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Paraguay: Article IV Consultation—Staff Report and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the Article IV consultation with Paraguay, the following documents have been released and are included in this package:

- the staff report for the Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **February 14, 2001,** with the officials of Paraguay on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 20, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 11, 2001, discussion** of the staff report that concluded the Article IV consultation.

The documents listed below will be separately released.

Recent Economic Developments
Letter of Intent *
Memorandum of Economic and Financial Policies by the authorities of Paraguay *
Technical Memorandum of Understanding *

* May also be included in the Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

PARAGUAY

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with Paraguay

Approved by Claudio M. Loser and Liam P. Ebrill

April 20, 2001

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I. Introduction

1. The 2001 Article IV consultation discussions with Paraguay were held in Asunción during January 30–February 14, 2001.[1] Paraguay has accepted the obligations of Article VIII, Sections 2, 3 and 4. The last Article IV consultation was concluded on March 1, 2000 (EBM/00/20). On that occasion Directors stressed the importance of reducing the fiscal deficit, implementing the recommendations of the FAD mission on the reform of the tax system and reorienting public expenditure toward the social sectors and basic infrastructure. Directors also emphasized interest and exchange rate flexibility and strict enforcement of the prudential regulations in the banking system. During the first quarter of 2001, the staff and the authorities agreed that the staff would monitor Paraguay's economic program for 2001. The program is outlined in this report for Board information, and its associated letter of intent is attached. The authorities have made their letter public.

II. Background

2. Paraguay's growth performance over the last 20 years has been disappointing, with real GDP per capita in 2000 below that of 1980. GDP growth has been particularly weak during the last five years, averaging less than 1 percent a year, compared with a population growth of 2½ percent (Figure 1). A banking crisis in 1995–98 led to reductions in credit to the private sector, a deterioration of the business climate and a sharp drop in private investment. This was compounded by a 20 percent drop in the terms of trade between 1998 and 2000, and by the effects of devaluation and recession in neighboring economies. Despite a strong fiscal impulse during 1999–2000, real GDP in 2000 is estimated to have decreased by 0.3 percent.

3. Inflation has been declining since the early 1990's. It reached its lowest level, around 5 percent, in 1999, but increased to 8½ percent in 2000 (Figure 1), mainly as a result of higher fuel prices and public utility tariffs, and a 15 percent raise in the minimum wage.

4. Weaker competitiveness and lower terms of trade widened the external current account deficit from 1.1 percent of GDP in 1999 to 4.2 percent of GDP in 2000. Higher inflation, and a nominal exchange rate that was maintained virtually unchanged throughout the year, led to an appreciation of the *guaraní* by 4.4 percent in real effective terms during 2000 (see Figure 1). Exports stagnated as the main commodity prices (soybeans, cotton) remained weak, while higher oil prices boosted the cost of imports.

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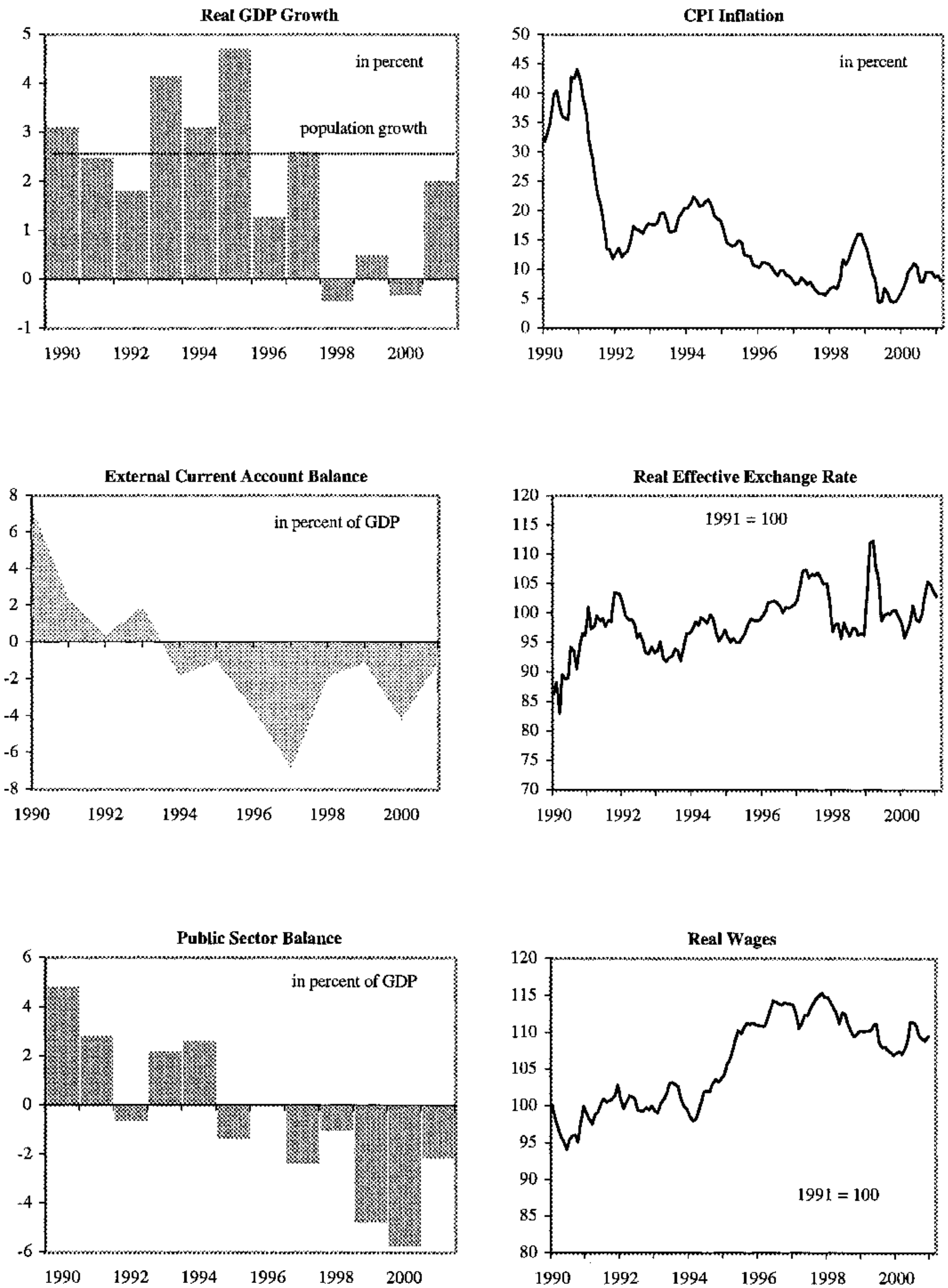
[1] The staff mission comprised Mr. Reichmann (head), Ms. Honjo, and Messrs. Braumann, Fuentes, and Jaramillo (all WHD).

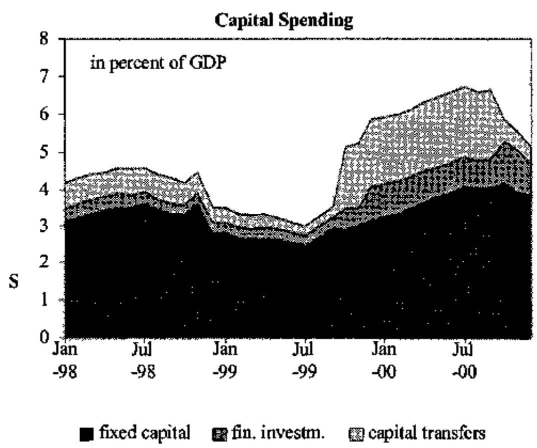
Figure 1. Paraguay: Selected Economic Indicators

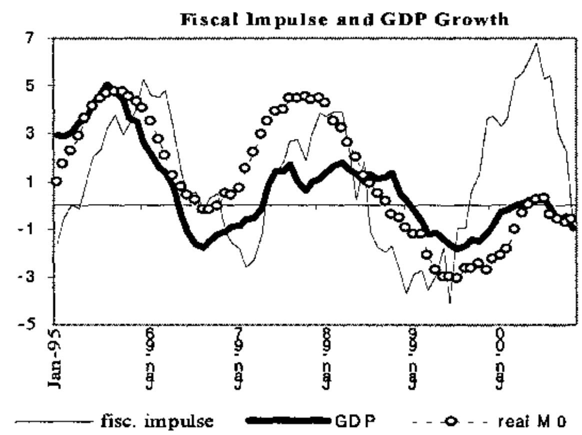


5. The central government produced fiscal surpluses in the early 1990s, but its financial position eroded after 1995 (Figure 1), with the deficit reaching 4.5 percent of GDP in 2000. Part of the recent deterioration was due to cyclical factors that resulted in lower tax revenues, but higher spending was the most important cause. Central government capital expenditure surged after the disbursement of two concessional loans in 1999 and early 2000 (Box 1). Current expenditure also expanded, reflecting increases in public sector employment and higher transfer payments to retired civil servants.

Box 1. The Effects of the Fiscal Stimulus

In July 1999 Paraguay made a 20-year bond placement totaling US$400 million underwritten by banks from Taiwan Province of China with an interest rate equal to that on US Treasury bonds of similar maturity. This was followed in January 2000 by a loan from the government of Taiwan Province of China for US$90 million. Together, the two operations amounted to 7 percent of GDP. This allowed a surge in capital spending of the central government, raising its share of GDP from 3 ½ percent in 1998 to 6 percent in 1999 and to 5 percent in 2000. Roughly, a fifth of the external funds were used to repay private depositors that had lost their savings in a banking crisis 1995–98. Most of these capital transfers were completed by the end of 1999. Around 40 percent of the external funds were spent on agriculture in the form of credits and transfers, especially in seeds and fertilizers. The remainder was devoted to counterpart funds for concessional lending from abroad directed mostly to road construction, and to additional current expenditure.



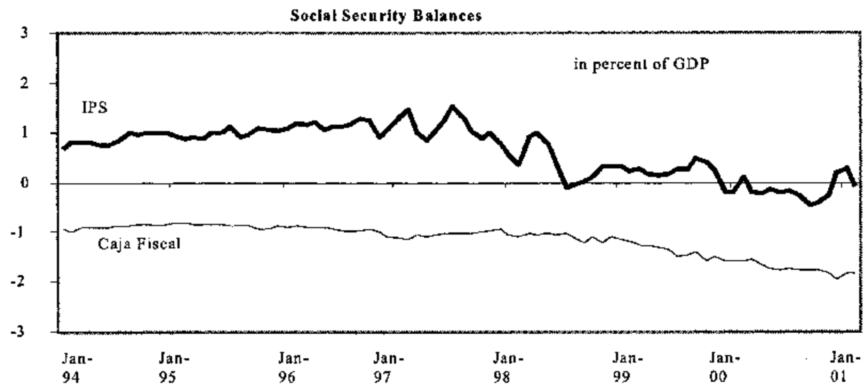


The massive injection of funds had temporary effects on the economy. GDP growth had been on a downward trend since 1995, but the fiscal impulse led to a brief recovery in growth, which created a short-term cycle during 1999–2000, superimposed on the declining growth trend. Activity indicators show positive growth rates during the first half of 2000, while narrow money aggregates halted their decline in real terms. The situation began to reverse in the third quarter of 2000 when most of the external resources had been used up.

6. Paraguay has two main social security entities (Box 2). In both, disequilibria are building up, reflecting poor management and a growing bureaucracy, and generating almost 1/3 of the public sector's deficit in 2000.

Box 2: Social Security in Paraguay

The two pillars of social security in Paraguay are the *Instituto de Previsión Social (IPS)*, which covers private sector employees, and the *Caja Fiscal*, covering most public sector employees. Together, both systems cover around 95 percent of contributing employees in Paraguay. IPS ran surpluses over most of the last decade, and is now breaking even. The system is still relatively young, with a high ratio of 8 contributors per beneficiary. Revenues at *Caja Fiscal* consist of contributions from workers (14 percent), and at IPS of contributions from employers (14 percent), workers (9 percent) and interest earnings on accumulated assets. The latter suffered a marked decline after 1997, when 50 percent of the investment portfolio became frozen in intervened banks. Of the remaining deposits, two thirds are concentrated in the troubled public bank.



Both the *IPS* and the *Caja Fiscal* operate on a pay-as-you-go basis and are estimated to be in actuarial deficits. In contrast to IPS, the public sector *Caja Fiscal* has been recording cash deficits for the past ten years, mostly reflecting the granting of benefits to individuals that have either not contributed to the *Caja* or have contributed for only a very limited time. In 2000, contributions covered only a third of benefit payments, with the remainder being financed from general tax revenues. The deficit of the *Caja Fiscal* has increased fourfold over the last five years, and is one of the main structural reasons for the rising deficit of the public sector.

7. Public enterprises recorded a deficit equivalent to 1 percent of GDP in 2000, as some tariff increases in September were insufficient to offset rising operational costs. The finances of the oil company (PETROPAR) deteriorated over the last two years, as the cost of imported oil rose by over 200 percent while its prices were increased by only 70 percent. The telecommunications company (ANTELCO) did not adjust its tariffs between 1994 and end-2000. After a long delay, Congress authorized the privatization of ANTELCO and the public water company CORPOSANA, to be carried out in 2001.

8. At about 32 percent of GDP at end–2000, Paraguay's external debt ratio has doubled in the past four years (Table 6). Virtually all the debt is owed to multilateral agencies or foreign governments, and has relatively long residual maturity. Debt service was equivalent to 9 percent of exports in 2000, up from 4 percent in 1996. As to net domestic debt, the

public sector has a net asset position of around 2 percent of GDP, mainly the result of former surpluses in the social security system.

9. Over the last two years, monetary policy was dominated by the financial implications of a rising fiscal deficit, in the context of a managed exchange rate.[2] After a small adjustment in January 2000 (Figure 2), the exchange rate of the *guaraní* was effectively pegged to the U.S. dollar until early 2001. In addition, the central bank lowered interest rates on its securities. Thus the full effect of the government's draw-down of deposits at the central bank reflected in a drop of net international reserves, which declined to US$651 million at the end of February 2001 (2.4 months of imports), down from US$896.7 million a year earlier[3] (Figure 2).

