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The Argentine financial sector: Performance, problems, and policy issues

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The Argentine Financial Sector:
Performance, Problems, and Policy Issues

by

Bernhard Fischer and Peter Trapp

Institut für Weltwirtschaft an der Universität Kiel

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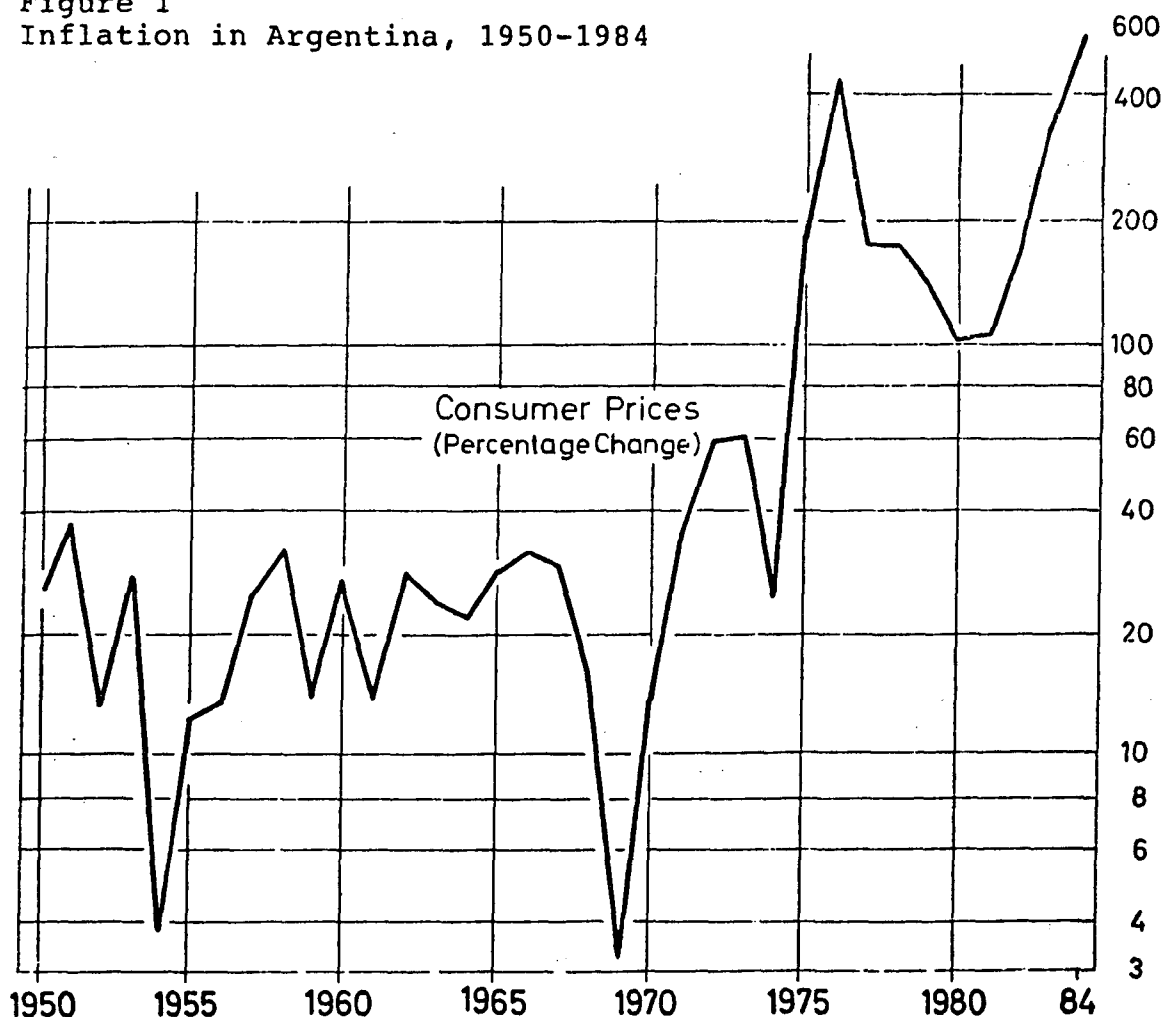
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The Argentine Financial Sector: Performance, Problems and Policy Issues

I. Introduction

Argentina has made headlines in the international press not only because of its external debt problem but also because of extremely high rates of inflation which reached a peak in September 1984 when the monthly change of the consumer price index climbed to 27.5 per cent corresponding to an annual rate of more than 1700 per cent. For the year 1984 as a whole the consumer price index rose by 688 per cent. Argentina has a long history of relatively high rates of inflation: From 1955 to 1975 the average annual increase of the consumer price index amounted to 35 per cent and in the

Figure 1
Inflation in Argentina, 1950-1984



Source: Fischer, Hiemenz, Trapp, 1984.

1976-1983 period the rate rose to 167 per cent (Figure 1), whereas world inflation was of the order of 5.5 and 12.6 per cent, respectively. The most recent price level increases mark a (preliminary) record in the post-war period.

From economic history it is well-known that high inflation impedes the functioning of financial markets, discourages investment and ultimately erodes the social fabric of the society (Keynes, 1924). The effects of inflation on growth and income distribution in Argentina have been discussed elsewhere (Fischer, Hiemenz, Trapp, 1984).

This paper focusses on the development of the financial sector under conditions of high inflation. It begins with a description of the Argentine financial sector (Section II) and then reviews three distinct periods of financial policies since the early 1970s (Section III). In the following chapter the main effects of financial repression are discussed and finally some policy suggestions for a restoration of the financial sector are presented.

II. The Financial System in Argentina

The Argentine financial system consists of a complex institutional framework with the Central Bank as a monopolistic supplier of high powered money, the banks and non-financial institutions acting as intermediaries between savers and lenders, and a security market¹.

