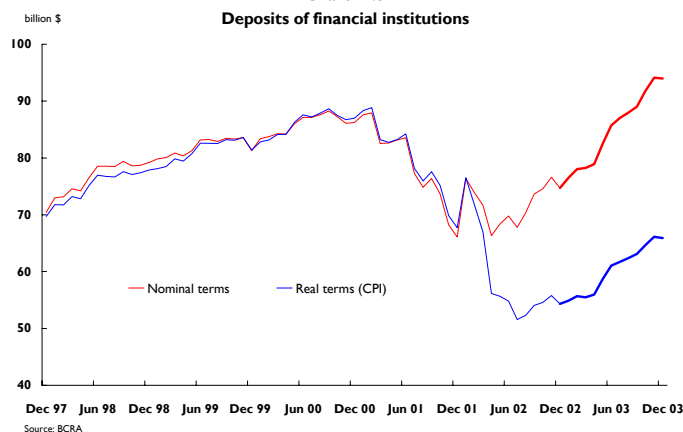
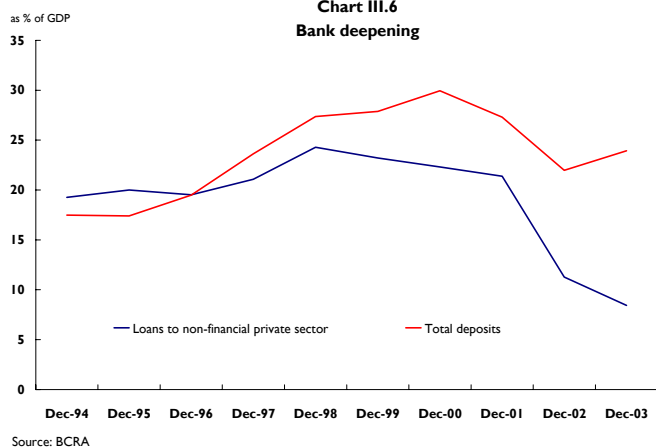


Chart III.6
Bank deepening



large presence in Latin America and Argentina in particular. Strategic decisions by head offices regarding changes in their regional presence and international acquisition and merger policies could lead to changes in the structure of the financial system. Furthermore, the domestic financial system is also not immune to the process of technology-driven bank concentration, as occurs in other countries. Cost reductions from increased scale and diversification generate a merger and acquisition environment at the local level that precedes the crisis (see Chart III.3).

III.2. Activity and financial situation

Financial sector activity grew during 2003. Although the increase in consolidated assets was slight, the growth in banking was reflected in a rise in deposit volumes (see Charts III.4 and III.5). The use of banking services as measured through deposit totals has picked up after the sharp decline in 2002, while in terms of financial system credit for the economy it remains depressed, with a recovery expected for 2004. It can be seen that domestic savings are slowly returning to the financial system, while informal credit channels continue to take advantage of the financial disintermediation process inherited from the crisis (see Chart III.6).

The recovery by traditional funding and bank customer levels, added to the low response from lending, had a determining effect on the balance sheet structure of financial institutions. Although the relative structure of bank assets and liabilities in general is proportionate to the risk management policies they follow, some of the risks to which the system is currently exposed derive from the crisis in 2001 and do not form part of their business strategy.

Following the distortions to their balance sheets, banks centered their efforts during 2003 on rebuilding their financial situation, aiming to expand the share accounted for by their traditional source of funding: deposits (see Table III.1). As a result, during the first part of the year, within the context of high rates of interest, banks gained funds, increasing the share of deposits in total funding³ (liabilities plus net worth).

Over the year, deposits contributed \$32.4 billion, of which one third came from deposits by the public sector. The rising trend in private sector deposits that began in the final months of 2002 recorded a change in its composition during 2003. Time deposits posted the greatest growth during the year, although easing off towards the end of 2003. As a result of this change in composition, the “profitability due to liabilities” recorded a slight improvement through a lower average cost and a rise in income from services linked to sight deposits.

As a consequence of the impact on the financial position of banks from the crisis in 2001, banks held a stock of CEDRO certificates that exposed them to a considerable liquidity risk. This arose because of the schedule of certificate maturities and the threat of their withdrawal under court orders. In the context of a Central Bank policy aimed at lowering liquidity risk, banks offered early repayment of CEDROs on two occasions (see Box 2 on Reduction

³ Excluding CEDRO and CER adjustments.



Table III.1
Balance sheet
Consolidated system total- %

	Dec-02	Dec-03
Assets		
Liquid assets	10	15
LEBAC	2	4
Lending to the private sector	22	19
Lending to the public sector	50	48
Other assets	16	14
Liabilities + Net worth		
Public sector deposits	5	9
Private sector deposits	28	40
CEDRO with CER	10	3
Liabilities with the BCRA	16	15
Outstanding bonds, sub. debt and for. credit	19	14
Other liabilities	9	8
Net worth	13	11

Source: BCRA

of CEDRO and liquidity risk in the section on liquidity risk), succeeding in significantly lowering this risk. During the year a total of approximately \$13.8 billion was applied to the settlement of CEDRO certificates, including payments under court orders (see Chart III.7) and the maturities of the certificates themselves.

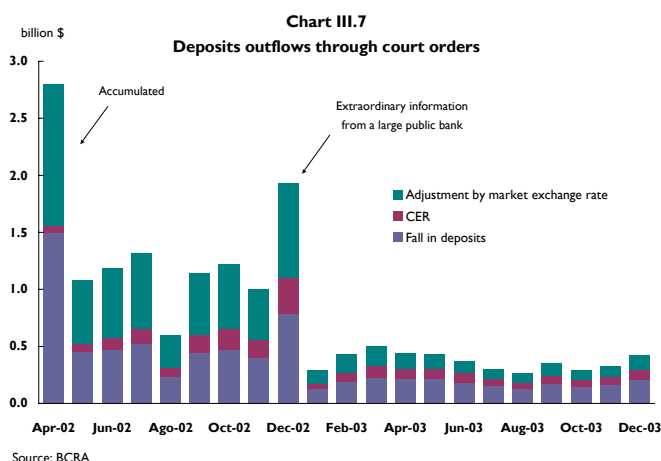
Another heavy burden on the financial system inherited from the crisis was the rise of its foreign debt. This borrowing increased at the rate of the nominal depreciation of the peso against the dollar during 2002 as from the collapse of convertibility. In addition, bank external debt constitutes a source of exchange risk for the financial system. Encouraged by the Central Bank regulation that the process of restructuring foreign liabilities abroad be underway as a requirement for access to the refinancing of liquidity assistance loans granted by the BCRA⁴, the banking system acted alongside other local companies in the process of external debt restructuring. As a result, a significant drop was recorded during 2003 in this type of funding (which includes foreign credit lines, corporate bonds and subordinated debt). This behavior was seen mainly among private banks, which by means of haircuts, government security swaps and – in the case of foreign banks – debt to equity swaps with their head offices (see section on Solvency) were able to lower their external debt in dollars by almost 26%.

Action by banks on the side of assets was less dynamic than for liabilities. One of the reasons has been the proximity of the crisis and its consequences on portfolio management policies. The latter aspect, added to the low demand for credit by both companies and individuals and the low average term to maturity of funding and its high volatility (in particular because of court orders), led banks to adopt a policy that aimed at rebuilding holdings of liquid assets. The sector applied \$11.6 billion during 2003 to the rebuilding of its excess reserves to minimum cash regulation, as banks began the year with a requirement shortfall.

Investment in LEBAC was the most popular alternative for financial institutions, due to their sizeable interest rates, especially during the first half of the year. Holdings increased to a level of 4% of total assets by December 2003. This increase took place by means of a use of funds totaling \$4.3 billion during the year, with positive but declining monthly flows until the last quarter of 2003, when yields on Central Bank securities began to drop.

The crisis left the banking sector with a high exposure to public sector credit risk (see following sector). Compensation granted to banks together with the conversion into pesos of the loans to the private sector led the public sector to become the largest banking system debtor, with a 48% share of assets at December 2003 (this calculation includes government securities, loans to the government and government compensation payments), falling 2 p.p. over the year.

In a context of low demand for loans by the private sector, there has been an annual decline in loan totals of 12%⁵, a significantly lower drop than in 2002. In the final months of the year, however,

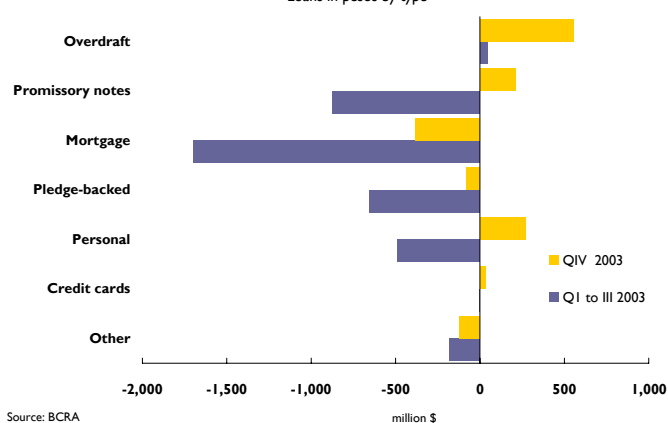


⁴ This condition was laid down by Com. "A" 3940, in the context of the refinancing of advances and rediscounts established in Chapter II of Decree 739/03.

⁵ If the calculation were to take into account the transfer to memorandum accounts by banks of those loans considered to be unrecoverable, the annual drop would fall to 7%.



Chart III.8
Change in the balance of financing to the private sector
 Loans in pesos by type



an increase was recorded in short-term lending, while the decline in longer-term lines slowed (see Chart III.8). Current account overdraft and credit card lines recovered the most. Marketing plans involving no-interest installment plans and the drop in interest rates on borrowing contributed to the growth of this type of line. The effects of rising levels of consumption in the context of a growing economy also contributed. Longer term loan balances, in spite of slowing their rate of decline, showed no clear signs of recovery in 2003 (for further detail on bank exposure to the credit risk represented by households, see Credit risk section).

IV. RISK MANAGEMENT

Summary

In 2003 the financial system saw a consolidation of the recovery in deposits that began in 2002, enabling banks to rebuild the liquidity that had deteriorated as a result of the crisis. In addition, the high rates of interest at the beginning of the year, which encouraged the rebuilding of traditional funding, declined systematically to historically low levels. In such a context, the financial system strengthened its exposure to liquidity risk, ending 2003 with liquidity coverage for 24% of total deposits. Other factors also contributed: the recovery of the role as lender of last resort by the Central Bank, and the sharp reduction in the threat posed by CEDRO maturities. The latter increased confidence in financial institutions, reducing the probability of deposits withdrawal on maturity.

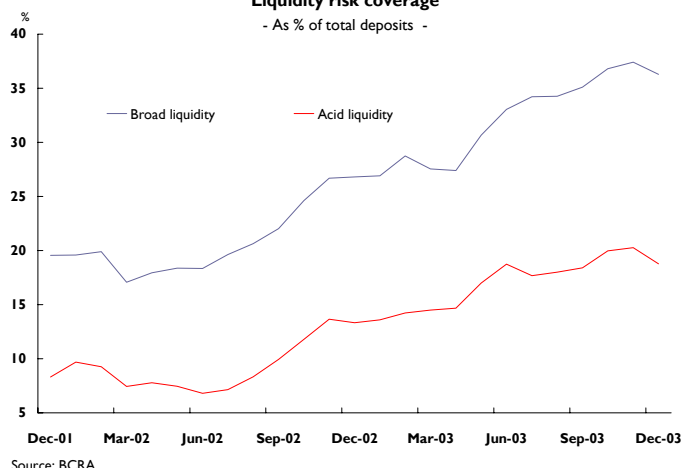
The public sector represents the principal source of credit risk, partly due to the situation of banks prior to the crisis, and partly due to the compensation received following the crisis. Currently, most of the public sector assets held by financial institutions are excluded from the sovereign debt restructuring process. Nevertheless, the future value of all government bonds currently in circulation will depend on the outcome of that negotiation.

During 2003 the financial system gained in strength in the face of private sector credit risk – delinquency fell 5 p.p. year on year, ending 2003 at 33.6% of the private sector portfolio. Current and future repayment capacity improved for all economic sectors, strengthening the position of the financial system in terms of corporate credit risk. The economic and financial position of households also improved, increasing the outlook for recovering credit to this sector. It is expected that the process of economic recovery, lower current debt levels and lower interest rates will not lead to any threat of an excessive increase in bank exposure to counterparty risk in the medium term.

The imbalances caused by the crisis are particularly evident in the exposure to the risk from foreign currency and index-adjustment mismatching. In addition, the increase in mismatching of the relative maturity of assets generates a rise in the interest rate risk. Furthermore, the increase in exposure to market risk has been due to higher holdings of frequently traded financial assets and the volatility of the peso-dollar exchange rate. Nevertheless, the stability of the local economy, particularly towards the second half of 2003, did not cause these sources of mismatching to have a significant impact on net worth. As a result, it is expected that in 2004 the stability of the principal economic and financial variables will be reinforced.