10. The financial crisis of 1995–98 led to the closure of most locally owned banks and, as a result, over 80 percent of the banking system assets are at present in the hands of foreign institutions. While private banks that survived the banking crisis are generally sound, with the capital adequacy ratio hovering at around 21 percent during 1999–2000, the 1998–2000 recession deteriorated their asset quality and weakened their profitability[4]. Nonperforming loans of private banks increased to 11.8 percent of total loans by end 2000, up from 8.1 percent in 1998, while an increase in loan loss provisioning (which remains relatively low at less than 50 percent of nonperforming loans), was constrained by continued low profitability, with pre-tax profits in the order of 1.5–2.0 percent of total assets (Table 5). Reflecting an increase in bankers' risk perception since the financial crisis, private banks have restricted new loans and have preferred to increase their holdings of liquid foreign assets (Table 4). Dollarization, as measured by the proportion of foreign currency deposits in M3, stands at 51 percent.[5]

11. The publicly owned *Banco Nacional de Fomento* (BNF), is the only remaining public bank and is the weakest institution in the financial system, with 44.5 percent of its portfolio nonperforming (Box 3). Its share in total deposits declined from 11 percent in 1998 to 6 percent by end–2000. The government has had to transfer public deposits to help BNF

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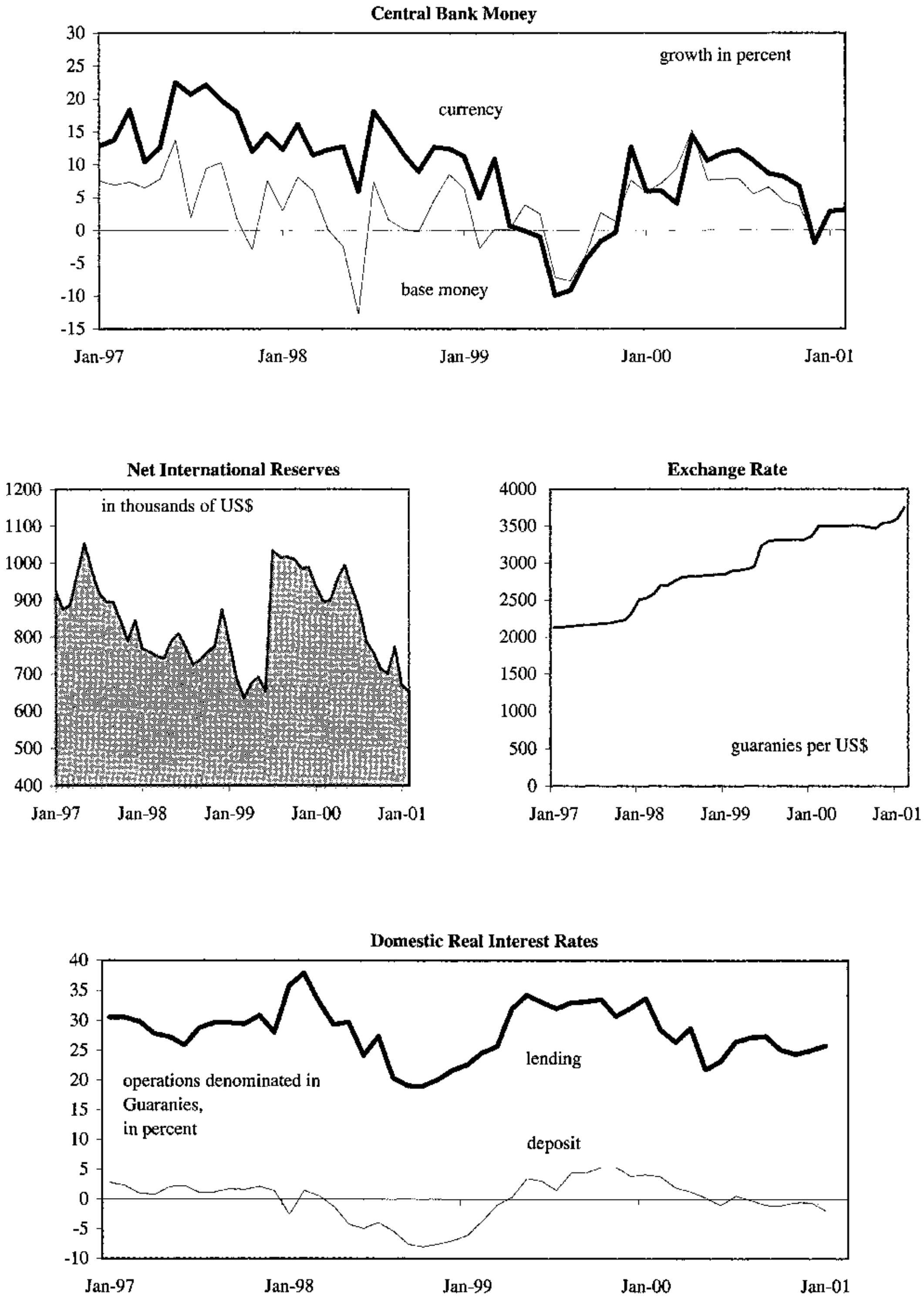
[2] The authorities characterize Paraguay's exchange rate arrangment as floating, although in practice they maintain the exchange rate stable, subject to very occasional step-wise adjustments.

[3] Just before the disbursement of the concessional loans in 1999, international reserves stood at US$652 million.

[4] The capital adequacy ratio should decline, however, as loan provisions increase to more fully reflect declining portfolio quality.

[5] If deposits held in nonbank intermediaries (for which data is still scant) are included in M3, the dollarization ratio increases to 54 percent.

Figure 2. Paraguay: Selected Financial Indicators



Source: Central Bank of Paraguay.

bolster its liquidity. In early 2001, the authorities created a generous refinancing scheme for industrial sector nonperforming loans at the BNF (and at banks that are being liquidated). The only operational limitation established for access to this scheme, aside from being an industrial firm, is the expected financial viability of the refinanced firm. Although the costs are to be borne by the Government, the decision creates an unequivocal moral hazard that may affect an already fragile institution.

Box 3: *Banco Nacional de Fomento*

The finances of the National Development Bank (BNF) have deteriorated markedly since 1998. Although by then the bank already showed financial distress, the prolonged recession further eroded its financial position. **Losses** incurred during 1998-2000 totaled US$28 million. However, recorded losses would have been higher had adequate provisions been made to deal with the decline in asset quality: while in March 1998, 74 percent of the bank's loans were classified as high quality (rank 1), in December 1999 these were only 49 percent. The deterioration was more striking when developments regarding **collateral** are considered. Since 1998, a massive amount of collateral documentation has disappeared from the bank, while further deterioration resulted from the practice of accepting future crops as collateral. As a result, in 1999 over 76 percent of low quality loans did not have any collateral. In December 2000, past due loans reached 45 percent of total loans despite the bank's refinancing of a large part of its overdue loans. At end-2000, nearly 60 percent of past due loans had not been provisioned.

The portfolio's deterioration largely reflects problems in the bank's legal **structure**, which establishes that all obligations of the BNF are fully guaranteed by the state and that losses attributable to agricultural loans are covered by the government. It also specifies very rigidly how the bank should be organized; and stipulates that the majority of the board be representatives of the bank's main clients. **Other problems** include (i) obsolete credit manuals; (ii) extensive use of exceptions in credit procedures; (iii) poor loan payment collection systems that do not allow for partial payments on amounts due; (iv) cumbersome and time-consuming foreclosure procedures; and (v) an inadequate accounting system that does not allow the bank to compute its due collections, or credit and interest balances on a daily basis.

Political influence further distorted the bank's operations by affecting loan approvals and by forcing the bank to provide subsidies without the corresponding fiscal resources. BNF loans are highly concentrated among a few dozen well-connected clients, as roughly 2/3 of its loans are in hands of less than 5 percent of clients. Of past due loans, the 50 largest loans, accounting for half of all past due loans in December 1999, were owed by 0.3 percent of total clients. Furthermore, the bank has so far been unable to successfully prosecute large but influential delinquent borrowers.

BNF: Asset quality ratios (in percent)

	1995	1996	1997	1998	1999	2000
Non-performing loans (NPL)/total loans	10.2	14.1	17.6	40.3	50.0	44.5
Loan provisions/NPL loans	32.0	25.4	19.0	29.9	36.0	40.3
Loan provisions/total loans	3.3	3.6	3.4	12.0	18.0	18.0
Uncovered NPL/total loans	6.9	10.5	14.3	28.2	32.0	26.6
Uncovered NPL/NPL	67.9	74.6	81.0	70.1	64.0	59.7
Uncovered NPL/net worth	47.7	76.5	105.7	144.6	182.4	144.9
Net worth/total assets	11.0	10.3	11.1	15.9	13.6	11.8

Sources: Banking Superitendency, Banco Nacional de Fomento, and World Bank report on BNF.

III. Policy Discussions

12. The authorities explained that their two immediate concerns were low GDP growth and the deterioration of the public finances. They noted that the growth revival sought in 1999–2000 through fiscal expansion was thwarted by internal political instability, subdued demand from neighboring countries, and falling terms of trade. They added that as a result of incentives provided to agriculture, cultivated areas had increased and bumper crops were expected in 2001, and should support GDP growth, although low international prices for cotton and soybeans were likely to limit the impact of agriculture on overall economic activity. They expected growth to reach 2.8 percent in 2001. On the fiscal issue, the authorities explained that the increased deficit had resulted from both policy decisions and adverse cyclical factors, but that during 2001 they would rein it in significantly, in order to place the public finances on a sustainable path.

13. The staff agreed that good harvests would support GDP growth in 2001, but indicated that a durable upturn required that private sector confidence be revived and that progress be made in confronting the basic structural problems of the country, such as those in the labor market, the tax and social security areas, and the public administration. Staff projects a 2001 real GDP growth of 2 percent. It believes that confidence would be enhanced by credible policies to halt the weakening of the fiscal position and international reserves, and by a firm implementation of the government's structural reform agenda. The staff agreed fully with the authorities on the need for fiscal adjustment, noting that the lack of finance, internal and external, would mark the limits of the fiscal deficit for 2001.

A. Fiscal Policy

14. The government intends to reduce the central administration's deficit in 2001 to about half the nominal level registered in 2000, which is consistent with the noninflationary financing that would be available. This is equivalent to a reduction from 4.5 percent of GDP to 2.0 percent of GDP, to be achieved primarily through adjustments in the expenditure of the central government, which would decrease by around 2.2 percentage points of GDP, and to a lesser extent through revenue measures. Expenditure restriction would come from reforms aiming at a leaner and more cost-effective civil service and from a more moderate level of public investment. Public sector wages will be frozen in nominal terms and public employment will be restricted, while overtime pay would be curtailed sharply. Spending on goods and services would also be curtailed, with interest payments expected to benefit from lower LIBOR rates. Capital spending would be scaled back from the very high levels of 1999 and 2000, which had been made possible by the extraordinary external finance available during those years.

15. Revenues of the central government are expected to increase by around ½ percentage point of GDP in 2001, reflecting changes already adopted in the tax system, including increases to the excise tax on diesel in late 2000 and early 2001; the elimination of a facility that permitted banks to deduct increases in their required capital from profits; the inclusion of transport and personal services in the VAT tax base; and the elimination of VAT exemptions

on goods in the re-export trade. Also, net royalties from the Itaipú hydroelectric plant are expected to increase, as the central government will no longer need to cover arrears of the electricity company, following the increase of electricity tariffs early this year.

16. The staff welcomed the expenditure restraining measures, particularly regarding current expenditure, was less sanguine than the authorities regarding their full immediate implementation, and encouraged the authorities to resist the many pressures emerging to reinstate expenditure to its recent high levels. The staff was of the view that, given the protracted recession, tax increases ought to be limited in 2001. The authorities explained that they had recently adopted a variety of measures to improve tax administration. These included the identification and removal of focal points of corruption in customs offices; the designation of service providing agencies, such as credit card companies and real estate offices, as fiscal agents for VAT collection; a clamp-down on the abuse of the nonprofit classification as a means to avoid taxes; the narrowing of the scope of re-export trade and increased transparency of customs procedures applicable to it; and the introduction of a "fiscal lottery" to provide incentives to consumers to request their VAT receipts. The government has been discussing these measures with affected parties in order to elicit their cooperation in the tax collection effort.

17. The authorities noted their intention to adopt additional measures during 2001 to streamline the tax system and strengthen revenues, along the lines suggested by the 1999 FAD tax mission. The government plans to introduce changes to the presumptive income tax and the VAT. It will also present draft legislation to Congress to widen the coverage of the VAT to personal services; impose the VAT on the import and distribution of oil products; increase excise taxes on luxury imported goods; concentrate the collection of the land tax (IMAGRO) on the 3000 largest landholdings; and reduce the scope of tax exemptions granted to foreign investors. The staff welcomed the authorities intentions to improve the tax system. It was of the view that the implementation of FAD's recommendations of 1999, would be key to provide resources over the medium term to finance improvements in basic infrastructure and social services. It noted, however, that the likelihood of obtaining immediate gains would be relatively low due to the weakness of the economy and lack of political support.

18. The staff expressed concern over the rapid increase of Paraguay's public debt. Total external public debt rose from 15 percent of GDP in 1996 to 33 percent of GDP at end 2000, reflecting high loan disbursements during 1998–1999, and the arrears of the electricity company that were recently formalized in a long-term loan. The staff noted that there were significant public sector obligations that, although not yet recorded as formal debt, represented real liabilities that the public sector would eventually have to confront. These included the losses incurred by the social security system during the banking crisis of the 1990s, the actuarial deficits of the publicly run social security systems, and the losses of the BNF (see below). The existence of these liabilities advised in favor of limiting further the growth of the public debt. The authorities explained that net disbursements of foreign loans were not expected to exceed US$100 million in 2001. They added that the central government had issued around US$200 million in domestic debt over the years, part of which

were held by the social security system. The government is preparing a consolidation of the public sector's debt accounts so as to allow the future monitoring of the total debt of the public sector. This work is to be concluded by June 2001. The program being monitored by the staff sets quarterly limits on the central government external debt.

19. The financial performance of the public enterprises is expected to improve this year as a result of tariff adjustments approved in the last quarter of 2000 and in early 2001. With a view to privatizing the telephone company, its rates were restructured and aligned with those of international long distance and cellular competitors. Also, to help privatize the water and sanitation company, its rates were increased by 10 percent. Fuel prices were recently increased to reflect world oil prices and currency depreciation. Electricity rates will be increased by 2.6 percent per month in the nine month period through September 2001 to eliminate operational losses. The staff noted that delays in tariff adjustments had created losses and severe cash flow problems in the public enterprises, and encouraged the government to move to a system of more frequent, albeit small, adjustments of tariffs to reflect changes in operating costs.

B. Structural Reforms

20. The authorities explained that during 2001 they would push ahead with public sector reform. The privatization of the telecommunications and water and sanitation companies (ANTELCO and CORPOSANA) is now expected to be completed before end–2001 (sale proceeds are not reflected in revenue projections). Regarding government agencies currently slated to be restructured or closed, Congress had authorized budgetary support only until June 2001 when a final decision is expected on their future status.[6] Additionally, with assistance from the Inter American Development Bank, the government is preparing draft legislation for the reform of the Central Administration, the restructuring of the public bank (BNF), and the consolidation into a single institution of several small second tier financial entities operated by the public sector. Work is also underway on the preparation of the regulatory decrees for the concessions law, to permit the private management of road maintenance and the private operation of toll roads.

21. The staff noted that progress was lagging in the reform of labor legislation applicable to public sector employees, where rigidities were a major obstacle to a leaner public sector. The authorities explained that last December Congress approved Law 1626, modifying labor relations applicable to public sector employees. The objectives of the new law were: the unification of labor legislation applicable to all branches of the public sector; the establishment of clear parameters for a professional public sector career; improvements in

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[6] These include the railroad, the National Housing Council (Conavi), the Municipal Development Institute (IDM), the National Indigenous People Institute (INDI), and *Banco Nacional para la Vivienda* (BNV). The latter, despite its name, is not a financial intermediary, but rather a public institution channeling subsidies to low income housing.

controls on personnel appointments; the establishment of compulsory retirement parameters for all public sector employees (except for the military); the equalization of work hour requirements among different public sector agencies; and rationalization in the use of remunerated overtime. The authorities noted that although Law 1626 did not eliminate the virtual tenure enjoyed by public employees, they believed it created a more balanced application of labor regulations among all public sector employees, which would result in a more professional public sector work force over the medium term. They would, however, continue to pursue more flexible regulations governing public sector employment.

