

Financial Stability Bulletin

First Half 2006

CENTRAL BANK OF ARGENTINA



FINANCIAL STABILITY BULLETIN

Central Bank
of Argentina

First Half 2006

Issue N° 5

Central Bank of Argentina

March 2006
ISSN: 1668-5164
Online edition

Reconquista 266
Capital Federal, Argentina
C1003ABF. Tel.: 4348-3500
www.bcra.gov.ar

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Preface

***Financial stability** is a state of affairs in which the financial services sector can channel the savings of the population and provide a nationwide payments system in a manner that is efficient, secure and sustainable over time. In the framework of the execution of consistent and stable macroeconomic policies, the resilience of the financial sector in the face of negative shocks serves to define the degree of approach towards a **financial stability** configuration.*

*The strong interrelationship between **financial stability** and sustained economic growth explains why the former is a social good that the state has to generate and protect. This is why the promotion of **financial stability** is one of the principal functions of most central banks.*

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

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

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

*The date of publication of the next issue of the **FSB**, with statistics that cover at the end of June 2006, will be on September 28, 2006, on the Central Bank website.*

Buenos Aires, March 30, 2006



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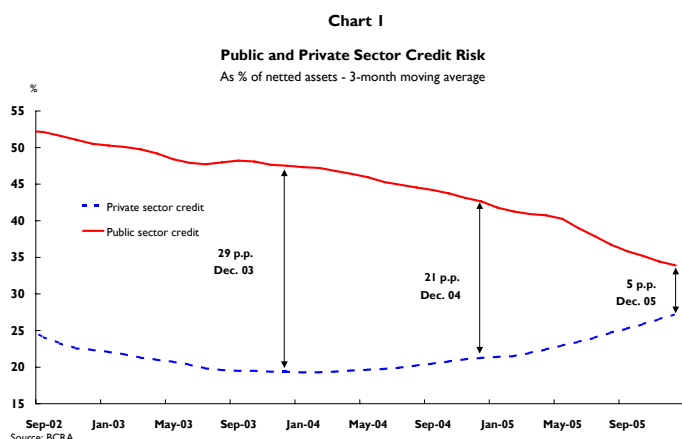
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CENTRAL BANK OUTLOOK

The recovery of financial system intermediation activity gained further ground, and substantial progress was made in rebuilding the system's balance sheet position. The sustained expansion in private credit, a noticeable reduction in exposure to the public sector, strong improvements in portfolio quality, lower liabilities with the Central Bank, the return of profits and the strengthening of solvency are a sample of the main features that spur the rebuilt framework of financial stability. During the second half of 2005, financial markets managed to grow in terms of depth and robustness. In particular, domestic capital markets developed favorably both in terms of prices and traded values.

The monetary authority set guidelines and incentives for the financial system to attain a substantial reduction in its exposure to the public sector. In particular, the Central Bank set down specific limits on lending to the public sector. These guidelines fix a maximum value that is a function both of the financial institution's capital and the level of government involved. There is also a global cap at 40% of banks' total assets, effective as from January 2006. The financial system is also following the schedule established by the Central Bank for the gradual adjustment in the accounting valuation of public sector assets towards marking to market. The favorable performance of domestic markets (government securities in particular), as well as the regulations mentioned above and some banks that are marking to market ahead of schedule, are providing the conditions for a strong improvement in financial institution balance sheets, leading to improved credit ratings and liquidity.



This favorable outcome in terms of increasing the monetary and financial system's independence from the public sector is quickly turning around the crowding-out of credit to the private sector that occurred during the domestic crisis in 2001-2002. **Although the margin between public and private credit has narrowed for the second consecutive year, most of the crowding-in of private lending occurred in 2005.** Credit to the public sector as a share of total assets declined by 9 percentage points (p.p.) in 2005, to 30% at the end of the year. The combination of this trend and the growth in credit to the private sector reduced the gap between public and private lending by 16 p.p. of assets, to just 5 p.p., down from a crisis-induced peak of 29 p.p.. These developments are particularly significant, as they enable both monetary policy and the financial system to become more autonomous from the public sector.

In addition to regulations encouraging the reduction of exposure to the public sector, **the Central Bank has developed an incentive policy targeted at consolidating private credit.** Within a favorable macroeconomic context, loans to the private sector increased by 39% during 2005, at a substantially higher pace than the 26% rate of growth registered in 2004. Some of the main measures adopted include: encouraging guarantees for mutual assurance societies, raising the maximum value required for classifying a commercial credit line as consumer credit, an adjustment of requirements for consumer loans of less than \$15

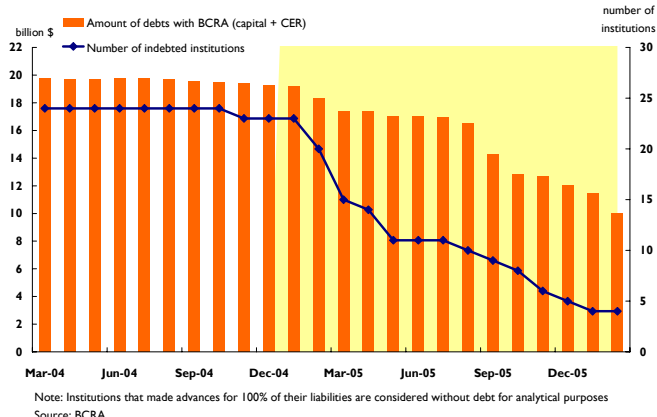


thousand, the elimination of margins for trade bill discounts, the extension of the coverage period for collateral, allowing for a greater ratio between lending and net worth, allowing for a deferment in the amortization of court ordered releases for banks offering medium and long term credit for production, broadening the range of production and investment activities that can be financed through the allocation of foreign currency deposits, the extension of preferred guarantee status for construction trust funds and the exclusion of the collateral established to import capital goods from the immobilized assets.

Non-bank financial intermediaries (NBFI) have also increased lending to the private sector, achieving a gradual improvement in the quality of their asset portfolios. Given the longer time horizon involved in this type of lending, the gradual reallocation of NBFI funds towards the private sector is increasingly contributing to finance the productive sectors over the medium and long term, giving a boost to the supply of credit that is allocated to investment.

As the financial system recovers the market for financial intermediation, it has made further steps in putting the liabilities inherited from the past crisis back in order. On one hand, **a large share of the funds allocated to private lending came from taking in new deposits from the private sector**, which increased by around \$7.4 billion or 16% in annualized terms, during the second half of 2005. On the other, **financial institutions made noteworthy efforts to speed up the reduction of their liabilities with the Central Bank.** In addition to paying the installments set down as part of the so-called matching framework, the financial system anticipated settlements and made early payments of installments through an auction system devised by the Central Bank, for a total of \$5.94 billion during the second half of the year. As a result, out of an original 24 institutions with debt to the Central Bank, only 3 had any outstanding debt as of the time of writing this report.

Chart 2
Matching Schedule Liabilities with BCRA



The appropriate Central Bank policy and the action of financial institutions, as well as a favorable domestic and international context, allowed for the growth in financial intermediation without an increase in the associated intrinsic risks. In particular, **the financial system's position in terms of liquidity risk was unchanged during the second half of 2005**, despite lower holdings of liquid assets due to the use of funds to provide private credit and settle rediscounts. The high level of liquidity reserves (both by historical and international standards), the deepening of markets for government and Central Bank securities, the repo market, the Central Bank's role as lender of last resort and, lastly, the expansion of money markets suggest that the system's outlook for resisting liquidity shocks is good.

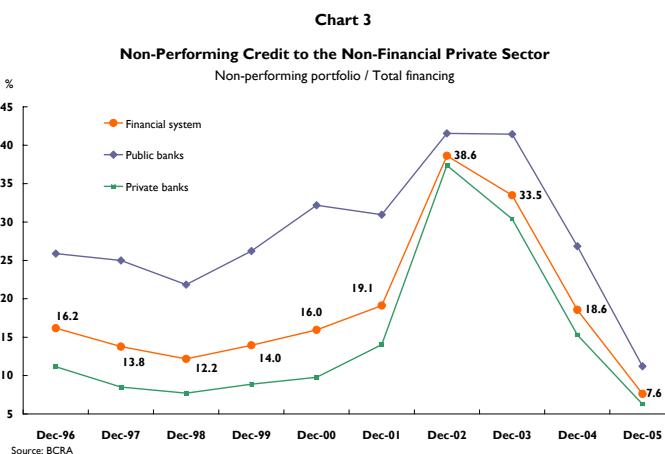
Additionally, **the financial system has continued to gain robustness in terms of its net exposure to credit risk.** This statement is backed by the reduction of public sector assets as a share of the total portfolio, plus the steady improvement in the government's financial position. Certain particular events have led to an improvement in the public sector's overall debt conditions: the national government's debt swap, the settlement of all sovereign debt with the IMF – in which the Central Bank



had an active participation in an operational role – and the debt swap by the province of Buenos Aires.

Improvements made by the Central Bank to the regulations on debtor classification, as well as the sustained advance in repayment capacity of both businesses and households, and the adequate loan granting policies of banks, are producing a **systemic improvement in the financial system's position in terms of private credit risk**. Asset quality has improved, with delinquency levels that declined by about 11 p.p. of private lending over 2005 to around 7.6% at the end of the year. Banks' loan-loss provisions are higher than the minimum required by the Central Bank, and in fact exceed the total value of non-performing loans, showing that there is a high degree of coverage from potential private sector default.

Foreign currency risk conditions for the financial system continued to improve during the second half of 2005. This was mainly due to three complementary effects: a reduction in mismatched asset in dollars, an expansion of bank capital and lower expected volatility in the exchange rate with the US dollar.



In this framework – in which financial activity is performing well, a large fraction of the problems inherited from the crisis have been overcome and there have been favorable developments in terms of risk management – **the financial system obtained annual profits for the first time since the 2001-2002 domestic crisis**. Profits reached \$1.8 billion, or 0.9% of assets, which is in line with values registered in other emerging economies. Removing the effect of items related to the gradual adjustment of the costs from the crisis, such as amortizations of court ordered deposit releases and adjustments to the valuation of public sector assets, earnings rise to \$4.0 billion (2% of assets) in 2005. The banking sector's financial margin consolidated in the second half of 2005, mostly due to growth in net interest income, gains on securities and earnings due to foreign exchange price adjustments.

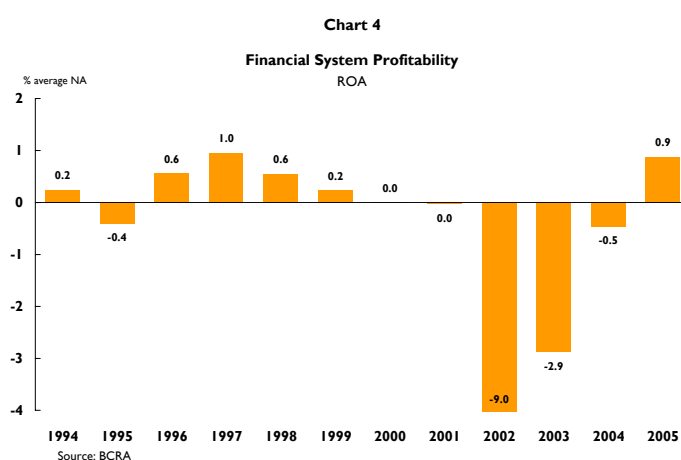
Favorable earnings and the ongoing capitalization process of the banking sector in the post-crisis period are helping the financial system gain solvency. The financial system received new capital contributions for almost \$1.15 billion in 2005. The flow of new capital injections in the 2002-2005 period has therefore reached almost \$12.6 billion, nearly two thirds of initial net worth. The process is expected to continue in coming months. Foreign banks accounted for more than two thirds of new capital contributions in the second half of 2005. This is an indicator of international confidence in the development of Argentina's financial system and its economy in general.

The financial system's recovery from the effect of the crisis is occurring at an accelerating pace, but **there are still some outstanding tasks for the medium term**. Although there has been a clear take off in private credit, bank lending stood at 10% of GDP at the end of 2005, despite a 1.3 p.p. increase. The recovery of the pre-crisis intermediation levels, when lending was close to 24% of GDP, will be a drawn out process. The Central Bank has put in place the appropriate incentives, conditions are favorable and the banking sector is on the right



path, all that remains is for the process to continue on the right track into the medium term, with appropriate monitoring of the risks that are involved.

Extending the maturity of both assets and liabilities is another medium term challenge for the financial sector. In terms of liabilities, although the banking sector is managing to extend the maturity of private time deposits, sight deposits as a ratio of total deposits remain high by historical standards, and thus shorten the average maturity of private deposits. Additionally, the reduction of medium and long term funding through corporate bonds and foreign lines of credit in the post-crisis period have substantially reduced the average maturity of liabilities. On the side of assets, lending is mostly focused on the short term. In addition to eliminating the bias in favor of short-term guided behavior that is often the effect of crisis episodes, the financial sector must keep to its policy of reducing exposure to public sector assets, as a means of shortening the term of assets and therefore allowing for medium term private credit.

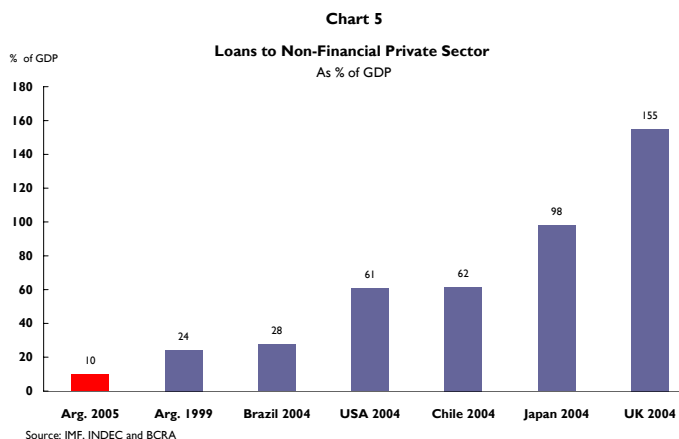


Banks' net worth exposure to real interest rate risk, which is directly linked to mismatches in CER-adjusted items on the balance sheet, **is declining gradually**. This outcome is mainly the effect of increases in the banking sector's capital reserves. Furthermore, Central Bank capital requirements on financial institutions already include an item to account for this risk. The reduction in the magnitude of the asset mismatch in CER-adjusted instruments must go further. Although the banking sector has reduced its holdings of CER-adjusted assets to a substantial extent by selling assets from its public sector portfolio, the effect was more than offset by the settlement of rediscounts with the Central Bank, increasing CER mismatching.

The Central Bank is taking measures aimed at increasing the use of bank services in the economy, with a stress on stimulating the regional aspect of bank use as well as a greater supply of financial products to reach a greater number of segments in the population. Measures include the updating of regulation for credit unions and changes to capital requirement regulations to include location aspects as well as the type and operating volume of each new financial institution. These measures are aimed at expanding the availability of lending in areas where bank coverage is low, but within a framework that involves prudential policy and Central Bank supervision. In tune with the objective of encouraging lending to micro, small and medium-sized enterprises, the Central Bank has eliminated the 30% capital reserve requirement on capital inflows that are targeted for microcredit programs.

Central Bank policy is carried out in terms of creating the appropriate market incentives that will encourage solutions to outstanding issues. For instance, the Central Bank aims to encourage the use of asset securitization, and the deepening of hedge markets such as those for interest rate swaps and US dollar futures (a market in which the Central Bank has had an active involvement) as well as CER swaps, and the development of the secondary market for certificates of deposit.

With the purpose of exploiting complementarities with the capital markets, **the Central Bank aims to encourage portfolio**



securitization, allowing banks to make improvements in risk management and expand their supply of lending. This type of transaction has gained substantial relevance following the past crisis, and gained a noticeable momentum in 2005.

In a setting in which macroeconomic policy remains sound, **the Central Bank expects the financial sector to perform favorably in 2006. Conditions are in place for banks to step up their role in enabling a sustained growth path.** Financial institutions will be able to keep making progress in terms of gradually completing the return to normal for some of the after effects of the domestic crisis. The Central Bank will strengthen its role in systematically monitoring individual financial institutions, as well as encouraging financial stability.

I. MACROECONOMIC CONTEXT

Summary

International conditions have remained favorable for approximately four years. Featuring a high level of world economic growth, low inflation and high levels of international liquidity, current global conditions create a setting that encourages the economic and financial development of both industrialized and emerging economies. In particular, the financial systems of the world's largest economies have performed well in recent years.

This positive international context, plus the historically high commodity prices, creates even more encouraging conditions for the economies of Latin America. This has helped economic growth in the region as well as the strengthening of its financial systems, which, although not in an entirely uniform manner, have improved in terms of the expansion of the credit market, asset quality, profitability and solvency.

The domestic economy expanded for the third consecutive year in 2005, growing by 9.2%. This outcome occurred in a setting of sound fiscal accounts and a strong performance by the external trade sector, in line with the Central Bank's reserve accumulation policy. However, this better than expected economic outcome has caused prices to be slightly higher than expected for 2005. The Central Bank stuck closely to its targets from the Monetary Program for 2005, and plans to continue with a moderately tightening bias for monetary policy in 2006. The government has also started to take a number of measures aimed at containing the rise in prices, so the current forecast for the first quarter of 2006 is that inflation will be approximately a third lower than in the same period a year earlier.

The economy is expected to keep growing in 2006, at a rate consistent with a sustained growth path. This will in part require that investment grow at a sufficient rate to allow for an expansion in the economy's productive capacity. In any event, the realization of this positive outlook will depend on the continued application of sound and stable macroeconomic policies.

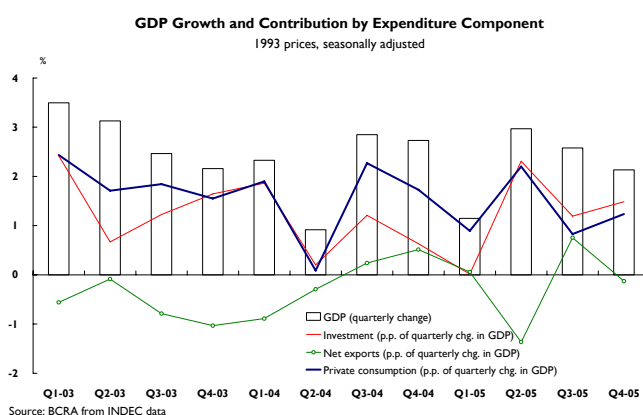
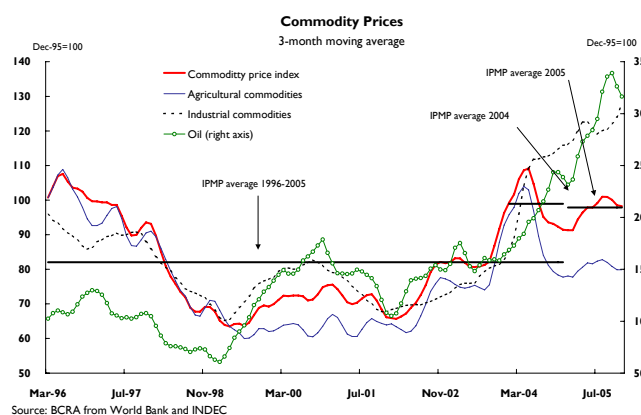
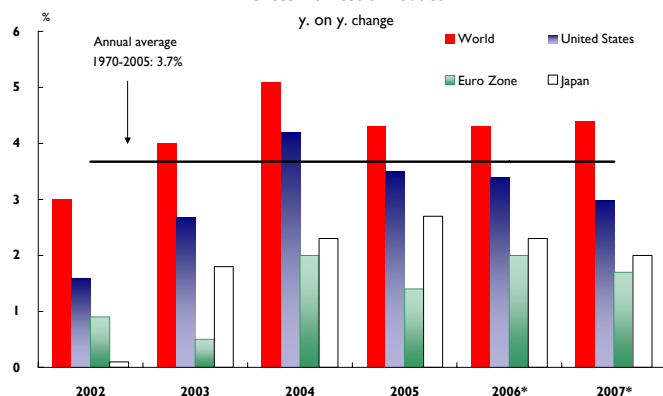




Chart I.1

Gross Domestic Product

y. on y. change



* Projected
Source: LatinFocus Consensus Forecast

I.1 International conditions

For almost four consecutive years, international conditions have been favorable to the development of emerging economies and the deepening of their financial systems

The international outlook remains favorable to developed countries, which provides an adequate frame of reference for the sustained growth of emerging economies and their financial systems. Robust global economic growth (see Chart I.1), as well as the high levels of liquidity in place and still high international commodity prices, were among the main features of current international conditions that favored emerging countries in 2005. Given this context, further deepening of the region's financial systems and capital markets should be expected.

At a global level, financial intermediaries consolidated a track record of strong performance during the second half of 2005. Although there are some signs of a gradual slowing down in the credit cycle, the expansion of lending to the private sector was sustained in most developed economies (see Chart I.2), as well as in emerging countries and Latin America in particular (see Box 1). In this framework, and given the continued improvements in the sources of income of households and corporations, in a context of low interest rates, delinquency levels in the world's largest economies have gradually declined (see Chart I.3). Additionally, the financial systems of developed economies have continued to make improvements in their profitability levels (see Chart I.4), which are slightly lower than in Latin American economies, with an adequate risk-return relationship.

Despite the ongoing adjustment to the benchmark interest rate in the United States, the slight slowdown in the Brazilian economy and the decline in commodity prices over the past six-month period, Latin America's fundamentals remain strong

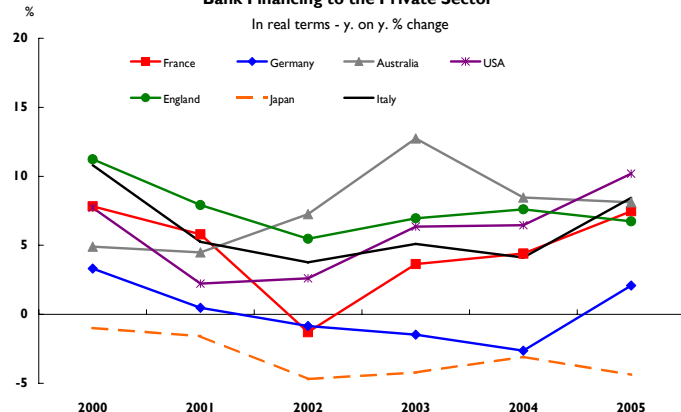
The financial systems of emerging countries are linked to the volatility of international capital flows, and these in turn are closely related to the monetary policy in the US. The US economy continued to grow at a robust pace in 2005, with a moderate increase in inflation. Although the Federal Reserve still notices certain inflation pressures that could lead to slight readjustments in the Fed Funds rate (see Chart I.5), it has also started to signal that the upward cycle of interest rates is coming to an end. Additionally, the still low long-term interest rates prevalent in industrialized countries have a positive effect on emerging economies.

Regarding the regional outlook, the Brazilian economy slowed during the second half of 2005. This outcome is a potential risk to the remaining countries in the region, and could also affect Argentina's export sector. However, there are signs that these conditions are set to turn around. Moderate growth in prices has

Chart I.2

Bank Financing to the Private Sector

In real terms - y. on y. % change

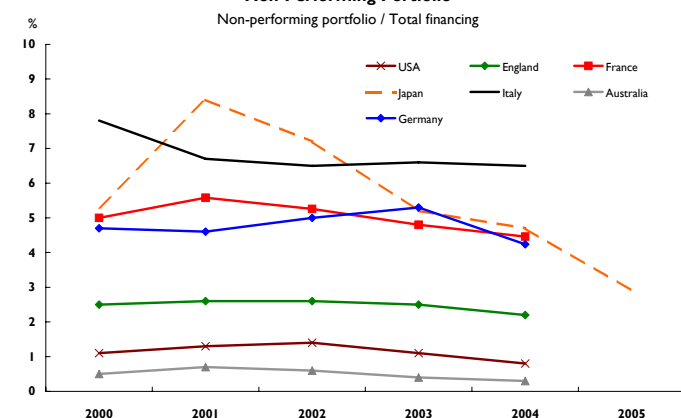


Source: BCRA from central banks data and FMI

Chart I.3

Non-Performing Portfolio

Non-performing portfolio / Total financing



Source: BCRA from central banks data and IMF



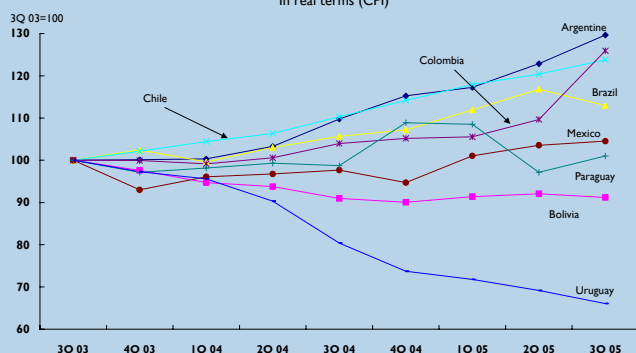
BOX 1: FINANCIAL SYSTEMS IN LATIN AMERICA

The deep and recurring financial crises in Latin America have sparked international interest in Latin America's financial systems (FSLA). In particular, given the effects of financial crises on capital flows in the region, and the continuous trade integration with neighboring countries, the probability of observing a local contagion from a financial crisis in one country in the region, has grown in recent years. This highlights the relevance of the evolution of the main strengths and weaknesses of the FSLA and their effects on domestic financial stability.

In a context in which most of the region's countries have enjoyed more favorable macroeconomic variables (more balanced fiscal accounts, greater GDP growth and inflation levels under control), and driven by positive international economic conditions (world growth with low inflation, high commodity prices and liquidity levels), the FSLA continued to show signs of growing stronger in 2005. The countries that underwent financial crises in recent years, Bolivia, Argentina and Venezuela, displayed recovery in 2005, while the remaining economies, as was the case with Chile and Brazil, had stronger growth.

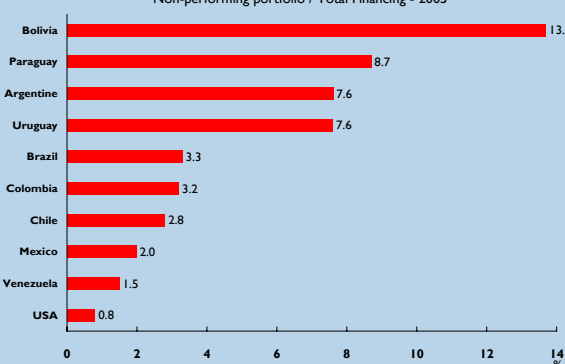
The strengthening of the FSLA featured a clear shift of financial activity in favor of transactions with the private sector. Overall, in 2005 there were increases both in credit to the private sector and in private deposits. The latter were the main source of bank resources. Credit grew at a very strong pace in Argentina, Colombia, Chile and Brazil. The growth of credit was more moderate in Mexico, and there were declines in Bolivia, Paraguay and Uruguay in particular (see Chart B.1.1). Although growth in credit for the FSLA occurred mostly in consumer lines, commercial credit still stands as the higher share of bank portfolios. Although there was a broad-based expansion in credit to households, credit to the private sector in Latin America still remains low compared to developed economies. This is mostly due to the recurring economic and financial crises that have struck this countries in recent years, putting the region's private credit to GDP ratio at 28%¹, compared to 84%² in developed economies.

Chart B.1.1
Lending to the Private Sector
In real terms (CPI)



Source: BCRA from central banks data and Superintendences of Banks

Chart B.1.2
Non-Performing Private Portfolio
Non-performing portfolio / Total Financing - 2005



Source: BCRA from central banks data and Superintendences of Banks

The consolidation of the main FSLA was linked to a lower exposure to the main risks usually faced by banks. In particular, the FSLA had adequate levels of coverage for liquidity risk. Additionally, the banking sector's strength in the face of an accelerated withdrawal of deposits relies on the greater development of capital markets (which are still incipient in many countries) and in the deepening of call money markets. Despite this, due to the high degree of dollarization in some banking systems (which lack a lender of last resort in foreign currency), some of the FSLA maintain high liquidity levels due to a precautionary motive³.

Although the region still remains high in terms of public sector counterparty risk, this feature is being gradually reduced. Some countries in the region are making concrete efforts to reduce their exposure over the short term: Argentina and Mexico. Furthermore, Chile, Bolivia and Peru have low levels of exposure to the public sector, while it still remains high for Colombia, Brazil, Venezuela and Mexico. Banks' position in terms of private credit risk has strengthened gradually. The expansion in loans to the private sector has occurred jointly with significant improvements in terms of portfolio quality: Venezuela, Mexico, Chile, Colombia and Brazil are close to the levels

¹ Chile is a special case in the region, as its private credit to GDP ratio is higher than 70%.

² Source: Interamerican Development Bank (2004), based on IMF and World Bank data.

³ As is the case of, for instance, Bolivia (see the Central Bank of Bolivia's *Boletín Informativo* Nro. 143).

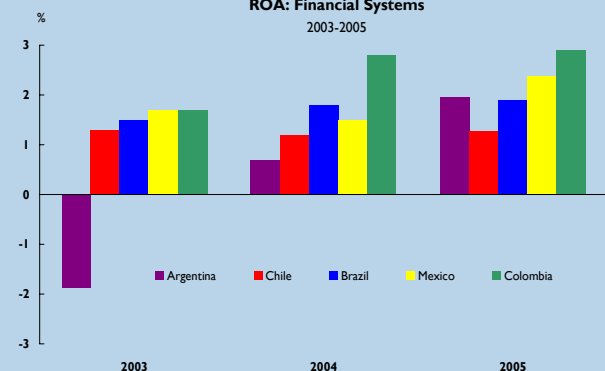


seen in developed economies⁴ (see Chart B.1.2). Another set of banking systems, such as those in Uruguay, Paraguay and Argentina, have higher non-performance levels but with a clearly downward trend over the past years.

The higher level of financial intermediation allowed the FSLA to rebuild their earnings in 2005 (see Chart B.1.3). While some countries in the region, such as Argentina and Uruguay, turned around a negative trend from previous years, other financial systems, such as those of Chile, Brazil, Mexico and Colombia consolidated their growth. The higher profitability margins helped the FSLA to register adequate solvency levels (see Chart B.1.4), above minimum recommended values at the international level.

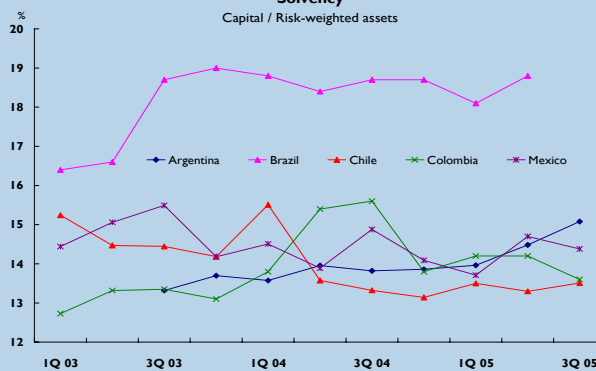
Although 2005 was a year in which the FSLA gained strength, there are still some issues left to tackle. On one hand, growing lending to households is becoming a source of vulnerability for certain financial systems: those of Chile⁵ and Colombia. On the other, one of the main weaknesses of some FSLA remains present: the high degree of dollarization of financial institutions' assets and liabilities. Although there have been slight reductions in the degree of dollarization, countries such as Bolivia, Uruguay, Paraguay and Peru feature high levels.

