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IMF Country Report No. 06/302

Paraguay: Request for Stand-By Arrangement—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Paraguay

In the context of the request for Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the Request for Stand-By Arrangement prepared by a staff team of the IMF, following discussions that ended on March 8, 2006, 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 May 15, 2006. 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 Press Release summarizing the views of the Executive Board as expressed during its May 31, 2006 discussion of the staff report that completed the request.

- a statement by the Executive Director for Paraguay.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Paraguay*
Memorandum of Economic and Financial Policies by the authorities of Paraguay*
Technical Memorandum of Understanding*

*Also included in 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

Request for a Stand-By Arrangement

Prepared by the Western Hemisphere Department
(In consultation with other departments)

Approved by José Fajgenbaum and Scott Brown

May 15, 2006

- **Arrangement**. The authorities are requesting a 27–month Stand-By Arrangement (SBA), which the authorities intend to treat as precautionary and will cover the remainder of President Duarte-Frutos' term. Access is proposed at SDR 65 million or 65 percent of quota (29 percent of quota on an annual basis). The main objectives of the arrangement are to reduce vulnerabilities exposed during the 2002 crisis, entrench the stability achieved under the previous SBA by strengthening macroeconomic fundamentals, and lay the foundations for a gradual increase in economic growth to 4–5 percent per annum on a sustainable basis. The previous SBA (the first since 1968) expired in November 2005. The last review was completed on a lapse of time basis on November 30, 2005. No purchases were made under that arrangement and Fund credit to Paraguay is zero.
- **Developments**. Following the best macroeconomic results in a decade during 2004, the economy suffered from a variety of supply shocks in 2005. A drought, higher international oil prices and a rapid strengthening of the Brazilian real led to a reduction in economic growth and an increase in inflation. Notwithstanding these shocks, fiscal discipline was preserved, and reserves continued growing to record levels in 2005. All in all, the main objectives of the previous SBA were achieved. However, developments in early 2006 have been disappointing, given the continuation of a drought, persistent inflationary pressures, and a large and underfinanced budget approved by Congress.
- **Policies**. Against this background, the authorities intend to implement over the next 2½ years a strong macroeconomic program and an ambitious structural reform agenda to reinvigorate potential growth. For 2006, the main objectives are to raise real GDP growth to 3½ percent, lower inflation to 7 percent, and alleviate poverty.
- **Discussions**. These took place in Asuncion during November 9–21, 2005 and February 23–March 8, 2006. The mission met with President Duarte-Frutos, Vice-President Castiglioni, Finance Minister Bergen, Central Bank President Pérez dos Santos, Industry Minister Vera, Education Minister Ovelar, Deputy Finance Minister von Horoch, senior officials, representative of the international, business and banking communities, and members of Congress and civil society. The staff included A. Santos (head), F. Frantischek, T. Roy (all WHD), P. Breuer, K. Alexandraki (PDR), and A. Novoa (MFD). J. Fajgenbaum (WHD) participated in the final policy discussions in March. L. Duran-Downing, the Fund's senior resident representative in Asunción, assisted the team. The mission liaised with the World Bank and IDB offices in Asunción.

List of Acronyms

ANDE	National Electricity Company
BCP	Central Bank of Paraguay
BNF	National Development Bank
BOP	Balance of Payments
CAR	Capital Adequacy Ratio
CONATEL	National Telecommunications Commission
COPACO	Telephone Company
DSA	Debt Sustainability Analysis
ESSAP	Water and Sewage Company
FAD	Fiscal Affairs Department
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GNFS	Good and Nonfactor Services
IDB	Inter-American Development Bank
IFS	International Financial Statistics
IMAE	Monthly Indicators of Economic Activity
INC	National Cement Company
IPS	Social Security System
JBIC	Japan Bank for International Cooperation
LEG	Legal Department
LOI	Letter of Intent
LRM	Central Bank Bills
MEFP	Memorandum of Economic and Financial Policies
MFD	Monetary and Financial Systems Department
NDA	Net Domestic Assets
NIR	Net International Reserves
NPL	Nonperforming Loans
PC	Performance Criteria
PDR	Policy Development and Review Department
PETROPAR	Petroleum Company
ROSC	Report on the Observance of Standards and Codes
SBA	Stand-By Arrangement
SDR	Special Drawing Rights
TMU	Technical Memorandum of Understanding
VAT	Value Added Tax
WB	World Bank
WHD	Western Hemisphere Department

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EXECUTIVE SUMMARY

Background and Recent Developments

- **Performance under the previous SBA was satisfactory.** The program largely achieved the objectives of restoring stability, and starting a reform process to create conditions for sustained growth and poverty reduction.
- **Nonetheless, there are still important challenges to continue strengthening fundamentals and address remaining vulnerabilities.** Significant institutional reform efforts are needed to sustain the recent macroeconomic achievements and mitigate vulnerabilities. These efforts include reforms to sustain fiscal consolidation, strengthen monetary policy operations to reduce inflation, further strengthen the financial system, and remove impediments to growth.
- **To support their efforts, the authorities are requesting a 27–month precautionary SBA.** The SBA will cover the remaining period of President Duarte-Frutos' administration.

Program Objectives and Policy Pillars

- **The key objectives of the program are securing macroeconomic stability, creating the conditions for sustained high growth, and reducing poverty.** However, macroeconomic conditions have weakened in early 2006 as the drought seems to continue, and inflationary pressures persist.
- **Pursue a tight fiscal stance to reduce the debt burden over the medium term.** For 2006, the achievement of a zero-deficit in the public finances is based on the strict implementation of a financial plan, which contains expenditure cuts relative to the approved budget.
- **Follow a solid monetary policy to reduce inflation to low digits toward the end of the arrangement.** For 2006, the objective is to lower inflation to 7 percent.
- **Adopt an ambitious structural reform agenda to eliminate impediments to growth and alleviate poverty.** The authorities are committed to implementing a broad set of structural reforms, including reforms of the public and financial sectors, as well as pro-growth policies and a strategy for poverty reduction. Measures include improving expenditure control, modernizing the tax code, restructuring of the public enterprises, enhancing regulations and legislation for the financial sector, strengthening the balance sheets of the central bank and the national development bank, improving Paraguay's business climate, and introducing a conditional cash transfer mechanism for poor families.
- **The staff supports the authority's request.** In staff's view, this as an ambitious program that addresses comprehensively the immediate and medium-term challenges facing Paraguay. The authorities have strong ownership of the program.

I. Introduction

1. **The authorities' program for 2003–05, supported by the previous SBA, successfully stabilized the economy despite difficult conditions.** The economy was facing difficult problems at the end of 2003 (when the previous SBA began). Contagion from the regional crisis exposed serious economic vulnerabilities—including large fiscal imbalances, inadequate banking supervision, and chronic low growth. The situation improved considerably following the adoption of a strong program, which encompassed a tightening of macroeconomic policies and an ambitious structural reform agenda. A full-fledged crisis was averted as fiscal consolidation was rapidly adopted, confidence was restored, the financial system recovered, arrears were cleared, economic growth resumed and inflation was contained.

2. **A new economic program for 2006–08 is needed to consolidate macroeconomic stability, address remaining vulnerabilities, and create the conditions for higher growth.** While the gains attained under the previous SBA were considerable, additional institutional strengthening is needed to sustain macroeconomic achievements, mitigate existing vulnerabilities, and reinvigorate growth. Improvements in the fiscal accounts hinge on a surge in tax collections that must be institutionalized to be sustainable. Further strengthening of monetary policy is needed to help bring inflation down. Additional structural reforms seek to improve productivity, reduce poverty and eliminate impediments to growth.

3. **In support of these efforts, the authorities are requesting a 27–month SBA.** The authorities' medium-term objective is to lay the foundations for a gradual but sustainable increase in economic growth to 4–5 percent a year, lower inflation to industrialized country levels, and reduce poverty significantly. The proposed access under the arrangement is SDR 65 million (29 percent of quota on an annual basis). The authorities intend to treat the arrangement as precautionary.

II. Performance under the 2003-05 Program and Recent Developments

A. Macroeconomic Performance

4. **Some of the best macroeconomic results in a decade were achieved under the previous program.** However, conditions deteriorated in late 2005 and early 2006 and policies were strengthened accordingly.

- ***Economic activity***. During 2004, the economy grew 4 percent—the highest rate since the mid-1990s—driven by livestock, telecommunications and commerce. In 2005, a series of supply shocks (including a drought and higher oil prices) reduced growth to

3 percent. Livestock, forestry and construction sectors drove such growth.[1] There are reports of a continued drought in early 2006, which could jeopardize the authorities' growth objectives.

- ***Inflation***. In the context of a benign environment, inflation fell significantly to 2¾ percent in 2004—the lowest inflation rate since the early 1970s. However, considerable pressures emerged since then. A number of exogenous shocks were accommodated and inflation increased to 10 percent in 2005 (outside the 4–8 percent objective range). The Central Bank estimates that about half of the 2005 inflation was due to the oil shock and imported inflation coming from the strengthening of the Brazilian real. The staff estimates that delays in addressing emerging pressures and monetary expansion explain the persistence of high inflation in early 2006, which reached 4½ percent in the first four months of 2006 (and raised the 12–month rate to 10½ percent). While the Central Bank estimates that about half of the inflation in the first quarter of 2006 is due to temporary increases in fruits and vegetables, likely to be reversed in the coming months, it acted with determination, raising it short-term interest rates on *"letras de regulación monetaria"* (LRM) by a total of 375 basis points (to 10½ percent) in February and April 2006.

Paraguay: Recent Developments
Annual Growth (in percent) 1/

	2003	2004	2005	Jan-Mar 2006
Production 2/				
Manufacture	0.7	3.3	3.7	...
Agriculture	11.7	3.0	-5.8	...
Livestock	-1.3	7.5	21.1	...
Inflation 3/ 4/				
Consumer prices	9.3	2.8	9.9	10.6
Monetary 3/				
Base money	57.7	17.6	4.3	3.2
Money supply	24.9	24.6	16.1	15.9
Public Finances				
Tax receipts	25.8	34.1	11.0	26.2
External				
Exports 5/	30.6	30.9	3.8	3.0
Imports 5/	23.5	42.2	22.6	84.2
Exchange rate 3/	-13.3	2.8	-2.2	-8.2
NIR (billion US$)	0.98	1.17	1.30	1.36

Source: Paraguayan authorities.
1/ With respect to same period of previous year, unless otherwise specified.
2/ Data for 2005 based on IMAE estimates.
3/ 12-month growth rate e.o.p. (G/US$ for exchange rate).
4/ Data through April.
5/ Registered trade.

- ***Monetary developments***. The return of capital flight in 2004 satisfied increases in the demand for money and generated a rapid growth of monetary aggregates. However, monetary imbalances emerged in 2005 as capital inflows continued and the demand for money stabilized. Currency issue growth accelerated to 17½ percent in 2005 due to a rapid accumulation of net international reserves (NIR). Significant sterilization efforts and an increase in the Central Bank's short-term interest rates on LRM's by 425 basis points (to 6¾ percent), were insufficient to offset the large purchases of foreign exchange in the first half of 2005.

[1] The livestock sector became more dynamic as Paraguay gained access to new export markets for meat (in particular Chile, Israel and Russia).

- ***Fiscal performance***. Fiscal consolidation efforts were successful under the program and the Treasury recorded a surplus in 2004 for the first time in a decade. The Treasury reported another surplus of over ½ percent of GDP for 2005 against a program objective of a deficit of the same magnitude. The better-than-programmed performance is due to strong tax collections (despite lower rates for the profit tax), low investment project implementation and across-the-board expenditure cuts made in the last quarter of 2005 to help address inflationary concerns. There are early indications of a further strengthening in tax collections in the first quarter of 2006. Congress approved—for the third consecutive year—a large and underfinanced budget for 2006, which the authorities aim to re-align with the objective of achieving an overall balance of zero.

- ***External sector***. A benign external environment in 2004 deteriorated in 2005 and the current account balance turned from a small surplus in 2004 to a deficit of 2½ percent of GDP in 2005, mostly reflecting a rapid growth in oil imports.[2] Exports grew at a slower rate, with several traditional export items affected by the drought and lower commodity prices (i.e., soybeans, vegetable oil, and cotton) and non-traditional exports growing at a faster pace (i.e., meat). Notwithstanding the deterioration in the current account balance and negative external financing of the public sector, a surge in private capital inflows (including an almost doubling of FDI) resulted in a balance of payments surplus and a record high level of international reserves in 2005 (US$1.3 billion). Following large foreign exchange purchases in the first half of 2005, the Central Bank introduced a policy of limited foreign exchange intervention in mid-2005.

B. Structural Reform

5. **An ambitious structural reform agenda was adopted under the previous program.** Achievements in the structural area included Congressional approval of:

- ***The fiscal adjustment law***. It introduced the personal income tax, eliminated tax exemptions, simplified the tax system and broadened the tax base.

- ***The customs code***. It granted operational and financial autonomy to customs and expanded its powers of investigation and enforcement.

- ***The banking resolution law***. It set up a deposit guarantee fund and provided the Superintendence of banks with increased ability to deal with banks in trouble.

[2] Interpretation of trade data is partly compromised by a switch from unrecorded to recorded imports following continued improvements in customs administration.

- ***The public pension fund law***. It introduced a parametric reform of the pay-as-you-go public pension system to reduce significantly its cash deficit. It increased contributions, reduced benefits, and increased years of service.

- ***The second-tier public banking law***. It created the Financial Development Agency (AFD) to provide long-term financing by making available external funds from international financial institutions and donors to commercial banks.

Other reforms included a census on public servants, a plan to reform the civil service career, introduction of prudential regulations for cooperatives, and audits of public enterprises. However, the general banking law was not approved (nor considered) by Congress and the version of the first-tier public banking law considered by Congress is significantly different from that supported by the government. The government intends to veto this law.

C. Political Situation

6. **In an important internal party election, President Duarte-Frutos won the Presidency of the Colorado party.** The President obtained an overwhelming majority (63 percent of the votes) in February 2006. In the wake of a controversy as to whether he could legally exercise the presidency of the party while being President of the Republic, Mr. Duarte-Frutos delegated the responsibilities in Mr. José Alberto Alderete, who in turn resigned as Minister of Public Works. Mr. Duarte-Frutos' victory in the party elections could consolidate his political power, which would help in advancing the economic policies envisaged in the program. However, the immediate reaction to his decision to assume the presidency of the party (for a few hours) has been negative.

III. The 2006–08 Program

7. **The long-term vulnerabilities and structural deficiencies identified in the last Article IV Consultation served to frame the new program.**

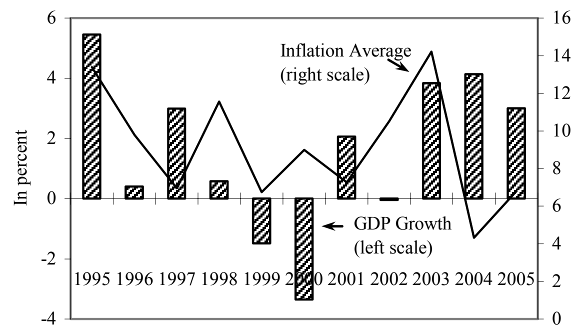
- ***Staff Report***. The main weaknesses identified in the Country Report No. 05/59 included: (i) political instability that translated into economic policy instability; (ii) governance problems that led to corruption and kept growth low; (iii) a weak financial system beset by a series of crises; (iv) inefficient public enterprises in key sectors that depressed efficiency and economic performance; (v) low and falling productivity which resulted in low growth; (vi) high poverty and unemployment with limited social protection.

- ***Selected Issues Paper***. This document analyzed similar issues, including corruption and low growth, financial vulnerabilities, fiscal rigidities, and macroeconomic instability. The selected issues papers was published by the Fund under the title: "Paraguay: Corruption, Reform, and the Financial System" (2005).

8. **The 2006–08 program has been tailored to address these economic weaknesses.** Following the expiration of the previous SBA in November 2005, the staff and the authorities engaged in a close dialogue and designed a policy matrix focused on tackling the key issues identified in the Article IV Consultation. This dialogue recognized five main weaknesses exposed during the 2002 crisis, and led to the five policy pillars under the program. This work benefited from the expert advice of FAD, MFD, the World Bank and the IDB (MEFP ¶10).[3]

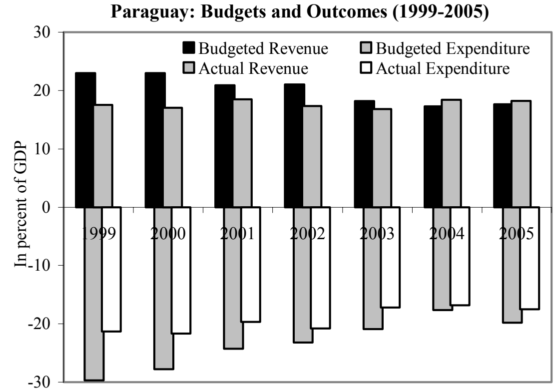
- ***Strong macroeconomic program***. While macroeconomic management has improved, it needs to be entrenched to avoid previous problems. Over the past decade, weak policy responses have exacerbated the impact of external shocks on output, employment and inflation, and have undermined confidence, leading to a number of financial crises.

Paraguay: Inflation and Real GDP Growth (1995-2005)



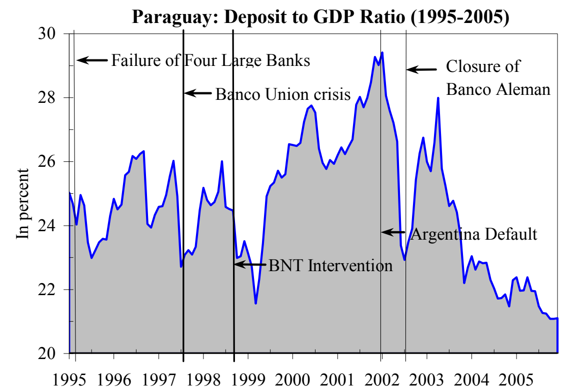
- ***Public sector reform***. This reform is designed to address remaining fiscal vulnerabilities and rigidities, including: (i) tackle deficiencies in budgetary planning and expenditure control; (ii) institutionalize improvements in tax collections; and (iii) reduce rigidities in current expenditures, which causes the authorities to cut capital expenditures as the main tool of fiscal adjustment, and thus undermines the credibility and consistency of the public investment program.

Paraguay: Budgets and Outcomes (1999-2005)

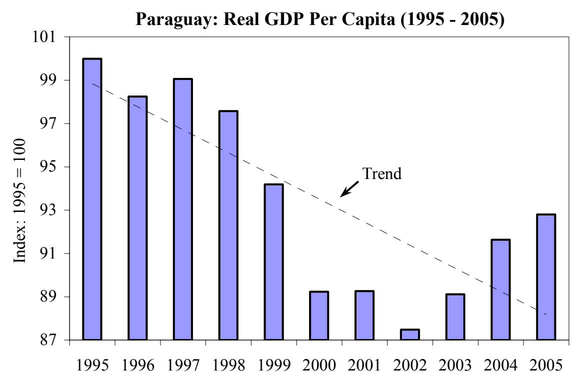


[3] The number in parenthesis with the ¶ sign refers to the paragraph number in the memorandum of economic and financial policies (MEFP) (Attachment II).

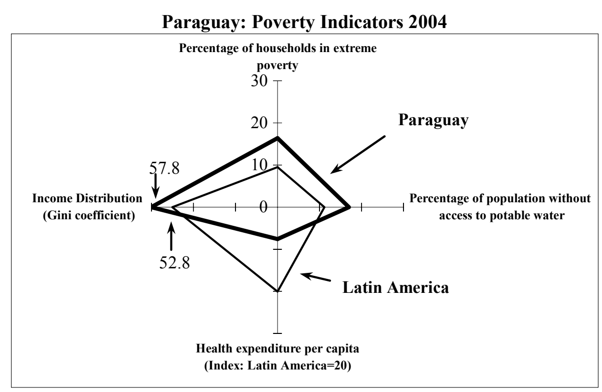
- ***Financial sector reform***. This is a key reform area, since weaknesses in the banking system and supervision have led to several banking crises over the last decade, and undermined public confidence in the system. Consequently, financial sector assets and liabilities are short-term, constraining financial intermediation and long-term investment (Box 3).



- ***Pro-growth agenda***. Paraguay has one of the worst long-term growth records in Latin America. Per capita GDP fell by 7 percent in real terms over the last 25 years. Shocks and structural impediments hampered growth and increased unemployment. There is a need to embrace reform in many diverse areas (including the judicial system, agriculture, public enterprises, labor markets, and the investment climate among others) to reinvigorate growth (Box 1).



- ***An effective social safety net***. This program seeks to alleviate the widespread poverty, and mitigate the social costs of reform. Lack of access to water and sanitary resources characterize the dire living conditions of the poor, particularly in rural areas. About 1/3 of the population lives with less than US$2 a day, and about 1/6 of the population lives under conditions of extreme poverty.



9. **The technical assistance program has been strengthened and refocused to address reform areas identified in the program**. To help address weaknesses in the implementation of a strong economic program, the authorities have requested additional technical assistance from the Fund (on fiscal and financial issues), the World Bank and the Inter-American Development Bank (IDB) (on growth and poverty issues). Efforts have been made to provide technical assistance prior to the adoption of key structural measures (Appendix IV).

Paraguay: Weaknesses, Objectives and Policies Under the Arrangement

Economic Weaknesses 1/	Program Objective	Policy Pillar
1. Unsustainable Macro Policies	1. Maintain Coherent Macro Policies	1. Macroeconomic Program
2. Fiscal Rigidities	2. Improve Public Sector Management	2. Public Sector Reform
3. Financial Vulnerabilities	3. Strengthen Financial System	3. Financial Sector Reform
4. Endemic Low Growth	4. Increase Economic Growth	4. Pro-Growth Agenda
5. Extreme Poverty	5. Reduce Poverty	5. Social Safety Net

1/ Present at the time of the 2002 crisis.

A. Macroeconomic Program

Macroeconomic Framework

10. **The program objective over the medium-term is to lay the foundation to double potential real GDP growth to 4-5 percent, reduce inflation and poverty, while maintaining macroeconomic stability**.[4] For 2006, the authorities expect real GDP to grow 3½ percent, (gradually increasing to 4½ percent by 2008), and inflation to fall to 7 percent (gradually declining to the low single digits by 2008).[5] While this is an ambitious inflation target, it is feasible if the temporary price increases in fruits and vegetables of the first quarter are reversed in the following months (MEFP ¶11).

Paraguay: Macroeconomic Framework

				Previous SBA		New SBA		
				Prog	Est.	Projection		
	2002	2003	2004	2005		2006	2007	2008
				Annual percent change				
Real GDP	0.0	3.8	4.1	3.2	3.0	3.5	4.0	4.5
Inflation (e.o.p.)	14.6	9.3	2.8	4 - 8	9.9	2½-7½	4.0	3.0
Money supply	-2.2	24.9	24.6	10.7	16.1	8.5	6.5	6.0
Real exchange rate 1/	-11.5	7.9	-7.9	2.0	2.4	...	...	...
				In percent of GDP				
Domestic investment	18.7	19.9	20.8	21.3	23.2	23.8	24.7	25.2
External current account	1.8	2.4	0.2	-0.4	-2.5	-2.2	-1.9	-1.9
Primary fiscal balance 2/	-1.9	1.0	2.7	0.7	1.9	1.0	1.2	1.2
Overall fiscal balance 2/	-2.5	-0.3	2.0	-0.5	0.6	0.0	0.0	0.0
Public sector debt	57.6	55.0	42.5	39.4	37.8	33.1	30.6	28.7

Sources: Paraguayan authorities; and Fund staff estimates; 1/ (-) = real depreciation; 2/ Central Government.

[4] Paraguay is one of the countries with the lowest long-term growth in Latin America. The average growth rate of the economy over the last 25 years is around 2 percent. Growth accounting exercises suggest that the economy could grow by over 5 percent a year with the right macroeconomic policies and structural reforms (Box 1).

[5] In view of the uncertainties and potential shocks, the Central Bank announced, in February 2006, their intention to keep inflation within the wide range of 2½–7½ percent. Given the inflationary pressures in the first quarter, they believe that inflation for 2006 is likely to be in the upper end of their range.

Fiscal Policy

11. **Fiscal policy aims at reducing the public debt to GDP ratio to 30 percent by the end of the decade, supported by maintaining an overall balance of zero in the public finances.** Sustained fiscal reform efforts will be needed to lock in recent improvements in tax policy and strengthen expenditure management. These efforts would ensure that the Treasury would generate an overall balance of zero over the medium term. A realistic price policy for public enterprises, together with efficiency gains, should permit them to generate moderate surpluses. These surpluses would cover expected losses of the Central Bank, yielding a balanced position for the consolidated public sector. This prudent fiscal stance, in concert with faster economic growth, would put the public debt to GDP ratio on a rapidly declining trend.[6]

Paraguay: Fiscal Program 1/

(In percent of GDP)

		Previous SBA		New SBA				
				Budget				
		Prog.	Actual	Approved	Effective	Prog.	Estimates	
	2004	2005		2006			2007	2008
Total Revenues	**18.4**	**18.3**	**18.2**	**18.5**	**17.9**	**17.9**	**18.2**	**18.4**
Tax	11.9	11.4	11.9	11.3	11.3	11.3	11.7	11.9
Non-tax	6.5	6.8	6.4	7.2	6.7	6.7	6.5	6.5
Total Expenditures	**16.8**	**18.8**	**17.5**	**19.8**	**19.8**	**18.0**	**18.2**	**18.4**
Current	12.9	13.7	13.5	14.3	14.3	13.7	13.5	13.3
Wages	7.2	7.5	7.2	7.5	7.5	7.4	7.2	7.2
Non-wages	5.7	6.2	6.3	6.7	6.7	6.3	6.3	6.1
Capital	3.9	5.1	4.0	5.6	5.6	4.3	4.7	5.1
Discrepancy	**0.4**	**--**	**-0.1**	**--**	**--**	**--**	**--**	**--**
Overall Balance	**2.0**	**-0.5**	**0.6**	**-1.4**	**-1.9**	**0.0**	**0.0**	**0.0**

Sources: Paraguayan authorities; and Fund staff estimates; 1/ Central Government.

12. **Strict application of a financial plan to keep expenditures below those approved by Congress will be critical to achieve the program's ambitious zero-deficit target for 2006.** In December, Congress approved a budget, which is at odds with the zero-deficit objective of the program. During the budget debate, Congress expanded expenditures above the executive's budget proposal (of which, about one-half was on wages). To ensure the achievement of the program's fiscal objective, the authorities are committed to keep tight control on current expenditure, while protecting social spending and supporting capital spending. They plan to cut budget expenditures by about 1¾ percent of GDP through the strict implementation of a financial plan. Expenditure measures include: (i) reducing allowances for senior public servants; (ii) lowering over-time outlays; (iii) eliminating hiring of temporary workers; (iv) freezing positions in the first four months; (v) phasing salary increases during the year; and (vi) restricting the purchase of goods and services. Accordingly, outlays in 2006 would be in line with recent expenditure levels (MEFP ¶12).[7]

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[6] Automatic stabilizers will be used as a countercyclical policy, if need be, and deviations around the broad fiscal balance objective could be envisaged in the following years.

