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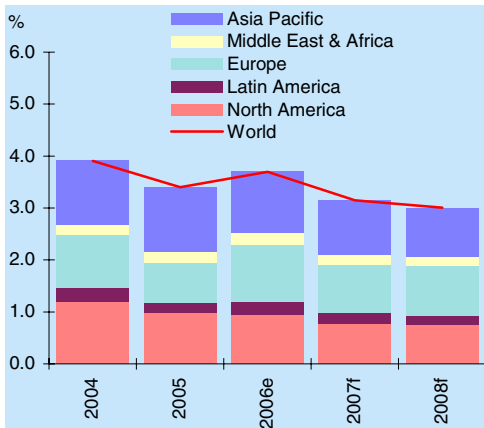
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This *D&B Country Report* was prepared in January 2007

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# Global Economic Outlook

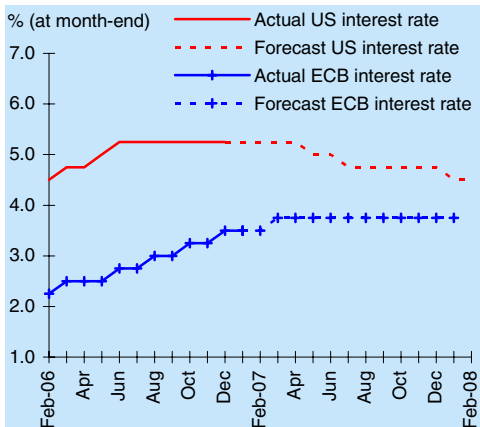
Real GDP growth forecast	2007f	Interest rates and oil price	Feb. 2007
World, %	3.2	US interest rate, %	5.25
US, %	2.5	ECB interest rate, %	3.50
Euroland, %	2.1	Japan interest rate, %	0.25
Japan, %	1.9	Oil price (Brent crude), USD/b	52.4



Sources: International Monetary Fund; D&B

## World Growth

We estimate that the world economy grew by 3.7% in 2006 on an exchange rate-based weighting, up from 3.4% in 2005. In 2007 global economic growth is expected to slow to 3.2%, due mainly to a moderation in US economic growth. However, relatively brisk demand growth in major European and Asian countries should help to reduce the imbalance in the world economy created by structural external savings in Asia and the US' high level of external debt. While this could reduce the medium-term potential for volatility in currency markets, the narrowing of interest rate differentials between the major currency areas points to a depreciating trend in the US dollar during 2007.

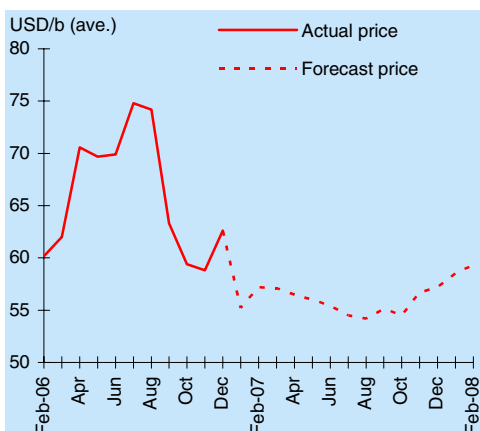


Sources: US Federal Reserve; European Central Bank; D&B

## US and Euroland Interest Rates

**US:** Stronger-than-expected economic data have significantly reduced market expectations for interest rate cuts in the first half of 2007. However, with the wider economy exposed to the housing market slowdown and with lower oil prices expected to help the inflation outlook, D&B believes a rate cut could occur as early as May 2007.

**Euroland:** Owing to recent euro appreciation and the fact that inflation is currently below its informal 2% target, the ECB decided to pause its tightening policy in January 2007, keeping the interest rate at 3.5%. However, D&B expects one further rise to occur in Q1 2007 taking into account strong money, credit and demand growth.



Source: D&B

## Oil Price (Brent Crude)

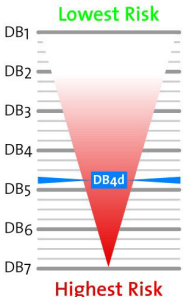
Oil prices fell by around 15% at the start of 2007 to reach their lowest point for 20 months. Mild weather in the US reduced demand, while supply remained firm. In addition, doubts remained whether OPEC countries would adhere to further cuts aimed at reducing supply by 500,000 barrels per day (b/d) from 1 February (Saudi Arabia also stated that there is no need to call a meeting to implement additional cuts). Forecasts of an increase in non-OPEC supply later in 2007 of 1.7-1.8m b/d are optimistic given shortages of drilling rigs and drill pipe. As a result, we forecast some upturn in oil prices from mid-2007, but we are lowering our average forecast for 2007 to USD55.8 per barrel.

# Country Risk Indicator

DB4d

For Country Risk Indicator Definition see page 57

Regional Risk Indicators	
Canada	DB1c
USA	DB1c
Chile	DB2b
Trin. & Tob.	DB2d
Mexico	DB3a
Costa Rica	DB3c
Brazil	DB3d
El Salvador	DB4a
Panama	DB4a
Peru	DB4a
Colombia	DB4b
Uruguay	DB4b
Dom. Rep.	DB4c
<b>Argentina</b>	<b>DB4d</b>
Guatemala	DB4d
Jamaica	DB4d
Honduras	DB6a
Venezuela	DB6a
Bolivia	DB6b
Ecuador	DB6b
Paraguay	DB6b
Nicaragua	DB6c
Cuba	DB6d
Argentina's Risk Indicator History	
End-2004	DB5c
End-2005	DB5b
End-2006	DB5b
Comparative Risk Indicators	
Turkey	DB4c
Kenya	DB4d
Pakistan	DB4d



**Moderate Risk**

Significant uncertainty associated with expected returns. Risk-averse customers are advised to protect against potential losses. .

The DB indicator is a comparative, cross-border assessment of the risk of doing business in a country. The indicator seeks to encapsulate the risk that country-wide factors pose to the predictability of export payments and investment returns over a time horizon of two years.

## Overall Outlook

- Argentina's country risk environment has improved substantially since the 2001-02 economic and political crisis with a sharp resurgence in economic growth. President Nestor Kirchner has fostered political stability; he is expected to contest and win the presidential election on October 2007. Nevertheless, economic and institutional weaknesses persist. The current policy direction is not likely to overcome these problems, posing uncertainty to the country's medium- to long-term outlook.

## Positive Risk Factors

- + Economic growth is broad based with an important recovery of investment. Positive prospects in the labour market will continue to boost private consumption. Good conditions in external markets will secure a further expansion of exports.
- + The political environment has continued to improve. Kirchner's arrival in office in 2003 has helped to restore power in the presidency.
- + The commercial environment has made a healthy recovery. There has been an upturn in business activity and a reduction in public perceptions of incidents of corruption; in addition, trends in Argentinean companies' payments performance have improved.
- + The monetary policy followed by the central bank is consistent with the macroeconomic goals of the government. High accumulation of reserves and strict sterilisation policies has helped to boost solvency in the external sector and mitigate inflationary risks.
- + Argentineans enjoy the highest per capita income in Latin America and comprise the most highly educated and skilled workforce in the region.

## Negative Risk Factors

- Argentina's inflation environment is a primary downside risk. Inflation reached a high of 9.8% year on year at the end of 2006 as strong demand-side pressures and capacity constraints pushed up consumer prices.
- The government's increasingly unorthodox policy direction, which includes the maintenance of distortionary taxes and price controls, as well as lax fiscal policy, creates uncertainties as to economic stability and the outlook for sustained economic growth over the medium to longer term.
- Exports continue to have a low level of added value being very dependent on the external market conditions.
- The lack of institutional reforms and increasing discretionary use of public resources ahead of the October presidential election, combined with a deteriorating regulatory and contractual environment, cast serious doubt on the sustainability of the current economic growth.

# Key Information

## Economic and Development Information

	2004	2005	2006e	2007f	2008f
<b>GDP (nominal)</b>					
ARS bn	447.6	531.9	656.3	696.8	709.2
USD bn	152.2	182.0	213.8	223.3	225.1
<b>Breakdown of GDP</b>					
Agriculture (%)	11.2	11.5	11.3	11.2	11.0
Industry (%)	34.8	34.9	35.0	34.9	35.1
Services (%)	54.1	53.6	53.7	53.9	53.9
<b>Economic indicators</b>					
Real GDP growth (% change)	9.0	9.2	8.4	7.4	4.7
Inflation, annual average (%)	4.4	9.6	11.1	12.0	13.0
Government balance (% GDP)	3.5	1.5	1.1	0.7	0.6
Unemployment (%)	12.1	10.1	10.2	8.5	7.8
Current account balance (% GDP)	2.1	3.0	3.7	1.6	0.7

Long-term real GDP growth potential, annual average, 2007-16: 3.0-5.0%

	Argentina	Brazil	Mexico	Uruguay	US
<b>Development indicators</b>					
Population, 2005 (m)	39.2	180.6	105.3	3.4	294.9
Population, 2015 (m)	42.9	190.9	120.6	3.6	318.0
Population, 2050 (m)	53.0	247.6	162.9	4.2	354.1
Internet users (per 1,000 people)	100.8	46.6	36.2	119.0	501.5
GDP per capita (PPP)	11,200	7,600	9,000	12,800	37,800
GNI per capita (USD)	4,060	2,830	5,910	4,340	37,610
Life expectancy (years)	75.7	71.4	74.9	75.9	77.4
Adult literacy (%)	97.1	86.4	92.2	98.0	97.0
Dependency ratio, 2005	0.57	0.47	0.57	0.58	0.49
Dependency ratio, 2015	0.52	0.46	0.48	0.54	0.53
Dependency ratio, 2050	0.60	0.59	0.57	0.63	0.68

## Political Information

Head of state	President Nestor Kirchner
Political system	Multiparty democracy
<i>Present constitution adopted</i>	<i>1853 (Last reformed in 1994)</i>
Ruling party	Peronist Party
Last elections	Presidential: April 2003; Legislative: October 2005
Next elections	Presidential: October 2007; Legislative: October 2007

## Miscellaneous Information

Religion(s)	Roman Catholic (90%); Protestant (2%); Other (8%)
Capital (population)	City of Buenos Aires (2.8m)
Timezone	GMT -3/4 hours

Sources: International Monetary Fund, *International Financial Statistics*; World Bank, *World Development Indicators*; UN Development Programme, *Human Development Report*; D&B

# Executive Summary

## Political Risk

Political instability in Argentina has been reduced under President Nestor Kirchner's leadership. Since coming to office in 2003, he has overseen the recovery of the Argentinean economy and successful conclusion of the sovereign's debt exchange in 2005. Overall he has proven a capable leader and has restored presidential authority. His political leadership has strengthened with his party's victory on the October 2005 congressional election, his high levels of popularity, his discretionary management of financial resources and the co-opting of political leaders from different parties.

The October 2007 presidential election dominates the political environment. Although he is yet to announce his candidacy, Kirchner (or his wife, Cristina Fernandez) is expected to win the election due to the lack of a united opposition to the government. The attempts of the opposition to build a more pro-business coalition ahead of the October election may create incentives to radicalise (or at least maintain) Kirchner's unorthodox economic policies and continue with his political strategy of power accumulation.

D&B expects the policy agenda of the government during the two-year forecast period to remain characterised by strong interventionism in the economy. We do not expect that needed political and institutional reforms will be implemented over the outlook period. Macroeconomic policy will continue to be characterised by the government's attempts to control inflation in the economy, the central bank's active intervention to both keep a competitive exchange rate and accumulating international reserves, and the lack of any agreement with international organisations such the IMF that may lead to some loss of economic sovereignty. Kirchner is unlikely to reopen negotiations over the government debt default, despite pressure to do from the international investment community.

## Macroeconomic Risk

Argentina's economy continued to recover in 2006, posting estimated real GDP growth of 8.4%, and by the end of 2006 the GDP in volumes was 39% higher than the lowest level of the 2001-2 crisis. The economic expansion was supported by all the components of domestic demand and a robust expansion of exports. Price controls along with the sterilisation policy pursued by the central bank have maintained the inflation rate at moderate levels (it averaged 9.6% between 2003 and 2006). The real depreciation of the peso has boosted investment, while increasing exchange rate stability has reduced macroeconomic uncertainty. The financial system has been revitalised by the elimination of provincial government-issued quasi-currencies as well as a sequential normalisation of banking activity. Interventions by the Central Bank have kept the exchange rate at competitive levels supporting robust foreign reserve accumulation. The fiscal situation is solid in the short term with constant increases of revenues. Moreover, a favourable external situation has boosted the exports.

D&B expects economic growth to continue during the forecast period, albeit at a lower rate more consistent with the long-term growth trend of the economy. During 2007, private consumption and investment will expand at high rates, while external conditions will remain favourable; however, government spending is expected to increase significantly ahead of the October presidential election. During 2008, D&B believes the positive conditions will continue, although we expect that economic growth will slow markedly. The economic prospects for 2008 are dependent on political developments arising after the October 2007 presidential election.

Despite the general improvement of the economy in recent years, we remain uncertain about the sustainability of the Argentinean recovery over the medium and longer term. A weak business environment and price controls have reduced the attractiveness of Argentina for long-term investments. As a consequence of the lack of investment in strategic sectors, we cannot rule out future supply bottlenecks in sectors such as energy. The government's anti-inflationary policy has been successful so far, but there is a high probability that the current policies will become less effective in the medium term. Moreover, the combination of (albeit historically relatively moderate) inflation with a tight labour market may start to harm external competitiveness by creating conditions for even higher inflation in the future.

## **External Economic Risk**

In 2006, strong global demand for Argentina's agricultural products and a recovery in manufactured goods exports supported robust current external receipts reducing external sector risks. The current account registered an estimated surplus of 3.7% of GDP, while the financial and capital account posted a 1.7% deficit (due mainly to the voluntary repayment of liabilities owed to the IMF). During 2006, foreign currency reserves climbed to USD32.0bn, although foreign investment fell, with estimated net inflows reaching about USD2.5bn. Although strong intervention by the central bank in the foreign currency market has kept the nominal exchange rate stable, this strategy represents an inflationary risk factor.

Over the two-year forecast period, external conditions will remain favourable, although less beneficial than during 2006. The overall balance of payments will remain in surplus in both years and the central bank will continue with its policy of international reserve accumulation. Despite this optimistic outlook for the forecast period, D&B remains concerned about external vulnerabilities into the medium-to-long term. Robust export earnings have mainly been the result of favourable external conditions and do not necessarily represent increased competitiveness or a diversification towards more value-added products. Export taxes and price controls implemented by the government during the 2001-02 crisis have been sustained and represent a serious disincentive to greater investments in export-oriented sectors. Combined with other discouragements to investment such as high inflation and contractual and regulatory risks, it remains uncertain whether the dynamism of the external sector can be sustained if global growth moderates. Finally, we expect the real exchange rate to continue to appreciate over the short to medium term, which will begin to hurt some tradable sectors.

## **Commercial Risk**

The commercial risk environment has improved substantially since 2003. Payments performance by Argentinean firms has recovered to almost pre-crisis levels, initiation of commercial litigation have decreased, and the rate of non-honoured cheques has fallen to adequate levels. Underlying the improvement in the commercial environment has been strong economic growth, robust FX liquidity and an appreciation in the real exchange rate, which reduces the cost of servicing foreign liabilities.

We expect these positive factors to continue supporting payments over the short term, although a sharper-than-expected slowdown in real GDP growth could undermine this outlook. Over 2007 and 2008, the largest risks facing the commercial environment will emanate from the regulatory sphere (increasing controls over the business activities) and still fragile banking sector. Moreover, importance of lobby groups to shape government policies signal the tendency towards the lack of consensus in the decision-making process; more recently, the fact that the Supreme Court upheld the legality of the so-called 'peso-ification' of 2002 signals the low cost of both unilaterally breaking contracts and disregarding property rights.

# Political Risk

**Key Point:** The political environment is dominated by the October 2007 presidential election. President Nestor Kirchner (or his wife, Cristina Fernandez) is expected to win the election. The policy agenda is likely to continue as in recent years, with strong concentration of power in the presidency and the use of unorthodox market solutions together with a heavy state presence in the economy.

## Recent Developments

Argentina has a long tradition of political volatility and severe difficulty in consolidating a republican institutional framework. For many decades the political system was characterised by a persistent alternation between military and civilian governments and a partially-free electoral game from which the Peronist Party (PJ) was frequently excluded. Democracy returned to the country in 1983 after the collapse of the military Junta. President Raul Alfonsin from the Union Civica Radical (UCR) defeated the PJ for the first time in open elections. After years of violent dictatorship the new democratic cycle opened with strong optimism. However, within a few years Argentinean society discovered that the path was more complicated than previously imagined.

Alfonsin's political capital evaporated as the economy underperformed, culminating in bouts of hyperinflation, while his weak punishment for the Junta's human right abuses disappointed much of society; consequently, Alfonsin renounced the presidency in 1989. With the election of President Carlos Menem, the PJ regained power for the first time since 1974. The fragile macroeconomic situation allowed Menem to start a radical economic change characterised by external openness, a privatisation programme and financial liberalisation

Menem's political style seriously undermined the already weak checks-and-balances system and reinforced the tendency to centralise power in the presidency. Non-accountable discretionary use of resources for partisan purposes, high levels of clientelism, the intensive use of decrees, and the use of corruption as a political tool became part of what has been called 'low-intensity' democracy of Argentina. With record unemployment rates, high social discontent and generalised distrust of voters in politicians, Menem concluded his second term in 1999 helping de la Rúa from the opposition UCR to come to power. The precariousness of Argentina's political institutions again became apparent when de la Rúa resigned in December 2001 amid an economic crisis, widespread social protests and political violence. Over a period of ten days, three new leaders came and went, unable to win sufficient political support to form a government.

### *After the 2001 collapse*

In early 2002, amid the most severe economic crisis of the Argentinean history and most important legitimacy crisis of the political class, Eduardo Duhalde was appointed president as a result of a congressional agreement between the PJ and the UCR. Duhalde, a PJ leader from the powerful Province of Buenos Aires and critic of Menem, led a low-key caretaker government with the goal of suppressing the political chaos until a fresh government could be elected and the economy could begin to recover after the abandonment of the Convertibility plan (see **The Convertibility Plan**).

Unpopular measures taken by Duhalde to guarantee a transition to a new economic plan, undermined his popular approval levels. After an outbreak of political violence

in August 2002, Duhalde was forced to bring the presidential election forward to April 2003. As a consequence of political fragmentation, the election was contested by two members of Argentina's most popular political party, the PJ: Menem (from the more conservative faction of the party) and the governor of Santa Cruz province, Nestor Kirchner (Duhalde's candidate and a representative of the nationalist/leftist faction of the PJ). Although Menem won the first round, his low popularity among the electorate forced him to withdraw his candidature for the second round and Kirchner was automatically designated Argentina's new president.

Table 1

**Result of April 2003 Presidential Election<sup>1</sup>**

<i>Candidate</i>	<i>% of vote</i>
Carlos Menem (Peronist Party, conservative)	24.5
Nestor Kirchner (Peronist Party, nationalist/progressive) <sup>1</sup>	22.2
Ricardo Lopez Murphy (RECREAR, conservative)	16.4
Adolfo Rodríguez Saa (Popular Movement, nationalist)	14.1
Elisa Carrio (Alternative for a Republic of Equals, progressive)	14.1
Others	8.8

Note: <sup>1</sup>Kirchner was elected president when Menem withdrew his candidature before the scheduled second round.

Source: <http://www.mininterior.gov.ar>

Kirchner assumed office in May 2003 facing a very challenging situation. On the economic front unemployment was high, more than half the population was living in poverty, the agreement with the IMF was expiring and his previous rhetoric against international banks, the IMF and the companies involved in the 1990s privatisation process frightened conservative business and political circles. On the political front, Kirchner, with little electoral support, was seen as a mere continuation of Duhalde's term. Kirchner's lack of his own political base required him to seek the support of Duhalde's loyalist legislators in Congress during his initial months in office.