Chart B.1.3
ROA: Financial Systems
2003-2005



Source: BCRA from central banks data and Superintendences of Banks

Chart B.1.4
Solvency
Capital / Risk-weighted assets



Source: BCRA from central banks data and Superintendences of Banks

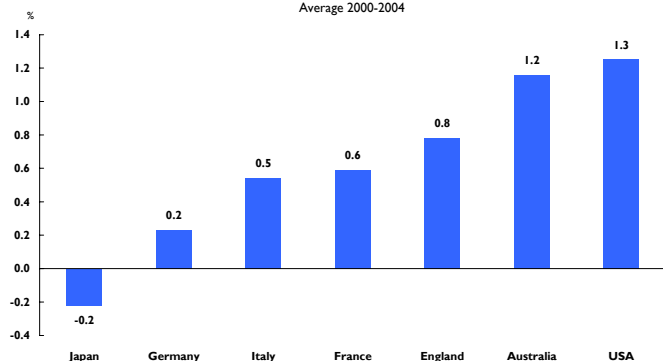
Most cases of dollarization in Latin America involve an increase in exposure to currency, credit and liquidity risk. First, the higher the gap between assets and liabilities in US dollars, the greater the financial system's exposure to the volatility of the exchange rate between the domestic currency and the dollar. Second, widespread lending in dollars (in most cases at a lower cost than in the domestic currency) leads the bank to take on a high degree of credit risk from debtors whose incomes are not related to the dollar. The dollarization of deposits requires the setting up of some mechanism by which to hedge against liquidity risk, which usually involves building up a high level of liquid reserves and then, reducing the investment opportunities of this funding. Lastly, although there still remain some issues for the medium term, FSLA are growing in strength, in a favorable international and local context.

⁴ However, these international comparisons should be taken cautiously due to differences in regulation between the countries.

⁵ Although the Chilean financial system's exposure to households is at a peak historical value, stress-testing for credit risk shows that the banking sector is robust to scenarios that are less favorable than the current one (see the Central Bank of Chile's Financial Stability Report for the second half of 2005).



Chart I.4
ROA
Average 2000-2004

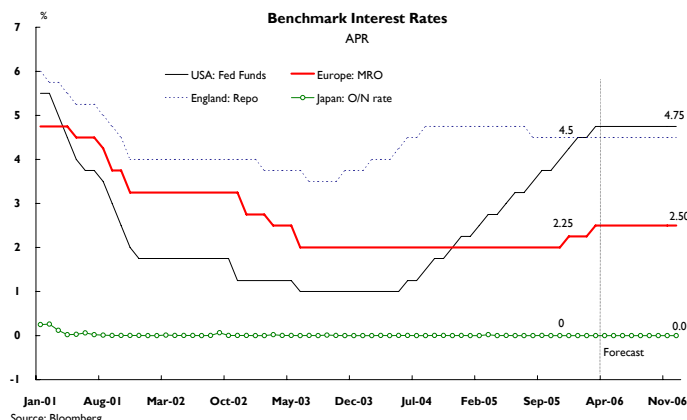


Source: BCRA from central banks and IMF

caused the Brazilian monetary authority to lower its benchmark interest rate, a trend that is expected to continue in 2006. Additionally, improvements in the economy's fundamentals (such as a substantial decrease in external debt) are causing the sovereign risk spread to decline, making an inflow of capital into that economy more likely. These factors, combined with a trend towards the appreciation of the real, substantiate expectations that Argentina's exports will gain momentum, with a positive effect on credit lines for export financing and on the repayment capacity of exporters.

Unlike previous periods, the performance of commodity prices was not uniform over the second half of 2005 (see Chart I.6). Although the prices on most agricultural commodities declined over the period, the price of oil remained on the rise. Despite the performance over the past six months, the favorable outlook for 2006 and expectations of a growing demand for commodities from China suggest that prices are likely to recover to some extent.

Chart I.5
Benchmark Interest Rates
APR



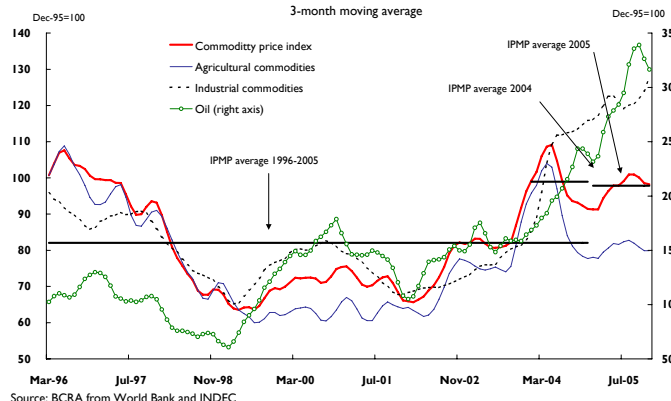
Source: Bloomberg

From a global perspective, international financial conditions in 2005 were positive for the region. Emerging economies continued to perform well while executing sound macroeconomic policies, with moderate levels of inflation and sustainable fiscal strategies. These factors encouraged a sustained decline in sovereign risk levels, and the performance of the corresponding securities became increasingly distinct to that of relatively high risk US corporate bonds (see Chart I.7).

Although the world financial sector, and emerging economies in particular, could still be affected by certain latent risk factors, the outlook for 2006 remains favorable

The global financial system is exposed to five main risk factors. First, there is a low probability of an abrupt correction to "global imbalances". Second, the price of oil, which is still high, poses a threat to the sustained growth of the world economy. Third, the upward cycle of US monetary policy could affect international capital flows, particularly affecting emerging economies. Fourth, China's growing insertion in the world economy is also a source of volatility, both for financial markets and the price of commodities. Last, on the regional level, the moderate performance of the Brazilian economy is still a risk factor, particularly for MERCOSUR countries. Overall, this configuration of risks suggests that prudential macroeconomic policies are advisable.

Chart I.6
Commodity Prices
3-month moving average



Source: BCRA from World Bank and INDEC

Despite this context, the Central Bank estimates that the likelihood that these risk factors could impact on the domestic financial system is low. The scenario of an accelerated adjustment to global imbalances is gradually becoming more remote, while the potentially negative effects of high oil prices on the world economy are moderate. The US Federal Reserve has signaled that the upward cycle in the Fed Funds rate is coming to an end, which would consolidate a favorable environment for the development of emerging economies. In particular, although a potential change in the direction of international capital flows could affect the region's financial systems, its domestic effect would not be pronounced, as Argentina's banking system has low exposure to external



Chart I.7

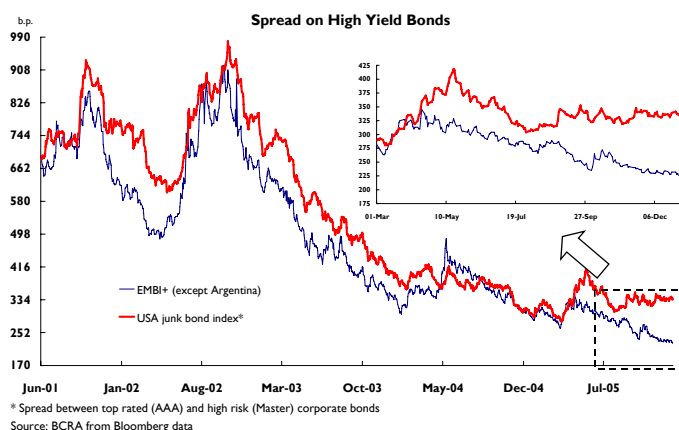


Chart I.8

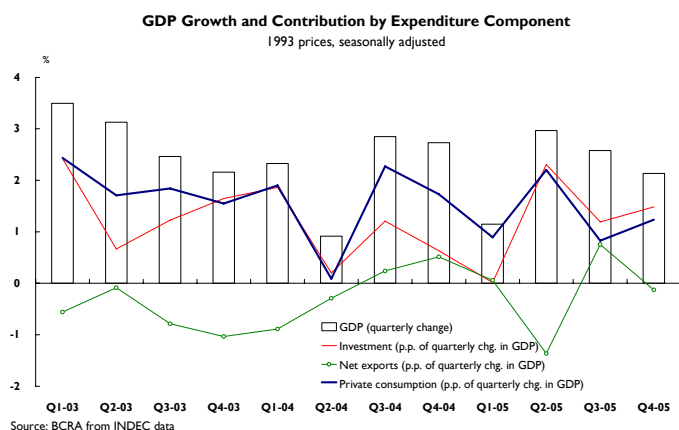
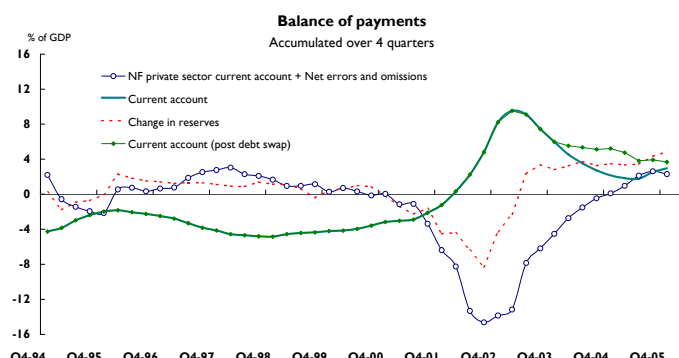


Chart I.9



(*) Since the second quarter of 2005, the current account (accrual basis) includes the effect of the public sector debt swap. The current account (post debt swap) includes an estimate for accrued interest for the restructured public debt from the first quarter of 2004. Both series will converge in the next three quarters.

Source: BCRA from INDEC data

funding. China's growing involvement in the world economy could have a positive effect for Argentina, as it drives the prices of Argentina's export commodities. Lastly, growth in Brazil's economy is expected to pick up in coming periods, following from the country's sound macroeconomic policies, and would generate a positive effect throughout the region.

I.2 Domestic conditions

The domestic economy has continued to grow at a substantial pace, in an environment of sustained trade and fiscal surpluses

The rate of economic growth remains high and there are no signs of a slowdown. The economy grew by an average 9.2% in 2005 (see Chart I.8), producing 3.6% carryover growth for 2006. The positive performance of domestic absorption continues to drive growth in economic activity. Private consumption has benefited from increases in the real wage bill, derived from growth in employment and pay, as well as a strong recovery in consumer credit. The path of investment is sustained by a steady growth in construction and by the incorporation of durable equipment to the productive process. The stable increase in domestic and external demand, the scarce levels of spare capacity in some economic sectors and the substantial improvement in access to credit, as well as the launching of fiscal incentives, continue to provide the appropriate environment for investment development.

Given the substantial carryover effect from the path of GDP in 2005, the Central Bank forecasts that it will grow by more than 6% in 2006 for a fourth consecutive year, following a path that is more consistent with a scenario of long-term economic growth. This scenario involves a growing flow of investment, which would allow for an expansion in productive capacity and drive the investment rate to more than 21 p.p. of GDP at constant prices.

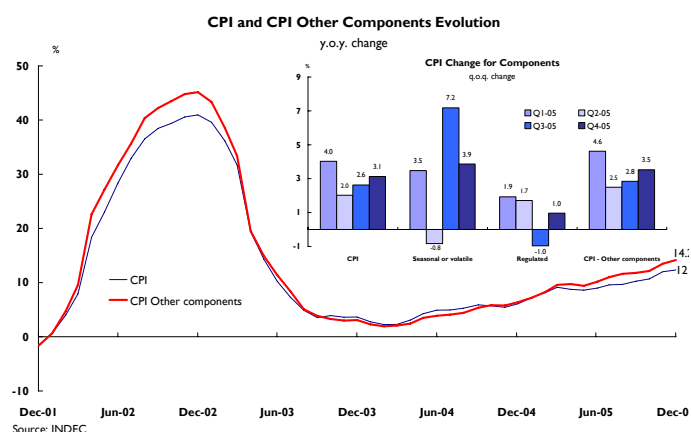
Additionally, this substantial level of economic growth is accompanied and supported by the strength of fiscal and external accounts. The current account surplus amounted to 3% of GDP (see Chart I.9) last year, mainly thanks to the path of the trade balance for goods, whose surplus amounted to approximately 7% of GDP due to record high exports. Public finances continued to develop favorably in 2005, propped up by national tax collection, which, in nominal terms, increased by 21% y.o.y.. Therefore, despite a build up in primary spending levels during 2005, the annual national primary surplus amounted to 3.7% of GDP, growing 25% y.o.y.. The level of the primary surplus was sufficient to cover interest payments and part of the principal on government debt.

The higher than expected increase in prices in 2005 led the government to take a number of measures, which added to the moderately contractive policy that the Central Bank carried out over the same period and plans to continue in 2006

In a context of a narrowing output gap and record economic growth, retail prices in the last quarter of the year increased by somewhat more than in the previous one. The monthly rate of increase in the fourth quarter averaged 1%, for an accumulated



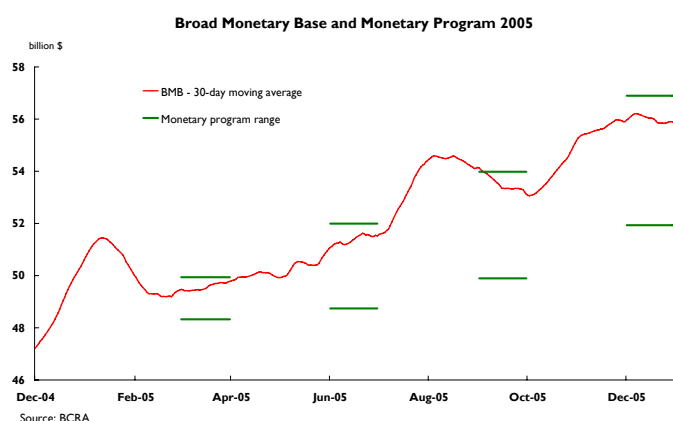
Chart I.10



annual inflation over 2005 of 12.3% (see Chart I.10). The greatest increase in prices in the last quarter was mostly due to the path of the CPI Other components (a proxy for core inflation), which increased by an average 1.2% per month. These increases led the government to take a set of measures aimed at reducing the export exchange rate for certain products, through the elimination of VAT reimbursements and raising export duties. The government also pursued agreements to reduce prices at major sales outlets, reduce the prices on certain staple products and encourage other retail sellers to lower prices.

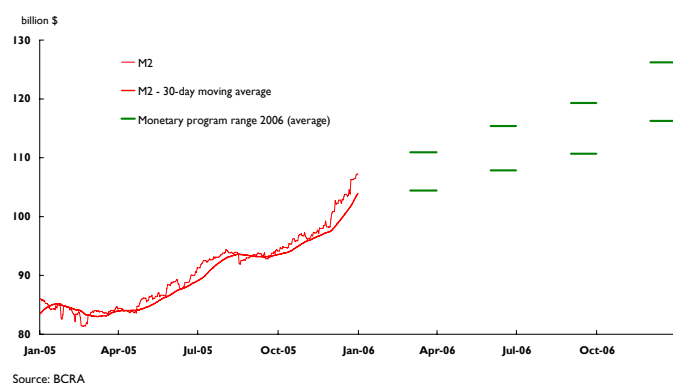
During the second half of 2005, the Central Bank focused its efforts on fighting an increase in inflation expectations, using all the monetary and financial instruments at its disposal. The Central Bank comfortably met the targets included in its Monetary Program (see Chart I.11). The monetary base (MB) came to \$55.8 billion, \$1 billion below the upper band established for the end of 2005. During the second half of the year the MB increased by 8.4% in nominal terms, or 2.4% in real terms. However, the MB declined 1.7% in real terms for 2005 as a whole, reflecting the change in the bias of monetary policy that the Central Bank put into effect at the start of 2005 by reducing the monetary stimulus. The Central Bank's benchmark rates – both those set in the repo market and on securities with the lowest maturity in the auction market for LEBAC bills – increased slightly, with the increases being transferred to the remaining short-term rates.

Chart I.11



The Central Bank designed the Monetary Program for 2006 based on quantitative targets for monetary aggregates, placing the focus of attention on monitoring compliance with M2 (see Chart I.12). The use of M2 in the monetary program follows from the transformation that the local banking and financial systems have undergone in recent years, and consequently leads to a closer control of monetary variables than the MB allowed. Additionally, M2 is the monetary aggregate with the closest relationship to the price level. A range for the path of M2 was set down in the program, the width of which is a function of the uncertainty surrounding the factors that account for the demand for money, its elasticity to changes in these factors and with regard to the path of the secondary process of money creation. The upper bound in the monetary program would lead to 21.2% growth in M2 over 2006, well below that seen over the previous three years (36%, 33% and 25% in 2003, 2004 and 2005, respectively), reflecting the continuation of the process of reducing monetary stimulus that the Central Bank started in 2005.

Chart I.12

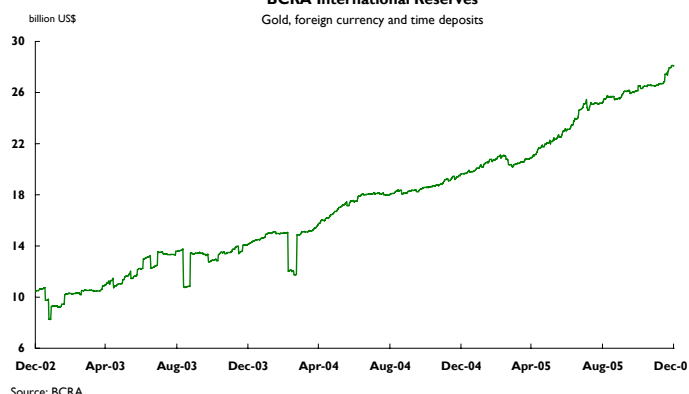
M2 and Monetary Program 2006

During the second half of the year, the Central Bank maintained its prudential policy of accumulating international reserves (see Chart I.13). The expansive effect that these transactions would have on the monetary base was offset by the settlement of rediscounts extended to banks during the domestic crisis in 2001-2002, as well as the contractive effect from public sector transactions and monetary absorption through the issue of LEBAC and NOBAC securities. International reserves amounted to more than US\$28 billion at the end of the year, more than tripling the level in early 2003. It is worth pointing out that in mid December the government decided to settle its entire stock of debt with the International Monetary Fund (IMF),



Chart 1.13

BCRA International Reserves
Gold, foreign currency and time deposits



for a total US\$9.5 billion, by means of the use of international reserves. The payment to the IMF was carried out on January 3, 2006, and had a neutral effect in both monetary and balance sheet terms for the Central Bank, since it received a non-transferable treasury bill in US dollars with a 10-year maturity and a similar yield to that obtained on international reserves.

The expected domestic context for 2006 features a high level of economic growth combined with declining levels of inflation. This favorable performance will arise from a framework of responsible and transparent fiscal and monetary policies, driving the country to a path of sustained economic growth.

II. FINANCIAL SYSTEM DEBTORS

Summary

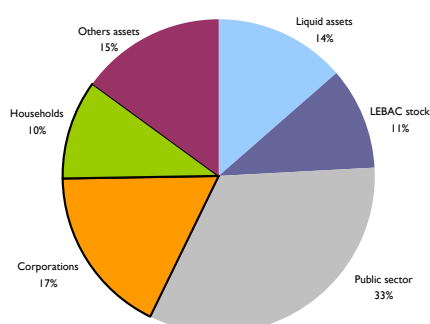
The economic and financial development of the main debtors of the financial system during the second half of 2005 was the key element in promoting the improvement of bank portfolio quality. Macroeconomic performance favored all sectors with debts to the financial system. The public sector, corporations and households registered improvements both in their economic and productive performance and in their balance sheets. Over coming months, the process of crowding-in for lending to the private sector will drive a further effort in the assessment of the financial conditions of corporations and households.

Fiscal accounts performed well during the second half of 2005. The public sector settled all due financial commitments and noticeably improved its debt conditions. The sovereign debt restructuring, the cancellation of liabilities with the IMF and the debt restructuring carried out by the province of Buenos Aires were some of the key events that will produce financial relief for the public sector over future years.

Overall, corporations in all branches of economic activity have performed favorably, with most attaining record output levels. However, this performance is leading to a high rate of capacity utilization, giving rise to the need for investments in 2006. The improvement in corporate balance sheets provides a substantial margin for firms to incur healthy levels of debt, which is expected to become increasingly linked to the domestic financial system.

Keeping with the outcome during the first half of the year, growth in employment and higher wages bolstered household incomes during the second half of 2005. Combined with the healthy debt levels of households, this outcome has helped drive consumer credit lines. Although this type of debt has increased rapidly, the low interest rates and the expected growth in household income help ensure that the financial position of households will be adequate in 2006.

Financial System Asset Portfolio
As % of netted assets - December 2005



Composition of Business Loan Portfolio
December 2005

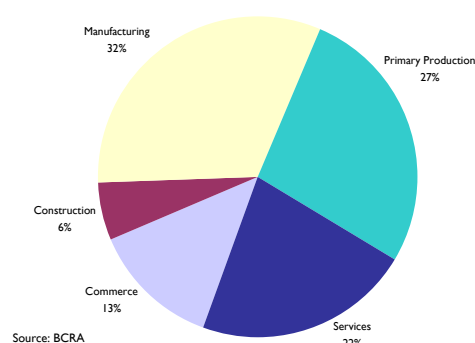
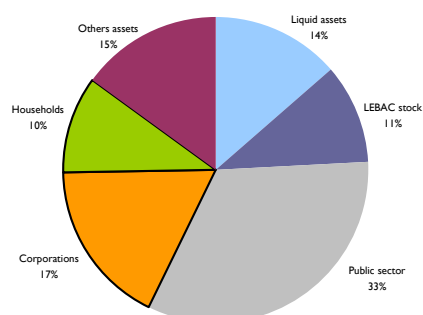




Chart II.1

Financial System Asset Portfolio

As % of netted assets - December 2005



Source: BCRA

II.1. Financial system asset portfolio

The private sector continues to crowd in on bank lending, at the expense of the public sector

Having accounted for more than half of the financial sector's asset portfolio, the decline in public sector credit risk exposure gained momentum in 2005 to reach 30% of total assets (33% of netted assets) at the end of the period. Financial institutions also managed to increase credit to households and corporations over the same period, in the context of a favorable business and financial outlook for the private sector (see Chart II.1).

The process of crowding-in the private sector is expected to continue in 2006, due to factors affecting both the supply and demand for credit. This highlights the need to focus the assessment of financial system debtors on corporations and households, as these will be the main recipients of funds from financial institutions in 2006.

II.2. Public sector

II.2.1 Fiscal conditions

In a framework of improved public finances, and the consolidated public sector met all outstanding payments on its performing debt, therefore starting to clear the road towards obtaining financing from capital markets

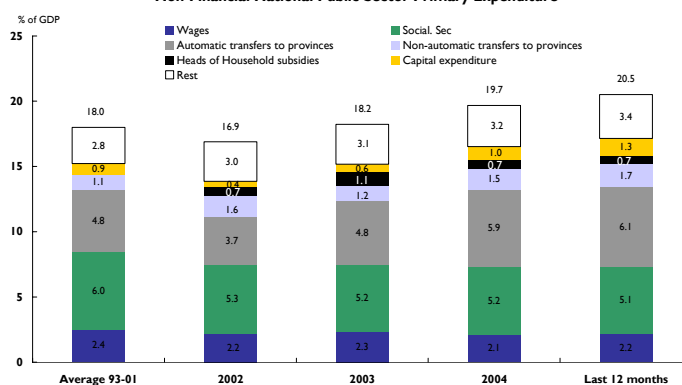
Although the non-financial national public sector's (NFPS) surplus as a share of GDP was lower than in 2004, it was still high in 2005, reaching 3.7%. This outcome was driven by the outstanding performance of national tax collection, which grew by 21% year-on-year (y.o.y.) to about 22.5% of GDP (see Chart II.2). This was partly offset by an increase in primary spending, which has grown by 22% y.o.y. to 20.1% of GDP. The NFPS therefore attained a financial surplus of 1.8% of GDP, allowing the government to keep reducing its liabilities.

The completion of the debt restructuring process enabled the government's return to domestic capital markets. New sovereign debt amounting to a total \$9.7 billion in nominal value (of which \$7.7 billion was denominated in US dollars) was issued during the second half of 2005. The government's substantial financial surplus, its new debt issues, the use of government accounts and temporary advances from the Central Bank – within the constraints set down in the Central Bank's charter – have allowed the government to meet payments on its maturing debt principal without difficulty.

Provincial governments accumulated a primary surplus of approximately 0.8% of GDP in 2005, putting the primary balance of the consolidated public sector (National and Provincial governments combined) at 4.5% of GDP (see Chart II.3). The consolidated government primary surplus is expected to decline to 4% of GDP (3.3% for the national government) in 2006, although this forecast should be adjusted for the resources that

Chart II.2

Non-Financial National Public Sector Primary Expenditure

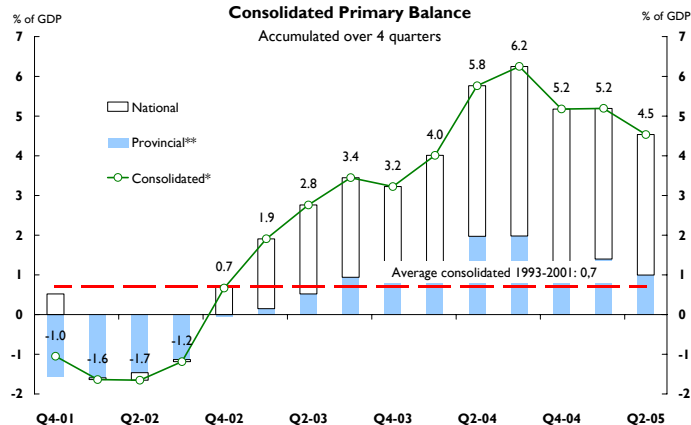


Source: BCRA from Treasury Secretariat data

Chart II.3

Consolidated Primary Balance

Accumulated over 4 quarters

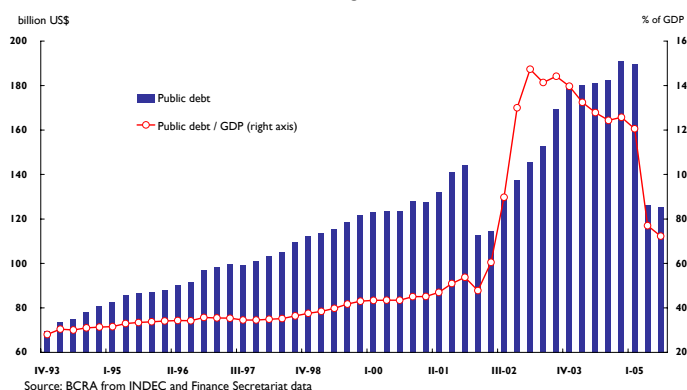


*Cash basis ** Accrued basis

Source: BCRA from Treasury Secretariat data



Chart II.4
Sovereign Debt



are to be allocated to the Counter-cyclical Fiscal Fund⁶. Under this scenario, the government would be able to continue meeting payments on its maturing sovereign debt.

II.2.2 Public debt

Particular circumstances such as the sovereign debt restructuring, the settlement of the government's entire stock of debt with the IMF and the debt restructuring conducted by the province of Buenos Aires helped to strengthen the consolidated public sector

The completion of the sovereign debt restructuring process helped to considerably improve the public sector's financial conditions and the sustainability of its liabilities. In fact, the stock of National Public Debt (NPD)⁷ amounted to US\$125.4 billion (72.3% of GDP) at the end of September 2005, declining by 4.7 p.p. of GDP from the previous quarter, almost entirely due to net payments to international financial institutions and net debt settlement (see Chart II.4).

Table II.1
Sovereign Debt by Currency
In %

	Jun-05	Sep-05
Argentine peso ¹	47	48
Dollar	37	36
Euro	12	12
Others currencies ²	4	5

1. Includes pesificated obligations (Feb-02) and adjusted by CER.

2. Includes yen, pounds, suisse franc and others.

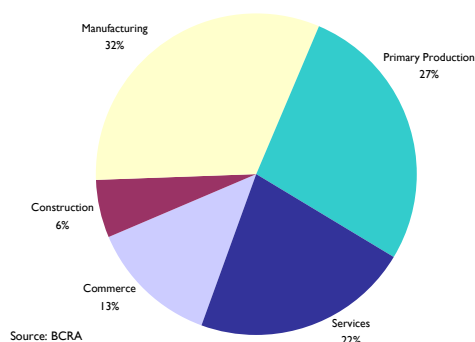
Source: Finance Secretariat

The sovereign debt restructuring created a new profile of debt maturities, strongly reducing principal and interest payments over coming years. Additionally, the average interest rate on the NPD came to 3.4% and the share of debt in pesos increased to 48% (see Table II.1).

The government's decision to settle its entire stock of outstanding debt with the IMF (US\$9.5 billion) has had a neutral effect on the stock of NPD because a liability with the IMF was replaced with another liability with the Central Bank, of the same magnitude. However, this transaction has substantially relaxed financial requirements through 2009.

The Province of Buenos Aires made a global restructuring proposal for total eligible debt amounting to US\$2.7 billion, for which acceptance was around 94%. The transaction, which involved almost 11% of the total stock of Provincial government debt, has produced a substantial improvement in the financial features of the Province's debt liabilities, allowing it to continue improving its public finances.

Chart II.5
Composition of Business Loan Portfolio
December 2005



Source: BCRA

II.3. Corporations

Encouraging developments in terms of businesses' real and financial variables suggest that the outlook for growth in investment is good

The financial sector continues to expand credit to the corporate sector in a sustained manner. Lending to the manufacturing, primary and services sectors are the main allocations of bank funds by industry (see Chart II.5). To a lesser extent, financial institutions have allocated lending to projects in the commercial

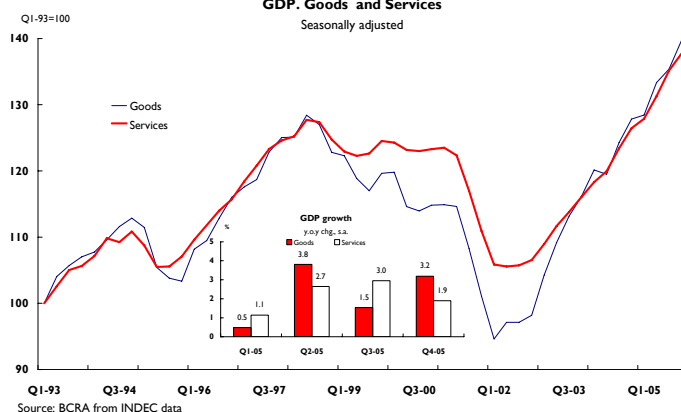
⁶ A policy instrument created in 1999 (Law 25,152) with the aim of accumulating resources to be used in the case of a downturn in the business cycle. According to the national budget for 2006 (Article 24 of Law 26,078), the fund will receive the financial surplus that is not allocated to cover the national government's global financing needs.

⁷ The NPD stock as of the end of September does not include the share of the debt that was not submitted for restructuring (hold outs), since according to Law 26,017, the Executive Branch cannot reopen the debt swap to include these bonds. As reported, the total stock of hold outs amounts to US\$23.5 billion (including accrued and unpaid interest) at nominal value. The addition of this value to the reported stock of debt would amount to a total US\$148.9 billion (91% of GDP).



Chart II.6

GDP, Goods and Services
Seasonally adjusted

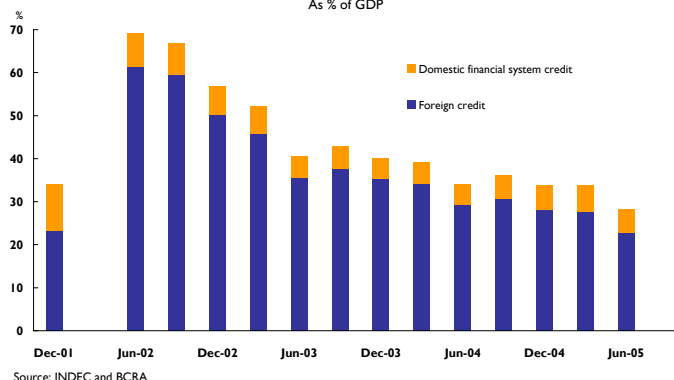


and construction sectors. These elements outline the overall map of banks' exposure to the corporate sector.

In the second half of 2005, the domestic economy continued to grow at a high rate, with broad-based growth in sectors producing goods and services (see Chart II.6). Particularly strong performance occurred in the construction, manufacturing, transport services, storage, communications and agricultural sectors. The sustained improvement in domestic production activities and corporate debt restructuring processes were the main engines driving the improvement in the financial position of corporations. Additionally, given the high degree of dollarization of corporate debt, particularly for debt contracted abroad, the reduction in the exchange rate between the peso and the US dollar in the post-crisis period has had a positive effect on corporate finances. Towards the end of 2005, aggregate corporate debt shrunk past pre-crisis levels as a share of GDP (see Chart II.7).