These institutions constitute the official financial market. In order to control the expansion of money and credit the Central Bank determines the deposit and lending rates as well as the reserve ratios and decides over the amount of rediscount facilities which are available to banks. Minimum

¹ For a detailed description of the institutional framework of the Argentine financial sector see Tami, 1978 and Rodriguez, 1979.

reserve ratios have been kept at a level close to or even at 100 per cent, because of the inflationary effects of large scale financing of public sector deficits by Central Bank credit. In the case of high nominal interest rates the lending capacity of non-interest bearing demand deposits allows banks, but not other financial institutions, to realize considerable profits. In order to avoid discrimination between banks and non-bank financial institutions the Central Bank introduced the Monetary Regulation Account (Cuenta de Regulación Monetaria - CRM) in 1977¹. Under this scheme a compensation (in the form of interest) is paid for reserves held by banks on interest bearing deposits and profits stemming from the lending capacity of demand deposits are partially taxed away by charging demand deposits with a fee. The balance of the CRM which depends on the level of nominal interest rates, the reserve ratio and the deposit structure, is at present negative and generates, therefore, an operating deficit of the Central Bank.

In 1983, the deposits collected by the financial system amounted to some 16.5 per cent of GDP, the volume of credit to the private sector (excluding Central Bank credit) was of the order of 9.8 per cent of GDP. About 54 per cent of the deposits held by the private sector were savings and time deposits at a regulated (controlled) rate. One third of the deposits was at a rate indexed to the consumer price index or the (official) a\$/US\$ exchange rate. The remainder (12.6 per cent) was held as non-interest bearing demand deposits. All deposits at the controlled rate - this includes demand deposits which may not earn interest - are covered by a state-backed Deposit Insurance System. This government guarantee is regarded as a protection of small savers against losses from bank failures. Since there is no need to withdraw insured deposits in the case of a bank crisis it is

¹ For a detailed discussion of the rationale and effects of the Monetary Regulation Account see Fischer and Trapp (1985).

seen as a factor adding to the stability of the financial sector. Finally the insurance scheme is to prevent public banks from enjoying a competitive edge in mobilizing deposits because deposits at these banks are considered to be without risks due to the public ownership status.

On the lending side 59 per cent of the loans had a regulated interest rate, one third were index-linked loans and the remaining 8.6 per cent were granted at a free market interest rate. About three quarters of the total volume of bank loans are given to the private sector.

The most important part of the official Argentine financial market is the group of commercial banks. In 1982 this group was composed of 31 public banks and 166 private banks; they accounted for 82 per cent of the total loan portfolio in 1982 (Table A2). About 40 per cent of these loans came from official banks. Foreign banks contributed more than 40 per cent to the credit volume granted by private banks. The number of domestically-owned private commercial banks exceeded that of foreign banks by one hundred and of the 133 domestically-owned private banks only 9 per cent provided 68 per cent of the total loans granted by this sub-group. This indicates a rather uneven distribution of the credit volume among local banks.

Among the non-bank financial institutions, the most important ones are the public development banks which accounted for about 11 per cent of total loans in 1982. The other financial institutions are rather insignificant. There were 111 finance companies in 1982 holding a share of only 2.2 per cent of total loans; about one half of the credits provided by this sub-group was granted by 28 companies.

The security market, once a thriving institution, is only of minor importance at present. Activities at the stock exchange - as recorded by the Buenos Aires Stock Exchange - have been stagnant since 1975 (Table A6) and the number of

firms whose stocks are traded on the exchange has been declining over time. Until 1982 trading in public sector securities increased steadily. However, since then the government has refrained from financing its deficit in the bond market. Thus, the trade in public sector securities quickly became insignificant.

In addition to the official market there is an informal, non-institutionalized market for short term capital (mainly acceptances). It started as a money market among first-class corporations but is now believed by many to have developed into an extensive and rather well-established operation. According to recent estimates by Central Bank officials the size of the informal market amounts to 15 per cent of the volume of the official market. Although the supply of funds in this market is at least in part at the expense of the official market the Central Bank has tolerated the informal market because it provides an additional source of credit for those who could not be satisfied in the official market.

III. Financial Policies, 1973-1984

1. The Economic Background

The Argentine economy has experienced a high degree of instability since 1973¹. In 5 out of the 12 years from 1973 to 1984 overall output declined (Table A1). Real per capita income in 1984 was some 5 per cent lower than in 1973. Each downturn was preceded by a balance of payments crisis resulting from overexpansionary policies and real wage hikes in the previous years. In order to reduce the external deficit each government - usually a new one - took recourse in heavy devaluations of the Peso, in (relatively) tight monetary and fiscal policies, and real wage cuts. Consequently,

¹ For a more detailed analysis of the economic performance and economic policies in Argentina see Fischer, Hiemenz, Trapp (1984).

domestic demand contracted sharply, imports dropped and exports recovered somewhat. However, as soon as the balance of payments constraint no longer seemed to be a problem more expansionary policies were pursued in order to avoid social tensions. Real wages were allowed to rise again and domestic demand recovered briskly. The main instrument to reduce inflation was seen in a fixed exchange rate. However, since domestic policies were not geared to the exchange rate target, this policy was bound to lead to a new balance of payments crisis sooner or later.

In fact, despite the attempt to import price stability via a fixed exchange rate, inflation was extremely high and variable since 1973. From 1974 to 1976 the increase in consumer price rose from 24 to 441 per cent. After declining gradually to about 100 per cent in 1980 it started to accelerate again and climbed to 688 per cent in 1984. Financial policies have contributed heavily to the fluctuations of output and inflation rates; at the same time these developments have impeded severely the functioning of financial markets. In order to show the effects of financial policies on the financial sector more clearly some sub-periods shall be analysed in the following.