[7] The financial administration law (1999) empowers the Ministry of Finance to reduce expenditures approved in the budget through a "financial plan" if tax collections or financing assumptions do not materialize. In the past two years under a Fund-supported program, the "financial plan" has been used successfully. The financial plan for 2006 was published as Presidential Decree No. 7209 on March 3, 2006.

13. **Additional revenue measures would be considered if necessary.** Over the past two years, tax collections have increased by over 1½ percent of GDP. Additional tax collections gains are expected over the medium-term through the full implementation of the 2004 tax reform (fiscal adjustment law) and sustained strengthening of the tax administration office, which should continue to increase revenue collection from Paraguay's large informal sector.[8] However, the tax revenue GDP ratio is envisaged to fall temporarily in 2006 due a reduction in the advances of the corporate income tax rate from 30 percent to 10 percent, as part of the tax reform. As other elements of the tax reform will become effective in 2007/08, tax revenue ratios are expected to recover to almost 12 percent of GDP by the end of the program. Non-tax revenues will pick up in 2006, as the government will obtain higher royalties from the binational hydroelectric entities.

14. **To support the growth objectives of the program, a higher level of public investment is planned**. The fiscal program envisages a level of capital expenditure of about 4¼ percent of GDP (mostly to improve basic infrastructure), which is realistic and can be easily financed. The authorities would like to implement a higher level of capital expenditures. The staff agreed with the authorities that fiscal targets could be relaxed in the context of the program reviews, if additional capital spending on high quality projects is identified, provided it is accompanied with adequate financing and does not jeopardize macroeconomic stability. The staff does not expect this additional public investment to exceed ½ percent of GDP in 2006. Staff will assess this spending in close consultation with the World Bank and the IDB. (MEFP ¶13).

15. **Multilateral institutions will provide over three-quarters of the gross financing requirements for 2006.** The IDB and the World Bank will be providing program financing in 2006 (on top of normal project financing). The World Bank is expected to disburse US$15 million, which is the first operation of the financial sector reform loan and the IDB is expected to disburse US$30 million in budgetary support.[9] This additional lending will be sufficient to reduce the net external financing need of the Treasury to almost zero in 2006. To cover scheduled amortizations of domestic bonds for G200 billion (almost ½ percent of GDP), the program allows the Treasury to use its deposits at the Central Bank. Staff encouraged the authorities to reopen the domestic securities market (MEFP ¶15).

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[8] The objective of the fiscal adjustment law (2004) was to simplify the tax system and broaden the tax base. The law eliminated most exemptions to the corporate income tax and reduced its rate, broadened the base of the VAT, instituted a new personal income tax (to be phased in over time), and established a new agricultural income tax to replace the previous IMAGRO tax. It also adjusted some excise tax rates, and strengthened the legal authority for tax administration. For a full description, see Box 4 in the staff report for the second SBA review (Country Report No. 05/59).

[9] The World Bank and the IDB already approved these loans. However, the loans need to be approved by Congress in order to authorize the government to receive the funds. The World Bank loan was approved by the Lower House and rejected by the Senate in March 2006. The loan went back to the Lower House for consideration. While the authorities are optimistic that Congress will approve these loans, they are considering alternative expenditure and financing options in the event the loans are not approved.

16. **The surpluses of the rest of the public sector are expected to offset the losses of the Central Bank in 2006**. As in 2005, the program will envisage a zero deficit target for the consolidated public sector in 2006. Given Central Bank projected losses of ¾ percent of GDP, it will be important that the rest of the non-financial public sector continue generating surpluses similar to those observed in the past. This will depend crucially on a realistic pricing policy for public enterprises and strict control over their costs (MEFP ¶14).[10]

Monetary Policy

17. **Monetary policy aims at reducing inflation to low single digits over the medium-term.** The authorities suggested currency issue as their monetary anchor for 2006, and committed to the continuation of a flexible exchange rate policy, with intervention guided by the NIR target. The staff recommended initiating the preparatory work to introduce inflation targeting (including strengthening the statistical infrastructure as well as developing models to track the transmission mechanism from interest rates to inflation).

18. **The monetary program for 2006 envisages a substantial tightening to achieve the program objective of bringing inflation down to 7 percent.** To that end, the Central Bank plans a sharp break with the previous accommodative policy of late 2005 and aims at reducing the growth of currency issue from 17½ percent in 2005 to 8½ percent in 2006 (significantly lower than nominal GDP growth). To achieve the inflation objectives, as noted above, the Central Bank increased short-term interest rates by 375 basis points to 10½ percent in two stages, in February and April 2006, and is ready to raise interest rates further if inflationary pressures remain. The staff supports this policy approach (MEFP ¶16).

Paraguay: Monetary Program 1/
(In percent of previous period currency)

		Previous SBA		New SBA		
		Prog.	Actual	Prog.	Projections	
	2004	2005		2006	2007	2008
Currency	**12.7**	**10.0**	**17.6**	**8.5**	**6.5**	**6.0**
Net international reserves	**52.6**	**9.6**	**32.6**	**4.3**	**6.5**	**6.0**
Net domestic assets	**-39.8**	**0.4**	**-15.0**	**4.2**	**0.0**	**0.0**
Credit to public sector (net)	9.2	4.1	1.8	6.5	3.8	-0.7
Credit to banks (net)	-45.9	-13.9	-26.1	-18.1	-10.9	-6.1
Reserve requirements	1.1	-4.9	-5.5	-6.0	-2.6	-4.1
Free reserves	-21.3	2.0	13.2	3.5	2.2	1.5
BCP bills (LRM)	-25.8	-11.0	-33.9	-15.6	-10.6	-3.4
Other items (net)	-3.1	10.2	9.3	15.8	7.1	6.8
Memorandum items:						
Base money growth (%)	17.6	8.2	4.3	6.0	4.2	4.5
Money supply growth (%)	24.6	10.7	16.1	8.5	6.5	6.0

Sources: Paraguayan authorities; and Fund staff estimates; 1/ Central Bank accounts

19. **The monetary program limits central bank credit expansion while allowing for some reserve accumulation in 2006**. The net domestic assets of the Central Bank (NDA) will expand by ₲123 trillion in 2006 (4¼ percent of currency) as the public sector is expected to use its deposits at the Central Bank (about 6½ percent of currency), the Central Bank will generate losses (over 10 percent of currency), and commercial banks are expected

[10] The government has limited control over the (independent) public enterprises and there are lags in collecting their financial information due to weak statistical frameworks. These problems complicate an adequate monitoring of this performance criterion.

to reduce their free reserves (about 3½ percent of currency). In order to curb credit expansion, the Central Bank intends to conduct a large amount of open market operations with banks (about 15½ percent of currency). The net international reserves of the Central Bank (NIR) will be strengthened by US$20 million (4¼ percent of currency) and could lead to some Central Bank intervention in the foreign exchange market (MEFP ¶17).

20. **The large Central Bank losses put at risk the effectiveness of monetary policy.** Over the last 10 years, a series of financial crises and rescue operations have weakened considerably the balance sheet of the Central Bank. In addition, the large number of non-performing assets (including loans to the government) and the need to place its own debt instruments to conduct open market operations have rendered central bank capital negative. Revenue enhancing and expenditure moderation measures adopted under the new Central Bank management reduced the losses of the Central Bank by 2/3 in 2005. However, increasing sterilization efforts and higher interest rates will cause the losses of the Central Bank to rebound to ¾ of GDP in 2006. The authorities agreed that the weak financial situation of the Central Bank distracts them from focusing on monetary policy issues and warrants a strengthening of its balance sheet. They have committed to design a strategy to strengthen the financial position of the bank by end–2006 (a structural benchmark under the program).

Paraguay: Central Bank Losses
(In percent of GDP)

	2003	2004	2005	Prog. 2006
Revenues 1/	**0.2**	**0.3**	**0.5**	**0.5**
Expenditures	**1.3**	**1.1**	**0.7**	**1.3**
Costs of monetary policy	0.6	0.4	0.4	0.7
Operational costs	0.3	0.3	0.3	0.4
Other expenditures	0.3	0.3	0.1	0.2
Profit (+)/Losses (-)	**-1.1**	**-0.8**	**-0.2**	**-0.7**

Sources: Paraguayan authorities; and Fund staff estimates.
1/ Mostly interest receipts from international reserves.

External Issues

21. **While the balance of payments is expected to continue under control over the medium-term, large external vulnerabilities remain.** Following the oil-related deterioration in 2005, the current account is projected to record deficits of about 2 percent of GDP over the next few years. These deficits are expected to be more than covered by private capital inflows (mostly in the form of FDI); the authorities intend to keep net external borrowing to a minimum. Net international reserves are expected to grow to maintain an import coverage of about 3½ months. No financing gaps are envisaged. While there is no imminent balance of payments need (hence the treatment of the arrangement as precautionary), the economy remains vulnerable to large shocks, not least those generated by the much larger

Paraguay: Balance of Payments
(In percent of GDP)

		Previous SBA		New SBA		
		Prog.	Prel.	Prog.	Projections	
	2004	2005		2006	2007	2008
Current Account	**0.2**	**-0.4**	**-2.5**	**-2.2**	**-1.9**	**-1.9**
Exports	39.6	39.1	40.6	39.4	39.2	38.8
Imports	-45.4	-45.4	-49.1	-46.6	-45.5	-44.8
Other	6.0	6.0	5.9	5.1	4.4	4.1
Capital Account	**1.8**	**0.9**	**1.8**	**2.7**	**2.3**	**2.2**
Public sector (net)	0.2	0.5	-0.8	0.1	0.0	0.3
Private sector (net) 1/	1.6	0.5	2.6	2.6	2.3	1.9
Overall Balance	**3.9**	**0.5**	**1.6**	**0.5**	**0.4**	**0.3**
Overall Financing	**-3.9**	**-0.5**	**-1.6**	**-0.5**	**-0.4**	**-0.3**
Net international reserves	-2.6	-0.5	-1.7	-0.2	-0.4	-0.3
Exceptional financing	-1.3	0.0	0.1	-0.3	0.0	0.0

Sources: Paraguayan authorities; and Fund staff estimates; 1/ Includes errors and omissions neighboring economies, as well as to commodity price shocks and the frequent droughts that impair exports.[11]

22. **The authorities will continue with their efforts to normalize relations with external creditors**. The fiscal and external problems of 2002/03 lead to the accumulation of large external arrears. These have been addressed, by and large, in the context of the previous SBA. However, there are some claims, which are either in the process of being normalized or in dispute. During 2006, PETROPAR will clear its suppliers' credits with maturities of over 90 days. The staff encouraged the authorities to find an early resolution to disputed claims. However, the authorities are not willing to pay or recognize the obligations to a syndicate of banks (for US$85 million or 1¼ percent of GDP), as ruled by the Swiss supreme court in May 2005, because they consider these claims the result of private fraud and not public borrowing. The Executive, Legislative and Judicial powers formally rejected the ruling of the Swiss court (Presidential decree No. 6295 of August 2005). The government is exploring the possibility of elevating the case to the International Court of Justice in The Hague. For the purpose of the program, these obligations are regarded as disputed claims and not arrears.[12]

B. Public Sector Reform

23. **The public sector reform will address institutional weaknesses to improve the composition and efficiency of public expenditure and cement improvements in revenue collections**. A primary objective of the reform is to improve expenditure management controls to devote more resources for essential social and investment spending. Furthermore, fiscal adjustment to date has relied heavily on increases in tax collections, which to be sustained require strengthening the legal and institutional framework of the revenue collecting agencies. The broad reform agenda to be implemented during the following three years includes measures to: (i) strengthen the budgetary framework to convert it in an effective financial management tool; (ii) reinforce the tax and customs administrations to consolidate recent revenue collections; (iii) enhance expenditure control mechanisms to prevent excesses and increase efficiency; (iv) rationalize the civil service to improve proficiency; and (v) design a comprehensive reform for public and private pensions and health insurance to secure financial sustainability.

[11] The regional economy is overwhelmingly larger than Paraguay. Brazil's economy is over 80 times bigger than Paraguay's economy and Argentina's economy is over 30 times bigger. Regional shocks have the potential of creating large disruptions and significant balance of payments needs.

[12] Disputed claims at end-March 2006 amount to some US$270 million (3¾ percent of GDP), including claims by: (i) Belgium's Ex-Herstal (US$7½ million); (ii) a South African supplier (US$0.03 million); (iii) French and Swiss import verification companies (US$75 million); (iv) the National Bank of Argentina (US$75 million), and (v) a syndicate of European and American banks following a Swiss court ruling against Paraguay in May 2005 (US$85 million). PETROPAR will clear any outstanding suppliers' credits (over 90 days) associated with diesel purchases by end-December 2006.

24. **For 2006, the authorities will focus on adopting the first steps toward achieving lasting improvements in revenue and expenditure management.** There is an immediate need to initiate these reforms to entrench fiscal discipline, and the authorities would like to focus on these areas in the first year of the program. Conditionality on public sector reform for 2007/08 will be articulated at the time of the second review under the arrangement. FAD and LEG are providing technical assistance in these areas.

- ***Tax Administration.*** In view of the importance of securing recent improvements in tax collections for the maintenance of macroeconomic stability, the preparation of a tax procedures code is a structural performance criterion for December 2006. The main purpose of the code will be to provide better legal and regulatory capacity to the revenue collecting agencies to enhance enforcement (MEFP ¶19).

- ***Expenditure Control***. Given recent problems with the inflated budget approved by Congress, and the importance of having a realistic budget for the conduct of a strong fiscal policy in the future, the design of an action plan to strengthen budget preparation, develop expenditure controls at the commitment level and the streamlining of the treasury account system—with a view for an early adoption—is a structural benchmark for June 2006. The plan is expected to define a broad-based path for public financial management (PFM) reform, including the preparation of a long-term macro-fiscal framework for setting expenditure limits and medium-term fiscal goals; the preparation of a medium-term expenditure framework to guarantee the sustainability of government programs; the preparation of a Treasury law significantly reducing the number of accounts, and regulating treasury operations; the recording of expenditure commitments for all transactions. The plan will build on the work of the recent fiscal ROSC and PFM technical assistance missions (MEFP¶ 20).

Paraguay: Structural Reform Agenda

Reform Area	Measures	Conditionality (Date)
1. Fiscal	Action plan to develop commitment control system and rationalize Treasury accounts	Benchmark (Jun 2006)
2. Financial	Audited and inspected CAR (provisioned) of 5 percent for BNF at end-June 2006	Benchmark (Sep 2006)
3. Financial	Implement regulatory measures outlined in banking strategy and put together legislation	Benchmark (Sep 2006)
4. Pro-Growth	Plan to improve business climate	Benchmark (Sep 2006)
5. Fiscal	Preparate a tax code in consultation with the Fund	PC (Dec 2006)
6. Financial	Strategy to strengthen the financial position of Central bank and timetable	Benchmark (Dec 2006)
7. Pro-Growth	Implement management contract for ANDE, COPACO, ESSAP, INC, and PETROPAR	Benchmark (Dec 2006)
8. Social	Create cash transfer mechanism for 7,000 families living under extreme poverty	Benchmark (Dec 2006)
9. Financial	Audited and inspected CAR (provisioned) of 10 percent for BNF at end-December 2006	PC (Mar 2007)
10. Financial	Send bill to Congress that reflects the implications of plan to strengthen BCP	Benchmark (Apr 2007)

Sources: Paraguayan authorities and Fund staff; PC = performance criterion.

C. Financial Sector Reform

25. **This reform seeks to reduce financial vulnerabilities, foster financial intermediation, bring the regulatory framework closer to international standards, and bolster monetary policy by improving the operational capacity of the central bank.** The financial system has been subject to five financial crises over the last decade. There is a need

to reduce its vulnerability and improve its functioning. The reform agenda in this area draws heavily on the diagnosis of the FSAP exercise conducted in 2005. The program will focus on the following areas during the next three years: (i) strengthen the financial position of the central bank to ensure its solvency and integrity; (ii) improve the framework for monetary operations by strengthening lender-of-last resort facilities, enhancing the reserve requirement system, and strengthening the regulatory framework for repurchase agreements; (iii) upgrade banking supervision by granting more autonomy and regulatory powers to the superintendence of banks and improving its human, material and technological resources; (iv) strengthen prudential regulations to enhance governance, sharpen the identification of corporate risk and enhance sanctioning capacities; (v) restructure public banks (especially the National Development Bank, BNF) to eliminate systemic risks; (vi) foster capital markets by developing the legal basis for a securities depositary and revamp electronic systems and procedures; and (vii) improve the payments system by establishing real-time gross settlement and an automatic clearing house.

26. **For 2006, the program includes some of the most critical actions recommended by the recent FSAP missions.** During the first year of the program, the authorities would like to focus on the strengthening of BNF to prevent a systemic risk; the financial strengthening of the Central Bank to improve its effectiveness; and improving the banking law and regulations to reduce vulnerabilities in the financial system. Conditionality on financial sector reform for 2007/08 will be articulated at the time of the second review under the arrangement. MFD is providing technical assistance in these areas.

- ***Public Banks***. An important objective of this reform is to strengthen BNF's financial position to meet international standards. Over the last two years, the BNF has improved its financial situation markedly. It is expected to continue improving its position by accumulating undistributed profits and engaging in a more aggressive asset recovery policy. Achieving an audited capital adequacy ratio (CAR) of 5 percent for end-June 2006 is a structural benchmark for September 2006. Similarly, an audited CAR of 10 percent for December 2006 is a performance criterion for March 2007. Any shortfall on these CAR targets will be met by the government (MEFP ¶21).[13] The authorities have also committed to maintain subsequently the capital of BNF at a level sufficient to meet both the CAR of 10 percent as well as any other prudential requirements of the central bank. Furthermore, they will continue the restructuring of BNF in 2007–08 aiming at reducing its operating cost, improving its risk management, lending practices and internal controls. BNF will continue to be an anchor to the payment system in the country (given its large network of branches) but will limit the scope of its credit operations. The authorities believe that the bulk of the

[13] The CAR will be measured under fully provisioning rules, similar to those included in the amended regulation 8 of the Central Bank, which will become effective in January 2007. BNF's CAR under this definition for end–2005 was about zero percent. It is estimated that BNF needs an additional capital of about ₲50 trillion (some US$8 million or 0.1 percent of GDP) to achieve the targeted CAR by end–2006.

long-term development financing in the country will be provided by the newly created Financial Development Agency (AFD) (MEFP ¶26).

- ***Central Bank***. Despite the Central Bank's determination to implement a tight monetary policy, the growing losses of the Central Bank have the potential of weakening their resolve. Therefore, a strengthening of the Central Bank's financial position is a priority. Preparation of a joint strategy by the Ministry of Finance and the Central Bank for the financial strengthening of the Central Bank is a structural benchmark for December 2006. Submission of a law to Congress adopting all legal and budgetary elements necessary to implement the strategy is also a structural benchmark for April 2007. The authorities would have preferred to complete both measures at the same time, but the legal framework prevents them from doing so. According to the budgetary law, the government has to submit the draft budget to Congress by end-August 2006 (before the strategy is ready). Furthermore, the earliest date to submit to Congress the budget implications of the strategy is April 2007, which is the first date the government can introduce a supplementary appropriations budget (MEFP ¶23).

- ***Commercial Banks***. Given the importance of strengthening the banking system and preventing further episodes of financial instability, the implementation of the financial sector action plan to achieve the broad objectives of the general banking bill currently in Congress is a structural benchmark for September 2006.[14] The plan envisages actions to strengthen monetary operations, redefining minimum capital requirements, setting out fit and proper tests for issuing banking licenses, sharpening the identification of corporate risk and enhancing sanction capabilities. The Central Bank Board can adopt some of these actions but some others would require amendments to the current banking law. The authorities expect to submit to Congress any legislation needed for this purpose by September 2006 (MEFP¶ 22).

D. Pro-Growth Agenda

27. **This reform pillar includes measures aimed at eliminating impediments to growth as well as restructuring and modernizing the economy.** This is the most diverse pillar as it includes broad-based reforms in a number of areas. The reform agenda—to be implemented over the next three years—has been discussed with the World Bank and the IDB, and focuses on: (i) restructure public enterprises to increase coverage and efficiency in the provision of their services and raise investment; (ii) improve the investment climate to boost investment and productivity; (iii) reform the hydrocarbon sector to modernize and regulate it for a more efficient and less costly delivery of products; (iv) strengthen

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[14] The general banking bill was submitted to Congress in December 2004 and has not been considered yet. In parallel, the Central Bank prepared an action plan to achieve most of the banking bill objectives in November 2005 (taking into account FSAP recommendations). The design of such plan was a structural benchmark for the sixth review under the previous SBA.

performance of the agricultural sector by promoting sustainable productivity among farmer and increase small farmers access to markets; (v) enhance the efficiency of civil court procedures by increasing judicial security and reducing the time it takes to make rulings; and (vi) introduce flexibility in the labor market to reduce the cost of formal employment and avoid firings before certain thresholds trigger significant increases in benefits.

28. **For 2006, the authorities will concentrate on steps toward enhancing efficiency in public enterprises and improving the investment climate.** The authorities have decided to take these steps in the first year of the program to enhance productivity and resource allocation in the economy, and promote private investment and growth. Conditionality on the pro-growth agenda for 2007/08 will be articulated at the time of the second review under the arrangement. The World Bank and the IDB are assisting the authorities in these efforts.

- ***Public Enterprises***. Following comprehensive audits of all public enterprises in 2005, the authorities intend to enter into result-oriented management contracts (including targets for specific performance indicators), with ANDE, COPACO, ESSAP, INC and PETROPAR. The objective of these contracts is to improve the managerial and operational efficiency of these companies. Implementation of these contracts is a structural benchmark for December 2006 (MEFP ¶24).

- ***Investment Climate***. The authorities believe that a process of rapid economic growth will require high levels of private investment. The design of an action plan to improve the investment climate is a structural benchmark for September 2006. The plan is expected to include steps to reduce red tape by simplifying procedures for company registration and licensing regulations, supporting exporter and foreign investors through one-stop shops; improving dispute resolution procedures and enforcement of judicial decisions; and strengthening public institutions certifying product quality (MEFP ¶25).

E. Social Safety Net

29. **This reform area reflects the authorities' commitment to protect the most vulnerable segments of society and to alleviate poverty and inequality.** The program will allow for an increase in social spending over the medium term, which will be accommodated by lower expenditure elsewhere to remain within the overall expenditure limits. The main objectives of this pillar during the following three years are: (i) strengthen social assistance programs with a view to reaching some of the Millennium Development Goals ahead of schedule; (ii) reorient and improve efficiency of social expenditure especially to reach the rural poor by focusing on education and health; and (iii) improve income inequality though an explicit transfer system.

30. **For 2006, the authorities will focus on certain elements of its subsidy/transfer policies**. The program envisages an increase in social spending in 2006. The social safety net is expected to have a direct and positive impact on the most vulnerable groups in society. Additional measures on the social safety net for 2007/08 will be articulated at the time of the

second review under the program. The World Bank and the IDB are assisting the authorities in these efforts.

- ***Cash Transfers***. The authorities will create a centralized system of targeted cash transfers to benefit 7,000 families living in extreme poverty conditioned by contracts with beneficiaries. The authorities believe this is the most direct manner to alleviate poverty. The conditions will include, *inter alia*, children's school attendance and visits to health centers. Implementation of this system is a structural benchmark for December 2006. The authorities plan to broaden the coverage of the targeted cash transfer system in 2007–08 (MEFP ¶27).

- ***Public Transportation Subsidies***. The authorities would like to improve the efficiency of their fuel subsidy program. To that end, they have sent to Congress legislation to provide limited subsidies to public transportation to protect the users from recent increases in international oil prices and to facilitate a gradual elimination of indiscriminate diesel subsidies.

IV. Program Risks

A. Program Vulnerabilities

31. **While significant progress has been made in improving medium-term prospects and promoting economic sustainability, the country remains vulnerable to exogenous shocks and domestic setbacks.** These include external shocks and the typical uncertainties of a small open economy with a non-diversified agricultural export base (including weather-related risks).

- ***External risks***. These shocks could include a sharp and prolonged rise in oil prices, a large drop in external demand and macroeconomic imbalances from the much larger neighboring countries. There are significant regional risks as policies in the bigger neighbors are not coordinated with Paraguay.

- ***Domestic risks***. Financial dollarization carries liquidity and solvency risks for the banking system. Delays in implementing structural reforms would lead to lower growth, threaten fiscal sustainability and undermine the de-dollarization process, thus increasing the economy's vulnerability to exogenous shocks. As the municipal elections approach (scheduled for November 2006) and the environment becomes more politicized, an important risk to the program will be the potential political challenges to the macroeconomic policies and the structural reform agenda. Delays in the approval of key legislation by Congress remain a potential risk. An additional risk to the program could be a deterioration of the political and social climate, which may complicate economic management.

B. Medium-Term Scenario

32. **While the medium-term outlook has improved significantly, it underscores the importance of cementing stability and deepening structural reform to foster sustained growth and reduce poverty**. Prospects depend crucially on continued prudent macroeconomic policies and further structural reforms to bolster medium-term growth. The medium-term economic outlook under a scenario of a lasting commitment to macroeconomic stability and broad-based reforms is quite positive and breaks with the pattern of the past. The scenario assumes the continuation of measures to consolidate macroeconomic stability; lock in improvements in tax collection and administration; mobilize resources to reduce poverty; and improve the environment for private investment. It also assumes favorable external demand conditions, particularly from MERCOSUR partners. Accordingly, real GDP growth is projected to rise to 5 percent by 2010, price and financial stability will be maintained, and the public debt-to-GDP ratio will decline to below 30 percent by the end of the decade.

33. **A passive scenario of no reform perpetuates the circle of low growth and high poverty of the last 25 years**. While macroeconomic stability could still be achieved in this alternative scenario, the economy will remain highly vulnerable to shocks and will continue in a low growth trap. This scenario assumes prudent macroeconomic policies, but no additional structural reforms. Under this scenario, growth projections would be around 2 percent (similar to the past), inflation would be higher, the external current account would be in surplus as investment would be depressed, and a weaker fiscal policy would drive the debt to GDP ratio to over 30 percent by the end of the decade.

C. Capacity to Repay the Fund

34. **Paraguay's capacity to repay the Fund is quite strong**. Even if the proposed access under this precautionary arrangement is fully used, the capacity of Paraguay to repay the Fund remains quite strong. The current Fund credit outstanding is zero and the proposed strong program will continue entrenching debt sustainability. The success of the previous arrangement improved significantly the payment capacity of the country. Therefore, notwithstanding the risks to program implementation identified in the preceding section, the staff believes that the risk of nonpayment to the Fund—in the event a purchase is made—is negligible. This program does not pose serious risks to the Fund.