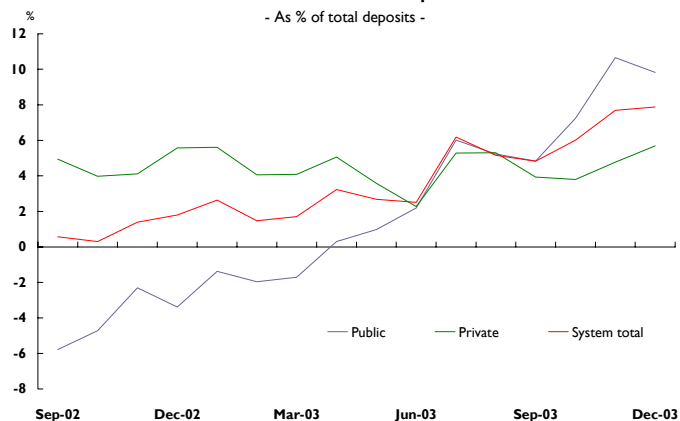


Chart IV.1
Liquidity risk coverage
- As % of total deposits -



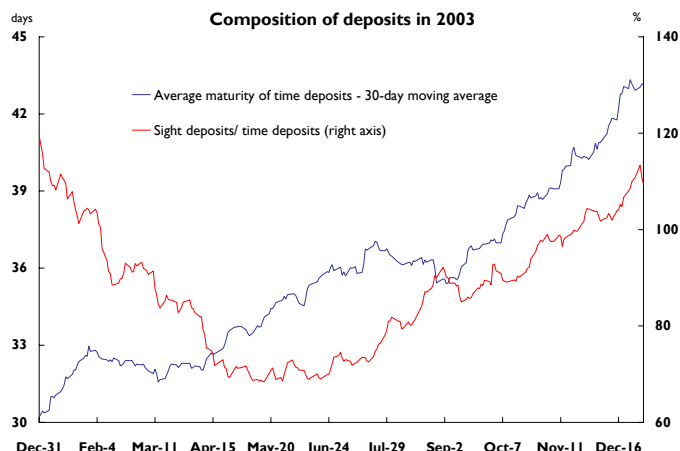
Source: BCRA

Chart IV.2
Excess cash reserves in pesos
- As % of total deposits -



Source: BCRA

Chart IV.3
Composition of deposits in 2003



Source: BCRA

IV.1. Liquidity risk

During the course of 2003 system liquidity reached a higher level than recorded on average during the convertibility regime, and was similar to that recorded after the tequila crisis, when the Central Bank had introduced a policy for the strengthening of system liquidity in a monetary system that lacked a lender of last resort. In contrast, during 2003 the increase in liquidity arose in particular from the behavior of banks in the context of the pulling out of a severe banking crisis.

In 2003 the financial system benefited from the slant in Central Bank monetary policy to encourage high levels of liquidity in the economy in general. The systematic reduction in interest rates is an example of this. In such a context, the financial system was able to quickly recover minimum liquidity levels. Rising levels of confidence in financial institutions (reflected in higher deposit levels), and a reduction in lending, resulted in a steady improvement as far as the coverage for bank liquidity risk was concerned (see Chart IV.1).

Liquidity indicators (for pesos and dollars together) improved steadily and significantly in 2003. This could be seen both for the narrower liquidity ratios as well as for the broader ones. Broad liquidity (defined as minimum cash compliance plus other liquid funds, and holdings of LEBAC) rose by 9 p.p. of total deposits, to 36% of deposits by the end of the year. In a similar manner, the narrow liquidity indicator (which takes into account only current account deposits at the Central Bank) changed accordingly, rising 5 p.p. to a level of 19% of total deposits (see Chart IV.2).

Liquidity measures compared to prudential regulations show that the banking system recorded a positive trend in 2003. This performance has included the effect of the increase recorded in public banks, which gradually pulled out from under-compliance. Hard hit by the extraordinary outflow of deposits, public bank liquidity levels had fallen below the minimum cash requirement, a situation that only began to improve at the beginning of 2003. State-owned banks recorded a notable increase in deposits (in part from the redemption of quasi-currencies). This allowed them to achieve the level of liquidity required for private banks by mid-2003, and to exceed them in the closing months of the year.

Furthermore, financial institutions easily met the minimum cash requirements for foreign currency. The sharp rise in deposits in dollars and the limited use made of such resources led to a low exposure to liquidity risk from the holding of assets and liabilities in dollars.

**BOX 1: BANKING OPERATION RISKS**

Exposure to various types of risk is inherent to the financial intermediation business. Maintaining credit relations over time and the ability to aggregate information on a large number of agents are two of the factors that underpin the comparative advantages of financial institutions in estimating the probability of occurrence of different scenarios. Situations of risk, which imply a known distribution of probabilities, must be distinguished from situations of uncertainty, in which insufficient information is available for an indication of the feasibility of the various possible outcomes.

Financial institutions set their business strategies to maximize profits, on the basis of the estimated risk and expected return. Nevertheless, the strategy must be adopted in the context of existing institutional arrangements, and according to the way in which they affect the incentives for financial institutions to bear risks. These include the legal system, the prudential framework, the official supervision system, the information provided for market discipline, the safety nets that exist (both explicit and implicit), crisis-management rules and the development of financial markets on which various risks may be hedged.

Although an appropriate institutional framework is a necessary condition for financial stability, it is also essential to rely on sound bank managers and the implementation of suitable internal risk management policies. The role of financial institution officials is particularly relevant, as these are mainly responsible for maintaining an adequate balance of risks.

Risk management by banks covers the identification, measurement and handling of the various risks taken, based on available information and with periodic reviews as the context changes. In addition, the handling of risk could imply it being retained, lowered or transferred. The depth of the financial system is of key importance to the transfer of risk, in so far as it is carried out through the sale of assets, diversification, hedging or insurance.

The main risks usually borne by financial institutions include:

- **Credit risk:** This arises from the possibility that debtors might not repay the loans they have been granted in due time and manner.
- **Liquidity risk:** This is a product of the mismatching of terms, as assets are typically less liquid than liabilities.
- **Interest rate risk:** This reflects the potential losses from the different sensitivity of assets and liabilities to changes in interest rates.
- **Market risk:** This relates to the effect on the balance sheet of changes in market prices of bank balance sheet holdings of regularly traded assets and liabilities.
- **Operating risk:** This relates to the potential impact on the balance sheet from changes in net income of an institution from alterations to the situation of the sector, technology or from internal failures or bad practices.

The effects of these different risks should not be considered on an isolated basis, as they are strongly interrelated. A distinction should also be made between the individual risk for each financial institution and systemic risk, in so far as the risk faced by one bank can lead to a contagion effect that ends up affecting the stability of the financial system as a whole. Analysis of systemic risk also involves factors likely to impact on the financial institution aggregate, including price shocks, changes in macroeconomic outlook or market openness and changes in market structure (including technological innovation and changes in regulations). In this regard, an environment of sound and sustainable macroeconomic policies is essential to ensure financial stability.

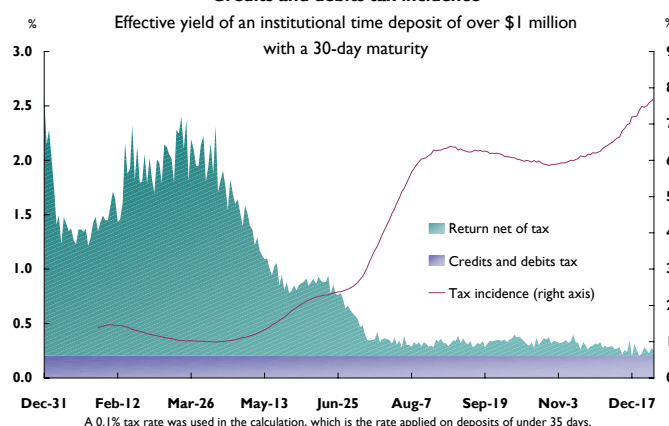


Lastly, it has been considered necessary to define the meaning of certain terms used in risk management analysis:

- **Exposure to liquidity risk:** This is measured in qualitative terms, and implies both the probability of an unexpected withdrawal of deposits and the capacity of the financial system to face such an outflow.
- **Exposure to credit risk:** The importance within a loan portfolio of a given sector in terms of total financial system assets.
- **Balance sheet exposure to credit risk:** Maximum potential loss derived from non-payment by debtors, expressed in units of net worth. The maximum amount at risk is estimated using the non-performing portfolio. This amount, net of the provisions set up, constitutes the maximum potential loss.
- **Balance sheet exposure to currency, interest rate and market risk mismatching:** The potential result from fluctuations in the principal macroeconomic variables (peso-dollar exchange rate, inflation, rates of interest and prices of financial assets) expressed in units of net worth.



Chart IV.4
Credits and debits tax incidence

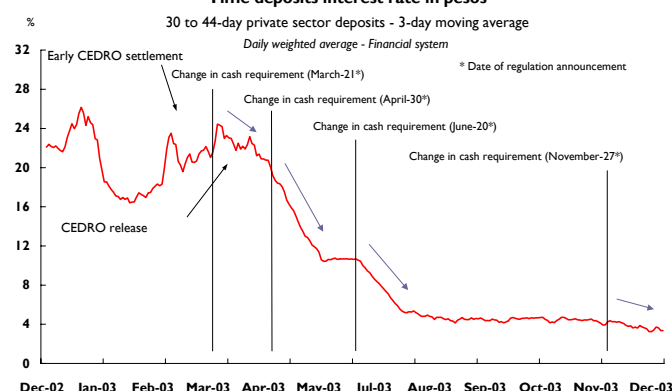


Source: BCRA

The performance of the composition of funding out of deposits during 2003 was consistent with the movement by the interest rate on deposits. High yields on time deposits in early 2003 encouraged a switch from sight deposits to time deposits, at that time for an average term of 30 days. As a result, in line with the increase in liquidity and the consequent decline in reference interest rates, financial institutions began to lower the interest rates paid on time deposits, leading to a relative increase in sight deposits compared to time deposits (see Chart IV.3). This latter effect was due mainly to the growing negative effect of the IDCCB on the yield on time deposits in the context of normalized interest rates (see Chart IV.4). Although this process influenced the average maturity of global bank funding, the setting up of time deposits took place for longer terms – as depositors sought to preserve profitability given the increased confidence in the sector – to increase by almost 50% over the year.

The recovery by the Central Bank of its role as a lender of last resort reinforces the current framework of stability in the financial system as regards its exposure to liquidity risk. The possibility of gaining access to direct lines of credit from the Central Bank at times of low liquidity builds an incentive framework that helps prevent unexpected outflows of liabilities. As indicated in detail in the section on Prudential policy, this policy for the providing of financial assistance for banks by the Central Bank forms part of a regulatory context that is fair and transparent, adding credibility to a responsible monetary policy.

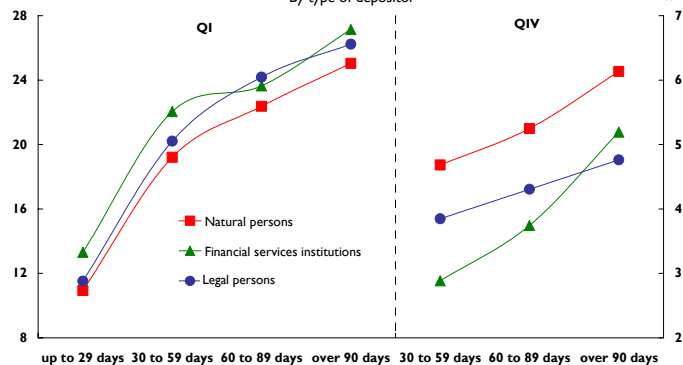
Chart IV.5
Time deposits interest rate in pesos



Source: BCRA

The improvement in banking liquidity helped lower borrowing rates, which declined to their lowest ever levels towards the end of the year. At the beginning of 2003 borrowing rates were high, because of the need for financial institutions to preserve their liquidity levels in the face of the release of CEDRO certificates (see Box 2: Reduction of CEDRO balances and liquidity risk). Once this situation returned to normal, with deposits rising steadily, interest rates began a downward trend. This trend was reinforced by the cash reserve reduction policy adopted by the Central Bank. As a result, the annual percentage rate for time deposits for 30- to 44-day maturities dropped to close to 3%, after having reached almost 25% in the first months of the year (see Chart IV.5).

Chart IV.6
Peso time deposit yield curves
- By type of depositor -



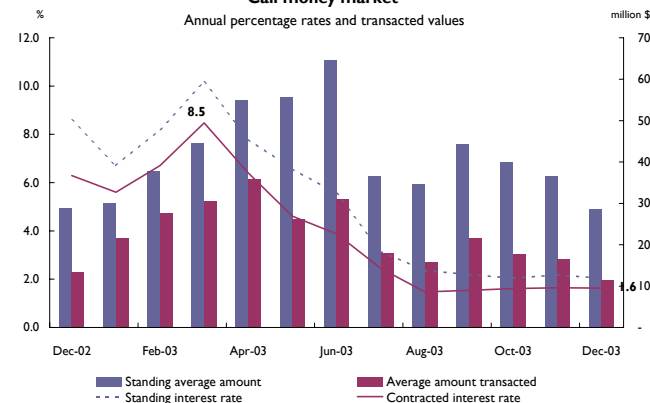
Source: BCRA

The high level of system-wide liquidity led interest rates on large time deposits to be lower than those paid on smaller amounts. This took place at the same time as microeconomic factors related to income on deposits and relative differences in the elasticities of demand for deposits. In the first quarter, the beneficiaries of higher interest rates were institutional investors, followed by corporations. Individuals received lower interest rates. The situation changed as from the second quarter, when interest rates on small deposits exceeded those paid on larger deposits. This was part of the commercial strategy adopted by financial institutions, aimed at securing the loyalty of retail customers by means of better relative interest rates (see Chart IV.6).

At the same time as interest rate levels dropped sharply, there was a flattening in yield curves. Furthermore, in the last quarter the rates of interest on deposits for between 30 and 59 days were around 4%, and interest rates for over 90-day deposits stood at around 6%. This was recorded for all types of depositor and in all deposit volume segments.



Chart IV.7
Call money market



Call market rates fell sharply during the course of the year. This was in line with the reduction in borrowing rates and the rising trends in bank liquidity levels. Trading volumes (daily open trade volumes) increased during the first few months of the year, dropping by December to levels similar to those at the end of 2002 (see Chart IV.7). At the same time as interest rates fell there was a sharp reduction in the average volatility of interest rates on daily trades (see Chart IV.8).