2. Financial Policies During the 1973-1976 Period

The election of 1973 ended a long period of military rule and brought a Peronist government into office. The main economic objectives of the new administration were to raise real wages and to stimulate economic activity. Public expenditures were allowed to increase markedly; the public sector deficit rose from 7.3 per cent of GDP in 1973 to some 15 per cent in 1975. In order to satisfy the public borrowing requirements smoothly, private bank deposits were nationalized in September 1973 by means of a 100 per cent minimum reserve ratio, i.e. banks had to take over part of the government debt. Under this system of nationalized deposits commercial

banks and other financial institutions acted only as agents of the Central Bank. Deposit and lending rates were determined by the Central Bank and interest payments due were credited and debited by the financial institutions on behalf of the Central Bank. To reimburse banks for their services the Central Bank paid a commission fee on deposits and granted a certain spread on interest rates for credits. Under the 100 per cent reserve system the Central Bank had full control over bank lending by determining the rediscount facilities of each bank. In addition, the Central Bank established limits, conditions and guarantees on banks' portfolios. Within these regulations banks were responsible for the distribution of credits and for the investment of funds.

Low interest rates were regarded as a prerequisite for a high rate of growth. Therefore the real rate of interest was kept at a level close to zero at the beginning and the expansion of the money supply was allowed to accelerate (Table A3). Until 1974 price increases were suppressed by strict controls. However, when the expansion of domestic demand gained momentum it became more and more difficult to keep inflationary pressures under control. Black markets for all kinds of products emerged and in 1975, despite price controls, there was a virtual price explosion. Since the adjustment of nominal interest rates did not keep pace with the increase of the inflation rate, real interest rates on most financial assets became highly negative (Table 1). This led to a rapid expansion of the informal acceptance market.

Due to the extremely high opportunity costs of holding non-interest bearing money and time and savings deposits (at a negative real rate of interest) the real value of private sector holdings of financial assets declined sharply (Table A4). The relation of M1 to GDP fell from 14.8 per cent in 1974 to 6.7 per cent in 1976¹. The reduction of time and

¹ These numbers refer to bank deposits only.

Table 1 - Selected Interest Rates, Argentina 1978-1984/II

- Rates per month, in per cent -

Period	Nominal ^a				Real			
	Credits		Deposits		Credits ^b		Deposits ^c	
	Controlled Rate	Free Rate	Controlled Rate	Free Rate	Controlled Rate	Free Rate	Controlled Rate	Free Rate
1973	1.6	2.5	2.1		-0.6	0.2	-2.0	
1974	1.6	2.2	2.1		-0.9	-0.4	-0.6	
1975	1.6	3.4	4.0		-4.7	-4.4	-3.6	
1976	3.3	7.0	7.4		-4.5	-3.9	-4.7	
1977	8.0	9.5	-		0.2	1.5	-	
1978		8.8		7.2		1.7		- 1.3
1979		7.3		6.4		- 0.4		- 0.9
1980		5.9		5.0		1.0		- 0.4
1981		9.8		8.1		1.9		0.8
1982 I		8.4		7.1		1.5		- 0.3
II		8.7		7.1		1.2		2.0
III	6.7	-	5.7	-	- 9.1	-	- 8.9	-
IV	8.7	13.9	8.0	10.2	- 3.3	1.4	- 3.1	- 1.2
1983 I	11.2	15.0	10.2	11.2	- 2.0	1.3	- 2.9	- 1.9
II	10.6	15.9	9.6	11.0	- 0.7	4.0	- 1.8	- 0.6
III	13.2	20.6	12.2		- 3.8	2.5	- 4.1	
IV	15.5	23.3 ^d	14.5		- 2.1	4.5	- 2.9	
1984 I	11.5	13.0 ^d	10.5		- 2.4	- 1.0	- 5.2	
II	14.0	18.0 ^d	13.0		- 4.5	- 0.9	- 4.1	

^aUp to 1977 the highest interest rates recorded, then up to 30 days deposits. - ^b1973-77 deflated by the Wholesale Price Index, 1978-1984 II deflated by the CARTECO Price Index. - ^cDeflated by the Consumer Price Index. - ^dInterest rates on bank acceptances.

Source: BCRA; Cavallo, Petrei, 1980; El Cronista Comercial, 1984; FIEL; Own calculations.

savings deposits was even more pronounced since there was an expectation of a massive devaluation of the Peso which caused an outright flight from the domestic currency in late 1975 and early 1976. Everybody tried to shift from domestic financial assets into real assets or foreign exchange thus intensifying inflation and the devaluation of the Peso in the black market. The result was that the ratio of M2 to GDP dropped from 26.3 per cent in 1974 to 9.6 per cent in 1976 (Table 2).

3. Towards Financial Liberalization, 1976-1981

At the beginning of 1976 the government had totally lost control over the situation. The rate of inflation reached an annual rate of 900 per cent, speculation was mushrooming, foreign exchange reserves were depleted and social unrest and guerilla activities put the society at the brink of dissolution. In the spring a military government took office and adopted immediately a stabilization plan: The public sector deficit was reduced drastically, the expansion of monetary aggregates was halved, real wages were cut by roughly one third, price controls were partially abolished, the Peso was devalued and trade as well as financial markets were partially liberalized. As a result domestic demand fell sharply, the current account moved into surplus and inflation stabilized at monthly rates of about 8 per cent. Speculation subsided and as real interest rates turned positive in the course of 1976 holdings of time and savings deposits (in real terms) increased markedly (Table A4). From 1976 to 1977 the M2/GDP ratio recovered by 4 percentage points. However, the holdings of non-interest bearing assets (M1) were kept at a low level in view of the persistently high rate of inflation (Table 2).

Whereas in the first phase the policy was dominated by typical stabilization measures, in 1977 there were pronounced

Table 2 - Liquidity Coefficients^a, Argentina 1970-1984

Year	Monetary base/GDP	M1/GDP	M2/GDP
<hr/>			
1970	10.5	14.7	25.1
1971	8.4	12.6	21.9
1972	6.3	9.7	17.1
1973	8.0	11.0	19.0
1974	12.3	14.8	26.3
1975	8.3	10.0	14.8
1976	7.3	6.7	9.6
1977	9.3	6.5	13.6
1978	10.6	6.4	17.9
1979	7.7	6.2	19.5
1980	7.1	7.7	25.4
1981	7.1	6.0	22.9
1982	11.9	4.7	15.6
1983	12.8	4.1	12.4
1984 ^b	11.8	3.9	11.0

^aDeposits issued by non-bank financial institutions are not included. Monetary aggregates are deflated by the index of wholesale prices (1970 = 100) divided by real GDP at market prices. - ^b 1st half of 1984.