22. The staff expressed serious concern over the deterioration of the social security systems. Regarding the Instituto de Prevision Social (IPS), the mission insisted that the joint management of old-age pensions and health services be separated to eliminate wasteful practices, the systematic use of pension resources to finance current expenditure in the health area, and room for corruption. The staff also questioned the advisability of portfolio management practices that included direct lending by IPS to the private sector, as well as the infusion of IPS resources to support BNF, the ailing public bank. As to the difficulties in the *Caja Fiscal,*[7] the staff noted that the rapid increase in public sector employment over the last decade should have generated surpluses of contributions over benefits, and not deficits. The authorities explained that legislative decisions had given access to pension benefits to individuals who had contributed for relatively short periods or not at all. As a result, contributions to the *Caja* currently cover only of benefit outlays, with the central government filling the gap (about 2 percent of GDP in 2000). The staff insisted on the need to align pension benefits for public employees with contributions by directly lowering current benefits and, if necessary, by increasing the age at which benefits are paid. The authorities pointed out that they were currently studying the shift from the current pay as you go system, to a system based on individual accounts, but added that the complete overhaul of the social security system would be a lengthy process. The staff encouraged the authorities to actively pursue this change.

C. Monetary Policy and Bank Reform

23. The staff noted that price stability should remain the objective of monetary policy, and added that the authorities could ill afford further losses of international reserves. Thus they would need to be prepared to raise interest rates as needed to counter inflationary pressures, and to let the exchange rate move as necessary to protect reserve levels. The authorities expected that the adjustment of the fiscal accounts would reduce the draw-down of government deposits at the central bank, eliminating the major source of monetary expansion of recent years. Moreover, the Central Bank of Paraguay (BCP) would conduct an active and independent monetary policy, focused on lowering inflation and, given the need to

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[7] The *Caja Fiscal* is the social security system applicable to most public sector employees.

preserve the level of international reserves, would allow the exchange rate to be determined by market forces.[8]

24. The authorities noted that several years of economic stagnation had adversely affected the quality of banks' portfolios but that, overall, the private financial system remained sound. The staff stressed the need to require capitalization to ensure bank soundness and was assured that all banks were complying with legal capital requirements and that, with the exception of the BNF, the system remained highly liquid. Private bankers explained that the increased risk perception over the past three years had reduced their willingness to extend new loans, leading the sector to maintain ample deposits abroad.[9] The authorities believe that the restructuring of significant volumes of loans in 2000 should lead to a moderate improvement in the quality of bank portfolios in 2001, and that the expected pickup in economic activity should further help improve bank earnings and prospects. The staff noted, however, that the high levels of loan restructuring would probably restrict banks willingness to extend new loans in the future, and added that a more flexible exchange rate management could affect the quality of bank portfolios. On the latter issue, the authorities noted that they did not expect a major deterioration in so far as movements in the exchange rate were gradual. They acknowledged, however, that a sharp unexpected variation of the exchange rate could affect the capacity to pay by some borrowers, and could thus affect portfolio quality. About 55 percent of bank loans to the private sector are denominated in U.S. dollars.

25. Reform seems to be on the way for the public bank. The staff argued that the situation of the BNF had to be addressed promptly and, based on the findings of a World Bank mission that visited Asunción at the time of the discussions, urged the authorities to restrict the bank's activities to a sub-group of its present clients, namely agricultural borrowers without access to private commercial bank credit. It also emphasized the need to avoid the concession of large loans to any single borrower. The authorities agreed to restructure the bank (see paragraph 20 of the attached MEFP) and orient new loans exclusively towards small rural borrowers in the agricultural, agro-industry and forestry sectors. To this end, the restructured institution would obey strict limits in regard to the amount of the loans it can extend to a single borrower.[10] The government expects the new scheme for the public bank to be operational before the end of the year, while the current loan portfolio that does not meet the new guidelines is gradually liquidated through the transfer of its management to an

[8] The authorities program includes quarterly floors on international reserves and quarterly ceilings on the net domestic assets of the Central Bank of Paraguay, as explained in the Technical Memorandum of Understanding attached to the Letter of Intent.

[9] During 2000, banks increased their liquid holdings abroad by over US$110 million.

[10] A maximum of US$15,000 per individual borrower, except in loans to cooperatives that on-lend to members, where the maximum would be $50,000.

independent trust.[11] The process of reform of the public bank is a structural benchmark, for June and December 2001, in the authorities' economic program.

26. The mission disagreed with the government's plan to reschedule nonperforming industrial loans, and insisted that the market participants should be permitted to deal freely with problem loans. It questioned the authorities' plan on moral hazard and fiscal grounds and noted that, although this could be a first step in the government's transformation of BNF, it would also have the unwanted effect of diluting prudential regulations that limit the extension of new loans to nonperforming borrowers. The banking superintendency acknowledged that the scheme could favorably affect the delinquent borrowers' credit ratings, but explained it had clearly instructed banks to reclassify borrowers strictly on their actual capacity to service all their obligations. The authorities acknowledged the moral hazard issues involved, but felt that their action was justified on grounds of preserving employment and fostering growth. As to the fiscal cost, they noted that failure to reschedule the loans would lead to the liquidation of most of the debtor firms, implying the write-off of the corresponding loans in the public bank. They thus believed that, either way, the fiscal costs had already been incurred.

D. External Sector

27. The authorities estimate that the current account deficit would decline to 1.1 percent of GDP in 2001, from 4.2 percent of GDP in 2000, reflecting mainly favorable soybean and cotton harvests, which account for about 40 percent of exports. Volumes of exports of both commodities are expected to grow by around 30 percent, although their prices are expected to drop by 6 percent. Continued growth in Brazil is also expected to foster growth of nontraditional exports, while lower petroleum prices in 2001 will reduce the value of imports.

28. The staff agreed with the authorities that as a result of the fiscal adjustment and of a moderate real depreciation of the *guaraní*, competitiveness would probably improve somewhat in 2001, promoting nontraditional exports and curbing import demand. The staff estimates that a real depreciation of the *guaraní* of about 9 percent during 2001–2002 would place Paraguay's real exchange rate at a sustainable level. On the other hand, the re-export business would probably continue to decline in 2001 as a result of the MERCOSUR integration. The authorities noted their efforts to improve the quality of export products, especially meat, through more stringent sanitary controls, and to foster the *maquila* (assembly) industry through tax exemptions to firms that mostly export their output.

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[11] A set of operational strategies to deal with the BNF's restructuring, including reforms to its legal and governance structures, was presented to the authorities by the World Bank mission that visited Asunción at the same time as the IMF mission.

29. Although Paraguay is a moderately restrictive economy as measured by the Fund's trade restrictiveness index,[12] it in nevertheless relatively open, with exports and imports in 2000 at 40 and 46 percent of GDP, respectively. The authorities explained that Paraguay's imports are not hampered by nontariff trade restrictions and the government is seeking to obtain the removal of frequently changing nontariff barriers affecting Paraguayan exports to MERCOSUR. They added that the government is committed to the MERCOSUR agreement to harmonize external tariffs and remove internal tariffs by January 1, 2006. They added that Paraguay had already removed all tariffs on goods imported from MERCOSUR with the exception of those on sugar.[13] The adjustment to the common external tariffs will imply increasing some tariffs, including intermediate products made in Argentina and Brazil, automobiles and electronic consumption goods.

E. Medium-Term Prospects

30. Two medium-term scenarios were analyzed. Both assume that the authorities follow a prudent fiscal policy after making the 2001 adjustments, and that they remain committed to the reform of the public sector over the medium term. However, given the uncertainty surrounding the growth prospects of Paraguay's neighbors (and main trading partners), the scenarios differ on their assumptions regarding the external environment. The baseline scenario takes a relatively optimistic outlook regarding the region's short-term growth prospects. Led by exports, Paraguay's growth would increase vis-à-vis rates observed in recent years, and the external current account would gradually converge towards equilibrium. The other scenario is pessimistic regarding the short-term growth prospects of the region. It assumes that export growth (and thus GDP growth) are lower than in the baseline scenario during 2001 and 2002, but that in 2003 the region's growth revives, as would Paraguay's exports and GDP.

31. In the baseline scenario (Table 8a), the output gap—which is estimated at around 4 percent of GDP in 2000—will gradually close. Initially, GDP growth would rise to 3½ percent before converging to 3 percent, which staff considers the potential rate under present conditions. Growth would be led by external demand, as the fiscal adjustment during 2001 and beyond dampens domestic demand. A modest real depreciation of the *guaraní* in 2001–02, a pickup in external demand, particularly in Brazil, and higher export prices would facilitate the crowding-in of net exports. After some downsizing of the re-export business, growth in export and import volumes is assumed to accelerate to around 6 percent, reflecting improved terms of trade and a real effective currency depreciation of

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[12] Paraguay currently has a rating of "5" under the Fund's restrictiveness index.

[13] Agreement has yet to be reached on common external tariffs on automobiles and sugar. Paraguay proposes a 20 percent tariff on automobiles. Argentina and Brazil favor a 35 percent tariff. Currently, Paraguay's external tariffs on automobiles range between 10 and 20 percent.

about 7 percent through end 2003. Parallel to the move to fiscal balance, the external current account would improve and return to balance by 2006. The privatization of ANTELCO and CORPOSANA would give a boost to private sector investment, while allowing for an increase in international reserves. With the public sector deficit narrowing towards balance at the end of the projection period, external public debt would level off near 33 percent of GDP, close to its present value. The decrease of public borrowing would also favor a recovery of private credit to accompany the rise in investment. National savings would increase by 4 percentage points of GDP by the end of the projection period, mainly reflecting fiscal performance. Inflation would decline gradually from the current 8½ percent, into the lower single digits.

32. In the second scenario (Table 8b), the lack of foreign demand growth sources to compensate 2001's negative fiscal impulse leads to stagnant GDP and export growth, and to dampened import growth. The current account deficit, after reaching almost 3 percent of GDP in 2001 would decrease towards 1 percent of GDP in the outer years (2005–06). The assumption regarding private financing and revenue from the privatizations of ANTELCO and CORPOSANA in 2002 would remain as in the baseline scenario. International reserves would fall by over US$110 million in 2001, but would tend to stabilize thereafter. The external debt ratio would continue to grow but would stabilize around 36 percent in the outer years. This scenario would require that the government's current program be revised, either to permit a higher reserve loss than currently envisaged for 2001 or, preferably, to incorporate the effects of a higher currency depreciation than in the baseline scenario. It would also require a revision of present fiscal targets.

IV. Staff Appraisal

33. The Paraguayan economy stagnated again during 2000. Aggregate demand was weak despite a large fiscal impulse, due to an adverse external environment, low export prices and high oil prices. Growth was also hampered by political instability and low private sector confidence. Cultivated areas appear to have increased significantly in the second half of 2000, however, improving harvest prospects for this year. As Paraguay's growth traditionally responds well to good crops, the staff believes that growth will revive this year to about 2 percent. For the medium term, the staff considers that sustained growth requires that confidence be restored among local and foreign investors and, to this end, the authorities' plans for 2001 appear to be a step in the right direction, particularly if planned structural reforms are implemented. It is true, however, that Paraguay's outlook may be clouded by the economic instability that may continue to affect the region.

34. Lack of financing, internal and external, will force an adjustment in the public sector's accounts. Since little can be expected from increased taxation in the face of a weak economy, resources will not be available to maintain the levels of expenditure of the recent past. The government's economic program seeks to contain the deficit primarily through scaling back investment, a wage freeze, and public employment curtailment. It also contains important measures to curb tax evasion and extend the tax base to de-facto exempt groups. A

successful implementation of the program will require the government to resist pressures to increase expenditure again. Furthermore, the staff believes that a durable fiscal containment will require decisive actions, based on benefit restrictions, to correct the growing imbalance in the *Caja Fiscal.* On a longer-term perspective, the staff encourages the authorities to strengthen the tax base along the lines of FAD's recommendations of 1999. This would provide resources to finance improvements in basic infrastructure and social services, and would help make the tax and expenditure system more amenable to reducing growing rural inequality in land ownership and income.

35. The financial situation of the Social Security Institute (IPS) continues to deteriorate reflecting poor management and investment policies. The staff urges the authorities to break-up the joint management of IPS's health and pension sections, which has contributed to the deterioration in IPS. Also, the IPS should reduce the proportion of its deposits held at BNF, refrain from providing further direct loans to private sector borrowers and expedite the recovery of existing loans.

36. Delays in the adoption of tariff adjustments in the public enterprises led to a deterioration in their finances. The authorities are correct in insisting that enterprise inefficiencies cannot be compensated for by ever-increasing tariffs. Staff believes, however, that more frequent but small adjustments to tariffs (in both directions) may be a way of avoiding the traumatic large increases that provoke resistance. The staff welcomes the progress made in the privatization of the telecommunications and water and sewage companies, and encourages the authorities to forcefully press Congress to increase the number of enterprises to be privatized, and to authorize the planned reforms of the central administration.

37. Price stability should remain the objective of monetary policy. At the same time, the staff is of the view that with the current low level of international reserves, the authorities can ill afford further losses. Thus the authorities would need to be prepared to raise interest rates as needed to counter inflationary pressures, and to let the exchange rate fluctuate as necessary to protect reserve levels. In this context, the staff welcomes the intention of the authorities to increase the level of net international reserves in 2001, and believes that, if the fiscal adjustment included in the authorities' program is enforced as planned, the use of central bank deposits by the government will be limited, reducing possible destabilizing pressures on the exchange rate and on inflation. However, if the situation in the southern cone region were to deteriorate further over coming months, the *guaraní* would tend to depreciate further, a trend that should not be resisted, but that would require and a more aggressive monetary stance to avoid higher inflation while preventing further drains on international reserves.

38. The authorities program envisages a gradual depreciation of the *guaraní* over 2001–2002, and the staff agrees that under current circumstances a more depreciated exchange rate could help Paraguay manage its adjustment process. However, in view of emerging fragilities in the banking system after three years of recession, sharp fluctuations of the exchange rate should be avoided to minimize the risks of debilitating bank soundness. The tight fiscal

stance envisaged in the authorities program will enhance the prospects of successfully achieving this difficult balance.

39. During 2000 the BNF's finances continued to deteriorate. The costs that are being incurred to keep this bank operating do not seem justified in terms of the benefits it provides to society. BNF's problems have been years in the making and will be very difficult to overcome because of problems with the bank's legal structure, with the composition of its board of directors, and because of political interference in the day-to-day management of the institution. The staff thus believes that the authorities should seek an alternative to the present bank that tries to avoid its shortcomings. A small institution, focused on the small and medium sized farmer lacking access to the private banking system, would be a better alternative in terms of cost, the democratization of access to credit, and the effective channeling of financial resources to agriculture.

40. Progress has been made in improving Paraguay's statistical base, most notably in the areas of balance of payments statistics, monetary statistics and the financial situation of the central government. Technical assistance by the Fund played an important role in this process. Nevertheless, weaknesses remain, particularly in national accounts calculations, public enterprise statistics and external tariff statistics, which hamper a meaningful discussion of macroeconomic policy. These limitations can be partly addressed by implementing the recommendations of recent technical assistance missions by the Statistics Department, and also by strengthening the institutional capacities that support the compilation of the data in different government agencies.