During 2003 call market funding focused on foreign capital branches, which towards the end of the year accounted for almost 90% of the total (see Chart IV.9). On the other hand, the presence of the public sector as a borrower on the call market declined over the course of the year, reaching minimum levels in December. This was consistent with the growing recovery of public bank liquidity, as mentioned. Banks with a majority of foreign capital lowered their borrowing of call money at the same time as local banks remained virtually outside of the borrowing market. As a result, public banks as well as domestic capital banks became net providers of funds towards the end of the year. Branches of foreign banks were net takers of funds over the whole year. Lastly, foreign-controlled banks did not record a defined position one way or the other.

The expected performance of the main variables in the financial system, such as deposit and loan totals and their interest rates, will define the path to be taken by exposure to liquidity risk. Lower rates of growth by private sector deposits and the incipient rise in lending indicate that liquidity levels will show a slightly downward trend in 2004.

Chart IV.8
Volatility of call money market rate
- 30-day moving average -

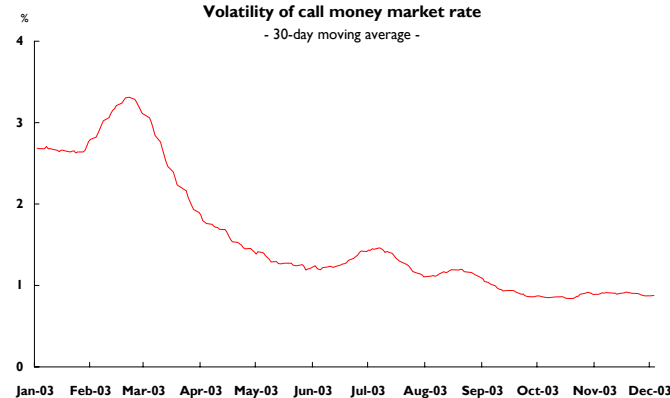
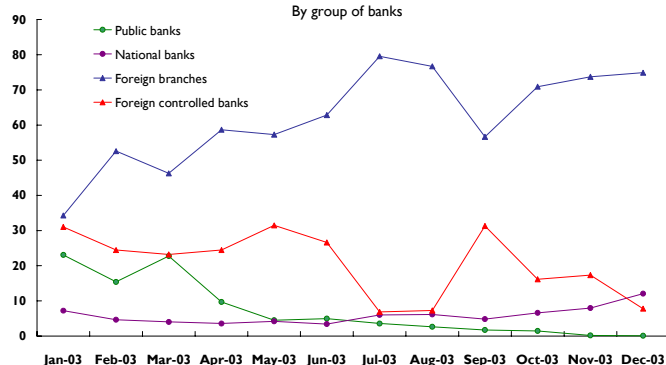


Chart IV.9
Share in the demand for call money
By group of banks





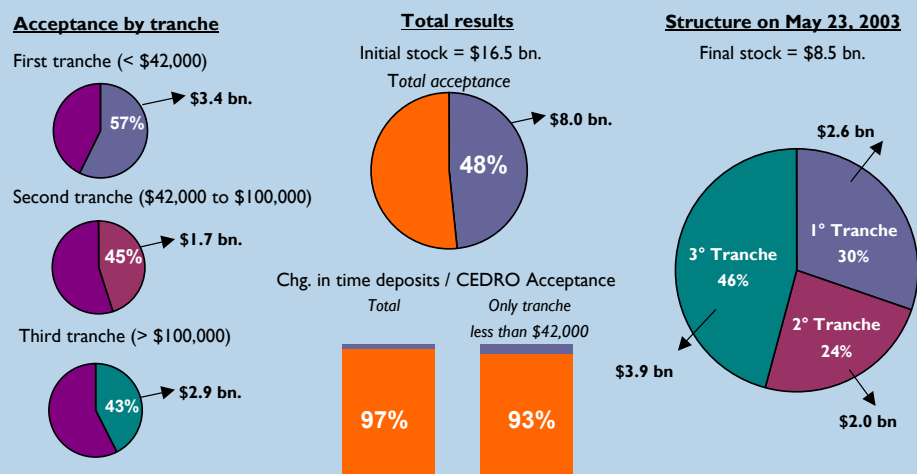
BOX 2: REDUCTION OF CEDRO AND LIQUIDITY RISK

The *corralito* (restrictions on withdrawals from sight accounts) was fully dismantled by the end of 2002, and during 2003 considerable progress was made towards the elimination of the *corralón* (rescheduled deposits). At the beginning of 2003, rescheduled deposits accounted for 29% of total deposits, while according to the schedule established, principal and interest maturities were spread as follows: 25% in 2003, 52% in 2004 and 23% in 2005. In this situation, with confidence in financial institutions only just beginning to recover and outflows still taking place due to court ordered releases, these CEDRO certificates in particular represented a threat from exposure to liquidity risk.

At the beginning of 2003, the vulnerability of the financial system to widespread withdrawals on the basis of the CEDRO maturity schedule led the Central Bank to adopt an active policy. In February 2003 changes were made to the regulations concerning the early settlement of rescheduled deposits, enabling almost all the banks holding CEDRO to participate in the scheme. Fears of the considerable liquidity risk inherent in a total release of all the CEDRO series caused most banks to release only a fraction of their total liabilities. These partial offers amounted to 26% of the total balance of rescheduled deposits. The significant withdrawal of deposits by means of court orders and the expectation of a supreme court decision on the overall conversion back into dollars of deposits conspired against the proposals made by banks, which ended with an acceptance level of 24% of the amount offered. These results were not very encouraging in terms of reducing the exposure to liquidity risk generated by the CEDRO maturities and the threat of court orders.

Nevertheless, this experience served to evaluate the reaction of depositors in the face of the return of deposits in cash. Initially, the banks that made proposals forecast reinvestment of the funds returned at 54%, whereas the actual rate of reinvestment was 77%, with renewed placement in time deposits of 70% of this total. During this period there was no notable increase in interest rates, so it could be considered that confidence in the financial system was returning. In this regard, rising levels of liquidity and the trend towards the normalization of the financial system were decisive factors.

Chart B2.1
CEDRO release - Decree 739/2003

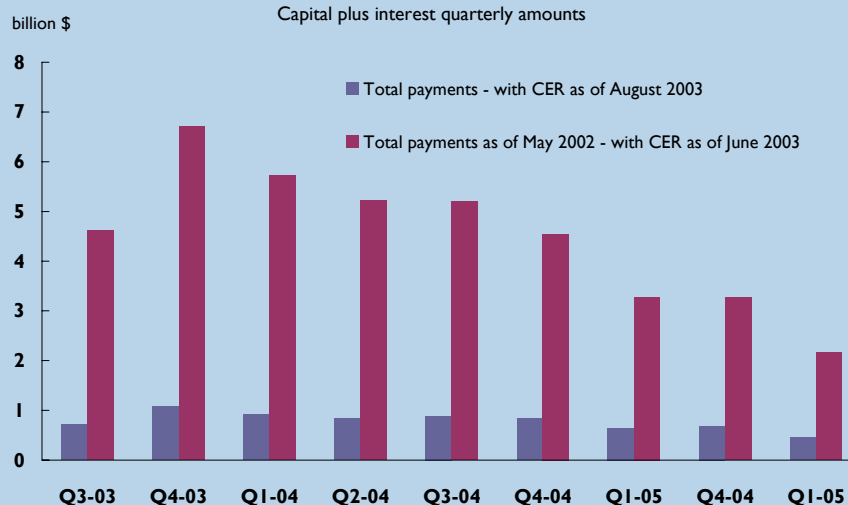


Note: Results correspond to the extrapolation of an 11-institution sample (90% of CEDRO as of Apr-07-03) to the entire system.



With this precedent of favorable reinvestment rates seen when CEDRO certificate maturities were brought forward, and faced by rising levels of systemic liquidity, in April 2003 the Central Bank, together with the Economy Ministry, announced the total release of rescheduled deposits. Under this proposal, depending on the size of the original deposit, part would be paid by the bank either in cash or in the form of a time deposit (at 1.40 pesos per US\$1 plus CER in the case of deposits set up in dollars), while the exchange rate difference was compensated for by means of the delivery of BODEN 2013 bonds in dollars. On average, using this procedure customers were able to recover in cash around 85% of their original deposits in dollars.

Chart B2.2
Change in CEDRO amortization schedule
Capital plus interest quarterly amounts



Source: BCRA

Therefore, although the release of CEDRO shortened the average life of liabilities, the proposal made to depositors was a great improvement in terms of a reduction in liquidity risk compared to the situation at the beginning of 2003. This was due to the notable increase in confidence and the disappearance of the threat represented by the concentration of CEDRO maturities (which had been considered to have a low reinvestment rate) and court orders. Acceptance of this offer totaled 48% of the balance of rescheduled deposits at the beginning of April. Once again, the estimated rate of reinvestment of customer funds was notably high, reaching 93% (see Chart B2.1). Towards the end of May 2003 the balance of CEDRO accounted for 12% of total deposits, 17 p.p. less than at the beginning of the year, sharply reducing the initial pressure from the concentration of maturities (see Chart B2.2).

It should be noted that at the end of March 2003, the Central Bank together with the Economy Ministry decided to extend the term for the return of rediscounts, taking into account the maturity of the assets assigned as collateral⁶, for which the requirement was added that the remaining creditors and shareholders of the institutions should begin to restructure their loans in a similar manner⁷. In practice, these measures for the extension of the terms of foreign liabilities and rediscounts cleared the outlook regarding future liquidity requirements, ensuring that the decision taken by the Central Bank to release the *corralón* deposits became entirely viable.

⁶ Decree 739/2003, Chapter II. Mechanism known as *matching*.

⁷ Communication "A" 3940.



IV.2. Credit risk

IV.2.1. Public sector

One of the main products of the Argentine financial crisis was the structural change that took place in bank exposure to credit risk. Compensation by means of the delivery of government securities (largely dollar-denominated) and the systematic reduction in lending to the private sector (mostly converted into pesos at the rate of 1 peso per dollar) explain this new context, characterized by a reduction in vulnerability to private sector lending offset by a rise in the exposure to lending to the government (see Chart IV.10).

At the end of 2003, exposure to public sector counterparty risk (excluding investment in Central Bank bills) amounted to 48% of the assets of the financial system. This sector thus became the principal financial system debtor. In terms of the lending instruments booked, government securities take the lead, representing almost half of all lending to the government. If the amounts recorded by banks as receivable from the government in compensation are included, the mentioned share rises to just under two thirds, with the balance corresponding to credit lines.

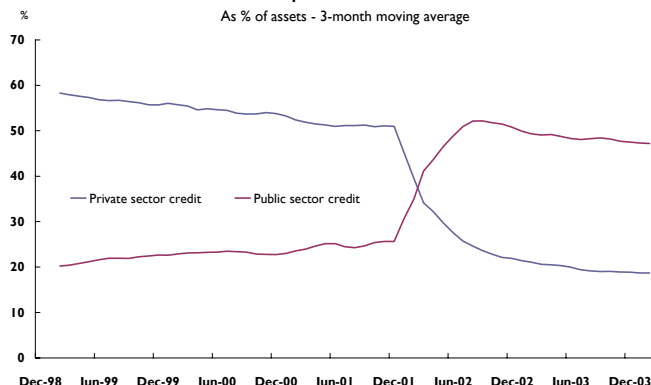
Private banks with branches nationwide show greater weakness in relation to the development of public finances and the repayment capacity of the national government. This has been due to the higher compensation for the asymmetric conversion into pesos received in comparison to the rest of the financial system. At the other end of the scale, regional banks and institutions involved in specialized lending (to both households and companies) record a notably lower exposure to the public sector than the average for the system, barely exceeding 20% of total assets (see Chart IV.11).

During 2003, the financial system reduced its vulnerability to the risk of lending to the public sector. This was due to a reduction in holdings and a decline in values in pesos of the government securities held in portfolio. On the one hand, financial institutions disposed of part of their lending, and on the other, the appreciation of the peso against the dollar (one third of public sector debt held by banks is dollar-denominated) explained part of the reduction in book value in pesos of these items.

The Central Bank established a schedule for aligning the valuation of public sector debt instruments to their market value. As mentioned in the section on changes to regulations, this took place as part of its efforts to achieve the gradual return to normal of bank operations. Financial institutions will be required to gradually record their holdings of public debt at present value (except for those securities currently valued at realization value), calculated on the basis of discount interest rates established for the purpose, until reaching market rates by early 2008. At present, based on the latest trends observed, the difference between the scheduled discount rate and market discount rates has fallen significantly (see Chart IV.12).