Chart II.7

Corporate Debt
As % of GDP

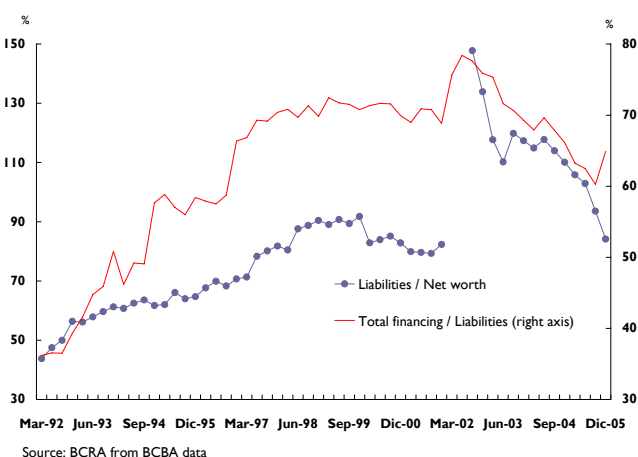


Corporations with the greatest access to the domestic capital markets⁸ further reduced their debt levels, attaining values that are lower than those previous to the crisis. In parallel with this behavior, this set of corporations favored incurring new debt with the banking sector (see Chart II.8). This change in behavior has caused a turnaround in the downward trend of bank lending as a share of the liabilities held by these corporations in the post-crisis period.

Favorable indicators on the performance of corporate solvency are part of a setting that also features production attaining record high levels and some sectors coming against supply restrictions, showing the need for further investment over coming years. An improved corporate repayment capacity and the requirements arising from the need for further investments suggest that the outlook for financial intermediation in 2006 is encouraging.

Chart II.8

Corporate Debt Burden
Companies reporting to the BCBA



II.3.1. Manufacturing

Manufacturing activity grew strongly in 2005, while the need for investments became apparent and was partially satisfied by the banking sector

Manufacturing activity grew at a healthy rate during the second half of 2005, at a higher pace than in the first half (see Chart II.9). Particularly strong growth occurred in the branches of automobile manufacturing, foods and beverages, and non-metal mineral products, the latter of which was mainly linked to strong growth in construction.

New investments were made in 2005, causing the stock of capital to increase in several branches of manufacturing. Capacity utilization came to 69% in December 2005, only 0.5 p.p. above that registered at the end of 2004. Although a fraction of new investments were financed out of reinvested earnings, credit to the manufacturing sector was one of the financial sector's main allocations of funds.

⁸ That is, firms that make balance sheet reports to the Buenos Aires Stock Exchange.



Chart II.9

Manufacturing Output Proxy (EMI). Long Run Performance

Seasonally adjusted

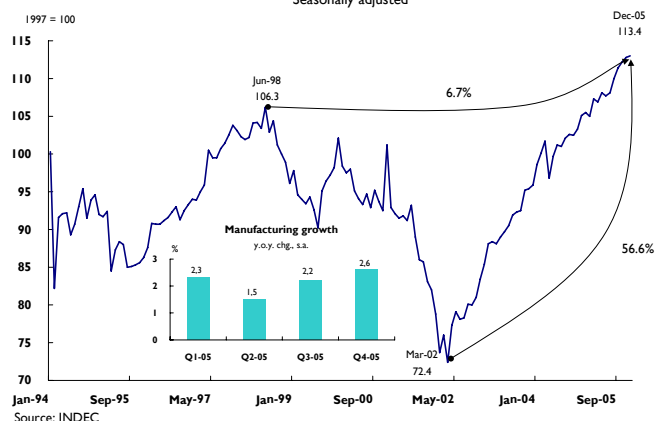


Chart II.10

Manufacturing Sector Debt

As % of GDP of the manufacturing sector

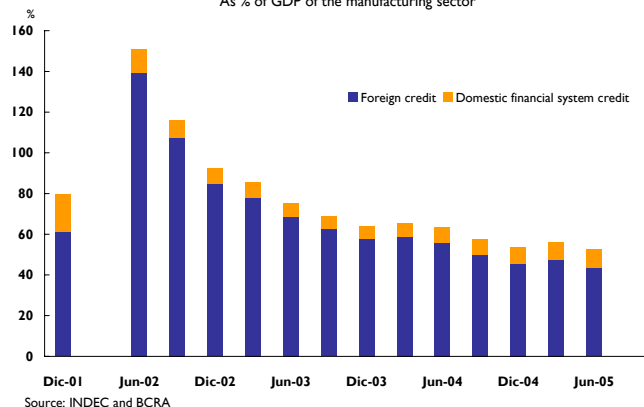


Table II.2

Grain Production

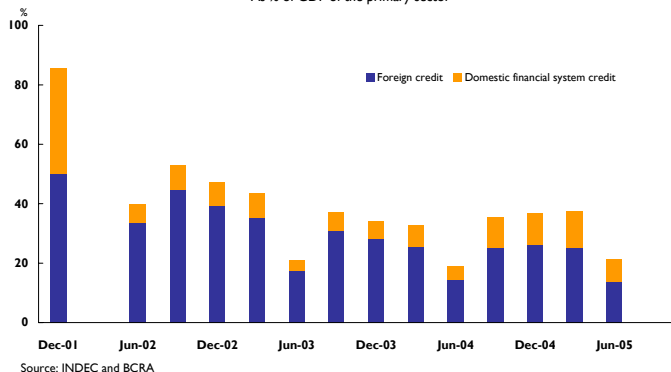
	2003-04		2004-05		2005-06 (estimated)		% chg. 2005-06 / 2004-05	Chg. 2005-06 / 2004-05
	million tns	%	million tns	%	million tns	%		
Cereals	34,142	49.1%	40,960	48.8%	35,189	43.2%	-14.1%	-5,771
Corn	14,951	21.5%	19,513	23.2%	17,577	21.6%	-9.9%	-1,936
Wheat	14,563	20.9%	15,970	19.0%	12,294	15.1%	-23.0%	-3,676
Grain sorghum	2,165	3.1%	2,894	3.4%	2,900	3.6%	0.2%	6
Rice	1,060	1.5%	1,027	1.2%	992	1.2%	-3.4%	-35
Brewing barley	1,002	1.4%	886	1.1%	844	1.0%	-4.8%	-42
Oat	332	0.5%	536	0.6%	457	0.6%	-14.7%	-79
Rye	37	0.1%	92	0.1%	82	0.1%	-10.7%	-10
Others	33	0.0%	41	0.0%	42	0.1%	3.2%	1
Oilseeds and oleaginous fruits	35,098	50.4%	42,520	50.7%	45,742	56.2%	7.6%	3,222
Soybean	31,577	45.4%	38,300	45.6%	41,148	50.6%	7.4%	2,848
Sunflower	3,161	4.5%	3,662	4.4%	3,962	4.9%	8.2%	300
Peanut	293	0.4%	445	0.5%	559	0.7%	25.6%	114
Others	68	0.1%	113	0.1%	73	0.1%	-35.3%	-40
Total	69,590	100%	83,928	100%	81,379	100%	-3.0%	-2,549

Source: BCRA from SAGPyA and USDA data

Chart II.11

Primary Sector Debt

As % of GDP of the primary sector



Although the manufacturing sector has a certain degree of exposure to volatility in the exchange rate due to its foreign debt, the sector's overall level of debt is low by historical standards (see Chart II.10). This indicates that it is feasible for the sector to acquire further debt. This factor is encouraging, as there are further needs for credit to finance the expansion of the productive base in certain branches of manufacturing industry.

Although the sector's growth is likely to slow down slightly in 2006, the performance of manufacturing is expected to remain favorable, driven by increases in both domestic and external demand. Given the need for investment, these conditions mean that it is likely that the downward trend in the debt levels of the manufacturing sector will turn around.

II.3.2. Primary sector

Although certain risks are still in place, primary sector activity and repayment capacity are expected to improve in 2006

Following a record 83.9 million tons harvest in the 2004/2005 season, the outlook for the current harvest is relatively less favorable given the reduction in the sowing of cereals and lower expected yields due to weather issues (see Table II.2). The livestock sector continued to grow in the second half, reaching a high level of growth in the second half of the year. Beef production increased by 3.6% y.o.y. over 2005, despite comparable slaughter from a year earlier.

The financial conditions of the primary sector are healthy, compared to standards in the past (see Chart II.11) as well as other sectors. In the aggregate, firms in the primary sector are increasing the share of debt with the domestic banking system, at the expense of lending from international financial markets.

Although the outlook for the agricultural sector in 2006 is favorable, there are some risk factors that could eventually have a partial effect on the repayment capacity of some firms in the sector. The strong performance of the agricultural sector depends on the path of international commodity prices. Additionally, an outbreak of foot and mouth disease has had a temporary effect on beef exports, and the favorable performance of beef production in 2006 is exposed to a delay in the resolution of this problem.

II.3.3. Services

Activity in the service sector is at a record level, while favorable future repayment capacity suggests that the outlook for investment in this sector is strong

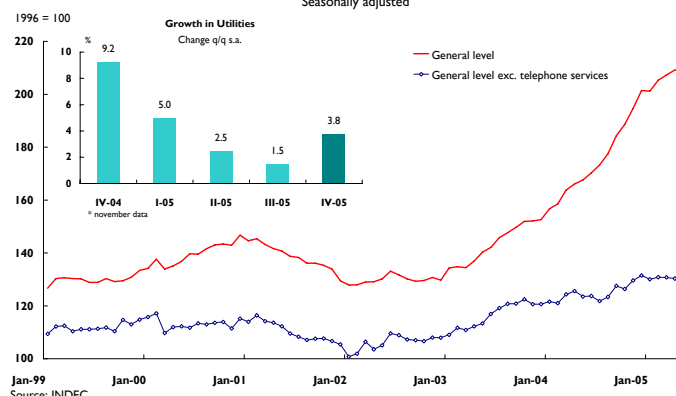
Growth in activity for public services accelerated in the last months of 2005, increasing by a 4% s.a. rate in the fourth quarter, higher than in the third quarter (1.8% s.a.) and in line with performance during the first half of last year (see Chart II.12). Output for public services therefore increased by 20.1% y.o.y. over 2005, a slightly lower rate than in 2004 (22%), allowing sector activity levels to reach a new record high. Mobile phone services were the main engine driving growth in this sector.



Chart II.12

Utilities

Seasonally adjusted



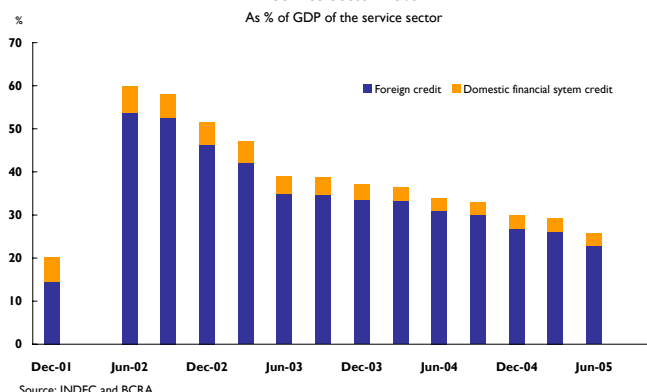
The government continued to make progress in carrying out the necessary infrastructure projects to ensure the normal provision of energy inputs and the adequate supply for a growing demand. Congress extended the economic emergency law (Law 26,077) for a further year, enabling the executive branch to renegotiate contracts with companies providing public services. Two decrees were published at the end of last year (1460/05 and 1462/05) endorsing sealed renegotiations with the main companies involved in the transport of electricity. In parallel, as the renegotiations came to a close some of the companies in the electricity sector managed to successfully refinance their debt.

The financial position of service providers continues to improve steadily, particularly through declines in foreign debt (see Chart II.13). Although the banking sector is allocating a substantial part of its resources to financing firms in the services sector, the effect on indebtedness levels is being offset by the substantial rate of growth in activity.

Chart II.13

Service Sector Debt

As % of GDP of the service sector



The sector's outlook for 2006 is encouraging. The strong level of growth during last year has produced a carryover effect of 4.7%, and the greater level of economic activity is expected to drive demand for public services. Despite the above, the greater use of these services will to a large extent depend on capacity expansion, as some sectors are currently operating at close to limit levels. The strong outlook for repayment potential and the substantial margin for further lending to service providers suggest that greater levels of investment in this sector could be financed by the domestic banking system.

II.3.4. Commerce

Sales in commerce have grown, and new investments have been partly funded by the financial system, at no expense to the sector's robust repayment capacity

Retail sales increased substantially during the second half of 2005, following from the strong recovery in private consumption and mainly linked to substantial improvements in real income for registered workers, growing employment and expanded consumer credit. Supermarket sales increased by 6% over the year (1.9% s.a. during the second half of 2005), while shopping center sales increased by 16% over the same period (8.5% over the six month period, s.a.) to attain record high levels (see Chart II.14).

Although credit to commercial businesses increased strongly during 2005, growth in output more than offset growth in liabilities. As a result, firms in the commerce sector managed to make new investments while improving their repayment capacity on outstanding debt. Investment in commercial activity is expected to continue in 2006, mainly linked to companies selling home appliances and supermarkets, without a decline in the commercial sector's financial position.

II.3.5. Construction

Growth in construction continues to outpace the rest of the economy, and features a low need to resort to the banking sector for funds

Chart II.14

Supermarket and Shopping Mall Sales

In real terms, 3 month moving average, seasonally adjusted series

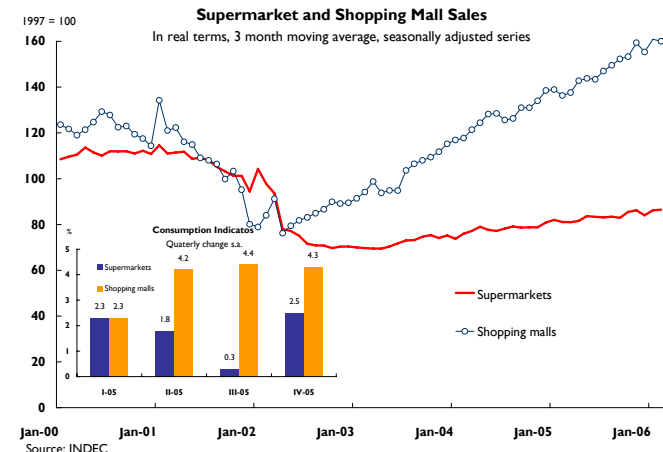
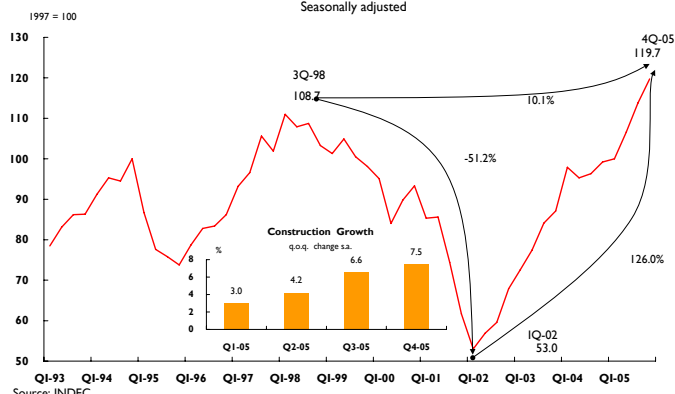




Chart II.15

Construction Activity Indicator (ISAC)
Seasonally adjusted

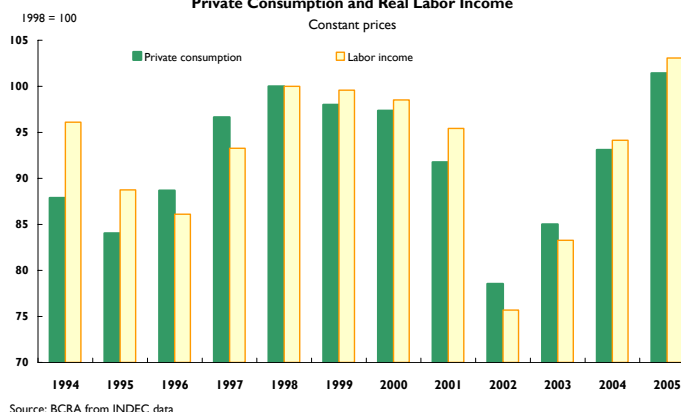


Maintaining the strong momentum that has been in place since the second quarter of 2005, construction activity accelerated further in the second half to become one of the highest growing sectors in the economy in 2005. Over this period, growth in this sector amounted to 14.6% y.o.y., and was broad-based across the different branches of the construction sector (see Chart II.15). Particularly strong performance occurred in private housing projects and public works related to infrastructure and highway development.

Construction activity continues to obtain its funding from outside the banking sector and foreign credit market, as it is mostly financed by the sector's own funds or by direct investment. Given the sector's low levels of debt and extraordinary performance, lending to these firms involves low credit risk.

Chart II.16

Private Consumption and Real Labor Income
Constant prices



The growth performance that the sector has displayed so far is expected to continue in 2006. The substantial number of projects currently under construction, added to 35.6% annual growth in the issuing of private building permits and a 30% budgeted increase for public works all suggest that the sector will attain two digit growth this year, higher than the rest of the economy. Funding for the sector is also expected to come from outside the financial sector.

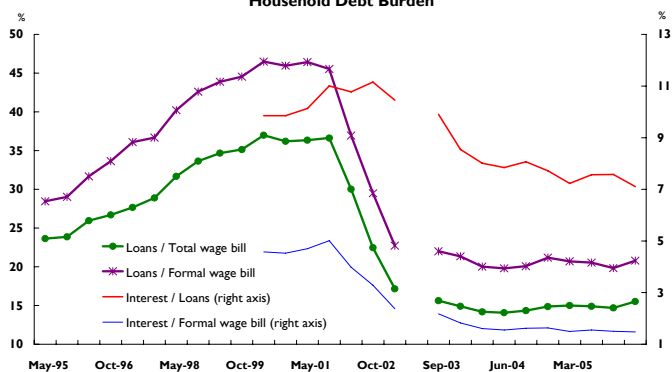
II.4. Households

Although households are incurring debt at a higher rate than the growth of incomes, their financial position is still relatively comfortable by historical standards

Private consumption continued growing during the last half of 2005, expanding by about 9%. The increase was once again driven by growth in the real wage bill (see Chart II.16), arising from higher employment and real pay (both in the private and public sector), as well as higher transfers from the public sector due to family allowances and pensions. The financial income of households was still held back by the high liquidity in the banking sector, which causes financial institutions to pay low borrowing rates.

Chart II.17

Household Debt Burden



In addition to higher household income, there was also growth in consumer credit lines. The financial system has increased both the number of products and the supply of loans to households. Although they remain well below pre-crisis levels, there has been an incipient trend towards a rise in household debt levels (see Chart II.17), as the rate of growth in household debt surpassed that in income. Controlling for the effects of greater indebtedness and lower maturities, the low interest rates paid by indebted households contribute positively to repayment capacity.

Private consumption is expected to keep growing in 2006, although possibly at a lower rate than GDP. In this context, households are expected to continue using the financial sector as an instrument with which to bring consumption forward in time, while keeping a favorable financial position.

III. FINANCIAL INFRASTRUCTURE

Summary

The increasing strength of the fundamental economic variables of the Argentine economy, together with an international context favorable to emerging countries, have made it possible to ensure the continuity of the process leading to the deepening of the local capital market. In such a context there has been a significant increase in activity volumes in the fixed income market, with new debt issues by the Government. The market for Central Bank bills has continued to grow, with a considerable lengthening of terms and higher trading volumes on secondary markets. Stock markets have again recorded certain volatility, although recovering by the end of the period. New bond issues were made on the corporate bond market for almost \$7 billion, and financial trusts were launched for approximately \$3.5 billion.

Both financial institutions and non-bank financial intermediaries maintained their steady rate of growth through to the end of 2005. Growth by the latter in particular was accompanied by increasing investment portfolio diversification. At the same time as rising numbers of contributors and higher income levels subject to social security charges generated an increase in the size of pension funds, the consolidation of the public debt market and the favorable development of the stock market provided a stimulus to mutual investment funds. Macroeconomic growth also continued to strengthen the insurance market.

In the second half of 2005 the trend towards the normalization of bank financial position was maintained, driven by a series of regulatory changes announced by the Central Bank for the development of lending to small businesses, improvements to debtor classifications rules, limits on exposure to the public sector, and marking to market of public sector assets. Higher totals for lending to the private sector and declining banking sector exposure to the public sector led this process of normalization.

In the period under review the structure of financial system funding consolidated its bias in favor of traditional sources. Changes in liabilities were mainly associated with the higher totals of private sector deposits during the period. In addition, during the second half the rate of repayment of rediscounts under the “matching” mechanism accelerated. Furthermore, the Central Bank continued to introduce measures to lengthen the duration of bank loans to the private sector, an essential factor for any increase in investment in the economy.

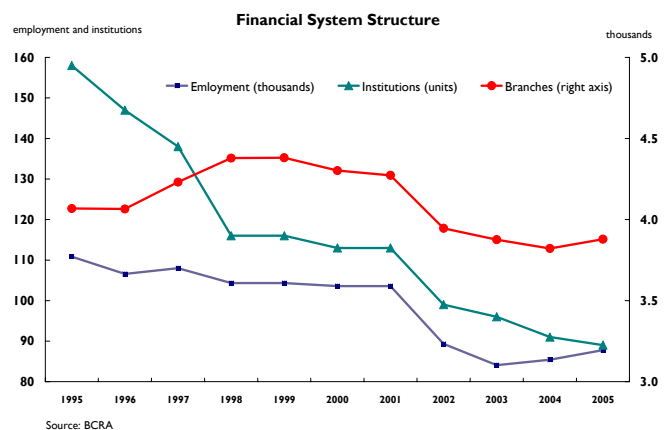
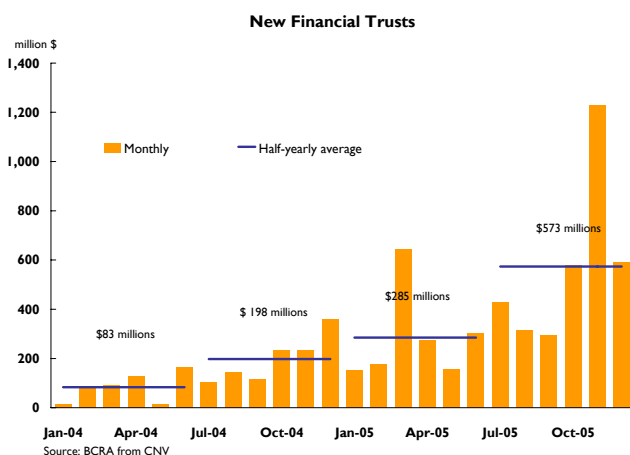




Chart III.1
USA Bonds Yields

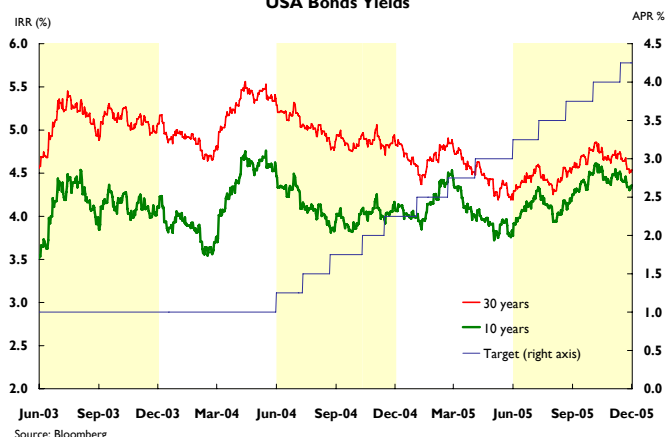


Chart III.2
EMBI+ Spread

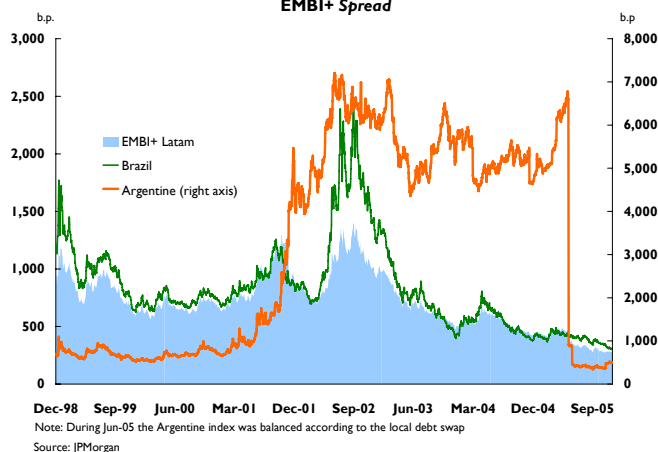
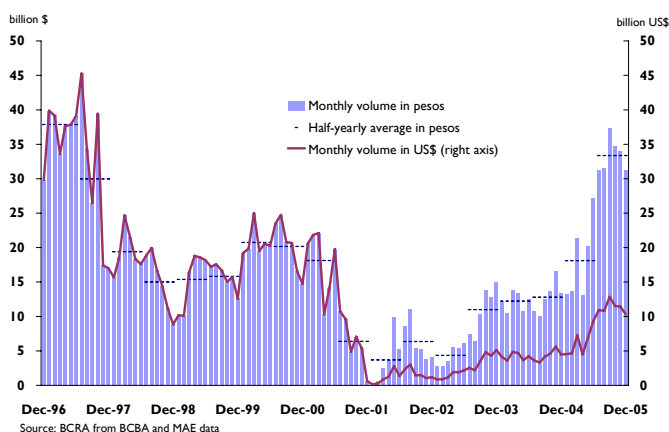


Chart III.3
Traded Volume of Public Bonds



III.1 Capital market

Despite the increase in reference interest rates in developed countries, the international context remains favorable for emerging markets

In the second half of 2005 the international situation continued to be favorable for financial markets in emerging countries, with synchronized growth at global level, high commodity prices, and in the most developed markets, abundant liquidity, interest rates that are still low, and relatively flat yield curves. To these factors should be added the strengthening of domestic fundamentals (dynamism in activity levels, prudent macroeconomic policies, inflation under control and improved indebtedness ratios), which also impact in the form of greater capital flows towards emerging economies. Taking advantage of these favorable conditions, various emerging countries were able to exercise a more active debt administration, including the advanced obtaining of sufficient resources to meet future disbursements (in addition to a rise in the proportion of debt issued in local currency) and the bringing forward of debt repayment, especially that held with international lending agencies.

As a result, there were therefore positive developments in emerging markets during much of the second half, with the exception of October. Already in September, and particularly in October, in the face of greater inflationary concerns in the USA and expectations with regard to larger increases in the Federal Reserve reference rates (in addition to the uncertainty provoked by the imminent appointment of a replacement for Alan Greenspan at the head of that institution), an increase took place in long-term interest rates (see Chart III.1) as well as a widespread rise in the volatility of financial markets. In the specific case of emerging markets, following several months of cumulative gains, there were signs of significant profit-taking in that month. Subsequently, markets were to show signs of a more stable performance, allowing the year to end on a positive note.

Greater interest in emerging economy assets was reflected in the performance by the EMBI+ spread for Latin America, which showed a declining trend, steadying at historically low values (see Chart III.2). In the case of Brazil, for example, there was a drop of almost 100 basis points over the course of the half, despite the complex political situation being faced by that country. At the same time, with private capital inflows in emerging economies running at record levels (given the need by more mature investors to improve the yields on their portfolios), price improvements were accompanied by increased trading volumes.

Sustained interest in emerging economy assets also benefited the Argentine market, where -despite persistent volatility- there was an increase in trading volumes

The favorable context for emerging economies in general, added to the impulse from factors of a local nature in the new scenario since the debt restructuring, ensured the Argentine capital market continued to show positive signs in terms of both prices and level of activity. Favorable developments were particularly



Chart III.4

Yield Curve of CER Adjusted Bonds in Pesos

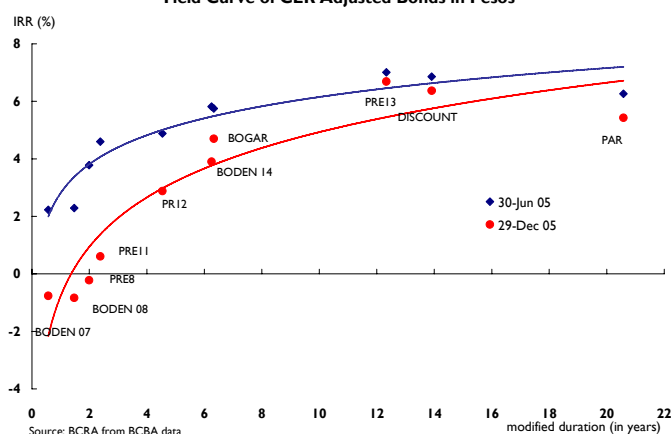


Chart III.5

Dollars Bonds Yields Curve

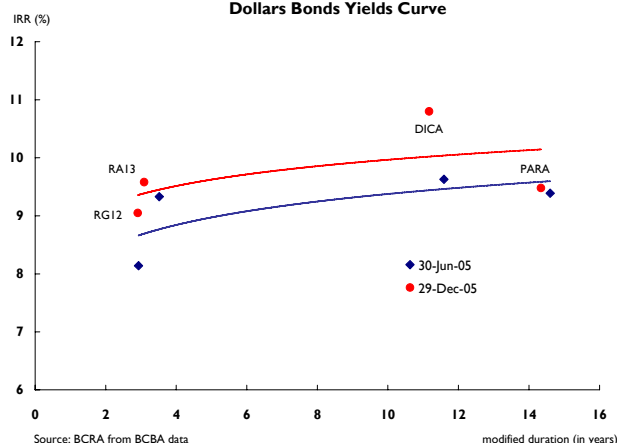
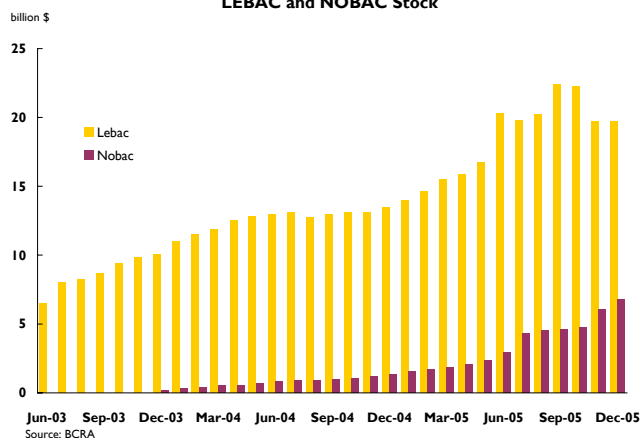


Chart III.6

LEBAC and NOBAC Stock



notable until the end of September, dropping back in October in line with the international situation. Subsequently, a context of uncertainty prevailed, mainly due to factors of a local nature (elections, changes at the Economy Ministry, announcement of the settlement of IMF debt).

The Government continued to launch new issues on the domestic bond market during this half, following its first voluntary post-swap debt placement in May, when it auctioned BODEN 2014 in pesos adjustable by the CER index. In July two further issues of this series took place, each for \$1 billion. Nevertheless, at the end of that month it was decided to discontinue the issue of CER-adjusted bonds. In July and August auctions were held for BODEN 2012 bonds in dollars for US\$442 and US\$350 million respectively, yielding slightly less than 7.85%. Lastly, following the canceling of an auction at the end of September (when the Government decided not to consent to the payment of yield that were not aligned with the international context) in October an auction was held of US\$632 million in BODEN 2015 through a quantity bidding system (with a pre-established yield of 8.75%). Several private placements of dollar government securities also took place, so that the issue of bonds in foreign currency totaled US\$2.65 billion during the half. In addition, in November a mechanism was introduced for the redeeming of debt using the Government's surplus payment capacity. As a result, debt was redeemed for a face value of almost US\$114 million. Lastly, at the end of December it was announced that all IMF obligations (totaling close to US\$9.5 billion) were to be repaid using freely-disposable reserves held at the Central Bank.