D. Debt Sustainability Analysis

35. **Strong macroeconomic fundamentals anchor the sustainability of public debt.** A combination of external shocks and weak policy responses placed Paraguay on an unsustainable debt path until 2002. The public debt to GDP ratio rose from less than 20 percent in 1997 to over 70 percent in 2002. One of the main achievements of the previous SBA was to place the public debt on a sustainable path. At end–2005, the debt to GDP ratio fell to below 40 percent. Macroeconomic fundamentals have improved significantly over the last two years. With the prospect of higher growth (4½ percent) and low real interest rates

(3 percent), the expected primary surplus (1¾ percent of GDP) would be more than enough to ensure a declining debt to GDP ratio.[15] Paraguay's public debt projections appear sustainable and relatively resilient to temporary negative shocks. The debt sustainability analysis (DSA) shows that less favorable assumptions on the underlying macroeconomic variables, such as interest rates and real GDP growth, would lead to a more moderate declining trend of debt-to-GDP ratios than in the baseline scenario. It also indicates that the economy would be particularly vulnerable to an exchange rate shock.

36. **The moderate current account deficits over the medium term ensure external debt sustainability**. With a benign external outlook and a relatively comfortable external position, it is not surprising that the external debt situation is manageable. The bulk of the external debt (about 95 percent) is public debt, and the public finances are solvent. Over the medium-term, the private sector will increase its borrowing as the public sector debt declines. The external debt to GDP ratio is expected to decline from about 40 percent in 2005 to below 30 percent by the end of the decade. As with the public debt exercise, the outlook is resilient to less favorable assumptions on the underlying macroeconomic variables. It also indicates that the economy would be vulnerable to a prolonged deterioration of the current account balance.

Paraguay: Sustainable Primary Fiscal Balance 1/
(As a percent of GDP)

GDP Growth Rate (%)	Real Interest Rate (%)				
	2.0	3.0	4.0	5.0	6.0
2.0	0.0	0.4	0.8	1.2	1.6
3.0	-0.4	0.0	0.4	0.8	1.2
4.0	-0.8	-0.4	0.0	0.4	0.8
4.5	-1.0	-0.6	-0.2	0.2	0.6
5.0	-1.1	-0.8	-0.4	0.0	0.4
6.0	-1.5	-1.1	-0.8	-0.4	0.0

1/ To maintain constant a debt to GDP ratio of 40 percent.

V. Program Modalities

37. **Length**. The authorities and the staff believe that an arrangement covering the period left in the Presidential term of Mr. Durate-Frutos, which is 27–months (May 2006–August 2008), will help insulate Paraguay from the normal pre-electoral expenditure pressures and could increase the chances for reform, growth and poverty alleviation.[16]

38. **Access and Phasing**. The staff proposes access of SDR 65 million or 65 percent of quota (29 percent on an annual basis). This compares with an access of 50 percent of quota (40 percent on an annual basis) under the previous arrangement. Since there is no Fund exposure to Paraguay now, the first purchase would be the first credit tranche (i.e., 25 percent of quota). The following five purchases would be for 6 percent of quota until reaching 50 percent of quota (achieved under the previous arrangement) within 15 months from

[15] The tabulation indicates that the current fiscal stance is enough to sustain the current level of debt for a wide range of real interest rates and real GDP growth.

[16] Presidential elections are scheduled for April 2008 and the change in administration for August 2008.

approval, thereby providing a comfortable line of defense against unexpected shocks. Subsequently, the remaining four purchases would be for 2½ percent of quota.

39. **Reviews.** The authorities requested quarterly reviews in the first year of the program, switching to semi-annual reviews subsequently (while retaining quarterly quantitative performance criteria and quarterly scheduled purchases).

40. **Conditionality.** The authorities and the staff believe that the structure of quantitative performance criteria under the previous SBA was adequate and an analogous structure is proposed for this arrangement.[17] This report includes conditionality mostly for 2006. Conditionality for 2007/08 will be proposed to the Board at the time of the second review under the arrangement (scheduled for December 2006).

41. **Monitoring.** The Program Monitoring Group was created and successfully used in the previous program. The staff reached understandings with the authorities that a similar group, meeting periodically, will continue to monitor the program.[18]

42. **Safeguards Assessment.** Under the Fund's safeguards policy the Central Bank is subject to a safeguards assessment. An assessment was completed in January 2003 under the previous arrangement. A FIN mission visited Asuncion in March and the ongoing assessment will be finalized before the first review of the program in September 2006.

VI. Staff Appraisal

43. **Performance under the previous program supported by an SBA was broadly satisfactory, although the revival of inflation was disappointing.** The authorities' previous program was designed at a difficult time with the aim of stabilizing the fiscal situation and the banking system and initiating needed structural reforms. On the macroeconomic side, the measures were timely and the results immediate. Fiscal consolidation efforts were successful and the Treasury registered a surplus in 2004 and 2005. The situation in the banking system improved considerably with confidence restored, better profitability and much lower non-performing loan indices. On the structural side, there were some delays (partly due to Congress), but five major pieces of economic legislation were approved (fiscal adjustment law, customs code, banking resolution law, public pension fund law, and second-tier public banking law). These efforts paid off and the economy actually grew more in the years

[17] There are 8 quantitative performance criteria: (i) overall balance of the central administration; (ii) wage bill of the central administration; (iii) overall balance of the public sector; (iv) net international reserves; (v) net domestic assets; (vi) contracting or guaranteeing of nonconcessional external debt of the public sector; (vii) contracted or guaranteed short-term external debt of the NFPS; (viii) non-accumulation of external debt arrears.

[18] The program-monitoring group consists of senior officials from the Ministry of Finance and the Central Bank, as well as the IMF resident representative and the IMF mission.

covered by the previous SBA (11½ percent growth in the period 2003–05) than in the previous ten years (10½ percent growth in the period 1993–2002).

44. **The authorities' new program is comprehensive and calibrated to the challenges still facing Paraguay.** It is based on a continuation of prudent macroeconomic policies that are expected to entrench economic and financial stability, and an ambitious structural reform agenda that should help reverse the vicious cycle of low growth and declining per capita income, which prevailed in Paraguay over the last quarter of a century.

45. **The program is ambitious and has more than a reasonable chance of success due to the high degree of ownership and commitment.** As the authorities do not have much experience in implementing some of the proposed reforms, technical assistance from the Fund and experts from other international financial institutions will be needed to support these reforms. Despite these constraints, there is a strong ownership and consensus within the whole cabinet of ministers in advancing the reform process. The economic team was successful in committing different ministers to lead specific reforms of the structural agenda. Therefore, the staff reached understanding on the program with broad sectors within the government.

46. **The staff welcomes the authorities' decision to implement a strict financial plan to achieve the program objective of a zero fiscal deficit in 2006.** As the approved budget—adjusted for realistic revenues—entails a deficit of almost 2 percent of GDP, against a target of a balanced budget in the program, fiscal developments will need to be closely monitored to contain expenditure pressures or if necessary take immediate corrective actions. An additional complication is that for the first time the financial plan will apply to wage items. The program allows for some flexibility on additional capital expenditure but has no margin for extra current expenditures.

47. **The monetary program needs to be implemented carefully to succeed in addressing inflationary pressures.** The authorities have adopted a very tight monetary program, with the growth in currency issue expected to decelerate sharply to 8½ percent in 2006, a much lower rate than nominal GDP growth. To achieve this objective, the central bank has raised its short-term interest rates by nearly 400 basis points in recent months. However, further actions may be needed to bring inflation down to the target rate. The authorities are encouraged to implement rapidly their strategy for strengthening the financial position of the Central Bank, as this would enhance the ability of the Central Bank to focus its attention on monetary policy.

48. **The structural reform agenda is quite ambitious.** In order to safeguard the timely implementation of the structural agenda, efforts were made to rely less than in the past on reforms that require congressional approval (although seeking approval of laws is unavoidable in some areas). As there are many reforms in different areas, the implementation will require a high degree of coordination among their different policy makers involved. Frequent meetings of the program monitoring group will help identify problems at an early stage, design corrective measures and ensure adequate performance.

49. **As with the previous program, there are a number of risks.** Important vulnerabilities to the program come not only from financial vulnerabilities, but also from political and social uncertainties. Municipal elections are scheduled for November 2006 and pressures to stop reforms and increase expenditures could arise. The staff welcomes the introduction of legislation to establish a subsidy on public transportation to protect vulnerable groups and address social concerns, while facilitating the adoption of a diesel pricing policy that would eliminate indiscriminate subsidies. The success of the program will thus depend not only on the authorities' determination to strongly implement the reforms contained in the program, but also on their ability to communicate policies appropriately and persuade stake holders about the merits of the policies adopted.

50. **The staff supports the authorities request for a new SBA.** The staff believes the program is appropriate in addressing Paraguay's many challenges. The authorities' program strikes a good balance between emphasis on macroeconomic and structural issues, building on initial efforts to address long-standing problems. Achieving its objectives will require sustained efforts and the full support of the international community. The accomplishments under the previous arrangement and the high level of ownership on the policies augur well for the success of this program.

BOX 1: PARAGUAY: WHY IS GROWTH SO LOW?

Paraguay's real per capita income has performed poorly relative to the region over the last quarter of a century. Following a period of rapid economic growth in the 1970s—associated with the construction of the Itaipú and Yacyretá hydroelectric complexes—Paraguay entered a period of relative economic stagnation since the 1980s. Over the last 25 years, real per capita income fell by 8½ percent. During the 1990s, Paraguay displayed the worst performance in the region, with an average real per capita income growth rate of -0.9 percent a year. With population growth projected at about 2 percent a year, it would take five years of economic growth at a consistent rate of 5 percent just to recover the losses in per-capita income since 1981.

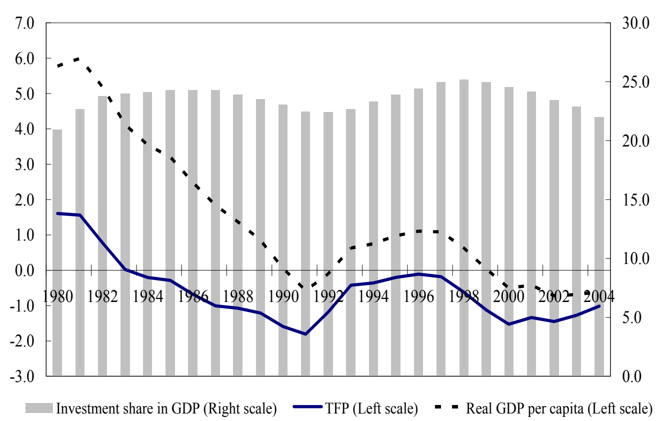
Real Per Capita GDP Growth
(Average annual growth rate, in percent)

	1980-90	1990-2004
Chile	1.7	4.8
Panama	-0.6	2.8
Costa Rica	-0.2	2.2
El Salvador	-1.0	2.2
Peru	-2.7	2.0
Mexico	-0.2	1.3
Bolivia	-2.0	1.3
Guatemala	-1.6	1.1
Brazil	0.2	1.1
Argentina	-2.5	0.9
Colombia	1.3	0.7
Ecuador	-0.4	0.7
Uruguay	0.0	0.6
Honduras	-0.7	0.4
Venezuela	-1.5	-0.9
Paraguay	**0.0**	**-0.9**

Source: IFS

A growth accounting exercise suggests that the decline in per capita income was primarily driven by a significant fall in total factor productivity (TFP). A standard Solow-type growth exercise—using production factor shares in income based on the newly released 1994-base national accounts—revealed that while labor and capital had positive and significant contributions to output growth (like in most countries), the TFP (the Solow residual) declined, on average, by 1¼ percent annually during 1980-2004. Efficiency losses in the utilization of factors of production appear to have dragged down real GDP per capita growth substantially.[1]

TFP Growth, Real GDP Per Capita and Investment Share in GDP
(1980-2004, ten-year rolling average)



Structural reforms are needed to increase growth in per capita income and reverse the trend of declining productivity. The decline in TFP reveals problems of efficiency and productivity rather than scarcity of input factors. The dismal growth experience over the last two decades reflects severe structural deficiencies that have adversely affected the private sector, such as poor regulation, institutional weaknesses, lack of infrastructure, and shortcomings in education and health care. While macroeconomic stability is crucial for anchoring private sector expectations, overcoming structural bottlenecks by means of an ambitious and focused reform agenda are necessary to reverse the trend and shift Paraguay to a higher growth path.

In the medium term, Paraguay's growth rate could more than double under a decisive and consistent structural reform strategy. A comparison with Chile, Latin America's best performer in this area, is particularly instructive. Combining Chile's efficiency gains in TFP with Paraguay's factor endowment would have yielded a growth rate of nearly 6 percent a year in the past 25 years. This implies that the economy could have more than doubled its current size if proper policies would have been adopted.

Paraguay: Growth Accounting (1980-2004)
(Average growth rate, in percent)

	Paraguay	Chile	Paraguay with Productivity of Chile
Economic Growth	**2.4**	**5.2**	**5.8**
Contributions from:			
Labor	1.5	0.9	1.5
Capital	2.1	2.0	2.1
Productivity (TFP)	-1.2	2.2	2.2

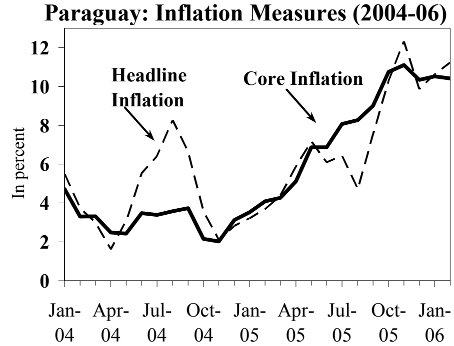
Source: IMF staff estimates.

[1] In an extensive cross-country regional analysis, Loayza et al. (2004) show that TFP performance in Paraguay is even worse when adjusting for improvements in human capital. See Loayza, Fajnzylber, Calderón (2004), *Economic Growth in Latin America and the Caribbean. Stylized Facts, Explanations, and Forecasts*; Central Bank of Chile Working Paper No. 265.

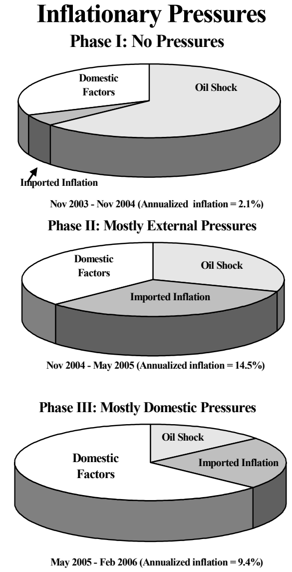
BOX 2. PARAGUAY: INFLATION DYNAMICS

After an outstanding inflation performance in 2004, inflationary pressures emerged during 2005. A combination of improved macroeconomic management and a benign external environment led to the lowest inflation rate in Paraguay in over 30 years during 2004. However, this pattern started to revert in late 2004 and through the first half of 2005. Agriculture was hit by a drought, international oil prices continued to rise, and the Brazilian *real* appreciated considerably against the U.S. dollar (exacerbating the real depreciation of the *guarani*).[1] The intensification of underlying inflationary pressures was partly masked in the CPI by the erratic behavior of fruits and vegetables prices. Core inflation (which excludes fruits and vegetables) displays a more discernible pattern of continued inflationary pressures during 2005.

Paraguay: Inflation Measures (2004-06)



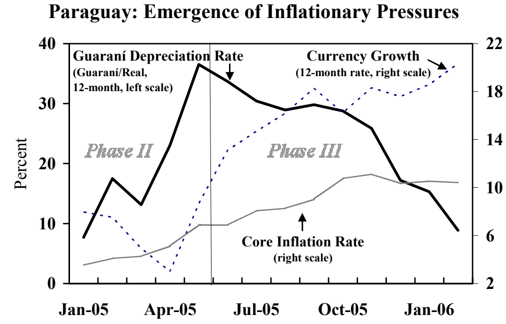
Paraguay: Decomposition of Inflationary Pressures



However, an analysis of the underlying sources of inflation reveals a significant shift away from external factors toward domestic factors during 2005. To determine these sources, BCP staff decomposed the consumer basket in categories related to trade with Brazil, oil-sensitive goods, and domestic items. During 2004 (phase I), overall inflation was very low (about 2 percent) and primarily driven by oil prices. In the first half of 2005 (phase II), external pressures intensified and brought inflation up to an annualized rate of 14½ percent. However, since the second half of 2005 (phase III), external factors subsided, and inflation appears to be driven increasingly by domestic factors, including non-core inflation. During the first half of 2005, monetary policy was eased as the Central Bank (BCP) was overwhelmed with inflows of foreign exchange, and was unable to fully sterilize the monetary impact of international reserves accumulation. Annual currency growth accelerated to 17½ percent at end-December 2005 while money demand growth began to ease up.

To combat inflationary pressures, the BCP recently intensified its efforts of monetary tightening. During the first four months of 2006, the BCP's Executive Committee for Monetary Operations (CEOMA) increased its key interest rates for Central Bank securities (LRM) by some 400 basis points to 10½ percent (35 days maturity). This has generated a better control of monetary aggregates and currency growth fell to about 15 percent by end-March 2006. The authorities are committed to tighten further to maintain a firm control on monetary aggregates.

Paraguay: Emergence of Inflationary Pressures



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[1] Since May 2004, Brazil's real appreciated by 30 percent against the U.S. dollar.

BOX 3. PARAGUAY: FINANCIAL SECTOR ASSESSMENT

The financial system in Paraguay is recovering after several years of financial crises that followed a rapid financial liberalization process in the early 1990s. Following a run on deposits and an attack on the currency in 2002/03, macroeconomic policy has succeeded in containing inflation while restoring economic growth, which has prevented further financial instability. However, the slow progress in overcoming weaknesses and vulnerabilities is partly due to the piecemeal character of measures adopted by the government. A more comprehensive effort towards financial reform is needed.

An upgrade of the banking legal framework and prudential regulations would spur oversight. Further initiatives should aim at strengthening governance and risk-oriented supervision; improving supervisory capacities and accountability, including legal protection to central bank (BCP) and superintendency of banks (SB) employees; granting more autonomy and sanctioning/regulatory powers to the SB; and upgrading the resources of the SB. The FSAP also recommends restructuring the National Development Bank (BNF) to minimize fiscal costs, eradicate moral hazard and assure its good future performance.

The framework for the supervision of credit cooperatives needs to be completed and implemented. Credit cooperatives have grown fast and are gaining systemic relevance as they account for 10 percent of total deposits and 16 percent of total credits of the financial system. A framework with new prudential regulations and coordination arrangements with the SB are needed for effective supervision. Improved quality and quantity of information provided by cooperatives should be a priority to ensure the adequate measurement and control of monetary aggregates.

Overall conditions for long-term financial contracts suffer from deficient insolvency procedures and the lack of a prudential framework for pension funds. Strengthening creditor rights and streamlining insolvency procedures are critical steps to promote the supply of credit to the private sector. Allowing a better use of pension funds to finance sound long-term investments requires the designation of an authority in charge of regulation. Moreover, clear risk management guidelines need to be defined for the *Instituto de Previsión Social* (IPS), the mandatory pension fund, which should be allowed to invest in government securities, and be repaid long overdue government obligations that constrain its capital base.

A debt management strategy consistent with Paraguay's budget cycle would help gain credibility and reduce implicit and explicit costs of public debt. The lack of a framework conspires against the credibility of government bonds issuances and a gradual lengthening of the maturity of government obligations. In the medium term, the development of a secondary market could act as a catalyst for developing the local capital market and facilitate the use of government securities for monetary operations.

An overhaul of the Paraguayan payments system would help mobilize long-term resources. Main areas of improvement include: (i) settlement finality protection of the system against bankruptcy procedures; (ii) establishing the legal bases for: dematerialization/immobilization of securities, custody and netting arrangements, and electronic documents and signatures; and (iii) the legal definition of repo operations. The approval of a comprehensive payments system law should be considered a priority by the Central Bank.

Table 1. Paraguay: Selected Economic and Social Indicators

I. Social and Demographic Indicators

Area (thousand sq. km)	407
Population	
Total (in millions-2004)	5.7
Rate of increase (percent a year)	1.9
Density (per sq. km.)	14.1
Unemployment	10.9
Population characteristics	
Life expectancy at birth (years)	70.6
Crude birth rate (per thousand)	29.7
Crude death rate (per thousand)	5.0
Infant mortality (per thousand live births)	26.0

Income distribution	
By highest 20 percent of households	61 percent
By lowest 20 percent of households	2 percent
Health	
Physicians per 1,000 people	1.1
Hospital beds per 1,000 people	1.3
Access to a water source	79 percent
Access to a sanitation facility	95 percent
Education (in percent)	
Male literacy rate	94 percent
Female literacy rate	92 percent
Primary school enrollment	92 percent
Secondary school enrollment	47 percent

II. Economic Indicators, 2002-2008

	2002	2003	2004	2005 Prog.	2005 Prel.	Projections 2006	Projections 2007	Projections 2008
	(Annual percent change; unless otherwise specified)							
National accounts and prices 1/								
GDP at current prices	10.0	22.5	16.4	7.5	11.1	13.1	8.8	6.7
GDP at constant prices	0.0	3.8	4.1	3.2	3.0	3.5	4.0	4.5
Per capita GDP (U.S. dollars, thousands)	0.9	1.0	1.2	1.2	1.3	1.4	1.5	1.5
GDP deflator	10.0	18.0	11.8	4.2	7.9	9.2	4.6	2.1
Consumer prices (end-of-period)	14.6	9.3	2.8	6.0	9.9	2.5–7.5	4.0	3.0
Real effective exchange rate 2/								
Average (depreciation -)	-11.1	-6.7	4.1	...	-7.0	...	...	...
End-of-period (depreciation -)	-11.5	7.9	-7.9	...	2.4	...	...	...
	(In millions of U.S. dollars)							
External sector								
Exports, f.o.b. (percentage change)	-1.6	16.8	27.2	3.0	10.2	7.6	5.8	5.2
Imports, c.i.f. (percentage change)	-14.6	14.4	29.2	6.2	16.1	5.4	3.9	4.5
Net oil exports and imports	-239	-327	-434	-510	-510	-519	-540	-564
Current account	93	131	14	-27	-190	-180	-170	-177
(in percent of GDP)	1.8	2.4	0.2	-0.4	-2.5	-2.2	-1.9	-1.9
Capital account	53	201	127	66	133	226	203	209
Overall balance	-83	211	269	39	121	46	33	32
Terms of trade (percentage change)	7.5	7.3	2.5	-5.4	-12.7	4.3	1.8	1.3
	(In percent of GDP)							
Savings-investment balance								
Gross domestic investment	18.7	19.9	20.8	21.3	23.2	23.8	24.7	25.2
Private sector	12.2	14.8	16.1	14.1	18.5	18.8	18.9	18.9
Public sector	6.4	5.1	4.7	7.2	4.7	5.0	5.8	6.3
Gross national savings	20.5	22.3	21.0	21.0	20.6	21.6	22.8	23.3
Private sector	17.8	17.7	14.5	13.9	15.1	16.7	17.0	17.1
Public sector	2.7	4.6	6.5	7.0	5.5	4.9	5.7	6.2
Public sector								
Central government primary balance	-1.9	1.0	2.7	0.7	1.9	1.0	1.2	1.2
Central government overall balance	-2.5	-0.3	2.0	-0.5	0.6	0.0	0.0	0.0
Consolidated public sector primary balance 3/	-1.4	2.6	3.1	1.4	2.7	1.7	1.7	1.7
Consolidated public sector overall balance 3/	-3.4	0.0	1.8	0.0	0.9	0.0	0.0	0.0
Public sector debt (end-of-year) 4/	57.6	55.0	42.5	39.4	37.8	33.1	30.6	28.7
External	50.3	49.7	38.6	36.0	34.4	30.5	28.4	26.9
Domestic	7.3	5.3	3.9	3.4	3.3	2.6	2.2	1.8
	(Annual percent change)							
Money and credit								
Monetary base	-1.0	57.7	17.6	8.2	4.3	6.0	4.2	4.5
M2	-2.2	24.9	24.6	10.7	16.1	8.5	6.5	6.0
M5 5/	-18.5	17.7	11.7	8.3	7.7	8.2	6.6	6.0
Credit to the private sector 5/	-20.9	-18.4	13.9	10.2	14.1	11.9	6.6	8.7
Velocity of M2	7.5	8.3	7.7	7.8	7.1	7.2	7.3	7.3
Memorandum items:								
International reserves (in millions of U.S. dollars)	641	983	1,168	1,220	1,297	1,317	1,350	1,382
(In months of imports)	2.8	3.4	3.5	3.9	3.6	3.6	3.5	3.4
GDP (in billions of guaranies)	29,105	35,666	41,522	44,516	46,135	52,156	56,752	60,548
Population (millions)	5.5	5.6	5.7	5.8	5.8	5.9	6.0	6.2

Sources: Paraguayan authorities; and Fund staff estimates.

1/ Revised GDP growth rates and GDP ratios reflects the use of a new national account data recently published by the authorities. However, program GDP ratios were not revised.
2/ INS calculations of real effective exchange rates.
3/ Consolidated public sector, including the quasi-fiscal operations of the BCP.
4/ Based on average exchange rate valuation of GDP.
5/ Foreign currency items are valued at a constant exchange rate.

