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C1003ABF. Tel.: 4348-3500
www.bcra.gov.ar

 Please address comments or enquiries to:
analisis.financiero@bcra.gov.ar

Preface

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

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

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

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

*The Central Bank publishes the **Financial Stability Bulletin** with that aim in mind, presenting an overall assessment of developments regarding financial system stability. The report merges the Central Bank's different sources of information on the subject into a single publication. Between each half-yearly issue of the **FSB**, the Central Bank releases a monthly Report on Banks to keep the public up to date on the most recent developments in the financial system. These two reports are the main channels by which the Central Bank communicates its outlook on the financial system.*

*The **Financial Stability Bulletin** can be approached in two different manners, depending on the depth of detail desired by the reader. Reading the Central Bank Outlook, the Balance of Risks and the summary for each chapter will provide the reader with the core of the analysis contained in the Bulletin. Naturally, a full reading of the report provides an in-depth assessment of each of the topics dealt with, and will be further enriched by the analysis of the topics covered in the Boxes.*

This issue of the FSB outlines a short-term outlook for the financial system based on developments during the first half of 2004. The following pages focus on the strengthening of normalization in the financial system, basically through the recovery of credit, which is the pillar that will allow a rebuilding of the financial intermediation business. This process, in a context of prudent risk management policy, will produce an improvement in financial system solvency and will contribute to long term economic growth.

*The next issue of the **FSB,** corresponding to the first half of 2005, will be published on the Central Bank website in the last week of March 2005, based on a statistical cut-off at the end of 2004.*

Buenos Aires, October 6, 2004

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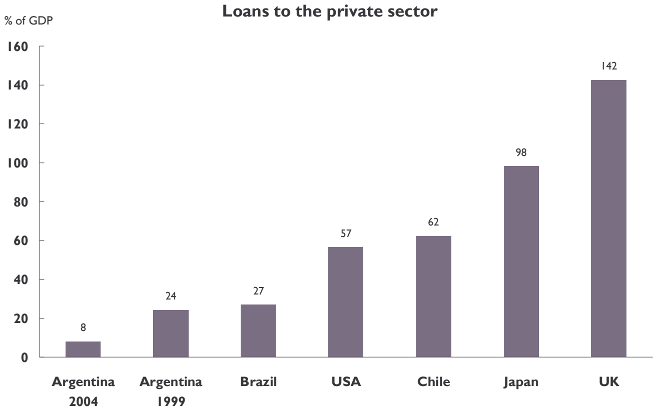
CENTRAL BANK OUTLOOK

During the first half of 2004, the financial system built on the gains achieved during the previous year, making moderate advances along the process of rebuilding financial intermediation. Although the rise in system liquidity has come to a halt, it remained at a relatively high 22% of deposits. Following a period of deep and widespread losses, the banking sector started to show a substantial turn around in results, and towards the second quarter reached profitability of 0.8%a. of assets. In the context of improved profitability, the capitalization process seen over recent quarters helped improve solvency in the sector, and net worth grew by 5% in the second quarter of 2004. So far this year, loans to the private sector have displayed a first attempt at recovery, particularly in the second quarter in which they grew at a rate of 35%a..

The financial system is undergoing a key stage in recovering the fundamental role that it must play in the economy. In 2003 the Central Bank managed to stabilize the financial system through a comprehensive regulation reform, in the context of a favorable macroeconomic environment. This stage – accomplished with relative success given the severe restrictions in terms of available resources and instruments – featured the return of depositors, the recovery in liquidity and lower uncertainty regarding balance sheets. The challenge over the coming periods must be focused on the complete recovery of the financial system's most important function: to take in the population's savings and transform them into the credit needed to finance investment in the private sector. To fulfill this objective it is essential that a short-term benchmark rate be established – to act as a pivot for the interest rate structure and reveal the stance of monetary policy – and this in turn requires a development of the repo market (both repos with the Central Bank and among financial institutions). This should go hand in hand with a greater role for banking activity in the economy – a process referred to in this report as bank use – and a recovery in the business side of financial intermediation. This aim sounds ambitious in terms of the recent, crisis-ridden past and bearing in mind the significant constraints still in place, but its achievement is absolutely necessary towards meeting the just claim for a sustained growth of our economy.

Chart 1
Loans to the private sector



After five years in which there was an extensive destruction of credit, loans to the private sector started to show a positive trend as from the last quarter of 2003. Although this development is encouraging, it must be put in perspective regarding the limited contribution of the financial system to the Argentine economy in channeling resources for production and consumption. Loans to the private sector currently stand slightly below 8% of GDP, compared to 22% six years ago. It is therefore clear that the growth in lending to corporations and households must recover strongly in coming quarters, so as to bolster the financial system's solvency (a necessary condition towards improving depositors' confidence) and to contribute to the development of our economy through further financing for investment and consumption.

To encourage growth in healthy credit by the financial system, the Central Bank has been putting in place a set of measures. Given the high value that the monetary authority places on this issue, work in this direction will continue. The Central Bank aims to establish growth in short term lending, and encourage the reappearance of long term credit. Additionally, diversification in financial institutions' portfolios will be promoted, driving a sustained growth in credit that does not put financial system solvency at risk. The development of new financial products will be key in attaining this objective. There will be strong pressure in favor of debtor assessment mechanisms that focus on future prospects instead of past performance, helping SMEs to enter the formal chain of credit and facilitating the refinancing of loans.

The Central Bank recognizes that a take off in long term credit crucially requires rebuilding a more adequate funding structure. In view of this, the first task is to promote the lengthening of maturities – not only on deposits, but also by encouraging other mechanisms such as indexed bonds, securitization of assets, term deposits with a floating interest rate and the deepening of the secondary market for term deposits. In second place, the Central Bank will promote bank use, attending to the need to correct extreme regional imbalances in the supply of bank services. Bank activity is currently at a very low level in international terms. Although the domestic crisis played a very important part in this outcome, the so-called "check tax" (the tax on bank account credits and debits) was a deathblow, by increasing transactions outside the formal system and therefore turning people away from banks. Finally, the Central Bank sets these goals seeking to find market solutions, taking unto itself the role of paving the road for credit through a simple and transparent regulatory framework.

Chart 2
Use of bank services
Sight deposit accounts per person

Source: BIS and BCRA

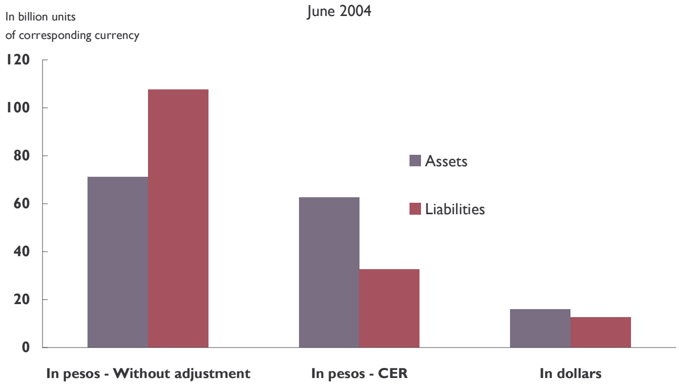
The path of sustained growth for private sector lending will additionally require a proactive behavior by financial institutions, applying a prudential approach to risk management. The outlook for potential demand is encouraging. In recent times, the repayment capacity of corporations and households has moved towards strongly reducing implicit counterparty risks, favoring the risk-return trade-off faced by the financial system in the business of intermediation, and outlining a large room for potential growth in private credit.

Regarding the performance of financial system solvency, a set of measures adopted by the Central Bank are creating the conditions that will prompt shareholders to provide a significant commitment to capitalization, some of which has already been carried out. As of June 2004, a relatively important share of the capitalization flow is still underway, mostly from official banks. Capitalization that has already taken place should be considered a clear sign of confidence in the outlook for the financial intermediation business. Other signs include the positive trend in the main market indicators, and upgrades to the credit ratings of several securities issued by financial institutions.

Despite the progress made so far, the financial system faces a set of weaknesses in the second stage of rebuilding intermediation. These weaknesses do not suggest a delicate condition of system fragility, but do require effective supervision and in some cases a prompt solution.

The high degree of exposure to credit risk from the consolidated public sector is perhaps one of the weakest points of the financial system, with an effect on its solvency and imposing strong limitations both to an improvement in profitability and to the taking of risks that are inherent to the intermediation business. Although the financial system's exposure to currently non-performing public debt is relatively reduced, the restructuring process being led by the national government is a key factor, both due to its effect on macroeconomic conditions and its direct consequences on financial system balance sheets and liquidity. As regulated by the Central Bank, the gradual convergence toward marking to market for public sector assets will tend to reduce this source of balance sheet uncertainty.

Chart 3
Currency mismatch
June 2004



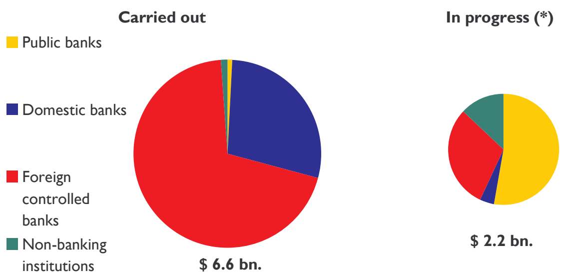
Source: BCRA

Another aspect in which the financial system continues to show a certain degree of vulnerability is that of balance sheet mismatches. Some of these asymmetries are part of the nature of the financial intermediation business, but the current weakness arises from the amplification of certain mismatches and the appearance of others following the crisis in 2001-2002. The financial system currently has significant interest rate, currency and term mismatches, giving rise to a relatively high net worth exposure to changes in context variables. This is compounded by the lack of adequate hedging mechanisms through which to lessen the mismatches, which naturally reduces financial institutions' willingness to take new risks. Financial institutions are starting to reduce some of these mismatches by taking CER-indexed time deposits. The Central Bank believes that it must promote and support current developments, with the aim of deepening hedge markets and thus enable an improved management of bank risks.

With the aim of promoting efficiency and equity in the financial system and the economy in general, it is essential that current and potential users of bank services be provided with reliable and easily-accessible information so that they can compare products across institutions. The Central Bank's new Transparency Regime (*Régimen Informativo de Transparencia*) was developed for this purpose. There is still a lot to be done, however, particularly by financial institutions themselves. This will help create a greater level of user confidence, encouraging bank use, which is an absolutely necessary step for the fledgling re-intermediation process to take hold.

Credit unions (*Cajas de crédito*) – which will be brought into existence by a law recently passed by Congress – have the potential effect of enlarging the number of suppliers of financial services. Accordingly, the Central Bank has created a special regulation framework for these to operate under. Given the features with which these types of intermediaries have been designed, it is hoped that credit unions will more adequately channel the financial needs for part of the population which for several reasons is outside the formal network of financial intermediation. The creation of this type of institutions – within the framework of adequate prudential policy – seeks to fulfill two objectives: to broaden the supply of financial services available to the population by covering regional needs, and to

Chart 4
Capital contributions



As of August 2004
(*) Includes partially settled contributions to be paid in installments.
Source: BCRA

encourage greater financial stability by tackling informality in the intermediation process.

Within its mandate, the Central Bank will continue to work jointly with financial institutions and other sectors involved to deal with unresolved issues in an efficient way. The strengthening of the financial system will require, from here onwards, a reinforcement of supervision policy and a deepening of the competition framework while balancing this with regulation policy, and finding a definite solution to the problems that arose as a consequence of the methods used to deal with the crisis. The Central Bank will also continue to promote the capitalization of financial institutions, fostering the process that began at the end of 2002 and has so far involved a total of $6.6 billion (32% of initial net worth). Fully aware of the links between price stability and financial stability, the Central Bank will keep to its policy of attaining low and stable inflation expectations, compatible with the sustained growth of our economy.

I. Macroeconomic context

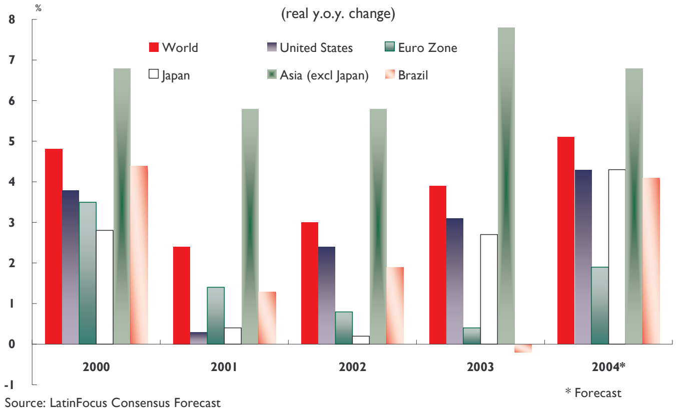
Summary

Current conditions remain favorable to the development of financial intermediation. The international conditions faced by emerging markets continue to be of significant global growth, low inflation, favorable terms of trade and high levels of liquidity, all of which are beneficial to financial development. Developed countries are expected to gradually adjust their monetary policies in view of an acceleration in growth, and added to the improvement in emerging market fundamentals the most likely scenario is one of incentives towards the net inflow of capital to developing countries. Additionally, the favorable growth prospects of the Brazilian economy set the conditions for relative regional stability that will have positive repercussions on the domestic financial system. The main short term risk is a faster than anticipated correction to the path of interest rates in developed countries.

In the first half of 2004, the real domestic economy displayed the same overall growth trend than in the previous year. The inflation rate was low, although slightly higher than in previous months due to already anticipated adjustments to relative prices. There was, however, a break in trend in the second quarter, but this was due in large part to temporary circumstances. After the stage of economic recovery following the deep crisis in 2001 and 2002, output growth rates are expected to converge on values more consistent with long term growth. As a large part of the recovery in the domestic financial system can be attributed to the sound performance of the domestic economy, as these trends become established there should be a positive outlook for recovery in the conditions for financial stability.

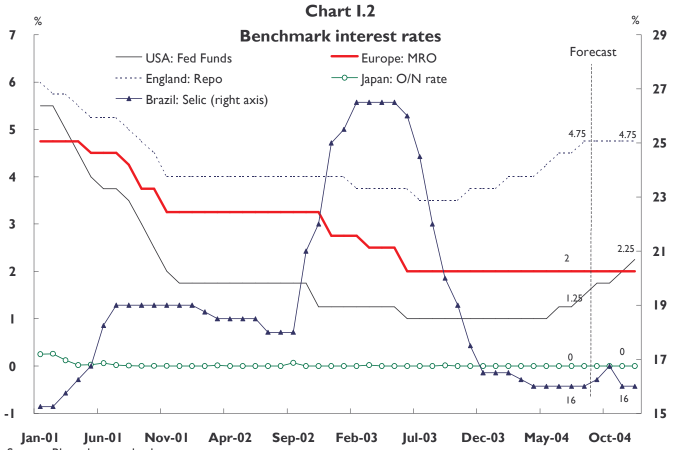
The circumstances that temporarily stalled growth during the second quarter are expected to abate in the second half of the year, so that increases both in consumption and investment are expected. For the financial system, this is expected to occur alongside an increase in intermediation and solid growth in private credit, improving profits and, as a result, solvency.

Chart I.1
Gross domestic product
(real y.o.y. change)



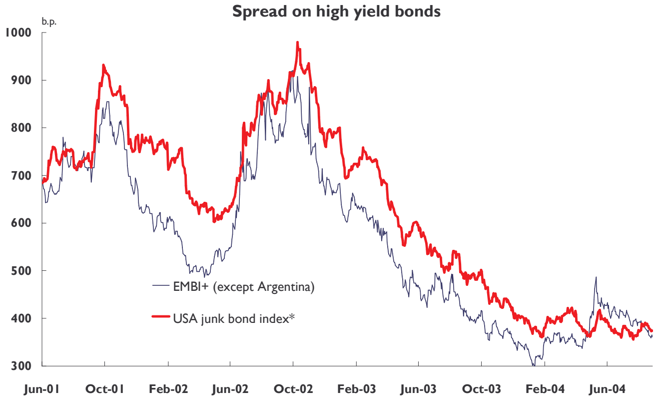
Source: LatinFocus Consensus Forecast

Chart I.2
Benchmark interest rates



Source: Bloomberg and others

Chart I.3
Spread on high yield bonds



* Spread between top rated (AAA) and high risk (Master) corporate bonds
Source: BCRA from Bloomberg data

I.1. Introduction

Our financial system operates in a context influenced both by the international economy and the real side of the domestic economy. It interacts with this setting by adjusting its exposure to the different risks that are inherent to the business. Changes in the context can affect its balance of risks, and in certain cases threaten stability. It is therefore important that any analysis of the financial system – such as that of the FSB – pay attention to the surrounding context.

An analysis of the international context should focus on general liquidity conditions (which influence the volatility of secondary markets, and the cost and availability of sources for financing and capitalization for the financial system) and on the developments regarding economic activity at the global scale – which influences the volume of international trade, and consequently the real side of the domestic economy. Links to the international context (the financial channel) in the Argentine financial system are currently weakened. Given the distinct set up of financial sector risks in Argentina, domestic macroeconomic conditions are relatively more important to the development of the intermediation business. Sector-by-sector financial positions, developments to money and exchange markets and the liquidity and volatility of the domestic capital market are the key components in the macroeconomic conditions affecting the domestic financial system.

I.2. International conditions

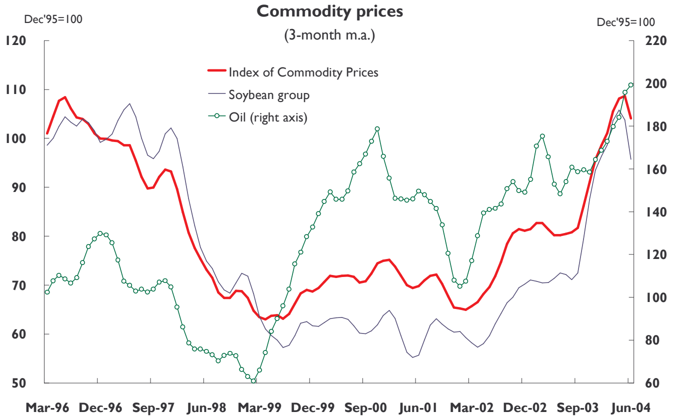
International conditions remain favorable to financial intermediation at a world-wide scale, but particularly in emerging markets due to considerable rates of global growth, low inflation, favorable terms of trade and high liquidity levels. Identifiable risks to international financial conditions are relatively reduced over the short term. From Argentina's perspective, the main risks lie in the future path of international interest rates and the performance of the Brazilian economy.

The strong growth in the global economy over the first months of the year, as well as an increase in inflation rates, is leading some developed countries to raise their benchmark interest rates (see Charts I.1 and I.2). A gradual approach to this rise is expected to prevail. The probability that the adjustment to interest rates could occur faster than expected – which is the main threat arising from the international setting – is low. If this were to occur, external financing to emerging markets could be disturbed, with direct consequences on interest rates and exchange rates.

The United States economy grew strongly in the first half of 2004, and its gross domestic product (GDP) is expected to grow by 4% in 2004. In this setting, the Federal Open Market Committee (FOMC) began in June to carry out an already anticipated process to gradually increase the Fed Funds rate, which would be raised by an additional 25 basis points on each of the subsequent meetings[1], to come to more than 2% at the end of the year.

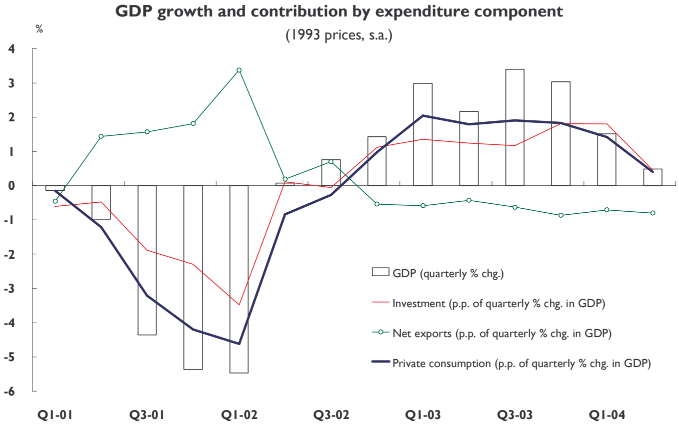
[1] On the date of publishing this edition of the FSB, the FOMC decided a 25 basis point increase to the benchmark Fed Funds rate.

Chart I.4
Commodity prices
(3-month m.a.)



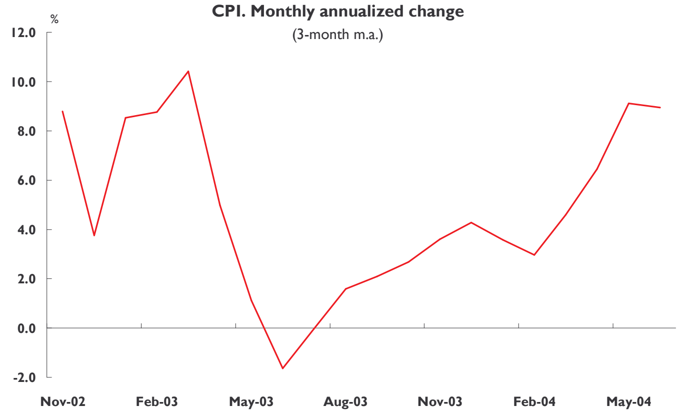
Source: BCRA from World Bank and INDEC data

Chart I.5
GDP growth and contribution by expenditure component
(1993 prices, s.a.)



Source: BCRA from INDEC data

Chart I.6
CPI. Monthly annualized change
(3-month m.a.)



Source: INDEC

The initial prospect of an increase to international interest rates caused the markets to overshoot in the first quarter of 2004, and as a result investors turned away from emerging market sovereign debt securities (see Chart I.3). The subsequent improvement in developing country fundamentals, added to the correction to interest rate adjustment expectations, produced an increase in capital flows towards emerging economies in 2004.

Commodity prices remained relatively stable during the first half of the year. Despite expectations for them to decrease moderately over the next three months, the general price level for these goods is set to remain above the average for the past years (see Chart I.4). The Central Bank's index of commodity prices reached a record high in March, and although it subsequently declined – mainly due to the performance of soy and its derivatives – it is still more than 10% above the value for 2003. The pace of growth in the world economy – and particularly China – is sustaining the demand for commodities, which helps produce a favorable setting for the local agricultural sector and has a positive influence on its financial conditions.

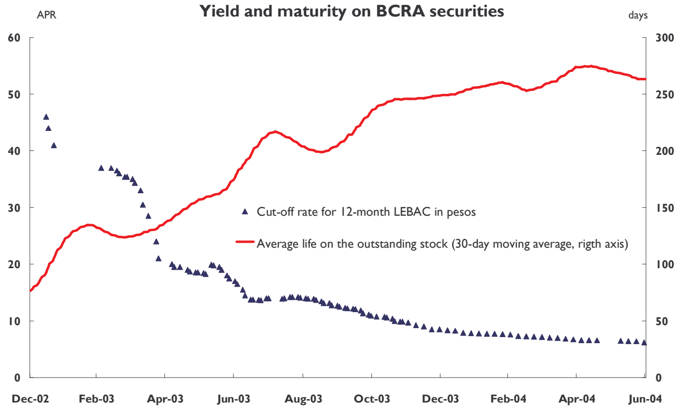
The domestic financial position is also exposed, through an indirect channel, to risk from Brazil. Trade links create the possibility of a certain contagion effect on the domestic economy and financial system by affecting, for instance, the financial position of some export sectors. Brazilian economic growth accelerated in the first half of 2004, led by the external sector – Brazil's exports increased by more than 30% year-on-year (y.o.y.). Imports also climbed significantly, favoring the Argentine economy. Economic activity in the neighboring country is expected to remain strong, and its GDP is expected to rise by around 4.5% in 2004, reducing the effect of risk from Brazil on the domestic financial system.

I.3. Domestic conditions

During 2003 and 2004, the improvement in domestic macroeconomic conditions was the main engine behind the recovery in the domestic financial system. The first half of the year featured considerable growth in economic activity, in a setting of price stability consistent with responsible management of monetary and fiscal policies. GDP expanded at a rate of 9% y.o.y., while retail prices increased by 4.9% y.o.y.. This economic performance, however, is an average of different behavior between quarters. In the second quarter there was a gradient change in the paths followed by the main economic variables. The rate of output growth recorded a significant deceleration, although it still remained positive, as in the previous nine quarters (see Chart I.5). Retail prices, as measured by the consumer price index (CPI), increased at a higher rate than in the recent past, as part of an anticipated process of relative price adjustment (see Chart I.6).

Although the deceleration in economic activity was more sudden than expected, the behavior was mostly linked to factors that are set to improve over the short term. Among these temporary conditions, the most relevant were: a higher tax burden due to the concentration of deadlines (with an effect on working capital) and the fear that constraints to the energy supply would come

Chart I.7
Yield and maturity on BCRA securities



Source: BCRA

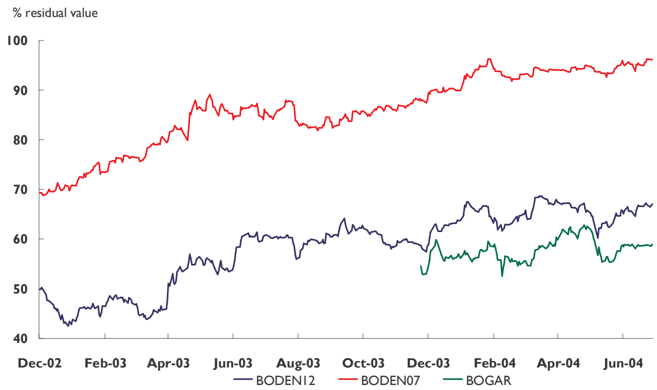
into effect (producing a shifting forward of production into the first quarter).

On the side of expenditure, some indicators show a significant downshift in consumption and investment. The first is basically due to the stagnation in real wages. The second is partly due to delays in certain investment projects.

The deceleration in the rate of economic growth did not translate into a lower rate of job creation. In the formal sector, the economy created employment at a rate of 1.6% in the second quarter. This result is further proof that the factors with a negative effect on output during the second quarter had been temporary. It is highly unlikely that corporations would continue to enlarge their payrolls if their outlook for demand were not positive.

The monetary policy being carried out by the Central Bank continues to strengthen the current phase of expansion in the real economy though interventions in the market for Central Bank bills (LEBAC) – and more recently through the deepening of the repo market. The monetary authority has systematically lowered interest rates in the domestic economy, as well as increased liquidity levels (see Chart I.7) and supported growth in domestic demand, both for consumer and investment goods. Amid an environment in which most sectors have idle installed capacity, a responsible use of monetary policy has produced only a small increase in the general price level so far in 2004, jointly with moderate inflation expectations.

Chart I.8
Price of performing government bonds



Source: BCRA from BCBA data

Positive domestic macroeconomic conditions led to an increase in the demand for performing public debt securities. This produced an increase in their prices (see Chart I.8), with a positive impact on financial system net worth. The positive outlook for the swap of defaulted sovereign bonds to begin at the end of the year also reinforced the improvement in bank balance sheets.