One of the most notable aspects of the domestic market this half was the increase in the volume of activity on local bond markets, as had been expected once the end of the sovereign debt swap had taken place (see Chart III.3). Trading volumes on the MAE and the Buenos Aires Stock Exchange rose this quarter almost 85% on average compared with the first half of 2005, while in comparison to the same period of the previous year the increase is in the order of 160%. As a result, volumes in pesos were similar to those observed in the second half of 1996 (if the comparison is made in dollars, the six-month total is still below that recorded in the first half of 2001). Given the weighting of fixed income assets in bank portfolios, the increased liquidity of such assets will ensure an improved risk profile for financial institutions, lowering the liquidity risk and ensuring further progress in its policy for reducing exposure to the public sector (incurring in declining costs).

Interest continued to be shown in CER-adjusted assets (although new issues have been discontinued). A strong impulse was provided to bonds with spread over BADLAR

The Government's decision to stop issuing CER-adjusted debt, at a time of growing demand for such bonds (from both domestic and foreign investors), led prices for that debt on secondary markets to rise sharply. The yield curve for peso CER-adjusted assets recorded a downward trend during the half (see Chart III.4). This behavior was sharper in the shorter segment of the curve (the part less sensitive to changes in interest rates), for which yields became slightly negative. In the



Chart III.7

LEBAC and NOBAC Yields in Auctions

\$ instruments without CER adjustments

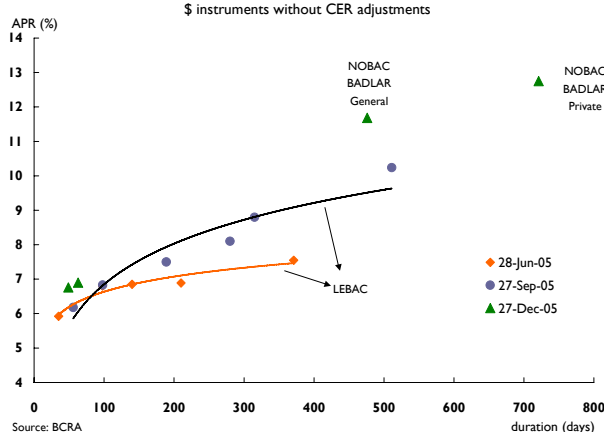


Chart III.8

LEBAC Yields in the Secondary Market

LEBAC in \$ without CER adjustment- MAE - End of month figures

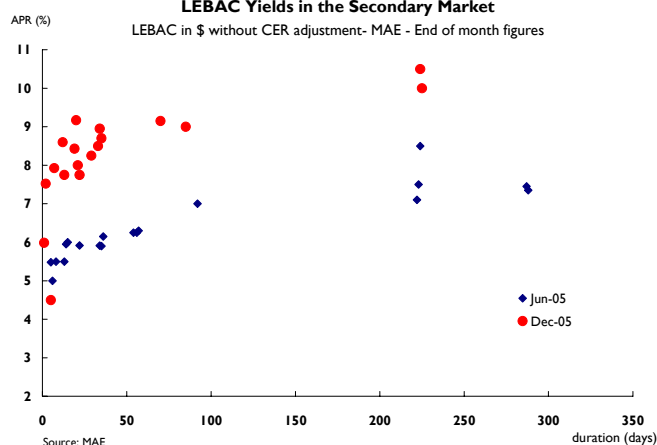
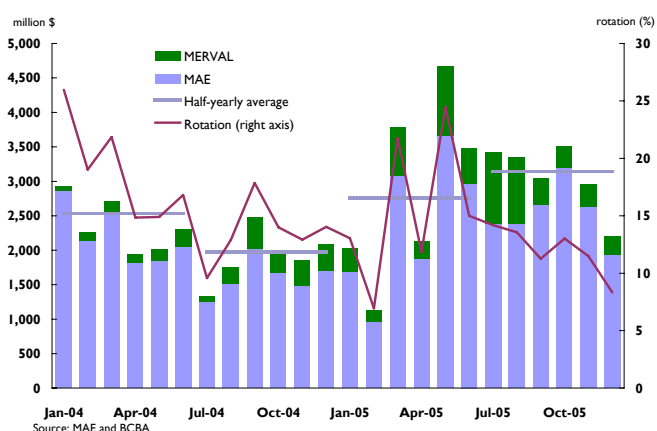


Chart III.9

Traded Volume of LEBAC and NOBAC



case of dollar bonds, there was an upward shift over the course of the six-month period (see Chart III.5), in addition to a certain increase in the Argentine EMBI+ spread. This upward movement has been a response to various factors, including the presence of arbitrage between dollar and peso securities and the changes that took place in the price of bonds delivered at the latest debt swap (since the end of November, the GDP-Linked Units began to list separately).

On the basis of the monetary targets that had been established, the Central Bank continued with an active issue of bills and notes (see Chart III.6). The total balance of these items went up almost \$3.3 billion between June and December, to a level of close to \$26.5 billion. In line with the policy followed by the Ministry of Economy, as from August the monetary authority stopped issuing CER-adjusted securities. In order to lengthen the duration of Central Bank resources, increased importance began to be assigned to the issue of variable-coupon (spread over BADLAR) NOBAC notes, which were well received by banks, as they provide a certain degree of hedging against the increased cost of funding. In interest rate terms, successive auctions of Central Bank instruments revealed a slight upward trend, as well as a steeper curve, consistent with the mentioned strategy for a lengthening of terms (see Chart III.7). On the secondary market implicit yields evolved in harmony with the cut-off rates accepted at the auctions (see Chart III.8). In the case of the secondary market for Central Bank securities, an increase in trading volumes was recorded this half (see Chart III.9). This has a positive impact on the activities of financial institutions, as LEBAC and NOBAC have a significant weighting in their portfolios, so that the increased liquidity of such instruments represents a lower implicit risk from the holding of them.

In addition to variable-link LEBAC that can be used by banks to provide hedging against possible increases in the cost of their funding, there are other hedge instruments available. These include futures markets (for currencies, interest rates, etc.). During the second half of 2005 currency futures continued to record an increasingly dynamic performance, mainly through the ROFEX (see Chart III.10), with record transaction levels. The OCT⁹ MAE market (made up of financial institutions and the Central Bank) recorded a growing level of transactions, although on a lesser scale than that seen in the case of the ROFEX. BADLAR and CER futures transactions also began to be performed on the OCT MAE.

Corporate bond issues continue to increase, driven by debt restructuring transactions, while there is a notable dynamism in the financial trusts segment

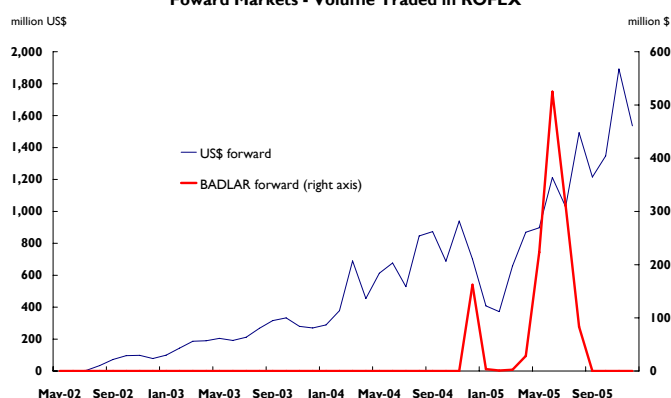
In the case of the private segment of the bond market, in 2005 almost \$7 billion was placed in corporate bonds (ON), both as part of debt restructuring transactions and for purposes of new funding. A significant portion of this amount corresponded to the result of the restructuring of the debt of Telecom (the second largest private sector default in terms of amount as a consequence of the crisis) which implied the issue of ON for almost US\$900 million falling due in 2014 and an issue for

⁹ Operaciones Compensadas a Término (Compensated Term Transactions).



Chart III.10

Forward Markets - Volume Traded in ROFEX

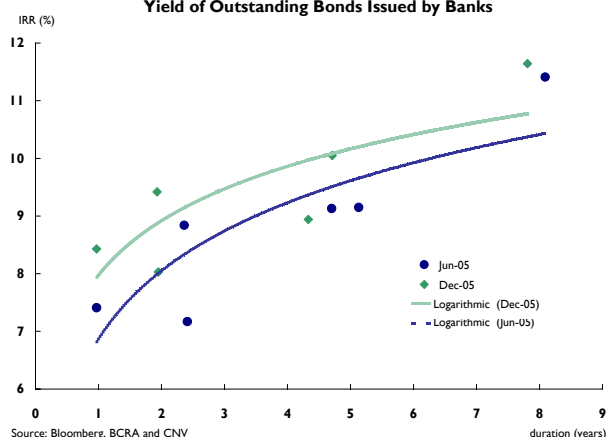


Volume = numbers of contracts by amount (US\$1,000 and \$120,000 respectively).

Source: ROFEX

Chart III.11

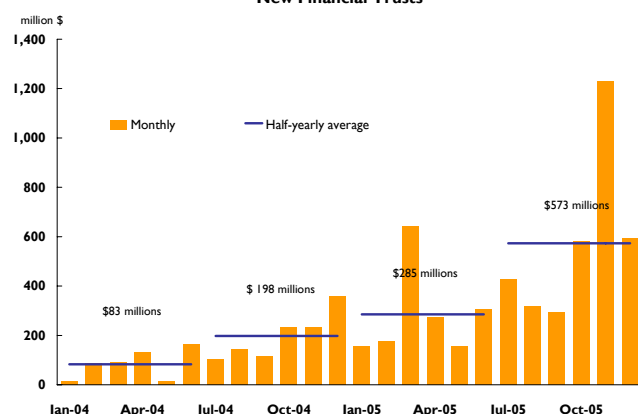
Yield of Outstanding Bonds Issued by Banks



Source: Bloomberg, BCRA and CNV

Chart III.12

New Financial Trusts



Source: BCRA from CNV

almost US\$1 billion falling due in 2011. On the secondary market there was a certain upward displacement in the yield curve, with a difference being established between those companies that defaulted and those that were able to avoid doing so. The upward displacement in the curve, in line with the performance seen in markets during the half, can also be seen when analyzing exclusively the debt issued by financial institutions (see Chart III.11).

The increased level of activity on the local capital market was particularly evident in the financial trust segment. In the second half of 2005 new financial trusts for almost \$3.5 billion were issued, double the amount issued in the first half (see Chart III.12). Given the leading role played by loans to the private sector (and personal loans in particular) as underlying assets, this growth has been closely associated with actions by banks and their administration of credit risk and liquidity¹⁰. Nevertheless, a notable variety of sectors made use of financial trusts, and there was wide diversity in the instruments issued. In the case of the issues made over the course of the year, there has been a gradual increase in the yield on the securities issued, in line with the trend observed in domestic interest rates. In turn, the average term varied as a result of the diversity that exists between the various types of trust that have been launched on the market, although trusts with personal loans as their underlying asset (those with the greatest weighting in the total) maintained an average term of close to six months.

Although records were reached, the share market remained considerably volatile

The share market recorded a steady increase in prices until the beginning of October (in line with rising oil prices and their impact on companies in that sector) followed by a more erratic but downward trend towards the end of the year, largely due to the volatility provoked by domestic factors. The MERVAL index, which reached record levels in excess of 1,700 in October, ended the year at under 1,550 points (see Chart III.13), with a positive variation for the half-year (almost 13% in pesos and 8% in dollars). Although the performance of the domestic market was positive, gains were more modest than those recorded by the other bourses in the region. The Mexican and Brazilian stock markets, for example, went up 33% in the second half of 2005, maintaining an upward trend that was only briefly interrupted during October (see Chart III.14).

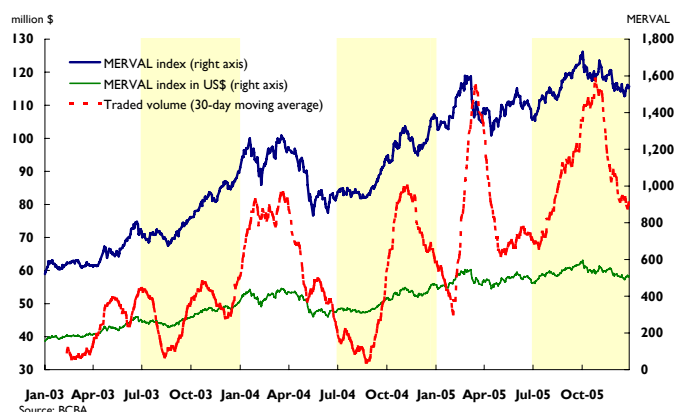
In terms of volume traded, the local share market performed in a manner similar to that of prices, with a steady rise until the end of October that was then reversed in the last two months of the year. Overall there has been a steady increase in volumes during the second half of 2005, with a trading volume that was 20% higher than in the first half and 55% higher than in the same half of 2004. Stock market capitalization went up 7% this half, 27% more than in the same period of 2004, by the end of the year reaching a level of close to 140% of GDP. In the specific case of banks, stock market capitalization recorded a rise of 3% and 28% compared with the first half of 2005 and the second half of 2004 respectively.

¹⁰ In addition, given the participation by banks as trustees, the higher level of trust activity has a positive impact on the profitability of financial institutions.



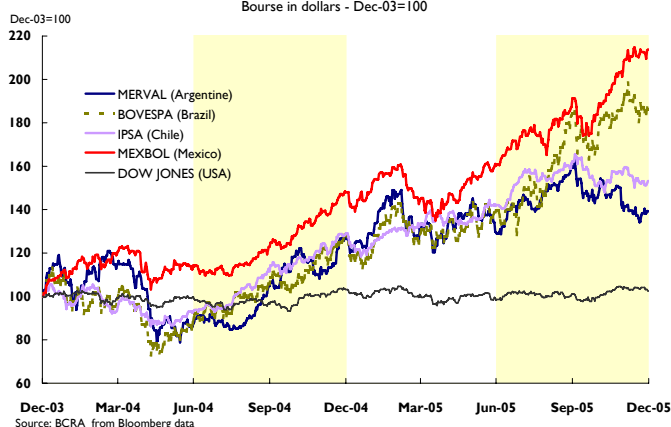
Chart III.13

Local Stock Market



The outlook for the domestic and regional capital markets continues to be positive based on the strength of its fundamentals, as long as there is no sudden change in the international situation. Referring particularly to the first half of 2006, in view of the debt redemption process embarked upon by several of the leading economies in the region (Brazil, Mexico, Venezuela, Colombia, etc.), it is expected that Argentine assets will benefit from such action, as long as the demand for emerging country assets remains buoyant. As a result, progress will continue to be made on market deepening, and the introduction of new types of financial instrument will be encouraged. The dynamism that has been forecasted for local activity levels will continue to provide an impulse to stock and corporate debt markets. In such a context, it is expected that the capital market will match the recovery taking place in financial intermediation, in view of the complementary nature of the financial market and banking activities.

Chart III.14

International Stock Markets
Bourse in dollars - Dec-03=100III.2 Financial intermediaries ¹¹

Although there is still high potential for development and deepening, both bank and non-bank financial intermediaries continued to their expansion during the half-year

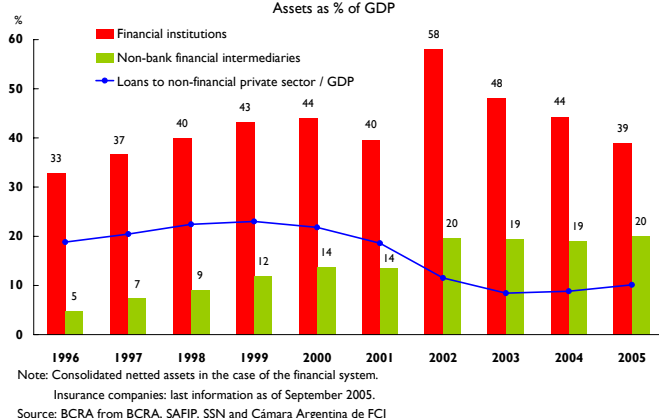
In general, the depth and level of development of the banking sector and NBFIs in a country are closely linked to the existence of a suitable regulatory framework to encourage growth, as well as the existence of past financial crises. In the specific case of Argentina, in the aggregate NBFIs are still approximately half the size of the local banking sector (see Chart III.15), although they have continued to grow steadily.

From an international perspective, local NBFIs continue to offer significant development potential. While in Argentina they total approximately 20% of GDP, this figure is equivalent to the GDP level for Chile, and is considerably higher in developed economies. In this context, it is estimated that the various segments of local NBFIs will continue to develop in coming years, in view of the increasingly mature private social security system (it has only been in existence for 10 years), a steady recovery of the mutual fund segment (particularly after the gradual growth of the domestic public debt market) and a process of consolidation in the insurance sector.

III.2.1. Non-bank financial intermediaries

Although pension funds find opportunities for investment in public sector assets, NBFIs are steadily increasing their financing to the private sector

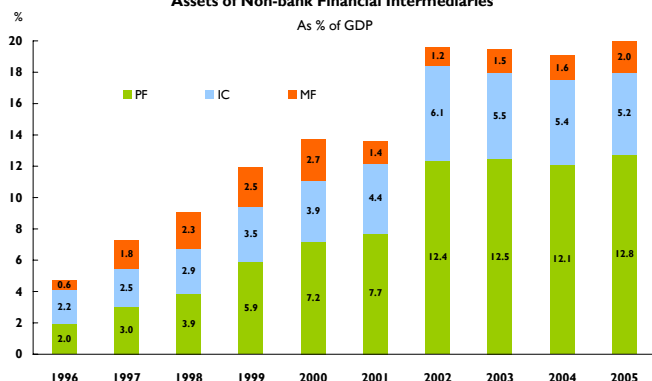
At the end of 2005 NBFI assets totaled close to \$106.3 billion (24% more than at the end of 2004) or almost 20% of GDP (see Chart III.16). As in previous periods, NBFIs continued to increase their private sector financing in the second half of the year, offsetting the adjustment to their investments in public sector assets.

Chart III.15
Financial Sector Scale
Assets as % of GDP

¹¹ This section analyses jointly the development and performance of bank and non-bank financial intermediaries (NBFIs). The former include exclusively the institutions covered by the Financial Institutions Act (mainly banks), while the NBFIs include the pension fund (PFs), mutual investment funds (MFs) and insurance companies (ICs).



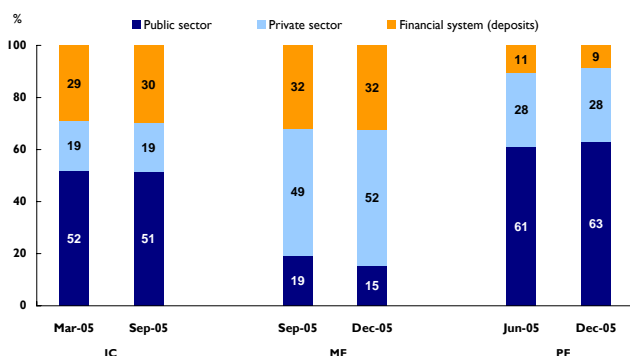
Chart III.16

Assets of Non-bank Financial Intermediaries
As % of GDP

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

Pension Fund portfolios grew by 16% in the second half of 2005 (doubling the rise recorded in the first half of the year), driven by both an increase in the number of contributing workers, higher average taxable worker income, and the yield from the portfolio investments themselves. PF exposure to the Government sector¹² rose almost 1.8 p.p. in the second part of the year, to approximately 63% of assets, at a time when the sovereign debt market was in the process of recovery (see Chart III.17). PFs increased their investment in the private sector by almost 0.5 p.p. to a level of 28.5% of their total portfolio, reflecting increased holdings of shares. The portion of PF portfolios accounted for by bank deposits fell by over 2 p.p. in the second half, mainly because of lower regular time deposits, as CER-adjusted placements rose during the period.

Chart III.17

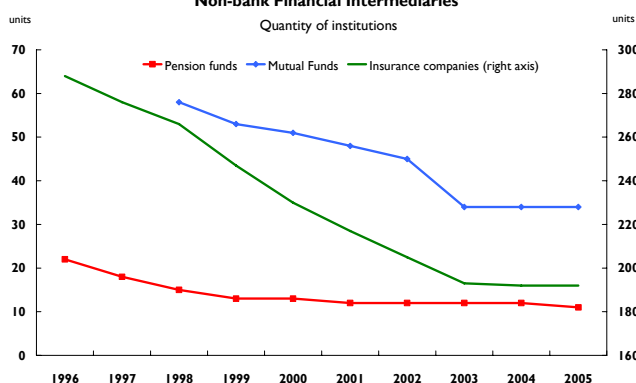
Non-Bank Financial Intermediaries Portfolio Composition
As % of total investment

Source: BCRA from BCRA, SAFJP, SSN and Cámara Argentina de FCI

Mutual Funds continued to grow rapidly during the second half of 2005 (over 36%), reaching a net worth of almost \$10.7 billion. Unlike the previous half, in the latter part of the year MF growth was largely explained by the dynamism of equity funds, accounting for 45% of the net worth of the sector. On the basis of information for the September-December quarter, a significant restructuring of MF portfolios can be seen to have taken place. Exposure to Government securities dropped almost 4 p.p. to approximately 15% of net worth. Although private sector financing continued to increase, to a level of 52% of the portfolio at the end of 2005, MF deposits in the system remained practically stable.

In September 2005 Insurance Company assets totaled close to \$27.7 billion (almost 10% more than in the previous half), at a time during which there was a steady increase in insurance underwriting. In the second half of the year there was a moderate fall in IC investment portfolio exposure to the Government. While the share accounted for by investments in the private sector remained almost unchanged, IC deposits held in the financial system rose in the period.

Chart III.18

Non-bank Financial Intermediaries
Quantity of institutions

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

In the second half of 2005 a merger took place between two PFs, continuing a gradual trend towards consolidation in the sector (see Chart III.18). There was no change in the number of MF managers or ICs during the second half.

III.2.2. Financial institutions

The structure of the financial system continued to develop. This trend was a result of higher levels of employment -without affecting productivity levels- gradual consolidation of the sector, and a rise in the number of branches

During the second half of 2005 the structure of the financial system maintained the pace of the recovery begun two years earlier. While the level of bank employment rose by approximately 1,960 during the period (see Chart III.19), the number of branches remained stable, although there was an increase over 2005 as a whole, firmly reversing the declining trend during the 2002-2004 period.

¹² Includes participation in financial trusts with government securities as underlying assets, and the sovereign debt GDP-linked securities.



Chart III.19
Financial System Structure

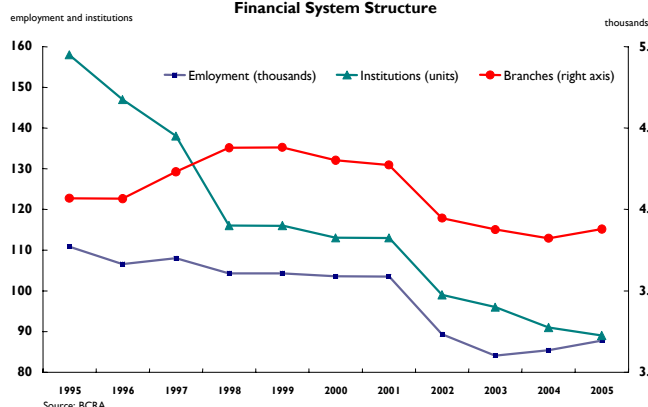


Chart III.20
Factor Productivity
At 1999 prices

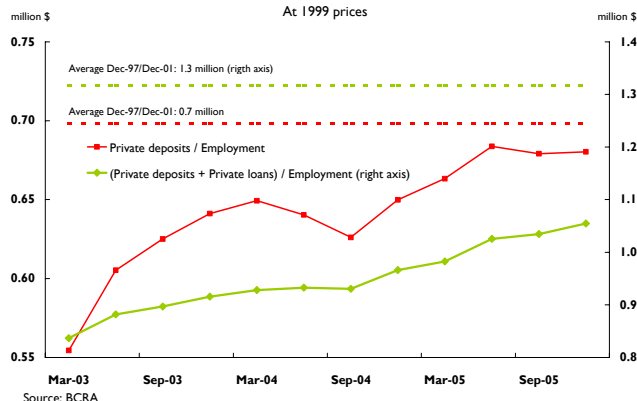
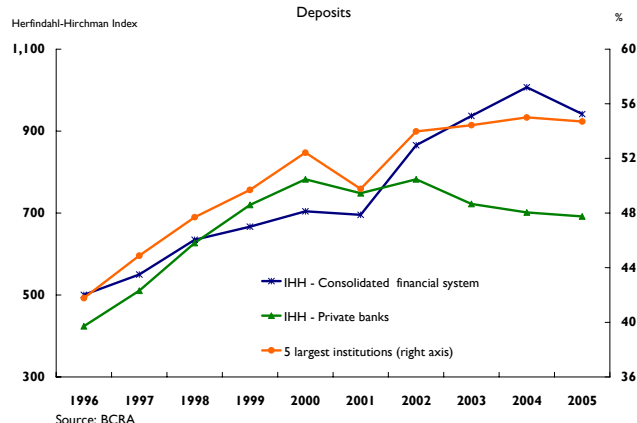


Chart III.21
Financial System Concentration
Deposits



Rising payroll numbers did not prevent a recovery in the productivity of financial system employees. Increased funding by means of deposits and the balance of private sector loans recorded in the second half of 2005 made it possible to gradually improve labor factor productivity (see Chart III.20). In addition, new technologies used in banking activities have had a positive impact on this trend. Nevertheless, the financial system still has a long way to go before it exceeds the productivity levels recorded at the end of the 90s, and before it achieves the levels of deeper financial systems.

As a consequence of the recent crisis, the structure of the financial system underwent a period of significant readjustment, reflected in a strong process of consolidation in the sector through to the end of 2004 (see FSB I-05, page 30). This process began to weaken since the beginning of 2005, however. In the second half of the year only one small cooperative institution left the market, transferring part of its net worth to a large domestic private bank. In this context, in the second half of the year there was a slight increase in the level of concentration of private sector deposits in the banking system, although a decline was recorded for the year as a whole (see Chart III.21), and a similar trend was recorded by private banks. Looking forward, further adjustments can be expected in the structure of the sector, especially in the case of mergers at international level with an impact locally.

During 2005 there continued to be changes in the market share held by the various bank groups. As has been happening since 2002, domestic private banks continued to increase their share of total funding by means of private sector deposits (see Chart III.22). The counterpart to this trend has been a reduction in the relative share held by foreign banks and official financial institutions. Nevertheless, foreign banks still make up the group with the greatest weighting in the market, at the same time as they are implementing measures to increase their health (through a reduction in their exposure to the public sector and growing injections of additional capital) that will enable them to increase their activities locally.

Financial intermediation volumes continue to increase, mainly driven by higher totals for lending to the private sector and declining exposure of banks to the public sector

In the context of a positive economic performance, financial intermediation volumes maintained their growth rate in the second half of 2005. Financial system assets¹³ rose by almost 2.2% (4.5% a.) during the period, significantly more than in the previous half (0.6% or 1.3% a.), while if adjustment is made for the change in retail prices, a drop has been recorded for the half of approximately 3.4% (-7% a.) (see Chart III.23).

The channeling of loans to the private sector has been the main use of funds for banks in the second part of the year, reaching 27% of assets (see Table III.1). In addition, financial institution

¹³ Assets net of the accounting duplications generated by repo, term sale and unsettled spot transactions. Consolidated for transactions between financial institutions.



BOX 2: PRODUCTIVE MEDIUM AND LONG-TERM CREDIT

In a consistently favorable economic situation, with orderly macroeconomic policies, the domestic financial system has continued to deepen its scope, in terms of rising funding by means of deposits, and in particular by steady growth in lending to the private sector. Lending to families and companies has remained highly dynamic, although there is considerable potential for the development of lending for longer periods, and in particular for the financing of investment projects that are reflected in greater productive capacity for the economy. In this context, the Central Bank is implementing measures to continue to encourage medium and long-term lending for production purposes.

Following the recession resulting from the 2001-2002 crisis, at the end of 2003 the negative performance by private sector lending began to show signs of improvement, at a time of increased liquidity and rising levels of public confidence in the financial system. Nevertheless, it was only as from 2005 that lending to the private sector finally took off, with the impulse provided by Central Bank policies.

During 2005, both the consolidation of the increase in traditional funding by means of private sector deposits and the steady reduction in exposure to the public sector (encouraged by the Central Bank) generated additional resources, allowing banks to increase their base of new loans to the private sector. As a result, loans to the private sector¹⁴ rose by 34% during the year, to almost \$57 billion. Despite this positive trend, this heading only accounted for 25% of total bank assets, around 10% of GDP, still a long way from the levels recorded in other emerging and developed economies (see Chart B.2.1).

Although at present around 63% of total loans to the private sector have been granted to companies, there is a bias in favor of consumer loans in the flow of new credit. Loans to families for consumption recorded growth of almost 135% since mid-2003 (see Chart B.2.2), in part as a result of bank strategy for lending to customers with payroll accounts (product cross-selling) and the renewal of agreements between banks and the main consumer durable retail chains to enable purchases to be made in interest-free installments, or with the offering of discounts.

Chart B.2.1

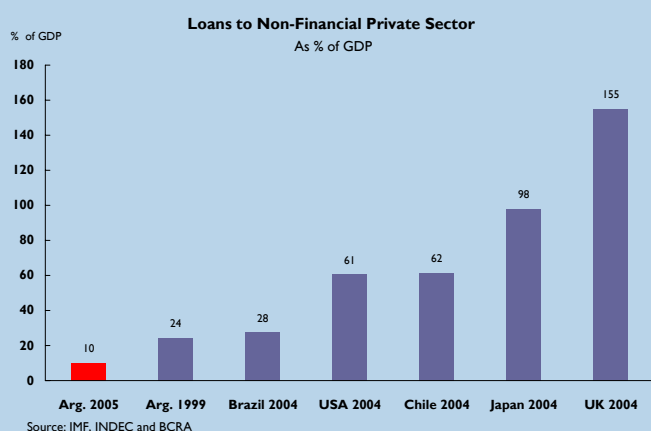
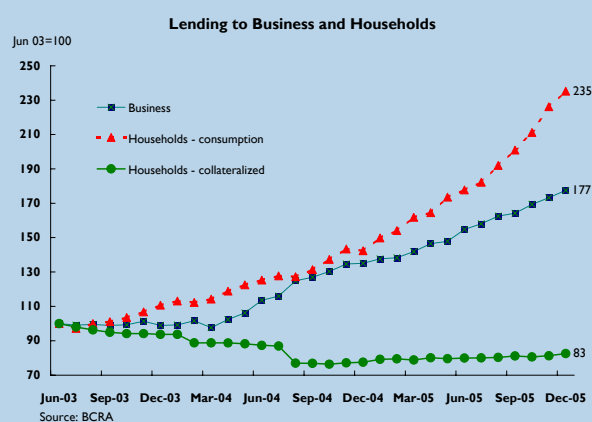


Chart B.2.2



Loans to the productive sector also increased, although at a more moderate rate, recording an increase of almost, 77% in the June 2003-December 2005 period. Financing of working capital needs by companies was particularly significant. During 2005 current account overdrafts for companies went up 40% (to \$7.9 billion), an increase of 120% since mid-2003. A similar trend was recorded in the case of financing through the discounting of promissory notes, which rose by 42% (to approximately \$12 billion), accumulating growth of 82% since June 2003. Nevertheless, new loans for longer terms to companies dropped in 2005: mortgage line total fell 3% in the year, while pledge-backed loans were down 1%.

¹⁴ The loans heading includes loans to the private sector resident in the country (without deducting allowances), other loans from financial intermediation, assets granted under financial leasing, and sundry credits. For purposes of the analysis, lending to companies has been considered to be that granted to legal persons and commercial loans to individuals; the families heading includes consumer loans to individuals. The data analyzed is taken from the Debtor Status Report.