41. It is recommended that the next Article IV consultation with Paraguay be held on the standard 12–month cycle.

Table 1. Paraguay: GDP and Prices

	1996	1997	1998	1999	Est. 2000	Proj. 2001
	(In percentage change)					
Real GDP	1.3	2.6	-0.4	0.5	-0.3	2.0
Real GDP per capita	-1.3	0.0	-3.0	-2.1	-2.9	-0.6
Consumer prices (end of period)	8.2	6.2	14.6	5.4	8.6	9.8
	(In percent of GDP)					
Gross domestic investment	**23.4**	**23.6**	**22.9**	**23.0**	**23.2**	**21.7**
Private	17.7	15.1	15.7	13.4	14.3	14.4
Public	5.7	8.5	7.2	9.6	8.9	7.3
Gross national savings	**19.7**	**16.7**	**21.0**	**21.9**	**19.0**	**20.7**
Private	14.0	10.6	14.8	17.0	15.7	15.4
Public	5.7	6.1	6.2	4.9	3.3	5.2
Memorandum items						
GDP (In billions of guaraníes)	19,805	20,934	23,437	24,144	26,216	29,844
GDP (In millions of U.S. dollars)	9,601	9,555	8,505	7,707	7,511	7,435

Sources: Central Bank of Paraguay; and Fund staff estimates.

Table 2. Paraguay: Operations of the Consolidated Public Sector 1/

	1995	1996	1997	1998	1999	2000	Proj. 2001
	(In billions of *guaraníes*)						
Revenue	**3,811.0**	**4,040.7**	**4,495.2**	**5,442.3**	**5,617.6**	**5,884.1**	**6,949.3**
Tax revenue	2,152.6	2,285.6	2,463.5	2,729.1	2,685.7	2,975.4	3,376.5
Nontax revenue and grants	1,140.9	1,295.8	1,499.4	1,773.5	2,056.7	2,088.7	2,519.4
Public enterprises' operating surplus	451.1	418.6	478.8	901.1	820.6	767.5	1,003.0
Capital revenue	66.4	40.6	53.6	38.6	54.6	52.5	50.4
Current expenditure	**2,418.0**	**2,910.0**	**3,209.6**	**3,985.3**	**4,438.6**	**5,027.9**	**5,387.9**
Wages and salaries	1,362.0	1,658.0	1,866.9	2,221.1	2,451.2	2,811.4	2,931.8
Goods and services	331.7	415.6	452.9	568.6	528.9	584.9	635.9
Interest payments	182.8	168.8	180.5	302.0	321.6	404.5	518.7
Transfers	516.1	642.6	688.2	786.9	1,055.3	1,184.4	1,272.5
Other	25.4	25.1	21.1	106.8	81.6	42.6	29.0
Capital expenditure and net lending	**1,625.9**	**1,124.8**	**1,770.3**	**1,687.2**	**2,324.0**	**2,338.9**	**2,181.2**
Net lending by BCP	684.1	247.2	298.9	14.9	60.7	20.4	0.0
Current account balance	**1,393.0**	**1,130.6**	**1,285.6**	**1,456.9**	**1,179.1**	**856.3**	**1,561.3**
Overall balance	**-232.9**	**5.9**	**-484.7**	**-230.3**	**-1,145.0**	**-1,482.7**	**-619.9**
Financing	**266.4**	**-108.3**	**730.7**	**581.0**	**1,251.1**	**1,285.9**	**619.9**
External debt (increase +)	-43.6	81.0	599.0	329.0	1,186.4	1,611.4	239.6
Internal debt (increase +)	27.8	-317.7	-34.2	76.5	-202.3	-291.7	188.8
Monetary expansion	282.2	128.4	166.0	175.5	266.9	-33.8	191.4
Errors and float	-33.5	102.4	-246.0	-350.7	-106.1	196.8	0.0
	(In percent of GDP)						
Revenue	**21.5**	**20.4**	**21.5**	**23.2**	**23.3**	**22.4**	**23.3**
Tax revenue	12.2	11.5	11.8	11.6	11.1	11.3	11.3
Nontax revenue and grants	6.4	6.5	7.2	7.6	8.5	8.0	8.4
Public enterprises' operating surplus	2.5	2.1	2.3	3.8	3.4	2.9	3.4
Capital revenue	0.4	0.2	0.3	0.2	0.2	0.2	0.2
Current expenditure	**13.7**	**14.7**	**15.3**	**17.0**	**18.4**	**19.2**	**18.1**
Wages and salaries	7.7	8.4	8.9	9.5	10.2	10.7	9.8
Goods and services	1.9	2.1	2.2	2.4	2.2	2.2	2.1
Interest payments	1.0	0.9	0.9	1.3	1.3	1.5	1.7
Transfers	2.9	3.2	3.3	3.4	4.4	4.5	4.3
Other	0.1	0.1	0.1	0.5	0.3	0.2	0.1
Capital expenditure and net lending	**9.2**	**5.7**	**8.5**	**7.2**	**9.6**	**8.9**	**7.3**
Current account balance	**7.9**	**5.7**	**6.1**	**6.2**	**4.9**	**3.3**	**5.2**
Overall balance	**-1.3**	**0.0**	**-2.3**	**-1.0**	**-4.7**	**-5.7**	**-2.1**
Financing	**1.5**	**-0.5**	**3.5**	**2.5**	**5.2**	**4.9**	**2.1**
External debt (increase +)	-0.2	0.4	2.9	1.4	4.9	6.1	0.8
Internal debt (increase +)	0.2	-1.6	-0.2	0.3	-0.8	-1.1	0.6
Monetary expansion	1.6	0.6	0.8	0.7	1.1	-0.1	0.6
Errors and float	-0.2	0.5	-1.2	-1.5	-0.4	0.8	0.0

Sources: Ministry of Finance, Central Bank of Paraguay; and Fund staff estimates.

1/ Comprises the Central Government, the Social Security Institute, the Public Enterprises, the Central Bank and other public entities.

Table 3. Paraguay: Operations of the Central Government

	1995	1996	1997	1998	1999	2000	Proj. 2001
			(In billions of *guaraníes*)				
Total Revenue	**2,774.7**	**2,979.6**	**3,299.0**	**3,795.2**	**4,093.8**	**4,287.3**	**4,985.4**
Tax revenue	2,152.6	2,285.6	2,463.5	2,729.1	2,685.7	2,975.4	3,376.5
Social security contributions	171.5	210.8	227.3	244.6	288.0	300.4	333.5
Income taxes	404.1	440.9	429.8	474.4	552.2	513.6	508.8
Taxes on goods and services	1,084.4	1,189.8	1,324.6	1,483.5	1,446.7	1,664.2	1,967.7
Excise taxes	212.0	275.7	272.6	302.7	308.2	454.5	546.5
Value added tax	772.3	814.3	951.3	1,063.7	1,048.4	1,112.2	1,321.8
Stamp tax	64.9	68.3	75.1	76.1	68.8	68.9	80.6
Other	35.2	31.4	25.6	41.0	21.3	28.6	18.8
Taxes on international transactions	492.6	444.1	481.8	526.6	398.8	497.2	566.5
Import duties	492.6	444.1	481.8	526.6	398.8	497.2	566.5
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nontax revenue	560.5	653.7	792.8	1,028.7	1,364.7	1,261.5	1,561.0
Itaipu	346.0	369.3	528.8	749.6	996.8	781.2	997.7
Other (including grants)	214.5	284.4	264.0	279.1	367.9	480.3	563.3
Capital revenue	61.6	40.3	42.7	37.4	43.5	50.4	48.0
Current expenditures	**2,062.7**	**2,449.3**	**2,665.0**	**3,199.7**	**3,549.5**	**4,163.8**	**4,434.0**
Wages and salaries	1,149.7	1,386.4	1,551.1	1,818.0	2,021.4	2,338.6	2,413.5
Goods and services	257.1	300.0	307.5	332.2	250.4	307.8	317.3
Interest payments	127.9	96.5	101.7	170.4	193.2	310.7	440.0
Transfers	511.4	644.5	686.6	774.9	1,009.5	1,170.3	1,240.7
Other	16.6	22.0	18.1	104.1	75.1	36.5	22.5
Capital expenditures	**762.3**	**685.0**	**936.5**	**822.5**	**1,409.5**	**1,303.4**	**1,151.4**
Capital formation	564.6	532.8	747.8	728.0	978.9	1,188.9	1,062.6
Capital transfers	171.2	132.9	140.3	94.3	430.4	113.8	88.7
Other	26.4	19.3	48.4	0.3	0.2	0.6	0.2
Current account balance	**712.0**	**530.3**	**634.0**	**595.5**	**544.3**	**123.5**	**551.4**
Overall balance	**-50.2**	**-154.7**	**-302.5**	**-227.1**	**-865.2**	**-1,179.9**	**-600.0**
Financing	**61.8**	**14.7**	**331.1**	**367.6**	**1,008.1**	**838.7**	**600.0**
External debt (increase +)	164.1	60.9	115.7	318.3	1,525.6	347.7	217.0
Internal debt (increase +)	66.2	10.8	92.6	-4.7	166.3	-79.5	226.1
Central bank deposits (increase -)	-168.5	-57.0	122.8	54.0	-683.8	570.5	156.9
Errors and float	-11.6	140.1	-28.6	-140.5	-142.9	341.2	0.0
			(In percent of GDP)				
Total Revenue	**15.7**	**15.0**	**15.8**	**16.2**	**17.0**	**16.4**	**16.7**
Tax revenue	12.2	11.5	11.8	11.6	11.1	11.3	11.3
Social security contributions	1.0	1.1	1.1	1.0	1.2	1.1	1.1
Income taxes	2.3	2.2	2.1	2.0	2.3	2.0	1.7
Taxes on goods and services	6.1	6.0	6.3	6.3	6.0	6.3	6.6
Taxes on international transactions	2.8	2.2	2.3	2.2	1.7	1.9	1.9
Nontax revenue	3.2	3.3	3.8	4.4	5.7	4.8	5.2
Itaipu	2.0	1.9	2.5	3.2	4.1	3.0	3.3
Other (including grants)	1.2	1.4	1.3	1.2	1.5	1.8	1.9
Capital revenue	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Current expenditures	**11.7**	**12.4**	**12.7**	**13.7**	**14.7**	**15.9**	**14.9**
Wages and salaries	6.5	7.0	7.4	7.8	8.4	8.9	8.1
Goods and services	1.5	1.5	1.5	1.4	1.0	1.2	1.1
Interest payments	0.7	0.5	0.5	0.7	0.8	1.2	1.5
Transfers	2.9	3.3	3.3	3.3	4.2	4.5	4.2
Other	0.1	0.1	0.1	0.4	0.3	0.1	0.1
Capital expenditures	**4.3**	**3.5**	**4.5**	**3.5**	**5.8**	**5.0**	**3.9**
Current account balance	**4.0**	**2.7**	**3.0**	**2.5**	**2.3**	**0.5**	**1.8**
Overall balance	**-0.3**	**-0.8**	**-1.4**	**-1.0**	**-3.6**	**-4.5**	**-2.0**
Financing	**0.3**	**0.1**	**1.6**	**1.6**	**4.2**	**3.2**	**2.0**
External debt (increase +)	0.9	0.3	0.6	1.4	6.3	1.3	0.7
Internal debt (increase +)	0.4	0.1	0.4	0.0	0.7	-0.3	0.8
Central bank deposits (increase -)	-1.0	-0.3	0.6	0.2	-2.8	2.2	0.5
Errors and float	-0.1	0.7	-0.1	-0.6	-0.6	1.3	0.0

Sources: Ministry of Finance; and Fund staff estimates.

Table 4. Paraguay: Summary Accounts of the Banking System

	End of period					
	Dec-96	Dec-97	Dec-98	Dec-99	Dec-00	Dec-01 Prog.
	(In billions of *guaraníes*)					
	I. Central Bank					
Net external assets	**2,246.6**	**1,978.5**	**2,504.4**	**3,308.5**	**2,802.1**	**3,161.7**
Of which NIR	2,240.3	1,970.7	2,484.4	3,275.9	2,736.3	3,087.5
(NIR in millions of U.S. dollars)	1,062.3	845.8	874.8	988.2	771.9	771.9
Net domestic assets	**-541.4**	**1,656.8**	**524.4**	**417.8**	**936.9**	**778.9**
Credit to public sector	665.3	457.3	612.4	60.6	655.9	893.7
Net credit to banking system 1/	-133.5	190.9	-282.2	-375.0	-397.7	-633.6
Credit	926.1	1,309.4	1,063.2	1,137.5	1,151.2	1,151.2
Of which: to intervened banks	85.4	794.7	1,017.8	1,133.0	1,144.0	1,144.0
Deposits	-1,059.5	-1,118.5	-1,345.4	-1,512.5	-1,548.9	-1,784.8
Central bank securites	-250.8	-319.1	-381.7	-75.9	-45.9	-100.0
Other	-822.5	1,327.8	575.9	808.0	724.6	618.8
Capital account	**-611.1**	**-2,381.6**	**-1,619.6**	**-2,138.8**	**-2,182.2**	**-2,197.2**
Currency issued	**1,094.1**	**1,253.7**	**1,409.1**	**1,587.5**	**1,556.7**	**1,743.4**
	II. Banking System					
Net external assets	**2,907.0**	**2,321.6**	**3,071.1**	**4,292.3**	**4,263.0**	**4,904.6**
(In millions of U.S. dollars)	1,378.4	996.4	1,081.4	1,294.8	1,202.5	1,226.1
Net domestic assets	**4,209.3**	**7,484.4**	**6,467.8**	**6,983.7**	**7,497.4**	**8,185.0**
Credit to the public sector	-281.0	-256.8	81.9	-342.9	9.4	285.8
Credit to the private sector	4,523.5	5,086.2	4,983.4	5,541.0	5,825.9	6,313.5
Other	-33.2	2,655.1	1,402.5	1,785.6	1,662.1	1,585.7
Capital accounts	**-1,958.3**	**-4,008.7**	**-3,229.2**	**-3,854.3**	**-4,072.3**	**-4,372.3**
Broad liquidity (M3)	**5,157.9**	**5,797.3**	**6,309.7**	**7,421.7**	**7,688.1**	**8,717.2**
Money and quasi-money (M2)	3,230.0	3,407.1	3,309.2	3,661.8	3,742.0	4,191.0
Money (M1)	1,572.8	1,785.4	1,918.9	2,100.6	2,416.0	2,705.9
Quasi-money	1,657.2	1,621.7	1,390.3	1,561.3	1,326.0	1,485.1
Foreign currency deposits	1,927.9	2,390.2	3,000.6	3,759.9	3,946.1	4,526.2
	(Annual percentage change)					
Currency issued	5.6	14.6	12.4	12.7	-1.9	12.0
Banking system credit to private sector	21.6	12.4	-2.0	11.2	5.1	8.4
M1	3.0	13.5	7.5	9.5	15.0	12.0
M2	0.2	5.5	-2.9	10.7	2.2	12.0
M3	12.8	12.4	8.8	17.6	3.6	13.4
Of which: foreign currency deposits	42.9	24.0	25.5	25.3	5.0	14.7
Memorandum items						
Exchange rate	2,109	2,330	2,840	3,315	3,545	4,000
Ratio of foreign currency deposits to M3 (percent)	37.4	41.2	47.6	50.7	51.3	51.9

Sources: Central Bank of Paraguay; and Fund staff estimates.