*Kirchner's construction of power*

The improving performance of the economy since early 2003 boosted Kirchner's general popularity. Importantly, Kirchner also benefited from middle class support (which had traditionally been ambivalent about the populist faction of the PJ) due to his early campaigns against policies lacking 'republican' spirit. Kirchner's 'retrospective justice' policy started with the abolition of forgiveness laws (passed during Alfonsín's presidency), while his removal of many of Menem's appointees from the judges of the Supreme Court of Justice boosted his support even among the non-traditional PJ's followers. The negotiation for the government debt reduction also helped to increase his popular support. With high popularity (70% in mid 2005), an affluent fiscal situation, and increasing discretionary use of public resources (due to extraordinary powers obtained from the Congress), Kirchner started the construction of a political wing within the PJ, the Front for Victory (FV), in a move to wrest control away from Duhalde's camp in the October mid-term congressional elections.

To gain the electoral legitimacy that he did lack in the 2003 election, Kirchner announced that the by-election would be a 'plebiscite' on his leadership. Notably, the president's wife, Cristina Fernandez, who (was already an important political figure) ran as the FV candidate against Hilda 'Chiche' Duhalde (Duhalde's wife) for a senatorial seat for Buenos Aires. Fernandez' won the election by 25 percentage points and Kirchner's FV won 50 of the 127 contested seats in the lower chamber and 14 of the 24 seats in the Senate. As is traditional in the Argentinean political system, massive internal post-electoral realignments brought the total number of FV legislators to 108 in the 257-member Chamber of Deputies and 43 in the 72-member Senate. Kirchner has managed to gain support from politicians from other parties as well. Powerful figures from centre-left parties and the UCR have become part of the

Kirchner support base. The UCR was particularly affected by Kirchner's strategy and the party has split into two main factions: the Kirchner-supporting "Radical K", which includes several provincial governors, and the traditional body of the party. By the end of 2005 the opposition to Kirchner had become completely fragmented; it did not have a leader or dominant figure.

Table 2

**Party Standings in Congress, October 2005**

<i>Party</i>	<i>Chamber of Deputies (seats)</i>	<i>Senate (seats)</i>
Front for Victory - Peronist Party	108	43
Radical Civic Union	38	13
Peronismo Federal	25	0
Others	86	16
<b>Total</b>	<b>257</b>	<b>72</b>

Sources: Latin News, <http://www.latinnews.com>

The 'realignment culture' is a consequence of the high degree of discretionary power that the president enjoys under the Argentinean political system, particularly concerning financial resources; it recently favoured Kirchner against Duhalde but pervasive throughout the political system (and is particularly strong in the PJ). In such a context, politicians aim to be close to the likely winner of the next election in order to secure future political favours, regardless of their ideological position. Those figures who are unable to win for any given reason (i.e. the constitutional bar on re-election that constrained Menem's second term) are abandoned by even their most loyal supporters. Kirchner has developed his electoral strategy ahead of the October 2007 election in response to this logic.

## Political Environment

### *Kirchner's strategy*

Although the government has tried to preserve the status quo and maintain political loyalties, the political environment has been dominated by October's election. Even though the constitution allows Kirchner a second term, he has declared that he will not run for a second term in the coming election. In any case, D&B considers that there is a high chance that Kirchner will change his decision and stand for re-election. So far, Kirchner's decision not to run responds to a long-term political strategy given the "realignment culture" of Argentinean politicians.

Kirchner's personal popularity may allow his wife, Fernandez, to win the presidency. If Fernandez is president between 2007 and 2011, Kirchner may maintain power during the next four years and return to the presidency for the 2011-15 term. However, if Kirchner wins a second term in October, the constitutional bar on serving a third consecutive term would lead to the dissipation of his power from the first day of his new mandate. Kirchner knows that in such scenario, even his most loyal politicians will try to find their own way to the 2011 election. Although Fernandez has not announced yet her intentions to run for the presidency, recent polls suggest that she has higher popular support than any opponent. However, since Fernandez would require a second round to gain the presidency, D&B cannot rule out that Kirchner will change his decision and run for re-election.

### *Movements in the opposition*

So far, Kirchner (or his wife) does not face any united opposition that could threaten the government candidate's triumph. Although in late 2006 former Economy Minister Roberto Lavagna announced that he will run for president, he needs to build ties with the fragmented opposition. Lavagna is credited with the rebuilding of the Argentinean economy after the crisis but he left the cabinet in 2005 after disagreeing

with Kirchner's 'shift to the left'. Although Lavagna is an independent, he has already managed to obtain the support of the main faction of the UCR which will give him national presence. To start with the unification of the segmented political system, the UCR president, Gerardo Morales, will try to woo UCR's rebel party members: "Radicals K" and radicals who want the UCR to choose its own candidate.

However, if the opposition wants to force a second round in the election, Lavagna still needs to build closer ties with centre-right presidential candidate Mauricio Macri. So far there have not been any signals of a potential alliance between them. Despite his attempts to create a coalition with several politicians capable of defeating the government, structural features of Argentinean politics have made the task difficult. What is needed is a leader capable of keeping together different political factions to defeat the PJ; however, only Alfonsín in 1983 has proved capable of achieving this goal to date. Moreover, since the collapse of the governing coalition Alianza in 2001, the party system has continued to fragment. Indeed, after the recent Alianza experience, the Argentinean electorate has a clear understanding of the risks associated with electoral coalitions that may not become effective governing coalitions. D&B believes that if Lavagna and Macri oppose each other, the government candidate will win in the first round.

Movements towards the construction of a more pro-business opposition open two main scenarios for the president in the coming months. Kirchner could moderate his policy agenda to gain the support of urban middle-class voters. Some of Kirchner's actions recently support this view: he nominated 'moderate' candidates for the elections in the two most important electoral districts later this year. However, D&B believes that these were probably reactions to particular setbacks (such as the government's failure to reform provincial constitutions) and considers a different strategy more likely. Under this alternative, Kirchner could radicalise (or at least maintain) his economic policies and continue with his political strategy of power accumulation. Barring significant exogenous macroeconomic shocks, it is unlikely that Kirchner will not change his economic or political strategy. D&B expects a triumph from the government in October and that Kirchner or Fernandez will become the next Argentinean president.

### Political System

Argentina is a federal republic with 23 provinces and one federal district, the city of Buenos Aires. Congress consists of two chambers: the Chamber of Deputies which represents the electorate in a proportioned way (although with relatively high minimum quantity of deputies per districts), and the Senate, which represents the provinces (each province has three senators). The former has 257 seats and the latter 72. Half of the seats in the Chamber of Deputies and one-third of those in the Senate are re-elected every two years.

*The Executive:* The office of the president dominates the political system. In 1994 the constitution was reformed to allow a second presidential term. Despite efforts to achieve a wider distribution of political power, the Argentine system still relies heavily on the president. Argentinean fiscal federalism is characterized by imbalance between resources and spending at the different levels of government: the national government undertakes a large portion of total spending and a small fraction of taxation. The federal tax sharing mechanism allows for discretionary behaviour generating recurrent political tensions between provinces and the national executive.

*The Legislature:* The Congress is responsible for drafting and passing laws, auditing the national civil service and appointing an ombudsman to defend human rights. A bill must be passed by both congressional houses and then approved by the executive before enactment; committees are then responsible for drawing up the details of new laws, which follow the same procedure. Constitutional amendments must be drawn up by a constituent assembly and approved by two-thirds of Congress.

*Judiciary:* The federal court system is headed by the Supreme Court of Justice, consisting of nine judges appointed by the president with the approval of the Senate. The president also appoints judges for the lower federal courts (from a list drawn up by the Council of Magistracy) with Senate approval. At the local level, each province has its own judicial system with a Supreme Court and several minor chambers. Although the constitution establishes the framework for an independent judiciary, in practice the system is weak compared with the other two branches of government and is highly influenced by political power.

### *Policy Agenda*

D&B expects that the government agenda during the forecast period will emphasise policy continuity. We do not expect significant progress on institutional reform (i.e. improvements in the accountability of the politicians, increasing the separation of powers, etc) or political reform, beyond changes to the deputies' elections. Macroeconomic policy will continue to be characterised by the government's attempts to control inflation in the economy, the central bank's active intervention to both keep a competitive exchange rate and accumulating international reserves, and the lack of any agreement with international organisations such as the IMF that may lead to some loss of economic sovereignty. Kirchner is unlikely to reopen negotiations over the government debt default. Concerning international policy, we expect Kirchner to deepen his ties with most radical presidents in the region.

Ahead of the October 2007 election we expect several changes in senior positions in the government as long as they decide to run for different posts, although they will not produce changes in policy orientation. In the political sphere we expect Kirchner to continue with its policy of 'retrospective justice'. More importantly, we expect that the discretionary use of public resources and clientelistic methods will also increase. D&B considers that one of the main risks of the coming election is that the government may deepen its populist policies to differentiate its candidate from the opposition. Finally, to secure victory, the government may minimise cuts in the energy power (due to lack of investment in the sector since the end of the 'Convertibility Plan') and avoid increases in prices (especially in public utilities). D&B expects that both goals will be achieved with non-friendly market strategies.

## **Socio-Political Risk**

### *Internal Stability*

With the return of democracy, Argentina eradicated the political violence that took place particularly during the 1970s. However, bouts of economic crisis have triggered violent streets protests and occasional cases of looting (i.e. 1989 and 2001). The raising unemployment during the 1990s led to the creation of well-organised groups of unemployed people (*piqueteros*) with a great capacity for protests and mobilisation. By threatening to use violence, these groups bring usual activities in cities to a standstill as a way of lobbying the government for social funding. Recent opinion polls show an increasing rejection of the *piqueteros* protests and methodologies. Kirchner has managed to get agreements with some groups of *piqueteros* (including by appointing some of their leaders to key government posts) but failed to reduce the animosity of others. Bearing in mind the high political cost of repression, Kirchner has avoided repressing these social protests. That decision has resulted in the use of the street as chaotic forums holding any kind of protests.

Recently the boundaries of Kirchner's 'retrospective justice' have expanded and important politicians (including former president and third wife of Peron, Isabel Martinez, and Alfonsin) have been investigated by the judiciary over their role during the repression years or during the transition to democracy. Kirchner's policy had generated some opposition and unfortunately the political consensus has slightly deteriorated. Several kidnapping cases presumably related with trials of alleged

repressors during the military regime have caused concern in recent months. In January 2007 a PJ union faction publicly warned against the launch of investigations into Peron's alleged complicity with the repressive paramilitary organisation "Triple A" during the 70s.

### *Interest Groups*

*Business Groups:* Strong lobby from the Union Industrial Argentina (UIA) shaped the economic policy during the 2001-02 crisis. The chairman of the UIA was then appointed in the National Cabinet during Duhalde's presidency and lobbied to devalue the peso.

*Armed Forces:* Democracy has taken root in Argentina and the military is under civilian command, with the president as commander-in-chief. Defence expenditure has been consistently reduced. Kirchner has followed a policy to bring to justice offenders from the 'dirty war' by passing important legislation; the public reputation of military personnel linked with the 'dirty war' is very low.

*Agricultural Producers:* Persistent government interference in the sector, including export bans and restrictions on beef, wheat, corn and milk products, rising export duties and price controls, provoked farmers to go on strike twice during 2006. Despite the strikes no agreement was reached, and leaders of farming associations have threatened further longer strikes in 2007.

### *Labour Relations*

Unionisation remains widespread and those doing business with the country should be aware of the risks inherent in Argentina's active union movement. There is a high degree of union militancy and most important unions are linked to the PJ. Union links with sections of the PJ have created a powerful lobby group in government against labour market deregulation, and, in turn, popular opposition to the legislative agendas of non-PJ governments. Unions are hierarchical, with few levels of external and internal accountability; in general union's leaders are not selected according to transparent or democratic process. The strength of the unions is based in both the high financial resources that they manage and their potential use of violence. Although Menem managed to gain independence from the unions during his presidency, in recent years, labour groups have recovered a substantial role becoming again a political player with informal veto power. Hugo Moyano, leader of the CGT (Confederacion General del Trabajo) is one of the closest political allies of Kirchner. Recently, Moyano managed to obtain from the government relevant changes in the pension system and the start of a new round table for salary increases between unions and companies without any pre-established ceiling.

## **External Political Risk**

### *Relations with the Southern Cone*

Argentina has no immediate external risks. With the return of democracy in the region, Argentina has forged close relations with its neighbours. The most important agreement is Mercosur, which links the economies of Argentina, Brazil, Paraguay, Uruguay and Venezuela; Chile, Bolivia and Peru are associate members. Mercosur is not solely a customs union, but also serves as a forum for political, economic and social issues. Kirchner has moved closer to Brazil as a way of both re-establishing Argentina's significance in the international arena and reinforcing the voice of the region internationally. Mercosur's members have tried to co-ordinate policies in different issues such as energy, debt management, and global trade policies. With the entry of Venezuela to the Mercosur in 2005, the political voice of the region has significantly increased although its unity was somewhat damaged.

Relations among Mercosur's members can sometimes be problematic. Argentina occasionally pressures Brazil to accept protectionist measures, and Uruguay and Paraguay often feel their trade interests are subordinated to those of the larger members. The recent escalation of tensions between Argentina and Uruguay over the ongoing construction of two pulp processing mills on a river that forms a common border between the two countries have substantially affected relations between the two countries. Although D&B does not consider this conflict to pose any risk, it shows the difficulties associated with closer integration in the region.

#### *Relations with the US*

During the 1990s, Argentina enjoyed excellent bilateral relations with the US. However, the 2001 financial crisis damaged the US' credibility within the country, with many Argentines holding the IMF and Washington responsible for the economic collapse. Kirchner's arrival to power implied a relative deterioration of relations given his nationalist-leftist rhetoric and Argentina's rapprochement with Cuba and Venezuela. However, recently Argentina has pursued some US interests, particularly in the war against terrorism.

Over the two-year forecast period, we do not rule out a further deterioration in Argentina-US bilateral relations. Although Kirchner's unorthodox policy approach and tough stance against the IMF and international investors is widely popular among Argentines, it frustrates relations with Washington. Kirchner's uncompromising line on debt-restructuring negotiations during 2004-05 (which aggravated Wall Street) and Argentina's closeness with Cuba and Venezuela remain two sensitive issues for Washington.

#### **Political Risk Outlook**

Political instability in Argentina has been reduced under President Nestor Kirchner's leadership. Since coming to office in 2003, he has overseen the recovery of the Argentinean economy and successful conclusion of the sovereign's debt exchange in 2005. Overall he has proven a capable leader and has restored presidential authority. His political leadership has strengthened with his party's victory on the October 2005 congressional election, his high levels of popularity, his discretionary management of financial resources and the co-opting of political leaders from different parties.

The October 2007 presidential election dominates the political environment. Although he is yet to announce his candidacy, Kirchner (or his wife, Cristina Fernandez) is expected to win the election due to the lack of a united opposition to the government. The attempts of the opposition to build a more pro-business coalition ahead of the October election may create incentives to radicalise (or at least maintain) Kirchner's unorthodox economic policies and continue with his political strategy of power accumulation.

D&B expects the policy agenda of the government during the two-year forecast period to remain characterised by strong interventionism in the economy. We do not expect that needed political and institutional reforms will be implemented over the outlook period. Macroeconomic policy will continue to be characterised by the government's attempts to control inflation in the economy, the central bank's active intervention to both keep a competitive exchange rate and accumulating international reserves, and the lack of any agreement with international organisations such the IMF that may lead to some loss of economic sovereignty. Kirchner is unlikely to reopen negotiations over the government debt default, despite pressure to do from the international investment community.

# Macroeconomic Risk

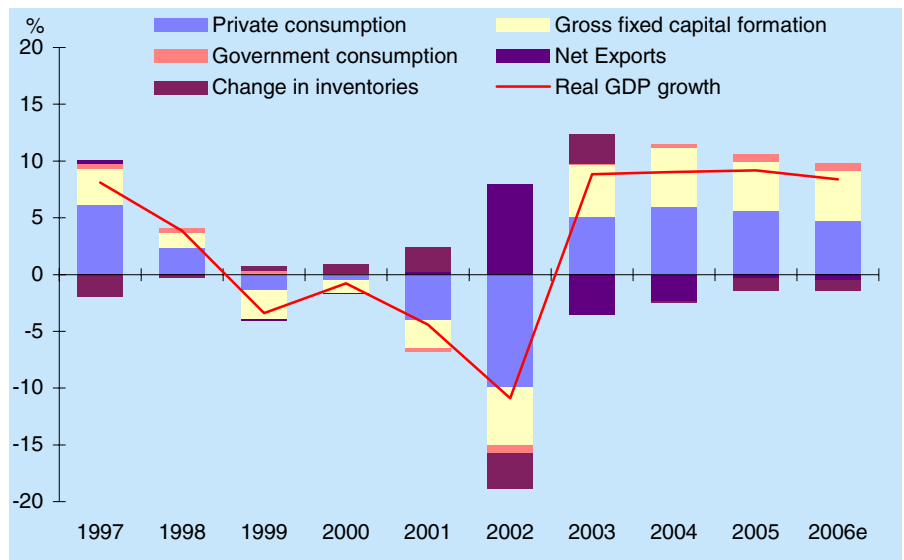
**Key Point:** In 2006, real GDP growth remained strong, helping to consolidate the economic recovery that began in 2003. While we expect growth to remain moderately strong over the forecast period, vulnerabilities related to the 2001-02 crisis and the consequences of current economic policies could negatively affect long-term economic growth.

## Short-Term Economic Performance

After the initial repercussions of the abandonment of the exchange rate peg against the US dollar in 2002 (see **Convertibility Plan**), which led to a real GDP contraction of 10.9%, the economy started a strong recovery in 2003; this trend continued in 2006. Unorthodox price-control policies have kept the inflation rate at moderate levels. The real depreciation of the peso has boosted investment in the tradable sector. The financial system has been revitalised by the elimination of provincial government-issued quasi-currencies as well as a sequential normalisation of banking activity; increasing exchange rate stability reduced macroeconomic uncertainty. Interventions by the Central Bank have kept the exchange rate at competitive levels supporting considerable foreign reserves accumulation. Freed up government resources as consequence of the debt default has been re-injected in the economy adding to domestic demand. In addition, a favourable external situation has boosted exports. As a consequence, the GDP measured in volume in 2006 was 39% higher than in 2002, at the peak of the crisis.

Chart 1

### Yearly GDP Growth Contribution by Demand



Sources: National Institute of Statistics and Census, <http://www.indec.mecon.ar>; D&B

Radical changes in the relative price of the economy have boosted domestic activity and increased employment-GDP elasticity. Since early 2005, level of industrial production has shown historical records, and by end 2006 the production figure was around 79% higher than the lowest recorded during the crisis. More important, the high sensitivity of employment to economic expansion resulted in the creation of more than 3.2m of new jobs between 2001 and 2006. The unemployment rate dropped also significantly, reducing poverty levels and improving the distribution of income.

The expansion since 2003 was driven mainly by private consumption, which averaged 8.6% of growth and contributed 5.4 percentage points (pp) to overall GDP growth per year on average. Investment has also played a role in the expansion. Gross capital formation as a percentage of GDP has increased by 4.5pp on average for 2003-06, in relation to the 1995-02 period and peaked in 2006 at 23.8%. Since the end of 2003 net capital formation has been positive, that is that the stock of capital is increasing, thereby helping to reduce the risk of inflationary pressures as the economy grows further.