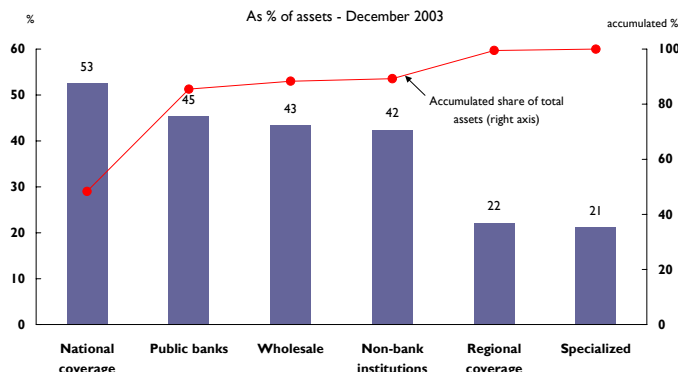
Although it is difficult to estimate the impact on financial system balance sheets of the restructuring of sovereign debt, this effect has been limited in part because of the significant holdings of performing public sector assets. In particular, as a result of the swap that took place in November 2001 of government securities for secured loans, post-crisis compensation in BODEN bonds and

Chart IV.10
Public and private sector credit risk
As % of assets - 3-month moving average



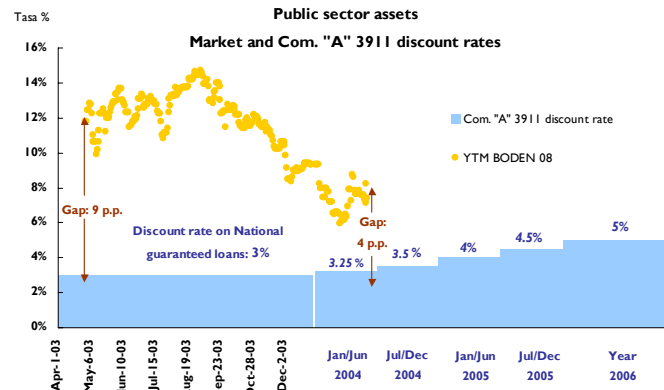
Source: BCRA

Chart IV.11
Public sector credit risk
As % of assets - December 2003



Source: BCRA

Chart IV.12
Public sector assets
Market and Com. "A" 3911 discount rates



Source: BCRA and Economy Ministry



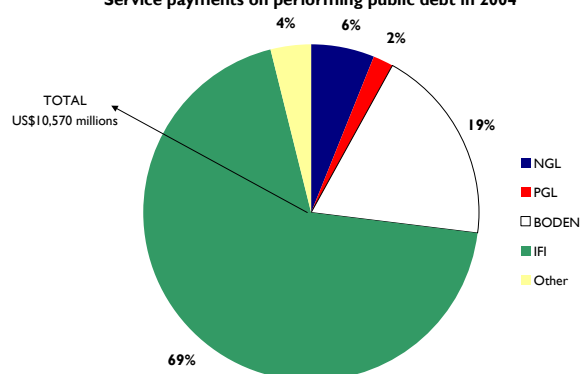
Table IV.1
Bank exposure to the public sector
December 2003 - In millions

	Pesos		Dollars		Total	
	Amount	%	Amount	%	Amount	%
Public bonds (*)	23,177	100	5,616	100	39,650	100
Performing	21,095	91	3,364	60	30,961	78
BOGAR	18,927	82	0	0	18,927	48
BODEN	2,168	9	3,364	60	12,034	30
Debt to be restructured	2,082	9	2,252	40	8,688	22
"Bono patriótico"	-	-	1,079	19	3,163	8
Global 18	-	-	335	6	984	2
Global 08	-	-	233	4	683	2
Other	2,082	9	606	11	3,858	10
Credit lines	32,742	100	132	100	33,130	100
Performing	28,447	87	-	-	28,447	86
National Guaranteed Loans	27,673	85	-	-	27,673	84
BODEN 07 bill	774	2	-	-	774	2
Compensation receivable	1,894	100	4,323	100	14,573	100
Performing	1,894	100	4,323	100	14,573	100
Total	57,812	100	10,072	100	87,353	100
Performing	51,435	89	7,687	76	73,981	85

(*) Does not include BCRA securities

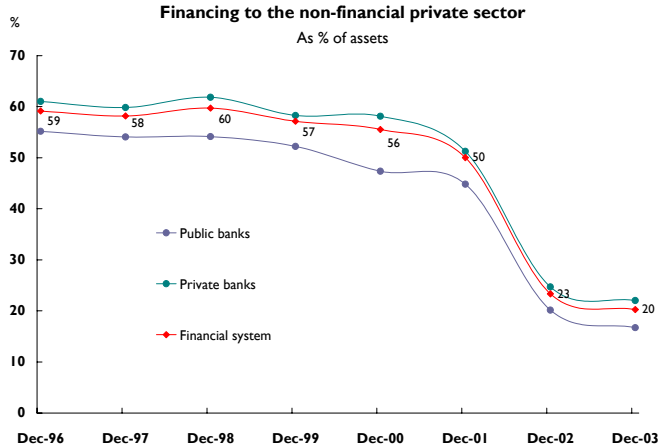
Source: BCRA

Chart IV.13
Service payments on performing public debt in 2004



Source: BCRA from Finance Secretariat data

Chart IV.14
Financing to the non-financial private sector
As % of assets



Source: BCRA

the exchange of provincial debt for national government-guaranteed bonds (BOGAR), it is estimated that the amount of the government debt eligible for the sovereign debt restructuring agreement does not exceed 15% of total exposure to that sector or 7% of total assets (see Table IV.1).

The manageable but nevertheless real dependence of the financial system on the results of the public debt negotiations is a source of uncertainty, with effects that spread over three dimensions. Initially, the structure of the new bonds to be received (taking into account haircuts on principal and interest and differing maturities and interest rates) would have a negative impact on financial institutions. In addition, the price of these new bonds will depend on the results of the negotiations and the future capacity of the public sector to meet its liabilities. Lastly, the price of the performing government securities will also be affected by the outcome of the restructuring, so that in the expectation that the end of negotiation will be good news in itself, it is predicted that it will have a positive effect on the performing public sector portfolio. Furthermore, it is considered that there will be a positive indirect effect from the impact of the agreement on the economy in general, improving the repayment capacity of both the public and private sector.

To conclude, in addition to the above arguments, it can be said that the performing bank debt of the national government and the provinces represents a small portion of the maturities of total sovereign liabilities. This fact, added to the improvement in fiscal accounts in 2003, makes it possible to argue that compliance with the commitments made with the financial system will not constitute a significant additional burden (see Chart IV.13).

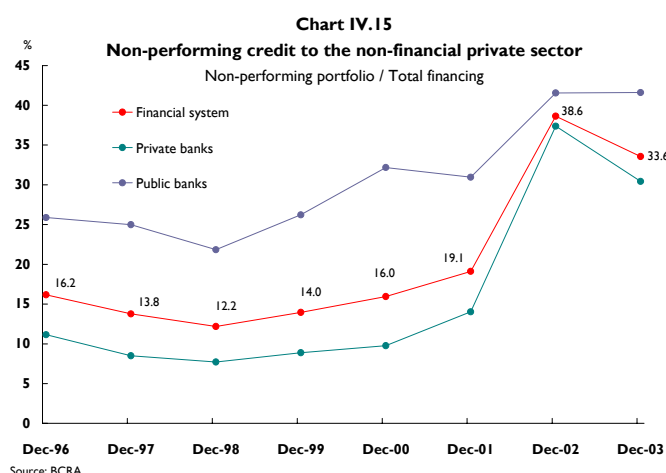
IV.2.2. Private sector

The notable recovery recorded in activity levels during 2003 and the downward trend in the various rates of interest have been responsible for a scenario of declining counterparty risk from the private non-financial sector.

Exposure to the private sector in both private and public banks fell between December 2002 and December 2003. Loans at the end of 2003 represented 20% of financial system netted assets, 3 p.p. less than at the beginning of the period. Chart IV.14 shows that this is a very low amount in terms of the level of activity, if it is borne in mind that towards the end of 1998 the weighting on assets of lending to the private sector for the financial system as a whole was 60%.

Following four years of deterioration, in 2003 private sector bank debtors reduced their delinquency rates. After the Russian crisis, non-performance by such loans rose steadily at a rate of 2 p.p. annually, until reaching a level of 19% at the end of 2001 (see Chart IV.15). After the collapse of convertibility the quality of loans deteriorated sharply (with an increase in non-performance of close to 20 p.p. for the system total in 2002), which impacted on the profitability and solvency of the financial system. This deterioration was seen most notably in the private bank sector.

The non-performance rate for the financial system's portfolio at the end of 2003 was 5 p.p. lower (33.6%) than one year earlier. The



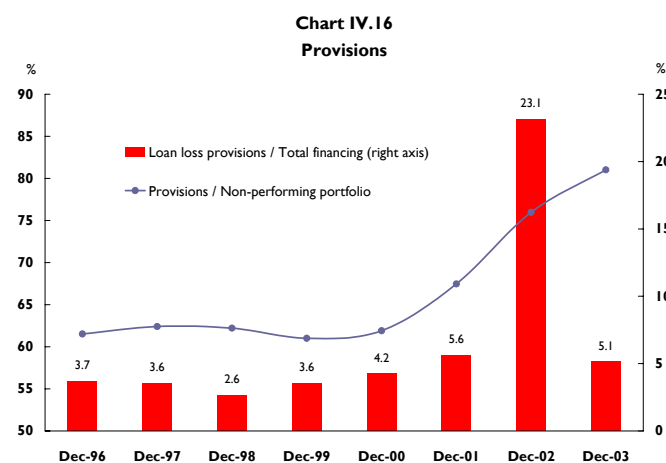
rising trend in the quality of lending was partially moderated by the behavior of the public bank segment. With a share of almost one third of total lending by the financial sector to the private sector, at the end of 2003 public banks recorded a greater deteriorating in their portfolio of loans to the private sector (with a 42% non-performance rate, 10 p.p. higher than that of private banks). These ratios have not shown major variations compared to the previous year, whereas private banks recorded an improvement of 7 p.p. in the same period.

In 2003 there was considerable reclassification activity by financial institutions in the post-crisis scenario. Most of the loans classified as in situation 1 remained at that level (see Table IV.2). Those loans in situations 3 and 2.b were the ones that recorded the greatest deterioration (with a worsening in the case of 47% and 40% of the loans initially classified in each of the two levels). Out of the total loans in existence at the end of 2002, one year later close to 55% maintained their level of classification, 15% had been repaid, and 7% had improved their classification, while close to 2% had been written off balance sheets on the grounds that they were unrecoverable, and the rest recorded a classification that was worse than the initial rating.

		December 2003								TOTAL
		1	2.a	2.b	3	4	5	6	Write off (*)	
December 2002	1	73.1	5.6	2.7	2.0	1.7	1.2	0.0	13.8	44.3
	2.a	16.4	42.6	5.2	16.5	7.1	2.8	0.0	9.4	12.1
	2.b	8.7	13.2	15.7	31.0	9.7	1.5	0.0	20.3	1.3
	3	6.3	9.9	1.0	22.1	39.9	7.0	0.0	13.7	13.1
	4	4.6	5.1	0.2	4.7	38.9	22.2	1.2	23.1	14.7
	5	2.0	0.5	0.0	0.4	1.1	56.2	3.4	36.4	13.7
	6	1.8	3.4	0.0	0.6	0.7	13.7	64.8	15.1	0.7
	TOTAL	36.3	10.0	2.2	6.9	12.9	12.9	1.1	17.8	100.0

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

During 2002, financial institutions were required to strongly increase their level of provisions to absorb losses in a gradual manner. The latter took place in the context of strong uncertainty regarding the ability to recover loans to the private sector. As a result, the level of provisions increased notably, so that towards the end of 2003, in the case of the system as a whole, the level of coverage for non-performing loans to the private sector was close to 80% (20 p.p. above the levels recorded prior to the unleashing of the crisis at the end of 2001). As shown on Chart IV.16, the greatest effort regarding provisions took place during 2002, returning the following year to levels slightly higher than those recorded previously, at the same time as there was a significant release of provisions set up during the most critical moments of the crisis.



Given the increase recorded in the level of provisions, the net worth exposure of the financial system to private credit risk has declined steadily in recent years. At the end of 2003 this exposure totaled approximately 10%, a further reduction compared to the previous year (see Chart IV.17). The mentioned process of capitalization carried out by financial institutions using own funds in the final months of 2003 helped to strengthen the financial system against credit risk.

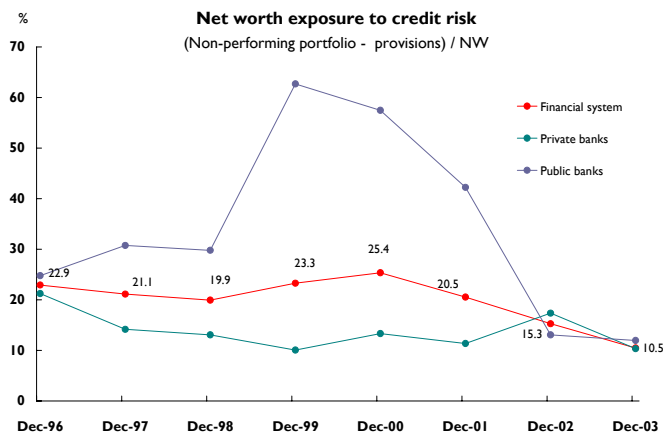
The outlook for 2004 regarding the non-performance of the portfolio of loans to the private sector is positive. This has been due to the coming together of several factors: improved prospects for economic activity, positive expectations for an increase in new lending, the positive impact on the finances of corporations from progress on the restructuring of liabilities (in a context of low rates of interest and little exchange rate volatility), and the effects of changes in regulations designed to facilitate refinancing.

It is therefore expected that in coming months the gradual improvement in system non-performance indicators will continue. In turn, this will have a positive impact by steadily reducing balance sheet exposure to the risk of lending to the private sector.