Most of the factors with a negative influence on the real side of the domestic economy are expected to vanish over the remainder of 2004. The effective tax burden is expected to return to values more in tune with the average over the year. Additionally, Congress recently passed a law to stimulate investment, which will result in a number of large scale projects. Lastly, increases to public and private wages as well as pensions will increase the economy's wage bill, which in turn will drive consumption. These expected developments should improve conditions for banks, particularly in terms of exposure to credit risk, and strengthen the financial system.

II. Financial system debtors

Summary

The positive macroeconomic conditions in the first half led to an expansion in all sectors of the domestic economy. The increase both in public and private sector incomes is helping to gradually improve the financial position of both sectors, reducing credit risk. These developments strengthen the quality of financial sector assets.

In the first part of the year, the public sector had an outstanding performance. As tax revenues maintained record levels on a sustained basis, the surplus income did not fully translate into greater spending, allowing the government to settle all performing liabilities as they matured. This implied – despite the conditions set by the exit from a severe crisis – net payments to international financial institutions. The behavior of public finances permitted the compliance of the goals set for the entire year in just six months. The positive developments in the public sector improve the outlook for the financial system – basically due to its high exposure to the consolidated public sector, which at mid-year reached 44% of assets.

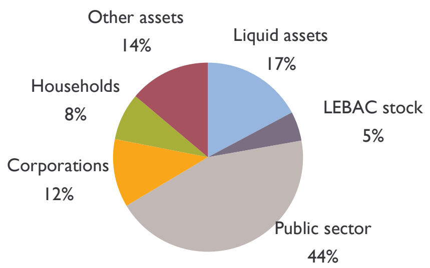
All branches of business recorded improvements over the first six months of 2004, although in the second quarter there was a temporary deceleration. Until the end of 2003, increases in output were possible thanks to reinvestment of earnings and the use of idle installed capacity following 15 consecutive quarters of recession. At the start of 2004, some sectors started to require an enlargement of working capital and investment, causing an increase in the demand for credit. This had a direct influence on the normalization of the financial system, by aiding the recovery of the intermediation business. Lending to corporations currently stands at only 12% of bank assets (without adjusting for provisions), so that an increase in the share of credit for production would improve the profitability of the financial system – assuming a low risk in relative terms – and would contribute to greater solvency.

Although households recorded the weakest progress in the first half, indicators of consumer expectations still show optimism for the remainder of the year. The income policy adopted by the national government, added to the strong recovery in consumer credit lines, suggest a positive outlook for the medium term. The increase in consumer lending that has already taken place helps financial institution profitability without the downside of a high exposure to household credit risk. At the end of June, lending to this sector accounted for barely 8% of assets.

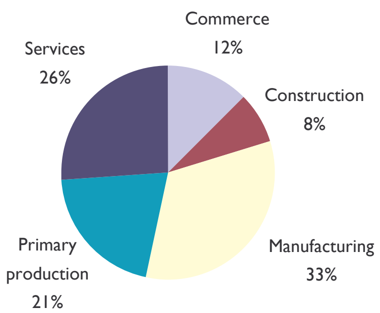
Chart II.1

Financial system portfolio of assets

June 2004



Corporate loan portfolio

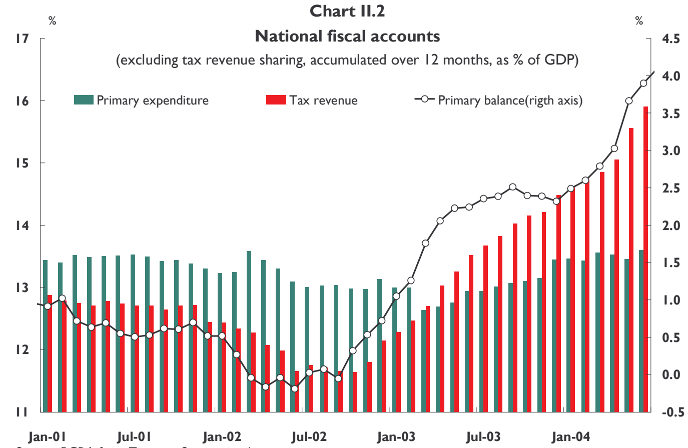


Source: BCRA

Chart II.2

National fiscal accounts

(excluding tax revenue sharing, accumulated over 12 months, as % of GDP)



Source: BCRA from Treasury Secretariat data

II.1. Economic conditions and the financial system

Among the main risks that are inherent to financial intermediation, credit risk is the most relevant. In terms of the stability of the financial system, a correct monitoring of this risk requires the analysis of two factors; on one hand, the state of affairs for the several aggregate groups of debtors (to determine their repayment capacity and therefore the degree of implicit risk), and on the other, the banking system's exposure to each group in particular. This section deals with the first of these factors, while detailed analysis of bank exposure to credit risk is dealt with below (see page 36 in the chapter on risk management).

To assess the current and expected financial position of the different sectors, a set of relevant variables is analyzed, which include output levels, profitability, debt burden and financing needs. The different agents in the economic environment are grouped under one of three headings: public sector, corporations and households. The public sector is currently the main debtor of the banking system. Credit to this sector accounts for 44% of the system's total assets (see Chart II.1). In contrast – and due to the financial disintermediation process that is currently showing signs of coming to an end – lending to corporations and households stands at only 20% of system assets. Out of lending to corporations (12% of total assets), 33% is lending made to the manufacturing sector, 26% to services and 21% to primary production.

II.2. Public sector

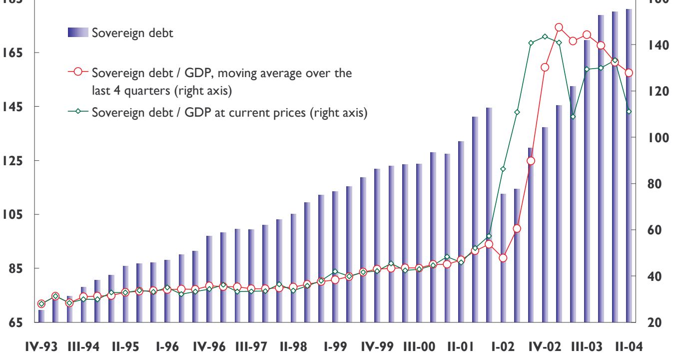
II.2.1. Fiscal conditions[2]

In the context of accumulating a significant primary surplus, during the first half of the year the government (the main debtor of the financial system) regularly serviced its performing debt. This was managed even though net disbursements from international financial institutions (IFI) were much lower than expected. The solid performance by public accounts allowed for annual fiscal targets – set in the budget and in the agreement signed with the International Monetary Fund (IMF) in 2003 – to be accomplished in just six months from January to June.

In addition to the improvement in national and provincial public finance figures, the passing of the Fiscal Responsibility Law (*Ley de Responsabilidad Fiscal*) provides a legal support for restraint in the administration of the public treasury, which will limit counterparty risk involved in lending to the public sector. To June this year, the non-financial national public sector accumulated a primary surplus of 2.8% of GDP ($11.8 billion), surpassing the 2.4% target set in the second review of Argentina's agreement with the IMF. The large primary surplus allowed the national government to settle interest on performing public debt, which includes National Guaranteed Loans (NGL), Provincial Guaranteed Bonds (BOGAR) and BODEN. The latter account for 85% of bank lending to the public sector. Liabilities with IFIs were also settled in a proper and timely manner.

[2] For a more detailed analysis of public sector revenue and spending, see the inflation reports published by the Central Bank in 2004.

Chart II.3
Sovereign debt
In US$ and as % of GDP



Source: BCRA from INDEC and Finance Secretariat data

Table II.1
National public sector debt as of June 30,2004
(billion US$)

	Without arrears	Arrears	Total	As % of total
TOTAL	**145.0**	**36.2**	**181.2**	**100.0**
Medium and long term	**142.2**	**36.2**	**178.5**	**98.5**
Notes and bonds	82.3	33.1	115.4	63.7
Peso denominated	9.1	6.5	15.6	8.6
BODEN	4.5	0.0	4.5	2.5
Denominated in foreign currency	73.2	26.6	99.8	55.1
BODEN	13.7	0.0	13.7	7.6
Loans	60.0	3.1	63.1	34.8
NGL	14.3	0.0	14.3	7.9
IFIs	31.3	0.0	31.3	17.3
Bilateral agencies	3.8	2.7	6.5	3.6
BOGAR	9.9	0.0	9.9	5.5
Commercial banks	0.5	0.4	0.8	0.5
Other	0.3	0.0	0.3	0.2
Short term	**2.7**	**0.0**	**2.7**	**1.5**
BCRA temporary advances	2.7	0.0	2.7	1.5

Note: "Without arrears" includes the stock of performing debt and outstanding non-performing debt

Source: Finance Secretariat

Table II.2
Main features of the new bond issues

	Par	Discount	Quasi Par
Currency	foreign and pesos adjusted by CER	foreign and pesos adjusted by CER	pesos adjusted by CER
Maturity (years)	35	30	42
Grace period (years)	25	20	32
Number of semi annual amortization payments	20	20	20
Interest compounding (years)	0	0(+)	10
Annual coupon (%)	1.35-5.25	8.4	5.95

(+): compounds part of the coupon up to year 10

Source: BCRA from Finance Secretariat data

The improvement in the primary result continues to be based on the sustained recovery of public revenues (see Chart II.2). National tax collection has sustained growth rates of around 40% y.o.y., owing to larger income from value added tax (VAT), income tax, export duties and contributions to social security. On the other hand, primary expenditure during the first half of the year continued to recover as a share of GDP, following the contraction caused by the crisis in 2001-2002. In addition to the planned increases in the 2004 budget, new increases have also been granted so far this year to pensioners and public sector workers. These increases have improved the repayment capacity of households, with a net positive impact on the financial system.

Conditions in the provinces were also favorable during the first half: record income coupled with relative austerity determined a primary fiscal surplus of approximately 1.5% of GDP.

Sound fiscal performance is expected to continue throughout the year, as a result of persistently recovering revenues. As a result, the national fiscal surplus would exceed previous estimates, allowing the government to settle payments on currently performing sovereign debt – which accounts for 85% of the financial system's total exposure to public sector risk – regardless of whether financing programs with IFIs are maintained over the short term.

II.2.2. Public debt

As of June 30, 2004, total sovereign debt amounted to 128% of GDP, or approximately US$181.2 billion (see Chart II.3 and Table II.1). Approximately 44% of this is currently performing debt. Regarding servicing features, two thirds of the debt pays fixed interest coupons, while the remainder pays a floating rate (mainly LIBOR). At the end of March, the (value-weighted) average interest rate was 5.8%.

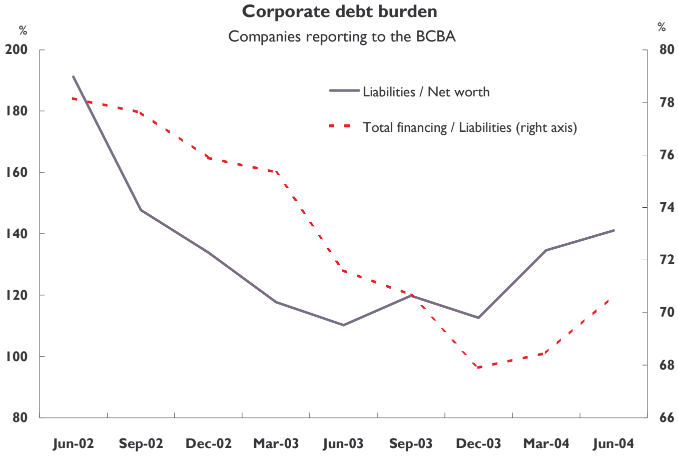
The government continued to make progress in the process to renegotiate sovereign debt. Following the selection of advisory banks and a series of meetings with bond-holder groups, the government presented new details regarding the final restructuring proposal (see Table II.2). Legal procedures were started in early July to register the new bond issues with the US Securities and Exchange Commission. Given the steps that have already been carried out, the debt swap process is expected to begin in the last quarter of the year.

The restructuring of non performing sovereign debt is therefore one of the main sources of uncertainty both for the economy in general and the financial sector in particular. Securities that are directly involved in the restructuring process, however, make up only a small share of the financial system's total assets.

II.3. Corporations

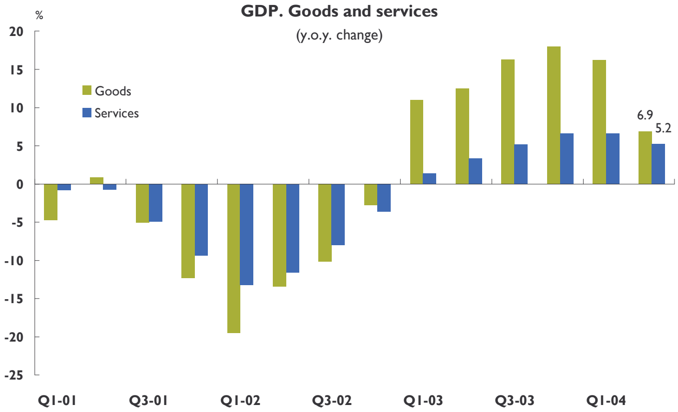
Since the beginning of 2004 – and mainly in the second quarter – there was a marked increase in financial system lending to corporations. This is affecting the sector's debt level, which is

Chart II.4
Corporate debt burden
Companies reporting to the BCBA



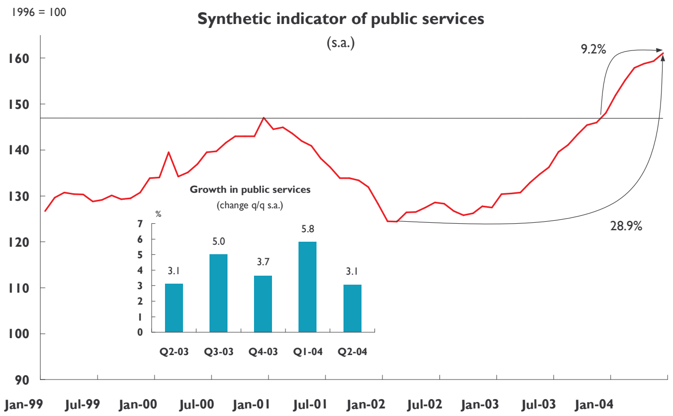
Source: BCRA form BCBA data

Chart II.5
GDP. Goods and services
(y.o.y. change)



Source: INDEC

Chart II.6
Synthetic indicator of public services
(s.a.)



Source: INDEC

expected grow according to the pace of improving economic activity (see Chart II.4). Growth in economic activity, sustained operating profit margins, lower lending rates – as compared to recent years – and debt restructuring continue to operate in favor of rebuilding corporate payment capacity, and thereby reducing credit risk.

The behavior of the productive sector in the first half of the year can be broken down into two distinct periods. In the first quarter, all sectors in the economy grew at very high rates (see Chart II.5). During the second, however, there were slowdowns in several sectors. The most significant among these were in manufacturing and construction, two of the sectors that drove economic recovery following the crisis in 2001-2002. The former is particularly relevant to the financial system, as credit to the manufacturing industry stands at a third of all banking sector credit to corporations (three times more than the volume of credit to construction). Circumstantial factors accounted for most of the slowdown (see page 14 in the chapter on the macroeconomic context). With the lifting of these factors, output is expected to grow throughout the rest of the year, although at rates somewhat lower to those seen in the first quarter. As this is combined with historically low lending rates, the prospect of a low corporate credit risk scenario is encouraging.

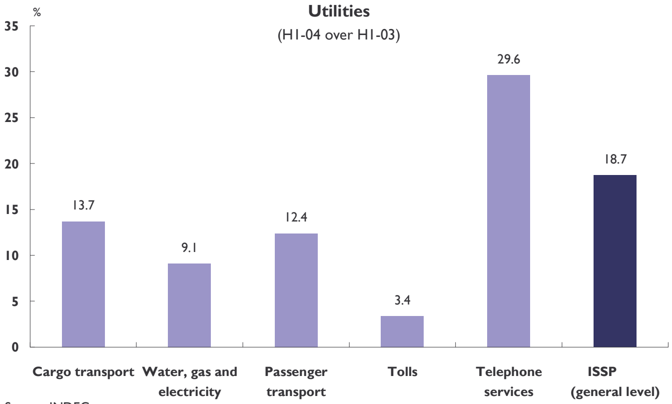
The recovery in lending to corporations over recent months is encouraging in terms of sustaining a high level of growth, as capacity utilization is approaching its limit in several sectors. As idle capacity starts to run out, the expansion of credit will be essential to enable an increase in investment and therefore in the stock of physical capital.

Lastly, during the first half of the year several corporations reached out-of-court settlements (*Acuerdos Preventivos Extra-Judiciales*, or APEs) with their creditors, to refinance their debt in default. Several of these corporations (mainly suppliers of non tradable goods) had foreign liabilities that were not forcefully converted into pesos (the process referred to as *pesificación*), and had to resort to restructuring to make the servicing of their liabilities sustainable. The restructuring of these corporate liabilities aided the recovery in the quality of domestic financial system assets, a process that should continue throughout the remainder of the year as new settlements are reached. The ongoing solution of corporate sector default will have a positive impact on the financial sector's profitability, through the release of provisions and an increased income from accrued interest.

II.3.1. Services

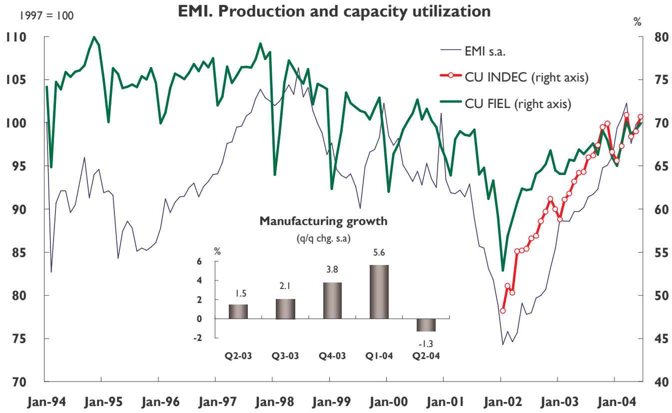
Consumption of public services remained on an upward trend through the first half of the year, increasing by 18.7% against a year earlier due to the large expansion in the first quarter. Activity in this sector is at record highs, 9.2% (s.a.) over the peak in output recorded in December 2000 (see Chart II.6). This is a positive factor for the financial system, as loans to the services sector – along with loans to manufacturing – have the largest weighting in lending to corporations.

Chart II.7
Utilities
(H1-04 over H1-03)



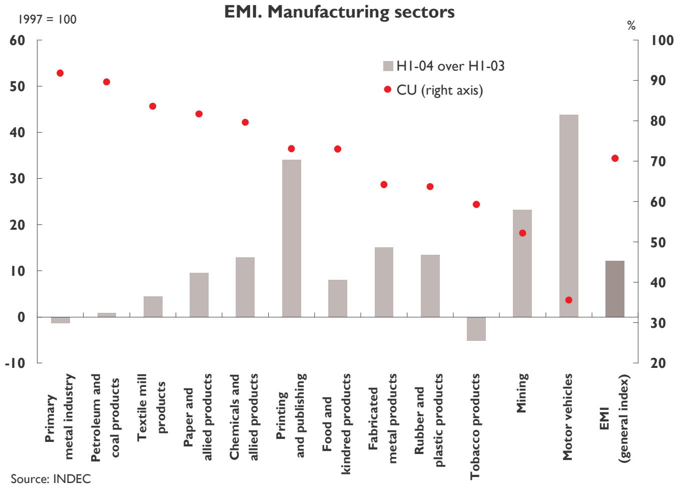
Source: INDEC

Chart II.8
EMI. Production and capacity utilization



Source: BCRA from INDEC data

Chart II.9
EMI. Manufacturing sectors



Source: INDEC

The growth in sector output was especially driven by the excellent performance by telephone services. In addition to debt restructuring agreements that are expected to occur in the second half, this suggests that the services sector's behavior will have a positive influence on the quality of the financial system's corporate portfolio: telephone operators are among the largest individual debtors. The remaining sectors also performed favorably (see Chart II.7).

There is evidence that several energy and transport sub sectors are approaching the limit of their production capacities. The ability to keep growing will therefore depend on future investments, which are an additional business opportunity for the financial sector. In this sense, the outcome of contract renegotiation with concession operators and the passing of a framework law to regulate them (recently submitted to Congress) will be essential in prompting capital acquisition by these businesses. Significantly, the profitability of these corporations is still constrained by the current structure of relative prices.

II.3.2. Manufacturing

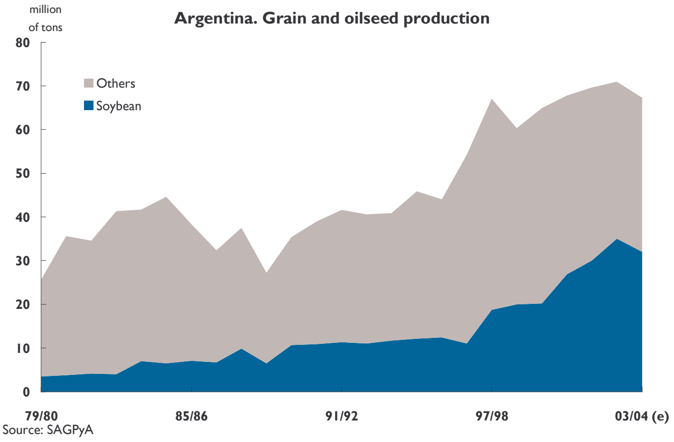
Maintaining the positive trend that started in 2003, growth in the manufacturing sector continued at a strong pace during the first half (see Chart II.8). This helped to reinforce a positive trend in the repayment capacity of this productive sector, which also accounts for a large share of the portfolio of bank loans to corporations. The strongest improvements over the first half were in car manufacturing, printing and publishing and in non-metallic mineral products (see Chart II.9). Most of the sectors recorded very strong growth in the first quarter and a slight decline in the second. Uncertainty regarding a potential shortfall in energy resources led businesses to bring forward production into the first quarter, and delay scheduled plant shutdowns into the second.

Aggregate capacity utilization (CU) in the sector reached 70.7% at the end of June, with some sectors producing at the limit of their production capacity. A relevant group of businesses is developing investment plans, mainly to upgrade process efficiency. A greater flow of investment is expected in the manufacturing sector over coming months[3], which will affect the level of activity in the financial sector.

Given the expected growth in domestic consumption, the manufacturing sector is expected to return to growth for the remainder of the year – although at somewhat lower rates than initially foreseen. The outlook for credit to this sector is therefore positive, with the possibility of new business opportunities. Additionally, the recovery in the Brazilian economy has already started to drive growth in some sectors, as a result of that country's larger demand and the lower export surpluses being shipped to our economy.

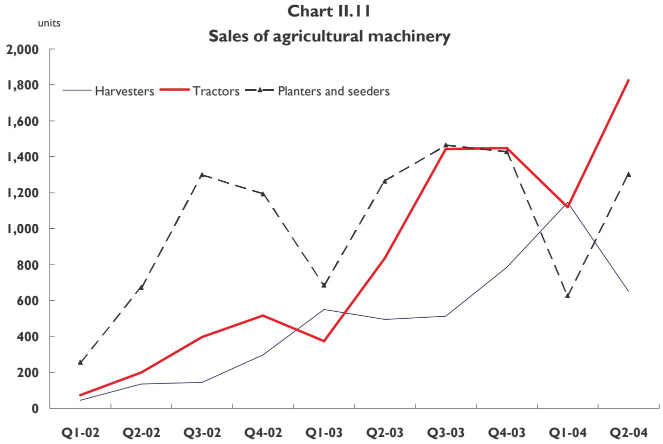
[3] Particularly since a law was passed shortly before the publication date of this FSB that allows early rebates on VAT and accelerated amortization on fixed assets.

Chart II.10
Argentina. Grain and oilseed production



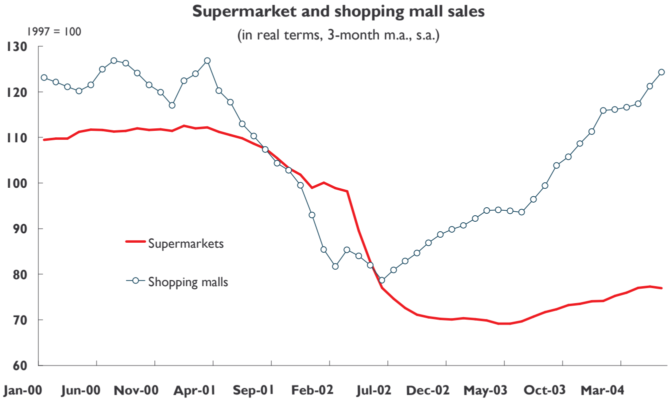
Source: SAGPyA

Chart II.11
Sales of agricultural machinery



Source: INDEC

Chart II.12
Supermarket and shopping mall sales
(in real terms, 3-month m.a., s.a.)



Source: INDEC

II.3.3. Primary sector

Performance across different branches of the primary sector was not uniform throughout the year. Production of beef and dairy grew significantly, with improvements in prices and the gradual opening of foreign markets. Despite the high prices of agricultural commodities compared to the previous year (see page 13 of the chapter on the macroeconomic context), some of these crops were affected by weather conditions and the 2004-2003 harvest will be slightly lower on annual terms (see Chart II.10).

Despite bad weather, profitability in the primary sector is at historically high levels, helping to limit credit risk from this sector. The agricultural sector, in particular, reinvested earnings through the purchase of machinery, improvements in the sowing process and increases in storage capabilities (see Chart II.11). There was also an increase in the number of investment projects aimed at expanding processing capacity in the oil seed sector. In contrast to 2003, bank lending this year has played a role in the sector's capital formation, causing an increase in the financial system's exposure to the primary sector.

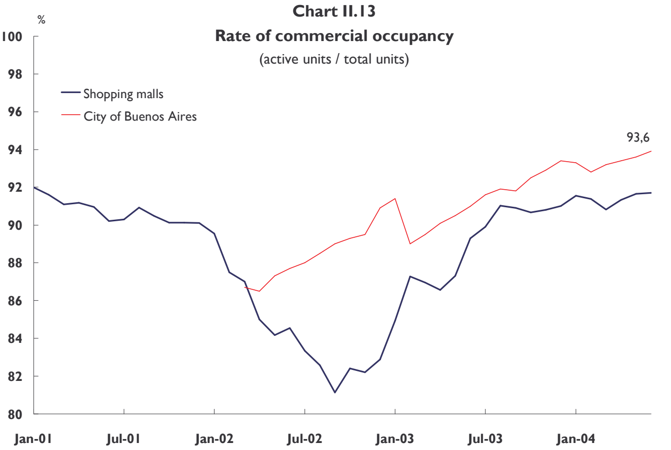
International conditions remain favorable to the economy in general, and the agricultural sector in particular (see page 13 in the chapter on the macroeconomic context). Despite recent falls in some commodity prices, overall they are still above the level at the end of 2003. The outlook for the agricultural sector remains encouraging, and it would be enjoying a record harvest had weather conditions been normal. Dairy and cattle were also favored by the rise in international prices and an increase in exports, strengthening the sector's repayment capacity on its outstanding debt.