### Components of Growth

Table 3

#### Contributions of Growth

	2004	2005	2006e
<i>Real growth rate (%):</i>			
Private consumption	9.5	8.9	7.8
Gross fixed capital formation	34.4	22.7	20.5
Government consumption	2.7	6.1	5.5
Exports	8.1	13.5	5.4
Imports	40.1	20.1	14.8
<b>Real GDP</b>	<b>9.0</b>	<b>9.2</b>	<b>8.4</b>
<i>Share of GDP (%):</i>			
Private consumption	62.8	61.3	58.9
Gross fixed capital formation	19.2	21.5	23.8
Government consumption	11.1	11.9	12.5
Change in inventories	-0.4	-0.6	-0.4
Net exports	7.3	5.9	5.2
<i>Contribution to real GDP growth (percentage point):</i>			
Private consumption	6.0	5.6	4.8
Gross fixed capital formation	5.2	4.3	4.4
Government consumption	0.3	0.7	0.7
Change in inventories	-0.1	-1.1	-0.9
Net exports	-2.3	-0.4	-0.5

Sources: National Institute of Statistics and Census, <http://www.indec.mecon.ar>; D&B

D&B expects the economy to continue to expand during 2007, although at a lower rate than observed in recent years. D&B expects the economy to start its slow convergence to its long-term growth rate of 3.0-5.0%. However, the likelihood of a strong expansion of government spending at national, provincial and municipal levels (both in consumption goods and in investment) ahead of the presidential election in October 2007 is high. This fiscal stimulus would help to boost private consumption and investment and therefore overall economic growth. Moreover, D&B believes that the external conditions will remain favourable during 2007. As a consequence of the combination of these factors, D&B believes that the economy will expand by 7.4% during 2007. During 2008, D&B believes the positive conditions will continue, although we expect economic growth to slow somewhat to 4.7%. However, economic prospects for 2008 are partly contingent on political developments arising after the October 2007 presidential election.

Going forward, despite the general improvement of the economy in recent years, D&B is concerned by several factors. The weak businesses environment and price controls have reduced the attractiveness of Argentina for long-term investments. As a consequence of the lack of investment in strategic sectors, we cannot rule out future supply bottlenecks in sectors such as energy. Although the anti-inflationary policy has been successful so far, there are high probabilities that the current policies will lose efficiency in the medium term. Moreover, the combination of inflation with a tight labour market may start to harm external competitiveness.

### Convertibility Plan

The Convertibility Plan (CP) and structural reform program adopted in 1991 allowed Argentina to grow strongly during the first half of the 1990s, after the economic stagnation of the 1980s, the so-called “lost decade”. The CP, a monetary scheme which pegged the domestic currency to the US dollar and linked the money supply to the surplus in the external sector, worked as an anchor to reduce the high and volatile level of inflation. At the same time, structural reforms (general privatisation plan, liberalisation of financial, goods and services markets, and trade openness) were undertaken to increase the productivity of the economy.

Although the CP successfully reined in inflation, important changes in relative prices of the economy, due to inertial inflation, generated a clear bias against productive investment. Indeed, the conjunction of both the structural reforms and the low level of the exchange rate boosted the investment in financial assets, non-tradable sectors investment, and consumption. Higher inflation in Argentina than in the US during the 1990s and fiscal imbalances produced a strong dependency for external capital. Both the private and public sectors spent above their sustainable levels using foreign capital as a source of liquidity.

Although risks associated with external imbalances were neutralised during periods of international financial stability characterised by capital inflows to emerging markets, changes in the direction of capital flows due to external shocks posted serious risks for the economy. The Argentinean economy weathered the 1995 Tequila crisis (prompting important financial reforms); the effects of which, owing to US government intervention, were limited among the emerging markets and did not trigger successive balance of payments crises. Effectively lacking an independent monetary policy and with little scope for fiscal intervention given the government’s imbalances, policy choices were limited to reduce the dependency on external capital inflows and therefore the negative effects associated with a sudden reversal of them. However, attempts to reduce fiscal imbalances, to increase the productivity of the tradable sector, and reduce exchange rate risk through a partial “dollarisation” of the economy were not sufficiently successful.

#### *The end of Convertibility*

A combination of negative external factors triggered the end of the CP. The Brazilian currency devaluation in 1999 together with the appreciation of the US dollar, and cyclical low export prices undermined the macroeconomic performance. By the end of 1999 Argentina started to suffer serious pressure on the balance of payments although international assistance helped to delay the CP’s end. The political fragility of the ruling government (Alianza) and global uncertainty in the aftermath of the terrorist attack of 11 September 2001 further worsened the situation. In December 2001, after 14 consecutive quarters of recession, without IMF support and external financial markets virtually closed to Argentina, expectations over the devaluation of the peso were globally widespread.

In a final attempt to save the CP and the bank sector, which suffered a massive reduction of deposits, the government froze and confiscated the deposits of the public. Popular violence, lack of domestic political support and the indifference of IMF forced the government to resign triggering the most important political crisis in recent Argentinean history (see **Recent Developments**). After the abandonment of the CP on 3 January 2002, macroeconomic uncertainty prevailed, the financial system collapsed, many contractual economic obligations were broken, the exchange rate oscillated abruptly and inflation rocketed; concurrently almost 13 quasi-currencies issued by provincial governments were circulating, creating an anarchical monetary environment.

### *Private Consumption*

After a huge contraction that peaked in 2002 (22.3%), household consumption recovered robustly since 2003 with an average growth rate of 8.6% between 2003 and 2006. Structural changes in combination with favourable macroeconomic conditions help to explain the momentum of private consumption during recent years. The consolidation of a new economic model after the collapse of the Convertibility Plan significantly reduced economic uncertainty, allowing households to make purchasing decisions on a longer time framework. The sequential normalisation of the financial sector, particularly the removal of restrictions on access to bank accounts, contributed also to the consolidation of the private consumption recovery.

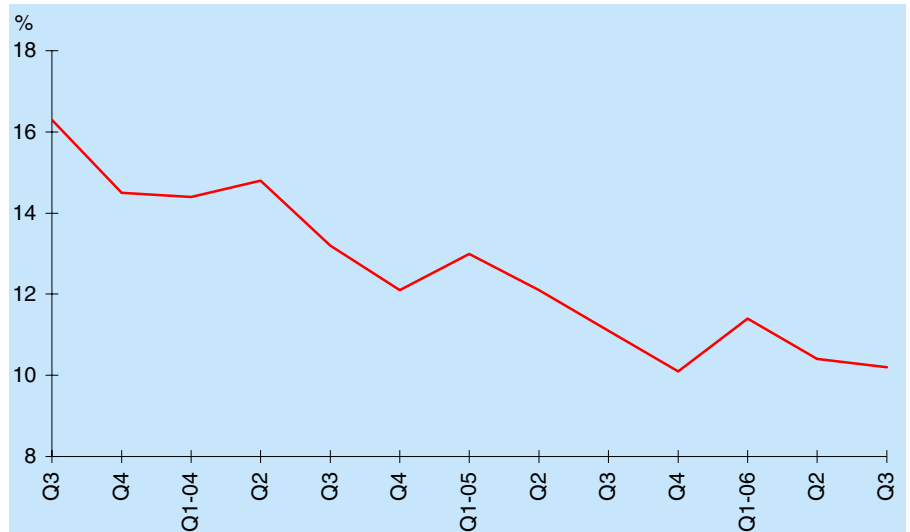
Moreover, the new way in which the economy operates improved substantially labour remuneration: wages as a proportion of GDP increased by 4pp between 2002 and 2005. With the economic expansion driven by labour-intensive activities since 2002, employment increased (more than 1.1m jobs were created between Q2 2002 and Q2 2006 in the private sector), income distribution improved (measured by both the Gini coefficient and the gap between highest and lowest salaries) and real wages rose (on average by 6.5% since end 2002) boosting consumption expenditure growth. Although conditions in the formal labour market have improved in recent years, the situation in the informal labour market clearly has deteriorated.

Over 2007 and 2008, we expect household consumption to continue to be one of the main drivers of the economic expansion. We expect continued economic expansion to support job creation and wage growth over the coming two years (see **Unemployment**). However, private consumption may suffer substantially if inflation accelerates (see **Monetary Environment**). Higher increases in prices may harm not only the real salary of households but also affect consumption through some indirect mechanisms. First, with higher-than-expected inflation, households may try to increase their position in assets (i.e. foreign currency) other than consumption goods. Second, inflation tends to deteriorate the income distribution which may affect negatively consumption. Finally, high inflation worsens public sector income (due to lags between the act that originates the tax and the effective collection) and presumably the developments of public employment.

### *Unemployment*

Unemployment has been persistently high, remaining in double digits since May 1994 as a result of economic liberalisation but the figures rose to historical levels during the crisis (reaching 21.5% in May 2002). The economic upturn since 2003 has helped to reduce unemployment constantly: the jobless rate stood at 10.2% in Q3 2006, its lowest level since the crisis (with the exception of the Q4 2005). This downward trend has been helped in particular by the fact that many of the sectors leading the recovery (such as construction, industry and manufacturing) are labour intensive. Sub-employment has performed in a similar way: after peaking in 2002, the current level (11.1% in Q3 2006) is one of the lowest since the recession started in 1998. We expect that the unemployment rate will continue to fall (although a lower rate than during recent years) as moderately strong economic growth is sustained over the two-year forecast period. Indeed, we expect the unemployment rate to fall to single-digits during the forecast period.

Chart 2  
Unemployment



Source: National Institute of Statistics and Census, <http://www.indec.mecon.ar>

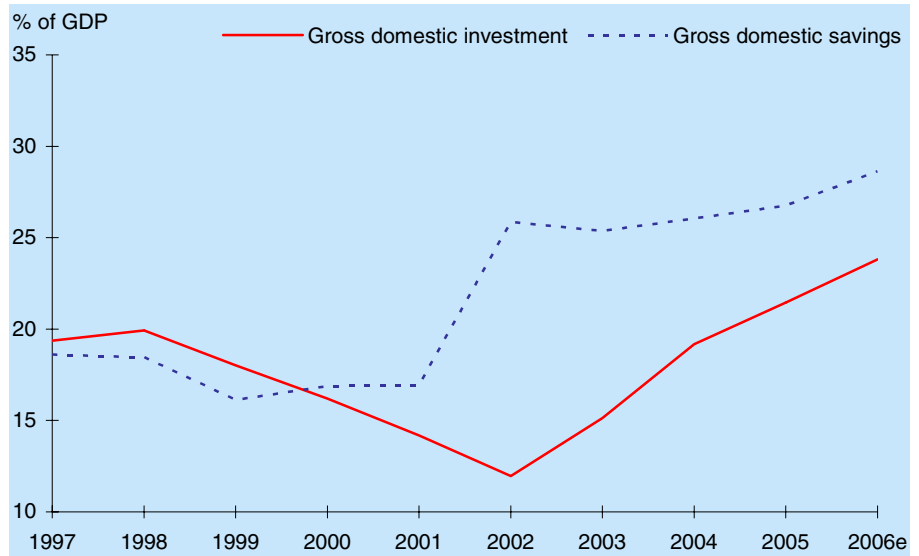
### Gross Fixed Capital Formation

The increasing uncertainty of the macroeconomic performance at the onset of recession in 1999 saw a marked fall in the level of investment which had increased substantially during the 1990s. Indeed, in the period between 1998 and 2002 gross fixed capital formation contracted markedly, falling by 56% in real terms, and investment as percentage of GDP reached its lowest level in years (11.0%). The restructuring of the economy following the end of the CP helped to boost investment which increased by an average 28.9% between 2003 and 2006. During the forecast period, we expect gross fixed capital formation to continue with its expansion, although at a slower rate than during previous years.

Despite strong investment growth in recent years, the recovery has been asymmetric with several sectors still in need of increased investment, including textiles, confectionary goods, oil and gas refining, metal fabrication and chemicals and metals production. Perhaps more important for capacity utilisation are investment constraints on key public utilities. This mainly reflects the fact that providers were forced to convert US dollar liabilities into peso-denominated debt (on detrimental terms) and have endured price controls, which were implemented during the crisis, but have been sustained to the present. Combined, these have not only resulted in damaged government credibility, but also incurred heavy financial losses for these firms and low investment rates in these sectors. The electric generation sector has been particularly affected: energy production has failed to meet the levels demanded by the economic expansion, resulting in frequent power cuts. Shortages of diesel in October 2006 at the start of the planting season of soybeans occurred. Frequent changes in fiscal policies affecting the agricultural sector have increased uncertainty and therefore the prospect of medium-term investment. As a consequence of this, farm sector went to in strike in December 2006.

The ability of existing economic infrastructure to meet increasing demand and the potential negative effect on prices stability has been one of the most important concerns of the government in recent years. Given the weak institutional framework and the low reputation of the Argentinean government as a consequence of the management of the departure from the dollar peg in combination with price controls the business environment has been affected negatively and long-term investment levels reduced. Unfortunately, the reaction of the government over bottlenecks has been the application of unorthodox measures (among others, fees payable by exporters) forcing the companies to ensure adequate supplies to domestic markets.

Chart 3  
Savings and Investment



Sources: National Institute of Statistics and Census, <http://www.indec.gov.ar>; D&B

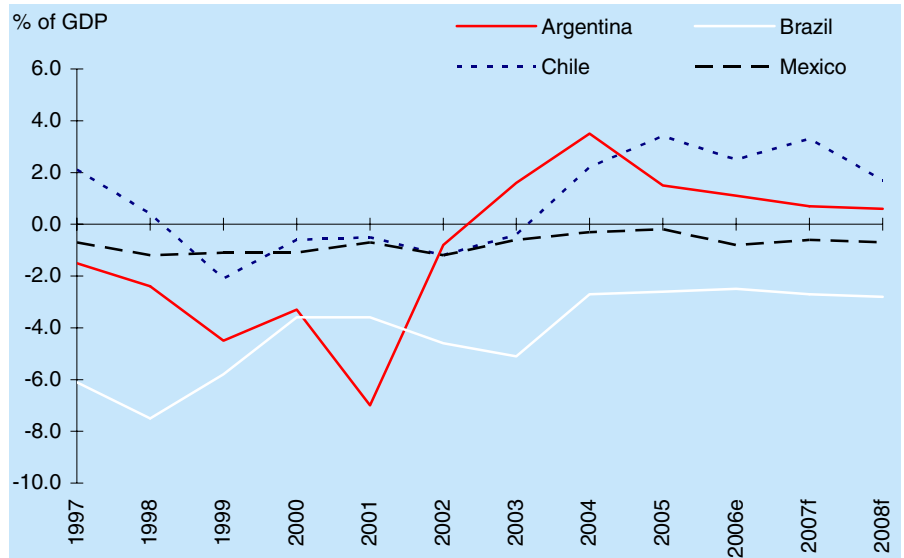
According to government's data the stock of capital in the economy grew by around 3.0% since 2001 and the current industry capacity utilisation is around 70% allowing the economy to meet the increasing demand. However, D&B believes that the Argentinean economy faces risks of bottlenecks due to relatively low levels of investment in recent years. Due to the proximity of the presidential election, we do not expect significant changes in the government's strategy yet. We consider that during the forecast period the problem of lack of investment in crucial sectors will resurface with more intensity with higher risks of inflationary pressures.

### *Government Consumption*

Since the economic recovery began in 2003, government consumption has accounted for around 12% of GDP annually, down from around 14% in the years leading up to the crisis. Since the recovery of 2003, the government has kept primary fiscal surpluses helped by increasing collection of taxes. Growth of tax revenues averaged 27% in the period 2003-06 and increased by 21.7% in 2006. As a consequence, the government primary surplus averaged 3.3% of GDP in the period 2003-06 with 3.6% in 2006. However, despite the positive macroeconomic conditions, government spending has also increased in recent years (21% on average between 2003 and 2006). Moreover, the presidential election of October 2007 will bring a big increase in government spending. However, the fiscal situation in the short term looks solid and we expect the government to continue with the previous levels of primary surpluses as percentage of GDP during the forecast period. Expected strong economic growth, and still solid exports will contribute to the government revenues.

Recent surpluses have given Argentina some room of manoeuvre in the case of worsening of the economic situation. However, we consider that the government still has several problems to overcome. From a short-term perspective, we believe that Argentina faces three main sources of risks. First, the presence of unorthodox economic policies to control inflation is leading to increasing government sectoral transfers and subsidies that over time could result in increased budget pressures. Second, the distortion in relative prices as consequences of some prices controls and sector-specific taxes may affect negatively prospects of future tax collection harming economic activity. Finally, government revenues are extremely dependent on export taxes, creating an extra vulnerability as adverse situation in the external front appear.

Chart 4  
**Government Balance<sup>1</sup>**



Note: <sup>1</sup>Figures for Brazil and Chile are for central government, figures for Argentina are for Non-financial public sector and figures for Mexico are for public sector.

Sources: Commission for Latin America and the Caribbean, <http://www.eclac.cl>; D&B

In a medium-to-long term horizon, Argentina also needs some reforms. First, Argentina still faces relatively high government debt ratios that in function of the economic growth of future years may become a risk. In this sense, Argentina needs to rebuild its reputation in the international markets. Although the government's bond exchange was successful, marred sovereign credibility and concerns over the policy direction could hamper government efforts to raise sufficient funds or be granted favourable lending conditions in debt markets over the short to medium term. This would constitute a particular vulnerability given undercapitalisation in the domestic financial sector and reliance on foreign financing. Second, Argentina has shown a particular inflexibility to make structural fiscal adjustment in order to reduce government spending, even during the upturn of the economic cycle. In this regard, fiscal behaviour is particularly linked to the electoral cycle. Finally, high discretionary power of the national executive in the use of financial resources and lack of clear rules for the sharing of financial resources between the national executive and the provincial government may create tensions and conflicts as the fiscal situation deteriorates.

### Government Debt Swap

More than three years after the announcement of the default on its debt, Argentina finally concluded its debt exchange in 2005, which has helped to reduce the burden of public sector external liabilities on bonds generally held by foreigners from USD115.8bn at the end of 2004 to USD63.9bn by September 2005. On 14 January 2005, the government launched its debt exchange. By the closing date of 25 February, 76.2% of creditors had accepted the offer of USD0.32 payment for each USD1.0 of debt on USD82bn in principal claims. Including outstanding principal and interest arrears of around USD26bn, the deal represented a reduction of 75% in net present value terms. Although this acceptance rate was viewed as a success for the government, many creditors accepted the deal begrudgingly and litigation by some 25% of bond holders who did not accept the offer delayed the final exchange of new paper until June. Crucially, the Argentine Congress passed a resolution, which explicitly bars the executive from reopening the debt exchange for creditors who did not accept the offer.

The reluctance of the government to reach a deal with these non-participating bond holders will continue to dampen sovereign credibility over the short term to medium term. That said, following the conclusion of the debt exchange the spread on the country’s benchmark bonds over JP Morgan’s Emerging Market Bond Index (a proxy for risk) fell from 6,505 basis points (bp) in May 2005 to 464bp in June and by end 2006 was at 217bp. In addition, in early 2007, Moody’s upgraded Argentina to a B3 positive from B3 stable.

Table 4  
**Government’s new debt issue<sup>1</sup>**

	2005	2006e	2007e
Nominal value	2986	5365	500
Average Life (years)	5.0	4.4	6.6
Yield (%)	8.4	8.2	7.7
Spread over US Treasuries	419.0	342.0	287.0

Note:<sup>1</sup>The data for 2007 just include the month of January

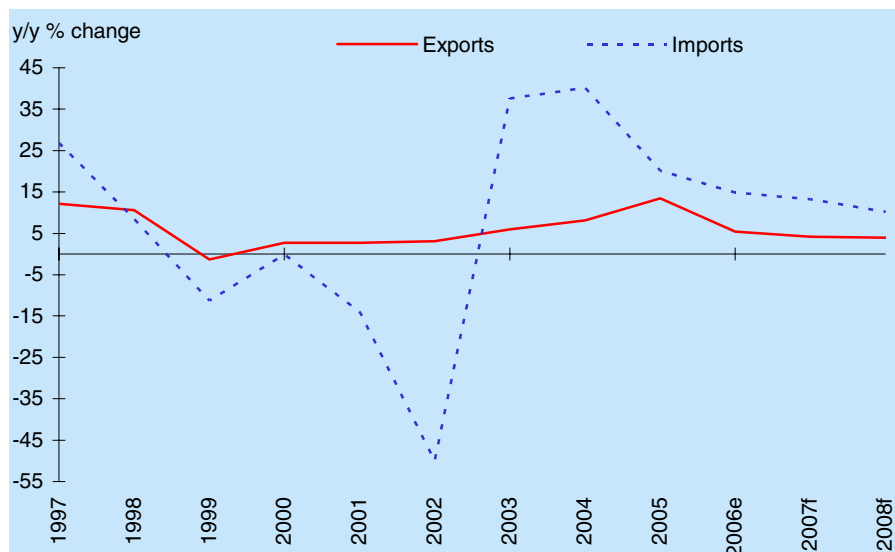
Sources: Ministry of Economy, <http://www.mecon.gov.ar>; D&B

The improvement has allowed the country to slowly return to international capital markets; in particular, the Venezuelan government has become an increasingly important creditor. By the end of June 2006 the ratio of government debt to GDP was around 62% with 46.6% of the debt denominated in pesos with an average maturity of 13 years.