Chart IV.17

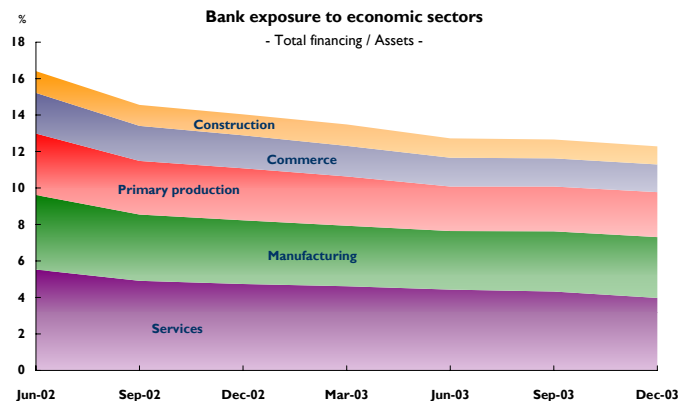
Net worth exposure to credit risk
(Non-performing portfolio - provisions) / NW



Source: BCRA

Chart IV.18

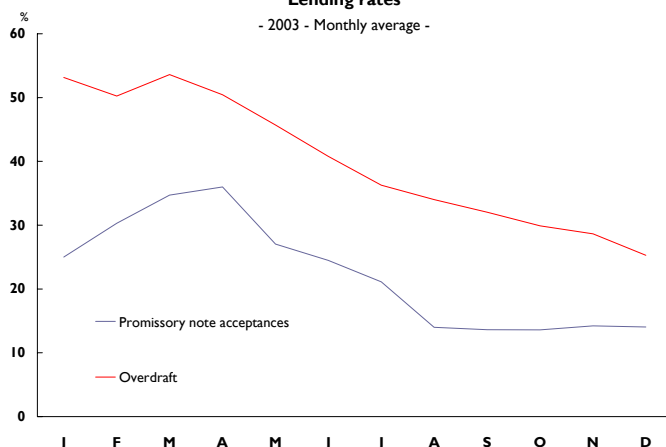
Bank exposure to economic sectors
- Total financing / Assets -



Source: BCRA

Chart IV.19

Lending rates
- 2003 - Monthly average -



Source: BCRA

This performance will be reflected in an improvement in the profitability of the system, by reducing the need for further provisions. Lastly, an effect from the improvement in the quality of loans on interest income cannot be ruled out, as loans not at present accruing interest could in future begin to do so. In addition, improved loan portfolio quality could lead to a lowering of the interest rate to be collected on new loans, thus contributing to the recovery of the credit market and the rebuilding of traditional banking intermediation.

Corporations

In the post-crisis period the financial system considerably reduced its exposure to risk from the corporate sector. During 2003 this effect could be seen from the reduction of bank lending to companies by 1.7 p.p. of assets (see Chart IV.18). In the same period, vulnerability to counterparty risk fell for all economic sectors borrowing from the financial system. If the performance of the provisions set up by banks to adjust the expected recovery value of their loans is included, the decline observed was even greater.

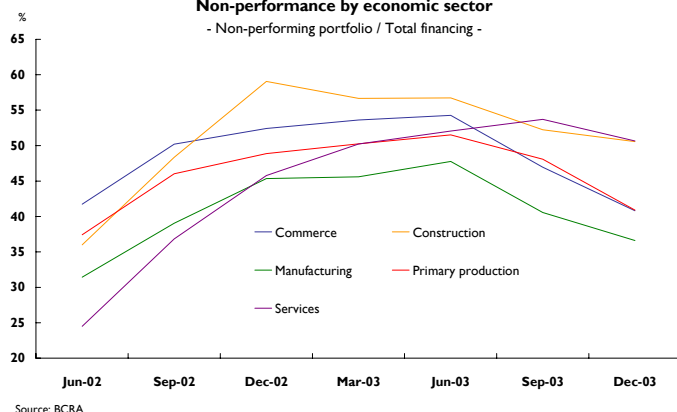
As analyzed in the first section of this Bulletin, 2003 was a year of significant recovery for the economy in general and productive sectors in particular. Productive sectors consolidated the growth that took place in the previous period and laid the foundations for the positive outlook for 2004 as regards level of activity and the rebuilding of commercial profit margins. This was stimulated by changes in relative prices, the impulse provided by consumption and the trend towards a healthier financial situation both locally and in relation to abroad.

The drop during 2003 in bank exposure to the corporate sector was in part a reflection of an economic recovery that needed virtually no financing from banks. This is partly explained by the low initial levels of utilization of installed capital, which limited the need for investment capital. In addition, increased profit margins, a product of both higher income (from changes in relative prices) and an effective reduction in debt servicing burden (lower debt from conversion into pesos, arrears in payments abroad and lower rates of interest), generated an increase in cash flows that facilitated the rebuilding of working capital. Also, the high level of liquidity in the system provided a context that encouraged certain direct investment (without banking intermediation) in the productive sector. This was to some extent reflected in the positive performance by the stock market.

At present the conditions exist for growth in the demand for credit by the corporate sector. Various factors help to explain this phenomenon. On the side of demand, it is assumed that the recovery phase of the business cycle, added to the need to make new investments, will generate a positive pressure in this regard. In addition, the mentioned reduction in the debt burden recorded in the last two years should have a positive effect on the demand for credit by corporations. In this context, both the prudential regulatory framework and the implementation of risk management policies by banks ensuring sound growth in lending will gain in relevance.



Chart IV.20
Non-performance by economic sector
- Non-performing portfolio / Total financing -



Source: BCRA

Table IV.3
Business credit risk
By economic sector
Portfolio quality (2002 / 2003 change)

		-	+
Outlook for 2004	-		
	+	Services	Commerce Construction Manufacturing Primary production

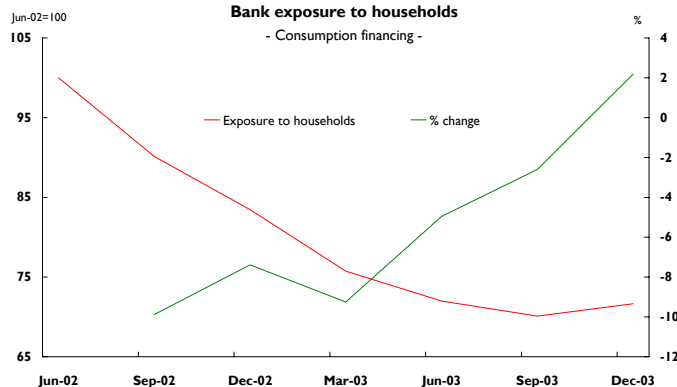
Source: BCRA

As far as banks are concerned, elements such as the comfortable liquidity position and the reduction in corporate counterparty risk it faces favor an increase in the supply of credit to this sector. The first of these factors is clearly reflected in the downward trend in interest rates, in this case rates on lines used to finance business. Both current account overdrafts (usually short term) and loans secured by promissory notes (for both short and medium terms) saw a decline in cost in 2003 to levels of close to half those at the beginning of the period (see Chart IV.19). As indicated when referring to corporations, the second factor is the macroeconomic context, which has contributed to a reversal in the upward trend for corporate sector counterparty risk in 2002, consolidating a clear annual improvement in 2003 (see Chart IV.20). The starting point for 2004, noted for a reasonably positive outlook in indicators for the various sectors, has laid the basis for further strengthening of the financial system against credit risk from its lending to companies.

In short, the strength of the financial system in the face of counterparty risk increased for almost all productive sectors. Service-providing companies are a special case. This business sector shows the highest bank debt, accounting for 4% of financial institution assets and around 25% of the leading 100 private non-financial sector bank debtors. During the time convertibility was in force, many of these companies gained access to credit abroad. The low rate of change in their income and the increase in the exchange rate led many of these companies to submit debt restructuring proposals, in part affecting domestic loans (converted into pesos). At the end of 2003, creditor agreements began to be implemented, leading to a drop in the perceived risk for the sector towards the last quarter of the year. The success of these agreements clears the way for healthy productive development financed by means of new funds from the domestic banking system. Therefore, exposure to the service sector is not seen as a significant source of systemic instability.

The remaining sectors (commerce, construction, manufacturing and primary production), which together account for 8.3% of financial institution assets, strengthened their position as sectors with a declining associated repayment risk. Similarly, debtor ratings by banks were noted for declining levels of non-performance, especially as from the second six months of 2003. This, added to the overall positive outlook for 2004, helps to explain the lower systemic vulnerability to the companies included in such productive sectors (see Table IV.3).

Chart IV.21
Bank exposure to households
- Consumption financing -



Source: BCRA

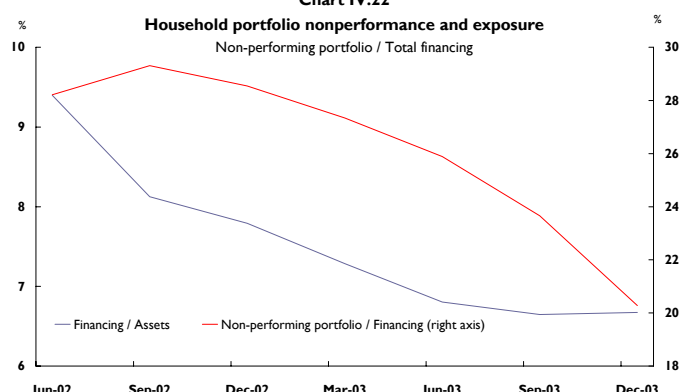
Households

In the context of a profound economic and financial crisis that is in the process of being resolved, the banking sector has in recent years reduced its net exposure to the counterparty risk from household lending (see Chart IV.21). This occurred both from a reduction in the nominal amount of lending and of its share of system assets. Further indication of this can be seen when viewing the level of provisions set up by banks.

The quality of the portfolio of lending to households has shown signs of improvement during 2003. This took place following widespread deterioration influenced by the adverse economic context since the beginning of 2002 (see Chart IV.22). The



Chart IV.22

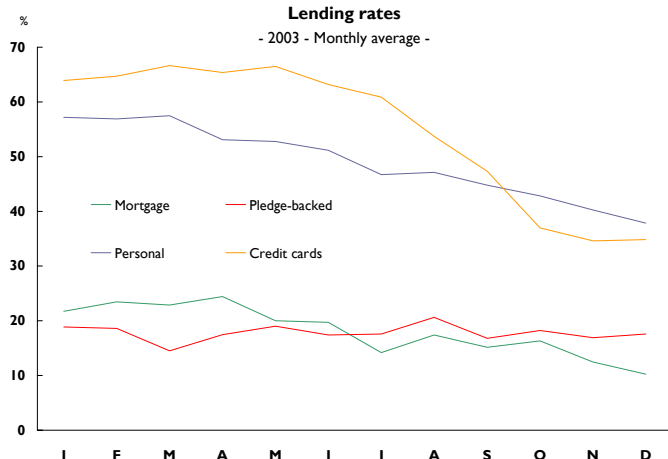


Source: BCRA

Chart IV.23

Lending rates

- 2003 - Monthly average -

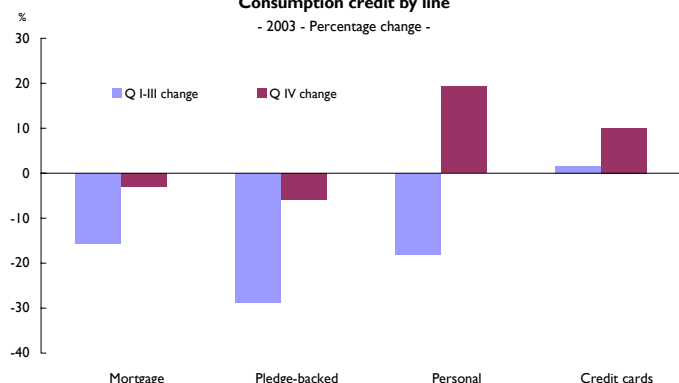


Source: BCRA

Chart IV.24

Consumption credit by line

- 2003 - Percentage change -



Source: BCRA

reduction in counterparty risk for this sector was in line with the improvement in macroeconomic factors, with a consequent change in the trend in current and expected income and in financial position (see section on principal financial system debtors). In turn, the recovery in CPI-deflated wages, and the rise in employment caused an improvement in the wage bill which, together with the early repayment of loans, placed households in a historically favorable situation in terms of debt burden. In addition, there was a positive wealth effect from the revaluation of financial and real assets.

The demand for consumer credit is on the verge of a significant recovery, as current macroeconomic conditions are characteristic of an economic recovery, driven mainly by increased consumption, and declining interest rates (see Chart IV.23). This is evident from the increase in the rates of change, with growth in lending to households already being seen by the third quarter of 2003. For 2004, indicators of the expected path of household income are optimistic, with an increase expected in the demand for consumer credit lines.

In terms of the future for lending to households, and considering demand factors, there are elements to indicate growth will be asymmetric, depending on the purpose of the loans. Short-term credit lines (credit cards and consumer loans) will take the lead, as a result of the mentioned effects of cash flows and balances. Lending for the purchase of consumer durables will react more slowly, given the rise in their relative prices, notwithstanding increased expectations to purchase, as mentioned in the previous section (see Chart IV.24).

Taking into account the performance of durable goods prices, a sharp fall has been recorded in real wages since the end of convertibility. Although wages in the formal employment segment rose by 24%, prices of new homes rose by 120%, household appliance prices went up by 73% and cars became 110% more expensive (see Chart IV.25). Limitations to the demand side of credit can be seen from the fact that whereas during the period of convertibility (when there was a sharp rise in mortgage lending) the loan installment for the purchase of a basic property was equivalent to approximately 49% of the average wage in the formal employment segment, at the end of 2003 this figure was 83% (see Chart IV.26). Furthermore, although the rate of interest that replicates the conditions of the period of convertibility is negative for 2002, this factor becomes positive for 2003, although at a relatively low level. Nevertheless, optimistic macroeconomic prospects, such as the perceived improvement in real wages derived from lower job insecurity, indicate that the initial conditions at the beginning of 2004 are a better starting-point than the outlook at the beginning of 2003.