Analysis of the amounts traded by banks in each of these sectors shows that the growth in lending to companies is closely linked to short-term lines. In recent years, average monthly amounts of loans granted for periods of less than 6 months were in excess of 90% of the total amount lent to companies (see Chart B.2.3), while those for terms of less than 30 days accounted for approximately 86%. Consequently, it is unlikely that the resources made available by the financial sector to the productive sector would be used to expand the productive capacity of such companies. The short-term bias for which company lending is noted leads to a high loan turnover, with amounts granted to companies exceeding those of lending to families, while the latter recorded an increase in total loan balances far greater than the former.

In addition, the considerable relative growth in consumer lending has been widespread across all financial institutions (see Chart B.2.4). Banks with greater activity in lending to the private sector were in the higher growth segments in lending to families. These banks, accounting for more than two thirds of family lending, have seen growth rates in excess of 60% during 2005 in these lines. Bank distribution in terms of growth in lending to companies are concentrated more in the segments showing lower growth rates. For almost half these banks, growth was below 20% during 2005.

Chart B.2.3
New Lending

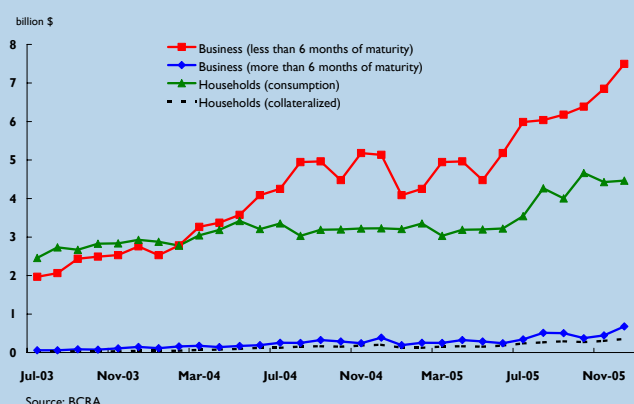
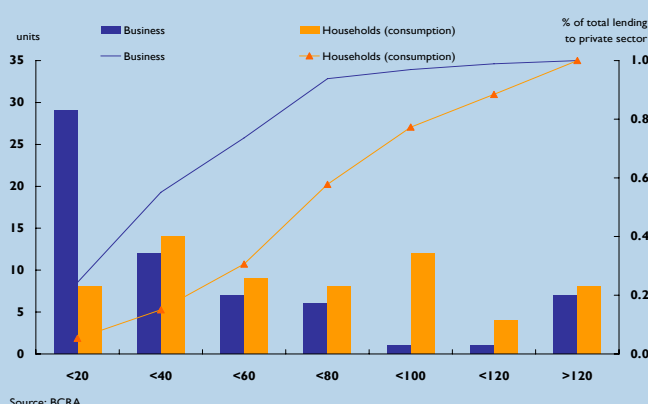


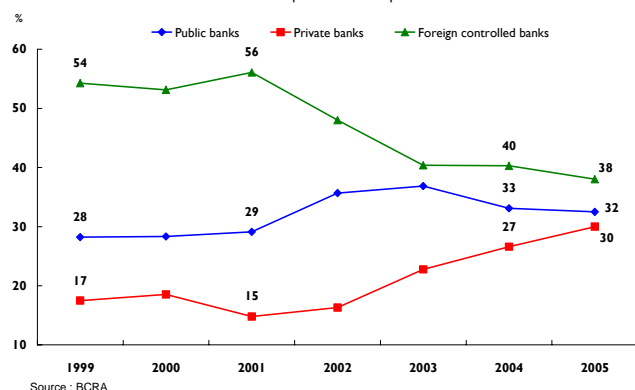
Chart B.2.4
Growth in Lending to the Private Sector - 2005



As a result, there is still unexplored scope for potential growth in credit lines for companies, and in particular, for those to be allocated to medium and long-term investment projects. With this aim in mind, the Central Bank continues to implement measures to correct the situation. Reduction in bank exposure to the public sector has been encouraged, thus releasing new resources for lending. In addition, banks have been allowed to extend the term laid down for the accounting recognition of losses derived from exchange differences from the payment of court orders, as long as new loans are granted for terms of over two years. In addition, potential uses of resources derived from foreign currency funding have been expanded, making available a wider range of financing for production and investment. Other measures with the same purpose included the granting of preferred guarantee status to trusts set up for construction, and the exclusion of immobilized assets from the guarantees set up for the import of capital goods. Although the Central Bank recognizes the gains that have been achieved in medium-term commercial lending, it continues to analyze changes in regulations that will deepen this particular segment of the credit market.



Chart III.22
Breakdown by Type of Institution
Non-financial private sector deposits

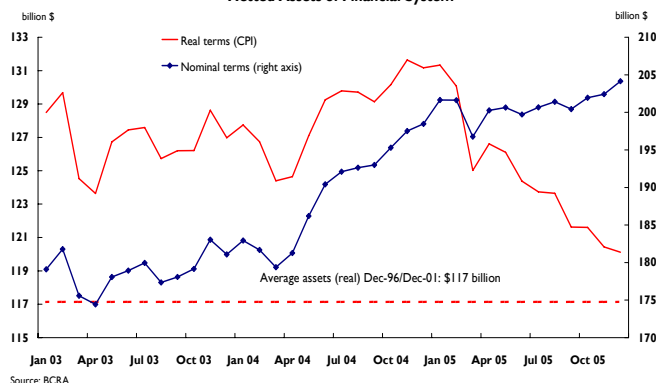


liquid assets fell towards the end of the year, gradually falling into line with the levels seen in the financial systems of other emerging economies (see page 44). At the same time, banks continued to lower their exposure to the Government. This development was a result of the strategies adopted for the sale of government debt in bank portfolios, the marking to market of such portfolios, and the receipt of pending compensation, part of which was paid in cash. In addition, financial institutions continued to gradually increase their holdings of Central Bank securities.

One particular feature of the development of the financial system during 2005 was the notable increase in loans to the private sector. This asset heading grew by almost 20% (44% a.) in the second half of 2005, a rise of 39% for the year, in line with the positive macroeconomic scenario and the improved income prospects for both families and companies.

While consumer loans showed greater dynamism compared with commercial loans in the second half of the year, there was a significant recovery in mortgage loans

Chart III.23
Netted Assets of Financial System



In the second half of 2005 consumer credit lines displayed a greater relative dynamism (82% a.) compared with commercial loans (52% a.) (see Chart III.24), while the latter were responsible for more than half the growth in total lending to the private sector in the period. Strengthening the signs seen in the first half of the year, collateralized (pledge-backed and mortgage) loans continued to increase, benefiting from the current context of reduced economic uncertainty.

In the case of consumer loans, personal and credit card financing lines recorded similar relative growth in the second half (80% a. and 86% a., respectively), while the former recorded greater growth in absolute terms. Personal lending continues to be driven by the various strategies adopted by banks, based mainly on the offering of loans to depositors (product cross-selling) and a rising number of agreements with leading consumer durable goods and services retail chains. Although interest rates on credit card financing posted a slight increase in the second half, those on personal loans declined.

Table III.1

Balance Sheet
Consolidated system total - % of netted assets

	Dec-04	Jun-05	Dec-05	Half-yearly change II-05 (%)	Annual change 2005 (%)
Assets	100	100	100	2	3
Liquid Assets	17	16	14	-11	-20
LEBAC / NOBAC	6	10	11	12	75
Lending to the private sector (*)	20	23	27	20	39
Lending to the public sector	42	37	33	-9	-19
Other asset	15	15	16	12	14
Liabilities + Net Worth	100	100	100	2	3
Public sector deposits	16	16	17	9	8
Private sector deposits	42	47	50	8	21
Liabilities with the BCRA	14	11	8	-25	-39
Outstanding bonds, subordinated debt and foreign credit	9	7	6	-6	-31
Other liabilities	7	7	7	-5	-9
Net Worth	11	12	12	8	14

(*) Total loans do not include CER and CVS adjustments nor interests accrued

Source: BCRA

Unlike the previous half, in the second part of 2005 commercial loans were mainly driven by the discount of promissory notes (39% or 93% a.), for funds to be used by companies to finance working capital. Although current account overdrafts showed slower growth, they continued to increase in the second half (9% or 19% a.). Here it should be noted that lending to companies continued to be allocated mainly to those productive sectors showing rising dynamism: industry and commodity producers (see page 50). Interest rates on the main types of commercial lending grew moderately in the period.

In the case of collateralized loans, in the second half of 2005 pledge-backed loans continued to record growth (21% or 48% a.), in part driven by the performance by car sales. Nevertheless, the most notable aspect of the second half was the reversal of the negative trend in the total for mortgage loans (which went up 1% or 2% a.), with new placements of mortgage loans for the first time exceeding scheduled repayments of maturities and early



Chart III.24

Loans to the Private Sector

By type of lending - y. o y. % change

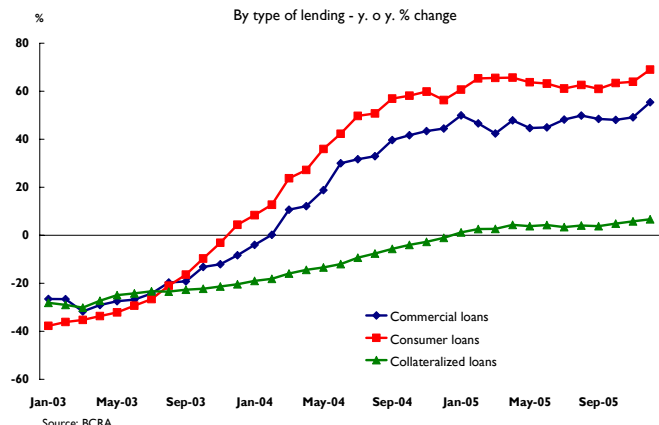


Chart III.25

Mortgage Loans

Financial system

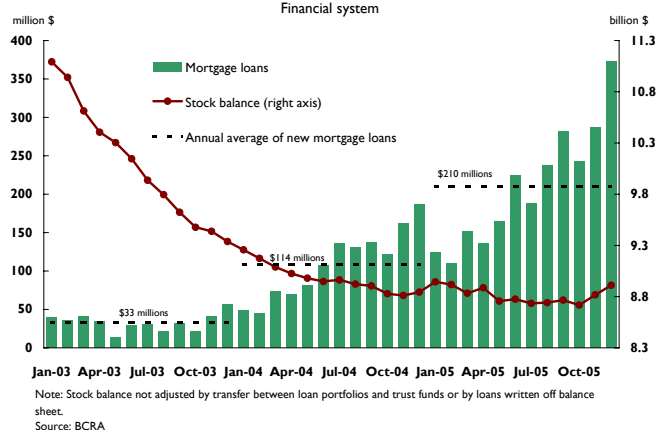
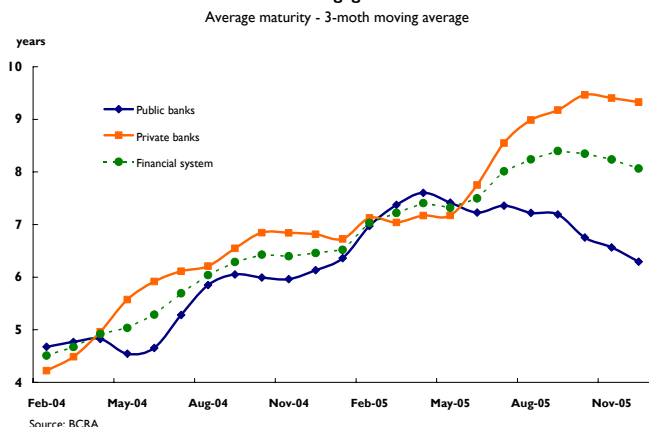


Chart III.26

New Mortgage Loans

Average maturity - 3-moth moving average



settlements. As a result, at the end of 2005 there was firm growth in the granting of new mortgage loans (see Chart III.25), with a gradual lengthening of loan contract terms (see Chart III.26).

With the exception of public banks, all groups of banks recorded a more dynamic lending pattern in the second half of 2005 (see Chart III.27). Although private domestic banks recorded the highest growth in the period, foreign banks continued to hold the greatest market share (almost 40%).

The Central Bank continues to promote changes to strengthen bank lending to the private sector

The Central Bank continues to implement measures to increase sound private sector financing by the financial system. Various regulatory improvements were extended to continue to take into consideration the accounting situation following the recent crisis of certain debtors with good business prospects. For example, the term during which commercial debtors are able to enter into payment agreements with banks has been extended, enabling their subsequent classification as normal debtors. In addition, the possibility of making further funds disbursements that exceed 300% of the RPC of banks has also been extended. Furthermore, the possibility of adjusting provisions once loans have been refinanced with a discount on principal has been made permanent.

In addition, as from December 2005 new incentives have been established for banks to increase their medium and long-term financing to the private sector. Banks have been allowed to extend the term laid down for reflecting on their books the losses arising from exchange differences on payments made in accordance with court orders, as long as they grant new commercial loans for terms of over two years.

In addition, the possibility of banks applying the resources derived from foreign currency deposits to the purchase of Central Bank bills in dollars was eliminated. However, such funds can now be used to finance working capital and investment projects that increase or are connected with the production of goods for export, even if company revenues do not entirely derive from export sales. Alternatively, such resources may be used for loans to commercial customers for the import of capital goods for the production of goods for the domestic market.

Traditional deposit-based bank funding continues to recover, while obligations to the Central Bank are being rapidly cut back as a result of scheduled payments, early prepayment and the settlement in advance of installments

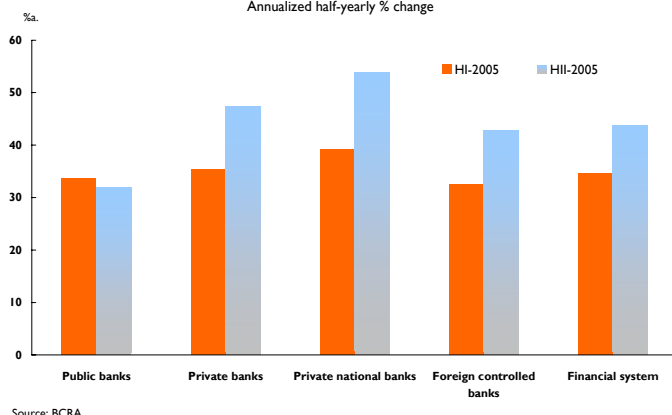
On the matter of financial institution liabilities, the marked increase of almost 8% (16%a.) in funding by private sector deposits in the second half (see Chart III.28) is a reflection of the lower public uncertainty regarding the sector. Sight deposits again showed greater dynamism than time deposits in the second half of the year (21%a. and 15%a., respectively), while public sector deposits recovered their growth rate (18%a.). CER-adjusted deposits recorded an increase of approximately 12% (25%a.) in the second part of the year.



Chart III.27

Loans to the Private Sector by Type of Banks

Annualized half-yearly % change

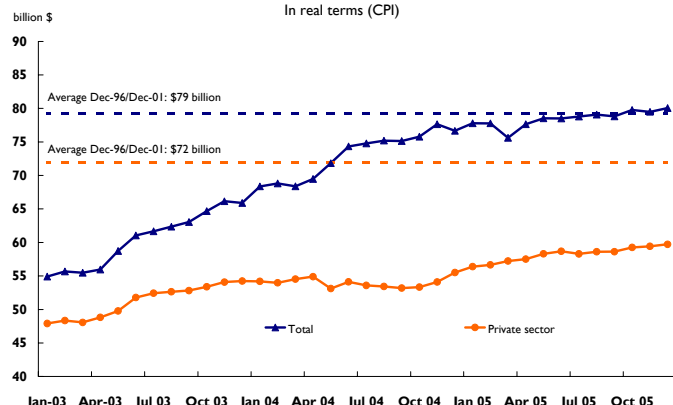


Source: BCRA

Chart III.28

Deposits

In real terms (CPI)

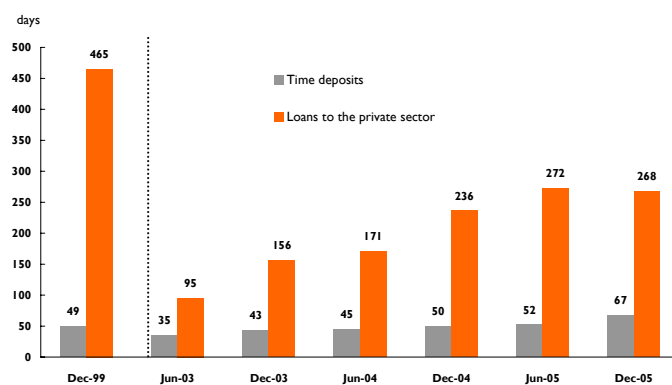


Source: BCRA

Chart III.29

Deposit and Loan Maturities

Weighted monthly average



Source: BCRA

Towards the end of 2005 the average term for new time deposits in the financial system continued to evolve favorably -rising above 2 months- (see Chart III.29), higher than the levels recorded in 2004 and 2003. This movement is an indication of the gradual recovery of confidence in the banking sector by private sector agents and the growing attractiveness in terms of yield of these deposits.

Nevertheless, the lengthening of deposit funding maturity is not the only pillar on which to base the lengthening of the terms of loans granted by banks. The continuation of the current process for the reduction in financial system term mismatching arising from the crisis, and on a more general basis, the reduction in the concentration of certain risks, are points worthy of note. In particular, the drop in exposure to the Government (especially as regards long-term securities), should continue to release resources for allocation to private sector medium and long-term projects.

In addition, the gradual decline in longer-term sources of bank financing (corporate bonds, subordinated notes and commercial lines from abroad) limits the capacity of banks to extend the duration of their loans. It should however be noted that the reduction in financing for financial institutions from abroad has slowed. In addition, certain banks are already entering into new obligations abroad in conditions that will allow them to generate longer-term domestic loans. The increased deepening of the domestic capital market will contribute to expanding the funding term of financial institutions.

During the second half of 2005 the process of normalization of financial institution obligations with the Central Bank accelerated. In addition to the installments paid by banks under the so-called “matching” system, in the second half of the year the Central Bank called a tender for the early settlement of such liabilities. Nevertheless, the most-used mechanism by banks in the period was the voluntary early repayment of a portion of their debt. Almost three-quarters of the nearly \$5.94 billion disbursed under the matching system by banks during the second half (almost 70% more than in the previous half) corresponded to voluntary early repayments (see Chart III.30).

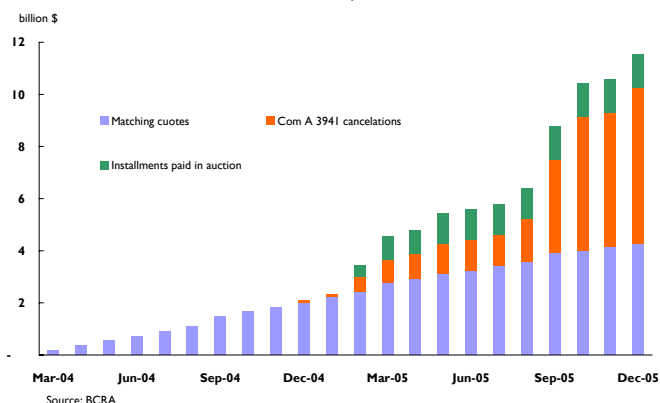
In addition, total payments made during this period were reflected in a reduction of almost 3 p.p. of total liabilities in bank obligations to the Central Bank. These liabilities at one time accounted for 8% of total bank funding. As a result, out of the 24 financial institutions that were originally indebted to the Central Bank, 5 still recorded debt at the end of 2005¹⁵ (12 and 6 completed repayment of their obligations in the first and second halves of 2005, respectively), and at the date of publication of this FSB only 3 recorded obligations outstanding.

Taking a medium-term view, it is expected that local financial intermediation activity will continue to grow, driven mainly by the sound increase in lending to the private sector, in a favorable economic context with coherent macroeconomic policies. In addition, the various strategies adopted by banks for their adaptation will lead them to lowering their exposure to the public

¹⁵ For this analysis, those banks repaying 100% of their installment are considered as not indebted.



Chart III.30
Matching: Accumulated Payments
Financial system



sector, and these resources, added to the gradual decline in liquidity, will encourage a greater flow of funds towards the financing of private sector investment projects. Banking sector liabilities will continue to rise on the basis of private-sector deposit funding and a recovery in longer-term capital market placements. In addition, it is probable that during 2006 those financial institutions still indebted under the matching scheme will repay their outstanding obligations, abandoning one of the most notorious legacies of the domestic crises in 2001-2002.

IV. RISK MANAGEMENT

Summary

In the framework of the regulations that the Central Bank adopted in order to strengthen the financial system against the risks remaining from the crisis, towards the end of 2005 the banking system maintained a prudent management of the new risks that it faces. The strategies followed by the banks, which are a response to the incentives undertaken by the Central Bank, led to a sharp fall in their exposure to government risk. Furthermore, it continued to reduce the vulnerability of the financial system to private credit, liquidity, foreign currency, and market risks.

The banking system deepened its approach to the public in 2005, which was reflected in a sustained increase in private deposits, with longer maturity terms. However, both a longer average term for deposits and a larger share of time deposits will enable an impulse towards new longer term loans in the future. The banking system also continued to readjust its liquidity levels, in order to reach levels that are more in line with those observed in other emerging economies. In this framework, led by a change in regulations established by the Central Bank, the financial system is finding market solutions to moderate its exposure to liquidity risk and to make the conditions of financial stability more robust. The high level of liquidity reserves, the deepening of the markets for sovereign bonds and Central Bank securities, the repo markets, the possibility of the Central Bank to act as a lender of last resort and, finally, the expansion of the inter-bank call money markets, improved the resistance of the banks to face liquidity shocks.

During 2005 the decline in the credit risk faced by the banking system was noticeable. In particular, the fall in the exposure of the public sector in the year stood out, to account for 30% of total assets (33% of the net assets of the consolidated financial system), while the non-performing share of the private sector portfolio was 7.6%. In a scenario of economic growth and of sustained support by the Central Bank for productive finance, the banks continue to increase their credit to the private sector, which reached a 29% share of assets. In this sense, the banks continued to improve their credit evaluation procedures, to enable them to reach a prudent resource allocation.

In addition, the financial system continued to reduce its vulnerability to the mismatch of its foreign currency assets, mainly by means of the reduction of its holdings of public sector assets in dollars. This, combined with a lesser market volatility, allowed for a contraction of the banking exposure to market risk. The exposure of the financial institutions to the real interest rate risk is gradually receding. However, the long maturity of adjustable public sector assets and the accelerated normalization of the bank debts owed to the Central Bank make a rapid reduction difficult.

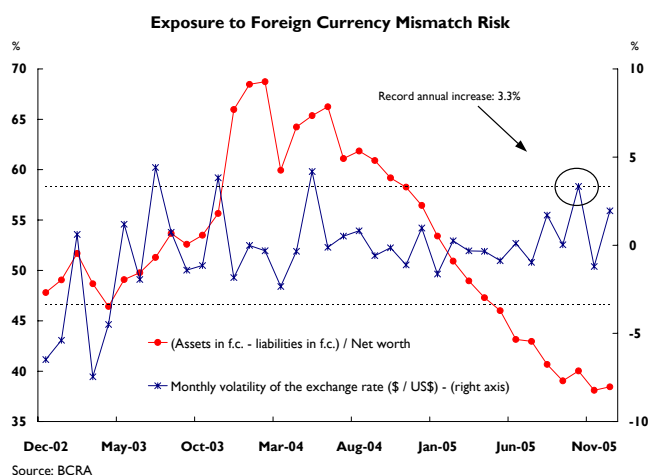
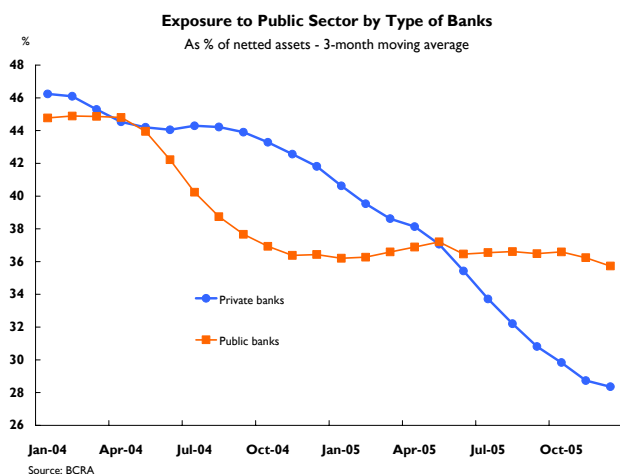
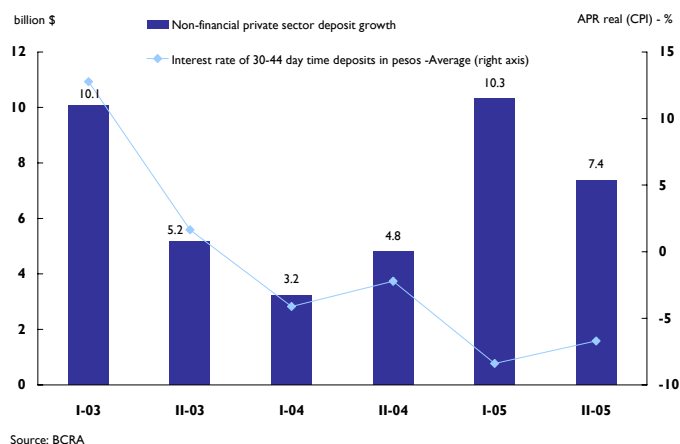




Chart IV.1

Flow of Private Funds to the Financial System



Source: BCRA

IV.1. Liquidity risk

The financial system exhibits an adequate coverage to face liquidity risk, although it records a decline in its portfolio of relatively more liquid assets

The economic agents increased their use of the financial system during 2005, whether by channeling their transactions and savings or through the demand of finance. This deepening of the process of individuals and firms returning to the banks, reflected in a rise of about \$18.0 billion (22%) in deposits during the year (see Chart IV.1), is a positive sign of confidence in financial institutions. The sharp recovery of the private deposits in the financial system is even more significant when the real interest rates paid for these deposits are considered, because during 2005 these rates (deflated by the CPI) were negative values on average.

In the latter part of 2005, the financial system was marked by strengthening the changes towards a definitive normalization of the financial intermediation activity. The financial institutions dedicated the funds that came from increases in private deposits and declines in both liquid assets and public sector assets to finance the private sector and to cancel debts with the Central Bank incurred during the 2001 – 2002 domestic crisis.

In this manner, the banking system showed a reduction of its high liquidity indicators. The liquid assets (cash, current accounts at the Central Bank and reverse repos with the Central Bank) contracted 3.1 p.p. of the deposits by the non financial sector, to end 2005 at a value of almost 22% (see Chart IV.2). If the holdings of Central Bank securities are considered among the relatively more liquid assets, this broader ratio rises to 37% of the deposits of the financial system at the end of 2005 (a similar level to that observed at the end of 2003).

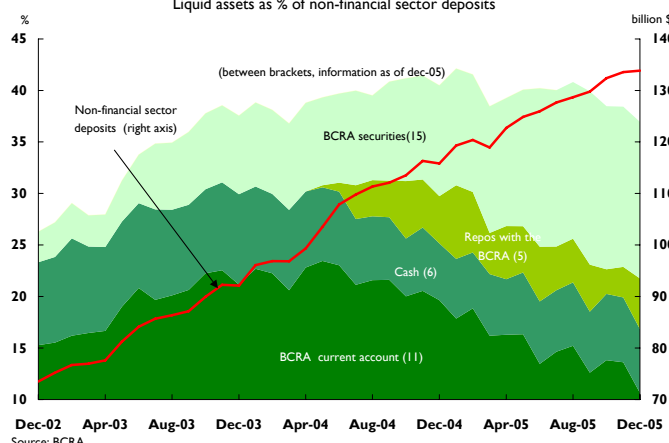
In the framework of the regularization of the asset structure, the liquidity levels of the domestic financial system are tending towards a range that is more in line with that observed in the international context, for both developed and emerging economies (see Chart IV.3). Despite the overall trend, the financial system continues to meet the reserve requirements set by the Central Bank. It is worth recalling that the Central Bank reduced the reserve requirements at the end of 2005 with the purpose of catering for a seasonal situation.

In addition to the relatively high levels of the principal specific indicators, the position of the financial system regarding liquidity risk was reinforced as from the recovery of the Central Bank's role to act as lender of last resort. The regulation of this instrument allows the Central Bank to grant credit lines to the financial institutions in cases of liquidity requirements in a transparent and efficient manner. This should generate a positive perception among economic agents about the ability of banks to respond to an unforeseen withdrawal of deposits. This mechanism, by helping to create a framework of more responsibility and consistency in the management of economic

Chart IV.2

Liquidity Risk Coverage

Liquid assets as % of non-financial sector deposits

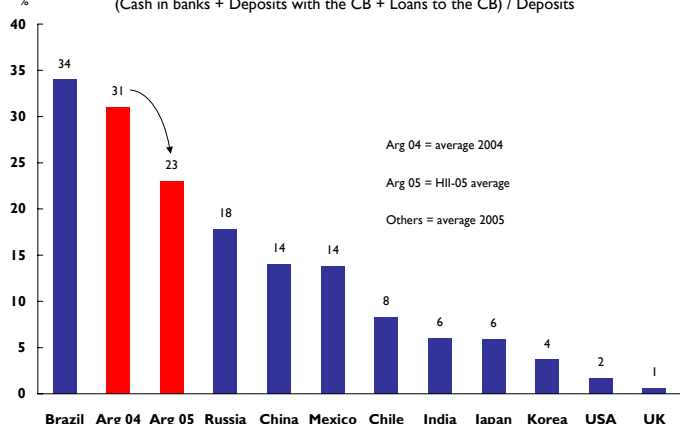


Source: BCRA

Chart IV.3

Liquidity Reserve Compared

(Cash in banks + Deposits with the CB + Loans to the CB) / Deposits

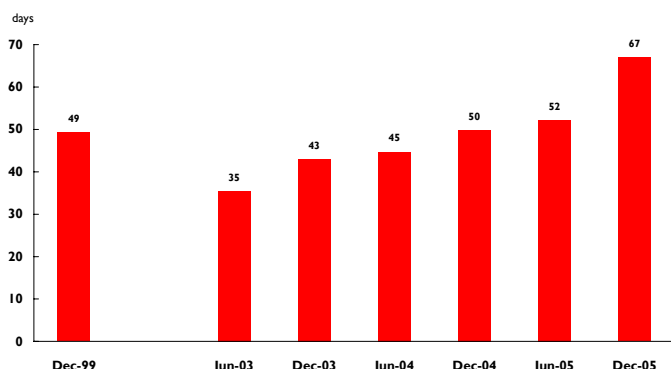


Source: BCRA from IMF data



Chart IV.4

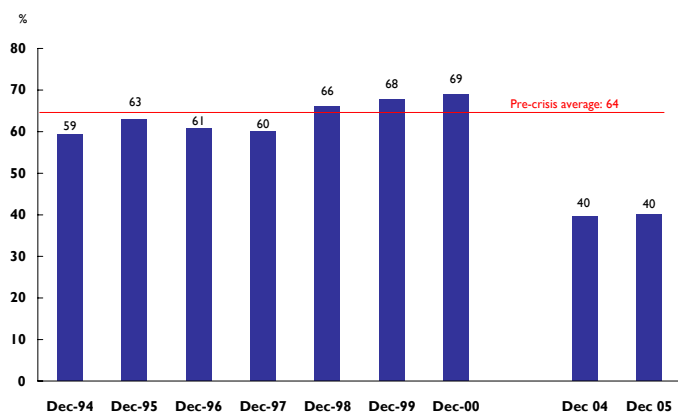
Deposit and Loan Maturities
Weighted monthly average



Source: BCRA

Chart IV.5

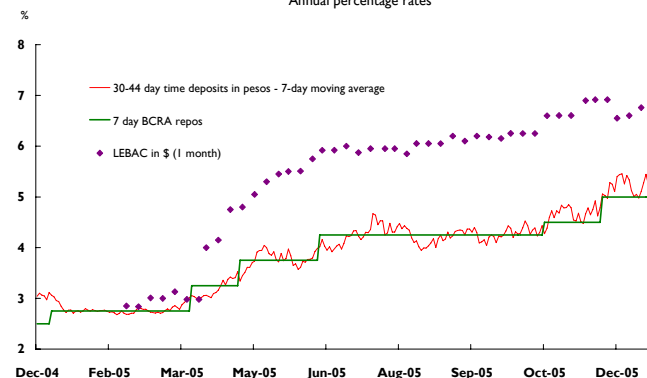
Private Sector Time Deposits
Time deposits / Total deposits



Source: BCRA

Chart IV.6

Interest Rates
Annual percentage rates



Source: BCRA

policy, also increases the effectiveness of the Central Bank action.