1/ Reflects debt write-offs of central bank credit to commercial banks during 1997 and 1998

Table 5. Paraguay: Financial Sector Soundness Indicators

(Ratios in percent)

	1995	1996	1997	1998	1999	2000
Share in total deposits						
Private banks	78.0	79.4	78.5	84.1	84.5	85.8
Public banks	13.4	13.8	13.7	9.1	9.0	6.3
Finance companies (*financieras*)	8.7	6.8	7.9	6.8	6.5	7.9
Capital adequacy ratios						
Private banks	20.9	20.0	22.8	24.8	20.9	21.0
Public banks	14.5	12.1	15.9	19.4	16.4	16.0
Finance companies (*financieras*)	29.2	33.1	35.7	38.4	40.1	36.1
Nonperforming loans over total loans						
Private banks	8.4	9.3	7.6	8.1	9.3	11.8
Public banks	11.1	17.0	31.8	44.5	49.1	44.7
Finance companies (*financieras*)	13.9	16.2	9.2	9.6	13.0	11.0
Provisions over nonperforming loans						
Private banks	62.1	47.6	60.9	48.1	45.1	45.5
Public banks	33.0	30.4	24.8	27.4	34.3	39.7
Finance companies (*financieras*)	65.5	52.5	41.9	45.1	43.9	45.7
Profits (before taxes) over assets						
Private banks	1.1	2.8	3.6	5.0	1.2	1.7
Public banks	0.6	0.5	-0.6	-6.9	0.2	-0.5
Finance companies (*financieras*)	1.2	1.9	6.2	6.1	3.8	4.4
Administrative costs over deposits						
Private banks	...	7.6	8.5	6.9	7.0	7.1
Public banks	...	10.2	11.6	12.3	10.5	14.8
Finance companies (*financieras*)	...	18.5	20.1	26.0	23.9	19.3
Liquid assets over total assets						
Private banks	36.1	36.4	38.7	41.0	38.7	41.0
Public banks	20.8	20.1	13.2	18.4	35.4	28.8
Finance companies (*financieras*)	19.6	19.3	20.7	20.4	24.6	24.3

Sources: Central Bank of Paraguay, Superintendency of Banks, *Boletín Estadístico*; and Fund staff estimates.

Table 6. Paraguay: Indicators of External Vulnerability

	1995	1996	1997	1998	1999	2000
Monetary and financial indicators						
Broad money (M3), percentage change	40.4	12.9	13.1	8.0	16.2	5.1
Credit to the private sector, real (percentage change)	18.1	11.7	7.4	-14.2	3.8	-1.5
Share of nonperforming loans in total loans (percent)	7.9	11.1	13.1	11.8	14.8	16.2
Average domestic lending rate, real	29.2	29.5	28.0	21.7	32.1	25.0
Central Bank bill yield, real	2.0	0.9	8.7	10.1	7.4	-3.2
International reserves (millions of US$)	1,106.5	1,062.3	845.8	874.8	988.2	770.3
in months of imports of gnfs.	2.6	2.5	2.1	2.3	3.4	2.8
base money to reserves	0.7	0.8	0.9	0.8	0.6	0.8
broad money (M3) to reserves	2.2	2.5	3.2	2.7	2.4	3.0
Central Bank foreign short-term liabilities (millions of US$)	9.2	0.5	0.1	0.1	0.0	0.5
External indicators						
Merchandise exports (percentage change)	25.5	-10.0	-12.4	6.6	-24.7	-15.8
Merchandise imports (percentage change)	24.6	-2.4	-4.4	-6.0	-22.8	-6.7
Merchandise terms of trade (percentage change)	-1.4	1.2	-0.3	-0.4	-5.9	-2.0
Real effective exchange rate (percentage change)	1.7	2.6	0.8	-5.9	3.3	5.6
Current account balance (percent of GDP)	-1.0	-3.7	-6.8	-1.9	-1.1	-4.2
Capital and financial account (percent of GDP)	2.9	1.8	4.6	3.8	6.8	2.5
Net foreign direct investment (percent of GDP)	1.1	1.5	2.4	4.0	0.8	1.6
Inward porfolio investment (percent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0
Other net investment (percent of GDP)	1.7	0.2	2.2	-0.3	6.0	1.2
External public debt (percent of GDP)	15.8	14.9	16.1	19.3	28.9	31.8
Debt service (in percent of exports gnfs.)	4.8	4.7	4.4	5.1	6.7	8.8

Sources: Central Bank of Paraguay; and Fund staff estimates.

Table 7. Paraguay: Balance of Payments

	1995	1996	1997	1998	1999	Est. 2000	Proj. 2001
	(In millions of U.S. dollars)						
Current account	**-92.3**	**-353.0**	**-650.4**	**-160.0**	**-86.2**	**-314.9**	**-80.3**
Trade balance	-270.4	-586.5	-864.8	-392.9	-368.2	-585.7	-335.9
Exports	4,218.6	3,796.9	3,327.5	3,548.6	2,673.3	2,251.1	2,352.4
Exports of domestic goods	1,213.8	1,243.7	1,365.9	1,267.9	920.0	1,032.1	1,197.2
Re-exports	3,004.8	2,553.2	1,961.6	2,280.7	1,753.3	1,219.0	1,155.2
Imports	4,489.0	4,383.4	4,192.4	3,941.5	3,041.5	2,836.8	2,688.3
Services (net)	-126.9	-58.3	0.4	49.6	76.9	46.5	73.1
Transport	-373.6	-319.3	-322.5	-258.4	-221.3	-226.6	-216.1
Travel	4.0	1.4	-10.9	-31.1	-28.3	-30.0	-25.2
Other	242.7	259.6	333.8	339.1	326.5	303.1	314.5
Factor income	109.7	109.6	33.1	6.0	29.9	47.5	5.7
Transfers	195.3	182.2	180.9	177.3	175.2	176.8	176.8
Capital and financial account	**258.8**	**173.7**	**438.8**	**325.0**	**523.4**	**194.4**	**80.3**
Capital transfers	10.6	14.2	7.5	5.4	19.6	3.0	3.0
Direct investment	98.1	144.2	230.1	336.3	64.7	119.2	119.3
Portfolio investment	-0.8	-3.7	-4.3	9.0	-20.9	-16.5	-16.5
Other investment	150.9	19.0	205.5	-25.7	460.0	88.7	-25.5
Assets	-58.5	-31.9	72.9	-5.0	-93.3	-159.1	-79.5
Commercial credits	0.0	-7.0	25.1	-10.9	13.5	13.0	0.0
Loans	-62.3	-148.5	64.8	19.0	-68.2	-212.6	0.0
Foreign currency deposits	47.6	193.8	-16.0	-97.1	8.3	69.5	0.0
Other assets	-43.8	-70.2	-1.0	84.0	-46.9	-29.0	-79.5
Liabilities	209.4	50.9	132.6	-20.7	553.3	247.8	54.1
Commercial credits	25.2	153.6	-114.2	-79.3	95.6	69.0	0.0
Loans	78.0	74.1	165.0	126.2	500.0	134.0	54.1
Foreign currency deposits	83.6	-206.7	22.0	-0.2	-53.4	-13.4	0.0
Other liabilities	22.6	29.8	59.8	-67.3	11.1	58.2	0.0
Reserve Assets	**-60.2**	**39.4**	**205.8**	**-23.4**	**-104.4**	**218.3**	**0.0**
Errors and Omissions	**-106.3**	**140.0**	**5.8**	**-141.7**	**-332.8**	**-97.8**	**0.0**
Memorandum items:							
Current account in percent of GDP	-1.0	-3.7	-6.8	-1.9	-1.1	-4.2	-1.1
International reserves (in millions of US$)	1,106.5	1,062.3	845.8	874.8	988.2	770.3	770.3
in months of imports of GNFS	2.6	2.5	2.1	2.3	3.4	2.8	2.9
External public debt in percent of GDP	15.8	14.9	16.1	19.3	28.9	31.8	33.0
Debt service in percent of exports GNFS	4.8	4.7	4.4	5.1	6.7	8.8	8.1

Sources: Central Bank of Paraguay; and Fund staff estimates.

Table 8a. Paraguay: Medium-Term Scenario I

	1999	2000	2001	2002	2003	2004	2005	2006
			Projections					
	(In millions of U.S. dollars)							
Balance of payments								
Current account	**-86.2**	**-314.9**	**-88.1**	**-61.5**	**-65.0**	**-43.5**	**-29.3**	**-12.2**
Exports	2,673.3	2,251.1	2,352.4	2,506.6	2,658.2	2,819.1	2,989.6	3,170.5
Imports	3,041.5	2,836.8	2,688.3	2,807.8	2,948.2	3,095.6	3,250.4	3,412.9
Services (net)	76.9	46.5	73.1	74.4	78.1	82.0	86.1	90.4
Factor income (net)	29.9	47.5	-2.1	-11.5	-30.0	-25.8	-31.4	-37.0
Transfers (net)	175.2	176.8	176.8	176.8	176.8	176.8	176.8	176.8
Capital and finacial account	**523.4**	**194.4**	**88.1**	**161.5**	**115.0**	**73.5**	**29.3**	**12.2**
Capital transfers	19.6	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Foreign direct investment (net)	64.7	119.2	119.3	344.3	184.3	204.3	224.3	244.3
Portfolio investment (net)	-20.9	-16.5	-16.5	-16.5	-16.5	-16.5	-16.5	-16.5
Other investment (net)	460.0	88.7	-17.7	-169.3	-65.8	-107.3	-151.5	-168.6
Errors and Omissions	-332.8	-97.8	0.0	0.0	0.0	0.0	0.0	0.0
Reserve Assets	**-104.4**	**218.3**	**0.0**	**-100.0**	**-50.0**	**-30.0**	**0.0**	**0.0**
	(In percent of GDP, unless otherwise specified)							
Public finances								
Total revenue	23.3	22.4	23.3	22.8	23.0	23.3	23.6	23.9
Taxes	11.1	11.3	11.3	11.3	11.3	11.3	11.3	11.3
Other	12.1	11.1	12.0	11.4	11.7	12.0	12.3	12.6
Total expenditures	28.0	28.1	25.4	24.2	24.1	23.9	23.9	23.8
Current expenditure	18.4	19.2	18.1	17.7	17.6	17.5	17.5	17.4
Capital expenditure, net lending	9.6	8.9	7.3	6.5	6.5	6.4	6.4	6.4
Public sector savings	4.9	3.3	5.2	5.1	5.4	5.8	6.1	6.6
Overall balance	-4.7	-5.7	-2.1	-1.5	-1.0	-0.6	-0.3	0.2
Real sector								
Real GDP growth 1/	0.5	-0.3	2.0	3.5	3.4	3.2	3.0	3.0
Consumer prices (average) 1/	6.8	9.0	9.8	7.8	6.0	5.0	4.0	3.0
US dollar exchange rate (avg.) 1/	13.7	11.4	15.0	10.0	6.0	5.0	4.0	3.0
Real effective exchange rate (avg.) 1/	6.5	-2.7	-4.5	-2.0	0.0	0.0	0.0	0.0
Gross domestic investment	23.0	23.2	21.7	22.0	22.4	22.7	22.8	22.8
Gross national savings	21.9	19.0	20.7	21.7	22.2	22.6	22.9	23.2
Memorandum items								
Current account balance	-1.1	-4.2	-1.2	-0.8	-0.8	-0.5	-0.3	-0.1
International reserves (in months of imports GNFS)	3.4	2.8	2.9	3.2	3.2	3.1	3.0	2.9
Debt service 2/	6.7	8.8	8.1	6.5	6.9	7.0	6.7	6.4
Public sector debt 3/	28.9	31.8	33.0	33.9	33.7	33.4	33.1	32.9

Sources: Ministry of Finance; Central Bank of Paraguay; and Fund staff estimates and projections.

1/ Annual change in percent.

2/ In percent of exports of goods and nonfactor services.

3/ Medium and long-term public external debt.

Table 8b. Paraguay: Medium-Term Scenario II

	1999	2000	2001	2002	2003	2004	2005	2006
			Projections					
	(In millions of U.S. dollars)							
Balance of payments								
Current account	**-86.2**	**-314.9**	**-199.7**	**-161.1**	**-112.7**	**-65.8**	**-51.1**	**-64.8**
Exports	2,673.3	2,251.1	2,273.6	2,319.1	2,504.6	2,679.9	2,840.7	2,982.8
Imports	3,041.5	2,836.8	2,715.8	2,715.5	2,851.3	2,993.8	3,143.5	3,300.7
Services (net)	76.9	46.5	67.8	73.8	93.9	110.4	122.3	128.4
Factor income (net)	29.9	47.5	-2.1	-15.4	-36.8	-39.1	-47.4	-52.0
Transfers (net)	175.2	176.8	176.8	176.8	176.8	176.8	176.8	176.8
Capital and finacial account	**523.4**	**194.4**	**88.1**	**161.5**	**115.0**	**73.5**	**29.3**	**12.2**
Capital transfers	19.6	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Foreign direct investment (net)	64.7	119.2	119.3	344.3	194.3	194.3	194.3	194.3
Portfolio investment (net)	-20.9	-16.5	-16.5	-16.5	-16.5	-16.5	-16.5	-16.5
Other investment (net)	460.0	88.7	-17.7	-169.3	-65.8	-107.3	-151.5	-168.6
Errors and Omissions	-332.8	-97.8	0.0	0.0	0.0	0.0	0.0	0.0
Reserve Assets	**-104.4**	**218.3**	**111.5**	**-0.3**	**-2.3**	**-7.7**	**21.8**	**52.6**
	(In percent of GDP, unless otherwise specified)							
Public finances								
Total revenue	23.3	22.4	23.5	22.7	23.1	23.3	23.4	23.6
Taxes	11.1	11.3	11.3	11.3	11.3	11.3	11.3	11.3
Other	12.1	11.1	12.2	11.4	11.8	12.0	12.1	12.3
Total expenditures	28.0	28.1	25.9	25.4	25.2	25.0	24.7	24.5
Current expenditure	18.4	19.2	18.5	18.5	18.4	18.3	18.1	18.0
Capital expenditure, net lending	9.6	8.9	7.5	6.9	6.8	6.7	6.6	6.5
Public sector savings	4.9	3.3	5.1	4.2	4.6	5.0	5.3	5.6
Overall balance	-4.7	-5.7	-2.4	-2.7	-2.1	-1.7	-1.3	-0.9
Real sector								
Real GDP growth 1/	0.5	-0.3	0.0	0.5	3.5	3.4	3.3	3.2
Consumer prices (average) 1/	6.8	9.0	9.8	7.8	7.8	5.0	4.0	3.0
US dollar exchange rate (avg.) 1/	13.7	11.4	15.0	10.0	10.0	5.0	4.0	3.0
Real effective exchange rate (avg.) 1/	6.5	-2.7	-4.5	-2.0	-2.0	0.0	0.0	0.0
Gross domestic investment	23.0	23.2	22.0	21.7	21.6	21.3	21.2	21.3
Gross national savings	21.9	19.0	19.2	19.4	20.1	20.5	20.6	20.5
Memorandum items								
Current account balance	-1.1	-4.2	-2.7	-2.2	-1.5	-0.9	-0.7	-0.8
International reserves (in months of imports GNFS)	3.4	2.8	2.7	3.0	3.0	3.0	2.9	2.8
Debt service 2/	6.7	8.8	8.4	7.0	7.3	7.2	7.0	6.7
Public sector debt 3/	28.9	31.8	33.8	35.8	36.3	36.0	35.8	35.6

Sources: Ministry of Finance; Central Bank of Paraguay; and Fund staff estimates and projections.

1/ Annual change in percent.

2/ In percent of exports of goods and nonfactor services.

3/ Medium and long-term public external debt.

Asunción, Paraguay
April 11, 2001

Dear Mr. Köhler:

In 1999, the government of Paraguay formulated an action program for the period 1999-2003 aimed at addressing the economic and social problems that affect the country, increasing the efficiency of the economy, and opening the way for the resumption of economic growth on a sustainable basis. The government has already taken important measures, and has now specified, in consultation with the IMF staff, an economic program for 2001 to further the objectives of it's overall action program.

The attached memorandum of economic and financial policies describes the program for 2001, for which the government requests the continued monitoring by Fund staff. The government intends to keep the public informed about its policies and objectives, and will therefore publish this memorandum as well as report periodically on the progress made under the program, enhancing thereby the program's credibility and ensuring transparency.