Table 2. Paraguay: Central Government Operations

	2003	2004	Prog. 2005	Prel. 2005	Program 2006 Jan-Mar	Program 2006 Jan-Jun	Program 2006 Jan-Sep	Program 2006 Jan-Dec	Projections 2007	Projections 2008
In billion of guaraníes										
Total revenues	**6,001**	**7,637**	**8,137**	**8,419**	**2,103**	**4,393**	**6,779**	**9,358**	**10,309**	**11,135**
Tax revenues	3,676	4,929	5,093	5,471	1,263	2,733	4,274	5,877	6,615	7,200
Income taxes	624	880	973	967	93	311	533	745	890	993
Excises	704	1,000	954	1,007	281	583	865	1,174	1,302	1,409
Nontax revenues 1/	2,318	2,696	3,035	2,946	840	1,660	2,504	3,479	3,691	3,933
o/w : Public pension contributions	364	440	394	541	136	277	417	565	615	656
Itaipu-Yacyreta	1,456	1,640	1,699	1,651	525	952	1,409	1,917	1,992	2,126
Capital revenues	7	12	9	2	0	1	1	2	2	2
Current expenditures:	**4,981**	**5,363**	**6,089**	**6,231**	**1,596**	**3,280**	**5,019**	**7,125**	**7,637**	**8,054**
Wages and salaries	2,724	2,984	3,328	3,334	883	1,795	2,695	3,880	4,105	4,343
Goods and services	408	447	526	546	99	265	430	638	663	683
Interest payments	489	483	561	560	167	275	441	547	665	707
Transfers	1,334	1,431	1,647	1,771	443	936	1,439	2,041	2,183	2,299
Of which : pensions and benefits	943	940	1,078	1,126	298	601	906	1,265	1,376	1,469
Other	26	18	26	19	5	10	14	19	21	22
Capital expenditures and net lending	**1,165**	**1,625**	**2,287**	**1,860**	**309**	**863**	**1,435**	**2,233**	**2,669**	**3,077**
Statistical discrepancy 2/	35	181	0	-39	0	0	0	0	0	0
Overall balance	**-110**	**830**	**-240**	**289**	**198**	**250**	**325**	**0**	**4**	**4**
Financing	**110**	**-830**	**240**	**-289**	**-198**	**-250**	**-325**	**0**	**-4**	**-4**
External debt (increase +)	588	103	301	-295	-175	-206	-99	28	5	187
Disbursements	1,151	763	1,142	658	133	362	795	1,192	1,144	1,354
Amortizations	563	660	841	953	307	568	894	1,164	1,140	1,167
Domestic bonds (increase +)	-58	-78	-167	-137	-193	-193	-208	-208	-129	-167
Net credit from the banking system	-308	-162	106	-44	330	279	83	190	121	-24
Other	-111	-693	0	188	-160	-130	-100	-10	0	0
In percent of GDP										
Total revenues	**16.8**	**18.4**	**18.3**	**18.2**	**4.0**	**8.4**	**13.0**	**17.9**	**18.2**	**18.4**
Tax revenues:	10.3	11.9	11.4	11.9	2.4	5.2	8.2	11.3	11.7	11.9
Nontax revenues 1/	6.5	6.5	6.8	6.4	1.6	3.2	4.8	6.7	6.5	6.5
Capital revenues	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current expenditures	**14.0**	**12.9**	**13.7**	**13.5**	**3.1**	**6.3**	**9.6**	**13.7**	**13.5**	**13.3**
Wages and salaries	7.6	7.2	7.5	7.2	1.7	3.4	5.2	7.4	7.2	7.2
Goods and services	1.1	1.1	1.2	1.2	0.2	0.5	0.8	1.2	1.2	1.1
Interest payments	1.4	1.2	1.3	1.2	0.3	0.5	0.8	1.0	1.2	1.2
Transfers	3.7	3.4	3.7	3.8	0.8	1.8	2.8	3.9	3.8	3.8
Capital expenditures and net lending	**3.3**	**3.9**	**5.1**	**4.0**	**0.6**	**1.7**	**2.8**	**4.3**	**4.7**	**5.1**
Statistical discrepancy 2/	0.1	0.4	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	**-0.3**	**2.0**	**-0.5**	**0.6**	**0.4**	**0.5**	**0.6**	**0.0**	**0.0**	**0.0**
Financing	**0.3**	**-2.0**	**0.5**	**-0.6**	**-0.4**	**-0.5**	**-0.6**	**0.0**	**0.0**	**0.0**
External debt (increase +)	1.6	0.2	0.7	-0.6	-0.3	-0.4	-0.2	0.1	0.0	0.3
Disbursements	3.2	1.8	2.6	1.4	0.3	0.7	1.5	2.3	2.0	2.2
Amortizations	1.6	1.6	1.9	2.1	0.6	1.1	1.7	2.2	2.0	1.9
Domestic bonds (increase +)	-0.2	-0.2	-0.4	-0.3	-0.4	-0.4	-0.4	-0.4	-0.2	-0.3
Net credit from the banking system	-0.9	-0.4	0.2	-0.1	0.6	0.5	0.2	0.4	0.2	0.0
Other	-0.3	-1.7	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Item:										
Primary balance	1.0	2.7	0.7	1.9	0.7	1.0	1.5	1.0	1.2	1.2
Balance of the Caja Fiscal 3/	-1.6	-1.2	-1.5	-1.3	-0.3	-0.6	-0.9	-1.3	-1.3	-1.3

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes receipts from the binational hydroelectric plants Itaipu and Yacyreta, and grants.
2/ Measurement error to reconcile above-the-line estimate with measure of the fiscal balance from the financing side.
3/ Includes pension payments to central government employees and Chaco War veterans.

Table 3. Paraguay: Operations of the Consolidated Public Sector 1/

					Program				Projections	
			Prog.	Prel.	Jan-Mar	Jan-Jun	Jan-Sep	Jan-Dec		
	2003	2004	2005		2006				2007	2008
				In billion of guaraníes						
Revenue	**7,450**	**8,959**	**9,665**	**10,067**	**2,576**	**5,342**	**8,205**	**11,261**	**12,375**	**13,332**
Tax revenue	3,676	4,936	5,098	5,482	1,266	2,739	4,284	5,890	6,629	7,214
Nontax revenue and grants	3,617	4,010	4,505	4,551	1,302	2,585	3,895	5,335	5,707	6,075
Capital revenue	157	14	62	34	8	18	26	36	39	42
Current expenditure	**6,247**	**6,959**	**7,532**	**7,879**	**2,072**	**4,281**	**6,550**	**9,275**	**9,820**	**10,366**
Wages and salaries	3,290	3,634	3,957	4,088	1,077	2,186	3,282	4,730	5,032	5,333
Goods and services	634	755	816	945	222	519	814	1,161	1,229	1,283
Interest payments	728	678	660	751	229	431	698	911	981	1,004
Transfers	1,544	1,699	1,952	2,067	525	1,103	1,690	2,378	2,549	2,716
Other	51	193	146	26	18	42	65	95	28	30
Capital expenditure and net lending	**1,819**	**1,956**	**3,217**	**2,170**	**402**	**1,049**	**1,714**	**2,605**	**3,292**	**3,791**
Of which : capital expenditure	1,850	2,189	3,309	2,358	455	1,155	1,874	2,818	3,524	4,038
Primary balance	**914**	**1,305**	**640**	**1,247**	**500**	**781**	**1,138**	**911**	**990**	**1,017**
Public enterprises' operating surplus	**801**	**583**	**1,063**	**478**	**169**	**337**	**499**	**619**	**746**	**838**
Statistical discrepancy 2/	-203	129	0	-78	0	0	0	0	0	0
Overall balance	**-17**	**756**	**-21**	**418**	**271**	**350**	**440**	**0**	**9**	**13**
Financing	**17**	**-756**	**21**	**-416**	**-271**	**-350**	**-440**	**0**	**-9**	**-13**
External financing net	459	-42	293	-445	-206	-250	-165	-43	-96	145
Disbursements	1,273	808	1,363	771	146	399	858	1,287	1,286	1,554
Amortizations	814	850	1,069	1,216	353	649	1,022	1,329	1,382	1,409
Domestic financing net	-24	72	-273	-202	107	52	-144	95	88	-158
Of which : quasifiscal deficit financing	390	333	260	112	50	145	245	376	255	237
Other	-417	-786	0	230	-171	-152	-132	-53	0	0
				In percent of GDP						
Revenue	**20.9**	**21.6**	**21.7**	**21.8**	**4.9**	**10.2**	**15.7**	**21.6**	**21.8**	**22.0**
Tax revenue	10.3	11.9	11.5	11.9	2.4	5.3	8.2	11.3	11.7	11.9
Nontax revenue and grants	10.1	9.7	10.1	9.9	2.5	5.0	7.5	10.2	10.1	10.0
Capital revenue	0.4	0.0	0.1	0.1	0.0	0.0	0.1	0.1	0.1	0.1
Current expenditure	**17.5**	**16.8**	**16.9**	**17.1**	**4.0**	**8.2**	**12.6**	**17.8**	**17.3**	**17.1**
Wages and salaries	9.2	8.8	8.9	8.9	2.1	4.2	6.3	9.1	8.9	8.8
Goods and services	1.8	1.8	1.8	2.0	0.4	1.0	1.6	2.2	2.2	2.1
Interest payments	2.0	1.6	1.5	1.6	0.4	0.8	1.3	1.7	1.7	1.7
Transfers	4.3	4.1	4.4	4.5	1.0	2.1	3.2	4.6	4.5	4.5
Other	0.1	0.5	0.3	0.1	0.0	0.1	0.1	0.2	0.0	0.0
Capital expenditure and net lending	**5.1**	**4.7**	**7.2**	**4.7**	**0.8**	**2.0**	**3.3**	**5.0**	**5.8**	**6.3**
Of which : capital expenditure	5.1	4.9		4.7	0.8	2.0	3.3	5.0	5.8	6.3
Public enterprises' operating surplus	**2.2**	**1.4**	**2.4**	**1.0**	**0.3**	**0.6**	**1.0**	**1.2**	**1.3**	**1.4**
Statistical discrepancy 2/	-0.6	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	**0.0**	**1.8**	**0.0**	**0.9**	**0.5**	**0.7**	**0.8**	**0.0**	**0.0**	**0.0**
Financing	**0.0**	**-1.8**	**0.0**	**-0.9**	**-0.5**	**-0.7**	**-0.8**	**0.0**	**0.0**	**0.0**
External financing net	1.3	-0.1	0.7	-1.0	-0.4	-0.5	-0.3	-0.1	-0.2	0.2
Disbursements	3.6	1.9	-0.6	1.7	0.0	0.0	0.0	0.0	0.0	0.0
Amortizations	2.3	2.0	0.6	2.6	0.0	0.0	0.0	0.0	0.0	0.0
Domestic financing net	-0.1	0.2	-0.6	-0.4	0.2	0.1	-0.3	0.2	0.2	-0.3
Of which : quasifiscal deficit financing	1.1	0.8	0.6	0.2	0.1	0.3	0.5	0.7	0.4	0.4
Other	-1.2	-1.9	0.0	0.5	-0.3	-0.3	-0.3	-0.1	0.0	0.0
Memorandum item:										
Primary balance	2.6	3.1	2.4	2.7	1.0	1.5	2.2	1.7	1.7	1.7

Sources: Ministry of Finance and Fund staff estimates.

1/ Public sector comprises only the nonfinancial public sector and the Central Bank.

2/ Measurement error to reconcile above the line estimate with estimates of the fiscal balance from the financing side.

Table 4. Paraguay: Summary Accounts of the Central Bank,

(In billions of guaranies; end-of-period; valued at constant exchange rate)

					Program				Projections	
			Prog.	Prel.	Mar	Jun	Sep	Dec		
	2003	2004	2005		2006				2007	2008
Currency issue	**2,207**	**2,488**	**2,816**	**2,925**	**2,486**	**2,435**	**2,459**	**3,174**	**3,380**	**3,583**
Growth	29.9	12.7	10.0	17.6	12.0	10.0	9.2	8.5	6.5	6.0
Net international reserves	**6,175**	**7,335**	**7,660**	**8,146**	**7,769**	**8,146**	**8,209**	**8,272**	**8,478**	**8,681**
(In millions of U.S. dollars)	983	1,168	1,220	1,297	1,237	1,297	1,307	1,317	1,350	1,382
Net domestic assets	**-3,969**	**-4,848**	**-4,844**	**-5,221**	**-5,284**	**-5,711**	**-5,751**	**-5,098**	**-5,098**	**-5,098**
Net nonfinancial public sector	1,163	1,366	1,058	1,410	1,740	1,689	1,493	1,600	1,721	1,697
Net credit to the central government	952	967	919	1,063	1,393	1,342	1,145	1,253	1,373	1,349
Net credit to the rest of NFPS	211	398	139	347	347	347	347	347	347	347
Net credit to the banking system	-3,362	-4,376	-4,873	-5,026	-5,554	-5,980	-5,926	-5,556	-5,903	-6,109
Reserve requirements	-2,219	-2,195	-2,413	-2,331	-2,344	-2,438	-2,466	-2,510	-2,592	-2,732
Free reserves	-543	-1,012	-842	-683	-761	-684	-619	-582	-512	-462
Monetary control bills (LRM)	-602	-1,171	-1,627	-2,014	-2,456	-2,864	-2,847	-2,470	-2,806	-2,922
Other	2	2	9	2	6	6	6	6	6	6
Other assets and liabilities (net)	-1,770	-1,838	-1,029	-1,605	-1,470	-1,420	-1,317	-1,142	-916	-686
Capital and reserves	-1,463	-1,722	-988	-1,368	-1,352	-1,257	-1,157	-1,025	-770	-534
Other assets net 1/	-308	-116	-41	-237	-117	-163	-161	-117	-145	-152
Memorandum items:										
Total stock of LRMs outstanding	1,071	1,552	...	2,293	2,670	3,124	3,105	2,686	3,059	3,188
Quasifiscal balance 2/	-390	-333	...	-112	-50	-145	-245	-376	-255	-237
in percent of GDP	-1.1	-0.8	...	-0.2	-0.1	-0.3	-0.5	-0.7	-0.4	-0.4
Costs of monetary policy operations 2/	219	181	...	179	62	151	252	353	306	287
in percent of GDP	0.6	0.4	...	0.4	0.1	0.3	0.5	0.7	0.5	0.5
Monetary base	3,406	4,006	4,384	4,180	3,873	3,736	3,700	4,432	4,619	4,826
annual growth (in percent)	57.7	17.6	8.2	4.3	4.8	6.9	4.9	6.0	4.2	4.5
Narrow monetary base 3/	2,954	3,122	3,616	3,667	3,279	3,219	3,248	4,018	4,275	4,532
annual growth (in percent)	44.3	5.7	11.8	17.5	12.5	10.4	9.3	9.6	6.4	6.0

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

1/ Includes LRM held by the nonbanking sector.

2/ Cumulative since beginning of year. Follows program definition.

3/ Narrow monetary base comprises currency issued plus legal reserve requirement deposits in guaraní held at the BCP.

Table 5. Paraguay: Summary Accounts of the Banking System
(In billions of guaranies; end-of-period; valued at constant exchange rate)

					Program				Projections	
			Prog.	Prel.	Mar	Jun	Sep	Dec		
	2003	2004	2005		2006				2007	2008
					I. Central Bank					
Net international reserves	**6,175**	**7,335**	**7,660**	**8,146**	**7,769**	**8,146**	**8,209**	**8,272**	**8,478**	**8,681**
(in millions of U.S. dollars)	983	1,168	1,220	1,297	1,237	1,297	1,307	1,317	1,350	1,382
Net domestic assets	**-3,969**	**-4,848**	**-4,844**	**-5,221**	**-5,284**	**-5,711**	**-5,751**	**-5,098**	**-5,098**	**-5,098**
Credit to public sector, net	1,163	1,366	1,058	1,410	1,740	1,689	1,493	1,600	1,721	1,697
Credit to banking system, net 1/	-2,760	-3,205	-3,247	-3,012	-3,099	-3,116	-3,079	-3,086	-3,098	-3,187
Central bank securites	-1,071	-1,552	-1,627	-2,293	-2,670	-3,124	-3,105	-2,686	-3,059	-3,188
Other	-1,301	-1,457	-1,029	-1,326	-1,255	-1,161	-1,060	-926	-662	-419
Currency issue	**2,207**	**2,488**	**2,816**	**2,925**	**2,486**	**2,435**	**2,459**	**3,174**	**3,380**	**3,583**
					II. Monetary Survey					
Net foreign assets	**8,405**	**9,478**	**9,965**	**10,028**	**9,805**	**10,277**	**10,327**	**10,353**	**10,716**	**11,072**
(in millions of U.S. dollars)	1,338	1,509	1,587	1,597	1,561	1,636	1,644	1,649	1,706	1,763
Net domestic assets	**2,152**	**2,313**	**2,496**	**2,671**	**2,682**	**2,680**	**2,589**	**3,391**	**3,942**	**4,459**
Credit to the public sector	699	531	-261	237	302	153	-128	27	-95	-431
Credit to the private sector	5,081	5,788	6,464	6,601	6,696	6,748	6,793	7,389	7,877	8,563
Other	-3,628	-4,006	-3,707	-4,167	-4,316	-4,221	-4,075	-4,026	-3,840	-3,674
Broad Liquidity (M4)	**10,558**	**11,791**	**12,460**	**12,699**	**12,487**	**12,957**	**12,916**	**13,744**	**14,657**	**15,531**
Bonds and issued securities	31	0	0	0	0	0	0	0	0	0
Other monetary liabilities	9	125	3	85	127	101	60	93	99	105
Central bank securities with private sector	469	381	713	280	267	312	310	269	306	319
Broad liquidity (M3)	**10,047**	**11,285**	**11,745**	**12,334**	**12,093**	**12,543**	**12,545**	**13,383**	**14,253**	**15,108**
Foreign currency deposits	5,253	5,310	5,726	5,396	5,576	6,041	5,970	5,855	6,235	6,610
Money and quasi-money (M2)	**4,794**	**5,974**	**6,018**	**6,938**	**6,517**	**6,502**	**6,575**	**7,528**	**8,017**	**8,498**
Quasi-money	1,208	1,482	1,378	1,472	1,606	1,701	1,703	1,597	1,701	1,803
Money (M1)	3,587	4,492	4,641	5,466	4,912	4,801	4,872	5,930	6,316	6,695
					Annual percentage change					
M0 (Currency issued)	29.9	12.7	10.0	17.6	12.0	10.0	9.2	8.5	6.5	6.0
Credit to the private sector	-18.4	13.9	10.2	14.1	13.9	21.6	16.8	11.9	6.6	8.7
M1	35.8	25.2	11.0	21.7	13.2	10.9	9.7	8.5	6.5	6.0
M2	24.9	24.6	10.7	16.1	13.4	11.1	9.8	8.5	6.5	6.0
M3	17.7	12.3	5.2	9.3	8.9	8.3	8.4	8.5	6.5	6.0
Of which: foreign currency deposits	11.8	1.1	0.0	1.6	4.0	5.5	7.0	8.5	6.5	6.0
Memorandum items:										
Ratio of foreign currency deposits to M3 (percent)	52.3	47.1	48.8	43.7	46.1	48.2	47.6	43.7	43.7	43.7
Ratio of foreign currency deposits to private sector deposits in banks (percent)	63.5	57.1	61.4	54.6	55.1	57.1	56.9	54.6	54.6	54.6

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 6. Paraguay: Banking System Indicators

	2001	2002	2003	2004	2005
I. Total banking system (II+III+IV+V)					
Share in assets	100.0	100.0	100.0	100.0	100.0
Capital adequacy ratio (percent)	16.9	17.9	20.9	20.5	20.4
NPLs/total loans	16.5	19.7	20.6	10.8	6.6
Provisions/NPLs	37.0	46.6	54.8	54.6	57.7
Rate of return on assets (ROA)	2.2	1.0	0.4	1.7	2.1
Rate of return on equity (ROE)	21.2	9.0	4.5	18.3	22.6
Liquid assets/total assets 1/	23.0	25.1	32.6	30.8	26.6
Foreign exchange deposits/total deposits	65.3	68.6	61.7	55.0	52.7
II. Total foreign-owned banks					
Share in assets	45.1	48.4	47.4	35.8	31.3
Capital adequacy ratio (percent)	16.0	17.6	20.4	26.0	27.2
NPLs/total loans	15.3	20.1	20.8	11.0	6.4
Provisions/NPLs	42.6	57.5	64.2	71.2	63.4
Rate of return on assets (ROA)	3.1	1.6	0.1	1.4	1.4
Rate of return on equity (ROE)	30.4	15.0	1.2	12.0	11.3
Liquid assets/total assets 1/	22.2	27.1	29.8	25.4	29.0
Foreign exchange deposits/total deposits	67.8	71.1	65.6	65.2	65.1
III. Total majority-owned foreign banks					
Share in assets	38.3	33.2	37.2	45.2	48.0
Capital adequacy ratio (percent)	16.8	19.9	21.0	17.7	17.8
NPLs/total loans	10.6	10.4	12.3	3.7	2.3
Provisions/NPLs	36.8	43.8	52.1	56.9	87.2
Rate of return on assets (ROA)	1.8	1.4	1.3	2.2	3.0
Rate of return on equity (ROE)	18.3	13.4	15.5	25.8	35.3
Liquid assets/total assets 1/	25.0	26.2	35.3	28.8	22.6
Foreign exchange deposits/total deposits	69.3	70.7	62.3	53.8	51.7
IV. Total domestic-owned private banks					
Share in assets	7.4	10.4	7.4	8.2	9.4
Capital adequacy ratio (percent)	14.8	13.6	14.1	13.3	13.4
NPLs/total loans	6.5	8.8	2.9	2.1	0.8
Provisions/NPLs	30.8	18.7	46.2	70.3	77.1
Rate of return on assets (ROA)	1.2	1.1	1.6	2.0	2.2
Rate of return on equity (ROE)	13.8	14.3	21.1	28.1	30.8
Liquid assets/total assets 1/	20.1	18.3	38.8	38.1	34.0
Foreign exchange deposits/total deposits	61.8	62.6	60.7	57.6	54.7
V. National Development Bank (BNF)					
Share in assets	9.2	8.0	8.0	10.7	11.3
Capital adequacy ratio (percent)	22.9	18.8	30.0	25.0	26.5
NPLs/total loans	46.5	56.2	56.2	48.9	40.3
Provisions/NPLs	31.7	39.6	47.6	43.1	45.1
Rate of return on assets (ROA)	0.3	-4.7	-2.8	0.5	0.4
Rate of return on equity (ROE)	2.0	-27.3	-18.7	6.8	5.3
Liquid assets/total assets 1/	20.4	17.3	30.7	52.0	31.2
Foreign exchange deposits/total deposits	27.0	42.5	32.7	23.6	20.6

Source: Superintendency of Banks.

1/ Liquid assets are calculated as the sum of cash, reserves, accounts in banks and lending in interbank market.

Table 7. Paraguay: Balance of Payments

(In millions of U.S. dollars)

					Program						
			Prog.	Prel.	Q1	Q2	Q3	Q4	Projections		
	2003	2004	2005		2006				2006	2007	2008
Current account	**131**	**14**	**-27**	**-190**	**58**	**114**	**-41**	**-312**	**-180**	**-170**	**-177**
Trade balance	-280	-404	-460	-632	-42	2	-155	-403	-599	-562	-564
Exports	2,163	2,751	2,820	3,033	751	897	882	734	3,264	3,454	3,632
Imports	-2,443	-3,156	-3,280	-3,665	-793	-895	-1,038	-1,137	-3,863	-4,015	-4,196
Services (net)	249	251	214	232	66	51	39	27	183	184	172
Factor income	-7	-31	6	-12	-10	13	-7	-3	-7	-16	-23
Transfers	165	194	215	222	45	48	83	68	243	223	238
Capital and financial account	**201**	**127**	**66**	**133**	**-118**	**-39**	**56**	**327**	**226**	**203**	**209**
General government	92	14	33	-59	-26	-3	19	23	12	1	29
Disbursements	213	139	185	107	22	37	68	62	188	178	209
Amortization	-130	-133	-161	-175	-50	-42	-52	-42	-185	-177	-180
Other	9	9	9	9	2	2	2	3	9	0	0
Private Sector 1/	110	113	33	193	-92	-36	37	304	214	202	180
Direct investment	24	86	83	148	35	38	36	15	125	130	137
Foreign currency deposits	336	24	-101	109	-58	-2	25	51	16	0	0
Other	-250	2	51	-64	-69	-73	-23	238	73	72	44
Errors and Omissions	-121	129	0	178	0	0	0	0	0	0	0
Overall Balance	**211**	**269**	**39**	**121**	**-60**	**75**	**16**	**15**	**46**	**33**	**32**
Net International Reserves (increase -)	-302	-181	-39	-129	60	-60	-10	-10	-20	-33	-32
Gross Reserves	-301	-179	-40	-129	60	-60	-10	-10	-20	-33	-32
Reserve Liabilities	-1	-1	1	1	0	0	0	0	0	0	0
Exceptional Financing	91	-88	0	8	0	-15	-6	-5	-26	0	0
Arrears deferral (+)/clearance (-)	91	-88	0	8	0	-15	-6	-5	-26	0	0
Reschedulings	0	0	0	0	0	0	0	0	0	0	0
Memorandum items:											
Current account in percent of GDP	2.4	0.2	-0.4	-2.5	2.8	5.5	-2.0	-15.1	-2.2	-1.9	-1.9
Gross reserves (millions of U.S. dollars)	983	1,168	1,220	1,297	1,237	1,297	1,307	1,317	1,317	1,350	1,382
in months of imports of GNFS	3.4	3.5	3.9	3.6	3.3	3.5	3.5	3.6	3.6	3.5	3.4
External public debt in percent of GDP 2/	49.7	38.6	37.4	34.4	30.6	30.3	30.4	30.5	30.5	28.4	26.9
Debt service in percent of exports GNFS	11.4	7.8	8.5	8.8	9.9	7.5	8.7	8.4	8.6	8.8	8.6
Export Volume (percentage change) 3/	13.2	17.6	5.7	12.6	…	…	…	…	3.1	6.0	5.0
Import Volume (percentage change) 3/	14.9	17.1	3.3	17.1	…	…	…	…	5.0	4.8	5.4
Terms of trade (percentage change)	7.3	2.5	-5.4	-12.7	…	…	…	…	4.3	1.8	1.3

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

1/ Includes public enterprises and binationals.
2/ Based on average exchange rate valuation of GDP.
3/ Registered trade.

Table 8. Paraguay: Indicators of External Vulnerability

	2001	2002	2003	2004	2005
Monetary and financial indicators					
Broad money (M3), percentage change 1/	0.7	-21.0	17.7	12.3	9.3
Credit to the private sector, real (percentage change) 1/	-8.7	-31.1	-25.5	10.9	3.9
Share of nonperforming loans in total loans (percent) 2/	16.5	19.7	20.6	10.8	6.6
Average domestic lending rate, real 2/	22.5	39.0	19.3	17.4	18.6
Central Bank bill yield, real 2/	12.8	12.9	-1.2	1.0	-0.1
International reserves (millions of US$)	723	641	983	1,168	1,297
Central bank foreign short-term liabilities (millions of US$)	0.2	0.5	0.5	0.3	0.7
External indicators					
Merchandise exports (percentage change)	-18.9	-1.6	16.8	27.2	10.2
Merchandise imports (percentage change)	-12.7	-14.6	14.4	29.2	16.1
Merchandise terms of trade (percentage change)	-1.4	7.5	7.3	2.5	-12.7
Real effective exchange rate (percentage change)	-4.4	-1.2	-6.6	4.1	-7.0
Current account balance (percent of GDP)	-4.1	1.8	2.4	0.2	-2.5
Capital and financial account (percent of GDP)	2.5	1.0	3.6	1.8	1.8
Net foreign direct investment (percent of GDP)	1.2	0.2	0.4	1.2	2.0
Inward portfolio investment (percent of GDP)	0.0	0.0	0.0	0.0	0.0
Other net investment (percent of GDP)	1.1	0.7	2.9	0.3	-0.4
External public debt (percent of GDP) 3/	38.3	50.3	49.7	38.6	34.4
Debt service (in percent of exports GNFS)	10.8	9.1	11.4	7.8	8.8
Gross reserves (in US$)	723	641	983	1,168	1,297
In months of imports of GNFS	3.5	2.8	3.4	3.5	3.6
Over short-term external debt 4/	1.2	1.0	1.6	1.8	1.9
Over foreign currency deposits in domestic banks	0.6	0.7	1.0	1.1	1.1

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

1/ Foreign currency components are valued at the accounting exchange rate of Gs. 6,280 per U.S. dollar.
2/ Latest available data, September 2005.
3/ Based on average exchange rate valuation of GDP.
4/ Private and public external debt with a residual maturity of one year or less. Excludes foreign currency deposits in banking system.