*Net Exports*

Since 2002, the external sector gained crucial significance for the Argentine economy. The devaluation caused net exports to contribute a robust 8.0pp to real GDP growth during that year as export levels increased by 3.1% and imports contracted by 50.1%. After the return to economic growth and the achievement of exchange rate stability the following year, import levels recovered strongly, while exports grew at a much slower rate. Net exports reduced overall growth by 3.5pp in 2003. Recently, growth of both the imports and exports has decelerated in real terms although net exports have reduced GDP growth.

Chart 5  
**Import and Export Growth**



Sources: National Institute of Statistics and Census, <http://www.indec.gov.ar>; D&B

While the level of import growth has been determined by the revival of internal demand and particularly by the needs for capital goods after years of low investment, export growth has been driven by the favourable exchange rate and positive global

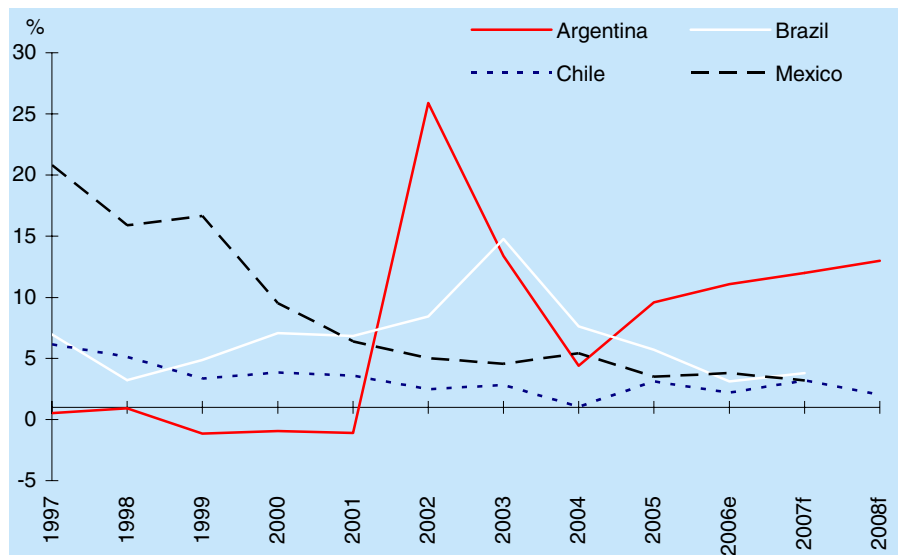
conditions. Looking forward net exports are expected to make slightly lower deductions from aggregate growth during the forecast period. Less favourable external conditions in combination with an appreciating real exchange trend will harm the outlook of exports. Moreover, export growth will depend also on the level of investments in tradable sectors. Indeed, investment will be needed to boost export competitiveness once favourable conditions begin to dissipate. The removal of export taxes and clear rules for investors in particular sectors would also be beneficial in encouraging growth dynamism.

### Monetary Environment

Although changes in the exchange rate system brought new challenges for policy-makers, Argentinean monetary authorities have managed to achieve their targets successfully. Despite expectations to the contrary (based on its recent hyperinflationary experiences), Argentina managed to devalue its currency under a framework of contained inflation. While in 2002 the domestic currency depreciated by 80%, consumer price inflation stood at 25.9% and since the end of the Convertibility Plan, the effective real exchange rate increased by 132%. The relatively low pass-through (both in terms of previous Argentinean experiences and in international terms) responded to several factors: a particularly high level of openness of the economy, a steadily increase in the capital stock (driven by strong investment) and heterodox policies of price control and taxes on exports.

Chart 6

#### Annual Average Inflation



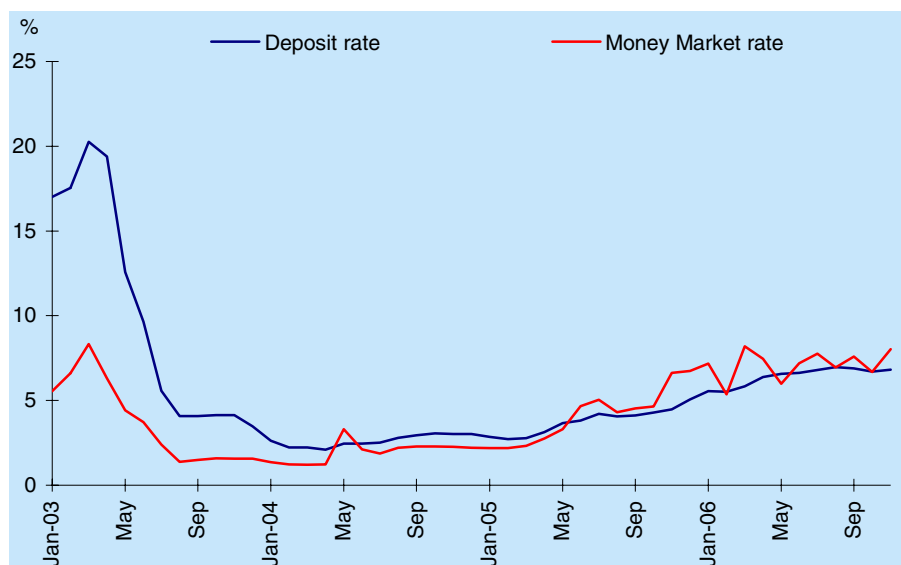
Source: International Monetary Fund, *International Financial Statistics*; D&B

More important, the monetary policy of Argentina has been efficient to keep the inflation under control. Indeed, the monetary policy of the Argentinean Central Bank (BCRA) is perfectly consistent with the government goals and its macroeconomic strategy. The BCRA has a monetary base growth target policy, which aims to create a transparent, predictable and stable monetary policy. The BCRA's main goal is to achieve a convergence of the M2 growth rate to the GDP expansion, reducing the level of money in the economy as a percentage of GDP. Although in end 2005 the BCRA has slightly modified its objective in order to target M2 growth, rather than the monetary base (in response to the increasing expansion of credit to the private sector that had expanded the level of broader monetary aggregates) the essence of the goal remained unchanged. Each year the BCRA pre-commits via the establishment of M2 growth target, although with some degree of flexibility since the target has relatively wide bands. The target for 2006 was achieved (the M2 grew by 18.9% compared with a target band of 11.7-21.2%); the BCRA has reached its target for 14 consecutive quarters.

The BCRA also pursues a policy of accumulation of international reserves to secure some degree of freedom in both economic policy-making and in case of a potential reversal of international flows. However, in reality the intervention policy in the foreign market is used by the BCRA as an industrial policy, to keep a competitive exchange rate level. In the absence of the BCRA's intervention, the frequent surpluses in the current account would put upward pressure on the exchange rate with the US dollar, appreciating the nominal exchange rate and harming Argentinean international competitiveness. Therefore, international reserves have increased in recent years and even the early repayment to the IMF in 2006 did not affect the momentum of reserves growth. By the end of 2006, the BCRA's international reserves totalled USD32bn, up from USD28bn at the end of 2005 and USD20bn in 2004 (see **Exchange Rate Risk**)

The BCRA has used different instruments to sterilise the monetary issuance associated to their foreign currency purchases (reserve accumulation). During 2006 the BCRA managed to contract by ARS27bn the monetary supply through by bank repayments of discount loans issued during the 2001 and 2002 crisis (around ARS6.6bn), and by changes in the reserve requirements (ARS4.4bn). However the most important instrument used has been the issue of BCRA's bills and notes (called LEBAC and NOBAC, respectively). The public sector has acted as major source of monetary contraction, by purchasing a good portion of the BCRA's notes. The constant use of BCRA's bills and notes to sterilise has led to an increase in the interest rate paid by the monetary authority: from 3.7% at December 2005, it reached 7.9% by the end of January 2007.

Chart 7  
**Interest Rates**



Source: International Monetary Fund, *International Financial Statistics*

The combination of price controls and the sterilisation of the excess of liquidity has allowed Argentina to keep inflation at relatively low levels. The inflation in 2006 (measured by the end year figure) was 9.8%, slightly below the target of the government (10%) and in line with the BCRA goals and below the previous year's figure of 12.3%. Moreover, the relatively stable monetary environment and the consolidation of the banking sector after the crisis (reflected in the strong reduction in the interest rate between 2003 and 2004) has helped the recovery of financial intermediation activity of banks. Private credit has grown by around 40% year on year during 2006 with even higher rates for loans for small- and medium-sized companies. Although timid, the mortgage market has increased expanding the average terms of the contracts.

We expect the inflation rate to increase moderately in the forecast period; we foresee the annual average inflation at 12.0% in 2007 and 13.0% in 2008. However, we consider that in the medium term, unorthodox policies to control inflation are not going to be sufficient and the government needs to secure a stable and high level of investment, especially in strategic sectors such as energy supply. Although the current monetary scenario looks stable, D&B identifies some risks that may alter significantly the monetary environment and therefore the inflation rate. It is likely that BCRA will find it more difficult in the coming years to continue with its sterilisation policy in the way that it was done so far. The main reason for that is that one of the instruments that has been used for this purpose (discount loans issued during the 2001 and 2002 crisis) will no longer be available soon given that only two banks continue to hold this kind of loan. Moreover, the increasing interest rate that the BCRA has paid to allocate its notes and bills will increase the interest rate of the economy. This would affect private loans with recessive effects; this would be inconsistent with government goals ahead of the presidential election.

We expect that during the forecast period the current account surplus will decrease from previous years (and therefore the need to sterilise the extra liquidity) (see **Current Account**); However we believe that the BCRA will face increasing costs to continue with its policy of sterilisation. We expect a low nominal depreciation of the peso given that domestic inflation will result in an appreciation of the peso in real terms. In the medium term, we also foresee other risks. Widespread concerns on the ability of the BCRA to maintain its sterilisation policy may trigger an opposite situation: the lack of confidence on the BCRA's strategy to reduce inflation may create incentives for the public to consider the USD as reserve of value forcing the traditional spiral of rising prices and falling exchange rates.

### Short-Term Economic Outlook

Argentina's economy continued to recover in 2006, posting estimated real GDP growth of 8.4%, and by the end of 2006 the GDP in volumes was 39% higher than the lowest level of the 2001-2 crisis. Underpinning the economic expansion were all the components of the domestic demand and a robust expansion of exports.

Table 5

#### Short-Term Economic Forecasts

<b>Forecast</b>	<b>2007f</b>	<b>2008f</b>
<i>Real growth rate (%):</i>		
Private consumption	6.4	4.5
Gross fixed capital formation	12.0	8.0
Government consumption	6.0	4.0
Exports	4.2	4.0
Imports	13.2	10.2
<b>Real GDP</b>	<b>7.4</b>	<b>4.7</b>
<i>Contribution to real GDP growth (percentage point):</i>		
Private consumption	3.8	2.7
Gross fixed capital formation	2.9	2.0
Government consumption	0.7	0.5
Change in inventories	0.4	-0.4
Net exports	-0.3	0.0
Annual inflation (%)	12.0	13.0
Interest rate (deposit, domestic currency, %)	7.0	8.0

Source: D&B

Price controls in combination with the sterilisation policy pursued by the BCRA have kept the inflation rate at relatively moderate levels. The real depreciation of the peso since the end of the US dollar peg has boosted investment (especially in the tradable sector). Increasing exchange rate stability reduced the macroeconomic uncertainty. The financial system has been revitalised by the elimination of provincial government-issued quasi-currencies as well as a sequential normalisation of banking activity. Interventions of the Central Bank have kept the exchange rate at competitive levels accumulating foreign reserves considerably. Freed up government resources, as a consequence of the debt default, have been re-injected in the economy adding to domestic demand. Fiscal situation is solid in the short term with constant increases of revenues. Moreover, a favourable external situation has boosted the exports. Since early 2005 levels of industrial production have reached record highs, and by end 2006 its value was around 79% higher than the lowest recorded during the crisis. The high sensitivity of employment to economic expansion resulted in the creation of more than 3.2m new jobs between 2001 and 2006 and the unemployment rate dropped also significantly, reducing the poverty levels and improving the distribution of income.

D&B expects the economy to continue to expand during the forecast period, although at a lower rate more consistent with the long-term growth of the economy. During 2007, private consumption and investment will continue to expand at high rates, government spending is expected to increase significantly ahead of the presidential election in October and the external conditions will be favourable. During 2008, D&B believes the positive conditions will continue, although we expect a clear deceleration of economic growth. However, economic prospects for 2008 are contingent on political developments arising after the October 2007 presidential election.

Despite the general improvement of the economy in recent years, D&B is concerned about medium-and-long-term stability. A weak business environment and price controls have reduced the attractiveness of Argentina for long-term investments. As a consequence of the lack of investment in strategic sectors we cannot rule out future supply bottlenecks in sectors as energy. Although the anti-inflationary policy has been successfully so far, it is likely that BCRA will find it more difficult in the coming years to continue with its sterilisation policy in the way that it was done so far. Moreover, the combination of inflation with a tight labour market may start to harm external competitiveness.

## **Long-Term Economic Potential**

### **Population**

Argentina's population stood at 39.2m in 2005. Approximately 89.3% of the population live in urban areas, with 10.7% in rural areas; the most populous provinces are Buenos Aires (13.8m); Cordoba (3.1m); Santa Fe (3.0m); and the city of Buenos Aires (2.8m). Average annual population growth slowed to 1.0% in 1991-2001, from 1.5% during the 1980s. The UN forecasts that population's growth will slow to 0.7% between 2020 and 2025 and to 0.4% between 2045 and 2050. Slower population growth will initially bring about a reduction in the dependency ratio. This will reduce the burden on scarce resources (housing, education and healthcare) and ease pension pressures. However, a rise in the eligible workforce will also increase pressure for accelerated job creation. As such, more needs to be done to reduce structural unemployment and improve the quality of the labour market. From 2035 the number of people aged over 64 is expected to rise, pushing up the dependency ratio (to a forecast 0.60 by 2050). Therefore, the initial fall in the dependency ratio should be exploited to push through structural reform aimed at reducing the eventual burden of an ageing population.

## Technological Progress

*Productivity:* Deregulation, privatisation and the opening up of the economy during the 1990s have helped to modernise the productive base and promote efficiency gains, particularly in the agricultural and extractive industry sectors. Productivity gains have also been made in other tradable goods sectors as they have become more exposed to international competition. This was particularly important given the increase in the price of non-tradable services, which were not subject to greater competitive pressures.

*Privatisation:* Divestiture has promoted organisational change and managerial efficiency. Improved access to cheaper and more technologically advanced imported capital goods during the 1990s has modernised the capital stock. More capital intensive production methods and competitive goods markets will see productivity gains passed on to consumers in the longer term. Although the economic recession meant that companies focused more on recovering lost ground rather than passing on the benefits of their investments, this situation should improve going forward.

*Quality of Human Capital:* The quality of human capital is high, reflecting the country's relatively advanced level of economic development. The UN *Human Development Index* places Argentina in the 'high human development' category. A well-developed healthcare system (with good primary care provision and 70% of the population covered by private insurance), rising incomes and an improved diet have extended life expectancy 75.7 years, close to developed country norms.

Education spending is a major government priority. Primary school coverage is almost universal and almost two-thirds of children go to secondary school (the literacy rate is 97.1%). However, large disparities persist in the distribution of education across different income groups and geographical regions, education standards are questionable and the drop out rate is high, leaving Argentina without a good base of science graduates. In addition, anecdotal evidence suggests that Argentina suffers from a 'brain drain', with highly skilled professionals migrating to companies and academic centres in the US and Western Europe.

## Investment

The contribution of investment to long-term economic growth generally depends on three factors: the availability of funds; the propensity of the private sector and the government to invest; and the profitability of investment. The more stable economic environment in the 1990s encouraged Argentines to take a longer-term view of consumption and savings decisions, and a relatively strong banking sector gave people the confidence to deposit cash savings over the medium to long term. However, this attitude has been severely eroded by the four-year recession and the collapse of the financial system in late 2001, which negatively affected the macroeconomic climate and damaged people's confidence in the system and reforms implemented during the 1990s.

Domestic savings are estimated to be 28.6% of GDP in 2006, which was sufficient to meet current investment levels for the year. We believe this is a transitory factor supported by the recent spurt of strong growth since 2002, which has helped to boost savings levels. Over the medium to long term, investment needs will continue to be high, which will necessitate borrowing from abroad, although this may be difficult given the sovereign's marred creditworthiness and the general weakening in the investment climate. This explains President Nestor Kirchner's interest in an export-led strategy that provides resources to increase investment and reduce foreign borrowing.

**Long-Term Economic Outlook**

D&B believes that Argentina's potential annual average real GDP growth rate over the next ten years will be around 3.0-5.0%. Despite the positive short-term outlook, the depth of the 2001-02 crisis, and the persistence of economic weaknesses engendered as a result cast uncertainty over the country's medium- to longer-term outlook. The 2001 debt default undermined investors' confidence; its prolonged nature and the reluctance of the authorities to seek a friendly rescheduling had made access to credit more difficult. The institutional realm also suffered from the crisis, and a long list of reforms is still on the agenda.

However, Argentina will benefit from favourable demographic trends, a relatively highly educated population and a potentially large increase in productivity and competitiveness created by the realignment of the currency to reflect Argentina's macroeconomic fundamentals. Reliance on external saving should remain low, partly due to minor overall government borrowing and positive trade account results, allowing a more efficient use of domestic sources of capital. Negatively, we expect protectionist sentiment, which has been on the rise since the crisis in 2001, to stall trade integration into the medium term.

# External Economic Risk

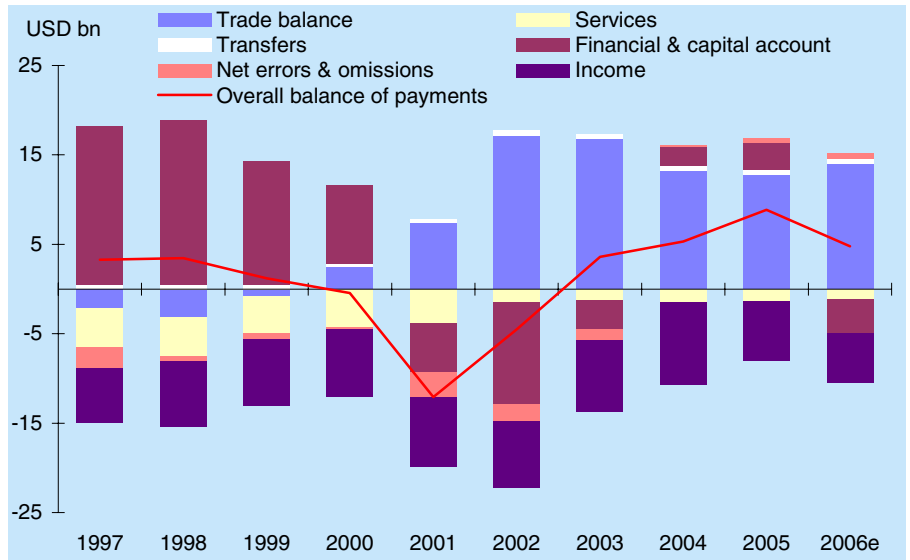
**Key Point:** Favourable external conditions in combination with a policy of international reserve accumulation have been key factors in Argentina's recovery. In 2007 and 2008, favourable external conditions will continue supporting current external receipts. However a real exchange rate appreciation may harm the competitiveness of the economy.