The government is making substantive efforts to improve the coverage and timeliness of economic statistics, and will provide the IMF staff with the information necessary to monitor the program. In this context, the government will consult regularly with the IMF staff and keep it informed of the progress made in the implementation of the policies included in the program. Furthermore, a midterm review of program implementation is scheduled for July 2001.

Sincerely yours,

/s/
Francisco Oviedo
Minister of Finance

/s/
Washington Ashwell
President
Central Bank of Paraguay

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, DC

Attachment:
Memorandum of Economic and Financial Policies

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

I. INTRODUCTION

1. This memorandum describes the government's economic program for 2001, which was formulated in consultation with the staff of the International Monetary Fund. The government has requested the continued monitoring of its program by Fund staff, and intends to maintain the public informed about the program's content and the progress made in its implementation.

II. RECENT DEVELOPMENTS

2. Paraguay's growth performance over the last 20 years has been disappointing, with virtually no growth in real GDP per capita in this period. The country has suffered from a secular decline in terms of trade—by over 60 percent over the past two decades—owing in part to a dependence on exports of unprocessed agricultural commodities. GDP growth has been particularly weak during the last five years, averaging less than 1 percent a year compared with a population growth of 2½ percent. A banking crisis in 1995–98 led to lasting reductions in private sector credit and to high real interest rates. Partly as a consequence, private investment fell six years in a row. This was compounded by a 20 percent drop in the terms of trade between 1998 and 2000, and by the effects of the devaluation of the Brazilian *real* and a protracted recession in Argentina.

3. The economy remained stagnant during 2000, despite a strong fiscal stimulus during 1999–2000. Growth is expected to resume in 2001, with excellent weather conditions in late 2000 promising bumper harvests. Inflation was gradually lowered over the last decade, to almost 5 percent in 1999. During 2000, inflation edged up to 8.6 percent in December, mainly as a result of increases in fuel prices, public utility tariffs and a 15 percent raise in the minimum wage.

4. The public sector produced surpluses in the early 1990s, but its financial position eroded after 1995, to reach a deficit preliminarily estimated well in excess of 5 percent of GDP in 2000. Most of this deficit reflects a negative balance in the central government. While part of the deterioration was due to cyclical factors, as weak growth and a reduction of trade lowered tax revenues, higher spending remained the most important factor. Investment and capital transfers surged, financed in 1999 and 2000 by two important sources of external funds. In addition, the ratio of public sector wages to GDP increased from 8.4 percent in 1996 to 10.7 percent in 2000, largely reflecting a steady increase in the public sector workforce. Transfer payments to retired civil servants have also increased rapidly over the last five years, while interest payments began to pick up in 2000 as a result of the higher foreign debt.

5. At about 32 percent of GDP, Paraguay's external debt remains moderate. However, reflecting the widening public sector deficits, the level of external debt has risen fast

since 1996, when it stood at 15 percent of GDP. Virtually all the outstanding debt is to multilateral agencies or foreign governments, and has a relatively long maturity, with over 80 percent of the outstanding amount maturing in ten years or more.

III. The Program for 2001

6. The government is determined to address the grave problems confronting the country, including in the economic structure, in attending to social needs, and in fighting corruption. Partly as a result of these problems, and also of adverse external developments, the financial situation has worsened markedly in recent years and requires immediate correction. The government's program aims to restore order to the public finances and allow the continuation of a prudent monetary policy, while making further progress in addressing deep seated structural problems, in order to create an environment conducive to higher growth over the medium term. To this end, the government has designed a medium term growth strategy that aims to foster competitiveness in the private sector and seeks to place the export sector as the main engine of growth. However, if external conditions continue to deteriorate, the resumption of growth, as well as the expected improvement of the current account, would probably not materialize as expected. Under such circumstances, the program and its targets would have to be adapted to the evolving situation in the world and in the region during the mid-term review.

7. In the program for 2001, real GDP is expected to grow at a rate of more than 2 percent, reflecting mainly a recovery in agricultural production and the positive effects on economic activity of a strengthening of private sector confidence. Notwithstanding the effects of the adjustment of public tariffs and of the depreciation of the exchange rate, the government expects to contain inflation in 2001 at a level similar to that attained in 2000. In the external area, increased output of the main agricultural export crops and the effects of the exchange rate adjustment are projected to result in a sharp reduction of the current account deficit.

A. Fiscal Policies

8. The financing of the public sector deficit registered in recent years has increased the public debt, taking away credit resources from the productive sectors, and thereby hampering the growth of the economy. The government, therefore, regards the restoration of balance to the public sector as a priority, and intends to exercise discipline in order to limit the central administration's deficit in 2001 to no more than ₲600 billion, about half the level registered in 2000. In terms of GDP, the deficit would decline from 4.5 percent to 2.0 percent. Given the seasonality of revenues and expenditures, the cumulative deficit during the year will not exceed ₲50 billion, ₲70 billion, and ₲170 billion at the end of the first[1], second, and third quarters, respectively. The corresponding targets, as measured from

[1] All targets for the first quarter 2001 are indicative only.

the financing side, and including the quasi-fiscal result of the central bank, are specified in Section I of the attached Technical Memorandum of Understanding (TMU). Moreover, the government intends to reduce the floating debt (arrears) in the execution of the budget, which at no point during the year will exceed the ₲380 billion carried over from the year 2000.

9. Revenues of the central government are expected to increase by around 0.3 percentage points of GDP between 2000 and 2001. The excise tax on diesel (which makes up 80 percent of the total fuel consumption) was increased in several steps from 5.5 percent in June 2000 to 14.1 percent in January 2001. At the same time, the tax base widened substantially, as the price of diesel was raised by over 100 percent. The full effect of these increases is expected to materialize in 2001.Yields on the profit tax of enterprises are set to improve, as the scope of a facility permitting banks to deduct increases in their required capital from profits, was limited. VAT revenues are expected to rise, as transport and personal services will be included in the tax base, and exemptions on goods in re-export trade are eliminated. Finally, net royalties from the Itaipú hydroelectric plant will increase, because the central government will not need in 2001 to compensate for payments arrears the electricity company was incurring before the adjustment of its tariffs (paragraph 13).

10. To strengthen the revenue base in the coming years, and contribute to equilibrium of the public finances while providing room to increase needed social spending, the government is preparing further measures in the tax area. The government intends to introduce a resolution modifying presumptive taxation in regard to the income tax and the VAT. The government will present draft legislation to Congress to widen the coverage of the VAT to personal services; impose the VAT on the import and distribution of oil products; increase excise taxes on luxury imports; concentrate the collection of the land tax (IMAGRO) on the 3000 largest landholdings; and reduce the scope of the tax exemptions granted to investors according to Law 60/90.

11. Expenditures of the central government are projected to decrease by around 2 percentage points of GDP. This reduction will be mainly the result of a tight budget passed in December 2000, and additional reforms aiming at creating a leaner and more cost-effective civil service. The current budget law includes provisions that permit a reduction of public sector employment, by requiring the elimination of all government vacancies existing at end 2000, and by ordering the elimination of an additional 10,000 government positions. Also, overtime pay will be reduced and public sector wages will be frozen in nominal terms. Spending on goods and services will also be curtailed, while interest payments are expected to benefit from lower LIBOR rates. Finally, capital spending will be scaled back from the extraordinary levels of 1999 and 2000, when the country spent the proceeds of two important sources of external funds.

12. Total external public debt rose to US$2,350 million at end 2000, including the external sources just mentioned, as well as arrears of the electricity company ANDE that were formalized in a long term loan. Net disbursements of foreign loans are not expected to exceed US$100 million in 2001, determining a target in the program for the stock of

external public debt of US$2,450 million at end 2001, with intermediate quarterly targets as specified in Section IV of the attached TMU. Over the years, central government has issued around US$200 million in domestic debt, part of which remain in the public sector as assets of the social security system. The government is preparing a consolidation of the debt accounts so as to allow the monitoring of the total debt of the public sector. This work is expected to be concluded by June 2001.

13. The financial performance of the public enterprises is expected to improve this year as a result of tariff adjustments approved in the last quarter of 2000 and in early 2001. With a view towards its privatization, rates at the telephone company were restructured and aligned with those of international long distance and cellular competitors. Also looking towards private participation in the water and sanitation company, its rates were adjusted by 10 percent. Fuel prices were recently increased to reflect increases in oil prices (Paraguay imports 100 percent of its oil needs) and currency depreciation. Electricity rates will be increased by 2.6 percent per month from January to September 2001, to eliminate operational losses. The government will move to a system of more frequent adjustments of tariffs to reflect changes in operating costs. During 2001, it is expected that public enterprises will reduce their stock of debt and payments arrears.

14. During this year, the government will continue to intensify its efforts to improve tax administration, including implementation of recommendations of the 1999 FAD Tax Policy Mission. Over the past several months important strides have been made in this area, such as: the identification and removal of focal points of corruption in customs offices (as a result, customs tax receipts have already increased significantly); the designation of service providing agencies, such as credit card companies, real estate offices and trade companies, as fiscal agents for VAT collection on their clients' transactions; the closure of loopholes used by firms to evade their tax obligations by constituting themselves as nonprofit organizations; the narrowing of the scope of re-export trade and increased transparency of customs procedures applicable to it; the increase in the effective base for VAT collection from independent professionals; and the introduction of a "fiscal lottery" to provide incentives to consumers to request their VAT receipts. In the adoption of most of these measures, the government has sought prior agreements with affected sectors to elicit their cooperation in the tax collection effort. Although the government is confident that these measures will result in a significant increase in revenues, their potential has not been incorporated into the fiscal program's revenue projections.

B. Fiscal Structural Reforms

15. The reform of the state ranks among the government's main priorities. Last December, Congress approved Law 1626, modifying labor relations applicable to public sector employees. The objectives of the new legislation were: the unification of labor legislation applicable to all branches of the public sector; the establishment of clear parameters for a professional public sector career; improvements in controls on personnel appointments in the different branches of the public sector; the establishment of compulsory retirement parameters for all public sector employees (except for the military); the

equalization of work hour requirements among different public sector agencies, and the rationalization of the use of remunerated overtime. Although Law 1626 does not eliminate present rigidities that impede the immediate reduction of the public sector work force, the government believes it goes a long way towards creating a more balanced application of labor regulations among all public sector employees, which should result in a more professional and dynamic public sector work force over the medium term. The new law has been judicially challenged by some affected sectors, and recently the Supreme Court has put an injunction on several important provisions of the law. The government is confident that it will find a satisfactory solution to this situation in the coming months.

16. Work is underway to close several government agencies, and studies are being conducted to restructure the central administration and the social security system. Congress has authorized budgetary resources only until June 2001 for entities that will be restructured, including the railroad, the National Housing Council (Conavi), the Municipal Development Institute (IDM), the National Indigenous People Institute (INDI), and *Banco Nacional* para la Vivienda (BNV). With financial assistance from the Inter American Development Bank, the government is preparing draft legislation for the reform of the Central Administration, as well as for the consolidation of the public financial institutions and the restructuring of the different social security agencies. While the restructuring of the Central Administration is to be completed within the next year, the reform of social security is expected to be a more lengthy process. In the meantime, however, the government will adopt the necessary measures to ensure that the Social Security Institute (IPS) continues to generate operating surpluses. Work is also underway on the preparation of the regulatory decrees for the concessions law, so as to permit the private management of road maintenance, the privatization of port and airport services, and the private operation of toll roads.

17. The government has pressed ahead with the privatization of the telecommunications and water and sanitation companies, ANTELCO and CORPOSANA. These two companies were transferred to the Reform Secretariat in the final months of 2000 in order to ensure an orderly transition from the public to the private sector during 2001. Regarding the telecommunications company, an international investment bank was chosen, through competitive bidding and with the assistance of the World Bank, to handle the privatization process, which was expected to be finalized in September 2001. Unfortunately, the winning investment bank recently withdrew its commitment, forcing the government to reopen the bidding process. This will probably delay the final privatization of ANTELCO by a few months. As to CORPOSANA, the process is underway to choose an investment bank to handle the incorporation of private investors to the company, which is expected to be finalized before the end of the year. The government has not included revenues from the sale of these enterprises in its projections for 2001 and, in any case, the government will consider such revenues as a financing item that will not justify increases in expenditure.

C. Financial Policies

18. The government is implementing a prudent monetary policy, aimed at maintaining the orderly financial conditions required for price stability and economic development. The

Central Bank of Paraguay (BCP) will continue to conduct an active and independent monetary policy focused on lowering inflation and, given the need to preserve, and eventually strengthen, the level of international reserves, will allow the exchange rate to be determined by market forces. To attain these objectives, the program for 2001 specifies targets for the expansion of the net domestic assets, and the level of the net international reserves of the BCP. The increase in the net domestic assets will be limited to no more than ₲187 billion in 2001 and no loss of net international reserves will be allowed for the year as a whole. The corresponding quarterly targets are specified in Sections II and III respectively of the attached TMU.

19. The effects of the stagnation of the economy over several years have weighed heavily on the quality of banks' portfolio. Past due loans for the private banks increased from 9.3 percent of total loans at the end of 1999 to 11.8 percent at end 2000, while earnings declined from 2.2 percent of total assets to 1.4 percent of total assets over the same period. The increased risk perception reduced the banks' willingness to extend new loans. As a result, the banking sector remains highly liquid and should be well poised to finance the expansion of economic activity if the demand for loans increases with the improved economic climate. Low loan activity during 2000 permitted banks to concentrate on managing the quality of their portfolio, including strengthening loan provisions. The restructuring of significant volumes of loans in 2000 should lead to a moderate improvement in the quality of bank portfolios in 2001, and the expected pickup in economic activity should also help improve bank earnings and prospects.

20. The government will move towards a solution of the difficulties of *Banco Nacional de Fomento* that will respect the principles of maintaining adequate financing for small agricultural producers, protecting the payments system in rural areas, and minimizing the costs of this transition for both the bank and the state. To prevent the re-emergence of the factors that gave rise to the bank's difficulties, the solution to BNF's problems will have the following characteristics: a) the institution that will replace BNF will lend exclusively to small and medium sized producers only in agriculture, agro-industry and forestry:[2] b) it will not have any special government guarantee; c) it will not have any privilege in the management of public sector deposits; d) it will be subject to the banking law and will be supervised by the banking superintendency; and e) it will not have any special tax advantages. The government will have a solution along the above lines defined by the time of the review of the staff monitored program (July 2001), with a view to its full implementation before the end of the year.

[2] The exclusivity of the bank's lending to small and medium sized borrowers will require that: a) as a general rule, loans to any one borrower will not exceed US$15,000, b) the above limit will not apply to loans to cooperatives in the agriculture, agro-industry or forestry sectors that are current in all their obligations with the bank, in which case the maximum loan may not exceed US$50,000.

D. External Sector

21. The external current account deficit is expected to decline from US$315 million (4.2 percent of GDP) in 2000 to less than US$100 million (1.1 percent of GDP) in 2001. This improvement will partly reflect favorable harvest expectations for the two main export goods, soybean and cotton, which account for about 40 percent of total exports. Export volumes of both commodities are expected to grow by around 30 percent; with prices, however, expected to drop by 6 percent on average. Expected lower petroleum prices in 2001 should reduce the value of imports. Owing to the substantial reduction in the public sector deficit and an expected small real depreciation of the *guaraní*, competitiveness is expected to improve, promoting nontraditional exports and decreasing import volumes. On the other hand, the re-export business is expected to continue declining in 2001, reducing somewhat both export and import volumes. Net disbursement of foreign loans to the central government would fall by about US$40 million, while net international reserves are projected to remain constant in 2001, after a loss of US$218 million in 2000.