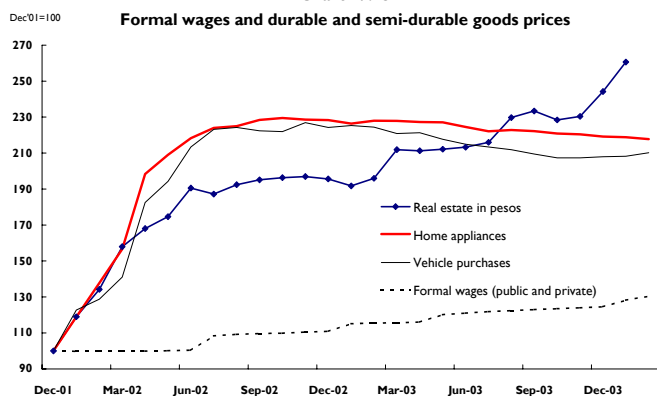
IV.3. Currency mismatching risk

After the crisis, the financial system saw its exposure to currency mismatching risk alter radically. During the 90s the widespread use of the dollar in particular as a unit of account and store of value resulted in a significant dollarization of the local banking system. Although there was a high implicit foreign currency mismatching (high dollarization of liabilities compared to a low proportion of debtors with foreign currency repayment capacity), the stability of



Chart IV.25

Formal wages and durable and semi-durable goods prices



Source: INDEC and UADE

the nominal exchange rate at the time and the perception of its permanence over time explained the view that there was no risk of any such asymmetry (see Chart IV.27). In that period there was a notable rise in dollar lending, for which customers paid lower rates than for loans in pesos. As a result, the stability of the financial system faced a threat from a scenario in which the exchange rate changed: 70% of bank lending in dollars was granted to debtors with significant difficulties in generating resources in that currency. This imbalance in the composition of balance sheets was the source of the fragility of the system in the face of the possibility of a change in the local exchange regime (see measures taken by the Central Bank to prevent similar situations on pages 18 to 20 in the section on Prudential policies: Regulatory re-foundation).

Chart IV.26

Household debt burden

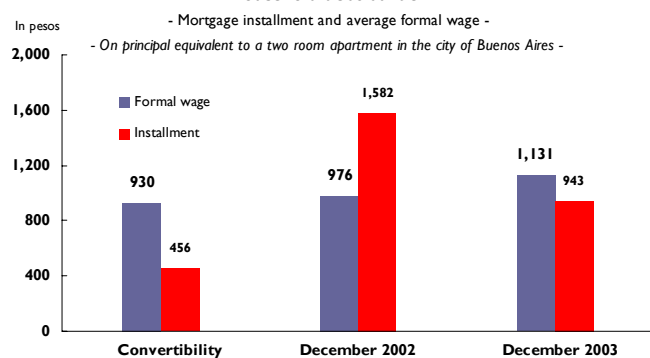
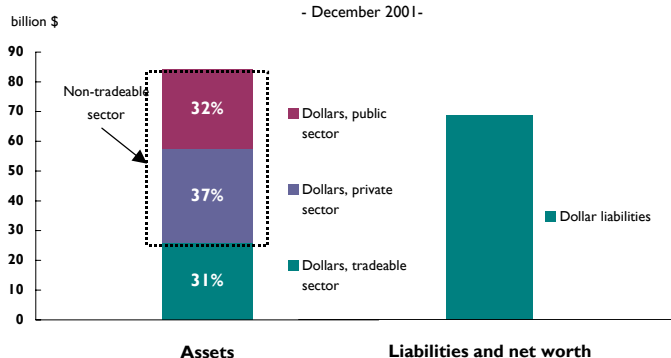


Chart IV.27

Foreign currency mismatch before the crisis

- December 2001 -



Source: BCRA

**BOX 3: BALANCE SHEET MISMATCHING IN THE FINANCIAL SYSTEM**

The nature of banking business generates balance sheet mismatching. To moderate their potentially negative effects on net worth, financial institutions need to manage these risks efficiently. This is done by limiting the size of the potential loss, which can be achieved by means of a reduction in the nominal amount of the exposure and/or by hedging using financial instruments available in the market. Balance sheet mismatching defines much of the risk profile facing the financial system.

Within this group, the mismatching of terms between assets and liabilities is one of the risks related to the financial intermediation activity. Investment in long-term assets (generally at a fixed interest rate) funded by short-term deposits (at an interest rate that is continuously updated) is at the heart of the banking business. As a result, assets and liabilities record different sensitivities to interest rate changes, causing fluctuations to the economic value of the claims making up the net worth of financial institutions.

In addition, as part of their regular operations, banks must bear currency mismatching. The implicit risk arises in this case when the amount of the assets denominated in one currency (peso, peso plus CER, dollar, among others) differs from the amount of the liabilities denominated in the same currency. Movements in nominal interest rates and/or adjustment indexes therefore have an impact on bank results. For instance, over a period in which the local currency is appreciating, a net positive position in assets denominated in foreign currency would imply a balance sheet loss.

The combining of term and currency mismatching (pesos adjusted for inflation) means that the financial system is exposed to risk from the real interest rate. This involves the holding of long-term assets at a fixed interest rate, to be adjusted, for example, by inflation, and short-term liabilities at market interest rates, and which are not adjustable. In this case, the financial system is exposed to increases in the real rate of interest. Losses from these increases derive from the greater growth of nominal interest rates (adjustment of outlays) compared to inflation (adjustment of income).

As a consequence of the current crisis, the Argentine financial system currently shows large scale involuntary balance sheet mismatching (see Chart B3.1). On the one hand, the effects of the crisis increased term mismatching. The exchange of public debt for secured loans lengthened the average term of a large part of the system's assets. Subsequently, the addition of compensation by means of BODEN bonds and the reduction in CEDRO certificates contributed to the mismatching of terms. In the post-crisis context, the Central Bank contributed to mitigating these effects by creating the so-called "matching" of Central Bank liquidity assistance to the public sector assets granted as collateral. One condition for participation in this matching was that the restructuring of bank foreign liabilities should be underway, which added to the slow but steady increase in the average term for deposits, acted to moderate the risk from mismatching of assets and liabilities.

Although exposure to the risk of currency mismatching has been reduced significantly as a result of the conversion into pesos of assets and liabilities, the local financial system retains a long position in foreign currency denominated securities. The size of this mismatching is explained by the receipt of compensation (BODEN) in dollars, and the settlement of liabilities in foreign currency. The latter was frequently carried out as part of debt restructuring and the capitalization of liabilities in foreign currency by various financial institutions.

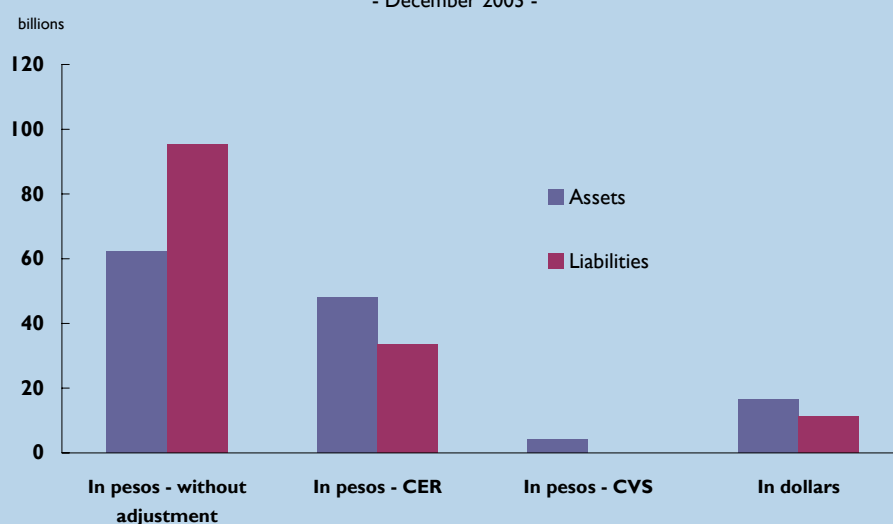
Although a large part of the assets and liabilities that were converted into pesos were adjusted according to the CER index (a smaller proportion were adjusted according to the CVS index), indexed liabilities declined over time. As the CEDRO deposits began to be repaid in advance, banks managed to retain a large part of these funds in the form of new time deposits in pesos, without adjustment clauses and at market rates of interest. This led to a significant asset position in CER-indexed securities. As a result, the system developed a high exposure to variations in the real rate of interest, given the possibility of losses in a scenario in which such rates were to rise. Assets converted into pesos that accrue the CER adjustment plus a low additional rate of interest obtain a constant real rate of interest, while the real cost of the corresponding funding is sensitive to the variations in the nominal interest rate and inflation.



These mismatches inherited from the crisis take up a large part of the capacity of banks to bear risks, influencing the possibility of accepting new risk exposure. The advisability of banks lending for long terms adjusting loans according to the CER is countered by the consequent increase in the asset position of this mismatching. Therefore, these balance sheet mismatches act to offset the desired recovery of financial intermediation.

At present there are insufficient financial instruments for banks to offset term and interest mismatches. The possibility of matching the interest rate of funding by resorting to market securities has been delayed due to the lack of development of futures markets. Given the size of the mismatches that exist, it will be difficult to settle interest rate swaps that would, for instance, allow the exchange of assets flows adjustable by CER plus a fixed interest rate for flows at a market rate. The currency mismatching risk could be covered at least partially by means of dealing on existing foreign exchange forward markets, or by means of the development of trading in currency swaps. In the near future the deepening of existing futures markets (for currency) and the creation of new futures markets (for interest rates) should be combined with the trading of swap contracts (for currency and interest rates) to mitigate the exposure of the financial system to the risk from balance sheet mismatching derived from the crisis.

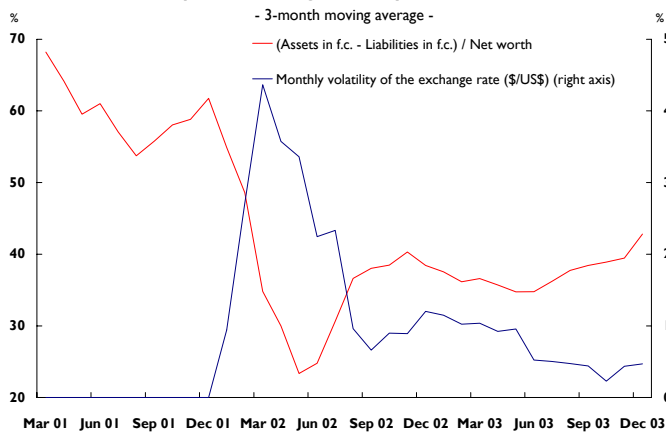
Chart B3.I
Currency mismatch
- December 2003 -



Source: BCRA



Chart IV.28
Exposure to foreign currency mismatch risk



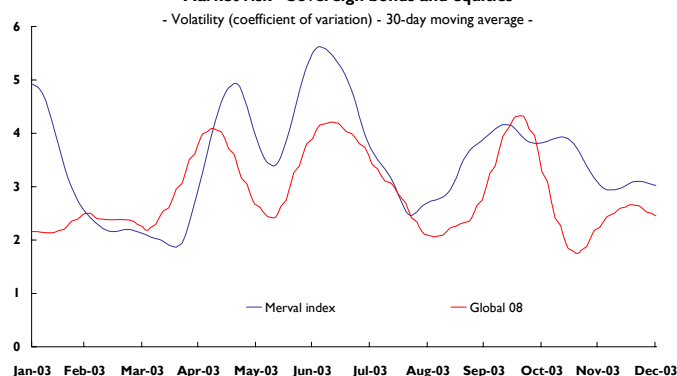
Source: BCRA

Currently, financial institutions record significant exposure from the mismatching between assets and liabilities that are adjusted according to the CER coefficient (see Chart B3.1). The end of the convertibility system was succeeded by mandatory conversion into pesos and compensation adjusted on the basis of the CER, responsible for a large part of these imbalances. This means that given the balance sheet structure at the end of 2003, the financial system is exposed to variations in the real rate of interest. The net positive position in instruments denominated in pesos with adjustments linked to the general price level and the negative position in those at nominal market interest rates has caused this situation.

Although risk-taking is a feature of the banking business, part of the current balance sheet exposure derives from the imbalances caused by the crisis rather than from the business strategy of the banks (that is why it is said that technically speaking all banks are “in the same position”), of which mismatching from indexation is a special case. The high levels of this mismatching, added to the lack of deep financial markets that enable the potential effects of variations in the adjustment indexes to be eliminated or moderated, reveals the difficulty that the banking system faces in getting rid of this risk. In its efforts to restore the financial system to normality, the Central Bank is evaluating alternative processes to help mitigate this source of instability (see Box 3: Balance sheet mismatching in the financial system).

At the beginning of 2002 a significant reduction took place in the balance sheet exposure to currency mismatching. This largely derived from the conversion into pesos of local customer assets and liabilities in foreign currency, while at the same time bank external debt remained denominated in foreign currency. Subsequently, the inclusion within assets of dollar-denominated government securities, added to the performance of the exchange rate, led to a recovery in the level of balance sheet exposure to currency mismatching risk. At the end of 2003, certain foreign private banks reached agreements with their head offices for the capitalization of their debts. This factor has helped to explain the moderate increase in currency mismatching (see Chart IV.28).

Chart IV.29
Market risk - Sovereign bonds and equities



Source: BCRA

Based on the starting point for 2004, the outlook for the evolution of bank exposure for this year is uncertain. It can be expected that the external debt restructuring process will continue to be carried out by local banks, increasing the gap between assets and liabilities in dollars. In addition, joint action by financial institutions and the Central Bank could result in progress being made in the reduction of risk from mismatched index adjustment. Lastly, the current macroeconomic framework and that to be expected for the future show indications of price-level stability, which can be directly translated into increased financial stability.



IV.4. Interest rate and market risks

Interest rate risk

The interest rate risk arises when the sensitivity of assets to changes in interest rates does not coincide with that of liabilities. The impact of this type of risk on the balance sheet is immediate in the case of frequently traded assets.

The changes that have taken place in the balance sheet structure of the financial system, to a large extent as a result of the recent crisis, reveal rising exposure to interest rate risk. The lengthening maturity of assets, in part offset by the restructuring of liabilities, and the mismatching because of index-adjustment – risk arising from movements in the real rate of interest – are part of the explanation for this. For these reasons, the Central Bank decided to increase its capital requirement for interest rate risk. On the basis of the foregoing, it can be seen that (as indicated in the section on Solvency) financial institutions are comfortably covered by the maximum potential loss for interest rate risk at a confidence level of 99% over a 3-month horizon.