Table 9. Paraguay: Schedule of Reviews and Purchases

Date	Amount of Purchase: Millions of SDRs	Amount of Purchase: Percent of Quota	Conditions
May 31, 2006	25.0	25.0	Approval of arrangement
September 15, 2006	6.0	6.0	First review and end-June 2006 performance criteria
December 15, 2006	6.0	6.0	Second review and end-September 2006 performance criteria
March 15, 2007	6.0	6.0	Third review and end-December 2006 performance criteria
June 15, 2007	6.0	6.0	Fourth review and end-March 2007 performance criteria
September 15, 2007	6.0	6.0	End-June 2007 performance criteria
December 15, 2007	2.5	2.5	Fifth review and end-September 2007 performance criteria
March 15, 2008	2.5	2.5	End-December 2007 performance criteria
June 15, 2008	2.5	2.5	Sixth review and end-March 2008 performance criteria
August 28, 2008	2.5	2.5	End-June 2008 performance criteria
Total	**65.0**	**65.0**	

Source: Fund staff estimates.

Table 10. Paraguay: Indicators of Capacity to Repay the Fund 1/

	Projections					
	2006	2007	2008	2009	2010	2011
Fund repurchases and charges						
In millions of SDRs	0.8	2.1	2.8	10.0	25.4	24.9
In millions of U.S. dollars	1.2	3.0	4.1	14.5	36.8	36.2
In percent of exports of goods and NFS	0.0	0.1	0.1	0.3	0.8	0.7
In percent of quota	0.8	2.1	2.8	10.0	25.4	24.9
In percent of gross official reserves	0.1	0.2	0.3	1.0	2.5	2.4
Fund credit outstanding						
In millions of SDRs	37.0	57.5	65.0	58.0	35.0	11.4
In millions of U.S. dollars	53.2	83.0	94.0	84.0	50.8	16.5
In percent of exports of goods and NFS	1.4	2.0	2.2	1.9	1.1	0.3
In percent of quota	37.0	57.6	65.1	58.1	35.0	11.4
In percent of gross official reserves	2.8	4.3	4.7	4.1	2.4	0.7
Memorandum items:						
Exports of goods and NFS (mlns. of U.S. dollars), baseline	3,862	4,062	4,249	4,476	4,765	5,078
Debt service (millions of U.S. dollars)	334	358	367	370	379	385
Quota (millions of SDRs)	100	100	100	100	100	100
Quota (millions of U.S. dollars)	144	144	145	145	145	145
Gross official reserves (millions of U.S. dollars)	1,317	1,350	1,381	1,424	1,474	1,527
U.S. dollars per SDR (e.o.p.) 2/	1.44	1.44	1.45	1.45	1.45	1.45

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

1/ Assumes all purchases made as scheduled under proposed program starting from May 5, 2006, and repurchases made on the obligation schedule.

2/ WEO projections.

Table 11. Paraguay: Medium-Term Scenario

(In percent of GDP, unless otherwise specified)

	Prel.	Projections					
	2005	2006	2007	2008	2009	2010	2011
I. Program scenario							
Real sector							
Real GDP growth (annual percentage change)	3.0	3.5	4.0	4.5	4.5	5.0	5.0
Consumer prices (annual percentage change)	9.9	7.0	4.0	3.0	3.0	3.0	3.0
GDP per capita (US dollars)	1,288	1,400	1,462	1,521	1,587	1,662	1,740
Public finances 1/							
Revenues	21.8	21.6	21.8	22.0	22.1	22.2	22.2
Current primary expenditures	15.4	16.0	15.6	15.5	15.3	15.1	15.1
Interest payments	1.6	1.7	1.7	1.7	1.5	1.4	1.3
Capital expenditures	4.7	5.0	5.8	6.3	6.8	7.0	7.5
Public enterprise operating surplus	1.0	1.2	1.3	1.4	1.5	1.4	1.6
Primary balance	2.7	1.7	1.7	1.7	1.5	1.4	1.3
Overall balance	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt (in millions of U.S. dollars)	2,820	2,743	2,700	2,690	2,783	2,891	3,002
(In percent of GDP) 2/	37.8	33.1	30.6	28.7	27.9	27.2	26.4
Balance of payments (in millions of U.S. dollars)							
Exports	3,033	3,264	3,454	3,632	3,849	4,123	4,417
Imports	3,665	3,863	4,015	4,196	4,411	4,655	4,912
Current account	-190	-180	-170	-177	-177	-154	-112
(In percent of GDP)	-2.5	-2.2	-1.9	-1.9	-1.8	-1.4	-1.0
Capital and financial account	133	226	203	209	220	203	166
Gross international reserves	1,297	1,317	1,350	1,382	1,425	1,475	1,528
(In months of imports)	3.6	3.6	3.5	3.4	3.3	3.4	3.3
II. No Reform Scenario							
Real sector							
Real GDP growth (annual percentage change)	3.0	2.0	2.0	2.0	2.0	2.0	2.0
Consumer prices (annual percentage change)	9.9	9.0	7.0	6.0	5.0	5.0	5.0
GDP per capita (US dollars)	1,288	1,377	1,411	1,433	1,459	1,484	1,510
Public finances 1/							
Revenues	21.8	21.7	21.2	21.0	20.7	20.5	20.3
Current primary expenditures	15.4	16.1	16.2	16.5	16.6	16.7	16.9
Interest payments	1.6	1.8	1.8	1.9	1.9	2.0	2.0
Capital expenditures	4.7	4.9	4.6	4.6	4.5	4.5	4.5
Public enterprise operating surplus	1.0	1.1	1.0	0.9	0.8	0.7	0.6
Primary balance	2.7	1.8	1.4	0.8	0.4	0.0	-0.6
Overall balance	0.9	0.0	-0.5	-1.1	-1.5	-2.0	-2.6
Public sector debt (in millions of U.S. dollars)	2,820	2,743	2,700	2,690	2,783	2,891	3,002
(In percent of GDP) 2/	37.8	33.7	31.7	30.5	30.4	30.4	30.4
Balance of payments (in millions of U.S. dollars)							
Exports	3,033	3,262	3,448	3,625	3,790	3,989	4,178
Imports	3,665	3,820	3,912	4,015	4,133	4,256	4,384
Current account	-190	-139	-62	18	73	152	227
(In percent of GDP)	-2.5	-1.7	-0.7	0.2	0.8	1.6	2.3
Capital and financial account	133	185	92	12	-33	-109	-181
Gross international reserves	1,297	1,317	1,348	1,377	1,418	1,461	1,508
(In months of imports)	3.7	3.7	3.6	3.6	3.6	3.7	3.7

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

1/ Defined as the nonfinancial public sector and the BCP.

2/ Based on average exchange rate valuation of GDP.

Table 12. Paraguay: External Financing Requirements and Sources

(In millions of U.S. dollars)

	2002	2003	2004	2005	Projections 2006	2007	2008
Total External Financing Requirements	**19**	**74**	**118**	**396**	**348**	**278**	**319**
Current account deficit (minus sign indicates surplus)	-93	-131	-14	190	180	170	177
O/w: net interest payments (net payments shown as positive)	66	69	65	55	55	43	49
Maturing short-term debt	0	0	0	0	0	0	0
Amortization of medium and long-term debt	111	205	132	206	168	108	142
By domestic private sector	-11	75	-1	31	-17	-69	-38
By domestic public sector	123	130	133	175	185	177	180
Total External Financing Sources	19	74	118	396	348	278	319
Net FDI	12	24	86	148	125	130	137
Contracting of short-term debt	0	-11	12	-19	50	-12	-13
Disbursements of medium- and long-term debt	148	205	144	122	227	200	240
Borrowing by domestic private sector	2	-8	5	15	39	22	31
Borrowing by domestic public sector	146	213	139	107	188	178	209
Other net capital inflows	-264	68	145	266	-9	-7	-12
Exceptional financing and arrears (+ in arrears shown as positive)	40	91	-88	8	-26	0	0
Change in reserves (minus sign indicates increase)	83	-302	-181	-129	-20	-33	-32
Financing Gap	0	0	0	0	0	0	0

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

Table 13. Paraguay: Public Sector Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

		2001	2002	2003	2004	2005	Projections 2006	2007	2008	2009	2010	2011	Debt-stabilizing primary balance 9/
1	**Baseline: Public sector debt 1/**	49.0	70.1	51.4	44.0	37.0	**34.0**	**31.2**	**29.3**	**28.5**	**27.8**	**27.0**	**-0.5**
	o/w foreign-currency denominated	48.5	69.5	50.9	43.6	36.6	33.6	30.9	29.0	28.2	27.5	26.7	
2	Change in public sector debt	9.7	21.2	-18.7	-7.4	-7.1	-3.0	-2.8	-1.9	-0.8	-0.8	-0.8	
3	Identified debt-creating flows (4+7+12)	8.7	21.2	-22.2	-8.3	-6.6	-5.0	-3.2	-2.4	-2.2	-2.1	-1.9	
4	Primary deficit	-2.2	0.3	-3.4	-3.7	-2.8	-2.0	-1.8	-1.7	-1.6	-1.5	-1.3	
5	Revenue and grants	35.4	35.0	34.5	33.7	34.5	34.5	34.6	34.5	34.5	34.5	34.4	
6	Primary (noninterest) expenditure	33.2	35.3	31.1	30.0	31.8	32.5	32.8	32.8	33.0	33.0	33.1	
7	Automatic debt dynamics 2/	10.9	20.9	-18.8	-4.6	-3.9	-3.0	-1.4	-0.6	-0.6	-0.6	-0.6	
8	Contribution from interest rate/growth differential 3/	-0.9	-2.5	-11.0	-5.8	-3.0	-3.0	-1.4	-0.6	-0.6	-0.6	-0.6	
9	Of which contribution from real interest rate	-0.2	-2.6	-8.8	-4.0	-1.8	-1.9	-0.2	0.7	0.6	0.7	0.7	
10	Of which contribution from real GDP growth	-0.8	0.0	-2.2	-1.8	-1.2	-1.1	-1.2	-1.3	-1.2	-1.3	-1.3	
11	Contribution from exchange rate depreciation 4/	11.8	23.5	-7.8	1.3	-0.9	...	...	...	...	...	...	
12	Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13	Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	1.0	0.0	3.5	0.9	-0.4	2.0	0.5	0.5	1.4	1.3	1.2	
	Public sector debt-to-revenue ratio 1/	138.3	200.2	148.8	130.7	107.1	98.4	90.1	84.9	82.6	80.5	78.4	
	Gross financing need 6/	4.3	9.3	6.2	3.2	4.9	5.0	4.8	4.6	4.4	4.2	4.0	
	in billions of U.S. dollars	0.3	0.5	0.3	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.5	
	Scenario with key variables at their historical averages 7/						**34.0**	**33.6**	**33.2**	**33.9**	**34.5**	**35.0**	**-0.6**
	Scenario with no policy change (constant primary balance) in 2006-2011						**34.0**	**31.0**	**28.9**	**27.7**	**26.4**	**25.0**	**-0.4**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	2.1	0.0	3.8	4.1	3.0	3.5	4.0	4.5	4.5	5.0	5.0	
	Average nominal interest rate on public debt (in percent) 8/	4.5	4.3	3.4	3.2	3.7	3.9	4.3	4.5	4.7	5.0	5.0	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-0.4	-5.8	-14.6	-8.6	-4.2	-5.4	-0.3	2.4	2.3	2.8	2.8	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-23.6	-33.8	15.3	-2.7	2.3	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	4.8	10.0	18.0	11.8	7.9	9.2	4.6	2.1	2.3	2.2	2.2	
	Growth of real primary spending (deflated by GDP deflator, in percent)	-6.3	6.2	-8.4	0.3	9.2	6.0	5.0	4.4	5.0	5.1	5.3	
	Primary deficit	-2.2	0.3	-3.4	-3.7	-2.8	-2.0	-1.8	-1.7	-1.6	-1.5	-1.3	

1/ Debt ratios refer to the nonfinancial public sector, excluding debt of the central bank and other financial public entities. For estimates only gross debt is used. Based on end-of-period exchange rate valuation of debt.

2/ Derived as $[(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp))$ times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 14. External Debt Sustainability Framework, 2001-2011

(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	10-Year Average	Historical Std. Dev.	Projections 2006	2007	2008	2009	2010	2011	Debt-stabilizing non-interest current account 6/
								I. Baseline Projections						
1 **External debt 1/**	45.4	61.8	58.0	45.4	41.2			**37.3**	**35.6**	**34.4**	**33.6**	**33.0**	**32.4**	**-1.2**
2 Change in external debt	1.6	16.4	-3.8	-12.6	-4.1			-3.9	-1.7	-1.2	-0.8	-0.6	-0.6	
3 Identified external debt-creating flows (4+8+9)	9.3	11.3	-6.8	-13.3	-1.2			-2.4	-1.1	-0.9	-1.0	-1.4	-1.8	
4 Current account deficit, excluding interest payments	1.8	-4.0	-4.4	-1.8	1.0			0.7	0.3	0.3	0.2	-0.1	-0.5	
5 Deficit in balance of goods and services	7.0	1.3	0.6	2.2	5.4			5.0	4.3	4.2	4.0	3.6	3.1	
6 Exports	37.8	47.2	49.4	47.9	48.6			46.6	46.1	45.4	44.9	44.8	44.7	
7 Imports	44.8	48.5	49.9	50.1	54.0			51.7	50.3	49.6	49.0	48.4	47.8	
8 Net non-debt creating capital inflows (negative)	0.8	1.4	0.2	-1.4	-0.7			-0.5	-0.7	-0.7	-0.7	-0.7	-0.7	
9 Automatic debt dynamics 2/	6.8	14.0	-2.6	-10.2	-1.5			-2.6	-0.7	-0.5	-0.5	-0.6	-0.6	
10 Contribution from nominal interest rate	2.3	2.2	2.1	1.6	1.6			1.4	1.6	1.6	1.6	1.6	1.5	
11 Contribution from real GDP growth	-1.0	0.0	-2.2	-1.9	-1.3			-1.3	-1.4	-1.5	-1.5	-1.6	-1.5	
12 Contribution from price and exchange rate changes 3/	5.4	11.7	-2.5	-9.8	-1.8			-2.8	-0.9	-0.6	-0.6	-0.6	-0.6	
13 Residual, incl. change in gross foreign assets (2-3)	-7.8	5.2	3.0	0.7	-2.9			-1.5	-0.7	-0.3	0.2	0.8	1.2	
External debt-to-exports ratio (in percent)	120.1	130.9	117.4	94.8	84.9			80.1	77.3	75.9	74.8	73.7	72.5	
Gross external financing need (in billions of US dollars) 4/	0.4	0.0	0.1	0.1	0.4			0.4	0.4	0.4	0.4	0.4	0.3	
in percent of GDP	5.9	0.3	1.2	1.9	5.2			4.8	4.4	4.2	3.9	3.4	2.8	
Key Macroeconomic Assumptions						10-Year Average	Historical Std. Dev.							Projected Average
Real GDP growth (in percent)	2.1	0.0	3.8	4.1	3.0	1.2	2.4	3.5	4.0	4.5	4.5	5.0	5.0	4.6
Exchange rate appreciation (US dollar value of local currency, change in percent)	-15.1	-27.8	-11.7	7.7	-3.4	-10.3	9.8	-1.9	-2.1	-0.5	-0.5	-0.5	-0.5	-0.8
GDP deflator in US dollars (change in percent)	-11.0	-20.5	4.2	20.4	4.2	-1.3	11.6	7.1	2.4	1.6	1.8	1.7	1.7	1.9
Nominal external interest rate (in percent)	4.9	3.9	3.6	3.4	3.7	4.1	0.6	3.9	4.5	4.7	4.9	5.0	5.0	4.8
Growth of exports (US dollar terms, in percent)	-16.4	-0.7	13.2	21.6	9.0	-1.6	15.3	6.4	5.2	4.6	5.4	6.4	6.6	5.6
Growth of imports (US dollar terms, in percent)	-12.0	-13.9	11.3	25.7	15.7	-1.4	15.7	6.2	3.8	4.5	5.1	5.5	5.6	4.9
Current account balance, excluding interest payments	-1.8	4.0	4.4	1.8	-1.0	-0.4	3.2	-0.7	-0.3	-0.3	-0.2	0.1	0.5	0.0
Net non-debt creating capital inflows	-0.8	-1.4	-0.2	1.4	0.7	0.4	1.1	0.5	0.7	0.7	0.7	0.7	0.7	0.7
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 6/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2006-11 5/								**37.3**	**38.2**	**39.5**	**41.4**	**44.1**	**47.5**	**1.6**
B. Bound Tests														
B1. Nominal interest rate is at baseline plus one-half standard deviation								**37.3**	**35.7**	**34.6**	**33.9**	**33.4**	**32.8**	**-1.2**
B2. Real GDP growth is at baseline minus one-half standard deviations								**37.3**	**36.0**	**35.2**	**34.8**	**34.6**	**34.3**	**-0.9**
B3. Non-interest current account is at baseline minus one-half standard deviations								**37.3**	**37.2**	**37.6**	**38.3**	**39.2**	**40.1**	**-1.4**
B4. Combination of B1-B3 using 1/4 standard deviation shocks								**37.3**	**36.7**	**36.5**	**36.7**	**37.1**	**37.5**	**-1.1**
B5. One time 30 percent real depreciation in 2006								**37.3**	**52.9**	**51.0**	**49.7**	**48.8**	**48.2**	**-1.8**

1/ Based on average exchange rate valuation of GDP.

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

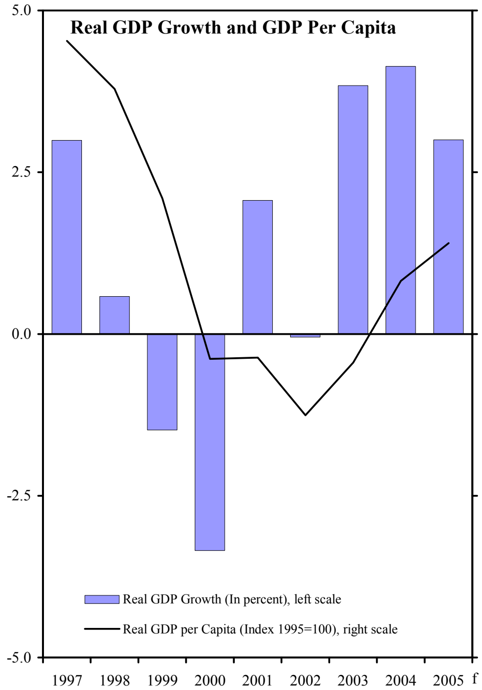
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

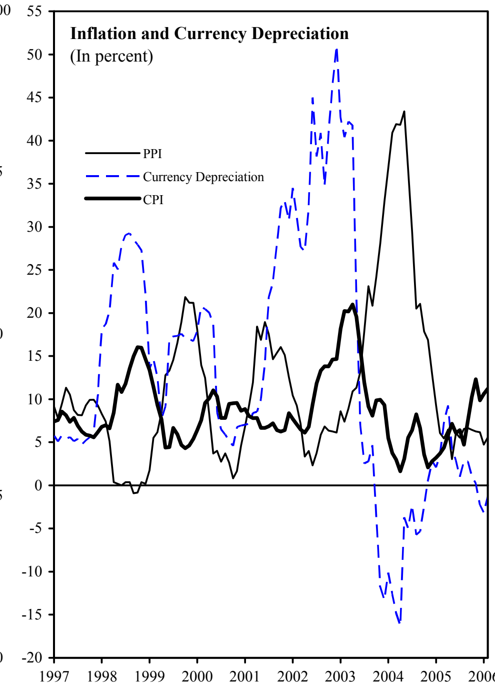
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 1. Paraguay: Selected Economic Indicators

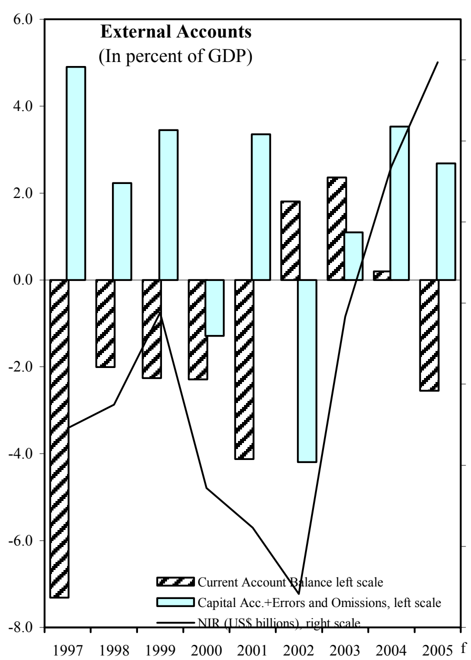
Significant recovery and a reversal of the decline in per capita income...



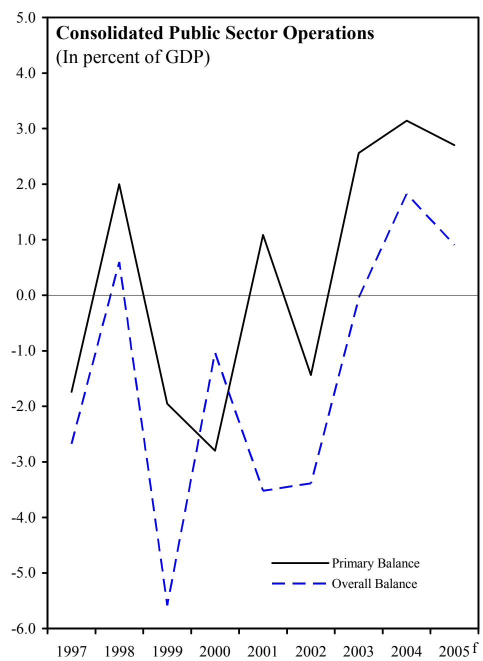
... but inflationary pressures re-emerged in 2005...



... as international reserves continued to rise in spite of deteriorated external conditions...

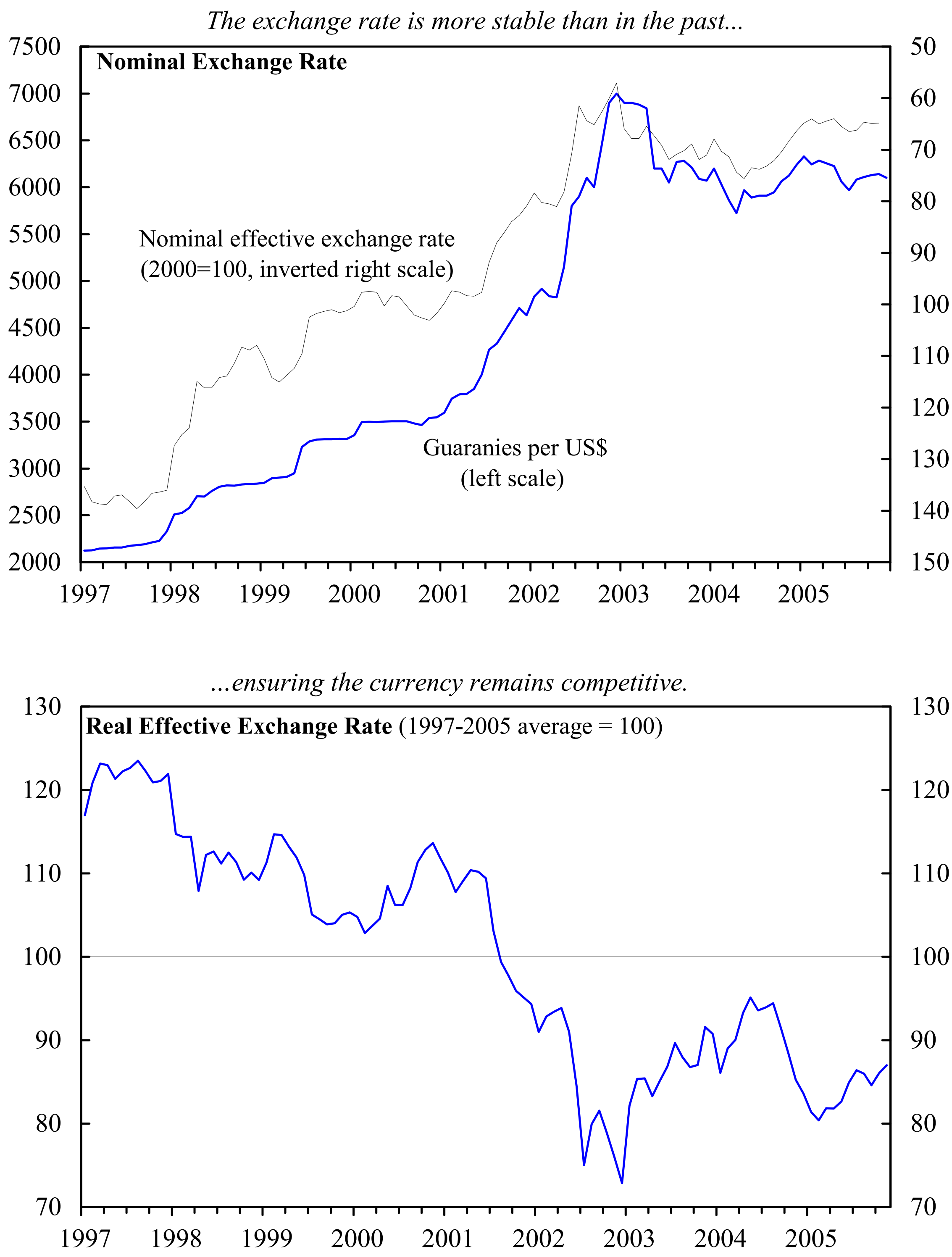


... and fiscal consolidation efforts continued.



Source: Central Bank of Paraguay and Ministry of Finance.