II.3.4. Commerce

Retail sales kept growing during the first half of 2004, favored by the rise in the wage bill due to increases in employment and wages. Consumption was also favored by banks' marketing campaign to finance credit card purchases in up to six installments at a zero-interest rate. When banks put an end to the campaign in May, several retail chains decided to keep the offer going by taking over the financial cost. However, this segment experienced a significant deceleration during the second quarter, to a large extent influenced by the stagnation of wages in real terms.

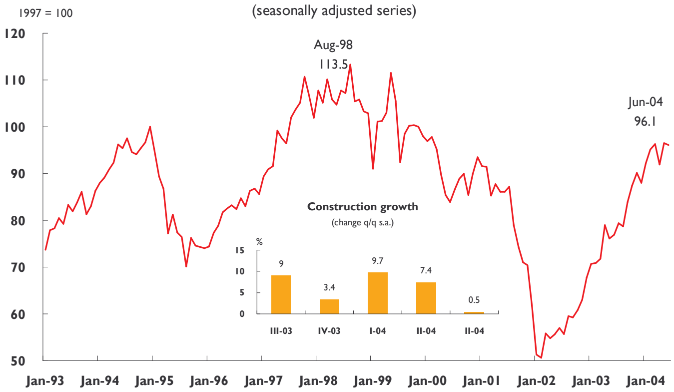
Supermarket sales so far this year have increased by 10.2% y.o.y. in real terms, recovering ground lost following the collapse in 2001-2002 (see Chart II.12). This trend has led several corporations to make new investments to enlarge the number of outlets. Sales at shopping malls grew by 29.9% y.o.y. in the first half, sustaining the solid performance seen in 2003. The larger inflow of tourism, the recovery in sales of home appliances and the high level of consumption by the segments of the population with the highest purchasing power all helped to keep sales levels at a high value. Additionally, changes to purchasing habits have brought life to other sales channels –

Chart II.13
Rate of commercial occupancy
(active units / total units)



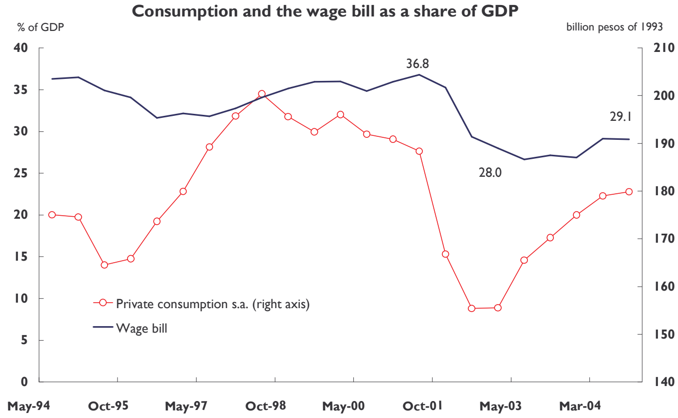
Source: INDEC and CEDEM

Chart II.14
Construction activity indicator (ISAC)
(seasonally adjusted series)



Source: INDEC

Chart II.15
Consumption and the wage bill as a share of GDP



Source: BCRA on INDEC data

such as grocery stores and small supermarkets – allowing for a high rate of commercial occupancy (see Chart II.13).

The broad outlook for commerce remains positive for the rest of 2004, in line with the recovery in consumer credit and the expected path of real wages.

II.3.5. Construction

Construction behaved like the overall economy over the first half of 2004 – following a very strong first quarter, there was a large deceleration in the second (see Chart II.14). Housing construction remains one of the main components of sector activity, although it is growing at a rate considerably below that of the previous year. There was also significant activity regarding construction for commercial and industrial use, as well as infrastructure projects, while road work was reduced. Oil industry construction surged significantly in the first half, following the rise in the international price of oil.

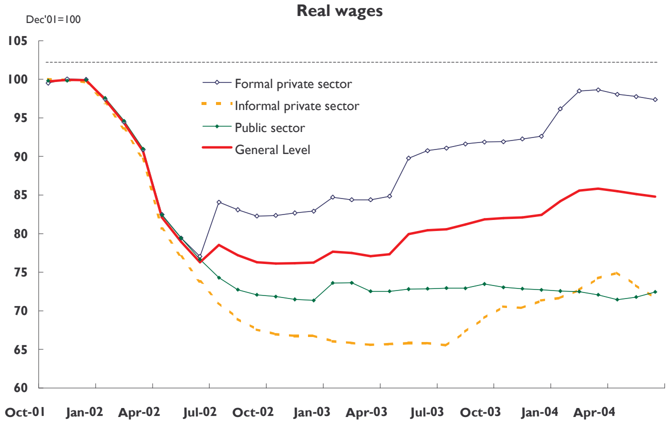
The sector's outlook is positive in overall terms. Public works and oil company projects are expected to be the most active branches over coming months. The outcome for residential construction will depend on the relative strengths of offsetting forces – a carryover effect from projects already underway, the large gap between construction costs and the market price of real estate and the increase in public investment are offset by the reduction in the wealth effect due to the devaluation and the real wage, which is still low and therefore reduces the demand for mortgage loans.

II.4. Households

There was an important downshift in private consumption as from the second quarter, despite it having been the determining component in the economy during 2003 and up to the first quarter of 2004 (see Chart II.15). The slowdown was explained mostly by temporary and circumstantial factors. For instance, the greater fiscal burden during the second quarter had the effect of reducing households' disposable income. Household expenditure was therefore affected, in a context in which credit is recovering remarkably but from very low levels, and therefore has a very limited capacity to smoothen the path of consumption.

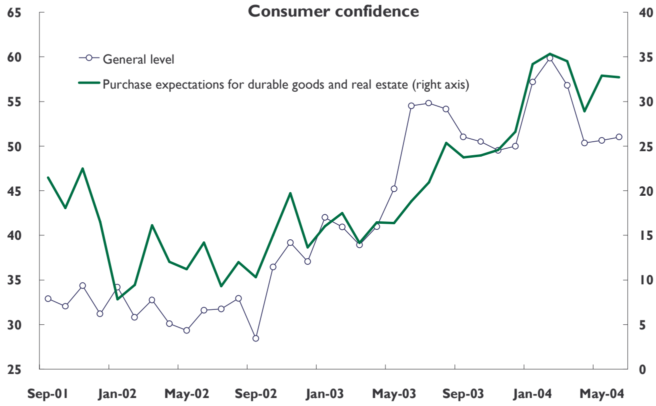
The slowdown was also caused by factors with a more long-term effect. On one hand, real wages lost the momentum from the past year and a half, recording a 1.2% quarter on quarter (q.o.q.) decline in the second quarter (see Chart II.16). Only public sector wages continued to recover, due to increases granted by the national government and some provincial governments. On the other hand, there was a slight decline in consumer confidence, although it remains at historically high levels (see Chart II.17). Expectations for the purchase of consumer durables and real estate were the least affected among the components in the indicator, a statistic that suggests that households will sustain a high demand for credit.

Chart II.16
Real wages



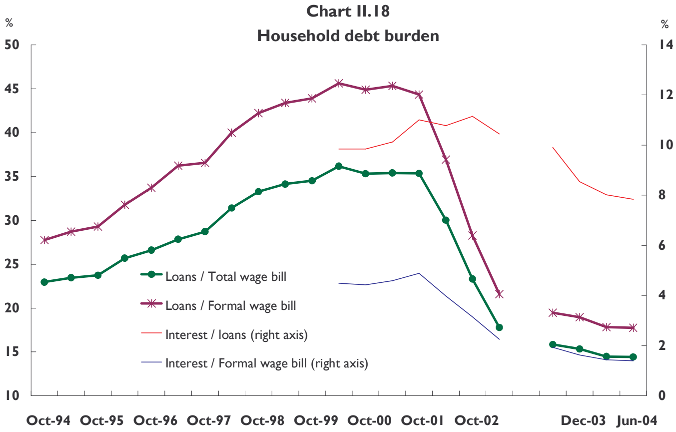
Source: INDEC

Chart II. 17
Consumer confidence



Source: UTDT

Chart II.18
Household debt burden



Source: INDEC and BCRA

Private consumption is expected to regain momentum in coming months, and close the year by growing more than the economy. Although the wealth effect produced by the devaluation has lost in relative importance as a factor driving consumption, the pace should be picked up by the recovery in the supply of consumer credit and the government's income policy.

Although the persistent degree of uncertainty constrains growth in the demand for credit from this sector, it also enjoys a significant potential for growth without the danger of a deterioration in underlying repayment risk. This can be inferred from the current burden of loans as a share of debtor cash flows. Debt burdens were reduced significantly in 2002 and 2003, due to a combination of different factors: incentives put in place in favor of early settlement, a special treatment in terms of price indexing for the bulk of the sector, the gradual accommodation of lending rates amid conditions of greater stability, the delay in the recovery of the credit market and the improvement in household income. During the first half of 2004, the debt burden remained at considerably low values in terms of historical averages (see Chart II.18), giving rise to a more solid financial position for households. This has a positive effect on financial system balance sheets, both through the supply of new loans and the quality of those outstanding.

III. BUSINESS STRUCTURE

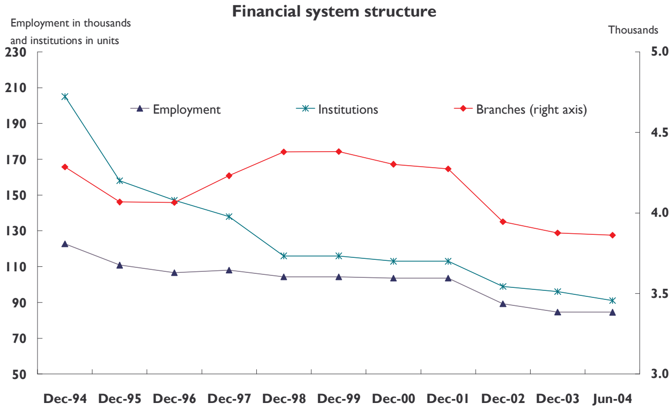
Summary

Since financial institutions adjusted their structures to post-crisis conditions, the financial system has started to rebuild its productivity indicators by creating a larger volume of business instead of by closing branches and reducing payrolls. However, the financial system is not isolated from global trends affecting the size and number of institutions in the intermediation business. These involve both technological progress and changes to the regional positioning strategies of multinational financial institutions.

Beyond problems inherited from the crisis – which continue to affect balance sheet structures – banks made progress in 2004 in deepening the positive changes started in 2003: establishing deposits as the main source of funding and increasing their lending activity. The improvement in activity levels for both corporations and households was one of the main determinants of growth in credit to the private sector, which strengthened the system as a whole as well as each individual group of banks.

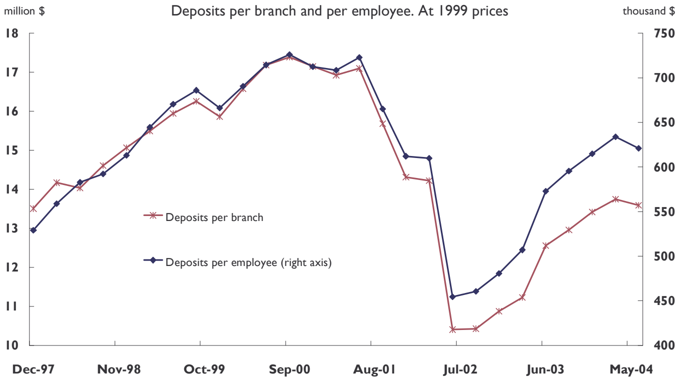
The rebuilding of the private sector asset portfolio, which at the end of 2003 was mainly focused on short-term credit lines, started to occur in longer term and collateralized lending as well. Only mortgage loans have failed to show a net positive increase in that segment so far this year, but the growing number of institutions for which the change has been positive is an encouraging sign that, for the financial system as a whole, the change in this heading may become positive before the year is over.

Chart III.1
Financial system structure



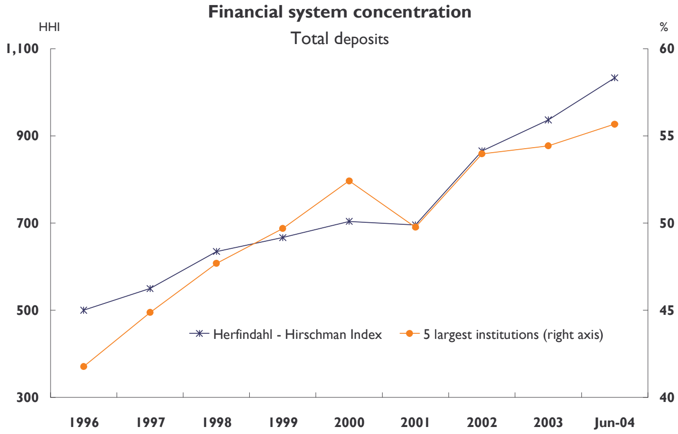
Source: BCRA

Chart III.2
Factor productivity
Deposits per branch and per employee. At 1999 prices



Source: BCRA

Chart III.3
Financial system concentration
Total deposits



Source: BCRA

III.1. Size

Following the adjustments that banks made to their structures so as to adapt to the new post-crisis conditions in the financial intermediation business, productivity indicators have continued to recover – but based on increases in the volume of operations instead of reductions in factor employment (see Charts III.1 and III.2). The recovery in economic activity, accompanied by the policies of the Central Bank and individual banks, are creating the conditions to sustain this new trend.

As in other parts of the world, the behavior of the financial system's structure is subject to changes in the nature of the processes that are inherent to the intermediation business. On one hand, the structure of the domestic financial system is partially linked to the strategies of the parent companies of foreign-controlled financial institutions. On the other, it is also affected by a trend towards concentration that is occurring worldwide, led in great part by technological progress. Economies of scale and diversification help to explain this trend, which was already in place before the crisis and continues to this day.

During the first half of 2004, the domestic financial system was reduced by 5 institutions, which represented only 0.4% of total assets. Employment levels were slightly higher than at the end of 2003, while the number of branches (branches themselves plus other annexes and sub-offices) was reduced slightly. Both employment and branches increased in terms of the number of institutions in the system. Improvement in the sector during the first half was consistent with an increase in concentration (see Chart III.3), which however remains low at international standards.

The Central Bank's regulation reform, which was aimed at encouraging the return of credit and profitability, helped create a positive outlook for financial intermediation and avoided the massive liquidation of institutions. The system's structure appears to be converging on a more adequate level given its current outlook, with some financial institutions starting to adjust their structures and increase their payroll (see Chart III.4). Towards the end of the first half of 2004, retail private banks with a nationwide coverage had accounted for more than 80% of growth in employment in the financial system. Small institutions such as specialized banks and non-bank institutions, however, led this increase in relative terms.

Technology acquisition returned to historical rates. Financial institutions are moving towards increasing client services and adopting automated solutions. This allows for a reduction in operating costs and an increase in income, for instance by allowing bank transactions 24 hours a day. The key features in this trend are the greater availability of automatic teller machines and the increasingly widespread use of home banking (see Chart III.5).

Box 1 : The domestic financial infrastructure

The first issue of the FSB underlined the importance of the banking system in Argentina's financial intermediation business. This trait is inherent both to Argentina's economy and to that of most emerging market economies. However, at a domestic level there are other (formal and informal) financial service providers, which interact with banks in both substituting and complementary roles. Within the sector that includes formal providers, the behavior of non-bank financial intermediaries (NBFIs) has a limited influence on the stability of the financial system.

NBFIs include pension funds (FJPs), insurance companies (ICs) and mutual funds (MFs). Due to a lack of information in closing this issue of the FSB, we have excluded financial trusts, credit cooperatives and other providers of auxiliary financial services from the following preliminary review on the topic of consolidating financial intermediaries. NBFIs manage funds amounting to 26% of GDP, a low figure by the standard of developed economies as well as other emerging market economies in the region.

After banks, FJPs are the second most important domestic source of lending. They obtain their funds from contributions to individual social security accounts, which are invested by pension fund managers (AFJPs), mostly as domestic financing. As of June 2004, the total portfolio of assets held by FJPs reached $47 billion, of which more than two thirds consisted of claims on the public sector.

ICs also play a large role in granting credit, by participating in the financial business through the investment of their funds. These intermediaries manage resources in excess of $20 billion. Although ICs also have high exposure to the public sector, it is to a considerably lower degree than FJPs – public sector exposure amounts to 40% of assets. MFs provide the domestic financial markets with funds worth $4.5 billion. Unlike FJPs and ICs, MFs have a particularly high exposure to domestic bank's credit risk, and in second place, to market risk derived from equity holdings.

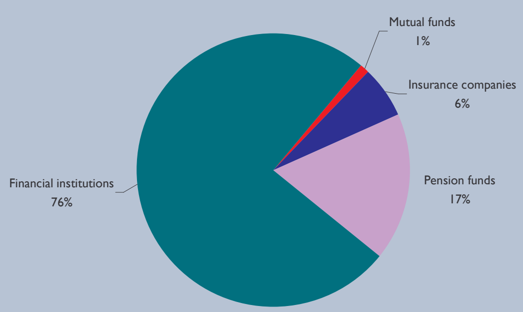
In total, the asset portfolio managed by NBFIs and financial institutions (FIs) amounts to more than $263 billion (93% of GDP). However, some of the transactions made by these institutions involve other group members as counterparties. These transactions have been consolidated to define a broad financial system (FIs plus NBFIs) – with total assets of $252 billion, or 89% of GDP – for which net worth exposure to the different sources of risk can be examined.

Estimating the consolidated balance sheet for the financial system reveals the dominant role of FIs in the domestic credit market (see Chart B1.1). Non financial sector assets held by FIs account for more than three fourths of the broad financial system's resources. In a distant second place, FJPs account for only 17% of the total, while ICs and MFs contribute very small shares.

Chart B1.1

Composition of the local financial infrastructure

Share of financial system consolidated assets - June 2004



Source: BCRA, AFJPs, ICs and MFs

The main use of broad financial system resources is lending to the public sector, accounting for slightly more than half of the total (see Table B1.1). FIs, FJPs and ICs, in particular, grant the largest share of their funds to the national government, either through the purchase of debt securities or through direct loans. Lending to the private sector makes up a large share of the broad financial system's resources, making it an essential component for both growth in consumption and in investment. A minor share of financial resources are used to finance the external sector.

Table B1.1

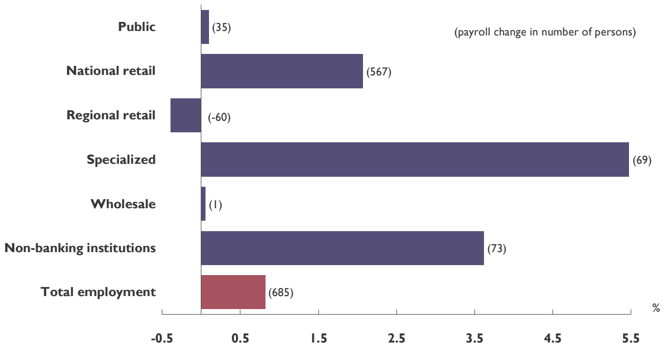
Broad consolidated financial system

	Dec-03		Jun-04	
	billion $	%	billion $	%
ASSETS	**244**	**100**	**252**	**100**
Domestic	235	97	244	97
Credit	181	74	186	74
Public sector	134	55	136	54
Private sector	47	19	50	20
Other assets	55	22	58	23
External sector	8	3	8	3
LIABILITIES	**166**	**68**	**175**	**69**
Deposits	86	35	101	40
Private	70	29	72	28
Public	16	7	29	12
Other liabilities	65	27	63	25
External liabilities	15	6	11	4
NET WORTH	**78**	**32**	**78**	**31**

Source: BCRA, AFJPs, I Cs and MFs

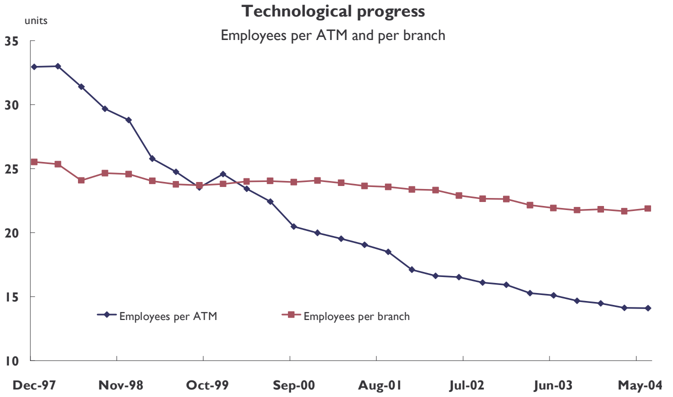
The financial system obtains its funding from two main sources: deposits and equity. Almost a third of the broad financial system's resources are of the latter class, basically due to the effect of FJPs and MFs for which the majority of funds are owned by proprietors. Approximately 40% of funds obtained by the broad financial system were in the form of deposits from the non-financial system.

Chart III.4
Payroll
By group of banks - % change Mar/Jun 2004



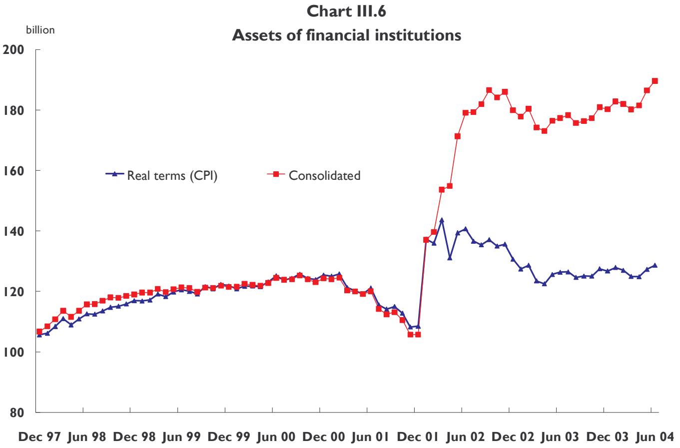
Source: BCRA

Chart III.5
Technological progress
Employees per ATM and per branch



Source: BCRA

Chart III.6
Assets of financial institutions



Fuente: BCRA

Lastly, credit unions are expected to gain relevance within the financial system throughout the rest of 2004 and over the medium term[4]. The regulatory framework newly set up for these institutions by the Central Bank is expected to provide an adequate level of transparency that will enable them to develop a financial intermediation business. Their business will consist of servicing small niche markets, such as corporations and individuals with little access to the traditional banking system.

III.2. Activity and financial situation

During the first half, the banking system extended the changes to balance sheet structures that had started to develop in 2003. The first six months of the year reinforced the role of deposits as the main source of funding for financial institutions, and also saw increased momentum in bank assets, which increased by 1.5% in real terms[5] (see Chart III.6), driving the recovery in loans to the private sector.

Deposits increased by 13% in real terms, with an outstanding performance by public banks which – due to the government's large tax revenues – received substantial inflows from the public sector. Sight deposits (current and savings accounts) retained a high share of new private sector deposits[6], at the expense of time deposits which suffered the impact from the tax on bank account credits and debits (IDCCB) amid lower borrowing rates offered on term deposits (see Chart III.7).

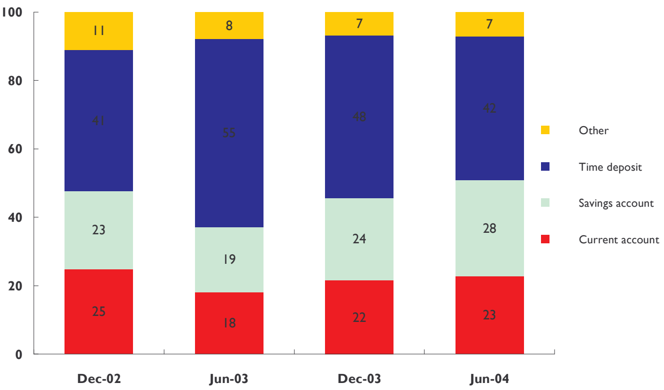
Given that expected real interest rates in term deposits are negative, CER-indexed instruments became an attractive choice for investors, producing a significant change in the structure of deposits. During the first part of 2004, these deposits increased by around $2.1 billion. CER-adjusted deposits are expected to continue increasing, thereby reducing banks' mismatches due to excess assets in CER-adjusted instruments.

Also on the side of funding, banks continued with a process that was underway since 2003 to reduce a source of risk inherited from the crisis: the settling of foreign liabilities (corporate bonds and subordinated debt with foreign residents, and direct lines of credit abroad). Through haircuts in the debt restructuring processes, debt-to-equity swaps and settling of debt with sovereign bonds, foreign indebtedness was reduced by 15% (in dollars) during the first six months of the year (see page 51 in the chapter on solvency). Foreign liabilities as a percentage of total funding (liabilities plus net worth) declined by 7.3 p.p. over the past 12 months (see Chart III.8). This occurred within the framework of Central Bank regulations to have financial institutions resolve foreign liability issues as a prerequisite condition to obtaining the refinancing of their debts from BCRA liquidity facilities[7].

Under the framework to settle Central Bank rediscounts – a framework commonly referred to as matching – as of June 2004

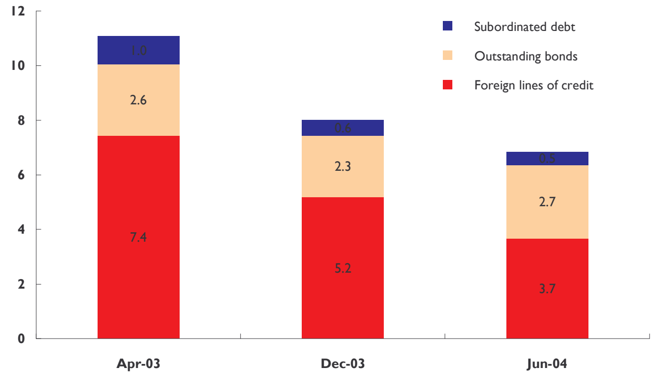
[4] For further details see Law 25.782 or Com. "A" 4183.
[5] Adjusted by the consumer price index (CPI), which increased by 3.3% since December 2003.
[6] Excluding rescheduled deposits and CEDRO, as well as accrued interest and CER-adjustment.
[7] According to terms in Com "A" 3940, as part of the framework for the refinancing of advances and rediscounts set forth in Chapter II of Decree 739/03. For further details on regulations for the matching framework, see page 18 of the FSB for the first half of 2004.

Chart III.7
Total deposits by the non-financial private sector



Source: BCRA

Chart III.8
Liabilities with non-residents



Source: BCRA

Table III.1
Balance sheet

Consolidated system total- %

	Dec-03	Jun-04
Assets	100	100
Liquid assets	15	18
LEBAC	4	5
Lending to the private sector (*)	19	20
Lending to the public sector	48	45
Other assets	14	13
Liabilities - Net worth	100	100
Public sector deposits	9	15
Private sector deposits	40	40
CEDRO with CER	3	2
Liabilities with the BCRA	15	14
Outstanding bonds, subordinated debt and foreign lines of credit	13	11
Other liabilities	9	7
Net worth	11	11

(*) Total loans before deducting provisions.