Market risk

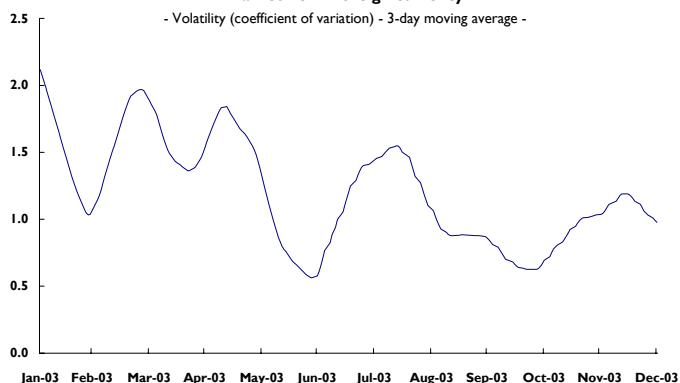
The Central Bank requires financial institutions to comply with capital requirements based on the market risk of their portfolios, measured according to the value at risk (VaR). The rule covers those assets that are frequently traded on capital markets, and excludes assets held in investment accounts (the latter require capital compliance for interest rate and counterparty risk).

The current balance sheet structure of the financial system indicates that there has been a slight increase in exposure to market risk compared to the pre-crisis period. Higher holdings of regularly-traded financial assets and the foreign currency positions are two of the reasons for this. On the other hand, increased stability in the yield rates (and thus in prices) for financial assets and the lower volatility of the peso-dollar exchange rate act to soften the impact, preventing an increase in balance-sheet risk for those holdings (see Charts IV.29 and IV.30).

Through its requirement for minimum capital compliance for market risk, the Central Bank establishes the mandatory need to cover the maximum potential loss that can take place with a confidence level of 99%. Therefore, the financial system holds capital reserves sufficient to absorb expected losses from such risk.

Chart IV.30
Market risk - Foreign currency

- Volatility (coefficient of variation) - 3-day moving average -



Source: BCRA

V. SOLVENCY

Summary

The crisis in 2001 severely harmed results reported by financial institutions in 2002. In 2003 there was a notable improvement in profitability compared to the previous year, with small profits being recorded towards the end of the period. Developments during the crisis conditioned both income and future expenses. Part of these expenses relate to the spreading of losses over time, including adjustment to the valuation of lending to the public sector to bring it into line with market values and the payment of deposits under court orders in their original currency. Another part relates to current matters: the high relative weighting combined with the low rates of interest accrued on lending to the public sector. In view of this, the Central Bank stresses that the creation of new business will gradually reverse the situation that has been inherited.

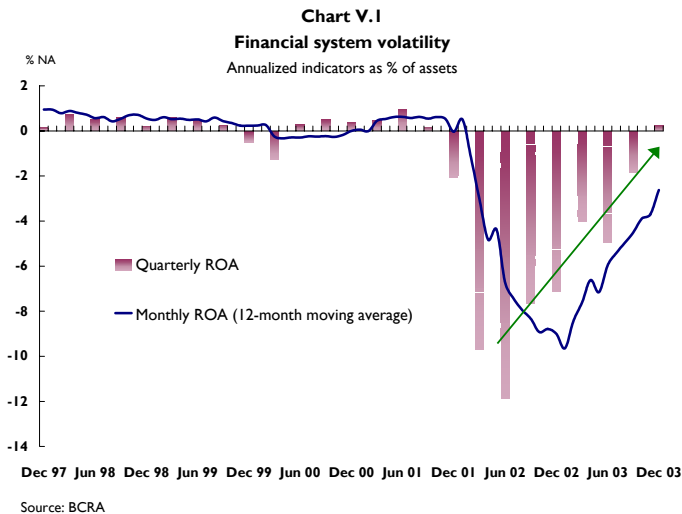
In 2003 the financial system reversed the negative interest margin that existed in the previous period, with a positive margin being recorded by the end of the year. This was a result of the reduction in the cost of funding, with lower interest rates on borrowing and the restructuring of foreign liabilities. Interest income levels remain a matter to be corrected in 2004. The recovery in debtor repayment capacity was partially reflected by financial institutions in 2003, with a sharp reduction in loan loss provisions.

For 2004 a gradual improvement in profitability levels can be expected. This presumes greater participation by lending to the private sector, currently with a high indebtedness potential and good repayment capacity. This improvement in the situation of financial system debtors in the private sector will also help in the recovery of profitability, and thus in the solvency of the financial system.

Financial system solvency began to show an upward trend at the end of 2003, basically as a result of direct capitalization and debt swaps (capital contributions since the crisis are equivalent to 25% of net worth), in a context of improved results. In 2004 new minimum capital requirements were introduced, with the elimination of the credit biases from the pre-crisis period. As a result, the capitalization of the financial system at the end of 2003 was higher than prudential norms require.



V.1. Profitability



The crisis in 2001 severely harmed results reported by financial institutions in 2002. In 2003 there was a notable improvement in profitability compared to the previous year, with small profits being recorded towards the end of the period. After recording losses for \$19.2 billion during 2002, at the end of 2003 the financial system recorded total losses for slightly under \$4.8 billion, 85% of which corresponded to the first half of the year (see Chart V.1). As a result, 2003 has marked a turning-point in the development of profitability in the post-crisis period. It is to be expected that in coming years aggregate results recorded by financial institutions will continue to show a gradual improvement, given the economic recovery. In the current circumstances, a steady flow of net income is a necessary condition for the shoring up of financial system solvency.

Table V.1
Profitability structure: Financial system
In annualized terms - as % of netted assets

	2002	2003	I. 03	II. 03	III. 03	IV. 03
Net interest income	-1.7	-0.5	-0.7	-1.4	-0.3	0.5
Restatement by CER and CVS	3.9	1.2	2.0	0.7	0.9	1.2
Foreign exchange price adjustments	2.7	-0.4	-2.6	-0.7	1.1	0.4
Adjustments to the valuation of government securities (1)	0.0	-0.4	-1.5	0.0	0.0	0.0
Other financial income	-0.1	-0.3	-0.6	-0.2	-0.2	0.0
Service income margin	1.9	1.9	1.9	1.8	1.8	1.9
Gains on securities	1.7	1.4	1.8	0.3	0.8	2.6
Operating costs	-4.4	-4.2	-4.2	-4.3	-4.1	-4.3
Loan loss provisions	-4.7	-1.1	-1.0	-1.6	-1.0	-0.6
Tax charges	-0.3	-0.3	-0.3	-0.2	-0.3	-0.3
Income tax	-0.2	-0.2	-0.1	-0.4	-0.1	-0.1
Sundry (2)	-1.8	0.2	1.4	1.0	-0.5	-1.1
Monetary results	-5.8	0.0	-0.1	0.0	0.0	0.0
ROA	-8.9	-2.6	-4.0	-5.0	-1.9	0.3
ROA before monetary results	-3.1	-2.6	-3.9	-5.0	-1.9	0.3
ROE	-59.2	-20.6	-29.3	-38.3	-15.3	2.3
Ordinary operating profit	-3.5	-1.6	-0.9	-4.7	-2.1	1.3

Ordinary operating profit: interest income + CER and CVS adjustment + other financial income + service income margin + gains on securities + operating costs + loan loss provisions.

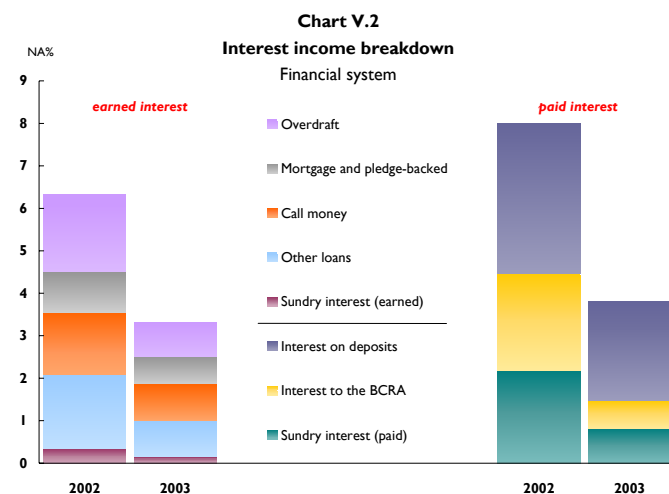
(1) Com."A" 3911

(2) Including amortization payments for court-ordered releases

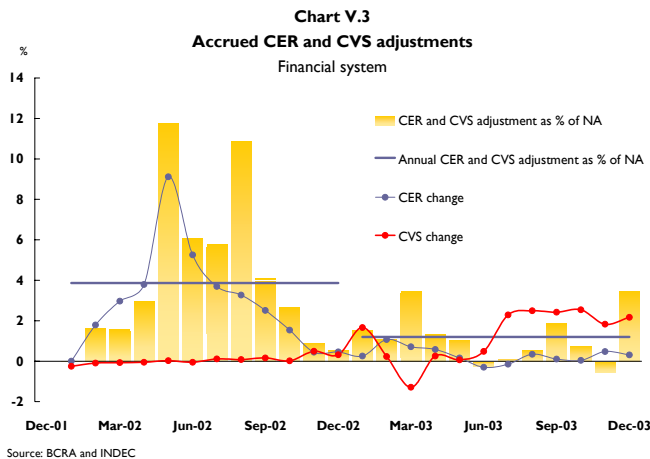
Source: BCRA

The effects of the crisis not only conditioned the results of the two following years, they also influenced the current balance sheet structure, affecting income flows and future financial system costs. For this reason, when analyzing bank profitability it is necessary to distinguish between those flows accrued that are linked to the inheritance from the crisis and those arising from new banking business. In 2003, on the basis of the prudential policy adopted by the Central Bank, the financial system was able to partially rebuild its deteriorated financial position. Of particular significance were the costs derived from the adjustment to market values of lending to the public sector and the losses caused by the payment of deposits under court orders. In addition, matters still remain to be resolved, such as the high exposure to the public sector, and these hinder the achieving of interest rate margins similar to those of the pre-crisis period. It is therefore to be hoped that in a beneficial macroeconomic context it will be the flows from the financial business that will gradually turn around the situation inherited from the crisis, leading the financial system along the path to a recovery of both profitability and solvency.

Although the operating result continued to be negative, losses were reduced to almost half the level of the previous year. An increase in interest rate margins, together with the strengthened repayment capacity of the system's principal debtors, was mainly responsible for this improvement (see Table V.1).



Responsible and transparent administration of monetary policy, which succeeded in overcoming expectations on the volatility of prices, had a positive impact on interest income. Although it continued to be negative in 2003, there was an improvement over the year of over one percentage point. Such a performance was closely linked to the drop in the cost of funding (see Chart V.2). This has meant the transfer of expectations for lower inflation to a steady fall in nominal interest rates paid on time deposits, the latter being complemented by a significant switch from time to sight deposits (see section on liquidity risk). This fall in nominal interest rates and the impact of the bank liability restructuring abroad helped ensure the negative post-crisis bias could be gradually lowered. Nevertheless, the reduction in interest paid



was not matched by growth in interest earned. This was due to the liquidity policy adopted by banks and the still incipient growth in private sector lending, at the same time as lending rates declined, as well as to the significant relative weight of public sector assets (with yields barely in excess of a real 3%).

As a counterweight to the lower inflation registered, there has also been a drop in CER accrual. During 2002 this had been the main source of income for the system. Whereas in 2002 the CER index rose by 41%, the following year this rise was barely 4%. On the other hand the CVS index, which went up by just 1% in 2002, rose by close to 16% in 2003. As the system's position in assets adjusted according to the CVS is much lower than that for assets adjusted according to the CER index, joint income from CER and CVS accrual dropped by over 2.5 p.p. in 2003 to a level of 1.2% (see Chart V.3).

As indicated above, the improvement in profitability in 2003 took place in the context of an optimistic outlook regarding the real economy and its effect on the level of provisions. Loan loss provisions, which in 2002 had reached a high, if non-recurring, level (-4.7% of netted assets), in harmony with the unprecedented crisis, were adjusted downward in the following year, so that such losses reached a level of barely over 1% of netted assets (NA) (see Chart V.4). In the context of a positive performance by indicators linked to the level of activity, financial institutions were able to revise the provisions set up at the height of the crisis, at a time when uncertainty on the future performance of the economy was far greater.

In the case of the remaining headings of an operational nature, income from services remained stable at a level of 1.9% of NA. Gains on securities were down 0.3 p.p. to a level of 1.4%. This was due to the relatively high level they recorded during 2002 as a result of the effects of the conversion into pesos and the influence of the real rate of exchange on the remaining assets in foreign currency. The drop in gains from securities was due to the fall in net gains from shares in financial trusts. Income from government securities remained stable at a level of 0.8% of NA, with higher income from government securities in pesos that offset the drop in net income on securities in foreign currency.

Operating costs recorded a slight downward trend. This behavior was explained basically by the performance of personnel costs, the heading showing the greatest variation between 2002 and 2003. This confirms the trend seen in recent years, whereby personnel costs have declined as a proportion of total costs, reflecting the adjustment taking place within the system (see section on structure and Graph V.5).