## Balance of Payments Performance

After a period of sustained inflows of capital during 1991-1999, external adverse conditions resulted in large balance of payments crisis in 2001. The devaluation of the peso in early 2002 and the implementation of temporary capital controls, together with an improvement in the external environment, helped to produce a sizable trade surplus that pushed the current account into surplus and supported the balance of payments in 2003. Between 2003 and 2006, Argentina's healthy balance of payments performance was sustained by favourable terms of trade, strong demand from main trading partners, a high exchange rate, the return of FDI and a reduction in private sector capital outflows.

Chart 8

### Balance of Payments



Sources: National Institute of Statistics, <http://www.indec.mecon.ar>; D&B

The Government's conclusion of its debt restructuring in June 2005 has closed one important issue affecting sovereign credibility. Although the Argentinean proposal was more consistent with its own needs than those of bondholders and international organisations (especially the IMF), Argentina has started to rebuild its debtor reputation. Given the favourable macroeconomic context, the government has no need to systematically raise funds in the international capital markets and therefore is still not clear the risk that investors considers Argentina represents (see **Government Debt Swap**).

However, despite this considerable achievement and the recovery in Argentina's external position, several vulnerabilities remain. In particular, the country's large trade surpluses (and by extension, the balance of payments recovery) in recent years owe partly to favourable external conditions and do not necessarily represent an improvement in export competitiveness. Indeed, supply-side constraints remain in some important export sectors, there are upward pressure on the real rate due to the

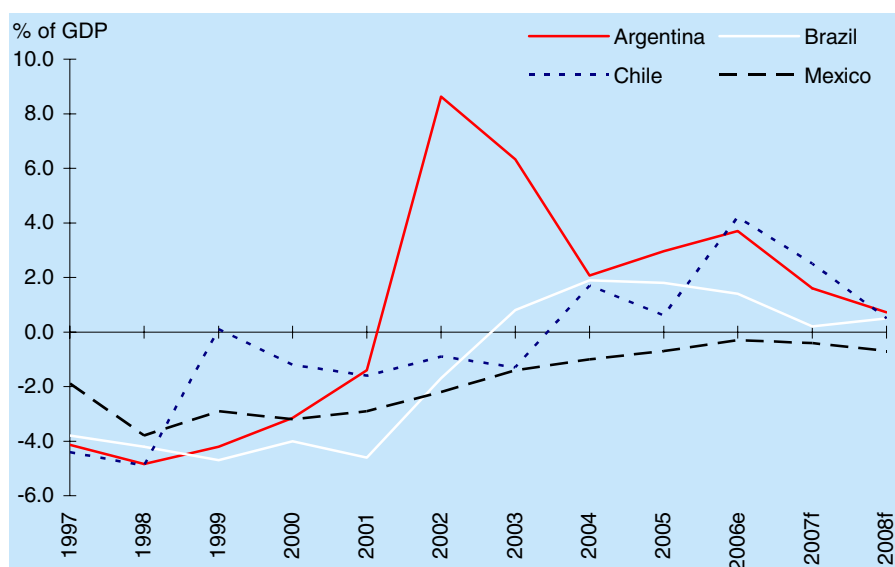
high inflation (which could threaten competitiveness) and the government continues to pursue prohibitive export taxes on select goods (mostly agricultural and food goods) and short-term capital control policies (see **Investment Environment**).

## Current Account

In 2002, Argentina's current account moved from a persistent deficit (averaging 2.6% of GDP during 1991-2001) into a large surplus (8.6%) due to the economic contraction and peso devaluation. Subdued internal demand brought on by the recession combined with the peso devaluation led to a reduction in the level of foreign purchases. Conversely, Argentine exports became more competitive abroad. As a result, the trade account surplus more than doubled to USD17.2bn in 2002; these same factors also caused the service account deficit almost to halve to USD1.5bn over the same period. However, the strong rebound in economic activity during the 2003-06 period revived brisk import growth, causing the surplus on the trade account to narrow to USD14bn in 2006. Over these years, demand for foreign services did not recover at the same pace and the service deficit remained below historic levels at just USD1.2bn in 2006.

Outflows on the income account increased in 2002 from the preceding year (up USD24m to USD7.5bn), reflecting greater profit and dividend remittances from foreign companies operating in Argentina. During the ensuing recovery, this trend continued, causing the income deficit to reach a peak of USD9.2bn in 2004, although it has decelerated in the past two years totalling USD5.5bn in 2006. Following the economic crisis, current transfers increased from an average of USD450m in the five years before the 2001 crisis to USD560m in the five years thereafter.

Chart 9  
**Current Account Balance**



Sources: Economic Commission for Latin America and the Caribbean; D&B

Over 2007 and 2008, we expect the current account surplus to narrow in response to sustained import demand and moderating (albeit still relatively strong) external demand for Argentine goods. We forecast current account surpluses of 1.6% and 0.7% of GDP respectively.

## Export Profile

After the devaluation of the peso, the exports-to-GDP ratio grew significantly from 10% in the pre-crisis years to around 25% afterwards. As such, the export sector has been a key driver of the economic recovery. The healthy performance has primarily

benefited from the upturn in international trade, higher commodity prices (particularly for grains), large investments into the agricultural sector during the 1990s and the competitiveness of the exchange rate. Total export earnings climbed from USD25bn in 2002 to USD46.5bn in 2006. Positively, the healthy performance of agricultural earnings was sustained throughout this period. Although industrial manufactures were initially poor performers (due to underinvestment and supply constraints), robust investment growth since 2003 has subsequently supported greater export levels. Over 2007 and 2008, we expect Argentina's export earnings to grow on the back of strong external demand (particularly from Asia), albeit at a slower rate than in 2006 due to supply constraints and slightly moderating demand.

Table 6

**Principal Exports**

Exports	2005		2006	
	USD (m)	%	USD (m)	%
Manufactures of agricultural origin	13,138	32.6	15,251	32.7
Manufactures of industrial origin	11,984	29.7	14,801	31.8
Primary products	8,098	20.1	8,953	19.2
Fuels	7,132	17.7	7,564	16.2
<b>Total</b>	<b>40,352</b>	<b>100.0</b>	<b>46,569</b>	<b>100.0</b>

Source: National Institute of Statistics and Census, <http://www.indec.gov.ar>

However, D&B considers several short- and medium-term vulnerabilities as potential risks. First, Argentina is very reliant on agricultural exports leaving the country vulnerable to sharp downturns in external demand or unfavourable weather patterns. Second, the combination of the increasing inflation and rigidity in the nominal exchange rate (brought on by continued intervention by the central bank, see **Monetary Environment**) may lead to an appreciation of the real exchange rate, thereby reducing market competitiveness in tradable sectors. Finally government's anti-inflationary policies (specially designed to reduce food and energy inflation as well as to support the federal budget) could deter investment needed to sustain volume output in important export industries in the medium term.

Table 7

**Exports by Destination<sup>1</sup>**

Exports	2005		2006	
	USD (m)	%	USD (m)	%
Mercosur	7,706	19.1	9,907	21.3
EU	6,847	17.0	8,172	17.5
NAFTA	6,032	14.9	6,026	12.9
Chile	4,500	11.2	4,390	9.4
China	3,336	8.3	3,676	7.9
Rest of ALADI	2,215	5.5	2,844	6.1
ASEAN	1,615	4.0	1,711	3.7
Middle East	1,113	2.8	1,086	2.3
<b>TOTAL</b>	<b>40,350</b>	<b>100.0</b>	<b>46,568</b>	<b>100.0</b>

Note: <sup>1</sup>Rest of ALADI includes: Bolivia, Colombia, Cuba, Ecuador, Peru and Venezuela  
Source: National Institute of Statistics and Census, <http://www.indec.gov.ar>

In terms of exports by destination, Argentina exports to a broad range of countries. Mercosur countries (see **Trade Environment**) comprise the largest export market, taking some 21.3% of total exports in 2006. The EU is Argentina's next largest export market, taking 17.5% of exports, while North American Free-Trade Agreement countries (Canada, Mexico and the US) are the third largest with 12.9% during 2006. The Asian market is also an important source of earnings (particularly for exporters of soybeans).

### Import Profile

After dramatic falls in both 2001 and 2002 (reflecting stagnant consumer demand), imports started to recover, reaching USD13.6bn in 2003. In 2004, this trend strengthened, with imports growing to USD22.4bn. By the end of 2006, the recovery had reached all the main import sectors, including capital (USD8.4bn), intermediate (USD10.4bn) and consumption goods (USD3.9bn). The recovery in the ability of firms to import needed capital and intermediate inputs for the domestic production process has been a primary factor in the recovery Argentine industry.

Table 8

#### Principal Imports

Imports	2005		2006	
	USD (m)	%	USD (m)	%
Intermediate goods	10,377	36.2	11,920	34.9
Capital goods	7,011	24.4	8,484	24.8
Parts of capital goods	4,859	16.9	5,900	17.3
Consumption goods	3,162	11.0	3,970	11.6
Vehicles	1,603	5.6	2,038	6.0
Fuels	1,545	5.4	1,729	5.1
<b>Total</b>	<b>28,689</b>	<b>100.0</b>	<b>34,159</b>	<b>100.0</b>

Source: National Institute of Statistics and Census, <http://www.indec.gov.ar>

Argentina's structural demand for capital and intermediate goods suggests that import spending will continue to grow over the medium term as the economic activity grows. Going forward, we expect Argentina's structural weakness as a net importer of capital goods to continue over the medium to longer term. Although this will bolster productive capacity, it also undermines the development of a domestic capital goods industry, increasing Argentina's reliance on expensive imports of machinery and technology from abroad.

Argentina's Mercosur partners are the main providers of imports, particularly Brazil, which supplies almost the entire share for the bloc. Combined, the Mercosur countries supply 37.1% of Argentina's foreign purchases. While this renewed dynamism in trade with neighbouring countries will underpin recent political co-operation among Mercosur members, it makes Argentina highly dependent on Brazil's imports. If Argentina wants to increase its exports and expand its share in other markets (including China, Southeast Asia and the Middle East) it will need to diversify its purchases to forge new business alliances. So far, this strategy has been particularly difficult to be followed.

Table 9

#### Imports by Source<sup>1</sup>

Imports	2005		2006	
	USD (m)	%	USD (m)	%
Mercosur	11,020	38.4	12,686	37.1
EU	4,833	16.8	5,813	17.0
NAFTA	5,000	17.4	5,597	16.4
China	2,271	7.9	3,153	9.2
ASEAN	807	2.8	1,052	3.1
Japan	789	2.8	933	2.7
Chile	549	1.9	599	1.8
Rest of ALADI	462	1.6	529	1.5
<b>Total</b>	<b>28,689</b>	<b>100.0</b>	<b>34,159</b>	<b>100.0</b>

Source: National Institute of Statistics and Census, <http://www.indec.gov.ar>

## Financial and Capital Account

After a decade of consistent surpluses, the 2001-02 crisis severely reduced the inflow of capital resources to Argentina. In 2001, the financial and capital account registered its first deficit of USD15.1bn. The deficit pulled the overall balance of payments into arrears, severely reducing international foreign exchange reserves and resources available for debt repayment. Political and economic events in 2002 worsened the situation. Although currency devaluation strengthened the current account balance following the crisis, the financial and capital account has recovered much more slowly. The account remained in deficit until 2004 when it registered a USD1.9bn surplus thanks to the normalisation of the financial system, the easing of capital controls and the positive performance of the overall economy.

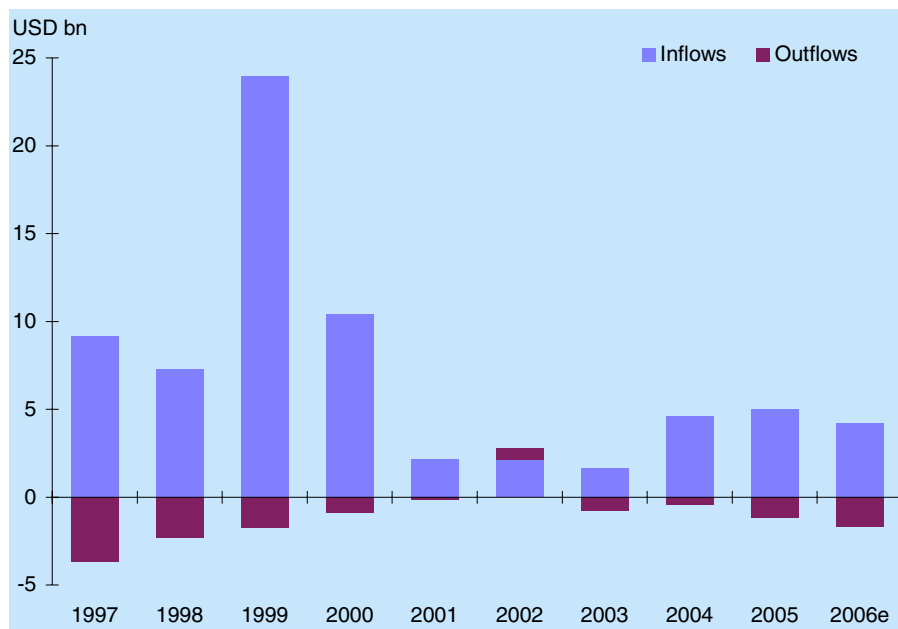
In 2005, the financial and capital account continued to recover, posting a USD2.6bn surplus. This partly reflects the clearance of amortisation arrears from the government's defaulted bonds following debt restructuring in June 2005, but also Argentine capital repatriation and greater investment opportunities given the climate of stronger economic growth. Although during 2006 the macroeconomic situation has improved, the financial and capital account posted a deficit of USD3.7bn due to government's decision of repay to the IMF around USD9.9bn. Continued real GDP growth and robust confidence in the economy will be crucial factors in sustaining the financial and capital account recovery, the importance of which will become more pertinent as the surplus on the current account gradually recedes over the short to medium term.

### *Foreign Direct Investment Flows*

The privatisation of large enterprises ended in 1999-2000 following a spurt in the mid- to late 1990s. Combined with the reduction in the number of divestitures, the prolonged economic recession leading up to the collapse of 2001-02 discouraged new investment. Indeed, some of the main target sectors for foreign investment, such as banking and utilities, have suffered disproportionately over the last few years, mainly as a result of the peso devaluation and the imposition of price controls.

Chart 10

### Foreign Direct Investment Flows



Sources: Institute of Statistics and Census, <http://www.indec.gov.ar>; D&B

Nevertheless, at the moment, there has been no generalised pull out of multinational companies operating in Argentina (other than some particular cases, such as the Canadian Scotiabank and the French Credite Agricole banks). Indeed, the devaluation of the peso has created new opportunities in export sectors, natural resources processing sectors (such as mining, steel and aluminium) and tourism.

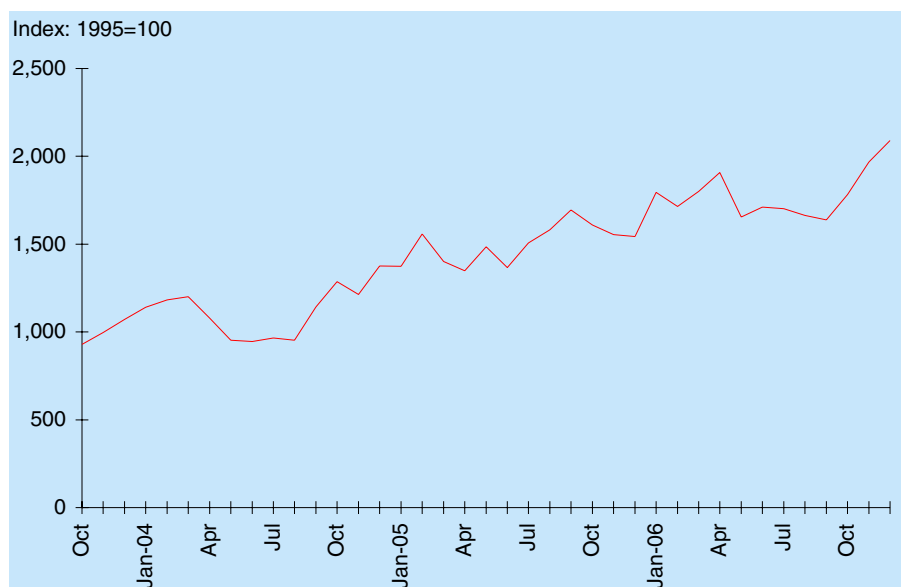
However, estimated net inflows of FDI fell during 2006 reaching USD4.2bn down from USD5.2bn in 2005 (the highest level since 1999). Going forward, D&B believes that the business environment must improve substantially to sustain with the attraction of foreign capital.

### Equities

Portfolio investment suffered during the economic crisis as investor confidence plummeted. Between end 2001, when the worst of the political crisis occurred (see **Recent Developments**) and devaluation of the peso became inevitable, and May 2002 when industrial activity started to recover, the leading Merval index fell by 40%. Nevertheless, the index began a general recovery thereafter, which has been sustained to the present. In December 2006, the index climbed to over 2,000 points for the first time since the crisis, up almost ten times (932%) from the lowest level in November 2001.

Chart 11

### Stock Market Performance, Merval Index



Source: Buenos Aires Stock Exchange, <http://www.bolsar.com>

In response to the relatively positive economic forecasts for 2007 and 2008 for Argentina and the region, we expect Argentinean equities to remain an attractive option for investors. However, equity markets remain vulnerable to shocks such as political crises, exchange rate volatility or energy shortages (the index fell by nearly 25% over a three-month period in March 2004 due to concerns over a regional energy crisis). Investor sentiment towards the country will also be salient for foreign traders in the equities market: especially when considering uncertainty over macroeconomic policy (see **Short-Term Economic Performance**).

### Debt

During the 1990s, Argentina was an active member of the international debt market. Funds were used to finance a large public deficit and the overvalued exchange rate. However, the prolonged recession and the banking run in 2001 that led to a financial and capital account crisis, ultimately led to a series of debt defaults, not only in the

corporate sector, but also on government debt. The economic recovery that began in 2003 and the conclusion of the government's debt exchange in June 2005 have supported a return to international capital markets for some Argentine entities. However, creditworthiness for many firms remains damaged and borrowing from abroad remains difficult for many businesses.

### Bank Lending

Argentina's international bank debt has contracted consistently since 2000, falling from a high of USD69.7bn to just USD16.4bn in June 2006. The 2001-02 crisis made local and international banks unwilling to finance the government and other debtors following the default on all debt repayments and the devaluation of the peso. Despite the brighter economic performance since 2003, Argentina's international bank borrowing continued to fall.

In the corporate sector, short-term creditworthiness is benefiting from the recent surge in economic growth, but concerns over the outlook further a field (particularly as regards policy direction and capacity constraints) cloud many firms' longer-term creditability. That said, creditworthiness also depends on the entity's industry. For example, many firms in the export sector (particularly commodities exporters) have benefited from healthy profit margins and external solvency, while some firms in the utilities sector remain saddled with arrears. Over the forecast period, we do not expect this situation to change significantly.