Source: BCRA

participating institutions allocated $770 million in four monthly installments, reducing by 1 p.p. to 14% the weight of these liabilities within total funding (see Table III.1). A large part of the disbursement allocated to settling these liabilities was paid out of interest charged on the assets used to collateralize the facilities.

Other liabilities that banks continued to reduce during 2004 were CEDRO certificates. Approximately $2.3 billion were allocated during so far this year to settling certificate maturities and the outflow due to court-ordered releases[8]. This value is considerably lower than that of the first half of 2003, a time at which the outflow due to court-ordered releases was much larger, programs were in place to encourage early settlement of CEDROs and so-called "*corralón*" deposit restrictions were subsequently lifted.

On the side of assets, the take-off in credit to the private sector started during the second half of 2003, and strengthened as one of the main uses of funds so far in 2004. Following a period in which banks rebuilt their portfolios of liquid assets, and given the improvements to corporate and household financial positions, banks face a relatively favorable risk-return trade-off in extending their lending to the private sector. The financial system increased its portfolio of loans to the private sector by 10%[9] (6% in real terms) during the first six months of 2004. Private sector loans increased as a share of assets by 1 p.p.. Credit is expected to grow even more strongly in the short-term, helped by the macroeconomic context and the Central Bank's actions[10]. Under this scenario, ready access to information on costs and interest rates is important for this growth to occur in an equitable and efficient way. With this in mind, the monetary authority has set up, among other measures, a Transparency Regime (*Régimen Informativo de Transparencia*), which provides detailed information on conditions for obtaining credit at the level of individual institutions.

Both so far in 2004 and in the recovery period starting in August 2003, loans to the private sector have grown more strongly for private banks than for public banks[11]. This difference arises partly from the fact that public banks have a greater weighting in collateralized loans, which have recovered the weakest for the aggregate financial system (see Table III.2). Regarding commercial credit, which enjoyed the strongest momentum in 2004, private banks with a nationwide coverage recorded the strongest growth both so far this year and in the past 10 months. Public banks recorded the largest increases in consumer credit lines.

[8] Includes CER-adjustment and exchange rate differences in the payment of court-ordered releases.
[9] Excludes interest due and CER-adjustment accrued over the period.
[10] For a detailed analysis of Central Bank measures, see page 19 of the FSB for the first half of 2004.
[11] The private bank group includes three financial institutions currently undergoing a restructuring process and under the administration of a national public bank.

BOX 2 : A MAP OF THE FINANCIAL SYSTEM

Taking geographical aspects into account enriches the analysis of the financial sector in several ways. On one hand, it helps to understand the way in which financial institutions distribute their activities and their coverage across the country. This gives rise to issues of equity but also of financial system stability, as some institutions are particularly exposed to regional economies. This is especially so for Argentina, due to its distinct geographic features and the history of its economic development. On the other hand, a breakdown of the financial system by regions provides grounds for the debate on the correct functioning of so-called local markets for financial services. This approach, in some ways more appropriate for economic analysis, provides elements on which to judge the design of regulation policy. It also calls for the presentation of a set of relevant figures that provide the first sketch of a map of Argentina's current financial system.

In first place, by disaggregating the stocks of loans and deposits to the province level as of June 2004, the picture that emerges is one of significant concentration of financial intermediation in very few districts (see Table B2.1). The first six districts accumulate 90% of private deposits and received 82% of loans to households for the entire financial system[12]. Out of these, the city of Buenos Aires accounts for 50% and 41%, respectively. Another indicator of high concentration is that private deposits and loans to households are 58 and 22 times higher, respectively, in the first six districts than in the last six. Such a distribution of the financial system is linked to the structure of wealth creation and the distribution of the population throughout the country. The six first provinces in terms of aggregate financial intermediation also account for 80% of Argentina's GDP and are home to almost 70% of the total population. Taking this into account, the dispersion of deposits and loans to households in terms of GDP is significantly reduced.

Table B2.1
Geographical distribution of the financial system
June 2004 - in %

Provinces sorted by private deposits	Total private sector deposits	Total loans to the private sector		GDP[1]	Population
		Total	Natural persons		
First quartile	90	86	82	79	69
City of Bs. As.	50	53	41	26	7
Bs. As. Province	22	18	26	33	38
Second quartile	5	7	9	9	12
Third quartile	3	5	6	7	14
Fourth quartile	2	2	4	5	5
Total	100	100	100	100	100

[1] Based on ECLAC estimates for 2001.

Source: BCRA

Regarding the second concern mentioned above, if local markets are proxied by those defined by provincial borders, then available figures as of June 2004 show that both the depth and the structure of the supply of financial services are not uniform across local markets. Regarding the degree of bank sector development in each province, there is a wide dispersion in the level of bank use[13] (see Table B2.2). For instance, compared to a national average of 45 deposit accounts per 100 inhabitants, the district with the heaviest bank use (the city of Buenos Aires) records 195 accounts, the second 52, while the last records as little as 14. Statistics on usage (for instance, deposit value over accounts and debits over deposit value) and on spatial coverage (for instance, average distance to branches or ATMs) also show large differences between provincial financial systems. In broad terms, levels of bank use among the population and across local financial systems is correlated to the degree of economic development in the respective provinces[14].

[12] The reference is made to household loans exclusively as the distribution of total loans may be skewed by the practice by medium and large corporations of obtaining financing in the city of Buenos Aires regardless of the location of their productive units.
[13] To estimate relative levels of bank use, a ranking was constructed giving equal weighting to several variables that capture different aspects of bank use.
[14] Estimating an ordinary least-squares linear regression for deposits per person in terms of GDP per person, the latter is statistically significant at a 99% confidence level, with an R^2 of 0.73. Removing the city of Buenos Aires from the sample gives 98% significance and an R^2 of 0.6. Estimating deposit accounts per person in terms of average income yields the same results.

Table B2.2
Depth of local markets
Selected ratios - June 2004

Provinces sorted by level of bank use	Accounts per100 persons	Persons / Branch	Persons / ATM	Surface area / Branch	Deposits / Accounts	Debits / Deposits	Deposits / Person
		Thousand		per 1.000Km2	thousand $	units	thousand $
First quartile	111	6	3	0.6	6.0	1.9	6.7
Without city of Bs. As.	56	7	6	1.4	2.8	1.5	1.6
Second quartile	35	12	6	0.6	3.6	0.9	1.3
Without Bs. As. province	37	10	7	1.0	3.8	1.3	1.4
Third quartile	21	19	12	2.0	3.0	1.2	0.6
Fourth quartile	19	22	13	2.4	2.2	1.0	0.4
Total	45	11	6	0.8	4.6	1.5	2.1

Source: BCRA

On the supply side of bank services, local markets are serviced by four types of institutions, according to geographic range. As of June 2004, institutions can be sorted according to local (52% of the total), regional (31%) or nationwide (17%) coverage[15], and most are private (86%). In general, the number of institutions present in a given market is closely tied to its absolute size, and remains consistent with fixed cost considerations requiring a certain scale for a bank to run. In terms of deposits, even though banks with a nationwide coverage tend to predominate in most provinces, there is a large group of markets in which regional or local banks have a large presence (see Table B2.3). Based on information as of June 2004, bank concentration can range substantially across provinces. Additionally, there is a statistically significant correlation between the level of concentration and the average time deposit rate in each province. It should be mentioned, however, that this is not necessarily due to a lower level of competition as there are other variables (size, term, depositor type, etc.) with an influence on the average rate and which show considerable dispersion across provinces.

Table B2.3
Local markets - Deposits by type of institution
Non-financial private sector deposits in pesos - June 2004

Sorted by	% share by type of institution				Leader's share	Interest rate - %	
% share in private depos.	National	Regional	Local	Total		General average	Time deposit
City of Bs As	75	12	12	100	14	1.4	3.2
Province of Bs As	67	32	0	100	26	1.6	3.0
Córdoba	47	53	1	100	32	1.8	3.1
Santa Fe	58	40	2	100	23	1.4	3.2
Mendoza	76	24	0	100	26	1.7	3.3
Entre Ríos	46	54	0	100	47	2.4	3.1
Tucuman	67	2	31	100	20	2.2	3.7
Chubut	70	7	23	100	23	1.7	3.1
Río Negro	95	5	0	100	31	3.0	3.0
Salta	96	4	0	100	31	1.9	3.1
Neuquen	66	34	0	100	31	1.6	3.4
La Pampa	29	71	0	100	71	1.2	2.9
Chaco	75	1	24	100	37	1.8	3.0
Corrientes	70	30	0	100	35	2.0	2.9
San Juan	70	30	0	100	24	1.4	3.4
Misiones	95	5	0	100	41	2.0	3.2
Jujuy	100	0.01	0	100	44	2.1	3.1
Sgo. del Estero	76	0.01	24	100	35	1.9	2.9
Santa Cruz	60	40	0	100	32	2.5	3.6
San Luis	66	34	0	100	30	1.9	3.0
T. del Fuego	74	26	0	100	26	1.9	3.0
Catamarca	100	0	0	100	56	1.7	3.0
La Rioja	92	8	0	100	40	2.4	3.3
Formosa	86	1	14	100	55	0.9	3.2
Total	70	22	8	100		1.6	3.1

Source: BCRA

[15] Includes private and public institutions. An institution is defined here as operating locally if it is present in only one market (district), and nationwide if it operates in more than half the number of markets.

Table III.2

Loans to the private sector by group of banks

% change based on balance sheet totals

	2004	Jun04/Aug03	Share of total (Jun04)
Public banks			
Total loans	***3***	***4***	***27***
Commercial	10	12	18
Consumer	29	54	22
Other	-4	-6	37
Domestic private banks			
Total loans	***16***	***24***	***31***
Commercial	29	41	37
Consumer	17	35	36
Other	3	4	24
Foreign controlled private banks			
Total loans	***10***	***7***	***40***
Commercial	25	19	45
Consumer	16	34	35
Other	-3	-9	37
Total private banks			
Total loans	***13***	***14***	***7034***
Commercial	26	28	8184
Consumer	16	34	7041
Other	-1	-4	62
Total system			
Total loans	***10***	***12***	***100***
Commercial	23	25	100
Consumer	21	41	100
Other	-2	-5	100

Note:

Does not include accrued interest or CER/CVS adjustments.

Commercial loans include overdraft and acceptance of promissory notes.

Consumer loans include credit card and personal loans.

"Other" includes pledge-backed and mortgage.

Balance sheet totals adjusted by the setting up/winding down of trust funds, and transfers/ sales of portfolios

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

Source: BCRA

Long term credit lines continued to show signs of recovering during the first months of the year. Pledge-backed loans (typically for autos and equipment) increased by 2% during the first half, with a high participation rate by private domestic banks. A growing number of institutions stated to record positive changes in the stock of mortgage loans during the first months of the year. Although amortizations and prepayments continued to exceed new loans for the financial system aggregate (and for foreign-controlled banks in particular), it is likely to turn around in the second half of the year.

In line with the expected path for the inflation rate, banks increased their asset position in CER-adjusted LEBAC throughout the first half of the year. The behavior across bank groups was uneven. For private banks, the fall in unadjusted LEBAC was more than offset by a $850 million increase in CER-adjusted bills. The system as a whole significantly increased its holding of LEBAC[16] (causing their share of total assets to increase to 5%), with public banks accounting for a large part of the increase.

As part of their balance sheet structure adjustments to meet their own risk management policies, banks reduced credit to the public sector. Sales of sovereign debt securities and the cancellation of foreign liabilities through swaps for these securities led to a 3 p.p. fall in the share of credit to the public sector in terms of total assets, to a level of 44% in June 2004 (see page 37 in the chapter on risk management).

[16] Holdings net of reverse repos with the Central Bank.

IV. RISK MANAGEMENT

Summary

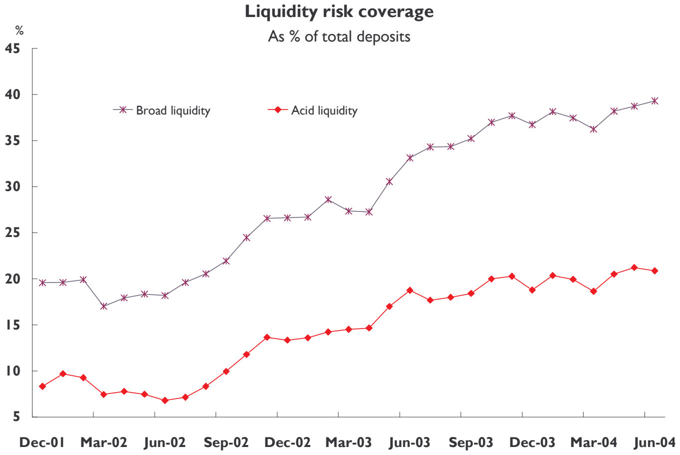
Although the financial system has yet to fully resolve the imbalances inherited from the crisis in 2001-2002, developments regarding the administration of the principal risks faced by banks have continued to strengthen the solvency and stability of the system. Actions by both the Central Bank and the financial institutions themselves, added to the positive macroeconomic context, were the basic reasons behind the favorable performance by banks during the first six months of 2004.

After a period of strong domestic turbulence, the main challenge that faced the financial system was to recover adequate liquidity levels by building up depositor confidence. Banks were notably successful in achieving this objective, liquidity levels both for the system as a whole (22% of deposits) and individually were in excess of Central Bank requirements by about 6% of deposits as of mid-2004. With a view to taking a further step towards normalization, the financial system began to lend again, which, while not affecting the robustness of the system in facing liquidity risks, nevertheless contributed to a deceleration in the rate of growth of these indicators. In the short to medium term the strength of the financial system in the face of liquidity risk will rest on four main pillars: consolidating the growth of private sector deposits, overcoming segmentation in the call money market, developing a repo market (between financial institutions and with the Central Bank) and the ability of the monetary authority to act as a lender of last resort.

In the first half of the year financial institutions improved their protection against the exposure to credit risk, providing an impulse to the normalization of the system. The reduction of the exposure of net worth to its principal debtor, the public sector, added to the reduction in implicit risk in government performing debt, have improved the outlook for banks. The favorable domestic macroeconomic context has also provided a positive framework for the performance of the private sector. Lower delinquency levels were recorded across all productive sectors, as well as for households, with a drop since the end of 2002 of 15 p.p. in overall private sector delinquency (which currently stands at a level of 25%). Growing needs for financing, added to lower counterparty risk (which stimulates the availability of credit) is causing a gradual increase in the exposure of the financial system to the private sector. These features (lower credit risk and low initial exposure level), added to the administration policies of the banks, will provide a wide margin for credit to the private sector to grow without becoming a source of system fragility.

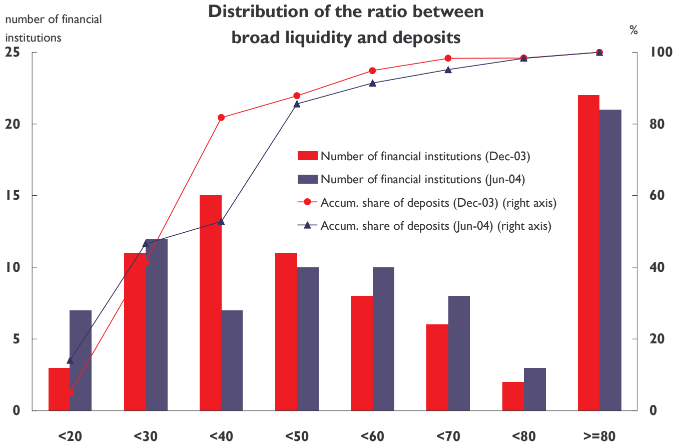
The financial system still records significant currency mismatches, in part as a consequence of the crisis in 2001-2002. Mainly as a result of the policy for administering liabilities in foreign currency, the exposure of the financial system to the volatility of the dollar exchange rate has recorded an increase from mid-2002 through to the present. Furthermore, the crisis also produced a mismatch in terms of CER-adjusted assets and liabilities that has not yet been solved. These elements are the most representative volatility factors in the post-crisis period. In the margin, although potential losses are limited, the market risk level is well above the historical average. The current development of hedge markets has started to provide instruments for a more efficient approach to such risks, and it is hoped that the market will deepen in the medium term. These are the elements on which the financial system will have to focus its risk management efforts.

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



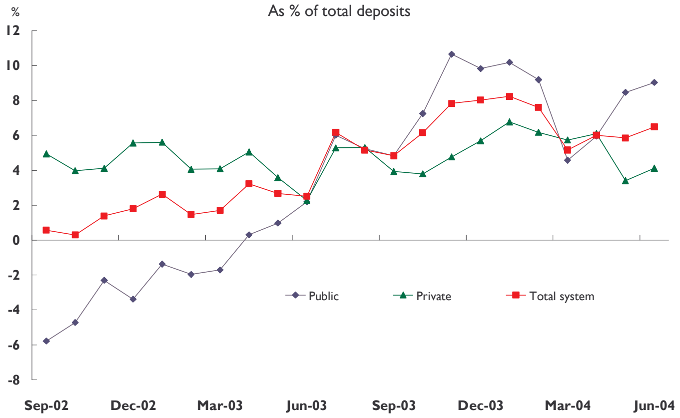
Source: BCRA

Chart IV.2
Distribution of the ratio between broad liquidity and deposits



Source: BCRA

Chart IV.3
Excess cash reserves in pesos
As % of total deposits



Source: BCRA

V.1. Liquidity risk

In the 2002-2003 period banks were able to noticeably strengthen their deteriorated levels of liquidity, inherited from the deep banking crisis. This achievement was based on the partial recovery of confidence in the financial system and the effects of the Central Bank's monetary policy. In the first half of 2004 deposits continued to grow, while interest rates remained at all-time lows. This situation, added to the still incipient take-off by lending, has consolidated the already high levels of cover against liquidity risk. (see Chart IV.1).

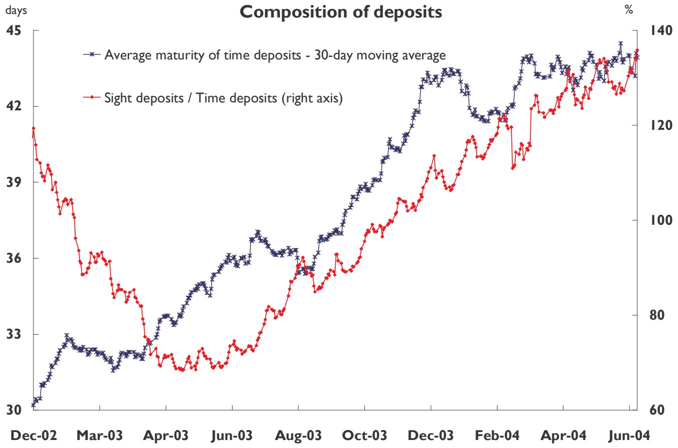
Contrary to what happened in the previous year, in 2004 the financial system began to increase the balance of its lending to the private sector, so that the share of deposits used towards liquid assets has been lower than in 2003. As a result, the liquidity risk coverage ratios grew at a significantly lower rate compared to the same period of the previous year. In terms of the acid liquidity rate (deposits in Central Bank current accounts only), cover by total deposits increased by just 2.1 p.p. in the first half of 2004 (to a level of 21%) compared to 5.4 p.p. in the same period of 2003. Broad liquidity (minimum cash reserve compliance, other available funds, holdings of Central Bank securities and holdings of LEBAC and NOBAC from repos) recorded a similar performance.

In mid-2004, the financial system is in a historically strong position against the risk of massive unexpected withdrawals of funds. Despite the favorable position in terms of aggregate liquidity, it is important to analyze the individual situation of the different banks, because of their potential impact on the system as a whole. Although at times of strong demand for liquidity there have been certain temporary difficulties, banks can count on a relatively even distribution of liquidity across the system. One group of financial institutions holding approximately three-quarters of all deposits records broad liquidity indicators within a range of between 20% and 50% (see Chart IV.2). Most smaller banks record indicators in excess of 50%. In June 2004 there was no bank with a broad liquidity ratio of less than 16%.

Both private and public banks began 2004 well in compliance with the Central Bank's minimum cash reserve requirements (see Chart IV.3). Various factors combined to increase volatility compared to levels of the previous year: the recovery in lending, payments to international financial institutions, tax deadlines, a reduction in cash reserve requirements, the elimination of remuneration on surplus compliance with reserve requirements and the creation by the Central Bank of a repo market using LEBAC and NOBAC.

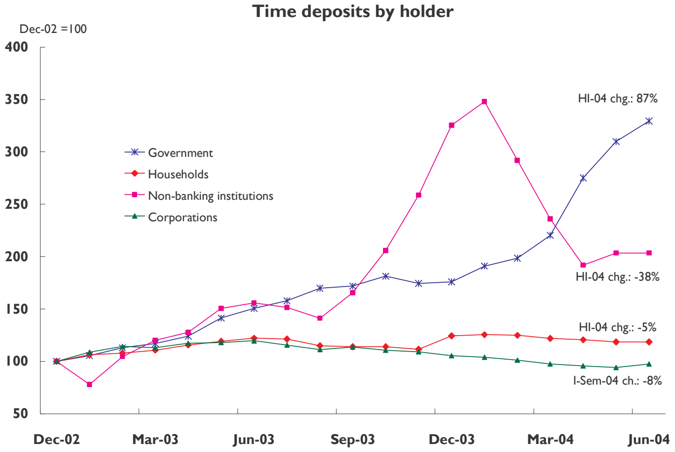
After 5 years of constant contraction, in the first half of 2004 there was a revival of lending to the private sector, leading to a significant allocation of resources by financial institutions (see page 28, chapter on business structure). As a result, the system is gradually returning to its principal role of intermediation (fundamental for the strengthening of its solvency), leaving behind a stage during which a large portion of the funds taken were used to acquire low-yielding liquid assets.

Chart IV.4
Composition of deposits



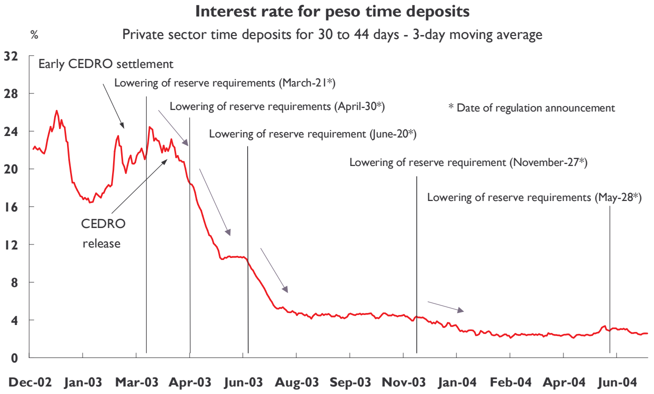
Source: BCRA

Chart IV.5
Time deposits by holder



Source: BCRA

Chart IV.6
Interest rate for peso time deposits
Private sector time deposits for 30 to 44 days - 3-day moving average



Source: BCRA

Furthermore, elements of a circumstantial nature contributed to the volatility of liquidity surpluses. Large payments were made to international agencies, using government funds held by public banks, and income tax payment deadlines led to a transfer of liquidity from private to public banks (from company accounts in the former to public sector accounts in the latter).

A new active policy for the regulation of the money market began to be implemented towards the end of the first half of 2004. At the same time, with the aim of establishing a benchmark interest rate, the ground was laid for a local Central Bank repo market using LEBAC or NOBAC as underlying assets. This was complemented by an initial reduction in cash reserve requirements in pesos. As there are no lender of last resort facilities in dollars, from August this year the liquidity requirement for liabilities in foreign currency was increased. In addition, the remuneration of surplus compliance with cash reserve ratios was eliminated, increasing the opportunity cost of these holdings and encouraging their use towards the growth of lending. In June 2004 the impact of the reduction in reserve requirements exceeded the amount of the funds transferred to the repo market, giving rise to a slight increase in the liquidity surplus in pesos.

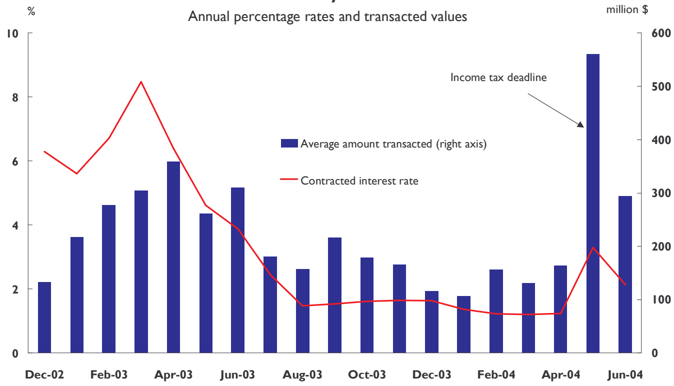
Certain aspects should be noted which, while not diminishing the overall strength in the face of liquidity risk, nevertheless will need to be taken into consideration in future. First, the upward trend in the average term of new time deposits came to a halt in 2004 (see Chart IV.4). There was also an increase in the share of sight deposits in terms of total deposits. During the first half of 2004 such deposits increased by 27 p.p. in terms of time deposits. This behavior has manly been due to the impact of the tax on bank account debits and credits on the yield of time deposits amid a context of low interest rates. These changes must be considered as a negative factor regarding exposure to liquidity risk, imposing restrictions on the reduction of term mismatches and thus having a negative influence on the supply of medium and long-term loans to the private sector.

The behavior of time deposits held by companies, households and non-bank financial intermediaries was consistent with what was said above (see Chart IV.5). The public sector recorded a strong increase in such deposits, with a rise so far this year of 87 percent. This increase in the participation by the public sector in time deposits adds certain volatility to bank funding.

In the first part of 2004, the strength shown by the financial system has been consistent with the Central Bank's monetary policy. Financial institutions matched declining benchmark interest rates with a cut in borrowing rates, significantly reducing their financial costs (see Chart IV.6). The combination of deposit growth and lower rates of interest is a sign of greater confidence in the financial system.

The robust liquidity position recorded by banks is supported on three basic pillars: a reviving call money market, an incipient market for Central Bank repos, and the return of the Central Bank's powers to act as a local currency lender of last resort.

Chart IV.7
Call money market
Annual percentage rates and transacted values



Source: BCRA

With the aim of restoring liquidity to the call money market and moderating its characteristic segmentation, the Central Bank began to generate incentives to stimulate participation by financial institutions in this circuit (see Chart IV.7). The setting up of a repo market using Central Bank securities is a step in this direction, providing a stimulus to money markets and providing banks with a new source of liquidity.