Source: BCRA, FIEL.

efforts to adopt a market oriented policy. The liberalization period is closely related to the person of Martinez de Hoz, the Minister of Economics of the new government¹. This policy brought significant changes to the financial sector. Under the liberalization program of 1977/78 the nationalization of deposits was abandoned and replaced by a fractional reserve system. Open market operations were to be the main instrument to control monetary expansion. In order to prevent a monetary explosion in the transition period minimum reserve requirements had to be fixed at a relatively high level and the Monetary Regulation Account was installed in order to cope with the effects of high reserve ratios and high interest rates on non-bank financial institutions. Interest rates were liberalized and to enforce competition in the financial market barriers to entry were removed for both domestic and foreign banks. Under certain conditions non-bank financial institutions were allowed to be transformed into banks and the regulations for branch expansion were eased.

The deregulation of interest rates resulted in a further increase in real interest rates for deposits, i.e., for the first time in years savers were able to protect their savings against inflation. There was a dramatic increase of savings channeled through the banking system and thus monetization was raised (Table 2). The increase of financial savings also allowed a two-fold increase in the volume of credit. The build-up of deposits, which was backed by new confidence in the Peso and repatriation of capital, was somewhat stronger than the growth of credits, thus the banks were able to increase their holdings of foreign assets (IMF, 1983). At the same time the share of credits granted to the private sector rose substantially because the public sector

¹ This period can only be outlined in the context of this paper. It has been intensively analyzed in the literature. See f.i. Canitrot, 1981, Gaba, 1981 and Barletta, Blejer, Landau, 1983, Nogués, 1985.

deficit had been cut by two third. Due to the expansion of financial markets in real terms the number of banks almost doubled from 1976 to 1979 and the number of branches increased by 28 per cent.

Despite the policy change the inflation rate remained stubbornly high. This was due to increasing capital inflows which led to a higher-than-intended growth of the money supply. Therefore, in April 1978 the exchange rate was allowed to float freely. The Central Bank justified this step by stating that according to the monetary approach of the balance of payments it was either able to fix the exchange rate and to treat the money supply as an endogenous variable or to control domestic monetary expansion and leave the exchange rate determination to the market (Beccaria, Carciofi, 1982, p. 156). Initially, the Central Bank chose the latter option. However, since this strategy failed to bring down the inflation rate, it switched to the opposite policy in 1979. A pre-announced crawling peg was introduced with a decreasing rate of depreciation (tablita). This was intended to gradually reduce inflation expectation and the differential between domestic inflation and world inflation. In this context, monetary expansion was to be considered as an endogenous variable. Actually, however, monetary growth was not allowed to adjust smoothly to lower inflation rates, on the contrary, the public sector deficit widened again and the expansion of M1 accelerated in 1979. Since inflation rates did not decline in line with the schedule of decreasing devaluations the competitive position of the industry, which by partial trade liberalization had been exposed to international competition, deteriorated. This was made worse by a marked increase in real wages in 1979 and 1980. In view of continuing high rates of inflation and a marked deterioration of the external position expectations of a devaluation began to emerge. The government tried to defend the exchange rate schedule: capital inflows were attracted by guaranteed rates of return in terms of foreign currency and

borrowing abroad was encouraged by offering forward market contracts. However, after adjusting the exchange rate schedule several times the exchange rate policy was no longer credible, the crawling peg had to be given up. In the end the government had accumulated huge liabilities through exchange rate guarantees, the total external debt of the country had tripled within four years and the financial position of the industrial sector was bleak.

Predictably, this created acute problems in the Argentine banking sector. In 1982, a large share of the credit volume, which had been massively expanded in the preceding years, was on the brink of becoming non-performing. In addition, the banks suffered from a sharp decrease in the real volume of deposits due to foreign exchange speculation (Table A4). The liquidity ratio M2/GDP, which had risen to more than 25 per cent in 1980, fell again to some 15 per cent.

In the literature the problems of the industrial sector and the banking system have sometimes been attributed to volatile and excessively high interest rates after the financial reform (Carbajal, 1980) as well as to other characteristics of the financial system like the high share of short-term lending, the short-term and unstable nature of deposits, the difficulties of extending maturities of loans, the weak portfolio position of many private domestic banks, and lack of sufficient supervision over financial institutions.

It has, however, to be pointed out, that the difficulties in the financial sector did not arise from the key elements of the financial reform program but were rather associated with the insufficient implementation of domestic stabilization policies and the attempt to keep inflation under control by an overvalued exchange rate (Sjaastad, 1983). The enormous rise of interest rates in the late 70's and early 80's was primarily due to the lack of credibility in the exchange rate policy, in view of the renewed increase of the public sector deficit and the persistently high level of inflation.

The lesson to be learned from this experience is clear: it is of utmost importance that stabilization policies are internally consistent and credible, particularly when (financial) markets are free (Nogués, 1985, p. 2). The lack of a comprehensive trade liberalization policy at that time was another obstacle for the reform program to be successful (Wogart, 1983).

4. Back to Financial Repression, 1982-1984

In June 1982, when a new administration - the 6th since 1973 - under General Bignone came into office the Argentine economy was characterized by a severe financial and foreign exchange crisis, a dramatic increase in the public sector deficit, high inflation rates as well as by depressed and declining economic activity. In July 1982, a so-called financial reform package was introduced in order to improve the efficiency of the banking system and to lengthen the maturity of the financial saving instruments. With these measures the government gave up the market-oriented approach and re-established a centralized financial system. Interest rates on short-term financial liabilities with a government guarantee were controlled and a ceiling on deposits with a maturity of up to 89 days was introduced. The indexation of financial assets of one-year maturity or longer was restricted and financial institutions were allowed to issue non-indexed certificates of deposit of 90-days maturity or longer at free market interest rates. However, the amount of such deposits was limited. Additionally, banks were authorized to pay interest on demand deposits at a maximum rate of 2.5 per cent per month. Finally, a 100 per cent reserve requirement was imposed on all above mentioned deposits except the non-regulated 90-day or longer deposits.

