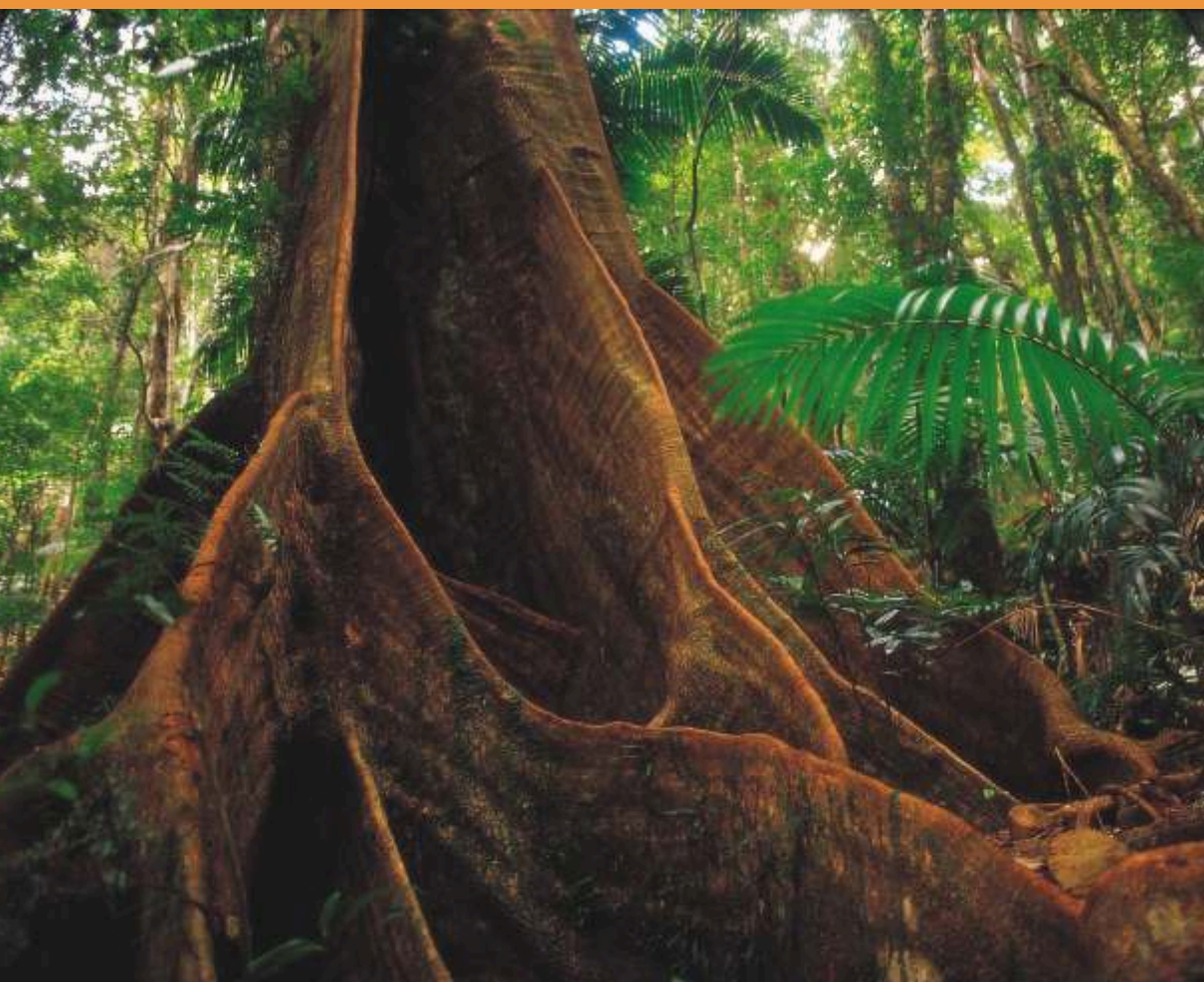


# Highlights of Argentina

A wrap-up of 2005  
and a forecast for 2006\*



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# 1 Political Environment

During 2005 the Government passed its election test with flying colors, gaining a high level of popular support. With this backing, the Kirchner administration raised the stakes and, emulating Brazil, announced that it planned to repay in advance the country's entire \$9.5 billion International Monetary Fund (IMF) debt in January 2006. This would be done using Central Bank reserves, sharply higher as a result of the monetary authority's policy for maintaining a fixed and high exchange rate, and a positive balance of trade that benefited from favorable conditions on foreign markets.