The gap between the maturities of assets and liabilities emerges as the principal challenge of the financial system in its exposure to liquidity risk

The contraction of the time horizon of the economic agents is one of the legacies of the 2001 – 2002 domestic crisis that harms the financial intermediation activity most. In this sense, the financial institutions remain prudent in terms of the mismatch in the maturity of assets and liabilities: they obtain funds at short term and mainly lend them for consumption and working capital. However as a consequence of the 2001 – 2002 crisis the financial system still shows a considerable mismatch in the terms of its balance sheet.

In the context of a larger need for finance for the productive sector over the medium and long terms the banking system is trying to extend the average term of its liabilities. Although it has been successful in extending the average maturity of its time deposits, which exceed the average pre-crisis term of the time deposits attracted then (see Chart IV.4), the banks exhibit a historically high proportion of sight deposits compared to its time deposits. While in the last pre-crisis years time deposits were 64% on average, in the past two years this ratio has remained at 40% (see Chart IV.5).

Although the imprint of the recent domestic crisis on the horizon of economic agents still remains, the low interest rates (see Chart IV.6) paid on deposits (negative in real terms) contributes to the current short term bias of the financial system. Despite the above, and considering the moderately contractive monetary policy set by the Central Bank in its 2006 Monetary Program a gradual increase in the amounts and in the terms of the savings on deposit in the financial system is expected.

However, this process of increasing the average maturity of the deposits must be accompanied by two principal elements: the reduction in the exposure to the public system (high maturity) and the expansion of the issue of medium term debt on the capital markets. The current activity of banks is strongly committed to the first target, while the second point is at an incipient stage. The financial institutions are beginning to assess obtaining funds through the capital markets. In the second half of 2005, two financial institutions managed to place corporate bonds, while one of them did so in domestic currency.

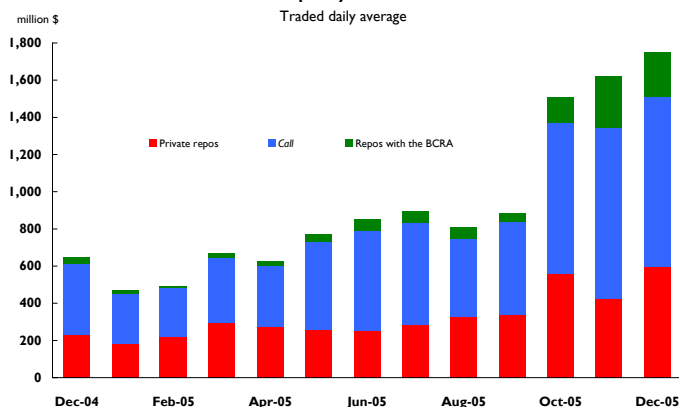
The solidness of the financial system to face liquidity risk rests increasingly on market instruments

During the second part of 2005, the inter-bank liquidity markets began to deepen. Both the call money market and repos between private parties exhibited growth paths. The repo market with the Central Bank also began to develop, to provide an interest rate parameter for the rest of the liquidity markets. Together, the amount traded daily on these money market increased almost triple in the year (see Chart IV.7), rising from 0.6% to 1.3% of the deposits of the non financial sector. In this manner the financial system, led by the Central Bank policies, is beginning



Chart IV.7

Liquidity Market
Traded daily average



Source: BCRA and MAE

to find market solutions to reduce its exposure to liquidity risk, to improve the management of its resources and to promote the conditions of financial stability.

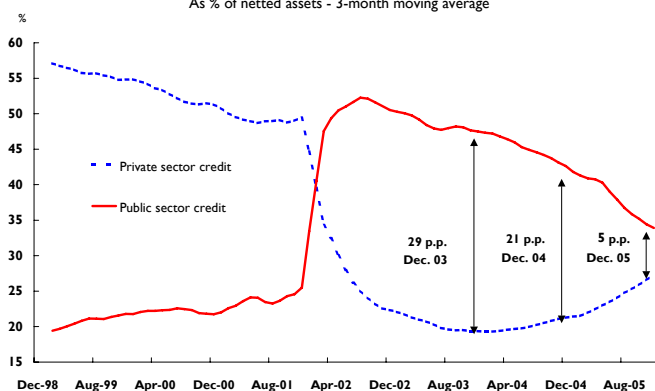
In addition, the sustained development of the domestic capital market (see Pages 30 and 33) is consolidating as a key element for coverage for exposure to the liquidity risk. Thus, a possibility is opened for financial institutions to invest in assets with secondary markets and to simultaneously obtain liquidity and yield.

For 2006, although a reduction in the specific liquidity indicators is expected, the strengthening of the financial system will come together with an expansion of market coverage and a reduction in the mismatch in the terms of assets and liabilities

Continuing on its current trend, the financial system is expected to sharpen its bias towards the private sector, attracting deposits and granting loans to individuals and corporations. This behavior will lead financial institutions to continue to reduce their holdings of liquid assets in order to assign these funds to the private sector financing and to trading activity. However, these trends are expected to proceed together with a greater deepening of the financial markets, which would have a positive impact on the profit rate and a lower exposure to the risk of unforeseen deposit withdrawals. In this sense, the Central Bank continues to promote market solutions that provide the possibility for banks to offload the risks typical of their operation.

Chart IV.8

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



Source: BCRA

In addition, the expansion of the secondary markets for debt (especially sovereign and Central Bank issues) will help the banks to place the funds which at present they have set up as liquidity reserves in financial assets. The development of the capital market will allow for a more agile use of the mechanisms to obtain liquidity, such as the sale of portfolio by setting up financial trusts. The behavior above will become even more evident if the dynamics of a growing inflow of capital to the domestic economy continues.

During the coming months, it is estimated that the financial institutions will continue to reduce their exposure to the public sector in favor of credit for the private sector (mostly with a shorter maturity), to diminish the mismatch in the terms of their assets and liabilities. Also, and associated with the moderately contractive policy of the Central Bank for 2006, the financial system is expected to manage to increase the average maturity of its deposits, to lessen the gap between the terms of assets and liabilities.



IV.2. Credit risk

IV.2.1. Public sector¹⁶

During the second half of 2005 an acceleration of the declining trend in the exposure of the financial system to the credit risk of the public sector was observed

In 2005 a sharp decline in the exposure to the public sector of financial institution portfolios was observed, which was largely in response to the regulations adopted by the Central Bank (equity limitations, convergence towards valuation at market prices and normalization of capital requirements). In December 2005 the ratio of the exposure of the public sector to total assets was 30% (33% of the netted assets of the consolidated financial system), to register a drop of 9 p.p. compared to the ratio exhibited at the end of 2004. Although the public sector continues to be the principal debtor of the financial system, the gap compared with the private sector continues to close at an accelerated pace: in the past 12 months the gap was reduced 16 p.p. (see Chart IV.8) of assets.

This trend was largely explained by the changes in the regulations led by the Central Bank. In this sense, the financial institutions continued to remain within the regulatory framework that sets a maximum individual exposure to the public sector at 40% of the assets. Furthermore, the compliance with the schedule set by the Central Bank in order to begin to value the public sector portfolio at market prices also contributes to reduce the exposure to public sector risk. Meanwhile, the private sector banks accompanied this trend, in a context of adapting the strategies of financial institutions to improve the risk – reward profile of their portfolios (see Chart IV.9).

The convergence between the market prices and the book values, spurred by the Central Bank rules that set a timetable for their adaptation to the market discount rate¹⁷, is having a positive impact on the assets of financial institutions. In this aspect, it should be noted that some specific cases have been detected where market prices are rising above the accounting values. On the other hand, as mentioned in the FSB II-05, the sovereign debt exchange also had a significant impact on the assets of financial institutions. In particular, the normalization of the payment flows, together with the favorable expectations about the performance of the prices of the securities that resulted from the restructuring process improved the quality of the bank portfolios. In addition, the sovereign debt swap had a positive effect on the prices of the securities that were paying services on a regular basis, by allowing their book values to approach market prices, thus making it easier to trade them (see Chart IV.10).

The payment capacity of the public sector was markedly strengthened in 2005. The positive effect on the assets of financial institutions that the sovereign debt swap held to was accompanied by an improvement in the financial position of the

Chart IV.9

Exposure to Public Sector by Type of Banks
As % of netted assets - 3-month moving average

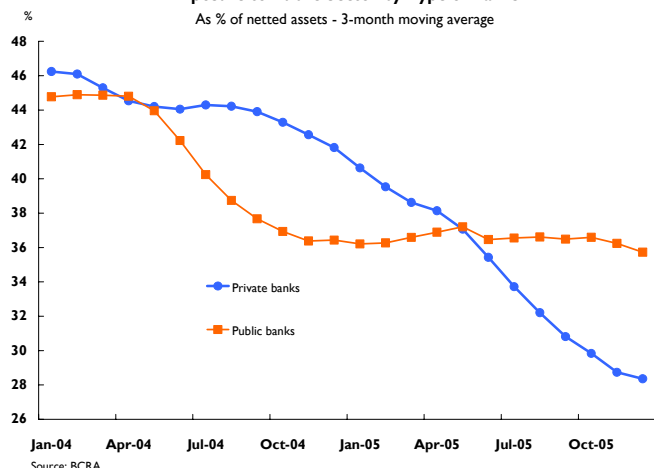
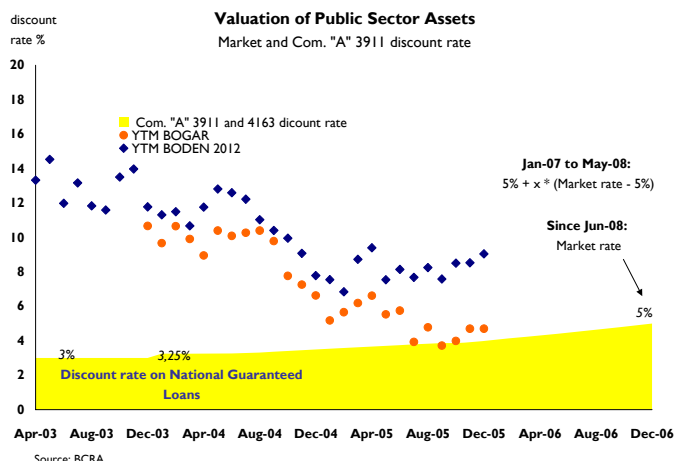


Chart IV.10

Valuation of Public Sector Assets
Market and Com. "A" 3911 discount rate



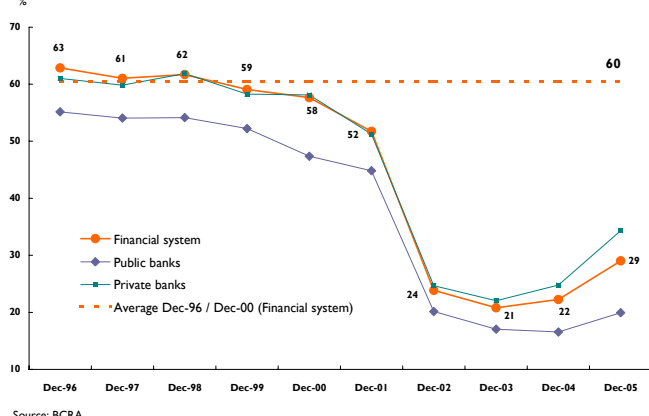
¹⁶ The concept of public sector credit used in the FSB (see definition in the Glossary) excludes the holdings of securities issued by the Central Bank.

¹⁷ Communication "A" 3911 and modifications.



Chart IV.11

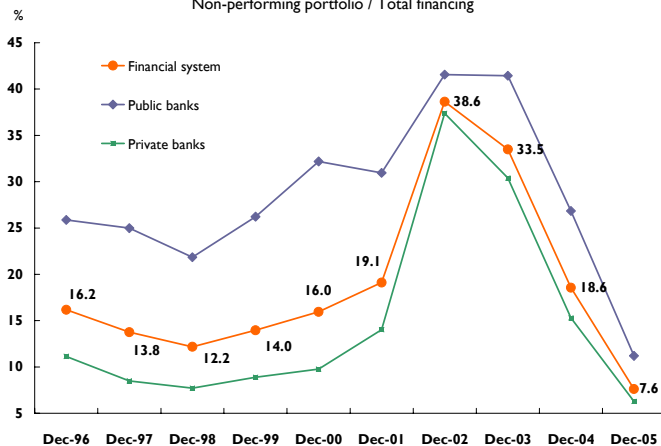
Financing to the Non-Financial Private Sector As % of netted assets



Source: BCRA

Chart IV.12

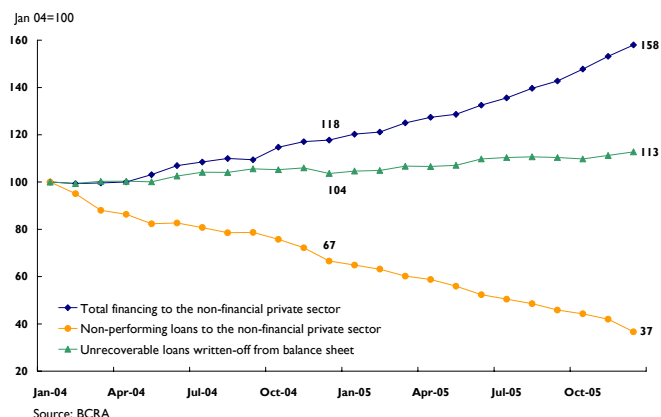
Non-Performing Credit to the Non-Financial Private Sector Non-performing portfolio / Total financing



Source: BCRA

Chart IV.13

Non-Performing Financing to the Non-Financial Private Sector



Source: BCRA

public sector, as it significantly reduced its principal and interest payments over the short and medium terms.

Furthermore, the more solid finances of the public sector were reinforced by the large surplus results of the fiscal accounts in recent years.

For 2006 the trend towards reduced exposure to public sector risk is expected to continue

The exposure of financial institution portfolios to the public sector will continue to contract this year. This is explained by both the continuity in the application of the different Central Bank regulations, and also by the banks' own initiative, in a context of readjusting their levels of exposure to the public sector. Finally, the strengthening expected on the fiscal front, added to more liquidity on the domestic capital market, is forecast to have a positive impact on the assets of financial institutions.

The public sector continued to exhibit a solid financial position in 2006 (see Page 23). On one hand, the large surplus projected for this year stands out. On the other, the conclusion of the sovereign debt exchange, the advance cancellation of the debt owed to the IMF and the debt exchange by the Province of Buenos Aires improved the financial position of the public sector. However, these developments will be partly conditional on the continuity of the favorable economic context in a framework of orderly macroeconomic policies.

IV.2.2. Private sector

Greater strengthening for the financial system to face private credit risk

The close of 2005 comes in a context of greater resistance by the financial institution to the private sector counterparty risk. This is consistent with the more solid position of families and firms, associated with the strong economic growth. The prudent granting of loans by the financial institutions also acted in the same direction. The improvement in the credit quality of the private sector, a trend that was repeated in recent years, was reflected in the fall in the financings¹⁸ classified as non-performing (in situations 3 to 6) together with a smaller counterparty risk implicit in the new loans that were granted.

Due to the strong growth in the loans aimed at families and business during 2005, the greater robustness in the face of counterparty risk occurred in a context of a greater exposure of the financial system to the private sector. In particular, at the end of 2005 the loans to the private sector reached a level of 29% of total assets, almost 7 p.p. more than at the end of 2004 (see Chart IV.11). Although this level of finance for business and families is reduced in comparison with the pre-crisis levels (and is equivalent to almost half the average value recorded in that period), it is expected that it will continue to grow in a framework of prudent expansion of loans to the private sector. The latter is consistent with the favorable expectations for

¹⁸ The concept of financing includes loans (without discounting provisions), other credits from financial intermediation, goods in financial leases, and sundry credits in connection with the sale of immobilized assets (see the orderly text on Classification of Debtors available on the Central Bank web site).



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

		December 2005								
		1	2.a	2.b	3	4	5	6	Write off (*)	TOTAL
June 2005	1	90.8	1.0	0.0	0.4	0.2	0.2	0.0	7.5	81.8
	2.a	24.8	55.9	0.0	4.8	6.3	0.4	0.0	7.7	3.3
	2.b	27.3	9.4	58.3	0.0	2.1	0.2	0.0	2.8	1.6
	3	10.5	5.8	3.1	59.5	11.5	2.3	0.0	7.3	3.1
	4	5.7	1.2	0.3	5.3	48.0	23.7	0.7	15.0	3.7
	5	3.8	0.4	0.0	0.2	0.6	48.0	0.0	47.0	6.0
	6	2.9	0.3	0.0	0.0	0.1	1.2	61.9	33.6	0.4
TOTAL		76.4	3.0	1.1	2.5	2.6	4.0	0.3	10.1	100.0

Figures based on debtor information at the start of the exercise

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

Source: BCRA

Chart IV.14

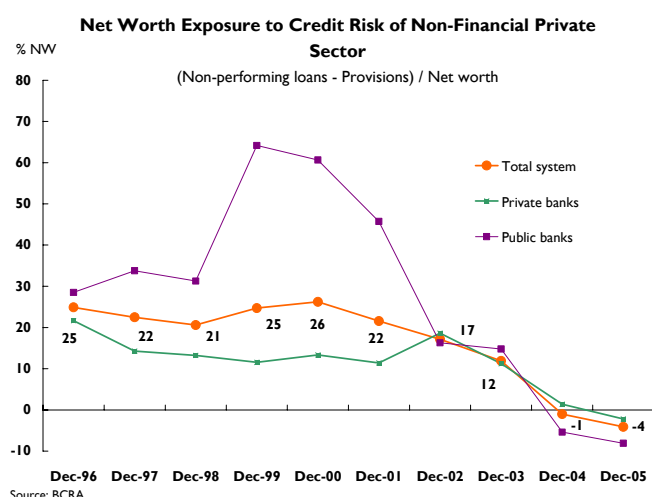
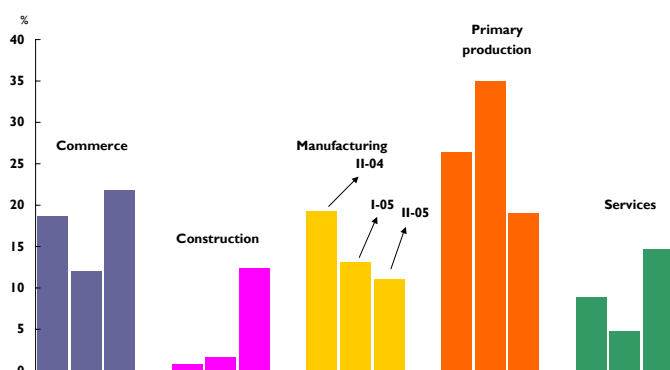


Chart IV.15

Changes in Financing by Economic Sector



Source: BCRA

growth during 2006. In this scenario, in which an increase of loans is forecast, the allocation of funds by financial institutions to debtors with a solid repayment capacity is a necessary condition in order to continue strengthening the financial system in order to face the private sector credit risk.

At the end of 2005, the non-performing rate of the portfolio of private sector loans not only recorded a significant fall in the year (11 p.p. to a level of 7.6%), but also reached its lowest level in the past 10 years (see Chart IV.12). The fall in the non-performing levels was associated with both the growth in loans for the private sector and the reduction in the loans classified as non-performing, with the latter being those that led the fall (see Chart IV.13). In particular, the fall in non-performing loans was due to the regularization of the payments by some debtors who had been in arrears, the transfer to memorandum accounts of loans classified as not recoverable, and to the improved business prospects of the debtors. Furthermore, the improvement in non-performance was also linked to the Central Bank regulations, which have the purpose of making the granting of new loans more dynamic.

The quantitative assessment of the financial institutions remained active in the second half of 2005, to reflect a similar movement to the previous semester. In December 2005, compared with June the same year, 93.4% of the debtors retained their classification¹⁹, 3.1% improved (\$1.4 billion), while 3.5% (\$1.5 billion) of the loans worsened their classification. As regards the better quality loans (in situation 1) a lesser worsening was observed than in the first half of 2005, because only 1.7% suffered a downgrade in their classification in the second half (see Table IV.1). Finally, the percentage of loans that was in a non-performing situation in June that became performing by December 2005 was the same as that registered in the opposite direction (9%).

Although the drop in the non-performing level of the financial system was explained by both the public and private sector financial institutions, it was the former banks that recorded the relatively sharper decline. In particular, the public sector banks accumulated a fall of 16 p.p. in their non-performing rate during 2005, while in private sector banks the decline was 9 p.p.. Nevertheless, the private banks continued to exhibit the relatively lower non-performing levels (6.3% against 11.2% in public banks). In particular, the improvement in the quality of the portfolio was mainly explained by the private sector retail banks with a national scope, the sub-group of private capital banks with the greatest weighting in terms of loans.

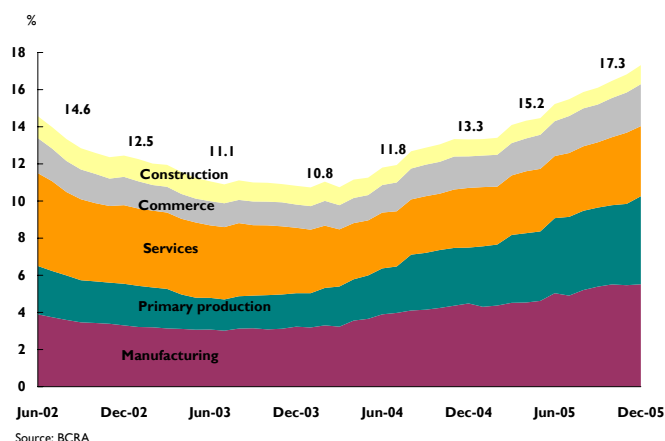
Although in relation to other countries in the region the non-performing rate of the Argentine financial system continues to remain high (see Box 1), the sharply downwards trend recorded in recent years is an indicator of the notable progress achieved on this issue. It is expected that in the short term the domestic financial system will be in harmony with the region.

The decline of the non-performing portfolio led to the contraction in the exposure of net worth to the private sector

¹⁹ This value results from the percentage of loans granted that retain their classification to total loans (net of cancellations).



Chart IV.16
Bank Exposure to Economic Sectors
Financing to legal entities / Assets



credit risk (see Chart IV.14). Due to the sharp fall in non-performing loans and the increase in the equity of the financial institutions, the decline in provisions did not prevent the ratio of the exposure of net worth of the financial system continuing to fall. The latter is consistent with the insightful strategies followed by the financial institutions, which assume in advance the losses expected from bad loan charges.

Higher loan levels and fewer non-performing loans will improve the quality of the portfolio in 2006

In a framework of continuity of the favorable domestic and international conditions, together with a prudent allocation of funds by the financial institutions, it is expected that in 2006 the portfolio quality will continue to sharpen its improvement, due both to the falls in the amounts of non-performing loans and to increases in the portfolio with a lower implicit counterparty risk. In particular, associated with the favorable expectations regarding economic activity this year, an increase in the demand for credit is expected to be recorded (especially in short and medium term loans) by both families and corporations.

On the supply side, this could increase in a context of a substantial availability of funds and an attractive risk to return profile for the different loan lines. The competition for larger shares of the credit market by the financial institutions reinforces this trend.

Corporations

The financial system increased its strength to face corporate credit risk during 2005

In a very favorable business context, loans to corporations grew 33% in the past 12 months. During the second half of 2005 in particular, the increase in credit was led by commerce and by primary production, with growth rates of 22% and 19%, respectively (see Chart IV.15). Although the loans to manufacturing grew at a more moderate rate in the second half of the year (11%), this sector, together with primary production, channeled almost 60% of the total loans.

The increase in loans during the six month period was associated with a slight increase, albeit generalized, in the exposure of the financial system to the corporate credit risk (to reach 17.3% of assets) (see Chart IV.16). In this sense, it should be noted that the rise in the exposure of the financial system to credit risk is a natural consequence, in the framework of a normalization of the financial intermediation operations. In this context, the challenge for the financial system is to increase its exposure to business without deteriorating the quality of its portfolio over the medium term.

The financial institutions continued with a healthy credit policy, employing the larger share of the funds in the sectors that exhibit the lowest relative non-performing levels (see Chart IV.17). In this regard, although 2005 saw an improvement in the quality of the portfolio for all branches of business, the sectors that received most banking finance: primary production and

Chart IV.17
Non-Performance by Economic Sector
Non-performing portfolio / Total financing

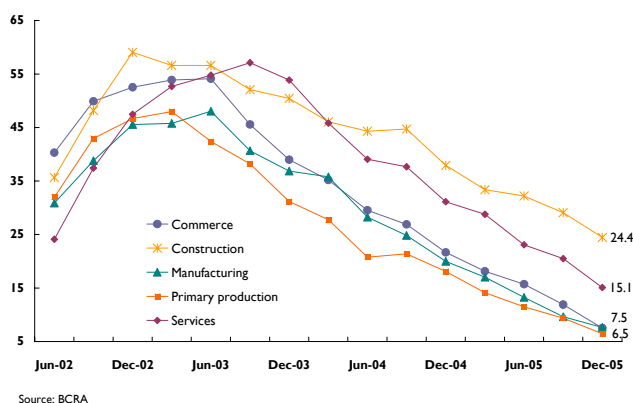


Chart IV.18
Lending to Companies by Amount Bracket
Financial system

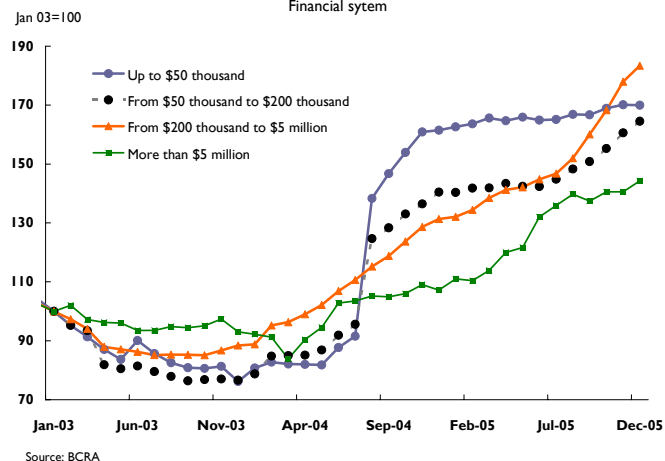
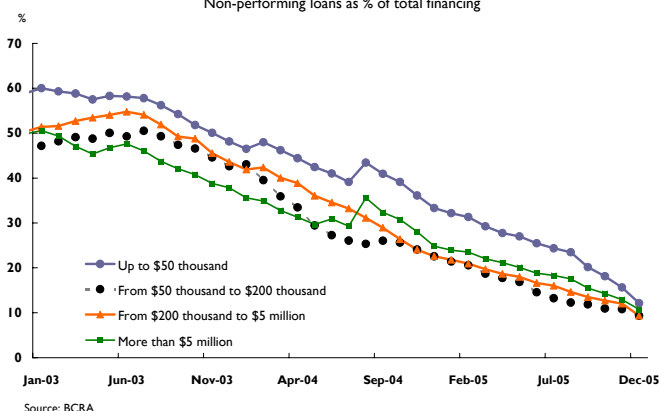




Chart IV.19

Non-Performance Portfolio by Amount Bracket

Non-performing loans as % of total financing



manufacturing, were at the same time those that exhibited the lowest non-performing levels (6.5% and 7.6%, respectively).

The medium and large scale tranches boosted the growth of credit

The development of the different kinds of loan tranches was far from homogeneous. In fact, the medium size (loans between \$200,000 and \$5 million) and large scale tranches (loans of over \$5 million), sub-groups that together account for 83% of the total loans, grew 40% and 35% in the year, respectively. The noticeable growth exhibited in the small scale tranche during the second half of 2005 (16%) should be noted (see Chart IV.18).

Loan of all sizes improved their credit quality. On the other hand, although the smaller loans exhibited the highest non-performing levels, if the sharply declining trend which began in recent years continues they should exhibit significant improvements in the quality of the portfolio (see Chart IV.19).

Uneven growth in the different kinds of credit lines for corporations

In 2005 an increase was recorded by almost all kinds of credit lines, with the exception of finance with pledge and mortgage guarantees. The overdrafts and promissory notes are those that had the most vigorous growth in recent years (see Chart IV.20), as well as exhibiting the relatively lower levels of non-performance, especially overdrafts for which non-performance was 3.7% (see Chart IV.21). Finally, although the loans with mortgage guarantees exhibited the most deteriorated credit quality, it is expected that these loans should continue to record significant cuts in non-performance that they have achieved so far (attaining a decline of 36 p.p. over the past two years).

For 2006 growth in bank finance for corporations is expected to continue

The high level of domestic economic growth projected for 2006 (see Page 18), together with the continuity of the positive international conditions (high commodity prices and low global interest rates) are factors that will boost a greater demand for bank loans. In sector terms, and associated with the higher rates of growth forecast for the service sector and for construction, it is expected that these branches of activity will exhibit growing requirements of banking finance for investment. In addition, the continuity of the strong performance recorded in 2005 by primary production and by manufacturing acts in the same direction. Specifically, in 2006 firms are expected to reduce the use of their own funds and increase their financing by domestic financial institutions (see Chart IV.22).

The supply of credit to corporations is expected to continue to expand in a context of high liquidity levels and attractive risk to return profiles for the new loans granted by financial institutions. The favourable macroeconomic prospects for the next few years provide the favourable conditions for the banking system to increase its supply of long term finance. As well as the increase forecast for traditional lines of credit, less traditional finance (leasing) is expected to continue to grow.