To ease the debt burden of the private sector and to promote economic recovery a rediscount facility (*prestamo básico*) was offered by the Central Bank for a rescheduling of the private sector debt. Initially a charge of 5.6 % per month

was imposed on the financial institutions, the interest rate ceiling for final borrowers was 6 %; this implied a highly negative rate in real terms. Such loans had to be repaid in 60 equal monthly installments thus the maturity exceeded by far those that were available in the market. There were even slightly better terms for mortgage loans. Through this debt rescheduling scheme part of the inflation tax revenues was channeled into the industrial sector in order to improve the financial position of companies.

However, since macroeconomic policies were not geared to reducing inflation and improving the competitiveness of the industry the result of the July 1982 reform was rather disappointing in terms of the objectives to be achieved. Neither the envisaged readjustment of the private sector portfolios towards lengthening the maturities of both deposits and liabilities nor the economic recovery took place. The real rate of interest became highly negative as a result of the inflationary impact of the large Peso devaluation of July 1982 and the implementation of the financial reform. As a consequence savers switched from Peso-denominated financial assets to physical assets or foreign currency, thus causing again a rapid financial disintermediation (Table 2). In the short run the measures led to an alleviation of corporate and household indebtedness and therefore to an improvement in the financial institutions' portfolio, however, this was only possible because of substantial interest subsidies to borrowers. The implicit real annual lending interest rate amounted to around -60 per cent per annum. But as the Peso was not allowed to more strongly depreciate the competitiveness of the industry remained low and economic recovery did not take place. Therefore, the portfolio improvement of firms and financial institutions proved only to be temporary and extremely costly.

In December 1983 when the Alfonsín administration came into office, it announced the replacement of the 100 per cent

reserve requirement system which covered most kinds of deposits by a fractional reserve system. However, the reserve quotas remained extremely high to keep bank credits at a low level in face of the huge fiscal deficit financed directly by printing money. Therefore, monetary expansion resulted mainly from a deficit-induced expansion of the monetary base and only to a small degree from bank lending.

On the whole, the basic framework of the 1982 reform was maintained by the monetary authorities in order to avoid further disruptions in the financial system. Regulated interest rates were raised but by far not sufficiently to become positive in real terms. Therefore, the decline in real money balances continued thus reducing the real lending capacity of the banks even more. In fact, total bank deposits amounted to only 6 per cent of GDP at the end of 1984 and credits to the private sector had declined by some 50 per cent in real terms since 1982. The overwhelming share of deposits was of a very short-term nature, i.e. depositors temporarily took advantage of high nominal interest rates and tried to switch into US-dollars before the interest differential was eaten up by the devaluation of the Peso. Part of the business was taking place in the informal money market which was flourishing due to the shortage of funds and credits in the official market.

The capital market has been non-existent for several years because of expectations of persistently high rates of inflation and continuing devaluation of the Peso. Even if there were a supply of medium or long-term funds at positive real rates of interest, demand would be very low because of the risk of any longer-term investment. The longer the time horizon of the project the higher is the uncertainty concerning the development of relative prices. Although this is true for any investment project it becomes more important under conditions of high inflation. With lending rates in

the order of more than 500 per cent per annum any decline of the relative price of the own product would inevitably create heavy liquidity problems. Thus long-term investment projects can only be carried out, when government loans at negative real interest rates are available and when interest payments due can be capitalized. But even in such cases it is much more attractive to reinvest funds in the informal money market or in foreign exchange than in production capacities.

IV. The Effects of Financial Repression

The main instrument of financial repression in the period since 1973 has been the combination of negative real interest rates and high inflation. The continuing erosion of the purchasing power of money represents a massive tax on currency holdings and on demand deposits. Because of the high opportunity costs of holding money M1 in per cent of GDP declined from about 15 per cent in 1974 to some 4 per cent in 1984 (Table 2). This demonetization implies a loss in overall economic wealth because of the services of money forgone.

At the same time, the ability of the financial sector to mobilize domestic savings has been reduced by the maintenance of negative real rates of interest. Since there was no way to protect financial assets from purchasing power losses savers increasingly turned to real assets (real estate) and foreign exchange as alternative investment possibilities. As a result, deposits held at commercial banks fell from 25 per cent of GDP at the beginning of the 70's to 11 per cent in 1984. Thus the depth of the financial sector has deteriorated markedly over the last 15 years. Compared to countries like Brazil and South Korea, which in per-capita-income terms rank below Argentina, the deposit-income ratio in Argentina reached a very low level in 1983 (Table 3).

Table 3 - Real Per-Capita Income and the Ratio of Money (M2)^a to Gross Domestic Product (GDP) in Selected Countries, 1960-1983

Country	Real GNP Per Capita ^b	M2/GDP				
	1981	1960-75	1975-80	1981	1982	1983
Argentina	2.560	0.307	0.358	0.376	0.225 ^c	0.165 ^c
Brazil	2.220	0.254	0.257	0.246	0.257	0.291
Chile	2.560	0.191	0.188	0.241	0.319	-
Colombia	1.380	0.199	0.258	0.319	0.318	0.347
India	260	0.280	0.383	0.416	0.439	-
Philippines	790	0.221	0.249	0.262	0.278	0.287
South-Korea	1.700	0.336	0.350	0.366	0.406	0.414
Sri Lanka	300	0.290	0.328	0.350	0.379	0.380
Turkey	1.540	0.283	0.220	0.223	0.299	0.288
Fed. Rep. of Germany	13.450	0.509	0.681	0.616	0.631	0.641
France	12.190	0.641	0.727	0.693	0.677	0.681
Great Britain	9.110	0.553	0.344	0.380	0.386	0.399
United States	12.820	0.734	0.686	0.572	0.608	0.644

^aIncludes IFS-items money, quasi-money and savings deposits. - ^bIn U.S. Dollar. - ^cData from El Cronista Commercial, 1984.

Source: World Bank, World Tables 1983, Washington 1984; IMF, International Financial Statistics, Washington, various issues; Own calculations.