Table 10

#### Maturity and Sectoral Distribution of Bank Lending to Argentina

USDm	Sep-05	Dec-05	Mar-06	Jun-06
<i>Maturities:</i>				
Up to & including one year	6,676	7,095	8,008	8,170
Over one year & up to two years	1,307	959	1,037	734
Over two years	5,535	5,681	5,403	5,209
Unallocated	1,805	1,686	2,067	2,598
<b>Total</b>	<b>15,323</b>	<b>15,421</b>	<b>16,515</b>	<b>16,711</b>
<i>Sectors:</i>				
Banks	1,713	1,942	2,029	2,090
Public sector	3,499	3,299	3,919	4,489
Non-bank private sector	10,069	10,076	10,517	10,079
Unallocated	42	104	50	53
<b>Total</b>	<b>15,323</b>	<b>15,421</b>	<b>16,515</b>	<b>16,711</b>

Source: Bank for International Settlements, *International Banking and Financial Market Developments*

### Foreign Exchange Reserves

Foreign currency reserve levels were closely monitored during the Convertibility Plan as they were needed to back the domestic monetary base and Argentina accumulated up to USD34.6bn by 1998. However, the deposit run in 2001 and the subsequent devaluation and debt default precipitated a huge depletion of reserves. The rush culminated in the introduction of capital controls to halt the outflow of currency. By the end of 2002, international reserves equalled USD10.5bn, their lowest level in years.

Under the new monetary framework, one of the main goals of the BCRA is to increase the level of international reserves. With the accumulation of reserves, the BCRA reduce the risk associated with a sudden reversal of international capital inflows. Although the BCRA affirms the accumulation of reserves will secure a degree of freedom in the case of any international financial crisis, the increase of reserves is a consequence of the policy of keeping a competitive exchange rate level.

Indeed, in order to avoid peso appreciation due to surpluses in the current account the BCRA buys US dollars in the foreign currency market and then tries to sterilise the extra liquidity of domestic currency (see **Monetary Environment**).

In 2006, robust FX earnings flowing from the export sector and open-market foreign exchange purchases by the central bank enabled international reserves to accumulate to the highest levels since the crisis. Foreign reserves rose by 14.3% from year earlier levels to around USD32bn at the end of 2006. Although the government's decision to prepay all of its outstanding debt to the IMF using foreign reserves saw holdings drops by about USD10bn in January 2006, it had no effect on the accumulation's trend. Over the forecast period we expect reserve accumulation to continue. In addition, we expect the government to continue to sell pesos in exchange for foreign currency in an effort to maintain the nominal exchange rate, which will help to rebuild foreign reserve levels albeit at the expense of creating inflationary pressures.

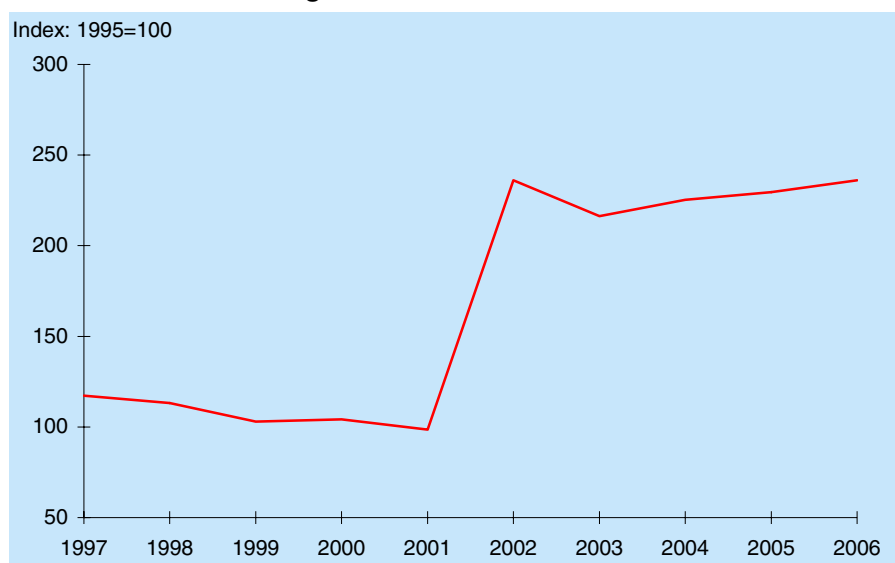
## Exchange Rate Risk

In early 2002 the government abandoned the currency board system that had pegged the peso to the US dollar at parity for 11 years. Although the authorities temporarily introduced a dual exchange rate, it was eventually abandoned and the peso was freely floated. Consequently, the rate plummeted as agents sought to exchange peso holdings for US dollars in a bid to minimise future potential losses. After floating, the peso fell to an all-time low of almost ARS4:USD in April 2002, triggering another period of political crisis.

However, with a more stable macroeconomic framework and given the large trade surplus, the exchange market finally stabilised during in 2002. During the first half of 2003, the peso continued its recovery and strengthened by about 20% against the USD. Since this time only the intervention of the central bank has prevented the peso from continuing to appreciate beyond the ARS2.75-3.0:USD declared target range. However, the large foreign currency purchases, led to an increase in the monetary base that the BCRA has need to sterilise to avoid inflation risks (see **Monetary Environment**).

Chart 12

### Multilateral Real Exchange Rate Index



Source: Central Bank of the Republic of Argentina, <http://www.bcra.gov.ar>

As such, we believe the peso is undervalued and that the central bank's unofficial policy of keeping the peso nominally pegged to the US dollar is only sustainable if it

manages to bring inflation down over 2007-08. However, pursuing such a policy may still create uncertainty over monetary policy and may negatively affect the central bank's credibility. Furthermore, maintaining the unofficial exchange rate band at the expense of higher inflation is likely to be a primary factor behind the general appreciation in the real exchange rate since 2003. Going forward, continued appreciation of the real exchange rate will begin to harm competitiveness in tradable sectors.

### External Risk Outlook

In 2006, strong global demand for Argentina's agricultural products and a recovery in manufactured goods exports supported robust current external receipts reducing external sector risks. The current account registered an estimated surplus of 3.7% of GDP, while the financial and capital account posted a 1.7% deficit (due mainly to the voluntary repayment to the IMF). During 2006, foreign currency reserves climbed to USD32.0bn, although foreign investment fell, with estimated net inflows reaching about USD2.5bn. Although strong intervention of the BCRA in the foreign currency market has kept the nominal exchange rate stable, this strategy represents an inflationary risk factor

Table 11

#### External Forecasts

<i>% of GDP</i>	<i>2007f</i>	<i>2008f</i>
Current account	1.6	0.7
Financial & capital account	0.9	0.4
Overall balance of payments	2.5	1.2
Import cover (months)	8.2	8.0

Source: D&B

Over the two-year forecast period, external conditions will remain favourable, although not so beneficial as during 2006. The overall balance of payments will remain in surplus in both years and the BCRA will continue with its policy of international reserve accumulation.

Despite this optimistic outlook for the forecast period, D&B remains concerned about external vulnerabilities into the medium-to-long term. Robust export earnings have mainly been the result of favourable external conditions and do not necessarily represent increased competitiveness or a diversification towards a more value-added product. Export taxes and price controls implemented by the government during the 2001-02 crisis have been sustained and represent a serious disincentive to greater investments in export-oriented sectors. Combined with other discouragements to investment such as high inflation and contractual and regulatory risks, it remains uncertain whether the dynamism of the external sector can be maintained if global growth moderates. Finally, we expect the real exchange rate to continue to appreciate over the short to medium term, which will begin to hurt some tradable sectors.

## Trade Environment

**Key Point:** The trade environment remains liberalised despite the ongoing recovery from the 2001-02 crises. Over the forecast period, Argentina will advance trade links as a way of boosting the country's economic recovery although increasing protectionism sentiments cannot be ruled out.

### Trade Overview

Argentina sought to strengthen its ties with regional neighbours through the Common Market of the South (Mercosur), which came into existence in 1995 and includes Brazil, Paraguay, Uruguay and Venezuela. Chile and Bolivia became associate members in June 1996 and January 1997 respectively, while Peru reached similar status in 2003. During Argentina's years of recession and the subsequent recessions in Uruguay and Paraguay, Mercosur suffered from great volatility, with trade values falling and governments failing to agree on the institutional strengthening of the bloc, which is essential to signing deals with other blocs around the world.

The arrival in office of President Nestor Kirchner gave Mercosur a renewed boost; Mercosur was also enhanced by the return of monetary stability and economic growth in the region as a whole. Under these new conditions, the bloc decided to complete the Mercosur Customs Union by January 2006. However, this failed to occur as protectionist sentiment increased between the two largest members Brazil and Argentina over 2004 and 2005. In early 2006, the two countries agreed a deal that will allow protection in some industries deemed sensitive. In end 2006 Argentina and Brazil have agreed to start using their domestic currencies for bilateral trade transactions instead of US dollars. Recent escalation of tension between Argentina and Uruguay over the ongoing construction of two pulp processing mills on a river that forms a common border between the two countries have deteriorated substantially the relations between both countries and some protectionist sentiments have emerged.

Mercosur members are currently in talks with the EU, aimed initially at further liberalising trade between the two blocs; most members of the EU wish to pursue a free-trade agreement as a way of increasing influence in a region that is physically closer to the US. Mercosur will be motivated by the potential complementarity of its exports and those produced in EU. However, the reluctance of the EU to reduce farming subsidies and tariffs works as a powerful deterrent to a Mercosur-EU agreement. The enlargement of the EU in 2004 places another limitation on an agreement, given the accession countries' large agriculture sectors. Following successive rounds of official talks and informal meetings over 2004 and 2005 which failed to produce an accord, negotiations continued in 2006, although without great success. Estimates put the potential for future trade in goods and services between the two bodies at USD5bn a year.

Mercosur is also negotiating as a bloc within the Free-Trade Area of the Americas (FTAA) initiative. The FTAA was due to be concluded in January 2005, but has not been finalised. Argentina, Brazil and Venezuela are among the main opponents to the agreement. However, given recent difficulties in the bloc Uruguay has started negotiations with the US for a free-trade agreement. Despite this, trade integration has progressed in other areas: Mercosur finalised a free-trade agreement with India in 2004, and it accepted Mexico as an observer member, pending Mexico's accession as an associate member. It also completed a free-trade agreement with the Andean Community (Bolivia, Colombia, Ecuador and Peru) in 2004, creating the world's fifth largest trade zone.

### Current Account Exchange Regulations

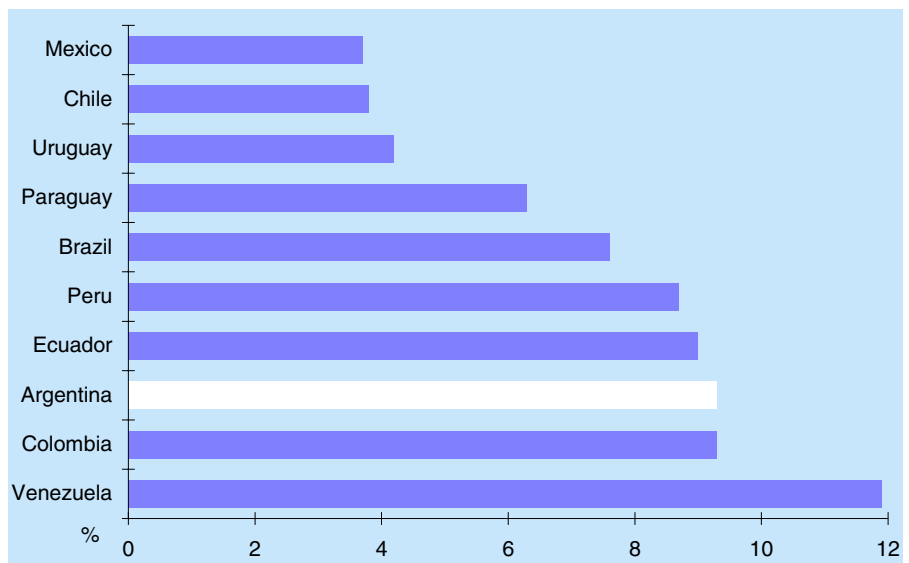
All exchange controls were lifted in December 1989 and there are now no restrictions on making transfers abroad. Argentina is a signatory to Article VIII of the IMF Articles of Agreement, and thereby pledges not to impose restrictions on payments and transfers for current international transactions or to engage in discriminatory currency arrangements without IMF approval. During the 2001-02 crisis several regulations for FX transfers were temporary installed. However, most of these controls were already removed.

### Tariff Barriers

Customs tariffs were reduced significantly during the 1990s. However, tariffs are sometimes subject to change according to fiscal needs and external account trends or to protect domestic industry. The WTO ruled against the 3.0% 'statistical tax' on imports and various ad hoc measures that Argentina introduced during the mid-1990s to protect its textile industry. After successive rounds of legal wrangling between the WTO and Argentine authorities the 'statistical tax' was reduced to 0.5% in 1998.

Chart 13

#### Weighted Mean Tariffs for All Products, 2004



Source: World Bank, *World Development Indicators*

Mercosur was established by the Asuncion Treaty of 1991. The customs union came into effect on 1995 and called for the phased elimination of tariffs between the members and the establishment of a common external tariff, including provisions to reduce non-tariff barriers, rules of origin and customs controls. Agreements have been signed guaranteeing investment protection and governing the regulatory process. Tariffs between member states were reduced to 0% in January 2006, although Argentina and Brazil agreed early in the year to maintain some tariffs to protect certain sectors (exemptions include cars, car parts and consumer electronics). The common external tariff is set at between 0% and 20% according to the product, with the average tariff being 11%. Agricultural goods are subject to tariffs of between 2% and 14%. Under Mercosur's long-debated car policy, a common import tariff of 35.0% (an increase on Argentina's 33.5% tariff) has been levied on cars, buses and trucks imported from outside Mercosur from 1 January 2000.

### Non-Tariff Barriers

*Bill of Lading:* The bill of lading should be issued (at a minimum) in one negotiable copy; additional negotiable copies may be required by the importer, bank, steamship line or other interested party.

The bill must show: the name of the ship; name of its captain; port of registry and registered tonnage; the name of the shipper or entity chartering the ship; the name of the consignee (unless it is 'to bearer' or 'to order'); number of packages; a specific description of the contents; the quantity, quality and marks of the goods; port of loading and unloading, with a declaration of the port of call, if any; the amount of the freight; place, manner and date of payment; date of preparation of the document and signature of the captain and the shipper (signatures of the shipping company and shipper should be signed by hand; facsimile signatures are not acceptable); container and seal number, and terms of shipment. It is suggested that the invoice number is also included on the bill of lading.

Under Circular RC-256 of the central bank all bills of lading must show the amount of freight and a statement 'Freight Paid' or 'Freight Payable at Destination'. The repetition of the numbers of packages shipped under one bill of lading is prohibited. Bills of lading covering general cargo must show the weight and volume of each package, according to the manner in which freight charges are levied; bills of lading covering other goods must indicate the total weight and volume of the shipment. The weight and volume should be shown for each package only when 'closed packages' of general cargo are concerned. This will not apply to casks, drums, cases of wines or beverages, paints, lumber, iron, etc., for which it will be necessary to show only the weight or the volume on which storage or freight is payable.

'To order' bills of lading are recognised except for shipments of arms and munitions. Under Argentine regulations, an Argentine bank will be considered the owner of merchandise (and therefore liable to any charges, such as storage, etc., incurred) if the bill of lading is made out to its order. It is suggested that bills of lading, when made out 'to order', be endorsed in blank and not to have the bank listed as the 'notify' party.

Air waybills replace the bill of lading on air cargo shipments. The number of copies required will depend on the importer's requirements and the airline used. Electronically produced air waybills are currently not accepted by Argentina.

*Certificate of Origin:* A certificate of origin is required for customs clearance of all imports from non-member countries of the WTO. Certain components and accessories, including those classified under chapters 84 and 85 of the Harmonised Tariff Code, are exempt from this requirement. This rule may also be applied to goods coming from free-trade zones and special customs areas.

The Argentine importer's name and the date and number of the commercial invoice from the exporting country must be shown on the back of the certificate. If the shipment is re-exported from another country to Argentina, the description of the product, along with the quantity re-exported to Argentina, must also be included.

In November 2000, additional modifications to the certificate of origin requirements for specific products were published. For manufactured products, separate certificates from each country involved in manufacturing the components of the finished product are required. The Argentine importer's name and the date and number of the commercial invoice from the exporting country must be shown on the back of the certificate.

*Commercial Invoice:* Commercial invoices must be presented in Spanish (one original and three copies), with the caption 'Original Invoice'. Carbon, printed or

photocopied invoices will not be accepted. Each copy of the invoice presented must be signed in ink by an authorised member of the firm. This member must be identified by typing their full name and position directly underneath the signature. When these commercial invoices are handled or in any way completed by the shippers or agents, a responsible representative should sign and identify their signature in the same manner, giving the full name of the firm as agents for the exporter or manufacturer. All agents and/or shippers countersigning and completing invoices for exporters or manufacturers should add their telephone numbers after the name of the firm.

The invoice (if in English, the common practice is to show the Spanish translation below the English text) should contain the invoice number; place and date of execution; full name and address of the exporter; full name and address of the consignee and name and address of the agent (freight forwarder), if any; quantity, indicating measuring units invoiced; name and description of goods; unit price and total; currency used in the transaction; terms of payment and delivery, using INCOTERMS; origin and place/port of export of the merchandise; means of transport (specifying via ocean, air or parcel post); and port or place of entry. All weights and measures must be accurate and given in the metric system. In addition to net and gross weights, the invoice should show the legal weight (defined as the weight of the goods including immediate wrappers or inner containers). The invoice must contain the following declaration in Spanish:

“Declaro bajo juramento que los precios consignados en esta factura comercial son los realmente pagados o a pagarse, y que no existe convenio alguno que permita su alteracion, y que todos los datos referentes a la calidad, cantidad, valor, precios, etc., y descripcion de la mercaderia concuerdan en todas sus partes con lo declarado en la correspondiente Shipper’s Export Declaration”. (“I swear that the prices on this commercial invoice are those really paid or to be paid, and that no agreement exists that permits their modification, and that all data pertaining to quality, quantity, value, prices, etc., and description of the merchandise agree in all their parts with what was declared in the corresponding Shipper’s Export Declaration”).

A fax of the commercial invoice may be used as a working copy for customs, but the original must be presented to complete entry.

*Import Licence:* Argentina implemented a new import licence regime in February 1999, which covers 1,276 products. Products covered include: certain organic and inorganic chemicals; plastics and plastics products; paper and paperboard products; textile products; apparel; footwear; wood products; books, newspapers and printed products; iron, steel and metal products; capital goods; furniture; and toys.

An import licence, known as a *Formulario Informativo*, must be presented for customs clearance to allow custom officials time to identify potential problems. The form must be approved by the under-secretariat of foreign trade (of the Secretariat of Industry, Commerce and Mining).

*Insurance Certificate:* Follow importer’s instructions. An insurance certificate is generally needed with maritime shipments. Marine insurance can be obtained from any Argentine or foreign insurance company.

*Packing List:* These are required for customs clearance and must describe the contents of each package and include any special marks. Where the contents of a parcel are the same as those in other parcels of the same lot, one description on the packing list covering the lot is sufficient. The packing list should preferably be in Spanish. If it is presented in another language, customs reserves the right to require the importer to present a Spanish translation. Follow importer’s instructions regarding number of copies issued. No packing list is necessary for goods imported

in bulk, such as coal, petroleum, sand, etc., or for articles identical in kind, characteristics, composition, weight, etc.

*Pro-Forma Invoice:* Although not always required, a pro-forma invoice may be requested by the importer for banking purposes or as the first step in negotiating an import contract. If the pro-forma or any other invoice does not pertain to an actual shipment, each copy should contain the following declaration (according to the purpose of the invoice): 'Declaro bajo juramento que la presente factura commercial sera utilizada para....' ('I swear that the present commercial invoice is to be used for....'). Consular legalisation is not required.