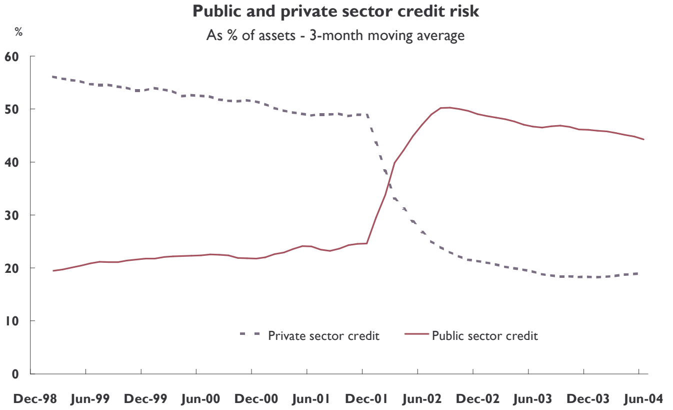
The third pillar is essential to the strengthening of the situation of the financial system in the face of exposure to liquidity risk, reinforcing systemic stability: the recovery by the Central Bank of its role as a lender of last resort. The possibility of gaining access to direct lines of credit from the Central Bank in times of liquidity shortage constitutes an incentive that helps to prevent unexpected outflows of liabilities. To achieve the mentioned objective, the Central Bank's policy for providing financial assistance to banks is included in a fair and transparent regulatory framework that grants credibility to the handling of monetary policy.

In the short term, although there is expected to be a reduction in the current high levels of liquidity, the position of the financial system in relation to liquidity risk will remain strong. This is explained by the growing allocation of liquid funds to private sector lending, added to the deepening of the call money and repo markets, and the position of the Central Bank as a lender of last resort, all of which form part of the progress towards the normalization of the local financial system. In coming months banks must concentrate their efforts on improving their main weakness in terms of liquidity risk, namely the low maturity of their deposits. This element is essential if there is to be any take-off in medium term lending, without an excessive exposure by financial institutions to liquidity risk.

IV.2. Credit risk

IV.2.1. Public sector

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

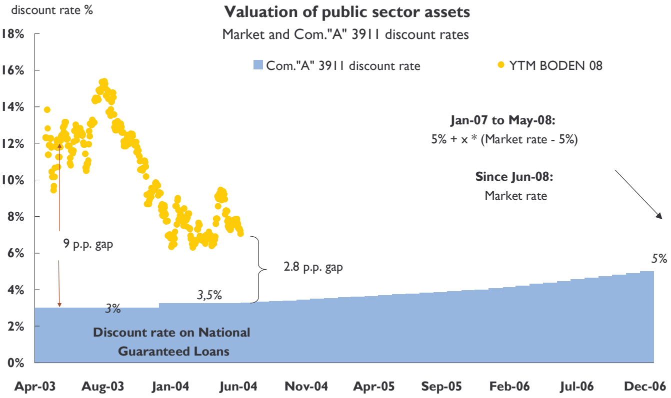


Source: BCRA

As a result of the crisis in 2001-2002, banks recorded a significant increase in their risk from exposure to public sector lending, with an opposite movement in their exposure to private sector credit risk. The public sector became the principal debtor of the financial system, largely due to compensation received from the forced asymmetric conversion into pesos (so called *pesificación*) of assets and liabilities. A considerable proportion of compensation was denominated in dollars to cover the resulting net negative position in foreign currency.

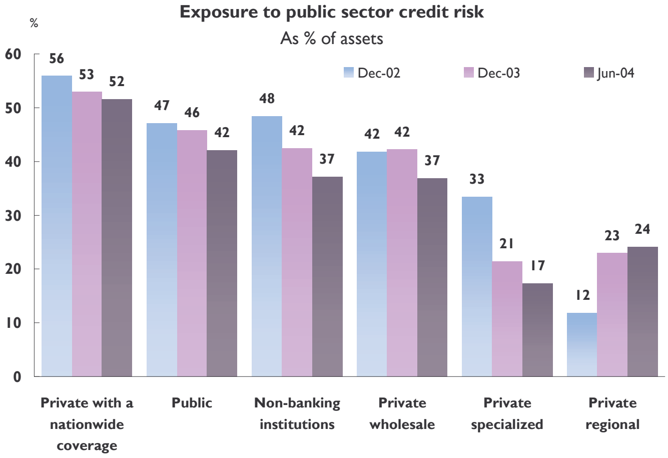
During the first half of 2004, the financial system recorded a moderate reduction in its exposure to public sector credit risk, which still remains at a high level in historical terms. As at June 2004 total lending to the public sector was equal to 43 percent of financial system assets, 3 p.p. below the level at the end of 2003 (see Chart IV.8). There are various reasons for this change. To begin with, there was a drop in the holding of government securities as a result of both direct sales on secondary markets and debt swaps. As part of the process for the restructuring of liabilities and the settlement of foreign debt, several banks made

Chart IV.9
Valuation of public sector assets
Market and Com."A" 3911 discount rates



Source: BCRA

Chart IV.10
Exposure to public sector credit risk
As % of assets



Source: BCRA

Table IV.1
Bank exposure to the public sector
June 2004 - In millions

	Pesos		Dollars		Total	
	Amount	%	Amount	%	Amount	%
Public bonds (*)	**22,234**	**100**	**14,707**	**100**	**36,941**	**100**
Performing	20,430	92	7,972	54	28,402	77
BOGAR	18,230	82	0	0	18,230	49
BODEN	2,199	10	7,972	54	10,172	28
Debt to be restructured	1,804	8	6,734	46	8,538	23
"Bono patriótico"	-	-	3,522	24	3,522	10
Global 18	-	-	1,192	8	1,192	3
Global 08	-	-	687	5	687	2
Other	1,804	8	1,333	9	3,137	8
Credit lines	**34,570**	**100**	**457**	**100**	**35,027**	**100**
Performing	31,022	90	-	-	31,022	89
National Guaranteed Loans	30,359	88	-	-	30,359	87
BODEN 07 bill	663	2	-	-	663	2
Compensation receivable	**3,116**	**100**	**11,121**	**100**	**14,237**	**100**
Performing	3,116	100	11,121	100	14,237	100
Total	**59,919**	**100**	**26,285**	**100**	**86,205**	**100**
Performing	54,568	91	19,094	73	73,661	85

(*) Does not include BCRA securities

Source: BCRA

settlements by transferring performing securities to their parent companies.

In addition, there was a drop in the amount of compensation receivable, as a result of the continuous downward adjustments to its calculation. These movements were partly offset by the increase in the balance of loans to the public sector from CER adjustments and the accounting impact of steps taken by certain banks to bring them into line with the new regulations on minimum capital.

The adjustments made to the valuation of public sector assets in accordance with Central Bank requirements also had an impact of loan and security balances[17]. In view of the development of the prices of these assets, the gap between the market discount rate and the interest rate currently used to discount the payments to be received for those assets (see Chart IV.9) has remained narrow. Furthermore, in the first half of 2004, with the aim of increasing the transparency of the financial position of banks, the Central Bank improved the valuation mechanism for certain public sector assets using their present value[18].

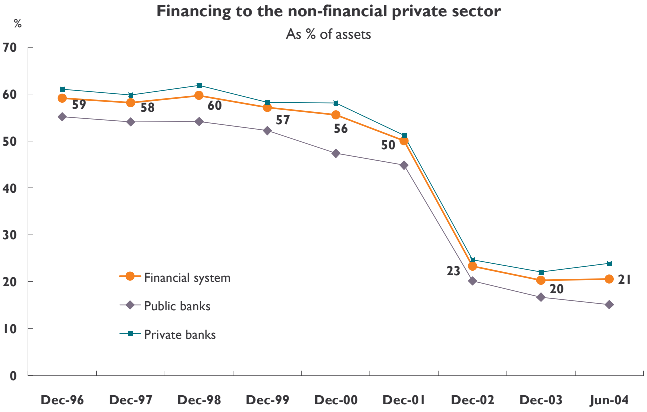
The reduction in exposure to the public sector was widespread among the various bank sub-groups (see Chart IV.10); there has only been a continuous increase in the case of private regional banks, which have less exposure to the public sector[19]. Larger banks (private banks with a nationwide coverage and public banks) continue to be those that hold balances that are most exposed to the risk of lending to the public sector.

Although the sovereign debt restructuring process continues, there are hopes that progress will have been made by the end of this year. Furthermore, as mentioned in the previous edition of the FSB, the influence of this process on the domestic financial system is indirect, as only 15% of the exposure of banks to the risk of lending to the public sector is made up of assets included in that negotiation (see Table IV.1). Nevertheless, as long as this matter remains unresolved, uncertainty will persist that will prevent any extending of the horizon for investors. In addition, the mentioned restructuring could impact on bank balance sheets if the prices of post-default government securities are affected, as they represent almost one third of the exposure of banks to the public sector.

The steady improvement in the fiscal front (based on a significant recovery in revenues) has enabled continued servicing of performing debt. As a result, prospects for the public sector's payment capacity have remained relatively positive, with a reduction in the level of perceived credit risk (see page 17, chapter on financial system debtors). The consolidation of this situation and the downward trend in the participation of such assets on bank balance sheets – which is expected to continue as maturities take place, valuation mechanisms are gradually implemented, and the compensation recorded on bank balances is

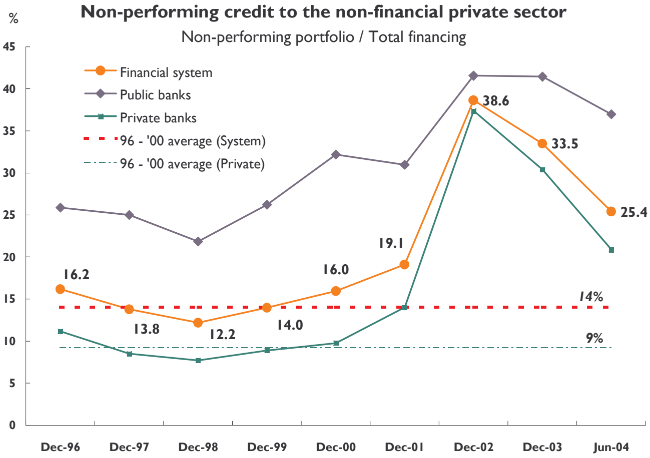
[17] The Central Bank has adopted a gradual approach for adjustments to the valuation of public sector assets. Under current regulations, the change from book value to market value is being carried out according to a set schedule, with the aim of marking them to market as from 2008.
[18] For further details, see Com. "A" 4163 and 4180.
[19] The regional private bank group includes three institutions currently in the process of being restructured that are under the administration of a national public bank.

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



Source: BCRA

Chart IV.12
Non-performing credit to the non-financial private sector
Non-performing portfolio / Total financing



Source: BCRA

Table IV.2
Transition matrix December 2003 / June 2004
Weighted by amount - In %

		June 2004								
		1	2.a	2.b	3	4	5	6	Write off (*)	TOTAL
December 2003	1	**87.7**	2.2	0.2	0.9	0.8	0.1	0.0	8.1	**54.3**
	2.a	15.6	**69.6**	1.2	6.8	3.4	0.1	0.1	3.2	**8.1**
	2.b	5.0	0.1	**91.8**	1.8	0.1	0.1	0.1	0.9	**2.2**
	3	9.2	5.7	0.2	**57.5**	9.7	1.2	0.1	16.4	**7.0**
	4	2.5	0.5	0.1	3.6	**67.0**	10.7	0.5	14.9	**11.6**
	5	2.0	0.5	0.4	0.5	1.6	**77.8**	0.5	16.8	**15.5**
	6	0.5	2.5	0.0	1.1	1.2	0.5	**91.7**	2.5	**1.2**
	TOTAL	**50.3**	**7.4**	**2.3**	**5.6**	**9.4**	**13.4**	**1.3**	**10.2**	**100.0**

Figures based on debtor information at the start of the excercise
(excludes debtors of institutions that have dissapeared over the period)
(*) Includes both repaid financing and that charged-off from balance.
Source: BCRA

gradually written down – will have a favorable impact on the exposure of bank net worth to risk from the public sector.

IV.2.2. Private sector

During the first half of 2004, private sector credit risk continued to decline (see page 18 of the chapter on financial system debtors). In this context, encouraged by new prudential regulations that favor expected cash flow analysis over the current situation as reflected on balance sheets (badly affected by the recent crisis), banks increased their lending and made progress on the refinancing of their receivables. As a result, the increase in the level of lending to the private sector took place at the same time as a steady improvement in indicators of portfolio quality (returning to close to historical levels), coverage, and exposure to credit risk.

For the first time in five years, in the six months under review there was a change in the declining trend in exposure to the private sector. The steady drop in credit to the private sector in terms of assets that took place since 1998 accelerated sharply during 2002, so that by the end of 2003 it stood at 20% of assets, almost one third of its historical level. This led to a relative decline in the significance of potential losses associated with private sector credit risk to the banking sector. The other side to this phenomenon has been the severe weakening of its profit base. It was in such a context that lending to the private sector increased by 10% between December 2003 and June 2004, led by private banks (with a 13% increase), while the rise recorded by public banks was lower (3%). As a result of these changes, loans measured in terms of assets have recorded a modest half-yearly increase for the system as a whole (see Chart IV.11), with a rise of 1 p.p. in this ratio in the case of private banks.

This new lending (granted at the same time as financial positions were improving) helped to ensure that the quality of the total portfolio of loans to the private sector continued to recover significantly. Private sector lending portfolio non-performance, which at the peak of the crisis reached levels of close to 40% for the system as a whole, ended the first half of 2004 at a level of 25% (see Chart IV.12). In addition, this improvement was reflected in the drop in the amount of loans rated as non-performing, in part due to refinancing agreements made according to changes by the Central Bank[20]. Furthermore, only a small portion of the gain in portfolio quality was due to the writing off and transferring to memorandum accounts of loans considered to be unrecoverable[21].

This improvement in portfolio quality was widespread, although the performance by private banks was particularly notable (retail banks with a nationwide presence leading the way), as they lowered their non-performance by 10 p.p. in the half-year. In the case of public banks, the recovery was not as sharp, with a drop of 4.5 p.p. in the first half. Nevertheless, it is clear that there is still considerable room for improvement in portfolio quality, bearing in mind that in the pre-crisis period delinquency rates

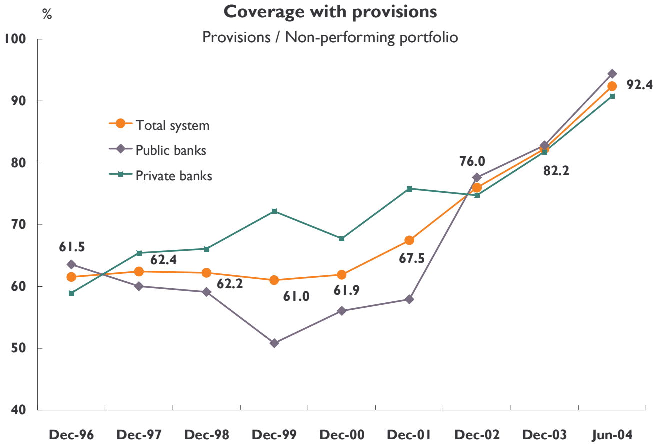
[20] For further information, see page 39 of the FSB for the first half of 2004.
[21] If an adjustment is made to compensate for this latter effect, it is estimated that the non-performance of the system's portfolio dropped 1 p.p. in the same period.

Table IV.3
Transition matrix June 2003 / June 2004
Weighted by amount - In %

		Jun-04								
		1	2.a	2.b	3	4	5	6	Write off (*)	TOTAL
June 2003	1	**78.7**	3.4	1.7	1.4	1.3	0.5	0.0	13.0	**46.5**
	2.a	24.2	**46.6**	2.5	9.6	3.3	1.6	0.1	12.3	**9.1**
	2.b	13.2	6.4	**59.4**	7.1	2.4	0.2	0.2	11.2	**1.7**
	3	14.8	6.1	1.8	**30.8**	18.4	6.1	0.3	21.8	**9.7**
	4	5.2	4.8	0.2	4.5	**36.8**	19.0	2.4	27.0	**17.0**
	5	3.6	0.9	0.0	0.9	1.9	**60.4**	2.9	29.5	**15.6**
	6	4.3	0.2	0.0	0.9	3.0	4.2	**68.1**	**19.3**	**0.4**
	TOTAL	**41.9**	**7.5**	**2.2**	**5.6**	**9.3**	**13.6**	**1.2**	**18.8**	**100.0**

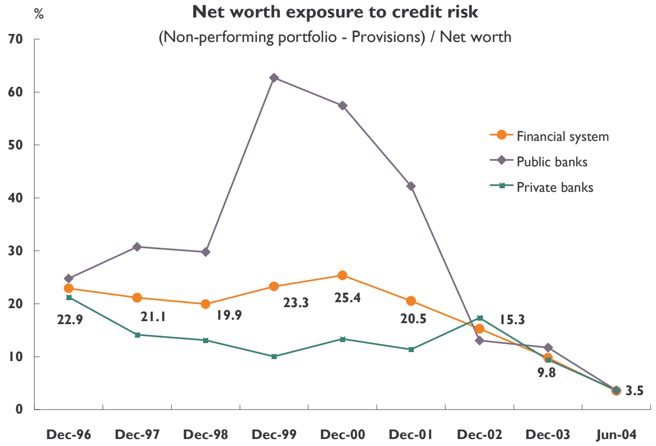
Figures based on debtor information at the start of the excercise
(excludes debtors of institutions that have disappeared over the period)
(*) Includes both repaid financing and that charged-off from balance.
Source: BCRA

Chart IV.13
Coverage with provisions
Provisions / Non-performing portfolio



Source: BCRA

Chart IV.14
Net worth exposure to credit risk
(Non-performing portfolio - Provisions) / Net worth



Source: BCRA

were close to 9% for private banks, more in line with portfolio non-performance levels seen in other economies in the region[22].

A significant reclassification has taken place for loans originally classified as level 3, as well as a notable elimination (from repayment or transfer to memorandum accounts) of non-performing loans, particularly in the case of those included in levels 4 and 5 (see Table IV.2). The classification of performing loans on the whole remained stable. After six months, 80% of the loans that existed at the end of 2003 retained their classification[23], while 4% recorded an improvement and 10% were repaid. In the case of loans in effect in mid-2003 (see Table IV.3), given the more extended period of analysis in the context of an improvement in portfolio quality, there has been a greater reclassification of non-performing loans to the better levels[24].

Provision levels continued to rise during these six months. The provisions to private sector non-performing portfolio ratio rose 10 p.p. to 92% between the end of 2003 and mid-2004 (see Chart IV.13). This behavior was similar for both private and public banks; coverage for the latter, traditionally lower than that of private banks, has moved into line with the average for the system.

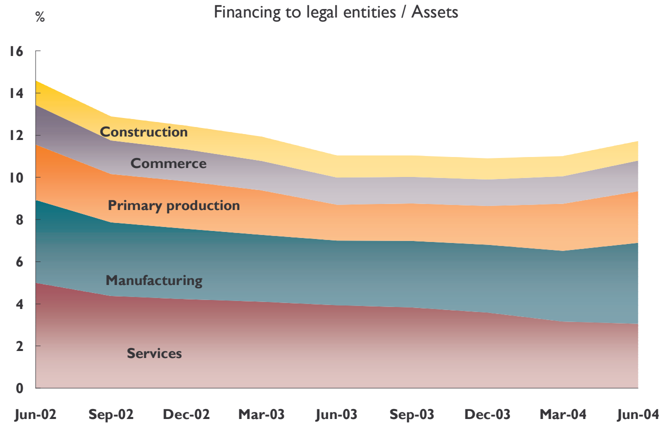
The exposure of net worth to private sector credit risk continued to decline as a result of the positive factors mentioned (a declining overdue portfolio and increased coverage through provisions), despite the decline in net worth over the six months. Non-performing loans not covered by provisions represent a diminishing share of net worth; by mid-2004 they represented almost 4% of net worth, almost one third of their level at the end of 2003 and well below the pre-crisis average (see Chart IV.14). The low level shown by this indicator highlights the reduced potential for erosion of bank net worth from any unexpected private sector uncollectability, in a situation noted for the low current weighting of private sector lending in relation to the level of activity.

The level of credit risk faced by banks is expected to fall in coming months, as the macroeconomic situation remains sound and situations of financial stress have diminished (see page 14, chapter on macroeconomic context). As a result, in the context of a drop in risk perception by banks and an improvement in the business outlook, the exposure to the private sector is expected to continue to gain strength. The upside is significant – given the low starting point in terms of GDP – and would be driven at the microeconomic level by the favorable risk-return trade-off that exists for this activity.

In the case of loans already granted, further progress with the restructuring of corporate liabilities (for significant amounts in the second half of the year) also suggest optimism regarding the continued decline in credit risk faced by banks.

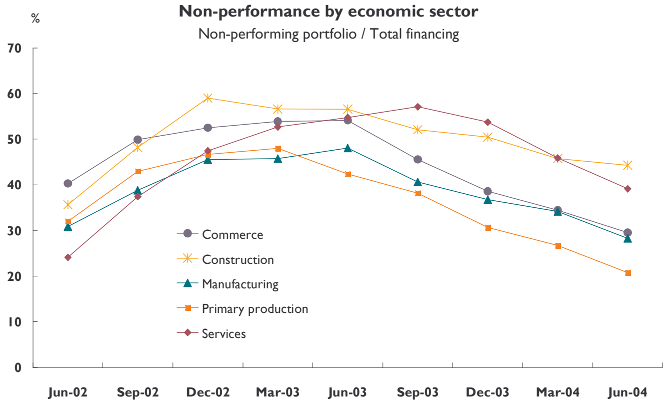
[22] Average non-performance for Latin America in 2003 was 9.6%, with an average of 7.8% (Source: Global Financial Stability Report, International Monetary Fund, April 2004. It should be noted that there could be differences in the classification criteria used in the various countries).
[23] This calculation is based exclusively on loans as of December from banks that remained in operation throughout the period.
[24] Changes to regulations at the end of 2003 included allowing the classification of commercial debtors in situation 1 (normal), even if their debt has been refinanced, as long as they meet the remaining parameters for classification in that category. However, the release of provisions by the financial institution may only take place once the principal repayments required by the regulations have been made.

Chart IV.15
Bank exposure to economic sectors
Financing to legal entities / Assets



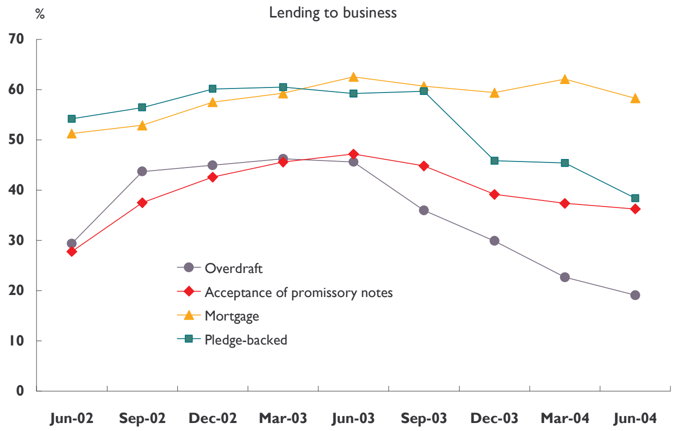
Source: BCRA

Chart IV.16
Non-performance by economic sector
Non-performing portfolio / Total financing



Source: BCRA

Chart IV.17
Non-performance by type of financing
Lending to business



Source: BCRA

It is expected that the private sector loan portfolio will become increasingly healthy, moving towards a situation in which loans to the private sector gain greater weighting, with single-digit non-performance levels.

Corporations

As a result of improvements in economy fundamentals, and as banks resolved their liquidity difficulties, the financial system was able to begin to revitalize its lending, accelerating the rebuilding of its profitability levels. In this situation, banks succeeded in slightly increasing the level of their lending to the corporate sector in the first half of 2004, after several years of steady decline. The manufacturing and primary production sectors were at the forefront of this change in trend, and there was also an increase in lending to the commerce sector (see Chart IV.15). In view of the starting point – noted for a limited exposure to corporate credit risk due to deteriorated financial intermediation – this turning-point in the path of bank exposure to the risk of lending to corporations is a clearly positive sign for the financial system and the economy as a whole.

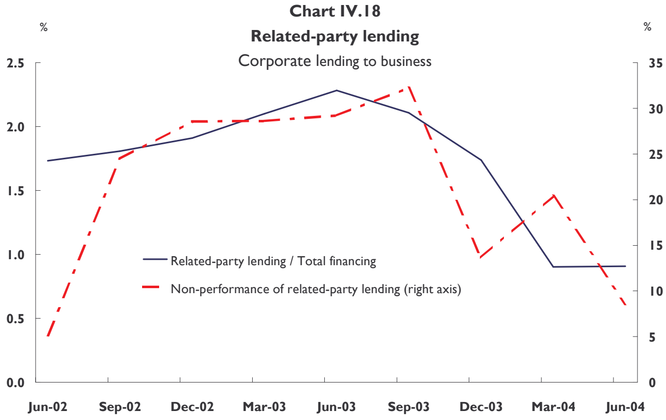
The notable improvement in economic activity as from 2002 was reflected in the strengthening of the payment capacity of corporations (see chapter on financial system debtors, page 17). The momentum was sustained through the first half of 2004, although in the second quarter the rate slowed. Nevertheless, the gains made in payment capacity continue to contribute to an environment in which banks face a declining counterparty risk. Changes to Central Bank regulations and institutions' prudent risk management policies have meant an overall improvement in credit portfolio quality indicators (see Chart IV.16). Manufacturing and services (sectors of importance to the financial system) have recorded significant improvement in delinquency levels.

It is hoped that as major instances of liability restructuring in the service sector come to a close, they will prompt pending improvements in portfolio non-performance. Primary goods sectors, together with manufacturing, have been the strongest in recent times, as can be seen from the increased lending to these sectors during the first half of this year. This helped these sectors achieve the lowest non-performance levels.

Growth in lending to companies during the first half of the year was headed by overdrafts, with a considerable increase also taking place in discounted and purchased promissory notes, as well as mortgage loans. There was significant improvement in the quality of overdrafts, the line that recorded the lowest non-performance in June 2004 (close to 19%), a drop of one third over the half-year (see Chart IV.17). The decline in delinquency in the case of promissory notes and pledge-backed loans was less noticeable, while mortgage loans recorded no major improvement in their high non-performance levels.