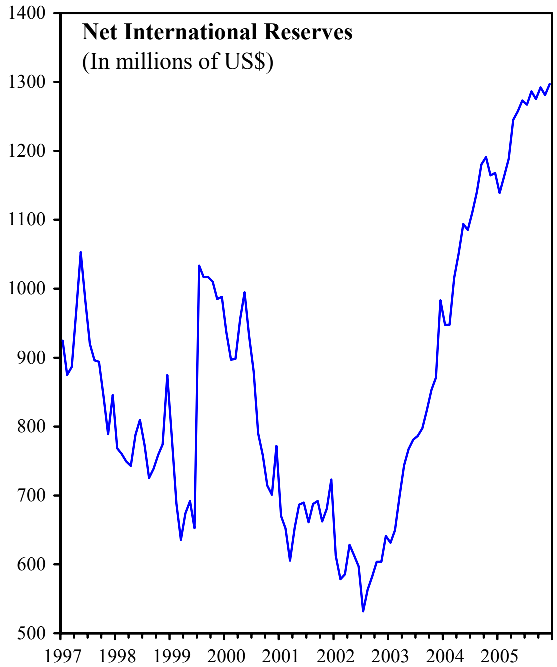
Figure 2. Paraguay: Exchange Rate Developments



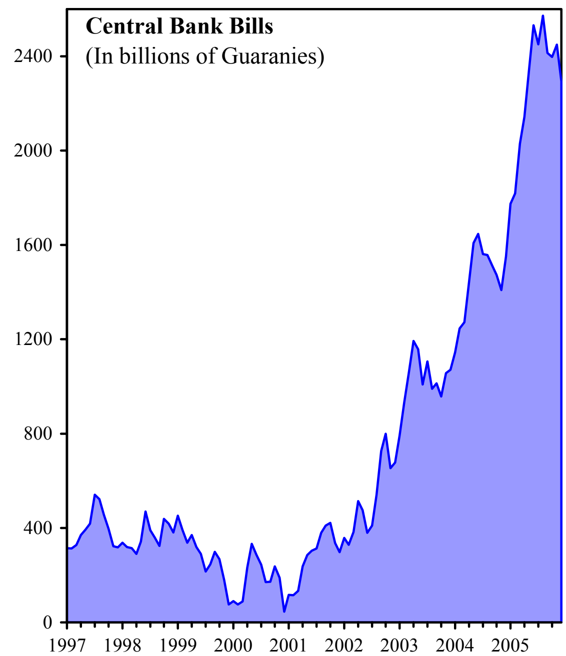
Source: Central Bank of Paraguay and Fund staff estimates.

Figure 3. Paraguay: Selected Financial Indicators

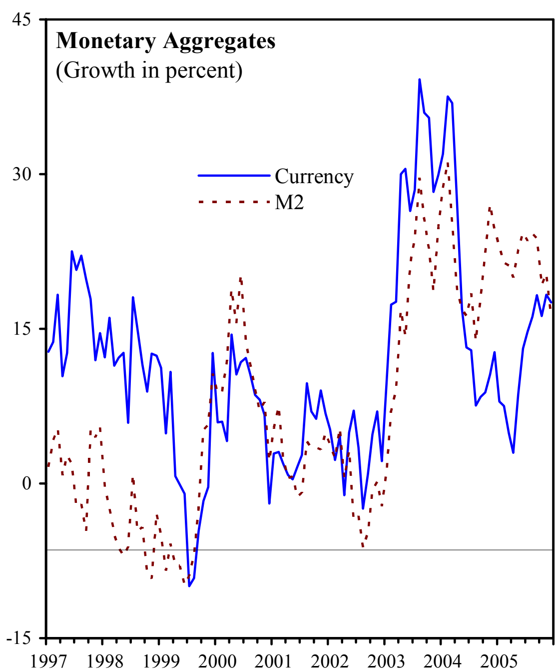
Capital inflows facilitated a rapid build up of reserves...



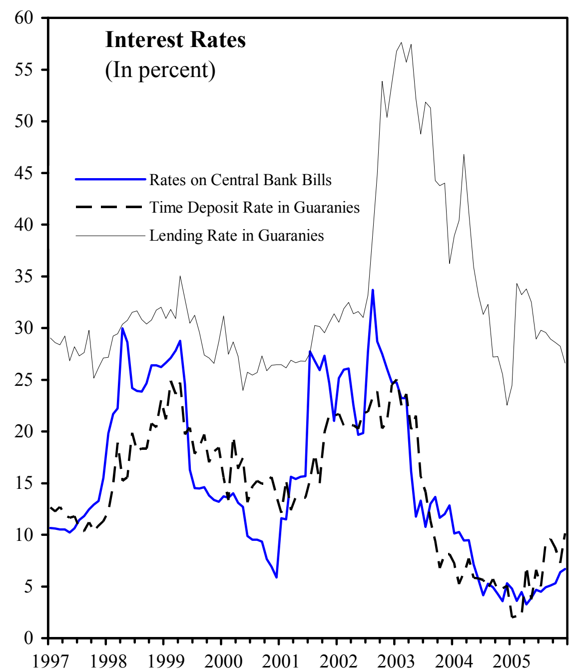
… and the Central Bank stepped up its sterilization efforts.



However, there was an upturn in currency growth in late 2005.



While short-term interest rates bottomed out, policies tightened.

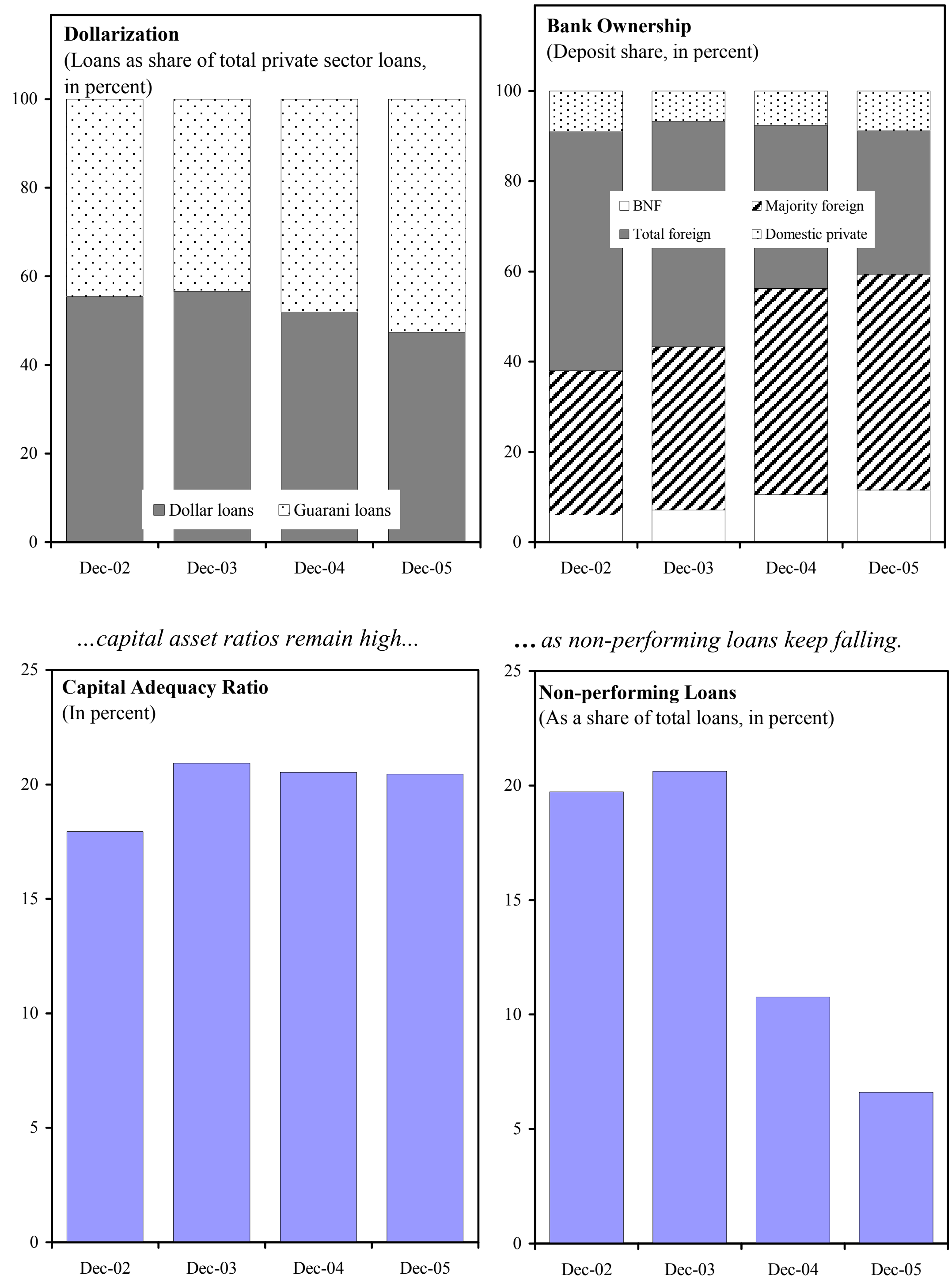


Source: Central Bank of Paraguay.

Figure 4. Paraguay: Selected Banking Indicators

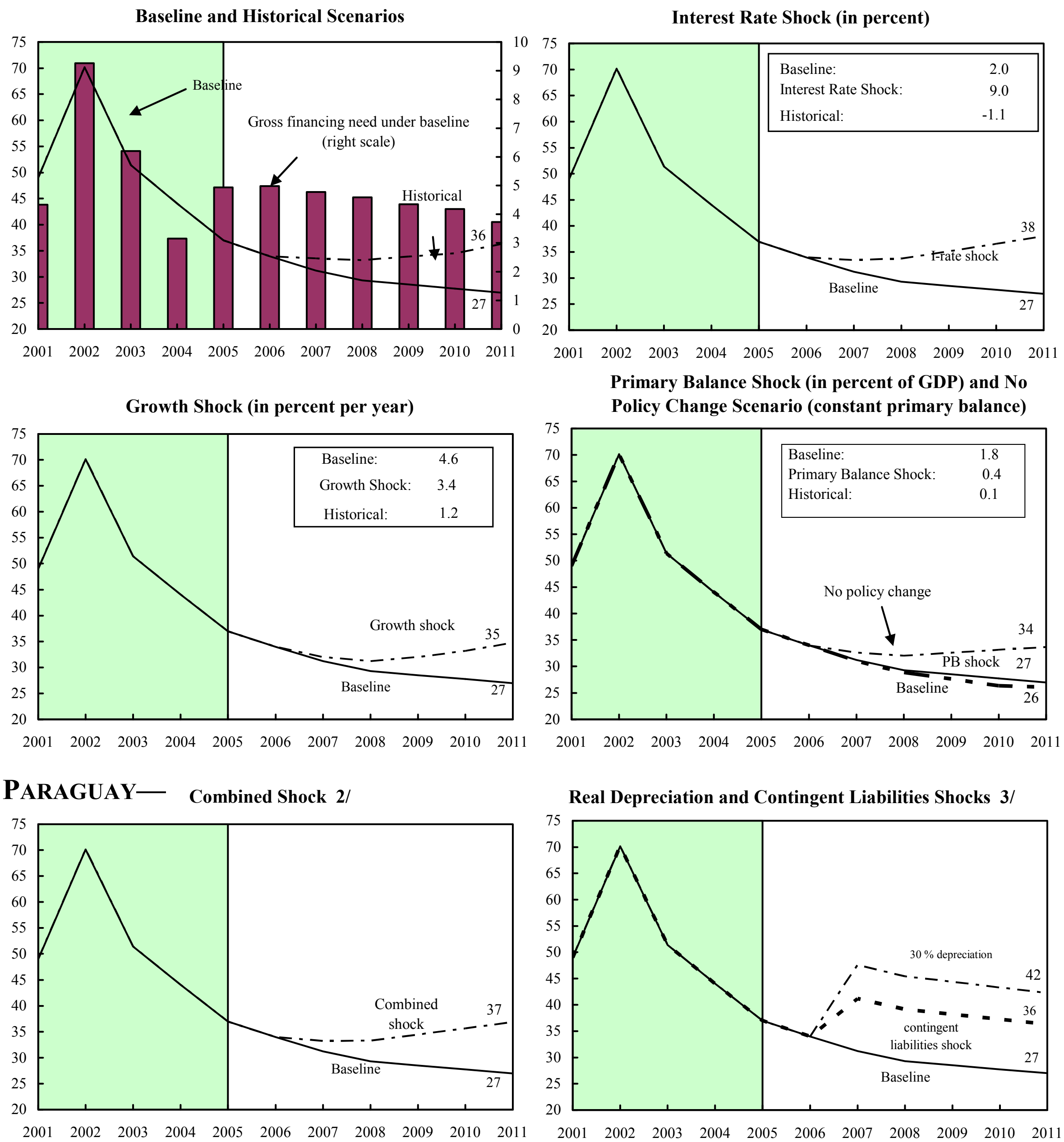
Dollarization remains high but is declining... *...although some foreign banks have left...*

...capital asset ratios remain high... *... as non-performing loans keep falling.*



Source: Central Bank of Paraguay.

Figure 5. Paraguay: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

PARAGUAY—FUND RELATIONS
(As of April 30, 2006)

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

II. **General Resources Account**:

	In millions of SDRs	In percent of Quota
Quota	99.90	100.00
Fund holdings of currency	78.43	78.51
Reserve position in Fund	21.48	21.50

III. **SDR Department**:

	In millions of SDRs	Percent of Allocation
Net cumulative allocation	13.70	100.00
Holdings	89.91	649.09

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

V. **Exchange Rate Arrangement:** The currency of Paraguay is the Paraguayan *guaraní*. The exchange rate regime is a managed float. The exchange rate is determined in the interbank foreign exchange market, but the central bank intervenes in the foreign exchange and monetary markets to smooth out exchange rate fluctuations in real effective terms. The U.S. dollar is the principal intervention currency. On April 28, 2006, the average interbank rate for the U.S. dollar was ₲5,765 =US$1.

VI. **Article IV Consultation:** The Executive Board concluded the 2004 Article IV consultation on July 30, 2004; the document is IMF Country Report No. 05/59.

VII. **Technical Assistance:**

Department	Purpose	Date of Delivery
MAE	Policy Advisory to the Central Bank	March 1994–Present
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
MAE	Currency Operations	March through September 2002

Department	**Purpose**	**Date of Delivery**
FAD	Customs Administration	May 2002
MAE	Financial Sector Surveillance	July 2002
FAD	ROSC	August 2002
STA	Multisector, follow-up	September 2002
MAE	Banking Supervision	September through November 2002
MAE	Central Bank Operations	November 2002
TRE	Safeguards Assessment	January 2003
MFD	Banking Supervision	January 2003 through April 2004
MFD	Currency Handling and Reform	February 2002 through April 2004
MFD	Payment System	July 2003
FAD	Customs and Tax Administration	December 2003
MFD	Reorganization of the Central Bank and Monetary Operations	January 2004
FAD	Customs Administration Advisor	July 2004 to May 2005
MFD	Monetary Operations and Monetary Policy Formulation	October 2004
MFD	Public Banking Restructuring	February 2005
FAD	Customs and Tax Administration	February 2005
MFD and WB	FSAP Mission	April 2005 and July 2005
FAD	Update of ROSC	September 2005
STA	ROSC	January 25-February 8, 2006
FAD	Public Financial Management	March 13-24, 2006

VIII. **Safeguards Assessment:** Under the Fund's safeguards assessment policy, Central Bank of Paraguay (CBP) is subject to a full safeguard assessment. A safeguards assessment for the Central Bank of Paraguay is required in respect of the proposed arrangement. An assessment is currently underway and should be concluded before the first review of the program.

X. **Resident Representative:** Mr. Luis H. Duran-Downing has been appointed as senior resident representative since May 2005.

PARAGUAY—WORLD BANK RELATIONS[1]
(As of April 30, 2006)

A new Paraguay Country Assistance Strategy (CAS) was approved on December 16, 2003, covering the period from mid-FY04 to FY07. The Banks strategy as outlined in the new CAS aims at restoring confidence in the economy and lays the basis for sustainable growth and poverty reduction. To this end, the CAS supports (i) the fiscal and financial reforms the Administration has to send to Congress; (ii) improved governance and transparency in public administration; (iii) sustained growth, particularly in the rural areas where poverty is concentrated and deepest; and (iv) social inclusion, to improve the coverage and efficiency of basic social services to help Paraguay meet the Millennium Development Goals (MDGs). The base case-lending program for the CAS period is for US$325 million, of which US$80 million, or about 25 percent, are envisaged for adjustment operations.

Three projects were approved in April 2005: a first Programmatic Financial Sector Adjustment Loan, a Modernization of the Ministry of Finance Project, and a Financial Sector Technical Assistance Loan. A fourth operation, Mother and Child Basic Health Insurance project, was approved in October 2005. Effectiveness of all four loans is pending legislative approval.

A comprehensive Policy Notes document was completed in May 2003 and discussed with the new Administration in June 2003. In FY04, the Bank also prepared a Social Protection Study and a Country Financial Accountability Assessment (CFAA). In FY05, the Bank completed a Public Expenditure Review (PER), an Institutional and Governance Review, and sector work on Health Strategy. A study on Land Taxes in underway and will be delivered in FY06.

Four World Bank-financed projects are presently under implementation, for a total value of US$120 million in commitments, of which US$33.3 million remain undisbursed as of March 31, 2006. These projects include Fourth Rural Water Supply, Natural Resource Management, Pilot Community Development, and the Secondary Education Reform. There is also an active program of grants currently being implemented.

Looking forward, a Sustainable Rural Investment project, which will be a follow-up to the ongoing Natural Resource Management project, a Road Maintenance project, a Modernization of the Water Sector project, and a Private Sector Development project are being prepared for delivery in FY07**.** A Forestry Project is also under preparation for delivery in FY08.

[1] Prepared by the staff of the World Bank.

FINANCIAL RELATIONS WITH THE WORLD BANK
(In millions of U.S. dollars)

I. IBRD/IDA Operations (as of April 30, 2006)

	Committed (Net of Cancellations)	Disbursed	Undisbursed
Active loans			
Natural Resource Management	47.0	47.0	0.0
Fourth Rural Water Supply	40.0	32.7	7.3
Community development	9.0	3.7	5.3
Education Reform	24.0	3.3	20.7
Modernization of the Ministry of Finance*	7.5	0.0	7.5
Financial Sector Adjustment Loan*	15.0	0.0	15.0
Financial Sector TA*	5.7	0.0	5.7
Mother and Child Basic Health Insurance*	22.0	0.0	22.0
Total active loans	**170.2**	**86.7**	**83.5**
Total inactive loans	728.8	728.8	0.0
Total IBRD/IDA	**899.0**	**815.5**	**83.5**
Repaid		**572.0**	
Total outstanding		**244.1**	
O/w IBRD		223.6	
O/w IDA		20.5	

II. IFC Operations (as of April 30, 2006)

	Loans	Equity	Total
Commitments	15.0	0.0	15.0
Repayments and cancellations	0.0	0.0	0.0
Held by IFC	5.0	0.0	5.0
Undisbursed	10.0	0.0	10.0

III. IBRD/IDA Loan Transactions (calendar year)[20]

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Disbursements	41.2	37.7	42.1	46.6	26.8	13.5	42.3	16.2	16.7
Repayments	27.5	24.6	24.6	20.2	15.3	16.8	21.0	34.8	26.6
Net lending	13.8	13.1	17.5	26.4	11.5	-3.3	21.3	-18.6	-9.9

[20] As of December 31, 2005

* Not yet effective.

PARAGUAY—INTER-AMERICAN DEVELOPMENT BANK RELATIONS [21]

(As of April 30, 2006)

Portfolio

1. As of January 2006, the active loan portfolio amounts to US$530.4 million, with an undisbursed balance of US$272.2 million. In addition, there are 45 active Technical Cooperation operations for US$18.8 million, of which US$9.9 million are undisbursed.

New Strategy

2. In July, 2004 the IDB approved its new strategy for 2004–2008 with Paraguay, which calls for the Bank's work to be concentrated in the following areas:

- ***Strengthening governance*** by restoring the credibility of State institutions. The aim of this component will be to enable the State to coordinate the economic development process by heightening the efficiency and transparency of public administration, promoting greater citizen participation, and consolidating democratic institutions;
- ***Laying the foundations for sustainable growth*** through the consolidation of the market economy and greater regional and global integration by creating conditions conducive to increased private-sector participation, greater competitiveness, and deeper integration; and
- ***Reducing poverty and improving the quality of life of low-income sectors of the population*** through the development of human capital and the provision of greater access to quality basic services.

Pipeline

3. The lending program for 2006-A includes the following operations:

   a. Strengthening of the Judiciary System II, US$10.8 million
   b. Electric Power Transmission and Distribution Program, US$80 million
   c. Integration Corridor and Road Rehabilitation Program, Phase I, US$100 million
   d. Institutional Strengthening of the National Institute of Cooperatives (INCOOP), US$5 million
   e. Asunción Coastal Development Program, US$80 million
   f. Depositary, Compensation and Liquidation Program, US$2 million
   g. Modernization of the Agriculture Public Sector Management, US$20 million
   h. Technical Education and "Escuela Viva" Program, US$45 million

4. In addition, the following operations are included for 2006-B

   a. Support to Paraguayan Exports Program, US$10 million
   b. Global Credit Line to Small, Medium and Micro enterprises, US$25 million

[21] Prepared by the staff of the IDB.

PARAGUAY–TECHNICAL ASSISTANCE PROGRAM

The technical assistance (TA) program for Paraguay has been designed in close collaboration with functional departments to support the main objectives of the new SBA program. Accordingly, the Fund TA strategy will concentrate on supporting reforms in the following policy pillars of the program: (i) public sector reform; (ii) financial sector reform; (iii) a pro-growth reform agenda; and (iv) a social safety net. Fund TA in the area of statistics will support Paraguay's objective of meeting international statistical standards. In all these areas, technical assistance has been planned to support the authorities' efforts preceding the adoption of key structural measures.

Public sector reform. This is needed to address remaining fiscal vulnerabilities and rigidities, including institutionalizing the improvement in revenue collection, improving budgetary planning and expenditure control.

Financial sector reform. This key reform area includes strengthening the functioning of the commercial banks, the Central Bank and public banks to reduce vulnerabilities in the system.

Pro-growth reform agenda. In the first year, the program will focus on restructuring public enterprises and in steps to improve investment climate. The World Bank and IDB are assisting the authorities in these efforts.

Social Safety Net. This reform pillar is needed to protect the most vulnerable segments of society and to alleviate poverty. For 2006, the authorities are focusing on launching a conditional cash transfer mechanism for 7000 families living under extreme poverty based on contract with beneficiaries. The authorities are requesting expert advice from the IDB to implement a monitoring system to evaluate the results of this program.

Statistics. The Report on the Observance of Standards and Codes (ROSC 2006) mission found that, with the exception of monetary statistics, there is a need for improvements in all sector statistics. Source data are not sufficiently developed for national accounts, government finance, and balance of payments statistics. The PPI basket is not fully representative of current national output. Statistical techniques need to be improved for most datasets, including updating the CPI weights, the reference year of the national accounts, and measuring the impact of informal activities. To address most of these weaknesses, TA would need to be programmed.

The following Table presents detailed TA needs and the planned schedules for TA provision.

Paraguay: Technical Assistance to Support Structural Reforms

Area	Task	Dates
Public Sector Reform	**Strengthening tax administration:** Prepare a tax code in consultation with the Fund (performance criterion for end-December 2006).	LEG and FAD mission, mid-May 2006
	Public financial management: Design and action plan to develop an effective commitment control system for the public sector and rationalize the Treasury account system (structural benchmark for end-June 2006)	FAD mission, March 20-31, 2006 and follow up.
	Strengthening customs administration: assist the authorities in coordinating the execution of the action plan for customs reform, (ongoing reform).	FAD customs advisor. Three visits scheduled in 2006: (i) March 16- May 5; (ii) July 10-August 25; and (iii) October 16-December 16.
Financial Sector Reform	**Strengthening financial position of the central bank:** Assess financial situation of central bank and develop recapitalization options. Complete a plan to strengthen the financial position of the Central Bank and submit to Congress the legislation necessary for its implementation (structural benchmark end-December 2006).	MFD mission, March 7-16, 2006 and follow up.
	Strengthening legislation and regulations of the banking system: Implement regulatory measures outlined in the banking strategy and put together draft legislation (structural benchmark for end-September 2006).	MFD expert visits (monthly) through June 2006
	Strengthen and restructure the National Development Bank (BNF) to reduce vulnerabilities in the system: Audited and inspected CAR for BNF of 5 percent in-June 2006 and 10 percent in December 2006 (structural benchmark for end-September-06 and performance criterion for end-March -07)	MFD mission requested
Pro-Growth Reforms	**Improve business climate:** Design a plan to improve business climate (structural benchmark for end-September 2006).	WB experts' mission, mid-2006.

Area	Task	Dates
Pro-Growth Reforms	**Restructuring public enterprises:** Design an implementation of result-oriented management contracts with ANDE, COPACO, ESSAP, INC, and PETROPAR (structural benchmark for end-December 2006)	WB and IDB to provide expert advice.
Social Safety Net	**Protect the most vulnerable segment of the population and alleviate poverty:** Create a conditional cash transfer mechanism for 7000 families living under extreme poverty based on contract with beneficiaries (structural benchmark for end-September 2006).	TA requested to IDB.
Statistics	**Consumer price index and producer price index (CPI/PPI).** STA will provide technical assistance to improve methodologies of both data sets.	STA mission, April 2006.
	Monetary and financial: Expand coverage of monetary statistics to include deposit-taking cooperatives.	STA mission, RAP 2007.
	Follow-up to the 2006 data ROSC mission: Evaluate implementation of major recommendations of the 2006 data ROSC mission including: (i) improving the methodological quality of national accounts and government finance statistics; (ii) establish regular mechanisms for enhancing intersectoral data consistency, (iii) strengthen data sources across all data sets, including the conduct of surveys and census, and (iv) adopt advance release calendar for all statistics.	STA TA to be requested.

PARAGUAY—WORK PROGRAM

Mission	Dates
Stand-By Arrangement	
Mission	Feb 23-Mar 8, 2006
Board Meeting	May 31, 2006
First SBA Review	
Mission	Jul 26-Aug 9, 2006
Board Meeting	September 22, 2006
Second SBA Review and the 2006 Article IV Consultation	
Mission	Oct 25-Nov 8, 2006
Board Meeting	December 15, 2006
Third SBA Review	
Mission	Jan 24-Feb 7, 2007
Board Meeting	March 9, 2007
Memorandum items:	
Previous SBA	
Approval of SBA	December 15, 2003
First SBA Review	April 12, 2004
Second SBA Review	July 30, 2004
Third SBA Review	December 20, 2004
Fourth SBA Review	March 28, 2005
Fifth SBA Review	August 22, 2005
Sixth SBA Review (lapse of time basis)	November 30, 2005
FSAP	
First Mission	April 18–29, 2005
Second Mission	July 5-15, 2005
Board Meeting	May 31, 2006

PARAGUAY—STATISTICAL ISSUES
(As of April 30, 2006)

Paraguay became a GDDS participant in September 2001 with the publication of its metadata on the Fund's Dissemination Standards Bulletin Board (DSBB). A ROSC data mission visited Paraguay in January-February 2006; the authorities' response to the report and the mission's recommendations are being finalized prior to publication.