This decision was more political than economic. The Government considers that such a move will increase Argentina's economic sovereignty and will favor its return to international capital markets, following the private debt renegotiation.

The real economy has shown a strong recovery, and economic agents are increasingly optimistic about growth prospects. Sustainable growth will nevertheless require the adoption of certain key structural measures, particularly in relation to investment and inflation. Special care should be taken with government spending, as in an economy that is working at full capacity, excess demand could be dangerous and could destabilize the entire economy.

The fact that many public utility rates have not been modified since the Government abandoned the currency board in 2001 means that there is a latent threat to inflation levels, as well to energy supplies, which could harm the industrial sector and place the sustainability of the recovery at risk.

# 2 Economic Performance

For the third year in succession, the economy grew at an estimated rate of 8% during 2005, with output levels in peso terms similar to those prior to the crisis of 2001. Many sectors are operating at full capacity, giving rise to serious concerns regarding the expected path of inflation and the real exchange rate.

## **GDP**

The expected 8% rise in GDP at constant prices for 2005 was mainly driven by construction, manufacturing, transport and financial activities. Government spending and social welfare programs continue to play an important role in stimulating consumption, but could easily provoke a rise in inflation if investment does not outperform the rise in capacity use.

## **Trade Balance and Balance of Payments**

The balance of trade continues to record a significant surplus, expected to reach US\$10 billion in 2005, although it will be lower than in previous years. Imports are rising faster than exports as the flourishing economy demands increased goods from foreign markets. This trend is likely to continue if domestic demand remains strong, although there are signs that export levels are picking up, so the problem may only be one of timing.

## **Public and External Debt**

The government exchanged a large portion of its defaulted sovereign debt during 2005, reducing its debt-to-GDP ratio by 27.5 percentage points. As a result, the country is paying substantially lower interest rates than in previous years. Regarding the announced pre-payment of outstanding IMF debt, a debt reduction program would have a positive impact on economic expectations, encouraging investment and trade.

## Industrial Activity

The manufacturing sector performed very well during 2005, with most sectors recording higher levels of production. The car and metal industries in particular posted strong gains in output. Demand for manufactured products is expected to continue to rise in the coming year, with a probable increase in exports.

## Unemployment

One of the main problems facing the Argentine economy during the last decade has been the exceptionally high level of unemployment. During 2005 there has been some improvement in this variable, but there is still a need for government policy to focus on improving skills to make it easier for worker to re-enter the labor market.

## Inflation

Argentina's inflation reached double figures during 2005, becoming the most important problem for the authorities. Rising demand, capacity constraints, monetary policy centered round a fixed nominal exchange rate, and growing wage pressure appear to be the main causes of this acceleration.

The government is trying to restrain inflation primarily by acting on its effects, although some structural measures are also being taken to cool inflation expectations.

## Exchange Rate

The Central Bank continued to build up its international reserves, which totaled US\$26 billion by the end of 2005. Purchases on the market helped keep the exchange rate steady at around AR\$ 3 per US\$ 1. The IMF repayment would not have a material impact on the nominal level.

## Interest Rates

Interest rates remained stable during 2005, and continue to converge on the path determined by the Central Bank. The monetary authority is making efforts to lengthen the duration of financial market contracts to ensure the availability of long-term funding.

## Fiscal Performance

The federal primary surplus agreed with the IMF was met and well exceeded by the Government in 2005. This was due to high Value-added tax receipts, and a strong performance by export and income taxes, reflecting the recovery in GDP. Tax revenues are continuing to rise sharply.



# 3 Taxes

2005 was not a year of major structural reforms in tax matters. The most significant changes were as follows:

## **General regulations and legislation on tax procedures**

Law 26044 (published in July 2005) made changes to tax procedural law, mainly to include measures to fight tax evasion, as follows:

- Creation of the “undercover tax agent” to perform certain inspections.
- Creation of presumptions applicable when making tax assessments.
- Changes to the tax fines system
- Suspension of the statute of limitation term for assessment and payment of taxes, in certain circumstances.

Law 26063 (published in December 2005) established measures to fight social security contribution evasion, including:

- Application of the economic reality principle
- Assessment of social security contributions calculated on the basis of estimates or presumptions, on a global basis if necessary (not for each employee).
- Presumption of the existence of a labor contract.