22. The government is committed to the process of implementing the external tariffs agreed among the members of MERCOSUR by January 1, 2006. Paraguay has removed tariffs on all goods, except sugar, imported from MERCOSUR. The sugar tariff remains pending agreement by the MERCOSUR partners on its final status. Paraguay is a moderately restricted economy. In 2000 exports and imports amounted to 40 and 46 percent of GDP respectively. Imports are not significantly hampered by nontariff trade restrictions and the government is seeking to obtain the removal of certain nontariff barriers affecting Paraguayan exports to its MERCOSUR partners.

E. Statistics

23. The Government of Paraguay is placing emphasis on strengthening the quality of its macroeconomic data. It has applied to join the GDDS, and for that purpose, a Fund multi-sector statistics mission visited Asunción in February 2001, and assisted the government in preparing metadata for posting on the IMF's DSSB. The government will nominate a GDDS Coordinator, and is aware that this is an essential step before posting. Paraguay had already received substantial technical assistance from the Fund during 2000 in the areas of balance of payments and monetary statistics. During the first semester of 2001, Paraguay will be able to compile and report its data according to the main principles of the new Monetary and Financial Statistics Manual. The government believes that substantial strides have been made in improving the quality and timeliness of fiscal data, particularly at the level of the central government. Shortcomings, however, persist in other areas of the public sector. Public enterprises and the social security system (IPS) continue to follow diverging accounting rules, and have so far not used the common computerized reporting system for the public sector, established by law 1535 in 2000. The central government is pressing for a speedy harmonization of accounting standards and will establish a uniform monthly reporting system during the first semester of 2001.

TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum presents a detailed definition of the variables included in the quantitative targets specified in the Memorandum of Economic and Financial Policies.

I. Cumulative Balance of the Central Administration 1/

	Floor 2/ (In billions of guaraníes)
Overall balance of the central administration and the result of BCP, from January 1, 2001 to:	
March 31, 2001 (indicative)	-187
June 30, 2001	-303
September 30, 2001	-493
December 31, 2001	-711

1/ As measured by the net financing requirement defined below.
2/ Minimum cumulative balance.

1. The **overall balance** of the central administration (CA) is defined as the sum of the overall balances of the CA and the operating cash result (quasi-fiscal balance) of the Central Bank of Paraguay (BCP). For any given calendar quarter, the overall balance of the central administration is measured in *guaranies* from below the line on the basis of information provided by the BCP as the sum of (i) its net domestic financing, (ii) its net external financing, and (iii) privatization proceeds as described below. Items denominated in foreign currency will be converted into *guaranies* at the actual exchange rate. The target in this program incorporates the expected net changes in the floating debt of the central administration.

2. The CA **net domestic financing** comprises (i) the change in its net credits from the financial system excluding bonded debt; (ii) the change in its bonded debt (including bonds denominated in or indexed to foreign currencies) net of valuation changes; and (iii) its net asset transactions. **Net external financing** of the central administration is defined as the sum of (i) disbursements of project and nonproject loans, including securitization; (ii) proceeds from bond issues abroad; (iii) the net changes in short-term external debt; (iv) any change in arrears on external interest payments; minus (v) cash payments of principal on current maturities for bonds and loans; (vi) cash payments to settle any external arrears; and (vii) any prepayment of external debt. **Privatization proceeds** are defined as the cash payments received by the CA, net of changes in assets held abroad or at the BCP, converted to *guaraníes* at the actual market exchange rate of each transaction. Nonrecurring fees for concessions of public services, such as in the telecommunications sector, are treated as

privatization proceeds. Proceeds from decapitalization of public enterprises will be considered as privatization. The **result of the BCP** is defined as interest earnings on gross international reserves (defined below) and on government bond holdings by the BCP, less interest paid, and less current expenditures of the BCP. For the purposes of the program, the costs of conducting monetary policy, i.e., the interest paid on *Instrumentos de Regulación Monetaria* (IRM) and call operations are excluded from the result of the BCP.

II. Cumulative changes in the net domestic assets (NDA) of the BCP

	Ceiling 1/ (In billions of guaraníes)
Outstanding stock of net domestic assets as of:	
March 31, 2001 (actual)	-965
June 30, 2001	-1,250
September 30, 2001	-1,194
December 31, 2001	-993

1/ Maximum level of end-of period outstanding stock of net domestic assets in the BCP evaluated at the Accounting Exchange rate of ₲3,545/US$.

3. **NDA** of the BCP are defined as the difference between currency in circulation and the net international reserves (NIR) of the BCP (defined below), both measured on the basis of end-of-period data of the corresponding period. The **NIR** of the BCP are equal to the U.S. dollar value of gross international reserves of the BCP minus its gross reserve liabilities. Gross international reserves include BCP's holdings of gold, SDRs, Paraguay's reserve position at the IMF, foreign currency in the form of cash, deposits abroad, and Paraguay's net cash balance within the Latin America Trade Clearing System (ALADI); and exclude participation in international financial institutions (including *Corporación Andina de Fomento* (CAF), IADB, IBRD, *Asociación Internacional de Fomento*, and *Bancos de Desarollo del Caribe*), the holdings of nonconvertible currencies, and holdings of precious metals other than gold. Gross reserve liabilities of the BCP include all foreign currency-denominated liabilities of the BCP with original maturity of one year or less, and the use of Fund credit.

4. For the purpose of NIR calculation (a) dollar assets and liabilities will be valued at an Accounting Exchange rate of ₲3,545/US$; the gold holdings of the BCP will be valued at the accounting rate of US$ 270 per troy ounce; (b) liabilities to the IMF will be valued at US$1.3 per SDR; (c) gains or losses from gold-swaps and other operations will be excluded; and (d) non-U.S. dollar denominated foreign assets and liabilities will be converted into U.S. dollars at the market exchange rates of the respective currencies as of December 31, 2000. The ceiling on NDA will be adjusted *upward* (*downward*) by the

equivalent in *guaranies* of the *downward* (*upward*) adjustments made to the floor on the NIR of the BCP as described below.

III. Cumulative changes in the net international reserves (NIR) of the BCP

	Target 1/ (In millions of U.S. dollars)
Change in the NIR of the BCP from December 31, 2000 to:	
March 31, 2001 (actual)	-163
June 30, 2001	-18
September 30, 2001	-45
December 31, 2001	0

1/ NIR as defined above. Positive (negative) signs indicate an increase (decline).

The floor will be adjusted *upward* by the amount of privatization proceeds held at the BCP.

IV. Stock of external debt of the public sector

	Target 1/ (In millions of U.S. dollars)
Outstanding stock of external debt of the public sector as of:	
December 31, 2000 (actual)	2,350
March 31, 2001 (indicative)	2,400
June 30, 2001	2,430
September 30, 2001	2,450
December 31, 2001	2,450

1/ Maximum level of external debt of the public sector.

This refers to the outstanding stock of external debt owed or guaranteed by the public sector including financing leases.[3] Debt will be measured on a disbursement basis as reported by SIGADE and excludes reserve liabilities of the BCP. Debt in the form of leases will be calculated as the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the

[3] The term "debt" has the meaning set forth in point No.9 of the Guidelines on Performance Criteria with Respect to Foreign Borrowing and Fund Arrangements (Decision No. 12274-(00/85) adopted August 24,2000).

operation, repair or maintenance of the property. The overall limit will be adjusted (1) up*ward* (*downward*) by the upward (downward) revisions made to the actual debt stock at end-2000; (2) *downward* by the amount of debt held by public enterprises guaranteed by the central administration included in the SIGADE in the event these enterprises are privatized with their debt.

STRUCTURAL BENCHMARKS

	Benchmark[4]	Expected time of completion
1.	Modification of the presumptive taxation in regard to the income tax and the VAT (paragraph 10)	June 2001
2.	Presentation to Congress, among others, of legislation to widen the base of the VAT raise excise taxes on luxury goods, redefine the collection of the land tax and reduce tax exemptions under Law 60/90 (paragraph 10)	June 2001
3.	Privatization of ANTELCO and private participation in CORPOSANA (paragraph 17)	December 2001
4.	Definition of a solution strategy for the BNF (paragraph 20)	July 2001
5.	Full implementation of the solution for the BNF (paragraph 20)	December 2001
6.	Consolidation of debt accounts in the public sector (paragraph 12)	June 2001
7.	Harmonization of accounting standards across public sector (paragraph 23)	June 2001

[4] References to paragraphs are to those in the Memorandum of Economic and Financial Policies.

FUND RELATIONS
As of March 31, 2001

I. **Membership Status**: Joined December 28, 1945; Article VIII

II. **General Resources Account**:

	In millions of SDRs	In percent of Quota
Quota	99.90	100.0
Fund holdings of currency	78.43	78.5
Reserve position in Fund	21.48	21.5

III. **SDR Department**:

	In millions of SDRs	Percent of Allocation
Net cumulative allocation	13.70	100.0
Holdings	79.44	580.0

IV. **Outstanding Purchases and Loans**: None

V. **Exchange Rate Arrangement:** Paraguay maintains a liberal foreign exchange market with a single exchange rate. The Central Bank follows a policy of a managed float and intervenes in the market to smooth out fluctuations in the value of the *guaraní*. On April 30, 2001 the average interbank rate for the U.S. dollar, the intervention currency, was ₲3,800.

VI. **Article IV Consultation:** The 2000 Article IV consultation was concluded by the Executive Board on March 1, 2000 (EBM/00/20); the documents are SM/99/300 and SM/00/12.

VII. **Technical Assistance:**

Department	Purpose	Date of Delivery
FAD	Advice on tax administration	February 1995
FAD	Advice on tax policy	September 1995
MAE	Policy Advisory to the Central Bank	March 1994–July 2000
MAE	Advisor to the Banking Superintendency	February–September 1995
MAE	Management of International Reserves	June 1995

VII. Technical Assistance (Concluded)

MAE	Internal Controls of the Central Bank	August 1995
MAE	Banking Supervision	August 1995
MAE	Banking Legislation	November 1995
MAE	Accounting procedures	March 1996
MAE/LEG	Bank Regulations	May 1997
FAD	Tax and Customs Administration	May 1997
FAD	Tax Policy	February 1999
FAD	Tax Administration	March 1999
STA	Monetary Statistics	February 2000
STA	Balance of Payments Statistics	June 2000
STA	Multisector, GDDS accession	February 2001

Financial Relations with the World Bank

The World Bank's FY 1998-00 Country Assistance Strategy (CAS) for Paraguay focused on: (i) human resource development, much of it directed towards addressing the needs of the poor; (ii) agricultural development and natural resource management; (iii) basic infrastructure improvement; and (iv) private sector development. Institutional capacity building was to be an important aspect of World Bank assistance.

The last CAS planned for a low level of lending on the order of $50 million per year, subject to improved portfolio performance and keeping the fiscal deficit below 2 percent of GDP. Due to portfolio performance problems, however, the Bank has not actually approved a new loan since 1997. The Bank has maintained a policy dialogue with Paraguay, however, and analytical work in recent years included a country economic memorandum and a decentralization study. Currently, the Bank together with the UNDP is assisting the government in the preparation of a Poverty Reduction Strategy paper. In addition, the World Bank Institute provided technical assistance during the past year to help a joint Government - Civil Society Commission prepare a National Anti-corruption Plan, which is now being supported by other donors.

Seven World Bank-financed projects are presently under execution with US$106 million undisbursed as of end-December 2000. These projects include: Rural Water Supply, Highways, Natural Resource Management, "El Niño" Emergency, Reform of the Water and Telecommunication Sectors, Secondary Education Improvement, and Maternal Health and Child Development.

A new Country Assistance Strategy is tentatively scheduled for next year. New loans in the education sector and for community development are currently under preparation.

Financial Relations With the World Bank
(In millions of U.S. dollars)

I. IBRD/IDA Operations (as of December 31, 2000)

	Committed (Net of Cancellations)	Undisbursed	Disbursed
Sector			
Agriculture and rural development	227.4	0.0	227.4
Education	63.9	.9	63.0
Environment	79.0	27.7	51.3
Finance	77.6	7.4	70.2
Population, health and nutrition	21.8	14.0	7.8
Multi-purpose	5.8	0.0	5.8
Transportation	214.0	6.9	207.1
Water supply	111.9	49.1	62.8
Total IBRD/IDA	801.4	106.1	695.3
Repaid (includes repayment 3rd parties)	456.9		
Total Outstanding	344.5		

II. IFC Operations (as of December 31, 2000)

	Loans	Equity	Total
Commitments	0.0	0.0	0.0
Repayments and cancellations	0.0	0.0	0.0
Now held by IFC	0.0	0.0	0.0
Undisbursed	0.0	0.0	0 0

III. IBRD/IDA Loan Transactions (calendar year)

	1993	1994	1995	1996	1997	1998	1990	2000
Disbursements	7.7	7.3	25.7	27.5	41.2	37.8	42.1	46.6
Repayments	43.0	42.9	42.6	35.2	26.0	24.6	24.6	20.2
Net lending	-35.3	-35.6	-16.9	-7.7	15.3	13.2	17.5	26.4

Source: World Bank.

Statistical Issues

A. Real Sector

National accounts have a number of shortcomings, including the use of an outdated conceptual framework, outdated base year for constant prices (1982), and the absence of quarterly information. Hopefully, improvements will come in 2002. With the technical assistance of an expert financed by the IDB, Paraguayan national accounts data are being made compatible with current international standards *(1993 SNA)*, which entails a fuller coverage of industries, an input-output matrix, an expansion of data sources for the compilation of the 1994 new benchmark and base year. Publication of new national accounts data for the years 1991-97 is scheduled for mid-2002.

Both the consumer and producer price indices are reported on a regular and timely basis. The CPI has a base period of December 1992, and the PPI of December 1995. A change in the base period and basket of the CPI is scheduled to take place after the results of a new household income and expenditure survey covering the period 2001/2002 become available. Employment and unemployment statistics have improved their coverage and quality significantly since a regular household survey was introduced in 1998. However, frequencies remain at the annual level, and the publication lag is close to one year. Wage indices are updated twice a year.

B. Public Finances

Reliable monthly data are available on a timely basis for the central government, where much improvement has been made over the past years. The asset position of the social security system is available on a daily basis. However, public enterprises and the social security system have been following somewhat different classifications of revenues and expenditures than the central government. A law (*Ley* 1535) that was passed in 2000 should bring closer integration, as it sets uniform standards and creates a database for the entire public sector. Data on medium- and long-term external debt are reliable and available on a monthly basis. Internal debt data are available on request, but need to be more fully integrated with the external debt database. Deficiencies remain in the registration of short-term supplier and commercial credit of the public sector. Regular reporting to STA has been restored.

C. Money and Banking

Money and banking statistics are broadly reliable as a result of the adoption in 1995 of a new accounting plan for commercial banks and finance companies. Following the work on methodologies initiated in the 2000, STA mission completed the establishment of a unified compilation and reporting systems for the whole range of monetary data. This new system intends to harmonize monetary data for use of the CBP, for reporting to STA for publication in *IFS*, and for operational and monitoring purposes. A revision of the classification criteria has led also to a marked reduction in the discrepancies of interbank positions. A recent STA money and banking statistics mission recommended that (1) institutional coverage of the depository corporations survey be expanded to include financial investment funds and financial cooperatives; (2) the compilation unit be given on-line access to the database maintained by the Superintendency of Banks; and (3) methodological notes be disseminated, including an explanation of improvements and reasons for breaks in the series.