Since inflation rates proved to be highly variable nominal interest rates were fluctuating heavily too. Under such circumstances any longer term fixing of interest rates was out of question. Indexation was possible to some extent, however, due to a lagged adjustment of interest rates to price level or exchange rate changes, it did not offer full protection. Another factor reducing the effectiveness of indexation is the variability of relative prices which to a large degree stems from price controls and exchange rate manipulation. Therefore, most savings are concentrated on deposits with a very short time to maturity (less than thirty days). In view of the lack of any long-term funds the supply of long-term credits and mortgages has completely dried out.

Demonetization and financial disintermediation have led to an erosion of the base from which the inflation tax is levied. The attempt to continue to finance the public sector deficit by the printing press resulted in a further increase in inflation rates. This has accelerated the process of disintermediation: The flight from the domestic currency has intensified. It is estimated that foreign financial assets in US-dollars of Argentine residents amount to more than 20 bill. \$ and increase at an annual rate of 3 bill. \$. At the same time the propensity to invest in production capacities at home dropped sharply in view of the gains offered by foreign currency investments. Gross domestic investment fell by about 50 per cent from 1980 to 1984, and the share of investment in GDP declined from more than 20 per cent to less than 10 per cent. Thus domestic capital formation has been severely impeded by financial repression.

Because of the marked decline of the supply of deposits (in real terms) and large-scale public sector borrowing the volume of credits available for the private sector shrank over the last years. Demand for credit, however, exceeded supply by a substantial amount given negative real interest

rates. In fact, negative real interest rates imply a heavy subsidization of lenders at the expense of the holders of financial assets. Therefore, credits had to be rationed by the Central Bank or in an informal way. This means, that the allocation of credit was not governed by efficiency criteria but by factors such as lobbyist activities, the existence of interlocking ownership between companies and banks or the possibility of mobilizing government support.

In view of the progressive dissolution of the financial system since 1982 it is important to keep in mind that during the liberalization period from 1976 to 1981 the economy strongly responded to interest rate incentives. When real interest rates were allowed to become positive financial intermediation was restored quickly and the confidence in the financial sector grew. The volume of deposits and credits rose vigorously and the banking sector expanded. The government was even able to finance part of the public sector deficit by selling long-term bonds.

Unfortunately, however, another source of financial repression was introduced during the liberalization period by bringing about a real appreciation of the Peso. While the overvaluation of the domestic currency was intended to reduce inflationary tendencies, it was at the same time equivalent to an undervaluation of foreign financial assets. As a consequence capital outflows occurred - even when foreign exchange transactions were controlled - and the attractiveness of the country for foreign investors suffered. Up through mid-1982 the government made the situation worse by offering exchange rate guarantees for capital inflows and borrowing abroad to defend the exchange rate schedule; i.e., economic policy subsidized the purchase of foreign assets. Ultimately, as a result of expansionary domestic policies, there was a massive capital flight - it is estimated that in 1982/83 more than 20 billions US-\$ were transferred abroad -

and a huge foreign debt amounting to about 45 billion US-\$ was accumulated, causing debt service obligations which greatly exceeded the country's capacity.

After the liberalization experiment had failed, not because liberalization was inadequate but because of an inconsistent mix of macroeconomic policies, negative real interest rates were reimposed and the financial sector began to shrink again. From 1977 to 1984 the number of financial institutions operating in Argentina declined from 723 to 380. While concentration in the financial sector increased, the banks extended the number of branches from 3300 to 4400 in order to improve the collection of deposits. However, this attempt to increase bank revenues failed because of the marked decline in the real volume of deposits. Therefore, operating costs of the banks in relation to overall business increased considerably.

According to World Bank estimates administrative costs as per cent of the total loan portfolio amounted to 13 per cent for state and municipal banks. The corresponding figure for commercial banks (10 per cent) was somewhat lower but still distinctly higher than in other countries. For the Chilean banking system for instance administration costs amounted on average to 5 per cent of total loans in 1982. Over the last years, the per unit operational costs are likely to have increased even more in Argentina, due to a further shrinking of the relative size of the financial system and to the increasingly short-term character of financial assets.

Thus, while the government succeeded in preserving a diversified structure of the financial sector it was not able to prevent a decline of the market as a whole. Furthermore, the deposit insurance has ultimately contributed to make the

financial market more unstable¹. Due to the insurance savers had no reason to apply risk considerations when a deposit was made at a bank or non-bank financial institution. Since banks were granted a fixed spread on the lending business by the Central Bank and given the uniform low risk premium charged to the various financial institutions with differing risks, there was no incentive to take into account profitability and solvency criteria². Thus, when the private sector incurred financial difficulties because of the devaluation of the Peso and excessive foreign borrowing, banks were heavily affected too. By granting medium term consolidation loans at a highly subsidized rate the government warded off a collapse. But since no fundamental reorientation of business activities followed the position of many companies and banks remained weak. According to the Minister of Economics some 200 of the 380 financial institutions operating in 1984 would not have been able to survive without government support. However, under the present system of regulations there is hardly scope for financial institutions to play a more active role in the intermediation process and to improve their position. Deposit and lending rates are determined by the Central Bank and the lending capacity is very limited. Thus, there is no incentive to compete for deposits by securing a high and secure flow of revenues from lending and other investment. Instead of financing private investment projects with the expectation of high yields banks are risk adverse and prefer to put their money into enterprises which are state-owned or backed by government guarantees. From a macroeconomic point of view this has led to a highly inefficient allocation of capital.

¹ For a critical assessment of the Argentine deposit insurance system see Fernandez, 1980 and 1983.

² The insurance premium is charged on the basis of a flat rate equal to 0.03 per cent of average monthly deposits.

V. Policies to Restore Financial Markets

At present the Argentine financial sector can barely fulfill its functions as a mobilizer of savings, as a clearing house for transforming risks and maturities, and as an efficient allocator of the funds to investors. In fact, financial institutions are no more than executive agents of the Central Bank.