# Commercial Risk

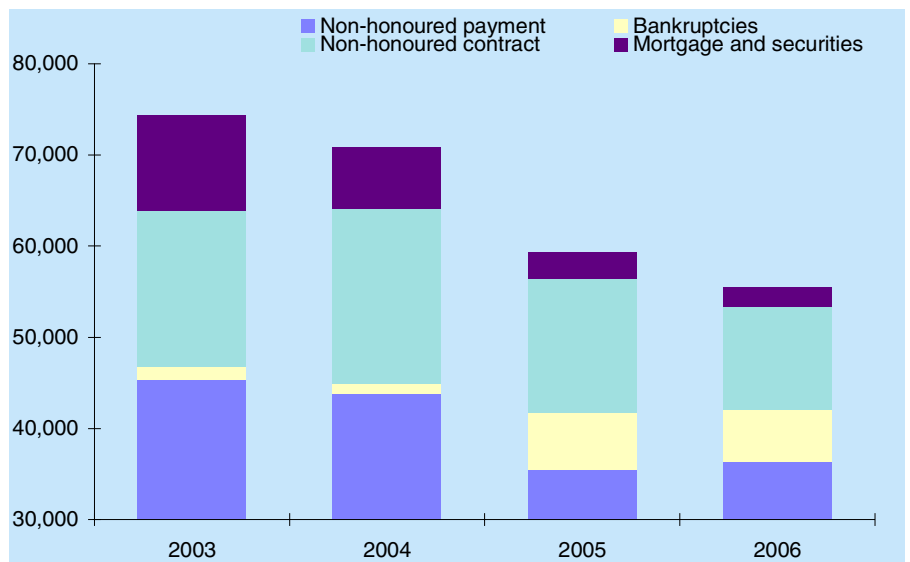
**Key Point:** Strong economic growth, abundant foreign exchange liquidity and an appreciating real exchange rate will support foreign payments over the two-year forecast period. However, regulatory and contractual risks have not improved since the 2001-02 crisis and constitute one of the largest downside commercial risks.

## Credit Risk

Changes in the macroeconomic context in recent years have contributed decisively to improve the credit risk. Robust export earnings and strong domestic demand driven by constant employment expansion accelerate the industrial economic activity to historic levels. More important, the change in the relative prices as a consequence of the high foreign exchange rate has altered considerably the sector dynamics helping to reactivate economic sectors that suffered considerably during the 1990s from the relative appreciated peso. Indeed, the expansion of the economy was based in a broad sectoral base. Tradable products sectors contributed to 32.2% to the economic recovery during 2003-2004, 11.8 percentage points higher than during the two years following the previous economic crisis (the so-called Tequila crisis in 1995). In particular, industry contributed 29.7% of the GDP expansion whereas the financial sector, which over-expanded during the 1990s, decreased its importance.

Table 14

### Commercial trials initiated



Source: *Buenos Aires Economico*

Several data indicate that the commercial risk environment has improved in recent years. Commercial litigations initiated have decreased systematically since 2003 and the level of the first nine months of 2006 was 25% lower than the same period three years before. The slight increase in the level of trials initiated due to non-honoured payments is driven by the improvement in the business activity and it is not a short-term source of risk. Moreover, according to data from the central bank, the quantity of rejected cheques as a percentage of honoured ones has been stable since 2003, averaging 1.9% between 2003 and 2006. This level compares positively with both the pre-crisis (4.7% in 2000-01) and post-devaluation level (4.4% during 2002). A similar trend is observed for the amount in pesos of rejected cheques as a percentage

of honoured ones (1.6% on average during 2003-06 versus the pre-crisis 3.4% and post-devaluation level of 3.1%).

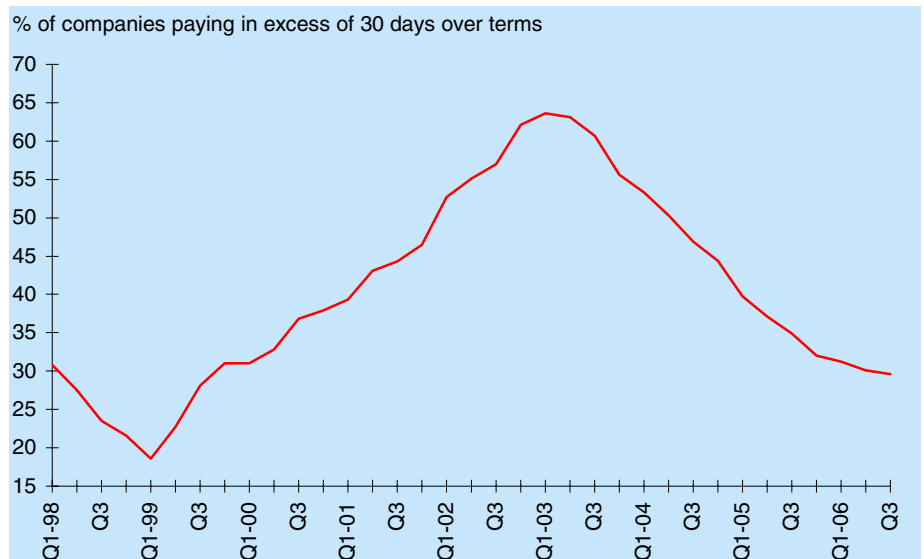
However, some worrying issues continue to be present in the Argentinean day-to-day business environment. Despite the improvement in the macroeconomic conditions, frequent changes to legislation (i.e. bankruptcy law, oil and gas company revenues decrees); high discretion and lack of transparency in the public resources allocation; violent actions against business (mainly foreigners) by radical political groups (in some occasions linked or protected with the national government); and government corruption and private sector business fraud are important sources of credit risk.

Effective lobby strategies conducted by business sectors, especially by the Union Industrial Argentina (UIA) in early 2002, which helped influence the foreign exchange policy showed the importance of corporative influence in the policy making process. At the same time, the national government’s debt default in combination with the *peso-ification* of the banks deposits signalled the low cost of both breaking unilaterally of contracts and disregarding property rights. As an example, on December 2006 the Supreme Court upheld the legality of the so-called ‘peso-ification’ of 2002 (restitution of dollar-denominated deposits in pesos losing two-third of their value), which affected USD46bn in bank deposits, arguing that the measure helped to achieve some social stability.

*Payments Experience*

D&B’s data on payments performance of Argentinean companies also show a considerable improvement. In the first quarter of 2003, still ailing from the economic crisis, payments performance by Argentine firms hit its nadir, with a registered 63.6% of payments arriving 30 or more days beyond agreed terms. However, since then, the proportion of payments arriving over agreed terms has fallen every quarter to the present. Indeed, by the third quarter of 2006, only 29.6% of payments arrived 30 or more days late. Several factors have underpinned the improvement in Argentina’s payments performance, including the strong resurgence in real GDP growth over 2003-06, stable low real exchange rate but appreciating, which is consistent with the strategy of fostering export-oriented industries.

Chart 15  
**Late Payments Trends**



Source: D&B

As the improvement in the commercial risk environment has been stimulated by the continued recovery of economic activity and strong inflows of FX export earnings,

we expect this positive trend to be maintained over the two-year forecast period, progressing towards pre-crisis commercial conditions. However, there remains a risk that payments performance could deteriorate towards the end of our two-year forecast period and into the medium term when a weakening in demand for Argentine exports becomes more pronounced following a slowdown in the global economy. In addition, the country still has to contend with other challenges that have affected the commercial environment, including the complexity of the legal challenges stemming from the bankruptcies and corporate defaults brought about by the 2001-02 economic crisis, and the low confidence among Argentines and foreign investors in the country's institutional structures and judiciary system.

*Usual Terms:* While an economic recovery has supported an improvement in the country's payments performance, we advise traders to be cautious when dealing with companies in Argentina; in particular, business with new contacts should be conducted on stricter terms than used for established contracts. LCs constitute minimum terms, although CLCs are recommended.

Although the government reduced restrictions on the capital account in 2003 and 2004, it maintains some limitations on short-term capital flows, which are designed to take appreciation pressures off the peso (see **Exchange Rate Risk**). The law requires investors to keep foreign currency inflows in the country for a minimum of 180 days.

Local banks avoid opening LCs to importers or exporters that are not previous clients, and request almost the same credentials and securities as for regular credits and loans. This is a common practice, both for the banks' sake and to discourage money laundering. Documents against acceptance and against payment may also be used, depending on the trust and credit between buyer and seller. OA terms are seldom extended or accepted unless great confidence exists between buyer and seller.

Few international banks have their own offices in other than the largest cities. Special care should be taken when choosing banks in order to consider communication time between subsidiaries. If a third local bank represents a foreign bank, aside from extra charges, unexpected delays may appear and constant supervision of payment may be necessary.

#### Usual Terms

Minimum Terms:	LCs
Recommended Terms:	CLCs
Usual Terms:	30-60 days

*Transfer Situation:* Over 2001-02, the introduction of capital account controls (see **Investment Environment**) and banking restrictions slowed payments. Buyers usually pay locally within one month, and reports suggest that banks average up to one month before transferring foreign exchange as well. Although the government eased regulations and controls in 2003, care should be taken to monitor changes.

#### Transfer Situation

Local Delays:	0-1 months
FX/Bank Delays:	0-1 months
Import Cover:	8.6 months

By Q1 2007, import cover was up to 8.6 months due to the increase in foreign exchange reserves levels to USD32.0bn. We expect forecast current account surpluses over the two-year forecast period, as well as foreign currency purchases, to

support robust reserve accumulation, which will not deteriorate significantly the import cover in 2007 and 2008.

*Export Credit Agencies:* The level of cover offered by commercial insurers was severely curtailed over 2001 and 2002. In 2003, Atradius started to offer cover for Argentina subject to an approved LC. We do not rule out slow improvements in this area during 2007-08. However, a return to more bullish outlooks from export credit agencies will take time and will be dependent on the evolution of the economy, business climate and investor sentiment.

#### Export Credit Agencies

US Eximbank	Limited short-term private sector cover
Atradius	Short term cover subject to approved LC; no discretionary limits
ECGD	Refer to underwriter
Euler Hermes UK	Short-term cover available; restrictions may apply

### Financial Sector Risk

Despite efforts made after the Mexican Tequila crisis in 1995 to strengthen the Argentine banking sector, the combination of the 2001-02 crisis with the partial dollarisation of the economy severely undermined financial sector solvency and stability. Banks suffered through different channels the crisis: the default of sovereign debt affected the value of their massive holding of bonds; the deterioration of balance sheets given the conversion of US dollars into devalued pesos at differential rates (ARS1.4:USD for deposits and ARS1.0:USD for loans); restrictions to basic banking operations that have prevented a possible return to normality, and the crisis in administration that has underpinned bankruptcies, and halted debt repayments and foreign currency payments. As a consequence, banks operating in Argentina registered a combined loss of ARS22.7bn during the period 2002-04.

Table 12

#### Top Ten Argentine Banks by Tier One Capital, 2006

Bank	Total assets (USDbn)	Equity (USDbn)	Capital assets on equity (%)	Rate of return on assets (%)
De la Nacion Argentina	19.8	2.0	11.2	0.2
De Galicia y Buenos Aires	8.2	0.4	5.9	0.0
De la Provincia de Buenos Aires	7.8	0.5	6.0	0.9
BBVA Frances	5.4	0.6	12.1	1.2
Rio de la Plata	5.0	0.4	8.4	-1.2
Ciudad de Buenos Aires	3.3	0.5	15.7	4.8
Hipotecario	2.9	0.8	34.5	4.4
BankBoston	2.7	0.3	14.1	0.8
Macro Bansud	2.6	0.7	29.0	5.6
Citibank	2.4	0.2	9.4	1.8

Source: Banco Central de la Republica Argentina [www.bcra.gov.ar](http://www.bcra.gov.ar); D&B

On top of Argentinean Central Bank's (BCRA) goals of increasing international reserves and monitoring the growth of money supply (see **Monetary Environment**), the monetary authority has established important guidelines. First, the BCRA established specific limits on the financial system exposure to the national, provincial and municipal public sector. Second, new regulations were established to remove the currency mismatches encouraging banks to lend in domestic currency to business and households that generate income in pesos. Third, the BCRA has taken measures aimed at increasing the use of bank services in the economy. Fourth, the

BCRA has managed to diminish the liabilities that the bank sector owes to it. The bank sector has achieved important progress in restructuring of its balance sheets, the profitability has returned and the solvency has strengthened. As a result, the banks in Argentina posted a combined profit of ARS4.1bn in 2006, compared with ARS1.9bn in 2005.

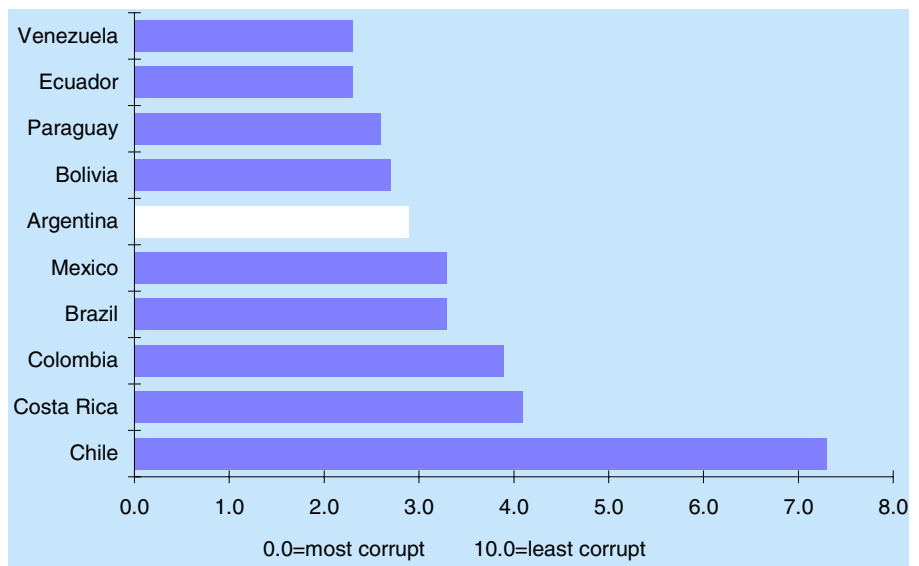
The combination of increasing private sector loans, expansion of bank assets, the ongoing of the capitalisation process, positive macroeconomic outlook and the BCRA's commitment with the rebuild of financial stability secures the Argentine financial system to continue to strengthen moderately over the two-year forecast period. Despite the improving situation, D&B considers that there are still some sources of risk in the medium term. Although the recent expansion, private sector loans is only 10% of GDP, well below international standards (around 155% in the UK, 98% in Japan and 31% in Brazil). The banks have a high proportion of SDs and as result the average maturity of private deposits is short by historical standards. Moreover, the bank sector must increase funding through capital markets, factor that may foster lending to private sector. Finally, the crisis has significantly reduced the market share of private banks and elevated the significance of large public banks (mainly the Banco Nacion and Banco Provincial de Buenos Aires), which introduces a degree of uncertainty into the market given that these institutions are more inclined to be put under political pressure. However, the government is also more likely to support the national banks in the event that the sector (or individual banks) experiences a further downturn.

## Corruption

Transparency International's 2005 survey on perceived corruption ranks Argentina at 97 out of 158 countries with a score of 2.7 (where 0.0 represents the highest level of perceived corruption and 10.0 the lowest); this compares favourably with the 2.5 registered in 2004.

Chart 16

### Corruption Perceptions for Selected Countries, 2006



Source: Transparency International, *Corruption Perceptions Index*

Government corruption and private sector business fraud, especially tax evasion, are common complaints in Argentina. The administration of former President Carlos Menem was linked with several corruption cases that remained unpunished by a scarcely independent judicial system, helping to undermine the public's confidence in politics and the country's institutions. In addition, the four-year economic

recession (1999 to 2001) undoubtedly opened the way for increased graft as the government's administrative skills were eroded and its power declined.

President Nestor Kirchner has sought to combat corruption in state administrations: in its first year in office, the government convinced the public that corruption could be punished and Kirchner has removed public officials suspected of illegal activities (particularly within the police force). However, concerns remain over lack of transparency in the public funds management, especially in government construction projects.

More generally, Argentina adheres to the principles outlined in the OECD's Recommendations on Bribery in International Business Transactions. An IMF assessment of the country's practices (mainly focusing on the fiscal accounts, monetary and financial policy, and banking supervision) commends recent efforts to improve transparency, but highlights the need to improve information and give more independence to supervisory agencies.

## **Other Commercial Risks**

The Commerce Code requires all companies (bar those individually owned) to publish comprehensive annual reports; publicly traded companies must publish quarterly reports. Financial statements must be accompanied by an audit report. Auditing standards are broadly in line with international standards and the local regulatory body is revising codes to ensure more detailed information is provided.

### *Commercial Law*

The legal requirements for most ordinary business transactions are detailed in the provisions of contract and remedy laws set in the Civil Code, the Code of Commerce and the Code of Civil Procedure. The Code of Commerce supplements and modifies the Civil Code in its coverage of commercial contracts, which often requires less formality than contracts governed exclusively by the Civil Code. Business customs are usually relevant in the interpretation of commercial contracts.

Certain financial aspects of transactions are governed by specific legislation that outlines the requisites for the use of various types of commercial paper, such as bills of exchange, notes and cheques. The Civil Code contains laws governing the sale of real and personal property. Some sellers use a transfer device called a *deposito* to approximate the terms of an otherwise unrecognised conditional sale. Argentina subscribes to the UN Convention for the International Sale of Goods. The Code of Civil Procedure establishes attachment procedures and executorial actions for the legal collection of a judgement or other property. Pledges of property to secure debts are recognised under the law.

The legal system has often failed to keep up with the widespread structural reform of the 1990s and evidence of apparently inconsistent rulings has sometimes compromised the integrity of the legal system. The chaos that followed the devaluation of the currency and the imposition of banking restrictions led to a significant raft of new (often temporary) legislation, making the administrative and legal environment particularly risky. Although the authorities have taken some steps to regulate the legal system and make it more stable and transparent, the executive still has considerable scope to issue executive decrees and bypass Congress.

### *Intellectual Property Rights*

The Office of Intellectual Property within the judicial branch of the Argentine government is responsible for providing copyright and trademark protection. Argentina is a member of the World Intellectual Property Organisation (WIPO) and has signed most international treaties on agreements concerning intellectual property, including the Paris and Berne Convention, the Universal Copyright Convention, the

Geneva Phonogram Convention, the Treaty of Rome and the Treaty on the International Registration of Audiovisual Works. It also acceded to the Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement of the Uruguay Round in January 1995.

The US Trade Representative has maintained Argentina on the Special 301 Priority Watch List for several years and reaffirmed this position in 2005 due the country's inadequate patent and copyright protection. Concern is focused on widespread piracy and counterfeiting, and the unauthorised use of protected material. The US initiated WTO dispute settlement cases in 1999 and 2000 over concerns about Argentina's failure to implement WTO TRIPS obligations. Although the US and Argentina reached an agreement in April 2002 with respect to most claims being disputed under the aegis of the WTO, Argentina remains on the US' Priority Watch List given that two important issues (protection of confidential test data and patent regimes) are unresolved. Argentine law does not deal specifically with protection for layout designs and semiconductors, although in theory these should be covered under the patent and copyrights law. Argentina has signed the WIPO Treaty on Integrated Circuits.

*Patents:* A patent protection bill sets the patent protection term at 20 years from the filing date (ten years for utility models) and provides protection for pharmaceuticals. According to this law, the pharmaceutical transition period is five years. However, the law is weak by international standards, as it does not meet all TRIPS and WTO requirements. It also fails to provide pipeline protection and has unacceptable compulsory licensing requirements. The Argentine Patent Office passed a resolution in 2000 to expedite the granting of patents that have already been passed in a foreign country. A copy of the foreign counterpart patent must be filed with the Argentine Patent Office, along with a translation of the patent into Spanish. If the foreign patent on which priority rights are based has been granted, the Argentine application will also be granted if it complies with local formal requirements, and no local prior application is found. In 2002 following negotiations with the US, Argentina agreed to amend its patent law to provide protection for products obtained from a process patent and also to ensure that preliminary injunctions are available in intellectual property rights court proceedings.