A. Real Sector

A new national accounts series—broadly consistent with the guidelines of the *1993 SNA*—has been prepared with the assistance of an expert financed by the IDB, and released in 2005. It comprises a more complete coverage of industries, an input-output matrix, and expanded data sources for the compilation of the new benchmark and base year (1994). However, no comprehensive regular data collection program of economic censuses and surveys exists (an industrial survey was conducted in 2002) and source data for nonfinancial services, household consumption, and changes in inventories are insufficient. Major areas of concern include: (i) the 1994 reference year is becoming obsolete; (ii) excessive use is made of fixed coefficients for value added and household consumption; (iii) changes in inventories are obtained residually; (iv) informal activities are not monitored; and (v) supply and use tables have been compiled only until1997. The periodicity of annual GDP meets GDDS recommendations, but not timeliness; because the data are disseminated with 11-months lag.

Both the consumer (CPI) and producer price indices (PPI) are reported on a regular and timely basis. The geographic coverage of the CPI is limited to Asunción the capital and expenditure weights are representative of the consumption patterns of urban households. The CPI has a base weight period of 1992, and the PPI of December 1995. The household budget survey 2005-2006, for which information is now being gathered, will be used as the basis for updating the CPI basket and weights and for developing the index methodologically in keeping with the classification and valuation systems established in *1993 SNA*. The PPI basket (150 items) is still not fully representative of current national output; electricity, water, gas, and services are not covered by the PPI.

Since the introduction of a regular household survey in 1998, the coverage and quality of employment and unemployment statistics have improved significantly. However, frequencies remain at the annual level, and the publication lag is close to one year. Wage indices are updated twice a year.

The ROSC data mission found that the resources are insufficient for real sector statistics and constrain their further development, particularly the full adoption of the *1993 SNA.*

B. Fiscal Sector

Paraguay's GFS are broadly consistent with the recommendations of *A Manual on Government Finance Statistics 1986* (*GFSM 1986*), but the authorities have not yet prepared a plan to migrate to the *Government Finance Statistics Manual 2001* (*GFSM 2001*). Monthly data are available for the central administration (budgetary central government). Data on the operations of the local governments are not included in the GFS. The asset position of the social security system is available on a daily basis. Contrary to recommendations in the GFS manuals, (i) statistics on the consolidated central government and general government are not prepared; (ii) statistics on the central administration include data of the Postal Service Directorate, a nonfinancial public corporation; and (iii) statistics on the nonfinancial public sector definition includes data of financial public corporations (four employer social insurance schemes). These social insurance schemes are treated as financial corporations in the monetary and financial accounts. 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. Moreover, there is a discrepancy in the fiscal data reported by the monetary and fiscal authorities. Measures are being taken to make reporting more transparent.

Annual data covering only budgetary central government through 2004 have been reported for publication in the *2005 edition of the GFS Yearbook*. However, since 1994 no outstanding debt data and no breakdowns for expenditure by function data have been provided for publication in the *GFS Yearbook*. Monthly and quarterly data are not reported for publication in *IFS*. The resumption of reporting quarterly and monthly data for the *IFS* is highly recommended.

C. Money and Banking Sectors

Money and banking statistics are broadly reliable because 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, Paraguay completed the establishment of a unified compilation and reporting system 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. However, the lack of coverage of the credit unions remains a matter of concern, since they account for around 25 percent of deposits and loans of the banking sector. There are plans for a technical assistant mission in fiscal year 2007 aiming at including the credit unions in the other depository corporation's survey.

The superintendency of banks publishes a detailed and informative report on the soundness of the financial system.

D. External Sector

Quarterly and annual data on balance of payments and the international investment position (IIP) are available from 2001 onwards on the central bank website, and reported to STA. Annual IIP data have been compiled and disseminated for the period 1995–2004. The classification of the balance of payments and of the IIP follows the recommendations of the *Balance of Payments Manual*, 5th edition. Improvements have been made in the quality of the data on capital flows, especially in the coverage of foreign direct investment, and in the recording of external debt transactions in the balance of payments and in the IIP. The central bank now produces a highly informative bulletin with balance of payments statistics. Special studies by the central bank have improved the estimation methods for remittances of Paraguayans abroad and unregistered trade transactions, but serious deficiencies remain.

Deficiencies remain in the area of private capital outflows, which are difficult to register due to Paraguay's open capital account. Major recommendations of the 2006 data ROSC mission include the need to: (i) design and conduct sample surveys to capture data for items currently excluded from balance of payments statistics or items not appropriately covered (e.g., some services, direct and portfolio investment abroad, real estate); (ii) review and update the statistical techniques to estimate unrecorded trade; (iii) prepare periodical reports to inform management of the CBP of the quality of survey's data (response, coverage, response errors); and (iv) initiate a process of quarterly reconciliation of flows and stocks of medium- and long-term external public debt with the MOF.

PARAGUAY—TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of May 10, 2006)

	Date of latest observation	Date received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of publication[1]
Exchange Rates	5/09/06	5/10/06	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	4/30/06	5/09/06	D	D	D
Reserve/Base Money	3/31/06	3/21/06	D	D	D
Broad Money	3/31/06	3/21/06	M	M	M
Central Bank Balance Sheet	4/30/06	5/09/06	D	D	D
Consolidated Balance Sheet of the Banking System	3/31/06	4/21/06	M	M	M
Interest Rates[3]	2/28/06	4/21/06	M	M	M
Consumer Price Index	Apr. 2006	5/02/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4] – General Government[5]	Mar. 2006	4/15/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4] – Central Government	Mar. 2006	4/15/06	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[6]	Mar. 2006	4/05/06	Q	Q	Q
External Current Account Balance	Dec. 2005 prov.	3/3/06	Q	Q	Q
Exports and Imports of Goods and Services	Dec. 2005 prov.	3/3/06	M	M	M
GDP/GNP	2004	2/01/05	A	A	A
Gross External Debt	Dec. 2005 prov.	3/3/06	Q	Q	Q

[1] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[2] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[3] Both market-based and officially-determined, including discounts rates, money market rates, rates on treasury bills, notes and bonds.
[4] Foreign, domestic bank, and domestic nonbank financing.
[5] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[6] Including currency and maturity composition.

Asunción, Paraguay
May 8, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Rato:

This letter and the attached memorandum of economic and financial policies (MEFP) outline the policies that the Government of Paraguay intends to adopt through the rest of the administration of President Duarte-Frutos (2006-08). Our main objective during this period is to entrench macroeconomic stability and embrace an ambitious structural reform agenda to create conditions for sustainable growth with equity for long-term development. We are requesting a 27-month Stand-By Arrangement (SBA) through August 2008 in an amount equivalent to SDR 65 million (65 percent of quota) in support of the program detailed in the attached MEFP. It is our intention to treat this arrangement as precautionary.

Significant achievements were reached under our economic program for 2004-05, supported by an International Monetary Fund's SBA, particularly in stabilizing the economy, putting the public finances on a sustainable trend and restoring confidence in the financial system, as well as beginning a process of structural reform. We achieved in 2004 some of the best macroeconomic results in a decade, with record high growth and one of the lowest rates of inflation in recent times. The economy continued with a positive performance in 2005 despite significant supply shocks, and the resulting inflationary pressures. By and large, our economic program has been successful.

We would like to build on the success of our recent stabilization efforts. We believe that the time is ripe to refocus our policy agenda on the more ambitious goal of increasing the rate of growth of the economy on a sustainable basis, while at the same time cementing our macroeconomic achievements. We understand that this is a more challenging task and that it will take some time to accomplish our goal, but we are determined to pursue it.

As in the past, the government will maintain a continuous dialogue with the Fund, the government believes that the policies set forth in the MEFP are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. Paraguay will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. We will also provide Fund staff with all the relevant information required to complete program reviews and monitor performance. The government will observe the standard performance criteria against imposing or intensifying exchange restrictions, introducing or modifying multiple currency practices, concluding bilateral payments agreements that are inconsistent with Article VIII of the Fund' Articles of Agreement, and imposing or intensifying restrictions for balance of payments reasons.

There will be quarterly quantitative performance criteria (with a similar structure to that of the previous SBA) and quarterly reviews during the first year, switching to semi-annual reviews later on. There will be six reviews to be completed by mid-September 2006, mid-December 2006, mid-March 2007, mid-June 2007, mid-December 2007, and mid-June 2008. These reviews will be associated with the observance of relevant performance criteria.

We have authorized the Fund to publish this letter and the attached MEFP, to facilitate a wider access and review of our policies among the international community and within Paraguay.

Sincerely yours,

_________/s/_________
Mónica Pérez dos Santos
President
Central Bank of Paraguay

_______/s/________
Ernst Bergen
Minister of Finance

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES OF THE GOVERNMENT OF PARAGUAY

I. BACKGROUND

1. **Paraguay was experiencing one of the most severe economic crises at the time President Duarte-Frutos took office in the second half of 2003.** The country faced an especially difficult fiscal situation and a distressed financial system following the regional financial crisis of 2002. Arrears were accumulating rapidly to creditors and suppliers, banks had failed, credit was shrinking, non-performing assets of the banking system were on the rise, and market confidence was low. There were serious risks of a deeper financial and fiscal crisis.

2. **Decisive policies were adopted in the context of an IMF-supported program in 2004–05 to stabilize the economy and avert further economic difficulties.** Soon after taking office, the government engaged in negotiations with the IMF on a strong program to restore confidence, strengthen the financial system and put the public finances on a sustainable path. A 15-month precautionary Stand-By Arrangement (SBA) for SDR 50 million was approved by the IMF Board in mid-December 2003. The authorities adopted a tight 2004 budget and an appropriate monetary policy that instilled confidence, helped to revert capital outflows and allowed a strengthening of the *guaraní*, while rapidly accumulating international reserves. At the same time, a strong structural reform agenda was adopted to safeguard stability and enhance growth prospects. Congress approved important pieces of legislation, including the banking resolution law, the deposit guarantee law, the fiscal adjustment law, the customs code and the second-tier public banking law. The economy responded rapidly, with 2004 showing the best macroeconomic performance in the recent past; the economy grew by 4 percent, the highest in a decade, and inflation fell below 3 percent, the lowest in a decade. Strong performance continued in 2005 despite supply shocks that have ignited inflationary pressures.

3. **Having successfully stabilized the economy, we intend to focus our attention on the design of policies that will promote growth with equity on a sustainable basis and cement macroeconomic balances.** The successful implementation and conclusion of the SBA in November 2005 marks the completion of the most immediate stabilization efforts. It also paves the way for a new phase in our policy formulation, which emphasizes on the elimination of obstacles to growth and poverty reduction, while maintaining macroeconomic stability. Paraguay experienced one of the lowest growth rates in Latin America over the last 25 years, with economic growth well below the population growth, and the consequent shrinking of per capita income. To reach higher economic growth rates, it will be important to embrace an ambitious structural reform agenda, while pursuing strong macroeconomic policies to safeguard stability. For that purpose, we are requesting a new precautionary SBA to the IMF, which will cover the remainder of the administration of President Duarte-Frutos.

II. Recent Developments

4. **While the economy is growing, there are wide disparities in performance across sectors.** There is an uneven pattern of growth. During 2005, livestock, forestry and mining expanded at healthy rates while agriculture, the traditional sector in the economy, remained depressed due to a drought earlier in the year. Other sectors like manufactures and construction are growing at modest rates. We estimate that the economy grew about 3 percent last year.

5. **Inflationary pressures have emerged, partly due to exogenous shocks.** Following one of the best performances in 2004, inflationary pressures emerged in December 2004 due to a temporary liquidity overhang. Since early 2005, the Brazilian currency (real) began to strengthen appreciably, and the price of Brazilian imports began to rise rapidly in *guaranies*. The improved competitiveness vis-à-vis the real also led to a higher Brazilian demand for local goods (mostly dairy products), putting upward pressures on domestic prices. At the same time, meat producers gained access to foreign markets (notably, Chile, Israel and Russia), which also put upward pressure on domestic meat prices. In addition, sharp increases in international oil prices prompted adjustments in the price of hydrocarbons domestically, despite a less than full pass-through on diesel prices. In the end inflation rebounded to almost 10 percent in 2005. We estimate that about one-half of the 2005 inflation is due to exogenous factors.

6. **The fiscal situation remains under tight control.** Mindful of the inflationary pressures, we strengthened our fiscal position relative to program objectives. Despite a reduction in the rate of advances on corporate income tax from 30 to 10 percent in August 2005 (as anticipated in the fiscal adjustment law), we managed to achieve a small surplus in 2005. We tightened fiscal policy towards the end of 2005 to ease inflationary pressures. To that end, we issued a decree in November 2005 to limit public expenditures to those established in the financial plan (approved in early 2005) for the last two months of the year, and prevent reprogramming expenditures not executed in previous months.

7. **A conservative credit policy led to record high international reserves despite less favorable external conditions.** Short-term interest rates on *letras de regulación monetaria* increased by about 400 basis points during 2005 contracting central bank credit and creating room for the accumulation of reserves. The Central Bank purchased foreign exchange in the first half of the year and maintained a more neutral position in the second half. On the external accounts, higher international oil prices and a drought weakened the current account, but private flows offset these developments.

III. Medium-Term Macro Framework and Structural Reforms for 2006-08

8. **The main objective of the medium-term program is to reinvigorate growth and reduce poverty while entrenching macroeconomic stability**. We aim at increasing gradually the growth rate of the economy from the historical average of 2 percent to 4-5 percent over the medium-term. Our poor growth performance in the past has been driven by low or even negative productivity growth in the economy. This suggests that unless we embrace an ambitious structural reform agenda, it will not be possible to break with the vicious circle of the past, which led to perpetuating low growth and a vulnerable economy. We also recognize that without a stable macroeconomic environment, it will not be possible to foster growth. For that reason, we intend to bring inflation down over the next few years to the levels of industrialized countries, by pursuing a combination of prudent fiscal policies and a strengthening of the monetary policy framework.

9. **The cornerstone of our macroeconomic framework is to maintain broad fiscal balance over the medium-term in order to manage the debt burden.** A broad fiscal balance, together with a prudent debt policy will create incentives for private investment and growth. This will also facilitate the conduct of monetary policy.

10. **The structural reform agenda will address four main areas of specific weaknesses in the economy**. We have identified these areas as:

- ***Public sector reform***. The fiscal problems of the past were the result of weaknesses in fiscal institutions and inappropriate policy responses. We will continue the fiscal reform initiated in 2004 to secure our fiscal objectives and correct these weaknesses, including: (i) strengthen the budgetary framework; (ii) build up the institutional framework for tax and customs administration; (iii) strengthen expenditure control mechanisms; (iv) rationalize the civil service; and (v) design a comprehensive reform for public and private pensions and health insurance.

- ***Financial sector reform.*** To ensure an efficient allocation of financial resources and eliminate vulnerabilities, we will: (i) strengthen the financial position of the Central Bank; (ii) improve central bank operations; (iii) upgrade banking supervision; (iv) strengthen prudential regulations; (v) strengthen public banks; (vi) foster capital markets; and (vii) improve the payment system.

- ***Pro-growth agenda***. There are many impediments to growth in diverse areas that need to be addressed, including by improving: (i) the performance of public enterprises; (ii) the investment climate; (iii) the productivity of the agricultural sector; (iv) the efficiency of civil court procedures; and (v) the functioning of the labor market.

- ***Social safety net***. We need to protect the most vulnerable groups of society and strengthen social programs to alleviate widespread poverty, including by:

(i) strengthening social assistance programs with a view to reach the Millennium Development Goals ahead of time; (ii) adopting a poverty reduction strategy; (iii) achieving a better targeting of diesel subsidies by realigning domestic to international prices facilitated by the introduction of a subsidy on public transportation; and (iv) introducing a cash transfer system to the most vulnerable groups conditioned by explicit contracts with beneficiaries. We are confident that these initiatives will contribute to reduce poverty and improve social equity.

IV. Macroeconomic Policies for 2006

11. **A key objective for the 2006 program is to consolidate the significant stabilization gains achieved over the last two years**. The macroeconomic framework for 2006 includes a growth objective of 3½ percent and a significant reduction in the inflation rate. The main elements of the program include a balanced fiscal position, and a tight monetary policy aimed at containing inflation. The Central Bank announced earlier this year the range of 2½ to 7½ percent as the inflation objective for 2006. However, unexpected price pressures in January and February suggest that inflation in 2006 will be at the higher end of the announced range. We believe that the policies described in this memorandum will achieve the objectives of the program. Performance criteria related to these policies are specified in Table 1 and Table 2 and defined in the attached technical memorandum of understanding.

A. Fiscal Policy

12. **We have designed a financial plan for 2006 to make the budget approved by Congress consistent with the available financing and the objective of broad fiscal balance**. The approved 2006 budget for the Treasury envisages a fiscal deficit of almost 2 percent of GDP. However, such fiscal imbalance is not consistent with the objectives of reducing inflation and the debt burden. In addition, there are no suitable sources of financing to cover such a deficit. Revised calculations indicate that revenues are likely to be lower than anticipated by Congress in 2006. For these reasons, the Ministry of Finance will adopt a strict financial plan, in accordance with the financial administration law, to bring the 2006 budget to an executable position. The tax to GDP ratio is expected to fall temporarily in 2006 following the reductions in the corporate income tax rate contemplated in the fiscal adjustment law. This will be offset only in part during 2006 by other elements of the law, such as the introduction of the personal income tax, which will be implemented more gradually over the next few years. The financial plan will be designed to limit current expenditures while allowing for an increase in public investment over the 2005 level.

13. **The program will allow for a higher-than-programmed level of public investment and poverty alleviation programs, provided there are appropriate safeguards**. The 2006 financial plan already provides for an increase in public investment from about 4 percent of GDP in 2005 to over 4¼ percent of GDP in 2006. In the event of revenue over-performance, additional resources will be directed to increase public

investment and social spending to alleviate extreme poverty (especially the conditional cash transfer system mentioned in paragraph 28). The program will also allow to exceed the public investment target and to tolerate a moderate fiscal deficit if the additional investment is growth–enhancing, covered with adequate financing, and does not jeopardize macroeconomic stability. This issue will be addressed in the context of program reviews.

14. **Additional efforts will be needed to reach the objective of fiscal balance for the consolidated public sector in 2006**. Even with a financial plan for the Treasury that would lead to fiscal balance at the Treasury level, there will be a need for further efforts in the rest of the public sector to ensure a zero deficit for the consolidated public sector, as the losses of the Central Bank are likely to rise in 2006. The Central Bank's efforts to fight the recent inflationary pressures are likely to lead to higher interest rates in the short-run, which will impact negatively on its financial position.

15. **We will take measures to ease budgetary financing constraints**. The public sector faces increasing amortizations in the next few years arising mostly from the repayment of obligations restructured in 2004. While our deposits at the Central Bank are sufficient to meet these obligations, this would put undue pressure on monetary policy. For that reason, we will explore ways to reorganize the bond market, which has been closed for some time. The broad objective will be to maintain a sustainable level of debt and prevent negative net domestic and external financing.

B. Monetary Policy

16. **Our main monetary objective for 2006 will be to reduce inflation significantly to within the 2½–7½ percent inflation range**. Inflationary pressures in the first quarter of the year indicate that inflation for 2006 as a whole will likely be in the higher end of our range. We believe that maintaining low inflation is a necessary condition for higher sustainable growth. While we estimate that an important part of the inflationary pressures is exogenous, as a precaution, we started tightening monetary policy in the last few months. Interest rates on "*letras de regulación monetaria"* were raised by 250 basis points in the last quarter of 2005, and by some 400 basis points in the first four months of 2006. We are prepared to tighten monetary policy further if necessary. We expect that the tightening in monetary policy will reduce inflationary pressures and contain inflationary expectations. For 2006, the central bank will accommodate an expected 8½ percent increase in the demand for currency, consistent with our inflation and growth objectives. Looking ahead, we will continue to use the exchange and interest rates flexibly to meet our inflation objectives.

17. **We expect to accumulate about US$20 million in international reserves in 2006, supported by a tight credit policy from the Central Bank**. While international reserves reached almost US$1.3 billion at end-2005, an all time high, we will continue strengthening our reserve position by conducting purchases of foreign exchange in 2006 to satisfy the demand for *guaranies*. In order to facilitate the reserve accumulation, the Central Bank will limit the expansion of its net domestic assets (NDA). Use of deposits by the government will

be sterilized with placements of *"letras de regulación monetaria"* to maintain the NDA target in 2006.

V. Structural Reforms for 2006

18. **The main structural objectives will be to modernize institutions and remove impediments to growth**. Our reform agenda is ambitious and aims at providing the conditions for sustainable growth. We will work with the National Congress to facilitate approval of legislation for those reform initiatives that require legislative modifications.

A. Public Sector Reform

19. **We will strengthen the institutional framework for tax collection to safeguard the recent improvements in revenue collections**. In particular, we will prepare a new tax code to modernize and standardize tax practices, as well as to rationalize tax exemptions. We will have a draft code approved by the economic cabinet by end-December 2006 (structural performance criterion). We have requested technical assistance from the IMF for this purpose.

20. **The budgetary framework will be strengthened to convert it into an effective financial management tool that reflects policy priorities**. We intend to rationalize the budgetary processes by improving planning and design as well as incorporating macroeconomic constraints. We will design an action plan to strengthen public financial management, including the introduction of a more effective expenditure control system at the commitment level for the Central Administration and the rationalization of the Treasury account system by end-June 2006 (structural benchmark). In order to strengthen the Treasury's liquidity management and control, we will adopt the long-term objective of having a Treasury single account. We have requested technical assistance from the IMF for these purposes.

B. Financial Sector Reform

21. **We will strengthen and restructure the National Development Bank (BNF) within the current legal framework to reduce vulnerabilities in the system**. The BNF is an important bank with systemic implications that needs to be financially strengthened, and restructured to improve its efficiency and ensure good performance. BNF has been making significant progress over the last two years to improve its financial position through a combination of undistributed profits and recovery of non-performing loans (NPL). We believe that a continuation of these efforts for about G 50 billion in 2006 will lead to a significant improvement in its balance sheet. The restructuring will proceed in two steps: (i) we will focus on strengthening the bank's balance sheet in 2006, to ensure it meets strict prudential norms and presents indicators consistent with a sound bank; and (ii) we will pursue a comprehensive operational restructuring in 2007-08 to ensure the bank's future viability by reducing operating expenses and improving its credit risk management, lending

practices and internal controls. In particular, the capital-adequacy ratio (CAR) measured under full classification and provisioning rules of the Central Bank Regulation 8/2003, for the purposes of this program, should reach 5 percent by end-June 2006 (structural benchmark) and 10 percent by end-December 2006 (performance criterion). BNF will be subject to audits for end-June and end-December 2006 as well as on-site inspections by the Superintendency of Banks. In the event these audits/inspections reveal shortfalls with respect to the CAR target, the government will cover those shortfalls promptly. BNF will maintain a CAR of 10 percent after end-December 2006 and will meet all other prudential regulations of the Central Bank. In order to focus on the strengthening of BNF's balance sheet, the increase in credit in 2006 will be limited to 10 percent over the end-2005 level. In an effort to strengthen NPL collection, BNF will also create a subsidiary or hire an independent firm by end–2006 to transfer all the NPL during the first quarter of 2007. We will also design an action plan on how to streamline the cost structure of BNF. We will request technical assistance from the IMF for this purpose.

22. **An action plan designed by the Central Bank to strengthen the functioning of the financial system will be implemented**. The Central Bank recently completed a study that identified the most immediate weaknesses in the financial system as well as a strategy to address these weaknesses. The strategy contains two plans: (i) a legal plan that includes measures that require changes in legislation and (ii) an operational plan that includes measures that can be implemented by the Central Bank. The legal plan identifies six issues that need to be modified in the current legislation, namely: (i) deficiencies in the process of sanctioning financial institutions; (ii) elimination of the sanctions when appealed; (iii) creation of fit and proper criteria for issuing banking licenses; (iv) modification of minimum capital requirements; (v) coordination with foreign supervisory bodies when issuing licenses to foreign banks; and (vi) strengthening monitoring of presumed connected lending. The operational plan include modifications related to: (i) design, structure and publication of the banking ranking (CADEF); (ii) provisioning for credit risk; (iii) foreign exchange position limits; (iv) streamlining sanctions' procedures; (v) capital requirements; and (vi) any change that is needed after the banking law amendments are approved. We expect to implement the operational plan and to submit amendments to the banking law to Congress according to the legal plan by end-September 2006 (structural benchmark). We have requested technical assistance from the IMF for this purpose.

23. **We will strengthen the financial position of the Central Bank to improve its effectiveness**. Weaknesses in the balance sheet of the Central Bank have been hampering the conduct of monetary policy. To address this problem, the Central Bank will design, in coordination with the Ministry of Finance, a plan and a timetable to strengthen its financial position. We will announce the agreed plan by end-December 2006 (structural benchmark). The government will send a bill to Congress by April 15, 2007 reflecting the legal and budgetary implications of the agreed plan to strengthen the financial position of the Central Bank (structural benchmark). We have requested technical assistance from the IMF for this purpose.

C. Pro-Growth Agenda

24. **We will adopt a comprehensive strategy seeking to improve the efficiency of public enterprises and the quality and coverage of public services.** Building on the comprehensive management audits that are being conducted (a performance criterion under the previous SBA); we will design and announce "Result-Oriented Management Contracts" (ROMC) for the National Electricity Company (ANDE), the Petroleum Company (PETROPAR), the Cement Industry (INC), the Telephone Company (COPACO), and the Water and Sewage Company (ESSAP) by end-September 2006. We will implement these ROMCs by end-December 2006 (structural benchmark). Each individual contract will comprise of relevant financial and managerial performance indicators. These indicators will be reviewed quarterly by the Planning Ministry (STP). The STP will publish the reviews, along with specific recommendations to monitor the performance of each public enterprise. Similar contracts will be adopted for the National Aerospace Authority (DINAC) and the National Port Authority (ANNP) during 2007. At the same time, we will also look for the possibility of private sector participation in the management of some public enterprises. This would be implemented through different modalities such as granting the management of the selected public enterprise to the private sector in exchange of a "success fee", private-public partnership schemes (PPP), or the outsourcing of specific business units. We will work closely with the World Bank and the Inter-American Development Bank in implementing these measures.

25. **We intend to design a master plan to improve the investment climate in the economy and facilitate higher sustainable growth**. A significant improvement in the investment climate has repeatedly been identified as a key factor to unlock the growth potential of the economy. The plan is expected to help promote the development of small and medium enterprises and direct investment by: (i) simplifying procedures to start and close business; (ii) implementing a plan for the modernization of properties registration; (iii) establishing a one-stop shop for exporters; (iv) strengthening of institutions involved in regulating firms and certifying product quality; and (v) improving mechanisms for VAT refunds. We expect to finalize the design of a master plan by end-September 2006 (structural benchmark). We will work closely with the World Bank and the Inter-American Development Bank in formulating this plan.

26. **The Development Financial Agency (AFD) is expected to mobilize long-term resources to provide adequate financing for private investment projects with long gestation periods**. One of the main impediments to growth has been the low level of private investment due to the lack of adequate long-term financing. The AFD is expected to eliminate that bottleneck. The AFD will channel resources from international financial institutions to the local financial system, which will intermediate the funds on competitive terms to private investors (and assume the credit risk). Eligible domestic financial institutions include commercial banks, *"financieras"* and cooperatives. The AFD is expected to begin operations in May 2006.