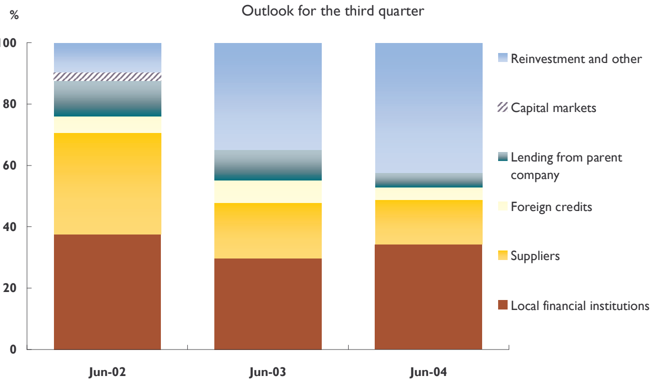
The outlook continues to be particularly favorable for lines such as overdrafts and acceptances of promissory notes, while any improvement in the non-performance of longer-term credit lines will depend on the progress to be made on liability restructuring

Chart IV.18
Related-party lending
Corporate lending to business



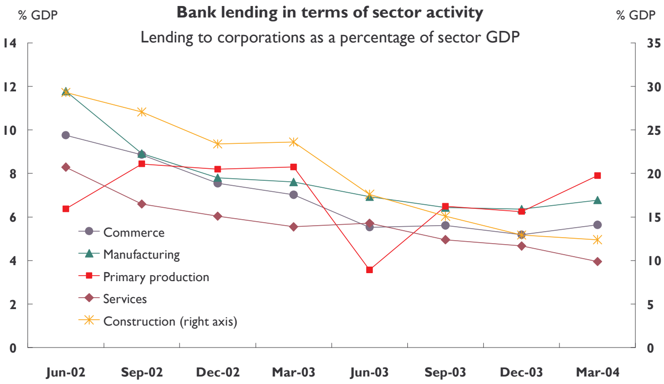
Source: BCRA

Chart IV.19
Expected sources of funds for meeting financing needs
Outlook for the third quarter



Source: EMI - Qualitative information - INDEC

Chart IV.20
Bank lending in terms of sector activity
Lending to corporations as a percentage of sector GDP



Source: BCRA from INDEC data

and the expected reinforcement to be provided in the medium term to lines used for investment financing.

One of the credit risk variables normally analyzed is lending to related parties. This type of credit assistance may be a source of some concern, as it can give rise to incentive problems that interfere with the implementation of a prudent risk management policy. As a consequence of the restrictions imposed by current regulations, in the local financial market credit risk from lending to related parties is very low, accounting for only 1% of lending to corporations as of June 2004 (see Chart IV.18). In recent times, the non-performance indicator for this type of lending has followed that for loan portfolios as a whole, with significant deterioration at the peak of the crisis and a subsequent recovery.

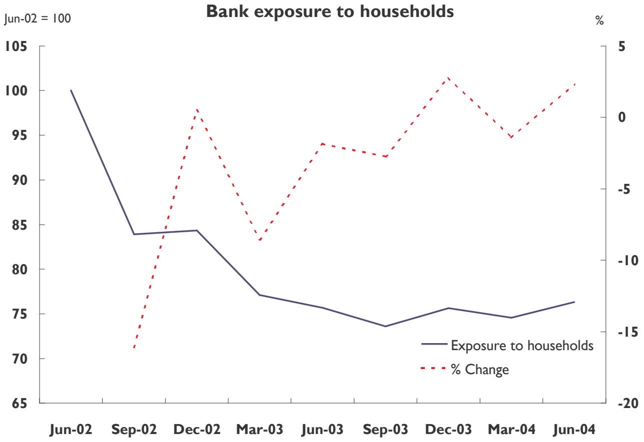
As indicated, expectations for the various productive sectors remain cautiously positive, leading to predictions of a stable level of credit risk and an increase in the exposure of banks to the risk of lending to corporations, given the attractive levels of return. Nevertheless, it is expected that growth in lending to productive sectors will be gradual, in view of the various factors affecting demand and supply of credit.

Regarding the demand for credit, during the height of economic recovery improving cash flows and the lower temporary pressure on outflows due to deferred debt servicing allowed most companies to meet their financing needs out of own funds. This was made possible by the significant under-utilization of installed capacity that existed at the time. Although these factors are gradually changing, there are signs that the proportion of companies meeting their financing needs by means of borrowings from local financial institutions will remain relatively low and stable (see Chart IV.19). Many large corporations indicate that they do not expect any significant change in their short-term borrowing requirements.

The potential for growth in the demand for credit from the majority of sectors might nevertheless be significant. This is particularly so in the case of longer-term debt. Loans in terms of GDP for the various productive sectors (see Chart IV.20) shows that in recent years in most cases (except primary production) the ratio has declined by 50%. Despite the change in relative prices, the trend observed indicates that there would be ample scope for an increase in bank exposure to the various sectors. As long as the positive trend in economic activity is maintained, the need for new investment by sectors currently operating at the limit of their installed capacity will drive demand for longer-term credit. Furthermore, the demand for shorter-term lending is expected to continue to grow in coming months. One positive factor is that the cost of this type of bank finance is currently at a relatively low level. Nominal and real interest rates have continued along their downward path (see Chart IV.22), currently standing below their historical averages.

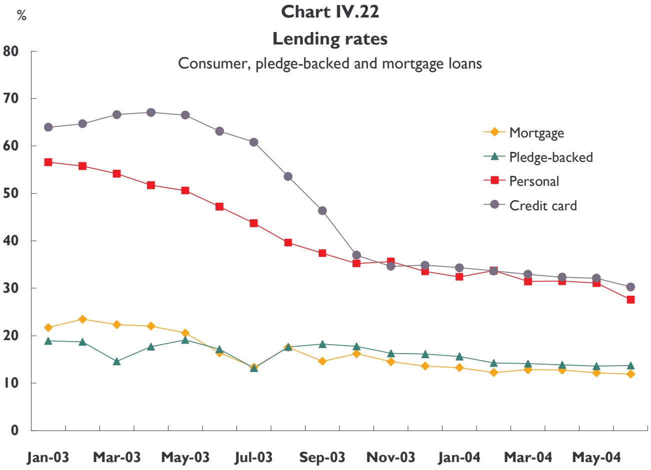
The financial system will remain able to meet increased demand for long-term credit as long as confidence in the system continues to recover. This will imply the need for a longer-term funding structure for banks, including greater access to foreign credit lines and the domestic capital market. In the case of the latter, the end to the restructuring of sovereign debt and the subsequent

Chart IV.21
Bank exposure to households



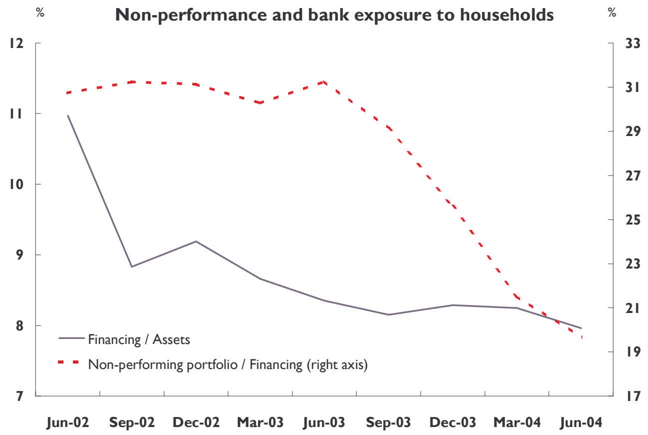
Source: BCRA

Chart IV.22
Lending rates
Consumer, pledge-backed and mortgage loans



Source: BCRA

Chart IV.23
Non-performance and bank exposure to households



Source: BCRA

reduction in uncertainty will lengthen the decision-making horizon for the different market agents involved. It can nevertheless be said that at the present time, given the relative decline in the risk involved in lending to the corporate sector, conditions are coming into place for the stock of lending to recover.

Households

Bank exposure to the household sector, which had already reached a turning-point in its downward trend towards the last quarter of 2003, recorded a slight increase during the first half of 2004. Close to half of all lending to the household sector corresponds to mortgage loans, long-term lines for which demand was particularly affected by the changes in relative prices in the recent past. As long-term lending has still not succeeded in taking off, a recovery of activity for consumer credit lines such as personal loans and credit cards enabled the total balance of lending to the household sector to show a slight positive change in the first half of 2004 (see Chart IV.21).

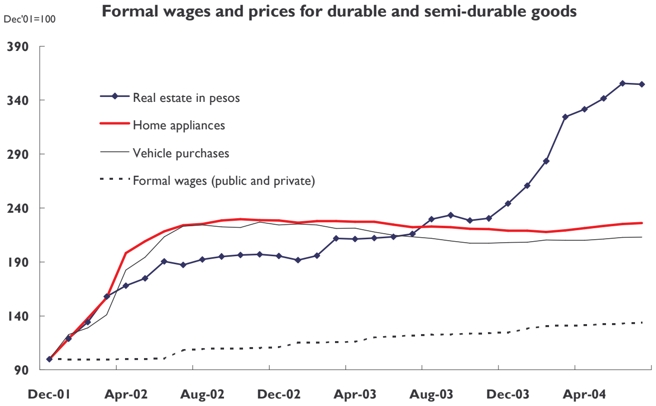
There has been a reduction in the risk implied in lending to households as from the growth recorded in the real economy and its improved outlook, the gradual decline in unemployment levels, a steady recovery in the wage bill (expected to continue in the near future, although at a slower rate) and a slight downward trend that still persists in lending rates (see Chart IV.22 and the chapter on financial system debtors, page 21).

This sector's lower credit risk, added to the incentives that exist for early repayment and the refinancing of debt, has meant that the quality of loans to households has improved steadily since the end of the crisis. This trend persisted during the first half of 2004, with a drop of almost 6 p.p. in the non-performance indicator for loans to this sector between December 2003 and June 2004 (see Chart IV.23). The improvement was prompted by the positive development of personal loan and credit card lending quality. Nevertheless, with a non-performance level of close to 20%, there is clearly much room for improvement in lending quality, compared to both historical levels for the domestic system itself and in relation to the levels usually seen in emerging market economies.

The lower vulnerability of household financial positions, added to the currently reduced level of exposure of banks to this sector, has created conditions in which the potential for credit risk losses is relatively low. At the same time, the risk-return trade-off remains favorable and this should provide opportunities for lending to these segments to increase. Several factors still persist, however, that limit supply and demand for lending to the household sector (in particular longer-term credit), so that such lending can be expected to show relatively moderate increments.

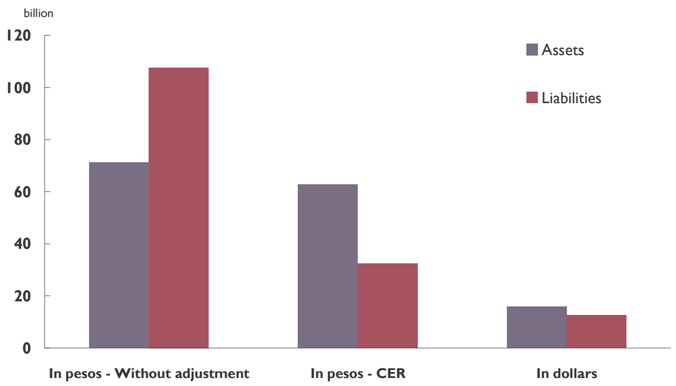
Regarding the demand for credit, there is still some job-loss uncertainty as the decline in unemployment rates has been slow. Furthermore, despite the improvement seen in real wages, as wages lag behind property prices (see Chart IV.24), strong recovery in the demand for mortgage loans is expected for the medium term. Meanwhile, it is expected that the downward trend in stocks of longer-term lending will continue to slow down,

Chart IV.24
Formal wages and prices for durable and semi-durable goods



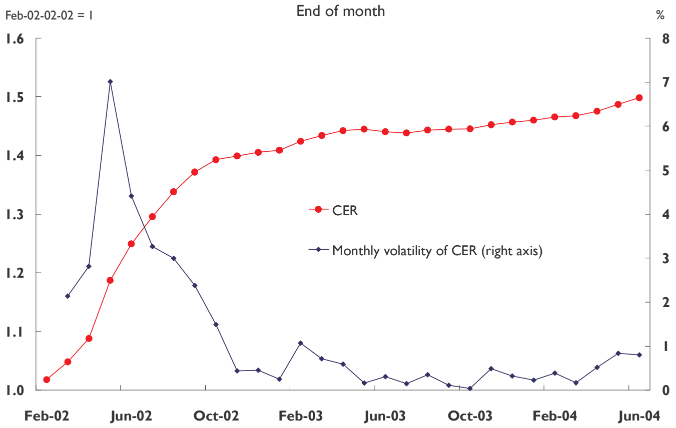
Source: BCRA from INDEC and UADE data

Chart IV.25
Currency mismatch
June 2004



Source: BCRA

Chart IV.26
CER mismatch risk
End of month



Source: BCRA

driven by pledge-backed loans (as has been seen in recent months), which are already showing positive rates of change.

Despite existing incentives for banks to increase their efforts to provide credit to households, the widening of their investment horizon will depend on access to longer-term funding and the resolving of certain outstanding matters (such as the restructuring of sovereign debt) currently causing uncertainty over the performance of the economy in the medium run.

IV.3. Currency and interest rate mismatch risk

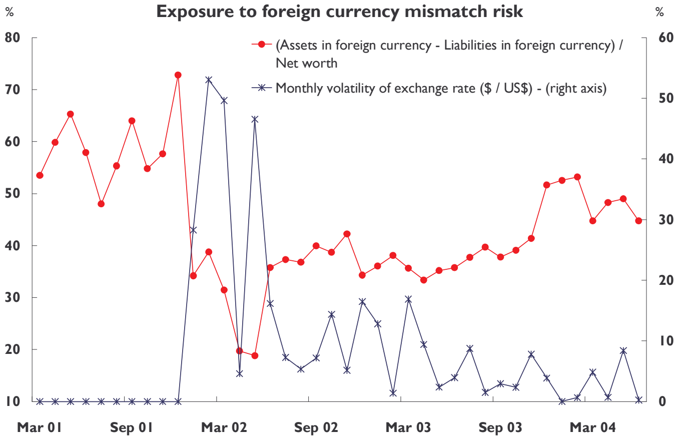
One of the most important aspects on which progress must continue to be made to strengthen the path to a greater degree of stability for the financial system concerns the currency mismatches inherited from the crisis in 2001-2002. As of June 2004, banks recorded an asset position (difference between total assets and total liabilities) in items denominated in pesos adjusted according to CER, estimated at around \$30 billion, almost 40% higher than their net worth (see Chart IV.25). Furthermore, foreign currency denominated assets (mainly in dollars) exceed liabilities by US\$3.3 billion.

By the middle of the year more than three-quarters of all CER-adjusted assets consisted of lending to the public sector. On the liability side, a similar proportion was made up of Central Bank rediscounts. Given the performance recorded by the CER index (see Chart IV.26), the asset position in adjusted items caused financial institutions to record net income under this heading of close to 1.2%a. of assets in the first half of the year. In addition to the CPI adjustment, the asset position earns a relatively low spread, given the interest rates set down in contracts. In recent months the gap between CER-adjusted assets and liabilities has shown a certain decline following significant growth in the volume of adjusted time deposits (see the chapter on business structure, page 27).

In addition, as of June 2004 the financial system still recorded a significant mismatch between assets and liabilities in foreign currency, which totaled 45% of net worth (see Chart IV.27). This reveals a significant exposure to changes in the peso-dollar exchange rate, with a significant influence on results. Although this imbalance was on a slight upward trend, towards the end of the first half of the year it took a downward course that brought it to the levels seen at the end of 2003. The main cause of this has been the disposal of investments abroad and the downward adjustments made to compensation receivables for the asymmetric conversion of assets and liabilities into pesos. One aspect limiting the latent instability derived from this position was the sharp drop in the volatility of the peso-dollar exchange rate.

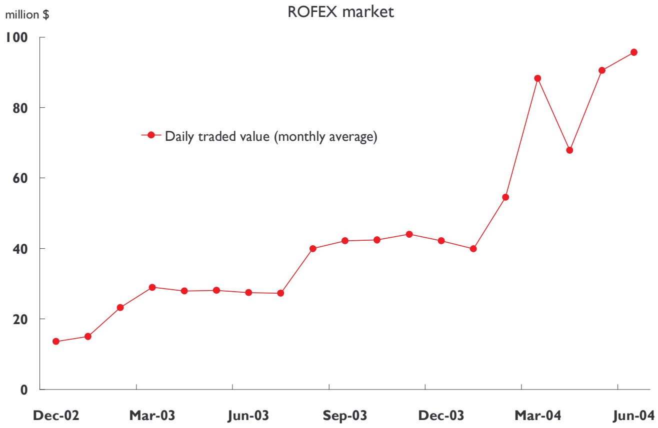
Because of the lack of any lender of last resort in dollars, since the exit from the currency board the Central Bank has reinforced regulations on foreign currency transactions. It established a requirement for dollar deposits to be exclusively allocated to lending in the same currency, made to companies with revenue sources in dollars, such as exporters or their suppliers. In addition, it introduced rules limiting foreign currency positions

Chart IV.27
Exposure to foreign currency mismatch risk



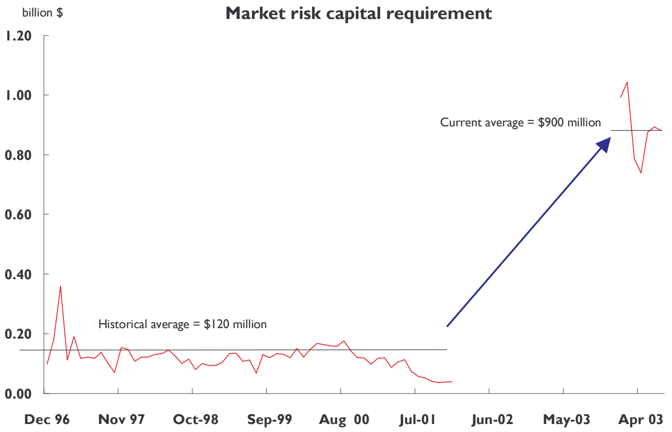
Source: BCRA

Chart IV.28
Dollar future trading
ROFEX market



Source: Rosario Futures Exchange

Chart IV.29
Market risk capital requirement



Source: BCRA

in terms of the capacity to meet short-term dollar requirements (liquidity), to limit exaggerated mismatches[25] and to protect the exchange market[26]. The Central Bank also sets a capital requirement for mismatches of foreign currency positions (solvency) (see page 43).

The Central Bank also sets a capital requirement for mismatches arising from the difference in sensitivity of assets and liabilities to changes in the interest rate. Post-crisis imbalances sharply increased the exposure of the financial system to the interest rate risk. Recognizing this problem, the monetary authority created a scheme for the gradual adjustment of capital compliance to cover this risk[27]. In 2004, the interest rate risk requirement rose by almost 20%, to 8% of total capital requirement.

Although balance sheet exposure to currency and interest rate mismatches increased during 2004, the market for financial hedge instruments is beginning to deepen. The Rosario futures market (ROFEX) accounts for most dollar futures transactions and has seen the average volumes traded nearly double in the first half of the year, compared to those at the end of 2003 (see Chart IV.28). In addition, both official and private sector bodies are assessing new hedge mechanisms.

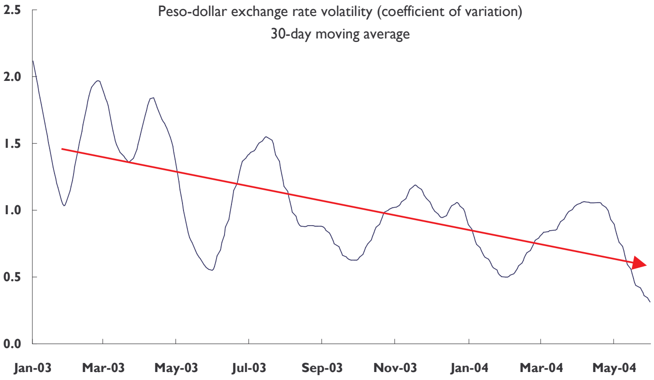
In the rest of the year no major changes are expected to take place in the exposure of net worth to currency or interest rate risk. In the first place, the taking of time deposits adjusted by CER, partly compensated for by the purchase of CER-adjusted LEBAC, could help to marginally reduce the global position in such instruments. It should be noted that a large portion of CER-adjusted assets and liabilities in pesos will continue to be covered by the so-called matching system[28]. Secondly, the development of the foreign currency mismatch risk will depend essentially on the mechanism for settling foreign liabilities and developments regarding the final amount of compensation to be received by banks for the asymmetric conversion into pesos. Nevertheless, it is expected that there will be a greater deepening of hedge markets, so that they will begin to operate as sources for the reduction and/or neutralizing of the volatility generated by fluctuations in the price of the dollar, inflation and the interest rate, leading the system to experience greater financial stability.

IV.4. Market risk

In the pre-crisis period, financial institution balance sheets showed a very low exposure to market risk (see Chart IV.29). The increased recording of government securities under investment accounts (exempted by the Central Bank from market risk requirements), plus low holdings of equities and the reduced volatility of financial assets helped to explain the low exposure. At present, following the imbalances and mismatches caused by the domestic crisis, the financial system has increased its exposure to market risk by over 7 times. This was mainly a result of the increased volatility of financial assets, added to the

[25] Global Position in Foreign Currency (Com. "A" 3889).
[26] Global Exchange Position (Com. "A" 3645).
[27] For further detail see page 21 of the FSB for the first half of 2004, available at www.bcra.gov.ar.
[28] As above, page 17.

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



Source: BCRA

new exposure from foreign currency holdings. Nevertheless, the total value at risk from the investment in assets routinely traded on domestic markets remains at a low 10% of total capital requirements.

Capital reserves – maintained as a precaution for extraordinary losses from changes in the price of assets – provide adequate coverage against the market risk involved in investments such as government securities, equities and foreign currency. Added to the fact that the price of the dollar has become increasingly stable, this is helping to create the conditions for financial system stability in terms of the exposure to market risk (see Chart IV.30). Lastly, although equity and government bond prices remain highly volatile, the related balance sheet impact is low, mainly as a consequence of the criteria established by the Central Bank for the accounting of public sector assets.

V. SOLVENCY

Summary

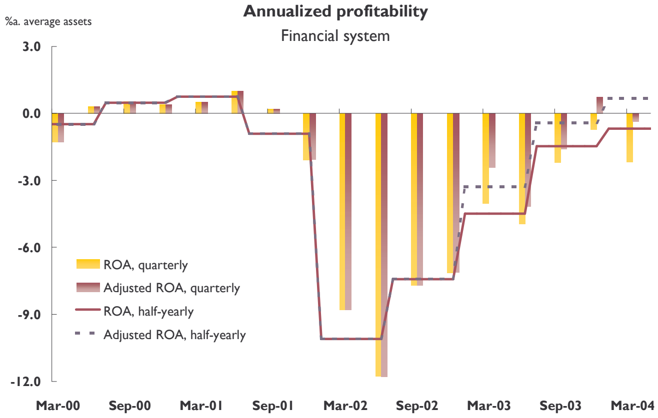
In line with the process initiated in the previous year, financial system profitability continued to improve in the first half of the year, with profits being recorded in the second quarter. Results for the half-year continue to reflect the impact of the crisis in 2001-2002. Total losses for the period are transformed into profits if results are adjusted to take into account two system-wide elements originating in the crisis: the amortization of exchange differences from payments under court orders recorded as assets on bank balance sheets, and the adjustments made to the valuation of public sector assets.

Interest income, which was negative in 2002 and the first half of 2003, strengthened its positive margin in 2004. This recovery reflects the impact of the take-off by lending activity, improvements in portfolio quality, and lower interest rates paid on deposits, all in a context of increased stability and the restructuring of liabilities by various institutions.

Profitability gains over the rest of the year will depend on the impulse provided by lending to the private sector. The outlook is encouraging as regards prices (lending rates are lower than the average recorded during the currency board period) and volume (the potential for growth in lending is large, as private sector financing as a share of GDP is well below pre-crisis levels). This growing level of intermediation will also lead to an increase in income from services, deepening the development of a source of income that continues to grow month by month.

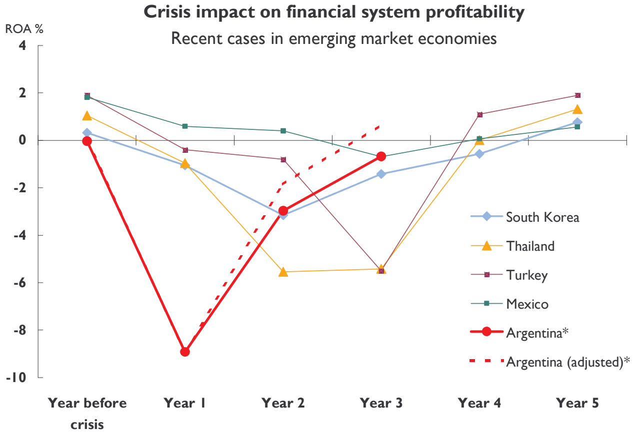
Results for the half-year have had a moderate impact on solvency levels, mainly because of the continued process of capitalization by the stockholders of a group of banks (contributions during the half-year were equivalent to 8% of net worth). The financial system has shown very favorable ratios under the new rules on minimum capital, that were re-introduced in January 2004. In the short and medium term, significant capitalization volumes have been committed to by both private and public institutions.

Chart V.1
Annualized profitability
Financial system



Source: BCRA

Chart V.2
Crisis impact on financial system profitability
Recent cases in emerging market economies



* Figures for Argentina are for up to 30 months after the crisis.
Source: BCRA from IFS, OECD and Global Financial Stability Report (IMF).

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

	2002	2003	2004	H1 03	H2 03	H1 04
Financial margin	6.5	1.2	3.3	-0.7	3.0	3.3
Net interest income	-1.7	-0.5	0.8	-1.1	0.0	0.8
Restatement by CER and CVS	3.9	1.2	1.2	1.4	1.0	1.2
Gains on securities	1.7	1.2	0.9	1.1	1.3	0.9
Foreign exchange price adjustments	2.7	-0.5	0.6	-1.6	0.6	0.6
Other financial income	-0.1	-0.1	-0.2	-0.4	0.1	-0.2
Service income margin	1.9	1.9	2.0	1.8	1.9	2.0
Operating costs	-4.4	-4.3	-4.1	-4.3	-4.3	-4.1
Loan loss provisions	-4.7	-1.2	-0.7	-1.3	-1.0	-0.7
Adjustments to the valuation of government securities (Com. 3911)	0.0	-0.5	-0.2	-0.7	-0.3	-0.2
Tax charges	-0.3	-0.3	-0.3	-0.2	-0.3	-0.3
Income tax	-0.2	-0.2	-0.3	-0.2	-0.1	-0.3
Amortization payments for court-ordered releases	0.0	-0.6	-0.8	-0.5	-0.8	-0.8
Other	-1.8	0.9	0.6	1.6	0.3	0.6
Monetary results	-5.8	0.0	0.0	0.0	0.1	0.0
ROA	**-8.9**	**-3.0**	**-0.7**	**-4.5**	**-1.5**	**-0.7**
ROE	-59.2	-23.4	-5.8	-33.6	-12.1	-5.8
Adjusted ROA (*)	-8.9	-1.8	0.7	-3.3	-0.4	0.7

(*) excluding amortization of payments for court ordered releases and the effects of Com "A" 3911 and 4084.
Source: BCRA

V.1. Profitability

In the first half of 2004, macroeconomic conditions remained favorable to the gradual strengthening of the financial system, which succeeded in recording profits in the second quarter of the year (see Chart V.1). The reinforcing of this trend will be essential for consolidation of the recovery in the system's solvency, strengthening its ability to withstand the impact of any future negative shocks.