*Trademarks:* Registration is valid for ten years from the registration date and is renewable for similar periods, provided that the trademark has been used in the five years prior to application for renewal. Five years of non-use are grounds for cancellation; only an exceptional event will excuse non-use. Although registration generally takes over five months, trademark enforcement is efficient after registration. The concept of trade secrets in contract law is also recognised.

*Copyright:* Argentina's present copyright law was enacted in 1993 and is adequate by international standards. Copyright protection extends to 50 years after the copyright holder's death. Argentina's government revised the copyright law in November 1998, expanding intellectual property protection to include software. Previously, unauthorised reproduction of software was not illegal and an estimated 70% of all software sold in Argentina was pirated. Enforcement of software protection is uneven, resulting in continued piracy of software, videos and recorded music, as well as cable television. Registered industrial models and designs receive protection for five years under Decree Law 6,673/63; this includes foreign models and designs that are filed within six months of registration in a foreign country.

**Commercial Risk Outlook**

The commercial risk environment has improved substantially since the economic recovery began in 2003. Indeed, the payments performance of Argentine firms has recovered to almost pre-crisis levels, initiation of commercial litigation have decreased, rate of non-honour cheques has also drop to good levels, and the perceived incidence of corruption has fallen slightly. Underlying the improvement in the commercial environment has been strong economic growth, robust FX liquidity (owing primarily to the strong performance of exports) and an appreciation in the real exchange rate, which makes servicing foreign liabilities less costly.

We expect these positive factors to continue supporting payments over the short term, although a sharper-than-expected slowdown in real GDP growth could substantially undermine this outlook. In addition, we remain uncertain about the sustainability of the Argentine recovery into the medium and longer term, particularly given the government's current policy programme. Over 2007 and 2008, the largest risks facing the commercial environment will emanate from the regulatory sphere (increasing controls over the business activities) and the continuing fragility of the banking sector. Moreover, the importance of the lobby groups (i.e. businesses, trade unions) to shape government policies during the crisis and more recently, the fact that the Supreme Court upheld the legality of the so-called 'peso-ification' of 2002 signal the tendency towards the lack of consensus in the decision making process and the low cost of both breaking unilaterally the contracts and disregarding the property rights.

# Investment Environment

**Key Point:** The investment environment has deteriorated as a result of the 2001-02 crisis and a weakening in contractual and regulatory risks. Over the two-year forecast period we expect only a meagre recovery in FDI. In the short to medium term the government will have to take measures to improve its image as an investment destination.

## Investment Overview

The economy was opened up to foreign investment in the 1990s: limits to foreign investment were reduced (with 100% foreign ownership permitted) and bureaucratic obstacles removed. Foreign investment is allowed in sensitive areas including banking, oil and mining, the mass media (albeit with some regulatory restrictions) and nuclear power. The reforms introduced post-1989 centre on the Law on Foreign Investment, which establishes the principle of non-discrimination, with the result that foreign investment is now treated on a par with domestic investment.

The current presidential administration of Nestor Kirchner has upheld these regulatory measures. Despite the government's nationalist rhetoric, these provisions continue to be part of the country's efforts to promote investment. However, the government will have to make a concerted effort to improve its image and the business climate as it continues to recover from the 2001-02 economic and political crisis. This has not been helped by the tough stance the Kirchner administration has taken in its negotiations with creditors holding some USD102.6bn in defaulted bonds (see **Government Debt Swap**).

Argentina's liberal investment regime now conforms to various OECD standards (including most of the declaration of International Investment and Multinational Enterprises). Argentina is an active member of the Multilateral Investment Guarantee Agency and the Overseas Private Investment Corporation, both of which insure investments against political risks, including wars, civil unrest and expropriation.

In addition, the country has signed bilateral investment promotion and protection treaties with many OECD member countries, including France, Germany, Poland, Spain, Sweden, the UK and the US. Argentina is a member of the International Centre for the Settlement of Investment Disputes (CSID). These mechanisms provide for supranational resolution of disagreements, thereby reducing uncertainty and concerns of political interference. The devaluation of the peso in 2001 and the breaking of several contracts (particularly in the utilities services sector) sparked claims at the CSID against Argentina from companies investing in the country, although a good portion of them were retired by the companies.

## Capital Account Exchange Regulations

Under normal circumstances, the Argentine authorities do not impose limitations on transferring funds associated with investment abroad in any currency and at the market-clearing rate. There are no restrictions on reinvestment or the repatriation of earnings, royalties or capital. During 2003, the authorities abolished the capital controls established in 2002, and also lifted the remaining banking restrictions in place.

## **Foreign Direct Investment Environment**

### *Investment Incentives*

FDI increased significantly towards the end of the 1990s, reflecting improving domestic macroeconomic prospects, the privatisation programme and the liberalised investment environment. However, during 1999-2000 a substantial number of large companies moved operations from Argentina to Brazil, lured by Brazil's devaluation-induced competitiveness. The Argentine authorities have taken a number of steps to stem the cross-border exodus by improving local business conditions:

- Companies with fewer than 40 employees and sales of up to USD50m can get reductions of 10-15% in electricity and gas tariffs and receive USD100 monthly for every new worker hired.
- The same firms are eligible for credit lines with a 7% annual interest rate where the funds are used to purchase locally produced capital goods.

Foreign companies also have access to investment incentives as part of the government's export promotion scheme. Notably, no export taxes are levied on manufactured goods, although export taxes on agricultural goods may be a disincentive for investment in this area. Industrial exporters can benefit from lower import duties and tax refunds; producers of capital goods can also qualify for tax refunds. Additional investment incentives are available to promote development in economically underdeveloped regions. Meanwhile, the Mining Law provides extra guarantees including tax stability for 30 years, tax deductions in the prospecting and exploration phases of a project, and accelerated depreciation rates for tax purposes.

### *Free-Trade Zones*

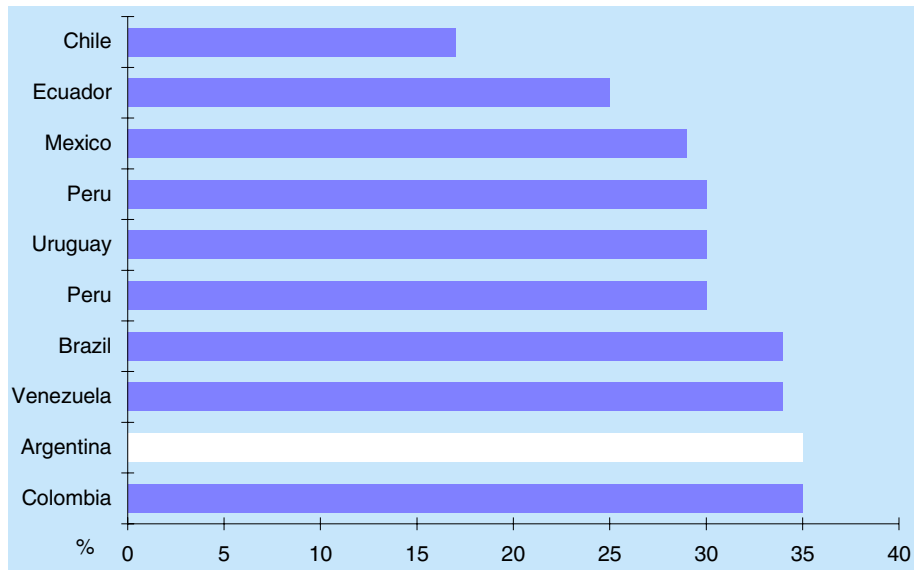
Law 24,331 of 1994 establishes the Foreign Trade Zone Regime and permits the creation of trade zones in each of Argentina's provinces. The zone near La Plata in the province of Buenos Aires is the most active zone given its proximity to the port of Buenos Aires. Goods brought into the zones enter free of taxes and duties. However, their entry does not imply that Argentina is their final destination for consumption, and goods will be inspected for quantity and type.

The free-trade zone system is intended to improve importers' cash flow by postponing taxes and customs duties. Goods can be kept in the zones for five years. The free zones allow exporters the possibility of importing free of customs duties. Furthermore, exporters manufacturing within the zones enjoy the benefit of buying supplies and raw materials from third countries without having to pay duties or taxes.

### *Taxation*

There are federal, provincial and municipal taxes. The main federal taxes are income tax, VAT, excise tax, real property transfer tax and tax on personal assets. The main provincial taxes are turnover tax, stamp tax and real estate tax. Income from most municipalities derives from rates and assessments.

Chart 17

**Corporate Tax Rates in Selected Countries, 2006**

Source: The Heritage Foundation, <http://www.heritage.org>

**Corporate Tax:** Corporations, limited liability partnerships, limited partnerships, limited partnerships by shares and branches of foreign business enterprises are taxed at 35% of their taxable income, and file and pay themselves. All other business enterprises calculate their income tax, but it is the partners or owners who file and pay in proportion of their respective holdings. Corporations may pay in 11 pre-payments or the balance five months after the end of the fiscal year.

**Value-Added Tax:** Some taxes, notably VAT, are subject to change according to fiscal needs. The VAT rate is currently 21%, although this increases to 27% on telecommunications, the supply of gas, electricity, water, sewage disposal and drainage. VAT is levied on sales of personal property located within Argentine territory, construction and other contracts and services. Definitive imports, whether recurrent or not, are subject to VAT and the importer must pay the VAT before imported goods are withdrawn from customs. The seller of goods or services is generally liable for paying VAT, although the VAT rate is added to the goods or services with the result that the cost is borne by the consumer.

**Stamp Tax:** Stamp tax is charged at 1%, but there is a 2% rate chargeable on real estate sales. Each province has its own stamp tax (and double taxation can occur), although the province of Buenos Aires has abolished stamp tax for most documents. Documents subject to stamp tax include most types of contract, notary deeds, receipted invoices confirmed by debtor, promissory notes and negotiable instruments. Stamp duty and securities transfer tax have also been abolished for shares and corporate bonds, with the result that there is currently no tax burden on securities transactions.

Argentina has signed treaties with various European and Latin American countries to avoid double taxation as a means of promoting investment and reciprocal trade. No such treaty exists with the US.

### *Company Organisation*

The following represent the major forms of corporate organisation structure:

- **Sociedad Anonima (SA):** A limited liability company with a minimum of two shareholders. Minimum capital requirements apply; there is no maximum. Can

operate in either the public or private sector. Liability of shareholders is limited to the amount paid for shares held.

- *Sociedad de Responsabilidad Limitada (SRL)*: Limited liability company. Must have a minimum of two and a maximum of 50 members. Liability is restricted to the amount of capital staked. Capital may not be raised from the public and transfer of quotas (shares) is restricted.
- *Sociedad Colectiva*: General partnership, with no limits on liability.
- *Sociedad en Comandita Simple (SCS)*: Limited partnership. At least one general (active) partner holds unlimited liability.
- *Sociedad en Comandita por Acciones (SCA)*: Partnership limited by shares.
- *Sucursal de Empresa*: Branch of a foreign company.
- *Agrupaciones de Colaboración*: Joint venture, temporary partnerships.
- *Uniones Transitorias de Empresas (UTE)*: Temporary union of companies.
- *Comerciant*: Sole proprietorship where liability for all debts is unlimited.

## Portfolio Investment

### *Stock Market*

The main stock exchange is the Buenos Aires Stock Exchange (BASE). The Buenos Aires Securities Market is the sole organisation entitled to trade securities on the exchange and establishes the framework by which brokers work. The modified Foreign Investment Act puts foreign investors on a similar footing to Argentine investors. There is no capital gains tax on shares obtained by individuals. The National Securities Commission (*Comision Nacional de Valores*), a government organisation that has similar functions to the Securities and Exchange Commission in the US, requires a company making a share offering to publish a prospectus detailing its trading and financial position and that of its subsidiaries. A listed company must file its financial statements and board of directors' reports quarterly with the exchange as well as annual audited financial statements. Foreign-owned companies may be listed on the stock exchange. To list its shares on the stock exchange, a company must comply with certain detailed requirements.

A trend towards more sophisticated financial instruments is reflected in the growth of the negotiable instruments and options market; both are traded on the BASE. In addition, the stock exchange saw a rise in foreign interest following the privatisation programme and an increase in institutional investors following the social security reform in 1994 that created private Pension Fund Administrators. The Merval index of leading shares is reweighted every quarter based on trading during the previous three months. A few large finance, telecoms or utilities companies usually dominate the index, with the majority barely accounting for 1%. Under normal circumstances the Merval is highly correlated to broader domestic and global macroeconomic trends and movements on the US Dow Jones and Nasdaq indices. Nonetheless, because the Merval is not yet company-driven, it is susceptible to instability and negative investor sentiment.

### *Bonds*

During the 1990s, the government was heavily dependent on bond finance and encouraged investment in government securities. A number of Argentine corporations utilised bond financing as an alternative to bank credit (although this remains a tiny fraction of overall market trading). However, the government's debt default during the 2001-02 crisis highlights the risk prevalent in Argentina's investment environment. Although several big companies have rescheduled their private defaults and reassumed debt payments, the sovereign (and possibly private borrowers) will probably experience a number of legal claims made by bond holders or insurers. In June 2005, the government concluded its bond exchange of around USD100bn, which has since allowed it to make relatively small bond placements in international capital markets.

## Additional Sources of Information

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**Ministry of Economy**

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<http://www.mecon.gov.ar>

**Central Bank of the Republic of Argentina**

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Buenos Aires C1003ABF  
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**Argentine Chamber of Commerce**

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<http://www.cac.com.ar>

**Secretariat of Trade, International Economic Relations and Consular Affairs**

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<http://www.mrecic.gov.ar>

**Investment Authority (Invertir)**

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Buenos Aires C1036AAF  
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<http://www.invertir.com>

**National Institute of Statistics and Census (INDEC)**

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<http://www.indec.gov.ar>

**All Argentine government internet addresses can be found at:**

<http://www.info.gov.ar>

### *Credit Information*

D&B provides information relating to over 110m companies worldwide. Visit [www.dnb.com](http://www.dnb.com) for details. Additional information relevant to country risk can also be found in the following services:

*International Risk & Payment Review:* Provides timely and concise economic, political and commercial information and analysis on 132 countries. Available as a subscription based internet service ([www.dnbcountryrisk.com](http://www.dnbcountryrisk.com)) and monthly update journal, the IRPR carries essential information on payment terms and delays. It also includes the unique D&B Country Risk Indicator to help monitor changing market conditions.

*Exporters' Encyclopaedia:* Information on 220 world markets to help customers decide where they can safely and profitably do business. Data provided include key contacts, transportation information, legislation affecting export commerce and tips on foreign business travel. Published annually in August plus ad hoc updates. English language edition.

## Glossary

Balance of payments	The sum of payments made to all other nations less the sum of external receipts.
Basis point	One one-hundredth of a percentage point.
CAD	Cash against documents: On payment, the buyer receives the documents that give access to the purchased goods.
CiA	Cash in advance: The buyer pays the seller before shipment is effected.
CIS	Commonwealth of Independent States (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Ukraine and Uzbekistan)
CLC	Confirmed letter of credit: A letter of credit in which payment is guaranteed by the opening bank in the buyer's country and by another bank.
CPI	Consumer price index
Current account balance	Part of the balance of payments that records a nation's exports and imports of goods and services, and income and transfer payments.
CWP	Claims waiting period: The time between when the covered risk materialises and the earliest time when indemnification of a claim can take place.
DSR	Debt service ratio: Annual interest and principal payments on a country's external debts as a percentage of exports of goods and services.
ECB	European Central Bank
ECGD	Export Credits Guarantee Department (UK)
EU	European Union
Eximbank	Export Import Bank (US)
FDI	Foreign direct investment: Investment in productive assets by a company incorporated in a foreign country.
Fitch	Fitch Ratings
FX	Foreign exchange
G7	Group of Seven industrial nations (Canada, France, Germany, Italy, Japan, UK and US)
G8	Group of Eight industrial nations (G7 plus Russia)
GDP	Gross domestic product: The value of goods and services produced within an economy.
GNP	Gross national product: GDP plus net income from abroad.
Government balance	The balance of government expenditure and receipts.

HIPC	Heavily Indebted Poor Countries initiative: A framework for creditors to provide debt relief to the poorest and most heavily indebted countries.
IMF	International Monetary Fund
Import cover	The amount of official FX reserves a country has in relation to the average monthly value of imported goods and services.
Inflation	The increase in prices over a given period.
IT	Information technology
LC	Letter of credit: A guarantee of payment to a seller from a buyer's bank. Payment is conditional on named documents being presented by specific dates.
Moody's	Moody's Investors Service
MP	Member of parliament
NATO	North Atlantic Treaty Organisation
NGO	Non-governmental organisation
Nominal effective exchange rate	The weighted average exchange rate of the local currency vis-à-vis a basket of foreign currencies.
OA	Open account: credit extended that is not supported by a note, mortgage or other formal written evidence of indebtedness.
OECD	Organisation for Economic Co-operation & Development
OPEC	Organisation of Petroleum Exporting Countries
Q1; Q2; Q3; Q4	First, second, third and fourth quarter
R&D	Research and development
Real effective exchange rate	The nominal effective exchange rate adjusted for inflation differentials with the country's trading partners.
Real GDP	GDP adjusted for inflation
S&P	Standard & Poor's
SD	Sight draft: A draft or bill that is payable on demand or on presentation.
STIPP	Short-Term Insurance Pilot Program (US): Provides short-term cover to buy US goods in countries where Eximbank is otherwise not open for medium-term financing in the public or private sector.
Terms of trade	The ratio of the index of export prices to the index of import prices. A rising ratio indicates improving terms of trade.
UN	United Nations
VAT	Value-added tax: A consumption tax levied at each stage of production based on the value added to the product at that stage.
WTO	World Trade Organisation

## Country Risk Indicator Definition

D&B's Country Risk Indicator provides a comparative, cross-border assessment of the risk of doing business in a country. The indicator seeks to encapsulate the risk that country-wide factors pose to the predictability of export payments and investment returns over a time horizon of two years. The risk indicator comprises a composite index of four over-arching country risk categories:

<i>Political risk -</i>	internal and external security situation, policy competency and consistency, and other such factors that determine whether a country fosters an enabling business environment;
<i>Macroeconomic risk -</i>	the inflation rate, government balance, money supply growth and all such macroeconomic factors that determine whether a country is able to deliver sustainable economic growth and a commensurate expansion in business opportunities;
<i>External economic risk -</i>	the current account balance, capital flows, foreign exchange reserves, size of external debt and all such factors that determine whether a country can generate enough foreign exchange to meet its trade and foreign investment liabilities;
<i>Commercial risk -</i>	the sanctity of contract, judicial competence, regulatory transparency, degree of systemic corruption, and other such factors that determine whether the business environment facilitates the conduct of commercial transactions.

The DB risk indicator is divided into seven bands, ranging from DB1 through DB7. Each band is subdivided into quartiles (*a-d*), with an *a* designation representing slightly less risk than a *b* designation and so on. Only the DB7 indicator is not divided into quartiles.

### Indicator Meaning Explanation

DB1	Lowest risk	Lowest degree of uncertainty associated with expected returns, such as export payments, and foreign debt and equity servicing.
DB2	Low risk	Low degree of uncertainty associated with expected returns. However, country-wide factors may result in higher volatility of returns at a future date.
DB3	Slight risk	Enough uncertainty over expected returns to warrant close monitoring of country risk. Customers should actively manage their risk exposures.
DB4	Moderate risk	Significant uncertainty over expected returns. Risk-averse customers are advised to protect against potential losses.
DB5	High risk	Considerable uncertainty associated with expected returns. Businesses are advised to limit their exposure and/or select high-return transactions only.
DB6	Very high risk	Expected returns subject to large degree of volatility. A very high expected return is required to compensate for the additional risk or the cost of hedging such risk.
DB7	Highest risk	Returns are almost impossible to predict with any accuracy. Business infrastructure has, in effect, broken down.