Both, high inflation rates and policy-induced distortions contribute to the severe financial repression. Any attempt to reestablish the functioning of the financial sector and to stop financial repression must therefore include a strategy of disinflation and a deregulation of the financial sector¹. For a credible anti-inflation policy it is first and above all necessary to cut the public sector deficit drastically in order to reduce the deficit-induced expansion of the monetary base. To reduce the recessionary effects of a sharp curtailment of monetary expansion production incentives should be restored immediately by eliminating price controls, adopting a freely floating exchange rate, and abolishing trade restrictions, in particular the taxes on agricultural exports. Indexation should be made available in order to smooth the adjustment to lower inflation rates².

In principle, the reform of the financial sector requires a freeing of interest rates and a thorough deregulation of other distortions. However, in the short run a comprehensive reform may not be suitable in order not to endanger the price stabilization plan. A cut of reserve ratios, for instance, which would enable banks to noticeably extend lending activities, does not actually represent a policy option since the increase in high powered money would fuel inflation and offset the effects of a declining public deficit on

¹ For a more detailed discussion of the rationale of such an anti-inflation program see Fischer, Hiemenz, Trapp, 1984.

² For a theoretical discussion of indexation see Friedman, 1974.

the money supply. Furthermore, if interest rates for all loans would be suddenly freed and would turn positive in real terms the service payments on the existing loans would probably cause substantial financial difficulties for many companies. Thus, it would be necessary to adjust (subsidized) interest rates on existing loans gradually to market levels.

But even if the complete revival of the functions of banking sector rather constitute a long term option, some immediate policy changes are required to increase savings and to improve the allocation of financial resources. A number of measures can be implemented to this end while anti-inflationary budget policies are pursued

- interest rates for new deposits and credit arrangements should be market-determined in order to reestablish a positive real rate of interest,
- an increase in indexed deposits to promote the flow of funds to the financial sector through a more rapid and adequate adjustment of nominal interest rates to the rate of inflation,
- an increase in the volume of bank acceptances to enlarge the volume of credit available at freely floating interest rates.

Such measures would impose a more active role on the banking sector in the allocation of credit and thus increase competition among those demanding credit and among the banks themselves.

A carefully designed policy to reduce the deposit guarantee system of the Central Bank would also contribute to more competition in the financial system. To avoid an outflow of deposit from private banks to official banks the latter should be restricted to hold demand deposits and be obliged to refinance themselves by issuing indexed bonds. As a desi-

rable result the state-owned part of banking sector would shrink thus improving the overall efficiency of this sector. The introduction of more competition would probably contribute to reduce the number banks and, thus, lead to more concentration in financial markets, however, the gain in efficiency through more operations on a large scale base would clearly outweigh this effect. Finally, the role of the Central Bank should be restricted to supervising the behavior of the banking system but not to intervene into the financial process.

With a reduction of the inflation rate and a more competitive structure of the financial sector the Central Bank can move towards full interest rate liberalization. A reduction of the legal reserve requirements, the privatisation of the deposit guarantee scheme and a dismantling of the monetary regulation account would give back to the financial sector its original responsibility in the financial intermediation process and allow the Central Bank to fulfill its role as a supervisor of the financial system.

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Abbreviations

BCRA	Banco Central de la República Argentina
FIEL	Funcación de Investigaciones Económicas Latinoamericanas
IFS	International Financial Statistics
IMF	International Monetary Fund
IEERAL	Instituto de Estudios Económicos sobre la Realidad Argentina y Latinoamericana
INDEC	Instituto Nacional de Estadística y Censos
\$a	Argentine Peso

Statistical Appendix

Table A1 - Basic Economic Indicators, Argentina 1970-1983

Year	Per-Capita Income ^a (Percentage change)	Public Sector Deficit ^b (P.c.of GDP)	Bank Credit to the Pri- vate Sector in Real Terms (Percentage change)	Monev Supply ^c M1 (Percentage change)	Rate of Inflation ^d	Real Wages (Percentage change)	Exchange Rate ^e (Percentage change) (1) (2)		Trade Balance	Current Account ^g (Millions of US-\$)
							Commercial Financial ^f			
1970	4.3	- 0.9	6.5	12.9	13.6	3.7		14	274	- 163
1971	2.1	- 3.5	-25.2	24.4	34.7	1.5	37	106	87	- 390
1972	0.4	- 5.2	-16.3	39.1	58.5	- 5.2	57	19	256	- 227
1973	1.8	- 7.3	26.6	74.7	60.3	4.9	9	0	1289	711
1974	4.1	- 9.4	15.0	70.8	24.2	10.5	-2	0	714	118
1975	-1.9	-15.1	-43.9	96.3	182.8	- 3.6	432	471	- 549	-1,287
1976	-2.0	-11.7	-13.8	303.1	441.1	-28.1	407	377	1153	651
1977	4.7	- 5.1	46.2	155.7	176.0	- 7.5		122	1852	1,126
1978	-4.9	- 6.8	14.9	135.6	175.5	- 2.2		96	2913	1,856
1979	5.0	- 6.3	43.5	155.8	139.7	13.3		66	1782	- 513
1980	-0.7	- 7.6	32.4	120.7	100.7	12.7		40	-1373	-4,774
1981	-7.5	-15.6	- 5.0	53.2	104.4	- 8.7	140	211	712	-4,712
1982	-6.6	-16.5	-24.7	165.2	164.7	-10.6	389	491	2726	-2,477
1983	1.6	-15.8	-52.2	312.0	343.8	+14.0	388	324	2000	n.a.

^aAt 1970 constant prices; ^bNon-financial public sector; ^cCurrency in circulation and demand deposits; ^dConsumer prices of Greater Buenos Aires, annual average; ^e\$ a per US-\$; ^fSince 1982 parallel market; ^gIncludes net current transfers; ^h(-) increase in reserves; ⁱEstimate.

Source: Fischer, Hiemenz, Trapp (1984: Table 2).