As indicated in the section on structure, the size of the system began to be adjusted at the time of the tequila crisis, and there was no change in this trend as a result of the local crisis. This was reflected in the gradual return to the efficiency levels that banks were recording in the pre-crisis period, a process that accelerated during the second half of 2003. This was basically led by the gradual recovery in interest rate margins, while it is expected that an increased use of banking services will lead to

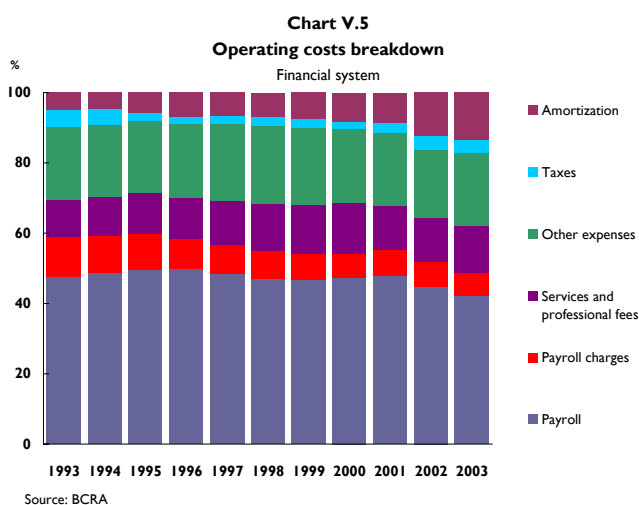
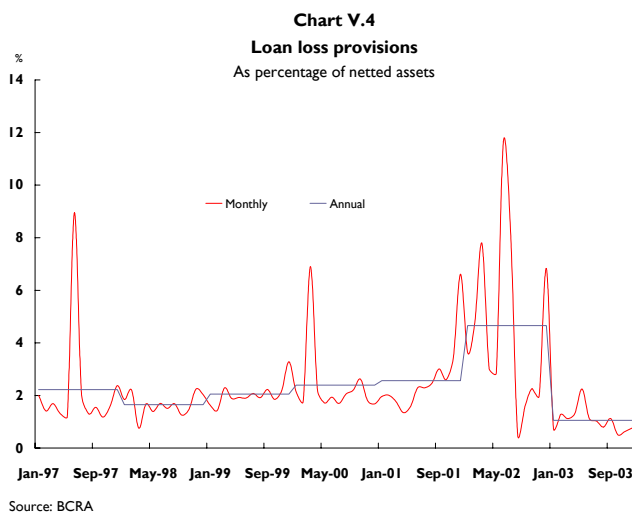
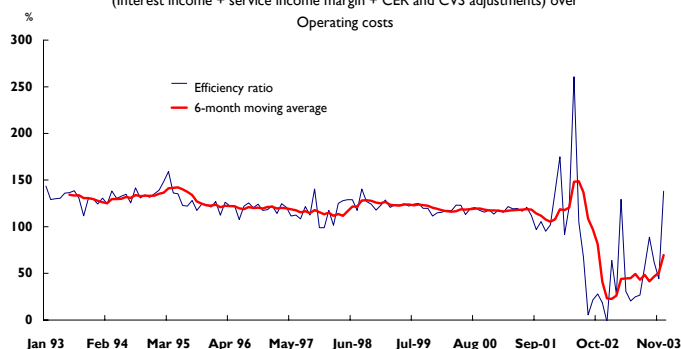




Chart V.6
Financial institution efficiency

(Interest income + service income margin + CER and CVS adjustments) over
Operating costs



Source: BCRA

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

	2002	2003	I. 03	II. 03	III. 03	IV. 03
Net interest income	-0.2	0.1	0.5	-0.8	-0.1	0.7
Restatement by CER and CVS	1.1	0.9	1.3	0.3	0.8	1.4
Foreign exchange price adjustments	4.4	-0.3	-2.4	-0.6	1.3	0.5
Adjustments to the valuation of government securities (1)	0.0	-0.6	-2.3	0.0	0.0	0.0
Other financial income	-0.1	-0.2	-0.3	-0.1	-0.3	0.0
Service income margin	2.0	2.0	1.9	2.0	2.1	2.2
Gains on securities	2.5	1.7	2.5	0.2	1.1	3.1
Operating costs	-4.8	-4.6	-4.5	-4.9	-4.4	-4.7
Loan loss provisions	-5.0	-1.3	-1.2	-2.0	-1.2	-0.7
Tax charges	-0.4	-0.3	-0.3	-0.3	-0.3	-0.4
Income tax	-0.2	-0.3	-0.2	-0.6	-0.1	-0.1
Sundry (2)	-3.0	0.3	2.0	0.8	-0.5	-1.1
Monetary results	-7.5	0.0	-0.1	0.0	0.0	0.0
ROA	-11.3	-2.4	-2.9	-6.0	-1.7	0.8
ROA before monetary results	-3.8	-2.4	-2.9	-6.0	-1.7	0.8
ROE	-79.0	-19.0	-22.0	-46.0	-13.9	6.7
Ordinary operating profit	-4.6	-1.3	0.3	-5.4	-2.1	2.0

Ordinary operating profit: interest income + CER and CVS adjustment + other financial income + service income margin + gains on securities + operating costs + loan loss provisions.

(1) Com."A" 3911

(2) Including amortization payments for court-ordered releases

Source: BCRA

a rise in participation in the financial services business (see Chart V.6).

In 2002 accumulated losses were closely linked to the results recorded by private banks. During 2003, 58% of total losses were posted by private banks, 40% were generated by the public bank segment, and the remainder corresponded to non-bank financial institutions (see Table V.2). Within the private bank sub-group there was a better relative positioning by regional retail banks and specialized institutions, which in both cases recorded positive results for the year (see Table V.3). These higher earnings came from their serving of niche markets that has enabled them to count on a strong base of recurring income. Larger banks, retailers with branches nationwide, recorded results similar to those for the system as a whole. Wholesale banks improved on the overall result for the financial system, basically because of higher gains from securities and foreign exchange price adjustments.

The profitability of the financial system is expected to show progress in 2004, subject to the recovery of financial intermediation levels, enabling financial institution resources to cease to be concentrated on low-yielding assets, instead favoring lending to the private sector (especially short-term lending, such as consumer loans and working capital finance for SMEs). The favorable outlook for the gradual improvement of interest rate margins will also be justified by the effect of the process of restructuring of banking liabilities, which will help to lower bank funding costs. Furthermore, the improved prospects for activity levels encourage optimism regarding a continued improvement in debtor repayment capacity, with the corresponding interest gains and lower loan loss provisions. In addition, income from services could confirm its rising trend, assisted by possible improvement to the level of banking service use by the population, and the use of new products. The possible reduction in the IDCCB would reinforce this trend.

V.2. Capital position

During 2003 the net worth of the consolidated system shrank by \$3.1 billion (-14%), largely as a result of the loss for the year recorded by financial institutions. Nevertheless, in the last quarter system net worth began to reflect the effects of capital contributions made by the banks, aided by a significant reduction in the level of current losses. Capital contributions since the crisis, whether direct or through debt swaps, are equivalent to 25% of the net worth of the financial system (see Chart V. 7).

Liabilities remained relatively stable over the year, growing by only 2% as a result of two major contrasting factors. On the one hand, deposits have been rising since the beginning of 2003, while on the other, liabilities abroad have been settled by means of debt restructuring or equity-debt swaps by private banks. As a result of these changes, liabilities at the end of the year stood at 8.4 times net worth, 1.4 higher than in December 2002. This figure incorporates differing results when comparing private and public banks, as in the case of the former the increase was 0.3% whereas in the case of public

Table V.3
Profitability structure by type of bank - 2003
In annualized terms - as % of netted assets

	Public	Private				
		Total	National coverage	Regional coverage	Specialized	Wholesale
Net interest income	-1.7	0.1	0.1	-0.3	10.5	0.5
Restatement by CER and CVS	1.7	1.0	1.1	0.2	0.0	0.8
Foreign exchange price adjustments	-0.6	-0.4	-0.4	-0.2	1.2	1.7
Adjustments to the valuation of government securities (1)	0.0	-0.6	-0.7	-0.1	0.0	-0.2
Other financial income	-0.4	-0.2	-0.1	-0.2	-8.3	0.2
Service income margin	1.5	2.1	1.9	3.1	1.8	1.8
Gains on securities	0.9	1.6	0.8	5.7	2.7	3.7
Operating costs	-3.3	-4.5	-4.0	-6.8	-14.9	-7.0
Loan loss provisions	-0.7	-1.2	-1.3	-0.9	-0.7	-2.0
Tax charges	-0.1	-0.3	-0.3	-0.5	-0.9	-0.4
Income tax	0.0	-0.2	-0.2	0.0	-0.4	-1.7
Sundry (2)	-0.2	0.2	0.0	0.8	6.3	1.8
Monetary results	0.0	0.0	0.0	-0.1	3.4	-0.2
ROA	-2.9	-2.5	-3.2	0.7	0.6	-1.1
ROE	-25.5	-21.2	-33.4	3.3	1.6	-3.1
Ordinary operating profit	-1.9	-1.2	-1.6	0.7	-8.9	-0.5

Ordinary operating profit: interest income + CER and CVS adjustment + other financial income + service income margin + gains on securities + operating costs + loan loss provisions.

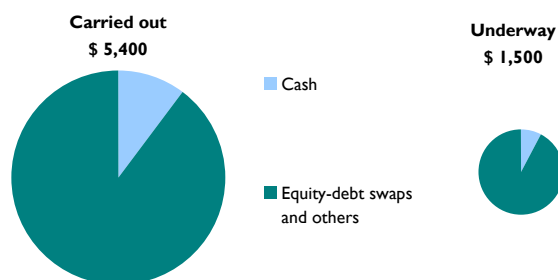
(1) Com."A" 3911

(2) Including amortization payments for court-ordered releases

Source: BCRA

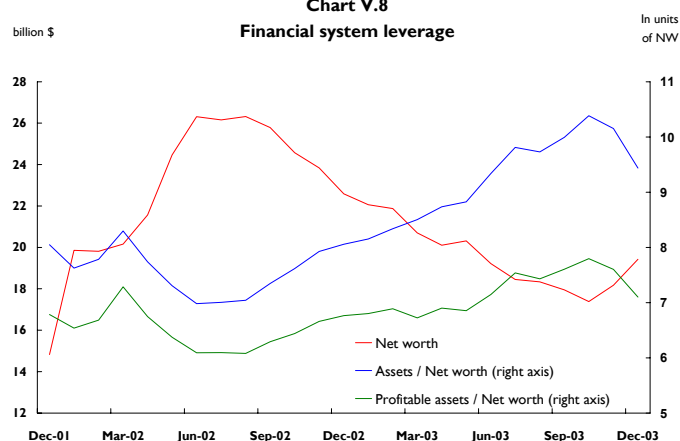


Chart V.7
Capital contributions 2002-2004



Source: BCRA

Chart V.8
Financial system leverage



Source: BCRA

Table V.4
Minimum capital by group of banks
December 2003 - in %

Group of banks	Surplus capital / Capital requirement	Capital compliance / Assets at risk
Public banks	201	14
Private banks	88	14
National coverage	62	10
Regional coverage	102	25
Specialized	127	44
Wholesale	319	46
Non-bank institutions	279	73
Total	116	15

Source: BCRA

banks growth went up 2.7 times because of increased losses and the lower weighting in liabilities from the effects of debt restructuring. As mentioned in the section on financial system activity, assets rose 1% for all banks over the year, leading to the leverage ratio (assets over net worth) showing a value of 9.3 times, growing at an annual rate of 1.4 (see Chart V.8).

Because of the effects of the severe crisis on the banking system in particular, in December 2001 mandatory compliance with minimum capital rules was suspended. In view of the gradual return to normal by the local banking system and the restoring of prudential policies, it was established that starting in January 2004 minimum capital rules adapted to the new regulations should once again be observed. As described in the section on Prudential policies of this report, capital requirements have been adapted to ensure rules are in accordance with the post-crisis environment.

In this context, a detail is provided of the information submitted to date, with the aim of carrying out a first approximation to the state of financial system capitalization in accordance with the new rules. It should be recalled that the data shown derives from the information reporting system corresponding to the regulation, and was requested by the Central Bank as from July 2003, although as indicated, compliance with the technical ratios contained in the regulations did not become mandatory until January 2004.

Based on information reported at December 2003, the financial system was showing favorable regulatory capitalization indicators. This leads to the likelihood that the new requirements included in the regulations will have been complied with in January 2004. Total banking system compliance was equivalent to 15% of risk weighted assets, while for private banks this indicator was 14%. Total surplus compliance (current over-compliance) at the end of December stood at 116% of the total capital requirement for the financial system as a whole, and 88% in the case of private institutions. Total capital compliance (measured according to adjusted stockholders' equity, RPC) ended the year at \$19.4 billion, with over 65% being accounted for by private banks.

Table V.4 shows that in terms of current regulations, all bank categories record an aggregate level of capital compliance significantly in excess of requirements.



ABBREVIATIONS AND ACRONYMS

\$: Argentine pesos.

APR: Annual percentage rate

BCB: Central Bank of Brazil.

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

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

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

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

BOGAR: *Bonos Garantizados*. Guaranteed bonds.

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

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

CCI: Construction cost index.

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

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

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

CPI: Consumer price index.

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

EB: Executive branch.

ECB: European Central Bank.

EMBI: Emerging markets bond index.

FS: Financial stability.

FSB: Financial stability bulletin.

FOMC: Federal Open Market Committee (USA).

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

GDP: Gross domestic product

HHI: Herfindahl-Hirschman index.

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

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

IFS: International financial statistics.

IMF: International Monetary Fund.

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

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

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

M0: Banknotes and coins

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

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

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

m.a.: Moving average

MAR: Minimum application of resources in pesos.

MC: Minimum cash.

MR: Market rate.

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

NA: Netted assets.

NDA: Net domestic assets.

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

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

NW: Net worth

p.p.: Percentage point.

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



PS: Price stability.

PV: Par value.

REM: BCRA Market expectation survey.

ROA: Return on assets.

ROOA: Ordinary return on assets.

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

s.a.: Seasonally adjusted.

SEFyC: Superintendence of Financial and Exchange
Institutions.

SME: Small and medium enterprises.

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

TD: Time deposits.

US\$: United States dollar.

USA: United States of America.

UTDT: Universidad Torcuato Di Tella.

VaR: Value at risk.

VAT: Value added tax.

WPI: Wholesale price index.

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

YTM: Yield to maturity.



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