The Superintendency of Banks publishes a detailed and informative report on the soundness of the financial system.

D. External Sector

Paraguay's balance of payments statistics continue to make improvements, and are now available on a quarterly basis. Data for the International Investment Position have been compiled for the period 1996-1999. The classification of the balance of payments and of the IIP follows the recommendations of the Balance of Payments Manual (5^{th} edition). Technical assistance by STA has led to improvements in the quality of the data on capital flows, especially in the coverage on foreign direct investment, and in the recording of external debt transactions in the balance of payments and in the IIP. The central bank produces now a highly informative bulletin on balance of payments statistics. Special studies by the central bank have improved the estimation methods for both remittances of Paraguayans abroad, and unregistered trade transactions. Deficiencies remain in the area of private capital outflows, which are difficult to register due to Paraguay's liberal capital account. Sizeable negative errors and omissions over the last few years can be attributed mostly to unregistered outflows of private portfolio investment. Progress in this area will require new surveying methods and substantial analytical efforts.

PARAGUAY: CORE STATISTICAL INDICATORS

as of end-March 2001

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	3/31/01	3/31/01	3/31/01	3/31/01	2/28/01	3/01	3/01	2/01	Q4/2000	2/01	2000	2/01
Date Received	3/31/01	3/31/01	3/31/01	3/31/01	3/20/01	3/20/01	3/31/01	3/20/01	1/24/01	2/05/01	1/21/01	3/20/01
Frequency of Data	Daily	Daily	Daily	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Annual	Monthly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Annual	Monthly
Source of Update	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Ministry of Finance	Central Bank	Central Bank
Mode of Reporting	Internet	E-mail	E-mail	E-mail	E-mail	E-mail	Internet	E-mail	E-Mail	E-mail	E-Mail	E-mail
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Annual	Monthly

Paraguay: Basic Data

I. Social and Demographic Indicators

Area (thousands of square km)	407.0
Population (2000)	
Total (in millions)	5.4
Rate of increase (percent a year)	2.6
Density (per square km)	13.6
Unemployment (Asunción, 1998)	7.2 percent
Population characteristics (1996)	
Life expectancy at birth (years)	70.7
Crude birth rate (per thousand)	29.8
Crude death rate (per thousand)	4.8
Infant mortality (per thousand live births)	23.8
Income distribution (1995)	
By highest 20 percent of households	46 percent
By lowest 20 percent of households	6 percent

Health		
Population per physician (1997)		2,174.0
Population per hosp. bed (1989)		762.0
Access to safe water (percent of population, 1995)		
Total		39.0
Urban		70.0
Rural		6.0
Education (in percent, 1999)		
Adult literacy rate		92 percent
Primary school enrollment		89 percent
Secondary scholl enrollment		41 percent
GDP (2000)	G billions	26,216
	US$ millions	7,511
per capita	US$	1,391

II. Economic Indicators, 1997-2001

	Average 1990-95	1997	1998	1999	Est. 2000	Proj. 2001
	(Percentage change)					
National accounts and prices						
GDP at constant 1982 market prices	3.2	2.6	-0.4	0.5	-0.3	2.0
Agriculture and mining	1.9	5.8	0.7	4.0	-9.0	...
Manufacturing	1.8	-0.2	1.0	0.0	1.0	...
Commerce and finance	3.0	0.2	-4.2	-9.2	-4.6	...
Consumer price index (end of period)	20.5	6.2	14.6	5.4	8.6	9.8
	(In percent of GDP)					
Gross investment	23.5	23.6	22.9	23.0	23.2	21.7
Private consumption	69.5	74.4	69.2	68.4	71.0	69.8
Public consumption	7.8	11.1	11.9	12.3	13.0	12.0
Gross national saving	25.0	16.7	21.0	21.9	19.0	20.7
Public Sector finances						
Revenue	17.9	21.5	23.2	23.3	22.4	23.3
Current expenditure	11.9	15.3	17.0	18.4	19.2	18.1
Capital expenditure	4.3	8.5	7.2	9.6	8.9	7.3
Primary balance	2.7	-1.5	0.3	-3.4	-4.1	-0.3
Overall balance	1.7	-2.3	-1.0	-4.7	-5.7	-2.1
	(Annual percentage change)					
Money						
Monetary Base	23.5	7.5	6.8	9.4	-1.0	15.5
M1	26.5	13.5	7.5	9.5	15.0	11.5
M2	33.0	5.5	-2.9	10.7	2.2	11.5
M3	34.7	12.4	8.8	17.6	3.6	11.5
Net foreign assets 1/	17.6	-10.7	14.9	19.2	-0.9	8.0
Net domestic assets 1/	29.7	34.4	6.6	4.3	8.9	10.2
Credit to the public sector 1/	-2.3	9.8	5.8	-6.7	4.7	4.4
Credit to the private sector 1/	31.1	10.9	-1.8	8.8	3.8	5.9

Paraguay: Basic Data (Concluded)

	Average 1990-95	1997	1998	1999	Proj. 2000	Proj. 2001
	(In millions of U.S. dollars)					
Balance of payments						
Trade balance	2.1	-864.8	-392.9	-368.2	-585.7	-335.9
Exports, f.o.b.	2,754.7	3,327.5	3,548.6	2,673.3	2,251.1	2,352.4
Imports, f.o.b.	2,752.5	4,192.4	3,941.5	3,041.5	2,836.8	2,688.3
Current account	74.4	-650.4	-160.0	-86.2	-314.9	-80.3
Capital account	55.4	438.8	325.0	523.4	194.4	80.3
Overall balance	-109.4	205.8	-23.4	-104.4	218.3	0.0
Memorandum items:						
Current account (as percent of GDP)	1.5	-6.8	-1.9	-1.1	-4.2	-1.1
External debt outstanding (as percent of GDP)	23.2	16.1	19.3	28.9	31.8	33.0
International reserves (millions of US dollars)	851.2	845.8	874.8	988.2	771.9	771.9
Real effective exchange rate (1990=100)	95.9	105.5	97.0	103.3	100.6	96.0
IMF data (as of February 28, 2001)						
Membership status						Article VIII
Intervention currency and rate						U.S. dollar (G 3,750/dollar)
Quota						SDR 99.9 million
Fund holdings of local currency						SDR 78.43 million
Fund holdings as percent of quota						78.5
Reserve position in the Fund						SDR 21.5 million
As percent of quota						21.5
Total Fund credit						None

Sources: Paraguayan authorities; and Fund staff estimates.

1/ Contribution to M3 growth.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Paraguay

On May 11, 2001, the Executive Board concluded the Article IV consultation with Paraguay.[1]

Background

During the decade from 1990 to 2000, real GDP per capita in Paraguay fell by over 5 percent. Growth was moderate in the early years and accelerated briefly during a credit-driven expansion in the mid-1990s. However, after a banking crisis brought the expansion to a halt in 1996, the Paraguayan economy has undergone a sustained contraction. A steep decline in investment, falling terms of trade, slow growth among trading partners and a contraction of the re-export business combined to reduce real GDP first in per capita terms and, since 1998, in absolute terms. As a result, poverty has deepened – especially in rural areas – and the income distribution has become more unequal.

In the fiscal area, structural reforms and a comprehensive adjustment in 1990 led to a series of fiscal surpluses during the first half of the decade that helped reduce the country's debt burden. The fiscal position deteriorated during the second half of the decade, as the public wage bill and pension payments crept up, and the public sector assumed the cost of a major banking crisis. Public enterprises saw their cash flow squeezed, as tariffs were not adjusted in line with costs. In addition, the social security system lost its surplus position after half of its assets were frozen in intervened banks and ceased to earn interest. The public sector deficit reached more than 5½ percent of GDP in 2000, when spending surged, financed by a large injection of external debt.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

As a consequence of increasing fiscal deficits, Paraguay's public external debt has doubled over the last five years to about 32 percent of GDP at the end of 2000. Virtually all the debt is owed to multilateral agencies or foreign governments, and has a relatively long residual maturity. As to net domestic debt, the public sector has a net asset position of around 2 percent of GDP, mainly as a result of former surpluses in the social security system.

The external current account recorded surpluses at the beginning of the decade. It swung into deficit during the credit-financed expansion of the mid-1990s, before narrowing briefly at the onset of the recession. Sharp increases in public spending widened the deficit again to around 4 percent of GDP in 2000.

Throughout the decade, Paraguay maintained an adjustable peg of the Guaraní vis-à-vis the US dollar. Monetary policy was largely geared towards keeping the exchange rate under control. In the early 1990s, the public sector surpluses permitted the absorption of net foreign exchange inflows from the external current account without creating pressure on domestic liquidity. Monetary growth temporarily accelerated in the mid-1990s, when the central bank assisted ailing banks. Under these circumstances, widening public sector deficits towards the end of the decade led to a progressive loss of international reserves, and to a higher frequency of exchange rate adjustments. However, the exchange rate anchor helped lower inflation from over 40 percent in 1990 to the single digits at the close of the decade.

After a sweeping deregulation in the early 1990s, Paraguay's financial sector underwent a boom-bust cycle similar to other countries where prudential supervision was not strengthened at the same time. During the upswing, the volume of credit expanded quickly, while real lending rates and spreads declined as competition among banks intensified. Strains appeared towards the middle of the 1990s, and during 1995-98 several banks representing a third of total deposits had to be closed.

As a result of problems in the financial system, private sector credit contracted sharply, and real interest rates rose to around 25 percent, while depositors increasingly shifted towards U.S. dollar-denominated assets. Foreign banks increased their market share to over 80 percent. The recession since 1998–which was in part a result of the banking crisis– led to a sharp rise in non-performing loans, and increased banks' reluctance to extend credit to the private sector. Increasing capital flight during the last two years reflected a deep lack of confidence and compounded the shortage of credit in the financial system.

Executive Board Assessment

Directors observed that, while adverse terms of trade developments and an unfavorable external environment have contributed to Paraguay's lackluster economic performance, policy slippages also bear a large responsibility.

Directors therefore welcomed the authorities' new resolve to restore macroeconomic discipline and to proceed with much needed structural reforms in the context of a staff monitored program.

They agreed that strict and timely implementation of the program will be critical in restoring investor confidence and paving the way for sustainable growth.

Directors expressed concern over the rapid deterioration of Paraguay's fiscal position. While recognizing that the weak economy has reduced fiscal revenue, they noted that the sharp increase in expenditure has played the determining role in the widening fiscal deficit. Directors welcomed the authorities' intention to reduce the fiscal deficit in 2001 significantly to a lower level. They were encouraged by the performance through end-April, but stressed the importance of continuing to adhere strictly to this ambitious target.

Directors observed that, aside from measures to curb tax evasion and extend the tax base, the scope for a significant improvement in revenue collection is limited in view of the present low level of economic activity. While revenue measures should not be ruled out, they emphasized that the envisaged reduction in the deficit will require a significant curtailment of expenditure, particularly current expenditure. In this regard, they pointed to the urgency of correcting the growing imbalance in the public sector employees' pension scheme.

Directors agreed that the authorities should seek to strengthen the tax base over the medium term, along the lines of the Fund's Fiscal Affairs Department recommendations of 1999, in order to generate needed resources to finance improvements in basic infrastructure and social services. While Paraguay's public debt is low by international standards, a number of Directors considered that its recent rapid increase, as well as the existence of significant liabilities that have not yet been recorded as public debt, required vigilance on the part of the authorities. They welcomed their decision to prepare consolidated public sector debt accounts which will improve monitoring capabilities.

Directors stressed the importance of moving forward with structural reform measures that are key to greater economic stability and efficiency. They expressed concern over the continued deterioration of the financial situation of the Social Security Institute, and urged the authorities to eliminate direct lending by the Institute, separate its health and pension sections, and avoid the concentration of its deposits in any single financial institution.

Directors noted that delays in the adoption of tariff adjustment in the public enterprises had led to a deterioration of their finances. While noting that an important adjustment was introduced at the beginning of the year, they suggested that smaller but more frequent changes to tariffs might better facilitate covering enterprise costs while being more socially acceptable.

Directors welcomed the progress made in the privatization of the telecommunications and water and sewage companies. They encouraged the authorities to complete these operations this year, to privatize additional enterprises, and to improve the efficiency of the remaining state enterprises. Care should be taken not to use privatization proceeds to finance public expenditure overruns. Directors also encouraged the authorities to press ahead with the planned reforms of the central administration.

Directors noted that price stability should remain the objective of monetary policy, as well as the importance of preserving and, if possible, increasing the level of international reserves. To this end, and to preserve competitiveness, Directors welcomed the authorities' intention to allow the market to play a larger role in determining the exchange rate, and to act on interest rates, if necessary, to counter inflationary pressures. They agreed that strict implementation of the fiscal adjustment program would help to prevent large exchange rate and interest rate movements, and safeguard the quality of the banks' loan portfolios. Directors encouraged the authorities to further strengthen bank supervision.

Directors welcomed the authorities' commitment to address the problem of the National Development Bank by the end of the year. They were concerned over the government's plan to reschedule nonperforming loans to the industrial sector and urged the authorities to pay due regard to the moral hazard risks and additional fiscal costs that the plan could entail.

Directors welcomed the marked improvement in Paraguay's statistical base, particularly in the areas of balance of payments, money, and the central government's finances, but noted that weaknesses remain in national accounts calculations, and the statistical coverage of public enterprise operations and external tariffs. They recommended that these data limitations be addressed by implementing the recommendation of recent technical assistance missions by the Fund's Statistics Department. They were encouraged by the progress made toward meeting the General Data Dissemination Standard (GDDS).

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Paraguay: Selected Economic Indicators

	1996	1997	1998	1999	Prel. 2000
Real economy (change in percent)					
GDP	1.3	2.6	-0.4	0.5	-0.4
GDP per capita	-1.3	0.0	-3.0	-2.1	-3.0
CPI (period average)	9.8	7.0	11.5	6.8	9.0
CPI (end of period)	8.2	6.2	14.6	5.7	8.6
Gross national savings (percent of GDP)	19.7	16.7	21.0	21.9	19.0
Gross domestic investment (percent of GDP)	23.4	23.6	22.9	23.0	23.2
Public finance (percent of GDP)					
Public sector savings	5.7	6.1	6.2	4.9	3.3
Public sector overall balance	0.0	-2.3	-1.0	-4.7	-5.7
Money and interest rates					
Money (M1) (change in percent)	3.0	13.5	7.5	9.5	15.0
Broad money (M2) (change in percent)	0.2	5.5	-2.9	10.7	2.2
Broad money incl. foreign currency deposits (M3) (change in percent)	12.8	12.4	8.8	17.6	3.6
Interest rates(average, in percent per annum)					
Domestic currency deposits 1/	13.0	7.6	6.7	9.5	8.1
Domestic currency loans 1/	40.0	36.0	39.5	39.2	35.8
Balance of payments (in millions of US$)					
Merchandise exports	3,797	3,328	3,549	2,673	2,251
Merchandise imports	4,383	4,192	3,942	3,042	2,837
Current account balance	-353	-650	-160	-86	-315
(percent of GDP)	-3.7	-6.8	-1.9	-1.1	-4.2
Net international reserves (end of period)	1062	846	875	998	772
External public debt (end of period)	1,398	1,444	1,596	2,108	2,354
(percent of GDP)	14.9	16.1	19.3	28.9	31.8

Sources: Central Bank of Paraguay, Ministry of Finance; and Fund staff estimates.

1/ Weighted annual average.