Chart IV.20

Lending to Companies by Type of Financing

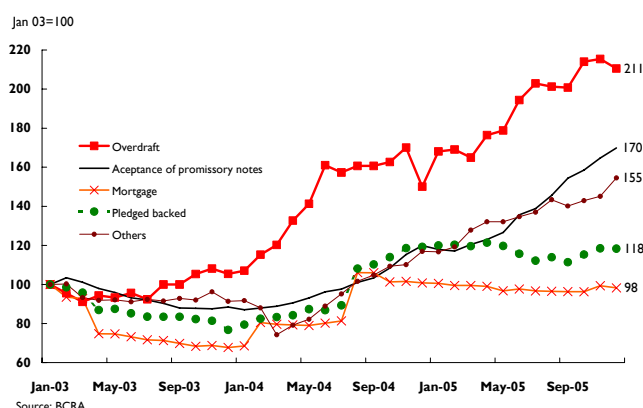


Chart IV.21

Non-Performance Lending to Business by Type of Financing

Non-performing portfolio / Total financing

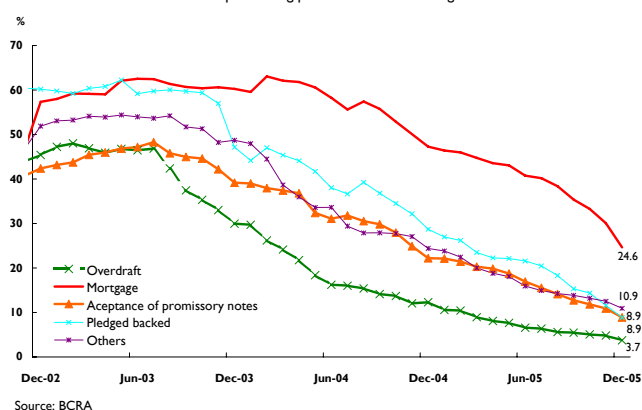
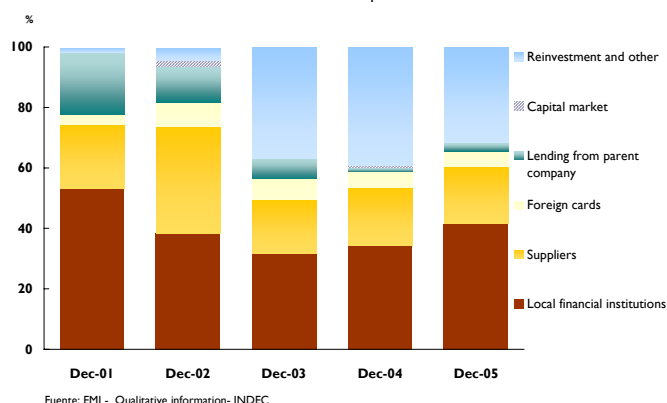




Chart IV.22

Expected Sources of Funds for Meeting Needs Outlook for the first quarter of 2006



Families

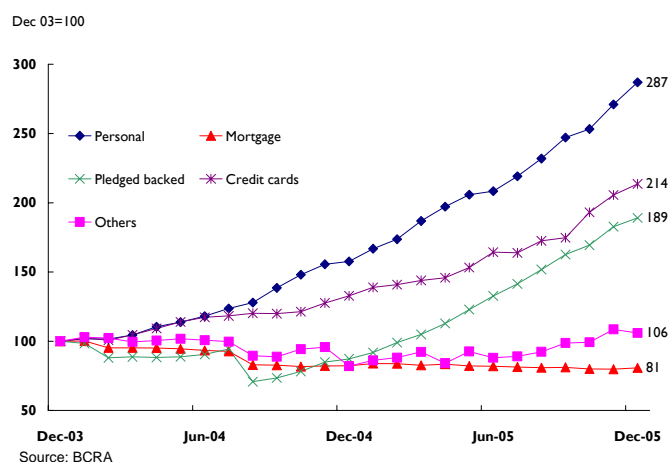
Although the financial system expanded its exposure to families, it continued to strengthen to face the counterparty risk of households

In a context of higher levels of income, credit to families increased by 38% during 2005 and exhibited a growth in almost all its lines. In this period, the development of the different kinds of finance was quite homogeneous, with the exception of loans with mortgage guarantees that recorded a slight fall during the year. In perspective, personal loans and credit cards led the growth of loans (see Chart IV.23). On the other hand, the growth of pledge backed loans marks the path for medium term finance for families.

In the second half of 2005 the growth in loans for families was associated with a slight increase in the exposure of the financial system to the credit risk of individuals, which was barely more than 10% of assets (see Chart IV.24). In particular, personal loans and credit cards were the lines that exhibited the largest relative increase in the exposure of the financial system to counterparty risk.

Chart IV.23

Lending to Households by Type of Financing

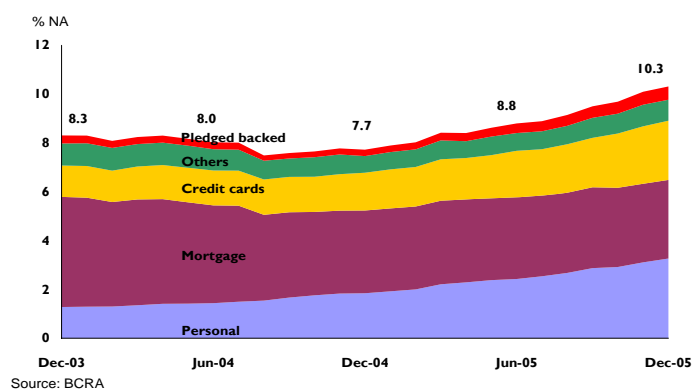


In 2005 the financial solidness of families was markedly strengthened. This was mainly due to several factors: the increase in employment levels, the higher wages in real terms (especially in the formal sector), and a level of household debt that is still low. These factors, added to the strategies of the financial sector to place a larger number of loans in this sector (to atomize their credit portfolio, and therefore their counterparty risk), occurred in a context of a decline in their costs during 2005 (see Chart IV.25).

Furthermore, the contraction in interest rates in the year was consistent with a reduction of the implicit credit risk of families. The latter was reflected in lower levels of non-performance, due both to the growth of new loans and the normalization of payments of those that were in arrears. In particular, the non-performance of the portfolio of loans to families was reduced 6 p.p. in 2005, to record a non-performance ratio of 4.8% in terms of loans. Although the improvement in the quality of the portfolio occurred for all kinds of finance, consumer finance (personal and credit card loans) together with those that require a pledge guarantee, were those that exhibited the lowest non-performing levels at December 2005 (4%, 1.5% and 2.7%, respectively) (see Chart IV.26).

Chart IV.24

Exposure to Households by Type of Financing As % of netted assets



Higher employment and consumption levels boost the demand for family finance

The positive expectations of economic growth in 2006 forecast a favorable scenario in order to continue the process of recovering bank finance for families. As regards the demand for credit, the expectations of higher levels of employment together with an increase in the levels of private consumption (although at a lesser pace than that registered in 2005), will allow for a boost in the demand for bank loans by families (especially for the short and medium terms). The continuity of the current

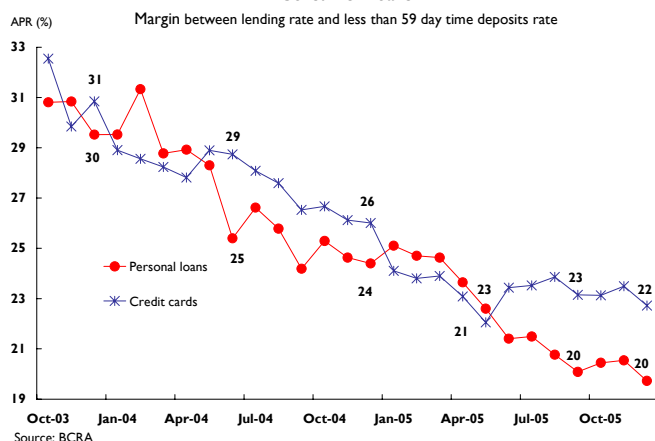


macroeconomic stability, together with a larger growth in real incomes, are consistent with the fact that families increase their demand for long term finance, in a gradual manner.

On the supply side of credit, the increased availability of funds together with the competition for new shares of the credit market could be reflected as an increase in the supply of loans. At the same time, the continued growth in the securitization of loan portfolios acts as an additional expansionary factor for loans.

Finally, although the short duration of bank funding through private deposits appears as a restriction to grant long term loans, the expansion of the long term funding instruments will soften this restriction on bank finance.

Chart IV.25
Consumer Loans



IV.3. Currency and interest rate mismatch risk

During the second part of 2005 the improvement of the financial system to face foreign currency risk continued

The financial institutions strengthened their position in the face of the risk derived from the asymmetry between assets and liabilities in dollars. This behavior was mainly due to the action of three forces that supplement each other: the reduction of the mismatch of assets in dollars, the expansion of bank capital and the smaller volatility expected in the peso – dollar exchange rate.

As occurred in the first part of the year, the banking system managed to reduce its dollar denominated assets by means of the contraction of the exposure to the public sector. However, this effect was partly offset by the net cancellation of credit lines arranged abroad. At the end of 2005 the mismatch between assets and liabilities in dollars was less than US\$3.5 billion (see Chart IV.27), and stood at 38% of equity; 18 p.p. less than at the end of 2004.

After the domestic crisis in 2001 – 2002, the Central Bank began to work to reduce the currency mismatch of the financial system which had remained as a legacy of the crisis. The restrictions imposed on loans, in terms of applying funds, helped the financial system to reduce to almost half the foreign currency net asset mismatches from the maximums reached in the post-crisis period.

During 2005, as well as reducing the exposure of banks to the volatility of the peso – dollar exchange rate, a more stable trend for this exchange rate was also observed compared with previous years. Should this macroeconomic context be maintained, another fundamental would be added in favor of the robustness of the financial system in the face of currency risk.

In addition, the strengthening of the financial system's position to face the foreign currency risk was led by the growing development, partly spurred by the Central Bank, of the futures market for the dollar (see Page 32). Although at present there is a substantial segmentation of these markets on which the financial system and the commercial sector largely operate separately, the expectation is for this to be reduced.

Chart IV.26

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

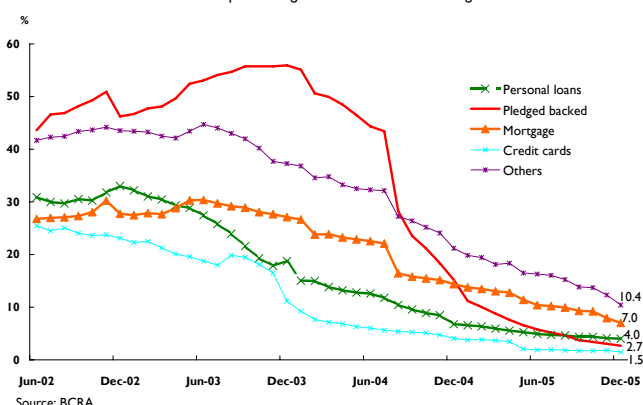




Chart IV.27
Exposure to Foreign Currency Mismatch Risk

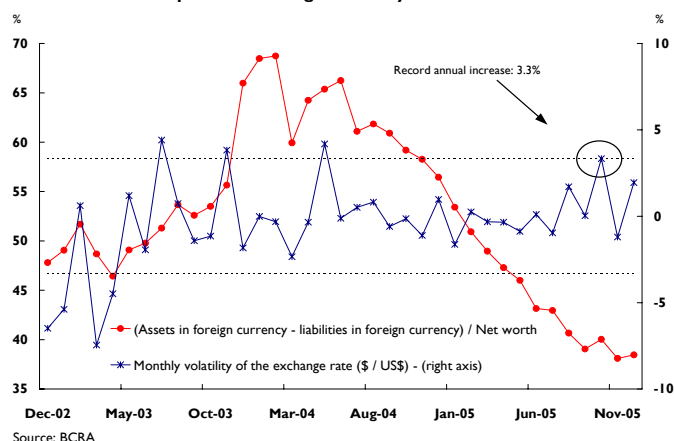
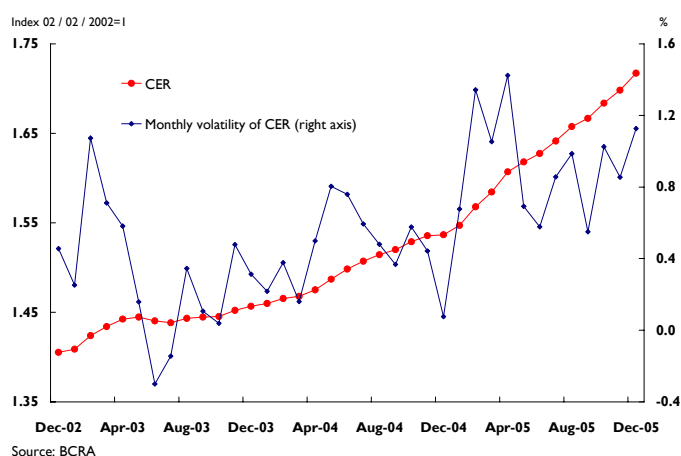


Chart IV.28
CER Mismatching



Chart IV.29
CER Mismatch Risk



The exposure of the bank to the real interest rate risk, linked directly to the asymmetries in the net assets of accounting items adjustable by the CER, is gradually receding

Although the financial system continues to maintain its levels of the Reference Stabilization Coefficient (CER) mismatch at around \$34 billion since the end of 2004, the expansion of bank capital generates a greater resistance to face an increase in real interest rates. It is worth noting that there is a specific capital requirement for financial institutions to face the real interest rate risk. During 2005 this mismatch between assets and liabilities was reduced by approximately 4 p.p. of net worth, to remain at a ratio of about 124% (see Chart IV.28).

For the financial system, the macroeconomic context was adverse in terms of reducing the CER mismatches, with the gap boosted by the dynamics inherent in inflation. The long maturity of the public sector assets (almost 90% of the total assets with CER) and the anticipated cancellation of debt owed to the Central Bank (adjustable by CER) contributed to broaden the gap between assets and liabilities with CER. However, these elements were partially compensated by the sharp reduction in the exposure to the public sector, especially through the portfolio sale and by valuation at market prices (see page 47). Meanwhile, the expansion of the equity of the financial system led to a moderate contraction in the exposure to the real interest rate risk.

Although the current macroeconomic context (inflation with low and stable interest rates) leads the financial institutions to earn profits, generated by the larger amount of assets with CER than liabilities (see Chart IV.29), an increase in interest rates higher than inflation would lead to an increase in the cost of funding which, depending on its scale, could lead to negative results for the banking system. During 2005 the financial system recorded a profit of about 1.5% of its assets due to the CER adjustments, an amount equivalent to that generated by net interests and 50% more than what was seen on this account in 2004.

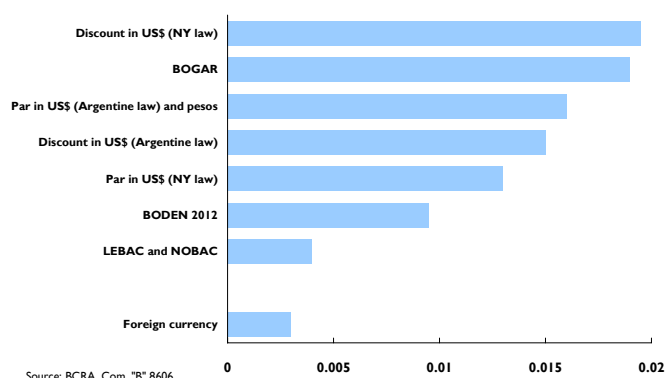
With both the purpose of promoting the development of credit for the private sector and of contracting the exposure to real interest rate risk, the Central Bank continues to foster the creation of market solutions for these asymmetries. Promoting the markets for interest rate swaps such as CER futures are an example of such measures. However, to date depth has not been achieved on these markets, which reveals the difficulties that the banks have to find a sizable counterparty.

In 2006 it is estimated that the gradual reduction of the exposure to foreign currency risk will continue, while the CER mismatch will remain at relatively similar values

The financial institutions will continue with the prudent policy for management of funds in foreign currency promoted by the Central Bank, without generating additional mismatches through their new transactions. Furthermore, the banking system is expected to continue reducing its exposure to the public sector in dollars. This latter action, added to a low volatility estimated for the peso – dollar exchange rate during 2006, leads to consider the strengthening of the banks in the face of foreign currency risk.



Chart IV.30
Daily Volatility Used for Market Risk Assessment
At December 2005

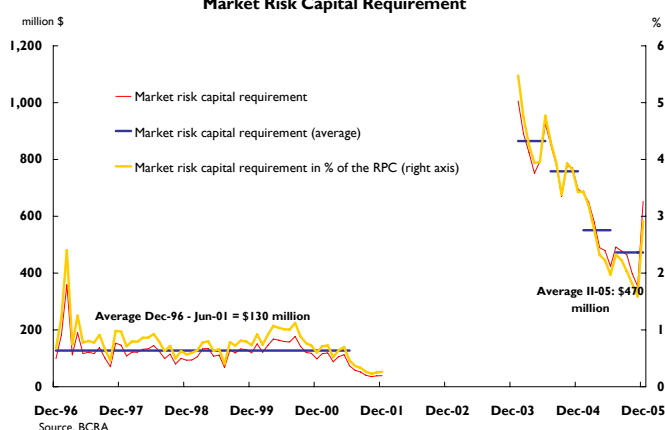


Meanwhile, in the coming months, the financial institutions will continue with the process of normalizing their liabilities, carrying out further anticipated cancellations due to the debts incurred with the Central Bank (adjusted by CER). To this factor, the fact that most of the financial institutions have already made a substantial effort to reduce their exposure to the public sector, especially in securities adjustable by CER, should be added. Based on these elements, it may be argued that it is unlikely that the financial system will achieve a significant reduction of the CER mismatch in 2006. This outlook presents a challenge to achieve higher levels of development of market instruments, in order to provide coverage to face up to these risks.

IV.4. Market risk

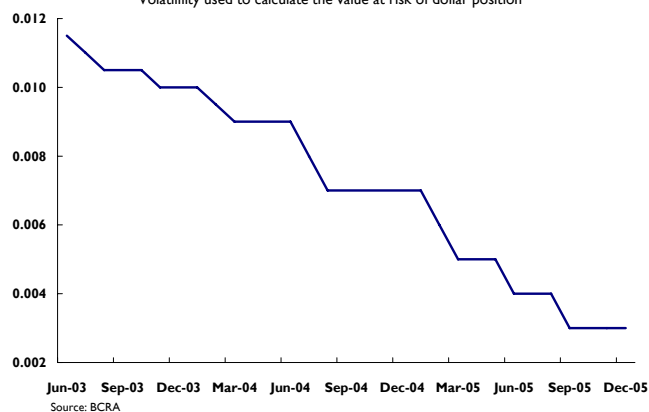
Less volatile markets and a reduction in the foreign currency position diminished the exposure of financial institutions to market risk

Chart IV.31
Market Risk Capital Requirement



With fluctuations in the market prices of the assets that trade on a regular basis that the banks hold on their balance sheets (basically bonds, shares and foreign currency) these financial institutions could possibly record losses. The so called market risk thus depends on the position that the banks adopt regarding their different tradable assets, and on the volatility of their respective prices (see Chart IV.30). From a prudential standpoint, in order to cover this kind of risk a certain amount of capital is required, calculated in terms of the so called value at risk (VAR). However, the requirement thus calculated has a low weighting on the total capital requirement (less than 10%), because an even more significant share of the assets portfolio is made up with securities not traded or held on investment account (considered for the calculation of the interest rate risk and credit risk requirements).

Chart IV.32
Foreign Currency Market Risk
Volatility used to calculate the value at risk of dollar position



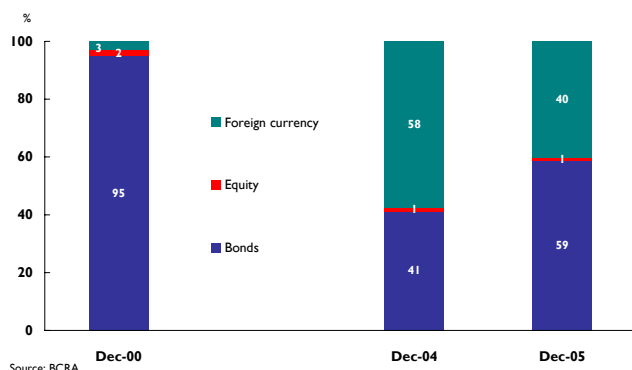
In terms of the variations of the position in different kinds of assets and in a context of lower volatility, the exposure to market risk remained on its downwards trend during most of the second half of 2005, which was reflected in a continual fall in the respective capital requirement. However, towards the month of December the latter exhibited a considerable increase, in terms of the behavior of certain financial institutions that began to value a larger share of their portfolio of government bonds at market prices. On average the half year period closed exhibiting a cut in the capital requirement for market risk coverage; although this continues to be relatively high when compared with the levels seen before the crisis (see Chart IV.31). This difference in level is explained by the larger weighting that the position in foreign currency began to have after the recent crisis (that includes both the direct position in foreign currency and the implicit position in holdings of assets denominated in foreign currency²⁰).

The heavier weighting of the position in foreign currency has been correcting itself to the extent that the bank balance sheets were purged of the effects of the recent crisis, an event that was noticeable in particular in the second half of 2005. In fact, the

²⁰ For the financial assets in foreign currency that have market prices the exposure to price volatility (the volatilities Published by the Central Bank for the assets are calculated based on the price in the original currency) and the volatility of the currency of denomination.



Chart IV.33
Market Risk Capital Composition



trend towards a lower exposure to market risk during a substantial part of the half year period continued to be explained by different factors mainly linked to the foreign currency position. Thus, for example, the payment of the first installment of the capital amortization of the Boden 2012 bond in dollars was made in August. In addition, there was further progress in the delivery of compensations that were owed (a substantial share of them in U.S. dollars) so that the banks could sell part of these securities and proceed with the strategy of reducing exposure to the public sector (see page 47). Together with a smaller volatility of the dollar (see Chart IV.32), these factors had an influence on the composition of the capital requirement for market risk, with a growing share seen in the capital linked to the market risk for sovereign bonds (see Chart IV.33).

The prospects in terms of market risk continue to be positive, due fundamentally to the declining volatility of the peso – dollar exchange rate. In addition, further cuts in the foreign currency position are expected, although the bond position may continue to rise (due in part to the increase in holdings for trading purposes, with further transfers seen from the unlisted portfolio to that at market prices). For this latter asset class, prices on fixed income markets should be expected to be progressively less volatile, to the extent that the market liquidity continues to grow and the sound perspectives for emerging countries and the domestic economy continue.

V. SOLVENCY

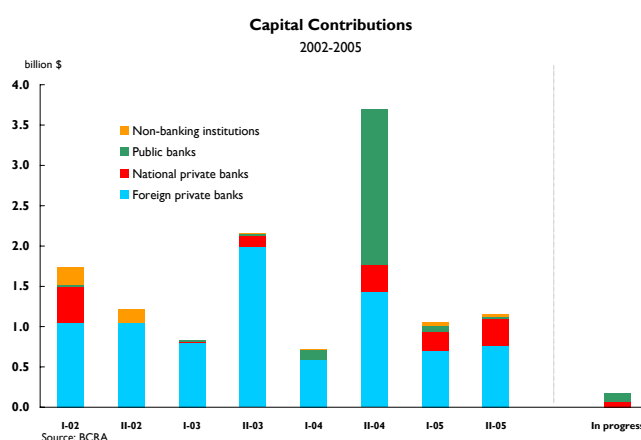
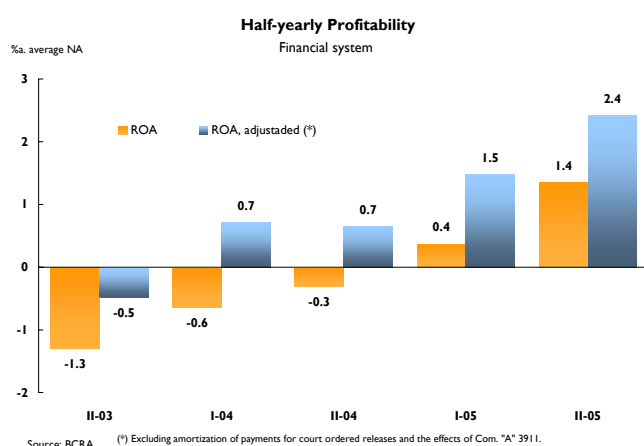
Summary

Alongside a significant improvement in profitability and a steady flow of new capital contributions, the financial system's solvency kept strengthening in the second half of 2005. In this context, the net profits of the financial entities were close to \$1.4 billion (1.4%a. of assets) in the period and totaled \$1.8 billion (0.9%a. of assets) in the entire year. This progression reverses firmly the stream of losses recorded in previous years, and the level of profitability attained is comparable to those observed in the financial systems of other emerging economies.

The profits obtained in the second half of 2005 were driven by an increase in the financial margin, heading that accounted for the larger profits derived from foreign exchange price adjustments, growing gains on securities and the growth in net interest income. This progress is in line with the ongoing strengthening of the credit to the private sector, within a macroeconomic framework that spurs the reduction in credit risk and which reflects in low levels of loan loss provisions. In the second half of the year, service income margin grew at an accelerated pace, while the gradual recovery of the banking cost structure did not prevent the efficiency level from improving beyond readings observed before the crisis.

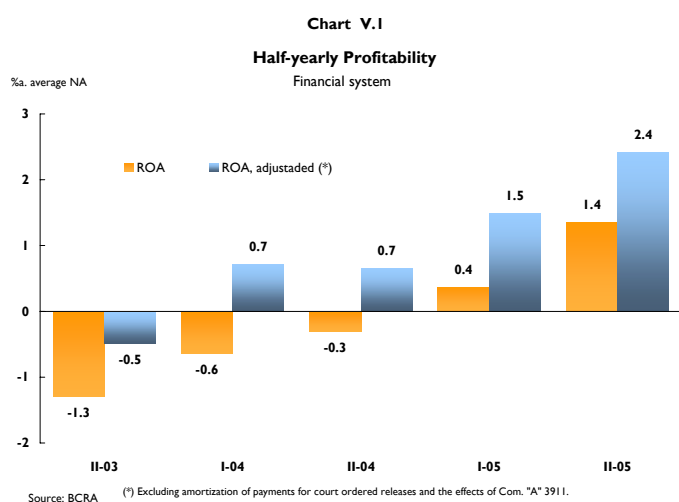
The banking system's solvency has consolidated in the period as a consequence of both larger profits obtained by the financial entities and new capital contributions. In the second half of 2005 capital contributions to the financial entities were close to \$1.15 billion, resulting in a 7.8% increase in their net worth and a sustained reduction in their leverage ratios. These improvements over the six-month period to date reflected in an increase in the capital compliance up to 15.3% of risk-adjusted assets, over the local minimum requirements.

From a medium-term perspective, the promising domestic macroeconomic environment feeds expectations of a higher rate of growth in traditional financial intermediation, breeding auspicious projections in matters of profitability and new capital resources. In this manner, the financial system's strength is forecast to build-up further, providing additional resilience in the event of external or domestic shocks that result in an improved financial stability framework.



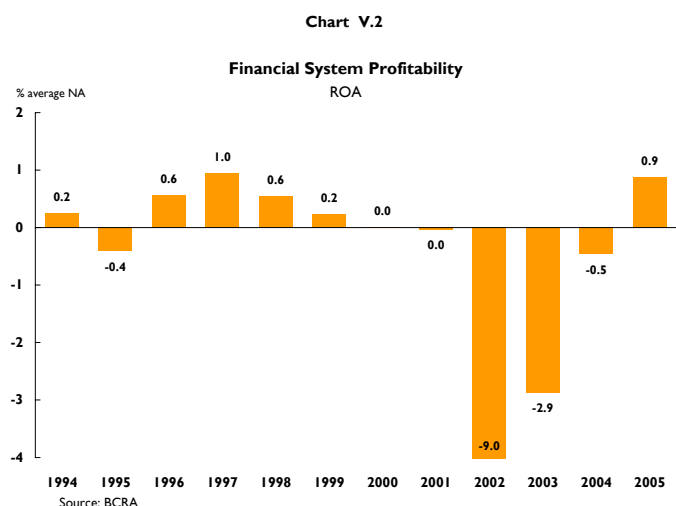


V.1. Profitability



Following the consolidation of the financial system's profitability in the second half of 2005, for the first time since the 2001-2002 crisis the financial system obtained an annual profit

The financial system's profits in the second half of 2005 were close to \$1.4 billion²¹ or 1.4% annualized (a.) of assets²², significantly outperforming the results attained in the previous half (0.4% a. of assets) and the performance over the same period of 2004 (-0.3% a. of assets). If, for the purpose of a better assessment of the financial system's current profitability, the main categories related to the gradual recognition of the consequences of the past crisis (amortization of court-ordered releases and adjustments to the valuation of government securities) are excluded, the benefits obtained in the second half of 2005 widen to reach \$2.5 billion (2.4% a. of assets) (see Chart V.1).



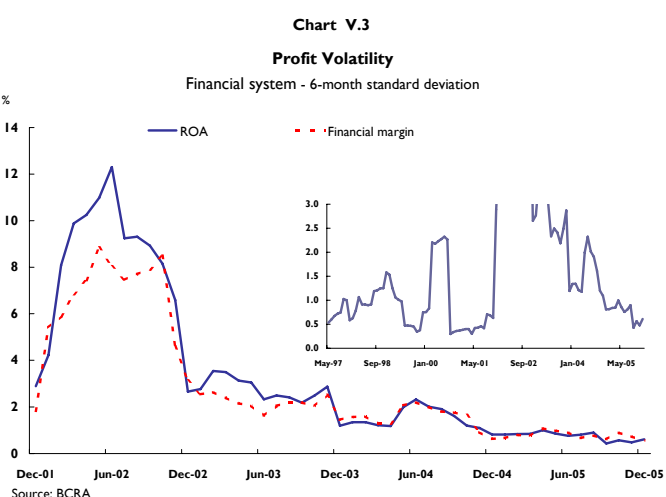
In annualized terms, 2005 represented a firm reversal of the stream of losses recorded by the financial system in the past years, realizing net profits for a total close to \$1.8 billion, or 0.9% a. of assets (see Chart V.2), rate that is akin to those observed in other emerging economies. In addition, total yearly net profits exceed \$4 billion (2% of assets) when the amortization of court-ordered releases and adjustments to the valuation of government securities are excluded.

Moreover, even when it is still above the pre-crisis levels, the volatility of the financial system's profits observed a decreasing trend during 2005 (see Chart V.3). The remaining spread is related, basically, to two factors. On the one hand, the financial system exposure to macroeconomic volatilities such as the peso-dollar exchange rate, inflation and interest rates. On the other hand, the variability witnessed in the banks' performance is linked to the gradual process of normalization of their balance sheets. Among other causes, this normalization process conveys the individual and temporarily isolated processes of marking-to-market the portfolio of securities and public sector assets sales.

In the second half of 2005 the bank's financial margin consolidated as a consequence of higher profits from foreign exchange price adjustments, growing gains on securities, and the growth in net interest income

The increase in the financial margin boosted the net profits obtained in the second half of the year, while net interest income consolidated as the main driver of the financial margin (see Table V.1). At the same time, the growth in services income margin also contributed to the broadening of the bank's revenue base in the period, while the rise in operating costs had an effect on the cost structure.

The system's aggregate financial margin accelerated its progressive rate of improvement in the second half of 2005, posting a 1.4 percentage points (p.p.) increase to reach 5.3% a. of



²¹ Computed using the latest available information. Data is provisional, and may differ from that published in previous editions of the FSB due to the adjustments that banks could have made in their accounting records.

²² Assets net of the accounting duplications generated by repo, term sale and unsettled spot transactions.



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

	2003	2004	2005	II-04	I-05	II-05
Financial margin	1.1	3.1	4.6	3.0	3.9	5.3
Net interest income	-0.5	0.9	1.5	1.0	1.3	1.7
Restatement by CER and CVS	1.3	1.0	1.5	0.8	1.6	1.4
Gains on securities	1.1	1.0	1.2	1.1	0.9	1.4
Foreign exchange price adjustments	-0.5	0.4	0.4	0.3	0.0	0.7
Other financial income	-0.3	-0.2	0.1	-0.2	0.1	0.1
Service income margin	1.9	2.0	2.3	2.1	2.2	2.5
Operating costs	-4.2	-4.1	-4.6	-4.2	-4.3	-4.9
Loans loss provisions (*)	-1.1	-0.8	-0.6	-0.9	-0.6	-0.6
Adjustments to the valuation of government securities (*)	-0.4	-0.2	-0.2	-0.1	-0.2	-0.2
Tax charges	-0.3	-0.3	-0.4	-0.3	-0.3	-0.4
Amortization payments for court-ordered releases	-0.6	-0.9	-0.9	-0.9	-1.0	-0.9
Other	0.9	0.8	0.8	0.9	0.8	0.8
Monetary results	0.0	0.0	0.0	0.0	0.0	0.0
Income tax	-0.2	-0.1	-0.3	0.0	-0.2	-0.3
ROA	-2.9	-0.5	0.9	-0.3	0.4	1.4
ROE	-22.7	-4.2	7.1	-2.8	3.2	10.7
Adjusted ROA (**)	-1.9	0.7	2.0	0.7	1.5	2.4

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

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

Source: BCRA

assets (see Chart V.4). In contrast with what happened in the first half of 2005, this phenomenon was led by the 0.7 p.p. expansion in foreign exchange price adjustments²³ gains. As financial entities maintain net long positions in foreign currencies, these profits were mainly related to the balance sheet effect of the increase in the peso-dollar exchange rate over the period (\$0.14 per dollar) (see Page 53).

Moreover, net profits derived from gains on securities posted a 0.5 p.p. increase. The major factors that drove this improvement include the net benefits obtained from intraday trading of public securities, the advantageous trend exhibited by the prices of public debt securities and net income derived from the sale of financial trusts certificates²⁴.