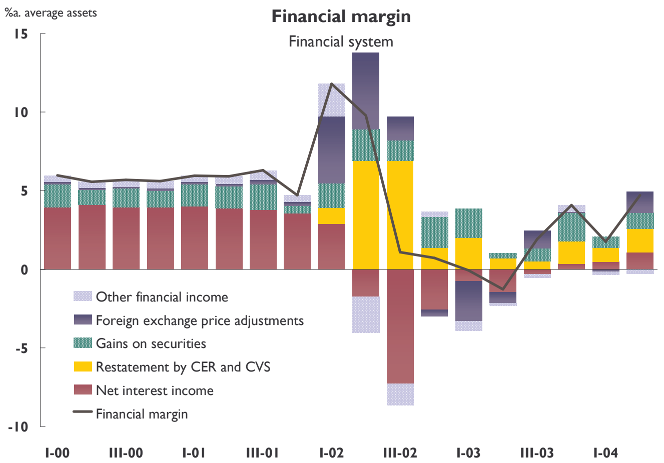
The momentum achieved in the recovery by results has been significant. The importance of this recovery is even greater if the dimension of the liquidity problem it faced is taken into account (real deposit levels collapsed at twice the rate recorded in recent crises in other emerging countries), as well as the losses that were recorded at the height of the crisis, and the concern that prevailed at that time regarding the potential for business in the sector in the medium term. As there were limited resources available to assist the system (whether from the national public sector or international financial institutions), time became the key factor enabling the financial system to improve its situation. It is therefore notable that two-and-a-half years after the structural change implicit in the collapse of the currency board and the conversion of assets and liabilities into pesos, the rate of recovery by results should have been better than that observed in the case of recent crises in other emerging countries, despite the fact that losses as a percentage of assets in the case of Argentina were unparalleled (see Chart V.2).

During the first half of the year the financial system recorded an annualized loss of 0.7%a. of assets (close to $600 million). These losses are almost half the total recorded in the previous half, and represent a radical improvement compared to the same half of the previous year (-4.5%a. of assets). If the result is adjusted to exclude the incidence of the two main factors that reflect the gradual recognition of the effects of the crisis (the amortization of court ordered payments and the valuation adjustments to public sector assets) a profit for the financial system of 0.7%a. is arrived at for the first half of 2004, a gain of almost 1 p.p. compared to the previous half-year and 4 p.p. over the same period a year earlier. The level of this adjusted ROA is moving increasingly closer to that recorded by other emerging market economies[29], as well as to the levels recorded by the domestic system itself prior to the crisis (between 0.5 and 1%a.).

Table V.1 shows that the narrowing of the gap between income and costs compared to the same half of the previous year has been due to the consolidation of the gains achieved as from the second half of 2003. In the first place, there has been an improvement in the financial profile. The recovery in financial margin picked up in the second quarter of 2004, mainly as a result of the improved yield on interest-bearing assets (with an increase in interest income and a certain improvement in the accrual of CER/CVS[30]) and the impact of the exchange rate on the valuation of assets and liabilities in foreign currency (exchange rate differences). In addition, in the first half of 2004 there has been an increased control on the cost structure, with a reduction in operating costs and loan loss provisions.

[29] Profitability for Latin American banks averaged 1.1% of assets in 2003, with a 1.4% median (Source: Global Financial Stability Report, IMF).
[30] Following the enactment of Law 25,796, items linked to CVS ceased to be adjusted as from June 2004.

Chart V.3
Financial margin
Financial system



Source: BCRA

In the case of the financial margin (see Chart V.3), there has been a significant increase in the yield on interest-bearing assets; the total for interest income and net CER/CVS adjustments totaled a level of 2%a. of assets for the six months, well above the level for 2003 (0.6%a.), although still low in historical terms. The performance of interest income, which was negative in 2002 and the first half of 2003, has been particularly notable, having recovered to a level of close to 1%a. of assets in the first half of the current year. This gradual recovery is an encouraging sign, reflecting the impact of various factors: a surge in lending activity, improved portfolio quality, lower rates of interest paid on deposits in a context of increased stability, and the effect of the liability restructuring carried out by various institutions. The indexation component (net CER/CVS adjustments) has also recorded a positive performance during this half; banks hold an asset position in items adjusted according to CER/CVS, and this has led to increased profits in the context of a certain rise in inflation.

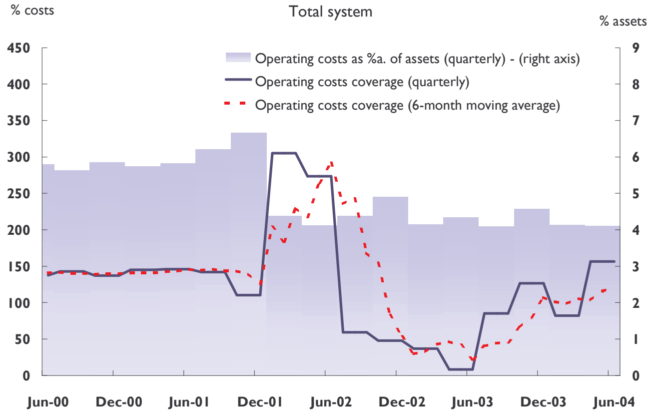
In coming periods, the yield on interest-bearing assets (and in particular, the interest income component) should stimulate the pending recovery in results, based on the growth expected to take place in lending. The outlook is encouraging as regards both price and volume: lending rates are attractive compared to those that existed during the currency board period[31] and the potential for growth in lending is substantial given that the level of private sector financing as a proportion of GDP is well below historical levels.

Financial margin further benefited during this half from the variations in the exchange rate. Given the asset position held in foreign currency instruments, the financial system recorded gains as the value of the peso declined in terms of dollars. The mismatches that exists in both foreign currency instruments and items adjusted according to CER/CVS represent sources of volatility for bank results (see chapter on risk management, page 43).

The erosion recorded by interest income at the height of the crisis forced banks to diversify their sources of income, focusing in particular on transactional banking services. As a result, the contribution from net income from commissions (income from services) gained in significance, becoming one of the pillars of operating profit. Thanks to increased activity in categories such as remote payment methods, credit cards, insurance, and services related to foreign trade, banks were partly able to offset the temporary drop in income from the traditional banking business. Income from services continues to rise over six-month periods: during the first half of 2004 net commissions represented 2%a. of assets, 0.2 p.p. above their level during the same period of the previous year. The development of a more proactive approach to transactional business enabled banks to maintain their customer base, as well as making it possible (through cross-selling) to re-establish certain lines of credit (such as overdrafts and personal loans).

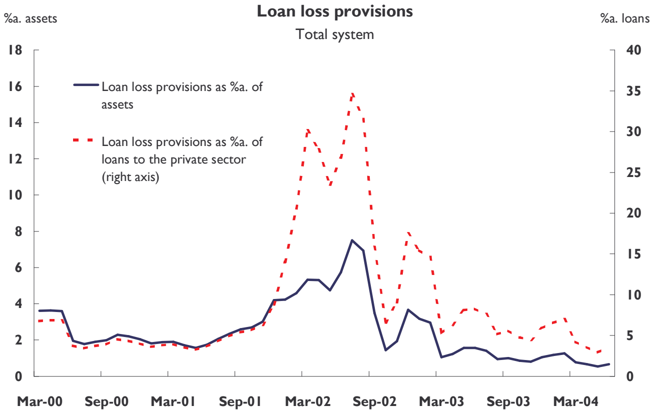
[31] Comparing the average real interest rates on the main lines of credit over the first half of 2004 with the average from 1994 to 2000, the more recent rates are between one quarter and one fifth the average during the currency board period (with the exception of credit card and personal loan rates, which are around 50% lower).

Chart V.4
Operating costs and efficiency
Total system



Source: BCRA

Chart V.5
Loan loss provisions
Total system



Source: BCRA

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

	2002	2003	2004	H_1-03	H_2-03	H_1-04
Financial margin	7.6	2.4	3.4	0.3	4.4	3.4
Net interest income	-0.2	0.1	0.9	-0.1	0.3	0.9
Restatement by CER and CVS	1.1	0.9	1.0	0.8	1.1	1.0
Gains on securities	2.5	1.8	0.8	1.3	2.3	0.8
Foreign exchange price adjustments	4.4	-0.3	0.9	-1.5	0.8	0.9
Other financial income	-0.1	-0.2	-0.3	-0.2	-0.2	-0.3
Service income margin	2.0	2.1	2.3	2.0	2.2	2.3
Operating costs	-4.8	-4.7	-4.5	-4.7	-4.8	-4.5
Loan loss provisions	-5.0	-1.3	-0.9	-1.6	-1.0	-0.9
Adjustments to the valuation of government securities (Com. 3911)	-	-0.6	-0.1	-1.2	0.0	-0.1
Tax charges	-0.4	-0.3	-0.3	-0.3	-0.4	-0.3
Income tax	-0.2	-0.3	-0.4	-0.4	-0.1	-0.4
Amortization payments for court-ordered releases	-	-0.7	-0.9	-0.6	-0.8	-0.9
Other	-3.0	1.0	0.7	2.0	0.1	0.7
Monetary results	-7.5	0.0	0.0	0.0	0.0	0.0
ROA	**-11.3**	**-2.4**	**-0.9**	**-4.5**	**-0.4**	**-0.9**
ROE	-79.0	-18.9	-7.0	-33.8	-3.2	-7.0
Adjusted ROA (*)	**-11.3**	**-1.2**	**0.6**	**-2.7**	**0.4**	**0.6**

(*) excluding amortization of payments for court ordered releases and the effects of Com "A" 3911 and 4084.

Source: BCRA

During the first half of 2004 operating costs declined to 4.1%a. of assets. The change was due to cut-backs in amortization and lower sundry costs, partly offset by an increase in payroll and social security costs as wage levels in the sector improved and some banks began to increase their personnel (see chapter on business structure, page 21). The coverage of operating costs by income (financial margin and income from services) returned to its pre-crisis level, after having deteriorated significantly over much of 2002 and 2003 (see Chart V.4). Nevertheless, this cover currently shows greater volatility from the impact of the position in foreign-currency denominated assets and items adjusted according to CER/CVS. It is expected that in coming months there will be further efficiency gains, as a result of certain limited adjustments from the consolidation of the sector.

Loan uncollectibility costs fell in the first half of 2004, reaching a level of 0.7%a. of assets, 0.3 p.p. less than in the previous six months and 0.6 p.p. lower than in the same period of the previous year. With portfolio non-performance well on the way to stabilization and a rising total of new loans with a lower credit risk (see chapter on risk management, page 41), banks have not been required to set up such large provisions, after experiencing a period of high uncertainty that led to the need for heavy provisions of an extraordinary nature (see Chart V.5).

In addition, the stabilization of the macroeconomic environment also resulted in lower charges for other provisions, enabling an improvement to be recorded under sundry income for the six-month period.

Lastly, the results for the period continued to be burdened by the weight of two factors reflecting the cost of the recent crisis. In the first place, the amortization of payments made under court orders has meant a loss for the system of approximately $130 million per month (0.8%a. of assets in the six months). In addition, banks have been steadily adjusting the book value of their public sector assets in portfolio to bring them in line with market value. This transition from nominal to market value (in accordance with the framework outlined by Communication "A"3911 and its modifications) has given rise to a slight loss (0.2%a. of assets) in the six-month period. According to the schedules established for the amortization of court-ordered payments and adjustments to the valuation of public sector assets, their negative effects will continue to be felt until 2008[32].

Furthermore, private banks have accumulated losses for 0.9%a. of assets ($500 million) in the first half, although if the effects of the amortization of court-ordered payments and adjustments to the valuation of public sector assets are excluded, they would show a profit up by 50% on the previous half and more than 3 p.p. higher year-on-year (see Table V.2). This improvement is even more marked in terms of quarterly performance, showing an adjusted result of -0.2%a. in the first quarter and 1.4%a. in the second. This group of banks has recorded a particularly significant positive trend in key lines of its profitability structure, such as interest income, and to a lesser extent, income from services.

[32] Under the terms of Com. "A" 3916, the effects generated by court-ordered payments are to be amortized in up to 60 equal monthly installments as from April 2003. Com. "A" 3911 (modified by Com. "A" 4163) establishes that adjustments to the valuation of assets are to be recorded gradually until converging on market value in mid-2008.

Table V.3
Profitability structure by type of banks: first half 2004
In annualized terms - As % of average assets

	Public banks	Private banks					
		Retail					Wholesale
		Total	National coverage	Regional coverage	Specialized		
Financial margin	2.9	3.4	2.7	6.1	18.5	2.0	
Net interest income	0.4	0.9	0.7	1.2	13.7	1.0	
Restatement by CER and CVS	1.6	1.0	1.1	0.9	-0.1	0.3	
Gains on securities	0.9	1.0	0.4	3.5	3.2	-2.2	
Foreign exchange price adjustments	0.1	0.8	0.8	0.7	1.9	2.9	
Other financial income	-0.2	-0.3	-0.3	-0.2	-0.2	0.0	
Service income margin	1.4	2.3	2.1	3.0	2.4	1.8	
Operating costs	-3.3	-4.4	-3.9	-6.1	-15.6	-6.8	
Loan loss provisions	-0.4	-0.9	-0.8	-1.0	-3.6	-1.0	
Adjustments to the valuation of government securities (Com. 3911)	-0.4	-0.1	-0.1	-0.1	0.0	-0.3	
Tax charges	-0.2	-0.3	-0.3	-0.4	-0.7	-0.4	
Income tax	0.0	-0.4	-0.5	-0.1	-0.5	-0.8	
Amortization payments for court-ordered releases	-0.7	-1.0	-1.1	-0.4	-0.4	-0.1	
Other	0.4	0.6	0.4	1.6	1.2	1.8	
Monetary results	0.0	0.0	0.0	0.0	0.1	0.0	
ROA	**-0.4**	**-0.7**	**-1.5**	**2.4**	**1.4**	**-3.8**	
ROE	-4.2	-6.4	-14.7	15.8	3.7	-11.4	
Adjusted ROA(*)	**0.8**	**0.7**	**0.2**	**3.0**	**1.8**	**-2.1**	
Weight in total assets (%)	37.9	58.5	47.0	11.0	0.5	2.8	

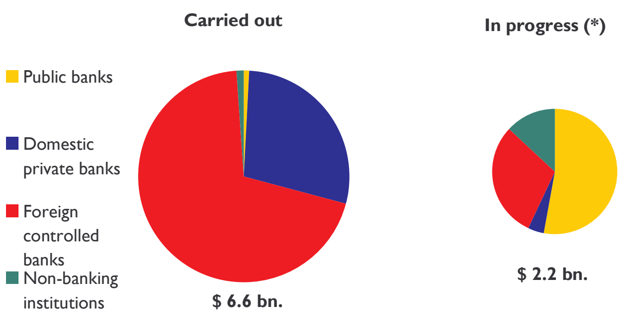
(*) excluding amortization of payments for court ordered releases and the effects of Com "A" 3911 and 4084.
Source: BCRA

Diversity in results among the various types of bank persists (see Table V.3). As in the previous half, regional and specialized banks have recorded the best performance, because of the size of their revenue base, with an increased weighting for interest on assets and services. Retail banks with nationwide branches (the main category within the private bank segment) have posted a below-average ROA, although they are increasingly close to recording balanced results on a sustainable basis. These are large banks with a weaker financial margin because of their larger holdings of lower-yielding government securities and a loan portfolio that has been harder hit by corporate sector default. These large banks have also been the most affected by the amortization of court-ordered payments. Public banks recorded a negative net income for the six months, although during the second quarter of 2004 they posted positive results, in part as a result of the size of their asset position in CER-adjusted instruments.

The outlook for the second half of 2004 encourages certain optimism as regards profitability, although future improvement is expected to be gradual. As indicated, the rate at which results improved will be set by the momentum in lending to the private sector. This will also influence income from services, because as lending growth increases in the longer-term segments (especially mortgage lines), this will lead to a broader base for commission income. In the mid-term, commission charges could in addition benefit from the recovery of the domestic capital market. Although the conclusion of the sovereign debt renegotiation process and greater progress in the restructuring of the liabilities of large utility corporations are of great importance, new issues of corporate bonds and financial trusts are also important.

Lastly, the possibility of further advances being made on the matter of profitability in coming months will be conditioned by two main factors. On the one hand, there is the impact of the adjustment to the initial calculations of the compensation to be received. On the other, there is the possibility of an increase in the cost of funding (as intermediation volumes increase), which will end up by offsetting part of any future increase in interest income. Nevertheless, as long as the existing liquidity surplus is channeled to private sector lending (at an attractive yield even if funding costs rise) it is possible that the final impact of any increase in interest rates paid on deposits will only be of minor significance.

Chart V.6
Capital contributions 2002-2004

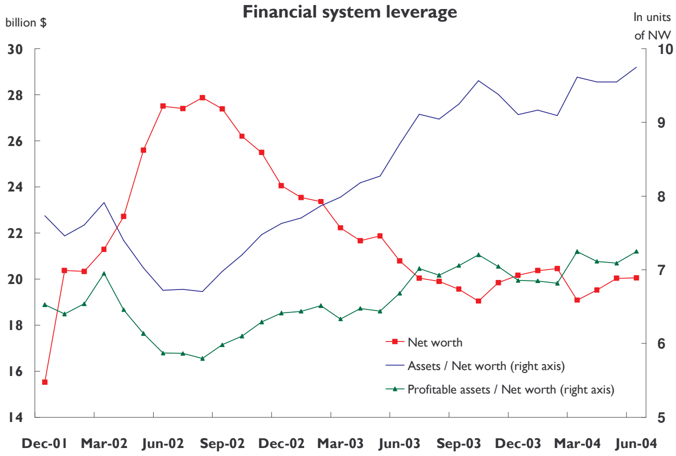


As of August 2004
(*) Includes partially settled contributions to be paid in installments.
Source: BCRA

V.2. Capital position

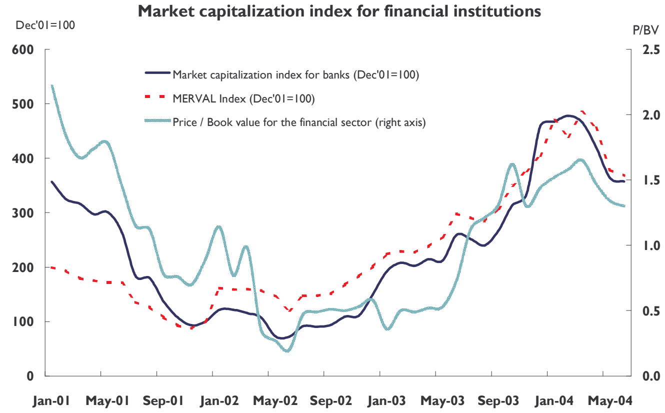
Despite the current losses incurred during the period, financial system net worth fell only slightly in the first half of 2004, by some $110 million (0.5%). The negative result in the first half – amounting to 5%a. of net worth – was almost entirely compensated for by the recapitalization of a group of banks by their stockholders. As can be seen from the second quarter (in which balance sheet profits of almost 6%a. were recorded), current income will soon cease to be a factor absorbing capital, instead contributing to the endogenous recovery in the solvency of the system.

Chart V.7
Financial system leverage



Source: BCRA

Chart V.8
Market capitalization index for financial institutions



Source: BCRA from BCBA data

Table V.4

Minimum capital by group of banks

June 2004 - In %

Group of banks	Surplus capital / Capital requirement (*)	Capital / Assets at risk (**)
Public banks	**221**	**12**
Private banks	**180**	**15**
National coverage	168	13
Regional coverage	168	22
Specialized	134	45
Wholesale	349	46
Non-bank institutions	**252**	**69**
Total	**192**	**15**

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

(**) Assets weighted by credit risk.

Source: BCRA

This process of capitalization by means of the injection of new capital is in line with the needs of the new operating context, in which prospects for the sector have improved. Capital contributions received by banks in the first half of 2004 totaled more than $1.6 billion, equal to 8% of the net worth of the system[33]. From the end of 2001 until June 2004 capitalization received ($6.6 billion) amounted to 32% of the net worth recorded at the beginning of 2002. Foreign-controlled private banks have been the most active in this sense, accounting for almost 70% of total contributions. Out of this total, the largest part corresponded to debt-to-equity swaps on securities held by parent companies. It is expected that this capitalization mechanism will continue in coming periods. At present, $2.2 billion in additional capital contributions are in the process of being paid in, with a notable participation by public banks, which account for over 50% of that amount (see Chart V.6).

In view of the relative stability of net worth in the first half, the growth in financial system assets (which rose by 5%) resulted in the leverage ratio (defined here as assets over net worth) increasing by 0.6 points, taking assets to 9.7 times net worth. There has been considerable disparity between public and private banks, with a leverage ratio of 11.8 for the former and 8.4 for the latter, although the increase in the second half was similar for both categories (see Chart V.7). The consolidated financial system recorded a ratio of $5.4 in deposits for every $1 of net worth, an increase of $1 (20%) compared to the level recorded at the beginning of the year. This ratio is already at its highest in the last 10 years (when the average for the first half of 2000 was 5.3).

In the framework of the process of normalization of the financial system, the better prospects for the sector were also reflected in the performance of the main market indicators (such as market capitalization and the price to book value ratio). Since the second half of 2002, after the crisis unleashed at the end of 2001, a positive trend has been recorded by main indicators. Reflecting in part the price corrections derived from the expectations of higher interest rates in developed markets, the price of publicly-traded bank shares followed the overall downward trend in the market during the first half (see Chart V.8). In line with the general trend, risk rating agencies improved the ratings for various securities issued by local banks, following the progress made on the restructuring of liabilities.

On the matter of regulations, minimum capital requirements were re-introduced in January 2004, following their suspension as from December 2001 at the time of a profound economic and financial crisis. The new prudential policy on minimum capital requires 8% on assets at risk for both the private sector and the public sector. In view of the magnitude of the crisis and its effects on the sector, as well as because of the existing restrictions on the adoption of corrective measures, a schedule was established for adjustments to capital requirements for private sector credit risk and interest rate risk.

[33] Includes both cash contributions and debt-to-equity swaps.

Box 3 : Changes proposed by Basel II

Under analysis

The Central Bank is analyzing guidelines for capital adequacy, supervision and market discipline outlined in the new Basel Committee Capital Accord, known as “Basel II”. The implementation of banking regulations that follow best practices while at the same time being adapted to local conditions is a long-term goal, underlying the decisions relating to the normalization of the financial system and other Central Bank regulations.

The new agreement

The Basel Accord aims to reflect best practices for the administration of bank risk, generating adequate incentives and ensuring minimum capital on the basis of the risk assumed by financial institutions during their operations. Furthermore, as the criteria are accepted worldwide, the Basel guidelines facilitate international comparison of regulations.

The main changes in the New Basel Capital Accord can be found in the fact that:

- The different risks from different bank assets are better defined, increasing the sensitivity of capital requirements to the level of risk undertaken.
- There is a range of approaches for dealing with credit and operating risk, rather than a single methodology.
- Operating risk appears for the first time in these standards.
- The most sophisticated approaches are largely based on the risk measurements made by the banks. It stresses the use of more advanced methodologies for bank management as well as regulation.
- The role of the supervisor is underscored by wide powers to require capital over and above the minimum levels.
- The most advanced approaches rely largely on the criteria of the supervisor, although within the guidelines established in the regulation.
- The role played by the communication of information on risk and its use as a tool for depositors and other creditors (“market discipline”) is highlighted.

Without neglecting these aspects, the Central Bank is evaluating the suitability of applying Basel II guidelines to the Argentine financial system, and if so, the best manner and timing for doing so, as well as the adaptations to the local context that may be advisable.

The New Accord is an improvement on the previous version (being more sensitive to risk and using more modern risk management methods). Nevertheless, the new aspects of the accord deal mainly with matters relating to improved allocation of credit to the private sector, with less consideration being given to other risks deserving equal attention in emerging market economies, as is evident, for example, from Argentina’s crisis in 2001-2002. Consideration should be given to exposure to the public sector, the concentration and volatility of liabilities and the mismatch of interest rates as typical problems facing emerging country financial systems.

Implementation

The crisis experienced by the financial system justifies a postponement of the implementation of these standards. Although the financial system is undergoing a process of normalization and revival that makes application of these new international standards unlikely at present, the current situation provides the opportunity to set basic guidelines in a planned manner, as well as to take advantage of the experience and efforts of the regulators and supervisors in other countries. The Central Bank will therefore continue to study these matters, interacting with other supervisors, financial institutions, professionals, academics and other organizations specializing in regulatory and central banking matters, in order to adapt Basel II to the Argentine financial system.

In this context, during the first half of 2004 the financial system reported very favorable indictors, easily meeting the new requirements. According to the information gathered by the Minimum Capital Information Regime, as of June 2004 banks reported regulatory capital compliance (equivalent to Tier I and Tier II capital) totaling 15% of risk-weighted assets. There is a certain disparity depending on the type of bank, but in all cases the aggregate minimum requirement has been exceeded.

The financial system's total surplus compliance with capital requirements amounted to 192% of the total capital requirement. The size of this surplus compliance partly reflects the effect of the temporary relaxation of the capital requirement, as per existing regulations. The figure rose by 65 p.p. since January, because of the increased compliance and the drop in the total requirement, mainly due to lower requirements for non-compliance with technical ratios. The change was largely a result of specific transactions made by some banks to ensure compliance with capital regulations (see Table V.4).

Nevertheless, there are a small number of banks (representing only 3% of total deposits in the system) that are operating at a level of capitalization that is lower than the minimum required. Some of these banks (1% of deposits) are already operating under programs for regularization and recovery approved by the SEFyC, to ensure they transition to full compliance with current laws and regulations, while the remainder (2% of deposits) are in the process of resolving their legal situation in a manner that will include the normalizing of capital compliance. Given the significant impact on the sector from the crisis in 2001, the situation can be viewed as reasonably positive.

It should be noted that the new prudential regulations on minimum capital – adapted to the post-crisis context, and establishing a gradual convergence through to 2009 towards initial levels that are below the minimum recommended level internationally – will be in place for a formally limited time period, with a final objective that imposes requirements higher than the international minimum[34]. The design of this regulation has taken into account the gradual impact in capital compliance of the marking to market of public sector assets. Argentina's minimum capital framework therefore encourages consolidation of system solvency, imposing on banks a strong need to increase the profit base through an increase in the level of intermediation, prudent risk management and increased efficiency.

[34] The difference lies mainly in the inclusion of public sector assets among risk-weighted assets.