Table A2 - Institutional Structure of the Financial System, Argentina 1982

	Institutions		Loans		Net Worth	
	Number	p.c.	Pesos (Billions)	p.c.	Pesos (Billions)	p.c.
1. Commercial banks	<u>197</u>	<u>47.7</u>	<u>1 317</u>	<u>81.5</u>	<u>139.6</u>	<u>83.3</u>
- Official ^a	31	7.5	378.2	23.4	172.7	43.4
- Private	166	40.2	939.3	58.1	66.9	39.9
- Domestic	(133)	(32.2)	(516.6)	(32.0)	(47.3)	(28.2)
- Foreign	(33)	(8.0)	(422.7)	(26.1)	(19.6)	(11.7)
2. Investment banks ^b	<u>3</u>	<u>0.7</u>	<u>3.3</u>	<u>0.2</u>	<u>0.3</u>	<u>0.3</u>
3. Mortgage banks	<u>1</u>	<u>0.2</u>	<u>33.5</u>	<u>2.1</u>	<u>10.2</u>	<u>6.1</u>
4. Development banks	<u>2</u>	<u>0.5</u>	<u>175.3</u>	<u>10.8</u>	<u>2.6</u>	<u>1.5</u>
5. Savings banks	<u>1</u>	<u>0.2</u>	<u>30.6</u>	<u>1.9</u>	<u>2.5</u>	<u>1.5</u>
6. Finance companies	<u>111</u>	<u>26.9</u>	<u>35.1</u>	<u>2.2</u>	<u>8.3</u>	<u>4.9</u>
7. Savings and loan association	<u>22</u>	<u>5.3</u>	<u>12.6</u>	<u>0.8</u>	<u>2.3</u>	<u>1.4</u>
8. Credit cooperatives	<u>76</u>	<u>18.4</u>	<u>7.8</u>	<u>0.5</u>	<u>1.8</u>	<u>1.1</u>
9. Total	413	100.0	1 615.7	100.0	167.6	100.0

^a Composed by banks owned by the federal government, state governments and municipalities.

^b Official and private domestic and foreign banks.

Source: BCRA.

Table A3 - Private Sector Holdings of Financial Assets, Argentina, 1970-83^a
(Millions of peso stocks at the end of the year)

	Money			Quasi-Money					
	Total	Currency	Demand Deposits	Total	Saving Deposits	CD's	M2 ^b	Accept- ance ^c	
1970	2	1	1	1	1	-	3	-	25
1971	2	1	1	1	1	-	3	-	34
1972	3	1	2	2	1	-	5	5	55
1973	5	2	3	4	3	1	9	10	105
1974	8	4	4	5	4	1	14	15	163
1975	26	12	13	7	6	1	33	33	371
1976	92	41	51	53	24	28	145	212	1699
1977	208	107	101	291	37	254	500	80	5080
1978	563	333	230	868	104	763	1431	33	14348
1979	1382	787	595	2914	254	2660	4297	71	43048
1980	2735	1641	1093	5282	627	4654	8017	52	80224
1981	4609	3020	1588	11368	1195	10172	15977	114	159891
1982	14864	8736	6128	23408	2977	20481	38322	-	383227
1983	69953	46342	23611	123645	30842	92803	193598	.	.

^a Does not include deposits issued by non-bank financial institutions. - ^b Defined as M1 plus quasi-money. -

^c Includes acceptances issued by finance companies. - ^d Defined as M2 plus acceptances.

Source: BCRA.

Table A4 - Real Monetary Aggregates^a, Argentina, 1970-1984

Year	Monetary base ^b 1970=100	M ₁	M ₂
1970	100.0	100.0	100.0
1971	83.2	89.2	90.6
1972	63.7	70.1	72.1
1973	82.9	81.6	83.0
1974	135.4	116.1	121.1
1975	90.7	78.0	68.1
1976	79.5	52.6	43.9
1977	107.2	53.8	66.2
1978	119.2	51.6	84.5
1979	91.7	52.9	97.7
1980	85.3	66.6	128.4
1981	80.4	48.7	108.5
1982	127.1	36.3	69.8
1983	140.8	32.4	57.1
1984 ^c	129.6	31.8	54.4

^a Does not include deposits issued by non-bank financial institutions. Deflated by the wholesale price index (1970=100), millions of pesos. ^b Not adjusted for changes in reserve ratios. - ^c 1st half of 1984.

Source: BCRA, FIEL.

Table A5 - Currency-Deposits Ratios and Money Multiplier,
Argentina, 1970-1984

Year	Demand deposit currency ratio	Time deposit currency ratio	Money multiplier ^a
1970	1,052	1,451	1,395
1971	1,136	1,569	1,497
1972	1,290	1,729	1,536
1973	1,371	1,746	1,372
1974	1,289	1,787	1,197
1975	1,244	1,105	1,192
1976	1,517	1,075	0,922
1977	1,311	2,537	0,720
1978	0,986	3,562	0,604
1979	0,942	4,179	0,804
1980	0,806	4,134	1,090
1981	0,629	4,568	0,845
1983	0,699	3,411	0,321
1984 ^b	0,582	3,016	0,337

^a M1/Monetary base. - ^b 1st. Quarter.

Source: BCRA.

Table A6 - Buenos Aires Stock Exchange Transactions in Private and Public Security, Argentina, 1960-1982

Year	Public Securities		Private Securities		Total	No. of Corporations traded
	(US-\$)	(p.c.)	(US-\$)	(p.c.)		
1960	20.0	4.8	398.2	95.2	418.2	522
1965	15.2	19.4	63.1	80.6	78.3	568
1970	103.5	63.5	59.4	36.5	162.9	414
1975	1339.1	98.1	19.1	1.4	1358.2	322
1976	3157.0	86.6	486.8	13.4	3643.8	309
1977	803.6	77.2	237.1	22.8	1040.7	303
1978	1377.9	76.0	435.6	24.0	1813.5	296
1979	1179.0	43.9	1507.3	56.1	2686.3	287
1980	1048.1	48.4	1115.5	51.6	2163.6	278
1981	1530.8	82.9	316.7	17.1	1847.5	263
1982	1633.8	90.6	170.3	9.4	1804.1	248

Source: Buenos Aires Stock Exchange.