In August 2005, through the issue of RG 1926, the AFIP established information requirements in relation to the bringing in of funds from abroad for amounts in excess of US\$ 50,000 per month per person (natural or legal)

## **Income Tax**

Resolution 328/05 (published in October 2005), issued by the National Industrial Property Institute (INPI), established interpretation guidelines with regard to services that will not be considered to be transfer of technology, registration of which would therefore be denied by the Institute. Guidelines were also established for the registration of contracts that could be considered to cover technology not obtainable in Argentina. These interpretations have significant income tax implications, particularly regarding the applicable withholding rates.

In a ruling issued on June 30, 2005 in a case brought by Santiago Dugan Trocello S.R.L., the Supreme Court rejected the remedy applied for by the taxpayer, which had claimed the right to make use of the inflation adjustment mechanism laid down in the income tax law that had been suspended as from the beginning of the previous decade. The ruling was restricted to declaration that the remedy applied for was inadmissible, without analyzing the substance of the matter, although there were some indications that any decision on the substance of the matter would also be contrary to the taxpayer.

## **Value Added Tax**

Law 25988 (published on December 31, 2004) established a mechanism for the crediting against other taxes (or cash refund) of favorable VAT balances at September 30, 2004 arising from the purchase, construction or import of depreciable goods since November 1, 2000, setting an annual fiscal quota for the purpose. During 2005 this law was regulated, detailing the specific requirements to be able to opt for the system, which include the making of new investment subsequent to September 30, 2004, submission of forms and documentation, etc.

During 2005 regulations were issued on the system for the early refund of VAT arising from investments in new capital goods for use in industry, as well as investments in infrastructure, as established by Law 25924 on Promotion, subject to tenders and a fiscal quota. This law also contemplates accelerated depreciation for income tax purposes.

## Social Security Employer Contributions

Effective October 1, 2005 the monthly cap for determination of most employer contributions has been eliminated, thus complying with the schedule laid down in law in mid-2004, according to which the cap had been rising from AR\$ 4,800 (in May 2004) to AR\$ 10,000 (in September 2005). The monthly cap of AR\$ 4,800 continues in place for all social security deductions to be withheld from employees, as well as for a portion of the employer contributions.

# 4 Outlook

The economy is expected to continue with its bullish performance in 2006, as long as investment as a proportion of GDP continues to increase. There is a pressing need for investment in capital goods, energy and infrastructure, which would help to lessen the threat from inflation by transforming the productive structure.

In addition to the social consequences, if inflation continues at above 10% it could prove a serious impediment to economic development. There would be a direct negative impact on private and public spending, as well as indirectly -via the appreciation of the real exchange rate- in export-oriented industries.

The IMF repayment, although likely to have a favorable impact on expectations, could mean that the Central Bank will have less freedom to defend its monetary and exchange rate policy in the event of any crisis.



# 5 Principal economic indicators

	2002	2003	2004	2004*	2005**
GDP ** (Current AR\$)	312,6	375,9	447,6		527,3 (e)
GDP *** (Current US\$)	100,1	126,7	149,1		180,8
GDP ** (AR\$ 1993)	235,2	256	279,1	274,4	299,6
GDP per cap. US\$	2.727	3.424	3.983		4.686
GDP var (%) (AR\$ 1993)	-10,90%	8,83%	9,02%		8,30%
CPI var (%)	41,00%	3,70%	6,10%	5,22%	11,10%
WPI var (%)	118%	2,00%	7,86%	6,93%	10,70%
Exports ***	25,7	29,6	34,5	28,5	33,28
Imports ***	9,0	13,8	22,4	18,1	23,49
Balance of trade ***	16,7	15,8	12,1	10,4	9,8
Balance of payments current account var (%)	323,20%	-14,10%	-56,50%		19,93%
Fiscal balance **	-4,55	1,80	11,63	12,4	8,80
Fiscal Balance var (%)	-48,10%	-139,50%	546,11%		-24,30%
Gross Fixed Domestic Investment ** (Current AR\$)	37,4	56,9	85,8	81,2	106,3
Investment as % of GDP	12,00%	15,10%	19,16%		20,00%
Foreign debt ***	156,9	165,0	170,8	167,5	117,2
Foreign debt as a % of GDP	156,72%	130,23%	114,55%		64,80%
Foreign debt in years of exports	6,1	5,6	5,0		3,5
International reserves of the Argentine Central Bank***	10,48	14,12	19,65	18,38	26,05
International reserves as a % of the foreign debt	6,68%	8,56%	11,50%		22,23%

\* Same date at last data 2005

\*\* Latest available data

\*\* In billions of AR\$

\*\*\* In billions of US\$

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