VI. PAYMENTS SYSTEM

Summary

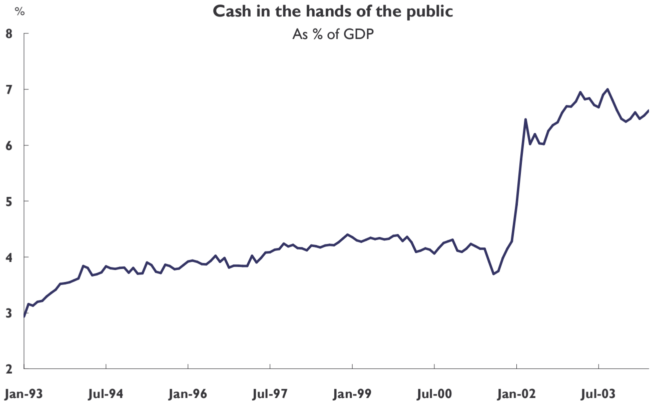
The payments system is made up of a series of instruments, processes and channels that enable users to exchange goods, services or assets for money. In view of the crucial role such a system plays in the economic structure of a country, and especially due to its effect on financial stability and the effectiveness of monetary policy, central banks take special care to ensure that it functions properly.

In Argentina there are various payment instruments that coexist within the National Payments System (NPS), cash and checks being the most commonly used means. In the case of the former, the natural decline in use as a result of technological developments was interrupted by the crisis in 2001 and the levying of a tax on bank debits and credits. This latter element also impacted on the use of checks as means of payment: although the value of checks debited to accounts increased by almost one third in the last year (in line with the increased levels of activity), it is still 30% below the level seen in the months before the tax was enforced. The recovery seen in the volume of checks issued and cleared has been based mainly on the documents issued by large and medium-size corporations (there has been a 20% increase in the average amount in real terms).

In the second half of the 90s the Central Bank developed and implemented the Electronic Means of Payment System (MEP) which, together with Electronic Clearing Houses (CEC) form the foundations of the NPS. The MEP is a system for gross settlement in real time that enables transfers to be made on line through the current accounts that banks hold at the Central Bank. This ensures a more efficient administration of the financial risks involved in payments systems, with a consequent reduction in systemic risk. During the first half of 2004 the average monthly volume of transactions traded on the MEP increased 50% in real terms compared to the same period of 2003.

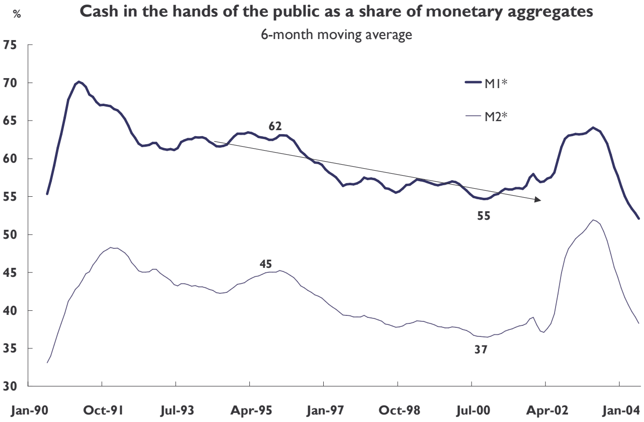
The risks to which users of payments systems are exposed lead to a clear need for identification and monitoring by the monetary authority. The Central Bank, by means of the publication of regulations and recommendations to financial institutions, works to increase efficiency in the management of the risks involved, within a process of sustained modernization brought on by advances in technology and free competition in the sector.

Chart VI.1
Cash in the hands of the public
As % of GDP



Source: BCRA

Chart VI.2
Cash in the hands of the public as a share of monetary aggregates
6-month moving average



Source:

VI.1. Introduction

In any market economy, millions of transactions are performed every day. Each transaction involves people and businesses exchanging goods, services or assets for "money". A payments system is a group of instruments, processes and channels enabling users to make such transfers of funds, and is an essential component in the economic organization of the country. An agile, reliable and efficient payment system contributes to economic development and financial stability, while increasing the effectiveness of monetary policy.

In general, given their priority objective of ensuring monetary and financial stability, central banks are especially concerned to create the conditions for the proper operation of payment systems. These central banks try to ensure continuous operation of the process by which interbank payments are settled on a daily basis, guaranteeing the sound performance of the financial system and avoiding possible disturbances that threaten its stability. Depending on the type of institution adopted, payment system users are exposed to various kinds of risk: credit risk, liquidity risk, and legal and operational risk. The payment system can be a source of systemic risk for the economy as a whole, both because of its potential for transmitting a problem arising in one agent to the rest, and because of failures in actual operation. This phenomenon gains in significance with the existence of "systemically important payment systems", so defined because they are the only one available in the economy and/or because they processes high value transfers.

The particular risk configuration of payment systems has generated international concern, and there have been recent developments in the fields of regulation and supervision. There are international standards that have been adopted by various central banks as overall guides for the definition of the operating regulations of their payment systems. In particular, the Bank for International Settlements has drawn up a series of basic principles for the design and operation of systemically important payment systems. Only two of the principles impose minimum recommended levels, and these refer to the need for prompt and final settlement on the day of value and the timely completion of daily settlements in systems with multilateral netting, in the event of an inability to settle by the participant with the largest single settlement obligation. The most significant features of the NPS are in line with the recommendations of that agency.

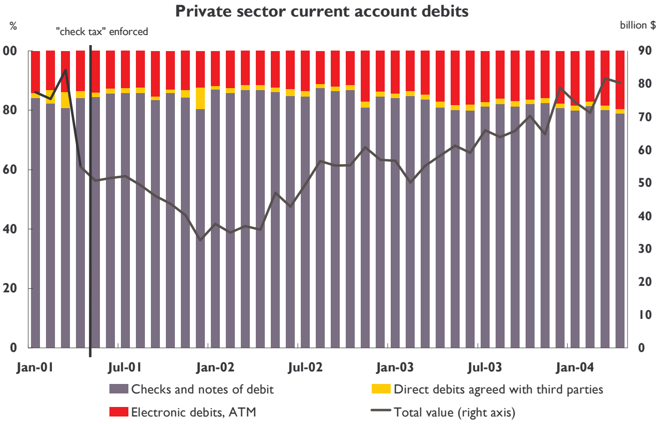
VI.2. The National Payments System

VI.2.1. Means of payment

Various different means of payment coexist within the NPS. Of these, *cash* is the most widespread in Argentina (see Chart VI.1). Both custom and various critical events affecting the financial system have combined to explain this propensity, which persists even in the case of major transactions such as those in the real estate, vehicle and financial markets. Over the long term, the relative importance of cash as a means of payment is tending to decline. This phenomenon, present in most countries, has been driven by the progress in technology in the sector. In recent years, the introduction of the so-called check tax[35], and subsequently the banking crisis unleashed at the end of 2001, have significantly destabilized this trend (see Chart VI.2).

Means of payment other than cash operate on the basis of transferable deposits corresponding to savings accounts and current accounts. These include *checks* and *transfers*. In a manner more significant than that of other economies, checks are used extensively in Argentina, being the leading means of payment after cash. The value of checks debited in current accounts by the private sector reached a monthly average of $65 billion during the first half of 2004. In line with the increased level of economic activity, this amount was 40% greater than the average recorded in the same period of the previous year (36% in real terms), although it still stands at a level 30% below that recorded in the months prior to the imposition of the check tax (see Chart VI.3 and VI.4).

Chart VI.3
Private sector current account debits

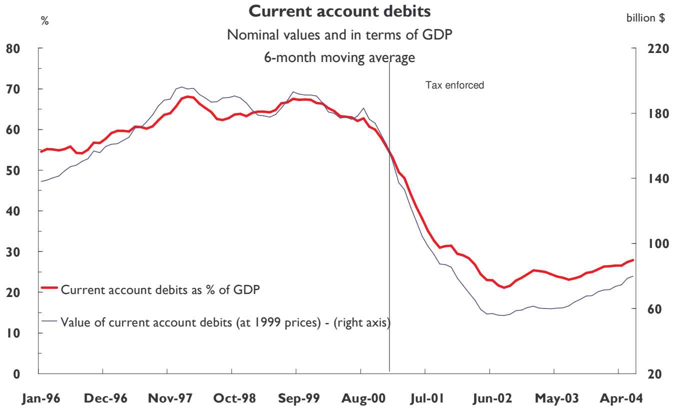


Source: BCRA

In Argentina, transfers are used mainly to settle labor-related obligations (wages, subsidies and pensions) for both the public and the private sector. At present, the growing importance of information technology to the banking system is leading most financial institutions to offer their customers alternative methods for performing their transactions, providing services for the transfer of funds for payments to suppliers, and between customers and third parties. The average amount per month for transfers was close to $1.1 billion in the first 6 months of 2004, recording steady growth since the beginning of 2003 (46%), with a marked positive trend in the number of transactions processed (see Chart VI.5).

Direct debit is another means of payment, based on the electronic exchange of data between the banks originating and receiving the transactions through the CECs. Thus, for example, the companies wishing to make collections by means of direct bank debit can operate in a simple manner through the bank of their choice.

Chart VI.4
Current account debits
Nominal values and in terms of GDP
6-month moving average

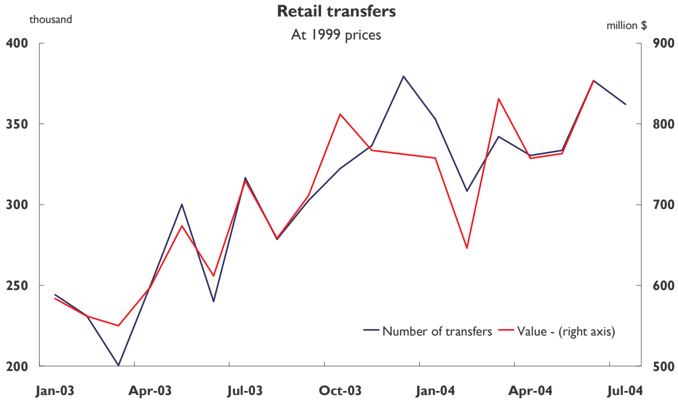


Source: BCRA

Credit and *debit cards* are also widely used in Argentina, compared to other similarly-developed economies. There are various credit cards active nationwide. Some of them belong to financial institutions and operate on an open system basis, while other belong to travel circuits and operate on a closed system basis. Also operating within the NPS are several credit card companies that operate exclusively at a regional or municipal level. Transactions using payment cards belonging to nationwide cards are cleared at network level and are settled through banks, using their accounts at the Central Bank. An agreement signed by all credit-card operators guarantees the interoperability of all the various circuits. As of June 2004 there were approximately 8 million credit cards and 11 million debit cards in circulation issued by banks, while credit cards issued by specialized companies totaled slightly over one million units. The monthly value of transactions using credit cards issued by financial institutions amounted to close to $1 billion at the end of the first half of 2004.

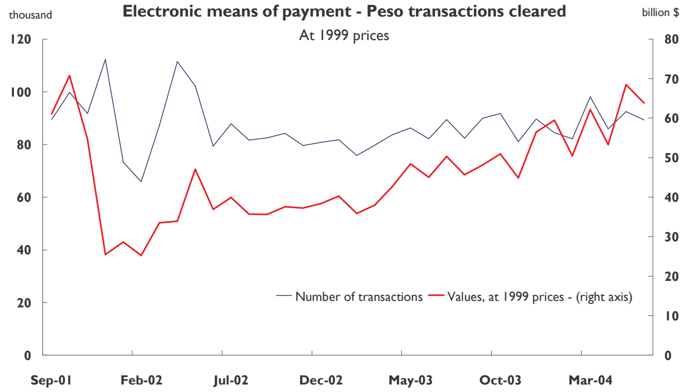
[35] For a more detailed analysis of the impact of the Tax on Bank Account Debits and Credits (IDCCB), refer to the Central Bank's Inflation Report for the second quarter of 2004.

Chart VI.5
Retail transfers
At 1999 prices



Source: BCRA

Chart VI.6
Electronic means of payment - Peso transactions cleared
At 1999 prices



Source: BCRA

There are several *retailer cards* in Argentina, some with a significant number of cards in circulation. These are owned by large retail sales networks such as shopping malls and supermarkets, which issue these cards for exclusive use in their own stores. One last sub-group is formed by cards known as *pre-paid cards*, and there are in the market a certain number of prepaid single or limited-purpose card systems (for instance, telephone cards).

Lastly, the Argentine postal system offers two types of payment instruments: *postal money orders* and *recurring payment services*. The postal administration has an account at the Central Bank for final settlement. The postal service also operates in the NPS though one of the clearing houses. In Argentina, the postal service is also used for recurring payments (utilities, taxes, etc.).

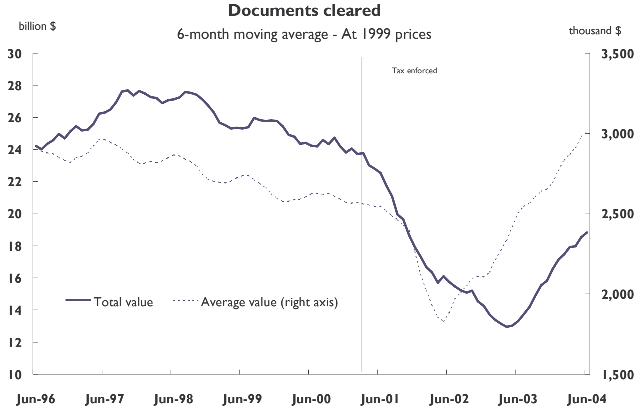
VI.2.2. Settlement and clearing channels

The structure of the NPS is based on a real-time gross settlement system (MEP), managed by the Central Bank, and four privately-owned CECs, operated by financial institutions.

The MEP, set up in 1997, is a development by the Central Bank which is used by banks, the CECs and the Central Bank itself. This real-time gross settlement (RTGS) system enables transfers to be made on-line through the current accounts that the banks hold at the Central Bank over an extended operating cycle, as well as providing information in real time on the funds available in the banks' accounts. The RTGS system is widely used in developed countries, with a rising level of acceptance in emerging market economies (it was recently adopted in Chile (2004) and Brazil (2002)). The use of the MEP enables a more efficient management of the financial risks involved in payment systems, with a consequent reduction in systemic risk. Transactions are only registered if there are sufficient funds in Central Bank accounts. They take place following rigorous procedures, and once posted and authorized they become irrevocable. Operations include inter-bank transactions, transactions initiated by bank customers, cross-border transfers, settlement of repos with the Central Bank, settlement of net clearing balances and court payments. In the first half of 2004 a monthly average of 90,000 transactions for an average of almost \$86 billion were traded on this system. This volume has been rising over recent six-month periods, with a real increase of almost 50% compared to the average for the same period of 2003 – while the number of transactions increased by 9% (see Chart VI.6).

Four CECs operate in the Argentine payment system, two defined as Low Value and two as High Value CECs. Low Value CECs, in operation since 1997, clear and settle net balances of transactions performed with checks, direct debits to accounts, customer transfers and automatic teller machines. Customer transfers can be used to credit wages, pay suppliers, and for movements between accounts opened in different banks. The two CECs are connected. A truncation mechanism currently exists for check clearing, whereby certain documents for smaller amounts are retained by the bank where they are deposited, so that the bank being drawn on receives only electronic notification.

Chart VI.7
Documents cleared
6-month moving average - At 1999 prices



Source: BCRA

The structure of the files and the messages between banks and the clearing houses have been developed following the standards of the National Automated Clearinghouse Association (NACHA). The two High Value CECs authorized by the Central Bank, one in operation since 1998 and the other since 1999, provide a service for net multilateral settlement by financial institutions and same-day electronic funds transfers. Although operations are netted, the system is backed by guarantees at the Central Bank submitted by each member. The value of the checks cleared by the CECs in the first six months of 2004 averaged $27 billion (6.3 million documents), 40% (18%) more in real terms compared to the same period of the previous year.

In the two years subsequent to the imposition of the check tax (March 2001) there was a sharp, sustained decline in the issue, and thus the clearing, of such items (a drop of 50% in real terms). Since then, the volume of clearing began to recover, largely as a result of movement generated by large companies, with greater average values per check (see Chart VI.7).

VI.3. The Central Bank and payments systems supervision

Payment systems can expose their participants to various types of risk, and may even be the source of systemic risk (given their operating characteristics and the central role they play in economic organization). Hence the evident need for the monetary authority to identify and monitor the risks in the NPS. The Central Bank directs, administers and controls the NPS by means of the issue and publication of regulations, as well as providing recommendations and procedural guides for banks to adopt them for their operations. These measures are intended to increase efficiency in the management of the financial risks involved, ensuring the continuous operation of the daily interbank settlement process. In particular, by means of its banking supervision role, the Central Bank through the SEFyC exercises control over the CECs. In addition, an Interbank Commission for Means of Payment in Argentina (CIMPRA) has been established, where the various players in the NPS (Central Bank, financial institutions, bank associations, CECs) study, plan and monitor the development of the NPS.

In view of the impact of technological progress and free competition in the sector, the Central Bank has undertaken a series of changes to endow payment systems and means of payment with increased security and efficiency. The steady process of NPS modernization is intended to maintain operating systems that may be easily accessed by the public nationwide, enabling transactions to be performed with a guarantee of actual recording and availability of funds in the shortest time possible. Ensuring access to the NPS under equal conditions is a basic objective of the Central Bank's role as a supervisor. To this end, criteria have been defined for public access on a non-discriminatory basis, to prevent the development of monopoly conditions in the supply of payment services. In addition, a new Transparency Regime has been set up to promote increased awareness by users, and encourage competition among providers of means of payment services[36].

To reduce exposure to operating risk, an alternative back-up system or "contingency plan" has been designed for the MEP, to prevent an interruption in the chain of transactions in the event of an inadequate operation of the communications links between the Central Bank and member institutions.

[36] Since the end of September 2004, it is possible to compare the conditions set by each individual financial institution for a series of products offered, including those concerning payment services. The information is available on the Central Bank's website: www.bcra.gov.ar

BALANCE OF RISKS

As a result of the severe economic and financial crisis in 2001-2002 and the subsequent change in regime, significant problems have arisen in defining a model of global risk to the stability of the financial system. This is particularly true if it is considered that such an exercise requires being able to count on probability distributions for alternative macroeconomic scenarios and equations for the behavior of all the players involved in the process of financial intermediation. In the face of these restrictions, the Central Bank has considered it would be more appropriate to perform a qualitative analysis of the degree of financial stability in the short term. This risk evaluation is based on the analysis contained in the body of the FSB. The elements that come into play in this evaluation for the system aggregate are the relative net exposure to the various risks (including hedge elements), the current and future bank solvency conditions, and the possible shocks derived from adverse changes to certain context variables, and a subjective appraisal of the probability of such extremes taking place.

Notwithstanding the persistence of matters pending resolution that are responsible for a certain degree of vulnerability, the developments seen in the first half of 2004 have begun to provide evidence of the **consolidation of the recovery in the financial system,** begun one year earlier. In this general evaluation of risk, two factors have been observed in the first half of 2004 **generating a moderately positive change** in the overall outlook. On the one hand, **the solvency of the system has been improving gradually**, based on improving profitability and the capitalization carried out by stockholders. Although these developments need to show increased vigor, they tend to fortify the general ability of the system to withstand unexpected shocks. In addition, it can be argued that for the short term there has been **a marginally favorable change in the overall pattern of risk to the system.** Despite the risk represented by the exposure to the public sector and the mismatch of interest rates and currencies, given the relatively positive context expected for coming months, and in view of the limited possibility of extremely adverse scenarios developing, the rising coverage that is expected to be provided for certain risks of a high relative exposure (risk from lending to the private sector and liquidity) justifies the view that the system has gained in strength.

As regards the overall risk configuration, it should be noted in the first place that the conjunction of a steady recovery in the financial conditions of the various sectors of the economy (expected to continue in the short term), together with the reinforced coverage in the event of credit risk, have helped to eliminate repayment risk as a further potential channel for deterioration of bank net worth. The risk from exposure to the public sector, although quite high in relative terms, recorded a slight improvement in the short term as public accounts improved, and in the expectation of a resolution in coming quarters of the process of restructuring of the debt currently in default. In addition, the main strength of the local banking system continues to be its high level of protection against the risk of any liquidity shortage. Reserves of liquid assets are at ratios far higher than those recorded in the past. Furthermore, banks can resort to the call money market, the new repo market (between themselves, or with the Central Bank) or gain access to direct credit lines from the monetary authority (observing the conditions laid down in regulations).

Part of the inheritance of the crisis in 2001-2002 was the mismatch between assets and liabilities in foreign currency, with the former exceeding the latter. It is expected that this exposure will remain contained, according to current regulations that limit asymmetry between the currency of loans and that of the income of borrowers. This, added to the expected reduction in volatility of the nominal peso-dollar exchange rate, means that the marginal contribution of the currency risk to the overall risk structure for the financial system will decline.

As a consequence of the crisis and the means used to resolve it, the financial system also records a relatively high level of interest rate mismatch. The main component of this mismatch arises from the difference between CER-adjusted assets and liabilities. In the first half of 2004 there has been a reduction in this type of imbalance, as a result of significant growth in CER-adjusted deposits. In this case it should be borne in mind that in mid-2004 currency future markets began to deepen and futures based on other types of underlying asset began to be evaluated. The increasing liquidity of these markets will be of great benefit to banks when arranging low-cost hedges against the risk from currency and real interest rate mismatch.

In conclusion, it is considered that the level of risk faced by the financial system will continue to decline in the near future. In the medium term it is hoped that, in conjunction with the macroeconomic context, the very own nature of the recovering intermediation business will gradually redefine the exposure and coverage of the leading risks. In addition, it is estimated that the profits from higher levels of bank lending will increase the strength of the system by providing a greater level of profitability.

GLOSSARY

$: Argentine Pesos

%a. : Annualized percentage

a.: Annualized

Acum.: Accumulated

Adjusted profit: Total profit excluding payments made due to court-ordered releases and adjustments to the valuation of public sector assets according to Com "A" 3911 and 4084

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

APR: Annualized percentage rate

BCBA: Buenos Aires Stock Exchange

BCRA: Central Bank of Argentina

BIS: Bank for International Settlements

BMB: Broad Monetary Base. Defined as monetary circulation in pesos, bank current accounts in pesos at the Central Bank, plus the stock of quasi-monies

BODEN: Optional National Government Bonds

BOGAR: Provincial Guaranteed Bonds

CAS: Argentine Chamber of Supermarkets

CEC: Electronic Clearing House

CEDEM: Center for Studies For Metropolitan Economic Development

CEDRO: Rescheduled Deposit Certificate

CER: Reference Stabilization Coefficient

CIMPRA: Interbank Commission for Means of Payment in Argentina

Consolidated assets and liabilities: Those arising from excluding operations between financial system institutions

CU: Use of installed capacity

CVS: Wage Variation Coefficient

EMBI: Emerging Markets Bond Index

EMI: Monthly Industrial Estimator

Exchange rate adjustment differences: Income arising from the monthly restatement of assets and liabilities in foreign currency. Also includes results from the purchase and sale of foreign currency, which arise from the difference between agreed-upon price (net of direct expenses from the transaction) and book value

FBS: Financial Stability Bulletin

FIEL: Foundation for Latin American Economic Research

Financial margin: Income less outlays of a financial nature. Includes interest income, gains from securities, CER/CVS adjustments, exchange rate differences and other financial results

FOMC: Federal Open Market Committee

FS: Financial Stability

FUCO: Unified Fund for Official Current Accounts

Gains from securities: Includes income from government securities, short-term investments, corporate bonds, subordinated debt and options. In the case of government securities, it includes the results accrued from income, quotation differences, exponential increase on the basis of the internal rate of return (IRR), and from sales, as well as the charge for impairment to value

GDP: Gross domestic product

HHI: Herfindahl-Hirschman Index

ICC: Construction Cost Index

IDCCB: Tax on Bank Account Debits and Credits, also referred to as "check tax".

IFI: International Financial Institutions

IFS: International Financial Statistics

IMF: International Monetary Fund

Income from services: Commissions collected less commissions paid. Includes commissions on liabilities, credits, securities, guarantees granted, rental of safe-deposit boxes and foreign trade and exchange transactions, excluding in the case of the latter results from the trading of foreign currency, which are recorded in the "Exchange difference" accounts (here included under the heading "Other financial results"). Outflows include Commissions paid, Contributions to the Banking Social Services Institute (ISSB), other contributions on service income and charges accrued for turnover tax

INDEC: National Institute of Statistics and Census

Interest income (interest margin): Interest collected less interest paid on financial intermediation, on an accrual basis taken from balance sheet, rather than on a cash basis. Includes interest on loans of government securities and premiums and repos and reverse repos

IPC: Consumer price index

IPIM: Wholesale price Index

IPMP: Commodities price index

IRR: Internal rate of return

ISAC: Construction activity index

LEBAC: Central Bank bills

LIBOR: London Interbank Offered Rate

Liquid assets : Minimum cash compliance (cash, current account at Central Bank and special accounts in guarantee), other liquid items (including correspondent accounts) and reverse repos with the Central Bank

M0: Notes and coins

M1*: M0 plus current account deposits in pesos and dollars, net of FUCO

M2*: M1 plus savings account deposits in pesos and in dollars (50% of balance)

MC: Minimum cash

MEP: Electronic Means of Payment

MERVAL: Executes, settles and guarantees security trades on the Buenos Aires stock exchange. Also the name of a capitalization-weighted index of the most liquid stock on the Buenos Aires stock exchange.

MR: Market rate

NA: Netted assets

NACHA: National Automated Clearinghouse Association

NBFI: Non-bank Financial Intermediaries

Net worth exposure to counterparty risk: Non-performing portfolio net of allowances in terms of net worth

Netted assets and liabilities: Those net of accounting duplications inherent to the recording of swaps, whether future or unsettled spot transactions

NOBAC: Central Bank notes

Non-performing portfolio: Portfolio in categories 3 to 6, as per the debtor classification system

NSL: Secured National Loans

NW: Net worth

Operating costs: Includes remuneration, social security payments, services and fees, sundry expenses, taxes and amortization

Other financial results: Income from financial leasing, adjustments to valuation of credit to the public sector, contributions to the deposit guarantee fund, interest on liquid funds, difference in market price of gold and foreign exchange, premiums on the sale of foreign currency and other unidentified income (net)

Other: Sundry gains (including gains from long-term investments, loan recoveries and release of allowances) sundry losses (including losses on long-term investments, amortization of differences from payments under court orders, loss on sale or impairment of fixed assets, amortization of goodwill)

p.p.: Percentage points

P/BV: Price over book value

PEN: National Executive Branch

Private sector credit: Loans to the private sector and private sector securities

PS: Price stability

Public sector credit: Loans to the public sector, holdings of government securities and compensation receivable from the Federal Government

PV: Par value

REM: Market Expectation Survey

ROA: Return on assets

ROE: Return on equity

RTGS: Real time gross settlement system

s.a.: Seasonally adjusted

SAGPyA: Agriculture, Livestock, Fisheries and Food Secretariat

SEFyC: Superintendence of Financial and Exchange Institutions

SIOPEL: Electronic Operations System

SMEs : Small and medium-size enterprises

UADE: Universidad Argentina de la Empresa

US$: US dollars

UTDT: Universidad Torcuato Di Tella

VaR: Value at risk

VAT: Value-added tax

y.o.y. : year on year

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