The categories that make up the core financial margin (net interest income and restatement by CER) exhibited disparate behaviors in the second half of 2005. Net interest income grew 0.4 p.p. over the period, reaching 1.7%a. of assets and consolidating the framework of steady advance in local financial intermediation. In particular, this increase was associated to the faster growth in interests accrued on loans than the deposits' interest outlays (see Chart V.5). The noteworthy expansion in the main commercial (discounted promissory notes) and consumption (personal loans) credit lines contributed largely to this outcome, in a framework of heterogeneous trends in their interest rates (see Page 39). Additionally, the persistent improvement in private credit quality sustained the expansion of interest income. These developments made up for the rise in interests accrued by deposits, which was consequence of both higher interest rates and a growing stock of time deposits. Providing additional support to this positive trend, the accelerated advanced payments of discounts supplied by the BCRA (see Pages 40 and 41) resulted in smaller interest payments.

The trend exhibited by the CER coefficient in the second half of 2005 resulted in a minor decrease of the net positive effect on the financial system's balance sheet. However, it was still higher than in the previous year (see Chart V.6). The decrease with respect to the first half of the year accounts for, basically, the effects of extraordinary adjustments that took place in the first six months of 2005, given that the growth in the index exhibited only a moderate reduction (from 5.9% to 5.5% at the end of each of the periods). Higher outlays due to the growth in the stock of CER-linked time deposits and lower income as consequence of the reduction in public-sector assets adjustable by CER held tend to be compensated for by the acceleration in the process of pre-cancellation of obligations in the framework of the scheme known as *matching*.

The financial system's aggregate expected loan loss provisions were lower than in the pre-crisis period, and remained in the neighborhood of 0.6%a. of assets. This figure is 0.3 p.p. lower than the one registered in the same period of 2004, portraying a firm decreasing trend since the 2001-2002 crisis (see Chart V.7),

Chart V.4
Financial Margin
Financial system

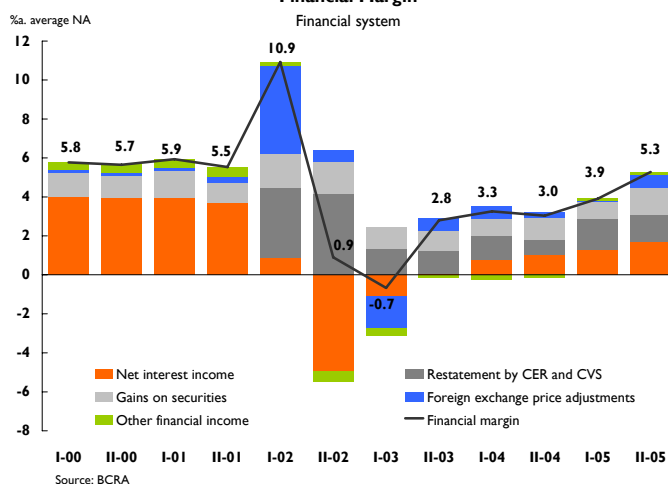
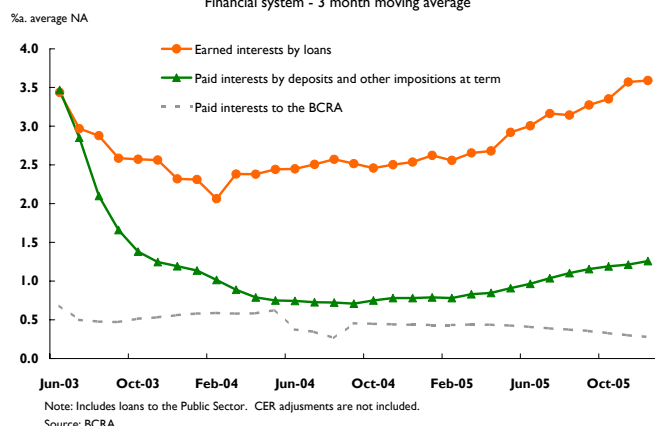


Chart V.5
Main Lines of Net Interest Income
Financial system - 3 month moving average



²³ Includes the currency operations of financial entities.

²⁴ In addition, extraordinary results were posted in financial assets. These stemmed, chiefly, from accounting revaluations of public debt securities held as collateral under the scheme known as *matching*.



Chart V.6

Interests and CER Adjustments

Financial system

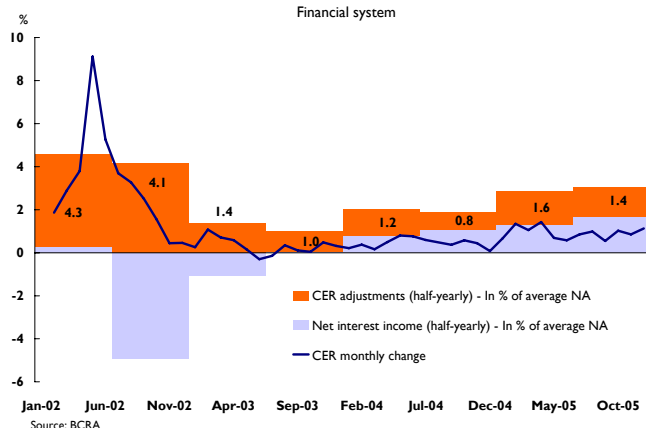


Chart V.7

Loans Loss Provisions

Financial system - 6-month moving average

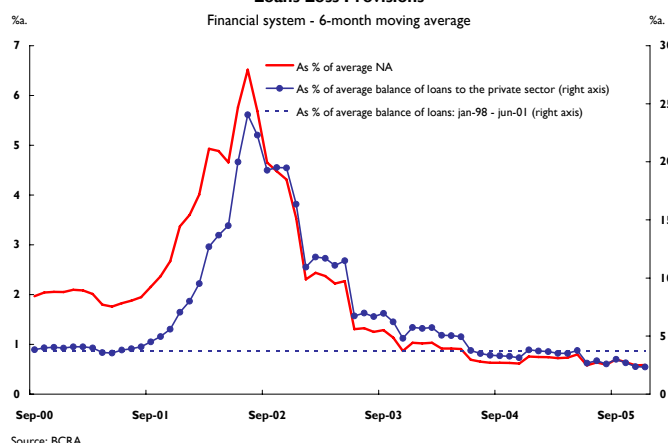
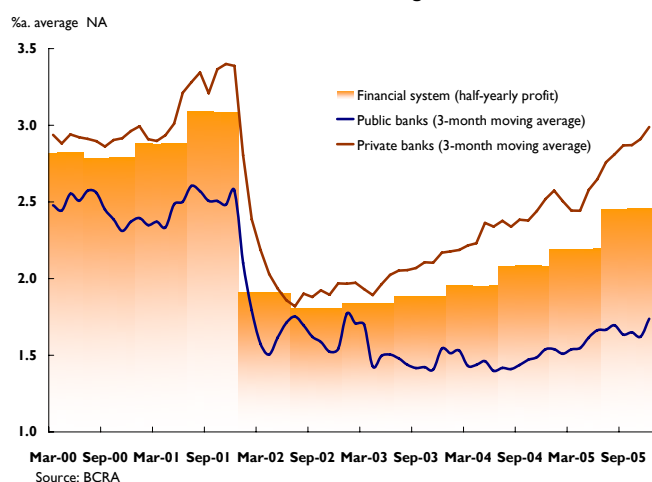


Chart V.8

Service Income Margin



fostered in part by the normative advancements set up by the BCRA. Given the enhancement of the prudential normative, this trend reflects the prudent credit strategy conducted by the banks and the favorable local macroeconomic background, with sustainable and sensible economic policies that have a positive effect on private credit risk. Additionally, loan loss provisions totaled 2.3%a. of the balance of outstanding loans to the private sector in the second half of 2005, 0.3 p.p. less than in the previous half, attaining in this manner a level that is lower than the average of the period immediately preceding the 2001-2002 crisis.

Net service income margin growth accelerates, whilst the increase in the costs of financial entities does not prevent efficiency levels from rising

The aggregate service income margin for the financial system grew 0.3 p.p. in the second half of the year, to reach a level of 2.5%a. of assets, confirming the pattern in place since mid-2002 and attaining levels close to those registered before the crisis. In similar fashion to the first part of the year, the expansion of this category was promoted particularly by private entities (see Chart V.8). Growing service income margin is associated to the greater dynamism in the sale of transactional products. Revenue linked to obligations, mainly maintenance and deposit accounts dealing fees still lead this expansion.

The ongoing adjustment process in the financial system structure, both in terms of employed personnel as well as compensation, reflected in growing operating costs during 2005. In this sense, the number of employees in the financial system payroll increased in the last months of the year (see Page 35), giving further support to a scenario of improving perspectives for the banking activity in the years to come. In this framework, in the second part of the year operating costs grew 0.6 p.p. with respect to the previous half, to total 4.9%a. of the financial system's aggregate assets.

Notwithstanding this latter expansion, efficiency improvements in the financial system were not overshadowed: the operating costs coverage was 158% in the second half of 2005, 16 p.p. and 35 p.p. higher than in the previous six-month period and the same period of 2004, respectively, and slightly above the pre-crisis levels (see Chart V.9). In addition, even when employee productivity is still below that of the latter years of the '90s decade, it portrays a gradually increasing trend (see Page 36).

Finally, both tax charges and the accrual of income tax exhibited a slight increase in the second part of the year (0.1 p.p. in each category), sticking to the moderately growing trend exhibited in previous periods. Besides, the categories linked to the gradual realization of the losses that stemmed from the crisis behaved unevenly: while court-ordered releases fell 0.1 p.p. in the second half of 2005, to 0.8%a. of assets, adjustments to the valuation of government securities were stable at 0.2%a.

Even when the growth of the financial system's profits is still lead by the official financial entities, privately-held banking



entities expand at a faster pace a more solid and recurring income-generating base, anchored in net interest income

Even as the profit spread with privately-held banks diminished, official financial institutions kept leading the generation of the financial system's profits in the second half of the year, as they obtained net benefits of \$750 million or 1.8%a. of assets (see Table V.2). The profitability of the subgroup of official entities reaches 2.8%a. if the effect of court-ordered releases and adjustments to the valuation of government securities are excluded. During the second part of the year, adjustments due to CER accrual declined slightly within the subgroup of publicly owned banks, but this heading still accounts for a significant share of their profits.

Moreover, the profitability of privately-held entities exhibits a significant upsurge in the second half of 2005: total net profits surpassed \$600 million (1%a. of assets), while a total in excess of \$1.3 billion (2.2%a.) is reached when the effects of court-ordered releases and adjustments to the valuation of government securities are excluded (see Table V.3). This improvement during the second half of 2005 was nurtured mainly by the enhancement in net interest income, which totaled 2%a. of assets. In addition, privately held banks achieved significant improvements in the profitability of their securities trading business, as well as growing profits from foreign exchange price adjustments and service income margin.

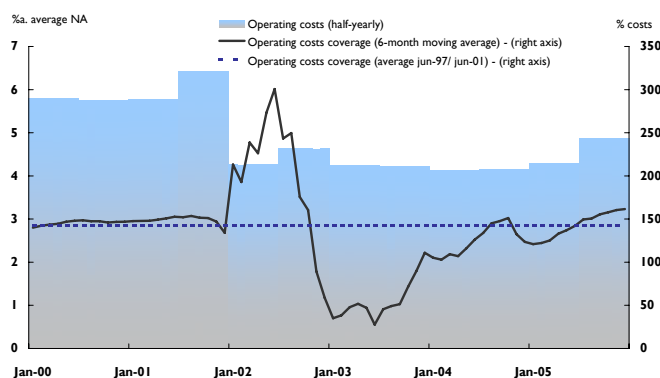
In the second half of 2005, the net profits obtained by different subgroups of privately held banks still exhibit a fairly high degree of variability (see Table V.4). Those retail privately-held entities with national coverage (cluster with the largest market share) were able to make up for the losses incurred in previous periods, obtaining a profitability of 0.2%a. of assets in the second part of the year. Furthermore, the income statements of privately-held banks with regional coverage maintained the pattern of recovery, obtaining a 3.8%a. profitability in the second half of 2005. Lastly, specialized banks are making profits that exceed by a long way those of the rest of the financial system, based on specific business niches defined both by type of client as well as for the operations they conduct.

It is forecast that in months to come financial intermediation will continue to intensify, promoting net interest income growth, growing profits from the trading of financial assets and an expansion in service income margin

As a function of the favorable progression of the financial system's profitability during 2005 (the second part of the year in particular), and given that the macroeconomic context keeps encouraging the advance of the banking activity, a consolidation in the financial system's profitability is forecast for 2006. Notwithstanding this favorable state of affairs, it is likely that a certain degree of volatility in some of the headings of the financial entities' income statement will persist, mainly due to the remaining balance sheet mismatches.

In particular, an expansion in the financial intermediation activity is expected to further support the strengthening of the financial margin. Additionally, the financial entities' growing

Chart V.9
Operating Costs and Efficiency
Financial system



Source: BCRA

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

	2003	2004	2005	II-04	I-05	II-05
Financial margin	-0.9	3.3	4.8	3.7	4.2	5.4
Net interest income	-1.7	0.5	0.9	0.6	0.8	1.0
Restatement by CER and CVS	1.8	1.4	2.2	1.2	2.3	2.2
Gain on securities	0.1	1.3	1.3	1.5	1.2	1.5
Foreign exchange price adjustments	-0.7	0.2	0.2	0.3	-0.2	0.6
Other financial income	-0.4	-0.1	0.1	0.0	0.1	0.1
Service income margin	1.5	1.5	1.6	1.5	1.6	1.7
Operating costs	-3.4	-3.2	-3.5	-3.2	-3.3	-3.7
Loans loss provisions	-0.9	-0.6	-0.5	-0.8	-0.5	-0.5
Adjustments to the valuation of government securities (*)	-0.1	-0.4	-0.2	-0.3	-0.2	-0.2
Tax charges	-0.1	-0.2	-0.3	-0.3	-0.2	-0.3
Amortization payments for court-ordered releases	-0.5	-0.7	-0.9	-0.7	-0.9	-0.8
Other	0.7	0.7	0.6	1.0	0.7	0.5
Monetary results	0.1	0.0	0.0	0.0	0.0	0.0
Income tax	0.0	-0.1	-0.3	-0.1	-0.4	-0.3
ROA	-3.5	0.3	1.3	0.9	0.9	1.8
ROE	-31.8	3.9	12.5	10.2	8.2	16.6
Adjusted ROA (**)	-3.0	1.4	2.4	1.8	2.0	2.8

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

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

Source: BCRA



Table V.3

Profitability Structure: Private Banks
In annualized terms - As % of average netted assets

	2003	2004	2005	II-04	I-05	II-05
Financial margin	2.3	2.9	4.3	2.5	3.6	5.0
Net interest income	0.1	1.0	1.7	1.2	1.4	2.0
Restatement by CER and CVS	0.9	0.8	1.0	0.6	1.1	0.8
Gain on securities	1.7	0.8	1.0	0.8	0.7	1.3
Foreign exchange price adjustments	-0.3	0.6	0.5	0.2	0.2	0.7
Other financial income	-0.2	-0.3	0.1	-0.3	0.1	0.1
Service income margin	2.0	2.4	2.7	2.5	2.5	2.9
Operating costs	-4.6	-4.6	-5.1	-4.7	-4.8	-5.5
Loans loss provisions	-1.3	-0.9	-0.6	-0.9	-0.6	-0.6
Adjustments to the valuation of government securities (*)	-0.6	0.0	-0.2	0.1	-0.1	-0.2
Tax charges	-0.3	-0.3	-0.4	-0.3	-0.4	-0.5
Amortization payments for court-ordered releases	-0.7	-1.0	-1.0	-1.0	-1.0	-0.9
Other	1.0	0.7	0.9	0.8	0.8	1.0
Monetary results	0.0	0.0	0.0	0.0	0.0	0.0
Income tax	-0.3	-0.2	-0.2	0.1	-0.1	-0.2
ROA	-2.5	-1.0	0.5	-1.1	0.0	1.0
ROE	-19.1	-8.1	4.1	-9.2	0.4	7.6
Adjusted ROA (**)	-1.2	0.2	1.6	-0.1	1.1	2.2

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

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

securities trading activity, in a context of better perspectives for deeper capital markets, will consolidate as an additional source of income for the banks.

Moreover, as the number and size of economic transactions performed through the banking sector keep growing, it is expected that the financial entities' service income margin source base will continue to expand. In this manner, the main sources of revenue for the banking system are expected to strengthen. These favorable developments should permit the expansion of their ability to face eventual adjustments in their funding costs and/or a possible restitution of their operating costs.

Additionally, it is estimated that the decreasing trend exhibited by the loan loss provisions will persist, supported by an ongoing context of credit risk reduction, alongside with significant improvements in the credit quality of the loan portfolios held by the banks (see Page 48). Also, the adequate degree of provisioning maintained by the financial system will constitute a counter-cyclical factor that will tend to temper the balance sheet effects of the realization of expected future losses.

Finally, a certain reduction in the losses stemming from the amortization of court-ordered releases is foreseen in 2006, in the context of the normative recently introduced by the BCRA, which allows their deferral to those financial institutions that provide long term loans²⁵.

V.2. Capital position

The ongoing process of capitalization of the banks in the post-crisis period, together with the enhancement in terms of profitability, is consolidating the strength of the financial system

Table V.4

Profitability Structure by Type of Bank - Second Half 2005
In annualized terms - As % of average netted assets

	Private				
	Retail				Wholesale
	Total	National coverage	Regional coverage	Specialized	
Financial margin	4.8	4.1	6.4	18.0	8.4
Net interest income	2.0	1.8	2.0	14.8	1.5
Restatement by CER and CVS	0.9	0.9	1.1	-0.5	-0.2
Gain on securities	1.2	0.7	2.7	2.3	4.2
Foreign exchange price adjustments	0.6	0.6	0.5	1.6	2.6
Other financial income	0.1	0.1	0.1	-0.2	0.4
Service income margin	3.0	2.9	3.1	3.2	2.2
Operating costs	-5.4	-5.0	-6.1	-15.0	-7.9
Loans loss provisions	-0.6	-0.6	-0.5	-3.1	-0.6
Adjustments to the valuation of government securities (*)	-0.2	-0.3	0.0	0.0	0.0
Tax charges	-0.5	-0.5	-0.5	-0.9	-0.4
Amortization payments for court-ordered releases	-1.0	-1.2	-0.2	-0.4	0.0
Other	1.1	0.7	2.4	3.7	-0.7
Monetary results	0.0	0.0	0.0	0.0	0.0
Income tax	-0.2	0.0	-0.6	-0.7	-1.1
ROA	1.1	0.2	3.8	4.8	-0.2
ROE	8.5	1.5	24.8	16.0	-0.7
Adjusted ROA (**)	2.3	1.7	4.1	5.2	-0.1
Weight in total assets (%)	56.7	43.0	13.0	0.7	2.7

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

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

Source: BCRA

The financial system's solvency improved significantly during the second half of 2005, reflecting both the larger profits obtained as well as the additional capital contributions carried out by the financial entities. Under a macroeconomic framework of sustained growth that promotes auspicious perspectives for the banking activity in forthcoming periods, in the second half of 2005 the financial system has channeled additional capital contributions totaling roughly \$1.15 billion (see Chart V.10). In this way, capital contributions to the financial system accumulated over the period starting in January 2002 and ending in December 2005 amount to close to \$12.56 billion, which is equivalent to almost two thirds of the net worth at the beginning of the period. With regards to the coming months, and considering the improved perspective for the sector, a minimum of about \$180 million in capital contributions is foreseen.

In the same fashion as in previous periods, foreign-controlled banks account for more than two thirds of the total capital contributions that took place in the second half of 2005. Likewise, shareholders of a group of national private financial entities executed capital integrations, while additional injections

²⁵ Communication "A" 4439.



Chart V.10
Capital Contributions
2002-2005

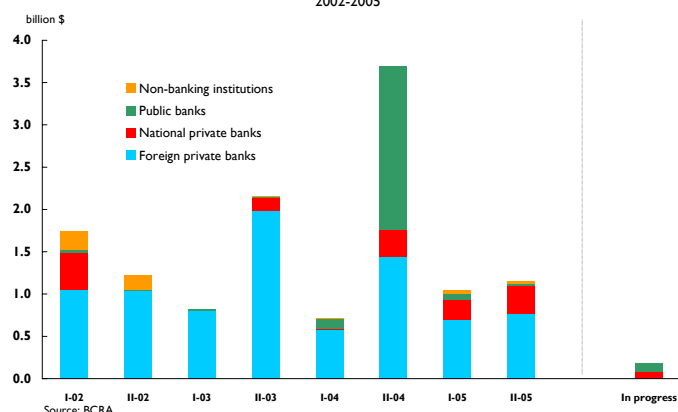


Chart V.11
Consolidated Financial System Leverage

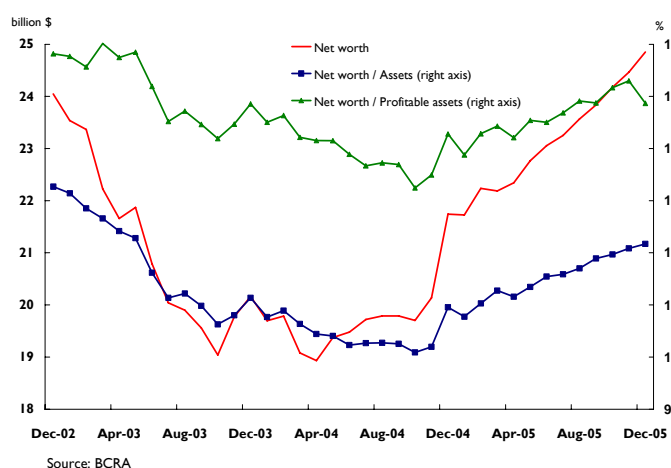
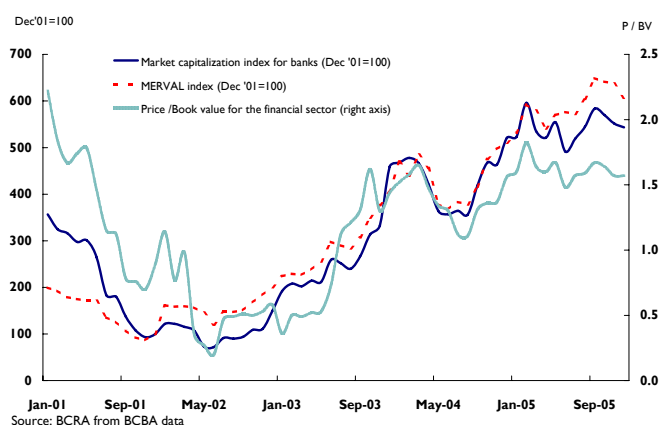


Chart V.12
Market Capitalization Index for Financial Institution



of resources to public banks were limited²⁶ in the period. In the case of privately held banks, some of those capital contributions were performed as part of strategies to adjust their exposure to the public sector (both in terms of volume and valuation), improving, in this manner, their business perspectives.

In the second half of 2005 the aggregate net worth of the financial system grew 7.8%, and 14% in the year, as a consequence of the profits obtained and the capital contributions carried out. In this regard, the ratio of net worth to total assets increased 0.7 p.p. in the second half of the year, attaining a level close to 12.2% as of December of 2005 (see Chart V.11).

The overall trend of the main market indicators for the financial system was in line with the above-mentioned trend. Even when they still exhibit considerable volatility, in correlation with the overall movements in the stock market, the prices of the banking shares evolved favorably in the second half of the year (see Chart V.12).

The solvency of the banking sector remains on a growing path, in a framework of overall observance of current capital requirements normative

The financial system keeps abiding steadily by the prudential minimum capital requirements²⁷. In line with the pattern observed since the past crisis, the level of capital compliance by the financial institutions posted an increase of 0.9 p.p. over the six-month period, to attain a level equivalent to 15.3% of risk-adjusted assets. In this way, the financial system surpasses considerably the local capital requirements and the minimum levels recommended internationally.

Nevertheless, even when a certain degree of heterogeneity is present in the solvency ratios among the different groups of banks, each of them exhibits adequate levels of solvency. The latter is true both in terms of the ratio of capital compliance to risk-adjusted assets as well as in terms of the fulfillment of the capital requirements established by local normative (see Table V.5).

It is expected that the financial system's solvency will continue to improve in 2006, meeting easily the terms of the minimum capital requirement normative

A good deal of the surplus capital in excess of the total requirements is consistent with a prudent behavior of the sector, in the face of the fulfillment of the arrangement of gradual balance sheet adjustment set forth by the BCRA, in the framework of the past crisis. These measures extended to public sector asset valuation standards and the regulation of minimum capital. With regard to the latter, a schedule for the temporary adjustment of requirements to allow for public sector credit risk and interest rate risk was introduced. The current capital levels maintained by the banks are by far in excess of the scheduled requirements for 2006.

²⁶ In some cases within the framework of capital integrations by installments.

²⁷ For more detail, refer to FSB I-04.



Table V.5
Minimum Capital by Group of Banks
 December 2005 - In %

Group of Banks	Surplus capital / Capital requirements (*)	Capital / Assets at risk (**)
Public banks	212	10
Private banks	156	18
National coverage	136	16
Regional coverage	184	22
Specialized	266	33
Wholesale	287	39
Non-bank institutions	401	47
Total	174	15

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

(**) Assets weighted by credit risk

Source: BCRA

Given the steady growth in the credit to the private sector in the year 2005 and the further expansion in this sector projected for the coming year, financial institutions are encouraged to restore their capital in order to take active part in this process. Similarly to what happened in 2005, the consolidation of growth in the credit market will boost the banks' profits, providing further support to the strength of the financial system.



BALANCE OF RISKS

During 2005 recovery by the financial system accelerated, and some of the main problems left behind by the crisis were resolved. This, added to the healthy growth by financial intermediation and a steady improvement in solvency levels, resulted in **an overall improvement in the financial system balance of risks.** This fact, together with the continuous monitoring and supervision of banks by the Central Bank, provides a favorable basis for the development of the sector in 2006.

In 2005, and particularly in the second half, **the strength of the financial system in the face of the risk of lending to the public sector improved significantly.** A sharp reduction in exposure and the Government's improved payment capacity were jointly responsible for this development. Such behavior was driven by the activities of the financial institutions, the incentive policies introduced by the Central Bank, and the financial policy measures adopted by the Government.

In turn, although financial institutions considerably increased their exposure to private sector credit risk, the consolidation of payment capacity in the case of both companies and families, together with an appropriate level of diversification, have helped to establish **an increase in the strength of the financial system in the face of private sector counterpart risk.** The steady rise in output, growing levels of employment and low private sector indebtedness explain this financial strength. During 2006 an increase in investment will be essential for the continuation of sustained economic growth, a basic component of financial stability. **It is expected that financial institutions will continue to apply prudent policies when granting credit. The quality of such policies will define the future exposure of the sector to the risk from lending to the private sector.**

At present **the financial system is adequately protected against the threat of liquidity shocks.** As a consequence of a deepening in the offer of financial services, banks adjusted the level of their holdings of liquid assets, so that their portfolios are at normal levels by both historical and international standards. In addition, the strength of the banking system in the face of liquidity risk relies increasingly on market instruments. The development of capital markets, inter-bank markets and the Central Bank repo market are an example of this. Lastly, the power of the

Central Bank to act as a lender of last resort completes the essential pillars on which the strength of the banking system in the face of liquidity risk is supported.

The recovery by the financial system has taken place in a context in which there have been **moderate gains in the reduction of exposure to real interest rate risk.** Incipient improvements have come from increased capital, any reduction in the size of the mismatching because of the CER indexation remaining as a task for the medium term. Nevertheless, this performance has been closely associated with the early settlement of Central Bank rediscounts (adjusted on the basis of CER) that had been granted during the recent crisis. However, **there is a low probability of any scenario in which this risk might impact on the solvency of the financial system in 2006.**

This evaluation of the overall financial system risk balance **assumes the existence of scenarios that are consistent with the macroeconomic policies being applied.** The definitive recovery of the financial system will therefore be in line with current responsible fiscal policy and a transparent monetary policy that is consistent with economic development.

For the first time in the post-crisis period, the financial system has posted profits for the year. This has been a result of the recovery of financial intermediation in an environment in which risk has been limited. Positive returns added to the capitalization process that has taken place have rebuilt the net worth situation of financial institutions. As a consequence, **banks have further reinforced their position in the face of any potential need to bear the cost of the materialization of the risks assumed.**

In 2006, it is considered that the financial system will continue its recovery and the deepening of financial activity, in a context of sound risk management policies. This will be essential for the medium term, when the probability will increase that the risks assumed might begin to arise, and when the opportunities for market growth will be marginally more risky. **In such a scenario, the Central Bank will continue with its financial sector monitoring tasks, promoting the conditions that will lead to financial stability.**



ABBREVIATIONS AND ACRONYMS

\$: Argentine pesos.

%a.: annualized porcentaje.

a.: annualized.

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

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

APR: Annual Percentage Rate.

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

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

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

BIS: Bank of International Settlements.

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.

BOVESPA: São Paulo Stock Exchange.

b.p.: basis points.

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

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

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

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

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

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

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

CPI: Consumer Price Index.

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

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

DGF: Deposit Guarantee Fund.

EB: Executive Branch.

EMBI: Emerging Markets Bond Index.

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

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.

ICs: Insurance Companies.

IDCCB: *Impuesto a los Débitos y Créditos en Cuentas Bancarias.* Tax on Current Account Debits and Credits.

IFI: International Financial Institutions: IMF, IADB and WB.

IFS: International Financial Statistics.

IMF: International Monetary Fund.

INDEC: *Instituto Nacional de Estadísticas y Censos.* National Institute of Statistics and Censuses.

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

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

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

IRR: Internal Rate of Return.

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

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

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

LIBOR: London Interbank Offered Rate.

MAE: *Mercado Abierto Electrónico.* Electronic over-the-counter market.

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.

MC: Minimum cash.

MFs: Mutual Investment Funds.

MR: Market rate.

MEP: *Medio Electrónico de Pagos*. Electronic Means of Payment.

MERCOSUR: *Mercado Común del Sur*. Southern Common Market.

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

MEXBOL: *Índice de la Bolsa Mexicana de Valores*. México Stock Exchange Index.

MF: Mutual Funds.

MOI: *Manufacturas de Origen Industrial*. Manufactures of Industrial Origin.

MOA: *Manufacturas de Origen Agropecuario*. Manufactures of Agricultural Origin.

MIPyME: *Micro, Pequeñas y Medianas Empresas*. Micro, Small and Medium Sized Enterprises.

MRO: *Main refinancing operations*.

NA: Netted assets.

NACHA: National Automated Clearinghouse Association.

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.

NPS: National Payments System.

NW: Net worth.

NBFI: Non-Bank Financial Intermediaries.

NFPS: Non-financial national public sector's.

OCT: *Operaciones Compensadas a Término*. Futures Settlement Round.

OECD: Organization for Economic Co-operation and Development.

ON: *Obligaciones Negociables*. Corporate bonds.

OS: *Obligaciones Subordinadas*. Subordinated debt.

O/N: Overnight rate.

P / BV: Price over book value.

p.p.: Percentage Point.

PGN: *Préstamos Garantizados Nacionales*. National Guaranteed Loans.

PFs: Pension Funds.

PS: Price Stability.

PV: Par Value.

q.o.q: quarter-on-quarter % change.

REM: BCRA Market expectation survey.

MAS: Mutual Assurance Societies.

ROA: Return on Assets.

ROE: Return on Equity.

Rofex: Rosario Futures Exchange.

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

RTGS: Real-Time Gross Settlement.

s.a.: Seasonally adjusted.

SAFJP: *Superintendencia de Administradoras de Fondos de Jubilaciones y Pensiones*. Superintendency of Retirement and Pension Funds Administrations.

SAGPyA: *Secretaría de Agricultura, Ganadería, Pesca y Alimentos*. Secretariat for agriculture, livestock, fisheries, and food.

SEDESA: *Seguro de Depósitos Sociedad Anónima*.

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.

SSN: *Superintendencia de Seguros de la Nación*.

TD: Time Deposits.

UFC: Uniform Federal Clearing.

UIC: Use of Installed Capacity.

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.



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