D. Social Safety Net

27. **We will implement a cash transfer system aimed at alleviating extreme poverty**. To mitigate possible adverse social effects of reforms, the government will improve on the quality of social spending. We intend to create a system of targeted cash transfers that will be conditioned by contracts with beneficiaries. We expect that some 7,000 families will benefit from this scheme by end-December 2006 (structural benchmark). Within the envelope of the allocated public investment program and additional transfers, the government intends to intensify implementation of several projects aimed at reducing the economic burden among the most vulnerable groups in the population. We will also introduce a centralized system that identifies the most vulnerable groups and those living under conditions of extreme poverty. We will work closely with the donor community for this purpose.

VI. Other

28. **We will continue negotiating disputed claims in good faith**. There are a number of existing claims in dispute, which we hope to resolve during the program. We will do the same for any new disputed claims that may arise.

Table 1. Paraguay: Proposed Quantitative Targets for 2006

	2006		
	end-Jun	end-Sep	end-Dec
Fiscal targets			
1. Overall balance of the central administration (floor, in billions of guaranies) 1/	250	325	0
2. Wage bill of the central administration (ceiling, in billions of guaranies) 2/	1,795	2,695	3,880
3. Overall balance of the public sector (floor, in billions of guaranies) 1/	350	440	0
Monetary targets			
4. Net international reserves (floor, in millions of U.S. dollars) 2/	1,297	1,307	1,317
5. Net domestic assets (ceiling, in billions of guaranies) 2/	-5,711	-5,751	-5,098
Public debt and arrears targets			
6. Contracting or guaranteeing of nonconcessional external debt by the NFPS (ceiling, in millions of US$) 1/	500	500	500
Continuous PCs			
7. Contracted or guaranteed short-term external debt by the NFPS 3/	0	0	0
8. Non-accumulation of external debt arrears 3/	0	0	0

1/ Cumulative flows from the beginning of the calendar year.

2/ NIR is adjusted upward (downward) for any increase (decrease) in reserve requirement for foreign currency deposits (above pre-specified amounts) and upward by the amount of any program disbursements. Similarly, the NDA target will be adjusted downward (upward) following the adjustment in the NIR.

3/ Continuous performance criteria.

Table 2. Paraguay: Proposed Structural Conditionality Under the Program for 2006/07

Measure	Conditionality [1/]	Timing
Public Sector Reform		
A. Preparation of a tax code in consultation with the Fund	PC	end-Dec 2006
B. Design of an action plan to develop an effective commitment control system for the public sector and rationalize the Treasury account system	SB	end-Jun 2006
Financial Sector Reform		
C. Audited and inspected CAR (fully provisioned) of 5 percent for BNF at end-June 2006	SB	end-Sep 2006
D. Audited and inspected CAR (fully provisioned) of 10 percent for BNF at end-December 2006	PC	end-Mar 2007
E. Implement regulatory measures outlined in the banking strategy and put together draft legislation	SB	end-Sep 2006
F. Announce a strategy to strengthen the financial position of the Central bank and a timetable for its implementation	SB	end-Dec 2006
G. Send a bill to Congress that reflects the legal and budgetary implications of the agreed plan to strenghten the financial position of the Central Bank	SB	mid-Apr 2007
Pro-Growth Reform		
H. Design a plan to improve business climate	SB	end-Sep 2006
I. Implement result-oriented management contract for ANDE, COPACO, ESSAP, INC, and PETROPAR	SB	end-Dec 2006
Social Safety Net		
J. Create a conditional cash transfer mechanism for 7,000 families living under extreme povery based on contracts with beneficiaries	SB	end-Dec 2006

1/ SB = structural benchmarks; PC = performance criteria

PARAGUAY—TECHNICAL MEMORANDUM OF UNDERSTANDING

This Technical Memorandum of Understanding (TMU) defines the variables subject to quantitative targets (performance criteria and indicative targets), specified in the Memorandum of Economic and Financial Policies (MEFP). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets.

A. Fiscal Targets

1. Targets on the Overall Balance of the Central Administration

Cumulative balance (from December 31, 2005)	Floor (In billions of *guaraníes*)
End-April 2006 (program projection)	213
End-May 2006 (program projection)	277
End-June 2006 (performance criterion)	250
End-July 2006 (program projection)	285
End-August 2006 (program projection)	309
End-September 2006 (performance criterion)	325
End-October 2006 (program projection)	320
End-November 2006 (program projection)	322
End-December 2006 (performance criterion)	0

For the purposes of the program, the central administration (CA) includes the executive, judicial and legislative branches. The overall balance of the CA will be measured and monitored from the financing side, as equal to *minus* the net financing of the CA. The net financing of the CA is defined as the sum of: (i) net external financing to the central government; (ii) the change in net credit to the central government from the financial system, excluding government bonds; (iii) the net issuance of government bonds; (iv) net financing from all other sources to the government (consisting of any form of financing other than government bonds) including by the private sector; (v) asset sales; (vi) the net change in domestic floating debt (*deuda flotante*), as defined below; and (vii) the net change in external arrears. Items denominated in foreign currency will be converted into *guaraníes* at the average exchange rate for each month.

For the purposes of the program, any government bonds issued to (i) capitalize the central bank, (ii) capitalize the Banco Nacional de Fomento (BNF), or (iii) finance the deposit guarantee will not be included in the definition of fiscal deficit.

Net external financing is defined as central government's foreign borrowing, including bonds issued abroad, less amortization payments (including debt prepayments) of foreign debt. Net credit from the financial system is defined as the change in net credit to government, as reported in the monetary accounts of the BCP, excluding government bonds. Net change in domestic floating debt is defined as the difference between accrued expenditure (*gastos obligados*) and payments transferred (*gastos transferidos*). Net change in external arrears is defined as the difference in the stock of arrears to external creditors during a period of reference, as reported by the Ministry of Finance's SIGADE system. Data will be provided to the Fund by the Ministry of Finance with a lag of not more than three weeks past the test date.

2. **Targets on the Central Administration Wage Bill**

Cumulative flows (from December 31, 2005)	Ceiling (In billions of *guaraníes*)
End-April 2006 (program projection)	1,185
End-May 2006 (program projection)	1,487
End-June 2006 (performance criterion)	1,795
End-July 2006 (program projection)	2,090
End-August 2006 (program projection)	2,389
End-September 2006 (performance criterion)	2,695
End-October 2006 (program projection)	2,999
End-November 2006 (program projection)	3,309
End-December 2006 (performance criterion)	3,880

The wage bill of the CA is defined as the accrued remuneration to all central administration employees *(servicios personales)*, including overtime and effective social contributions (budget line items 100–199)[22], as reported in by the Ministry of Finance's monthly *Situación Financiera de la Administración Central*. Data will be provided to the Fund by the Ministry of Finance with a lag of not more than three weeks past the test date.

22 It will exclude any Treasury transfers to the Caja Fiscal registered as wages for new employment positions authorized in the budget but not yet appointed.

3. **Targets on the Overall Balance of the Consolidated Public Sector**

Cumulative flows (from December 31, 2005)	Floor (In billions of *guaraníes*)
End-April 2006 (program projection)	289
End-May 2006 (program projection)	361
End-June 2006 (performance criterion)	350
End-July 2006 (program projection)	395
End-August 2006 (program projection)	426
End-September 2006 (performance criterion)	440
End-October 2006 (program projection)	441
End-November 2006 (program projection)	448
End-December 2006 (performance criterion)	0

For the purposes of the program, the consolidated public sector comprises: (i) the non-financial public sector (NFPS) and (ii) the Central Bank of Paraguay (BCP).

The NFPS includes the CA as defined above, the social security institutes, the provincial governments, autonomous decentralized agencies, and the nonfinancial public enterprises.[23]

Under the program, the consolidated public sector's overall balance will be measured and monitored as equal to *minus* the net financing of the NFPS, *plus* the operating balance of the BCP. The net financing of the NFPS is defined as the sum of: (i) net external financing; (ii) the change in net domestic credit to public sector from the financial system, excluding government bonds; (iii) the net issuance of government bonds; and (v) other net financing of the nonfinancial public sector by the private sector, including net increase in the stock of domestic floating debt, external arrears, and asset sales. Items denominated in foreign currency will be converted into *guaraníes* at the average exchange rate for each month.

[23] Altogether they include: Pension funds (Instituto de Previsión Social (IPS), Caja Bancaria, Caja Ande, Caja Ferroviaria, Caja de Empleados Municipales), the public universities (UNA, UNE, UNP, UNI), 17 provinces (*gobiernos departamentales*), 17 autonomous regulatory and development agencies, the public enterprises (PETROPAR, ANDE, ANNP, DINAC, and INC) and incorporated enterprises owned by the state (ESSAP and COPACO).

Net external financing of the NFPS is defined as all external disbursements less amortization paid by the NFPS as defined above. The change in net credit is defined as the net flow of gross domestic credit (excluding treasury bonds) plus use of deposits by the NFPS in the domestic financial system. Domestic floating debt of the NFPS is defined as the difference between accrued expenditure (*gastos obligados*) and payments transferred (*gastos transferidos*) vis-à-vis the private sector. It will be measured as the central government floating debt net of debts with the rest of the NFPS as defined herein. External arrears are defined as the sum of (i) any principal and interest accrued by the NFPS and not paid by the due date as reported by the Ministry of Finance's SIGADE; (ii) the net change in arrears to foreign suppliers of the NFPS. The operating balance of the BCP is measured as all administrative and financial revenues minus costs (including costs of monetary policy and interest on BCP external debt). Data will be provided to the Fund by the Ministry of Finance and the central bank with a lag of not more than three weeks past the test date.

B. Monetary Targets

4. Targets on Net International Reserves of the Central Bank of Paraguay (BCP)

Outstanding stock as of:	Floor (In millions of U.S. dollars)
End-April 2006 (program projection)	1,254
End-May 2006 (program projection)	1,273
End-June 2006 (performance criterion)	1,297
End-July 2006 (program projection)	1,303
End-August 2006 (program projection)	1,306
End-September 2006 (performance criterion)	1,307
End-October 2006 (program projection)	1,311
End-November 2006 (program projection)	1,314
End-December 2006 (performance criterion)	1,317

For monitoring purposes, net international reserves (NIR) of the BCP are defined as the U.S. dollar value of gross foreign assets in foreign currencies minus gross liabilities in foreign currencies with original maturity of less than one year. Data will be provided by the BCP to the Fund with a lag of not more than five days past the test date.

Gross foreign assets are defined consistent with SDDS and include all liquid foreign currency-denominated claims of BCP, including monetary gold, holdings of SDRs, the reserve position in the IMF, and foreign currency in the form of cash, deposits abroad, and Paraguay's net cash balance within the Latin America Trade Clearing System (ALADI). Excluded from gross foreign assets are participations in international financial institutions (including *Corporación Andina de Fomento* (CAF), IDB, IBRD, *Asociación Internacional de*

Fomento, and *Banco de Desarrollo del Caribe*), the holdings of nonconvertible currencies, and holdings of precious metals other than gold. Gross foreign liabilities are all foreign currency denominated BCP liabilities of contracted maturity up to and including one year plus the use of Fund credit. 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, 2005.

NIR targets will be adjusted *upward (downward)* for any *increase (decrease)* in reserve requirement deposits (*encaje)* associated with foreign currency deposits in commercial banks, compared to the following levels: June 30, 2006: US$263 million; September 30, 2006: US$267 million; and December 31, 2006: US$265 million.

NIR targets will also be adjusted upward (downward) by the surplus (shortfall) in program disbursements relative to the baseline projection. Program disbursements are defined as uncommitted external disbursements that are usable for the financing of the overall central government budget.

External Program Disbursements (Baseline Projection)

Cumulative flows (from December 31, 2005)	(In millions of *U.S. dollars*)
End-April 2006 (program projection)	0
End-May 2006 (program projection)	0
End-June 2006 (program projection)	0
End-July 2006 (program projection)	0
End-August 2006 (program projection)	30
End-September 2006 (program projection)	45
End-October 2006 (program projection)	45
End-November 2006 (program projection)	45
End-December 2006 (program projection)	45

5. **Targets on Net Domestic Assets**

Net domestic assets (NDA) of the BCP are defined as the difference between currency issue (provided by the BCP) and the net international reserves (NIR) of the BCP, both measured based on end-of-period data. Data will be provided to the Fund by the BCP with a lag of not more than five days past the test date.

Outstanding stock as of:	Ceiling (In billions of *guaraníes*)
End-April 2006 (program projection)	-5,372
End-May 2006 (program projection)	-5,540
End-June 2006 (performance criterion)	-5,711
End-July 2006 (program projection)	-5,740
End-August 2006 (program projection)	-5,742
End-September 2006 (performance criterion)	-5,751
End-October 2006 (program projection)	-5,768
End-November 2006 (program projection)	-5,728
End-December 2006 (performance criterion)	-5,098

For the purpose of NDA calculation, NIR will be converted into *guaraníes* at an accounting exchange rate of G 6,280/US$. The ceiling on NDA will be adjusted *upward* (*downward*) by the equivalent in *guaraníes* of the *downward* (*upward*) adjustments made to the floor on the NIR of the BCP as described above.

C. Financial Sector Targets

6. **Targets on Banco Nacional de Fomento (BNF)**

For the purposes of the program, the capital adequacy ratio (CAR) of the Banco Nacional de Fomento (BNF) will be measured as the ratio of the summation of risk-weighted assets, excluding risk-free assets as Cash and Government Bonds (Disponibilidades and Valores Publicos), divided by total net equity, as of end-June 2006 (structural benchmark) and end-December 2006 (performance criterion). For the calculation of risk-weighted assets and net equity, the bank's loans portfolio (inclusive of both performing and non-performing loans, to the financial and the non-financial sectors) will be fully classified, provisioned for, risk-weighted and accrued for interests in accordance with the rules set by the Central Bank in the Resolution No. 8/2003.

Targets on the Capital Adequacy Ratio for BNF

CAR of BNF:	(In percent)
End-June 2006 (indicative target)	5.0
End-December 2006 (performance criterion)	10.0

D. Public Debt and Arrears Targets

7. Targets on Contracting or Guaranteeing of New Nonconcessional External Debt by the Public Sector

Cumulative flows (from December 31, 2005):	Ceiling (In millions of U.S. dollars)
End-April 2006 (program projection)	500
End-May 2006 (program projection)	500
End-June 2006 (performance criterion)	500
End-July 2006 (program projection)	500
End-August 2006 (program projection)	500
End-September 2006 (performance criterion)	500
End-October 2006 (program projection)	500
End-November 2006 (program projection)	500
End-December 2006 (performance criterion)	500

The limit applies to the contracting or guaranteeing by the public sector within the calendar year of new nonconcessional external debt with an original maturity of more than one year, including commitments contracted or guaranteed.[24] For program purposes, a debt is concessional if it includes a grant element of at least 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates (CIRR).[25] Excluded from the limits are credits extended by the IMF and balance of payments support

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

[25] The grant element is calculated as the difference between the net present value (NPV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt (i.e., Grant = (Nominal Value – NPV) / Nominal Value). The NPV of debt is calculated by discounting the future stream of payments of debt service due on this debt. For debt with a maturity of at least 15 years, the ten-year average CIRR will be used to calculate the NPV of debt. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. For the purposes of the program, the CIRRs published by the OECD in February 2006 will be used.

loans extended by multilateral and bilateral creditors. The Ministry of Finance will provide data to the Fund with a lag of not more than 30 days from the test date.

The concessionality of loans in currency baskets will be assessed on the basis of U.S. dollar interest rate tables. For loans with interest rates based on the internal policy of the creditors, the relevant interest rate to define concessionality will be the interest rate for each creditor at the time of the commitment. Loans or portions of loans extended in the context of a debt rescheduling or a debt reduction operation will be excluded from the ceiling.

8. **Performance Criterion on Short-Term External Debt of the Nonfinancial Public Sector**

As a continuous performance criterion, the NFPS will neither contract nor guarantee any short-term external debt during the program period. Short-term debt is defined as debt with a contractual maturity of one year or less. Excluded are normal import-related credits, forward contracts, swaps, and other futures market contracts. The public enterprises will provide the necessary information to the Ministry of Finance, which will provide the data to the Fund, with a lag of not more than 30 days from the test date.

9. **Performance Criteria on External Payments Arrears of the Public Sector**

The Public Sector, excluding PETROPAR, will accumulate no new external arrears during the program period. The stock of external arrears of the PS will be calculated based on the schedule of external payments obligations reported by SIGADE. Data on external arrears will be reconciled with the relevant creditors, and any necessary adjustments will be incorporated in these targets as they occur. For the purposes of this performance criterion, an arrear will be defined as a payment, which has not been made within 30 days after falling due. In addition, the public enterprises will report to the Ministry of Finance and the BCP arrears on any external debt that is not recorded under SIGADE. The same 30-day grace period will be applied to all external payments of public enterprises, except where explicit agreements exist with creditors on an extended grace period. The Ministry of Finance will provide the final data on the stock of public sector external arrears to the Fund, with a lag of not more than 30 days from the test date.

In addition, the government is engaged in good faith efforts to resolve overdue claims in dispute, and will attempt to negotiate and resolve these as soon as possible.

E. Reporting

Monitoring the program requires accurate and timely data. All information on performance criteria, indicative targets, and balance of payments support loans will be reported to Fund staff within the timeframes prescribed above. Debt stocks and associated flows broken down by both creditor and debtor types and maturity will be provided on a quarterly basis.

The Ministry of Finance will be responsible for gathering data on a monthly basis from all the institutions that comprise the consolidated public sector, including the incorporated enterprises (*Sociedades Anónimas*) COPACO and ESSAP. It will compile this information according to the standard format of the Ministry of Finance's monthly financial situation report *(Situación Financiera).* The data will be supplied to the Fund and published on the Ministry of Finance's external website within 30 days of each test date.

Press Release No. 06/117
FOR IMMEDIATE RELEASE
June 5, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US$97 Million Stand-By Arrangement for Paraguay

The Executive Board of the International Monetary Fund (IMF) has approved a 27-month SDR 65 million (about US$97 million) Stand-By Arrangement for Paraguay to support the country's economic program. The approval makes SDR 25 million (about US$37 million) immediately available. However, the authorities have indicated their intention to treat the arrangement as precautionary.

The main objectives of the arrangement are to reduce vulnerabilities that were exposed during the 2002 crisis, entrench the stability achieved under the previous Stand-By Arrangement by strengthening macroeconomic fundamentals, and to lay the foundation for a gradual increase in economic growth to 4–5 percent per annum on a sustainable basis.

Following the Executive Board discussion on May 31, 2006, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chairman, said:

"Paraguay, under its previous Fund-supported program, successfully stabilized its economy under very difficult conditions. The adoption of a strong policy framework, incorporating well-targeted macroeconomic policies and an ambitious structural reform agenda, enabled the authorities to avert a full-fledged crisis. In this context, government arrears were cleared as part of a prudent fiscal policy, and strengthened financial regulations and a supportive monetary policy restored confidence in the financial system. In this improved policy environment, economic growth resumed, international reserves increased, and inflation and unemployment were reduced.

"While much has been achieved over the past two years, important challenges remain, including the further strengthening of macroeconomic fundamentals and addressing remaining vulnerabilities through institutional reform. This will entail sustaining fiscal consolidation, reinforcing monetary policy, further strengthening the financial system, and structural reforms aimed at removing impediments to growth and alleviating poverty.

"The authorities' program for 2006-08 addresses these challenges, with an objective, over the medium-term, of establishing the foundations for doubling the annual rate of real GDP growth to 4-5 percent. This program will be supported by a new 27-month Stand-By Arrangement.

“Fiscal policy includes as a medium-term objective the further reduction of the debt burden. For 2006, the targeted zero public financial deficit reflects a financial plan that incorporates significant expenditure restraint relative to the approved budget. The realization of fiscal balances targeted for 2007-08 will support a further decline in public debt.

“Monetary policy will be set with the objective of bringing inflation to low single digits by the end of the arrangement. For 2006, the continuation of tight monetary polices is targeted to limit inflation to 7 percent. Important institutional reforms in the fiscal and monetary areas will support the strengthened policy framework encompassed in the program.

“Structural reforms, including reforms of the public and financial sectors, as well as pro-growth policies and a strategy for poverty reduction, constitute important building blocks for the program. Envisaged measures include improving expenditure control, modernizing the tax code, and restructuring of the public enterprises. In the financial sector, enhancements to regulations and legislation and strengthening the balance sheets of the central bank and the national development bank are planned. Measures to improve to Paraguay’s business climate and the introduction of a conditional cash transfer mechanism for poor families round out the foreseen structural reforms.

“These policies will help strengthen macroeconomic fundamentals further, and lay the foundations for a gradual increase in economic growth over the medium term, thereby allowing Paraguay to reverse the vicious cycle of low growth and declining per capita income, which prevailed over the last quarter of a century,” Mr. Kato said.

ANNEX

Recent developments

Following an acute recession in 2002, which was triggered by a regional crisis and a poor agricultural harvest, Paraguay has been recovering. The country had its the best macroeconomic results in a decade during 2004, with the support of the Stand-By Arrangement agreed with the Fund in December 2003 (See Press Release No. 03/218). The program was highly successful in helping to stabilize Paraguay's economy.

The economy suffered again from a variety of supply shocks in 2005. A drought, higher international oil prices and a rapid strengthening of the Brazilian real led to a reduction in economic growth and an increase in inflation. Notwithstanding these shocks, fiscal discipline was preserved, and reserves continued growing to record levels in 2005. All in all, the main objectives of the previous arrangement were achieved. However, a number of challenges arose in 2006 with the continuation of a drought, persistent inflationary pressures, and a large and under-financed budget approved by Congress.

Program Summary

The key objectives of the 27-month program are securing macroeconomic stability, creating the conditions for sustained high growth, and reducing poverty. Paraguay has to continue strengthening fundamentals and address remaining vulnerabilities. Significant institutional reform efforts are needed to sustain the recent macroeconomic achievements and mitigate vulnerabilities. These efforts include reforms to sustain fiscal consolidation, strengthen monetary policy operations to reduce inflation, further strengthen the financial system, and remove impediments to growth.

The country's main weaknesses identified by the IMF staff included: (i) political instability that translated into economic policy instability; (ii) governance problems that led to corruption and kept growth low; (iii) a weak financial system beset by a series of crises; (iv) inefficient public enterprises in key sectors that depressed efficiency and economic performance; (v) low and falling productivity which resulted in low growth; (vi) high poverty and unemployment with limited social protection. The 2006–08 program has been tailored to address these economic weaknesses.

A strong **macroeconomic program** needs to be entrenched to avoid previous problems. Although macroeconomic management has improved, over the past decade, weak policy responses have exacerbated the impact of external shocks on output, employment and inflation, and have undermined confidence, leading to a number of financial crises.

The **public sector reform** is designed to address remaining fiscal vulnerabilities and rigidities, including tackling deficiencies in budgetary planning and expenditure control, institutionalize improvements in tax collections and reduce rigidities in current expenditures.

Reforming the financial sector is key. Over the last decade, public confidence in the banking system declined due to a number of banking crises. Consequently, financial sector assets and liabilities are short-term, constraining financial intermediation and long-term investment.

Paraguay has experienced long-term low growth and thus needs to further a **pro-growth agenda**. Per capita GDP fell by 7 percent in real terms over the last 25 years. Shocks and structural impediments hamper growth and restrain employment. To reinvigorate growth, there is a need to embrace reform in many diverse areas.

The latest IMF-supported program seeks to **alleviate widespread poverty**, and mitigate the social costs of reform. Lack of access to water and sanitary resources are one of the main concerns and attempts are being made to resolve this issue. About a third of the population is poor and about a sixth of the population lives under conditions of extreme poverty.

Paraguay joined the IMF on December 28, 1945; its quota is SDR 99.9 million (about US$146 million), and it has no outstanding use of IMF credits.

Statement by Javier Silva-Ruete, Alternate Executive Director for Paraguay and Luis Enrique Salgueiro, Advisor to Executive Director
May 31, 2006

1. The authorities would like to thank the staff for a well-written and comprehensive report, which recognizes their intention to reinforce macroeconomic stability and press forward with the structural reform agenda to ensure sustainable growth.

Recent Economic Developments

2. In 2004, Paraguay experienced the best macroeconomic results in a decade. The economy grew by 4 percent, driven by livestock production, telecommunications, and commerce. Despite this high GDP growth, inflation decreased to 2¾ percent —the lowest rate since 1970. In 2005 the economy faced several shocks —including an extended drought, higher international oil prices and a rapid strengthening of the Brazilian real— which led to a reduction in the pace of growth to 3 percent and inflationary pressures. The harsh drought severely affected the agricultural sector, especially the soybean crops, which is one of the most dynamic and important economic sectors of Paraguay.

3. During the first half of 2005, as a result of the Brazilian real appreciation, domestic prices of Brazilian imports rose rapidly leading to inflationary pressures. At the same time, higher Brazilian demand for local goods (mostly dairy products) put upward pressure on domestic prices. Additionally, higher exports of meat —which grew by 57.5% in 2005— caused a shortage of domestic supply leading to a higher trend of inflation during 2005. Increases in international oil prices resulted in adjustments in the domestic price of hydrocarbons. These exogenous factors explained half of the 9.9 percent inflation rate in 2005. The monetary authorities reacted to these higher inflationary pressures adjusting the interest rate of *Letras de Regulación Monetaria*, during the second half of 2005 by 250 basic points which led to lower Central Bank credit. These quick responses of monetary policy allowed to address all the quantitative monetary targets of the precautionary Stand By Agreement and paved the road to disinflation during 2006.

4. On the fiscal front, the authorities adopted prudent policies to ensure macroeconomic stability. They are committed to persisting in their fiscal consolidation efforts under the program. The Treasury reached surpluses in 2004 —for the first time in a decade— and in 2005. The latter surplus —which amounted to over ½ percent of GDP— exceeded program expectations due to strong tax collections (despite lower rates of companies' income taxes), low investment project implementation, and across-the-board expenditure cuts made in the last quarter of 2005 to help address inflationary concerns. There are early indications of a further strengthening in tax collections during the first quarter of 2006.

5. The small current account surplus in 2004 deteriorated into a deficit of 2½ percent of GDP in 2005, mostly due to a rapid growth in oil imports. Notwithstanding, a surge in private capital inflows resulted in a balance of payments surplus and a record high level of international reserves in 2005 (US$1.3 billion).

6. Regarding the structural reform agenda, under the previous program the government reached significant achievements, especially the passage of laws on fiscal adjustment, customs, banking resolution, public pensions, and second-tier public banking. The overall evaluation of the previous Stand By Agreement with the IMF is that the Government of Paraguay has successfully implemented the reform agenda of this Agreement and addressed all the quantitative targets of the program. As a result, Paraguayan macroeconomic management has substantially improved during the last two years.

Fiscal Policy

7. The fiscal authorities consider that the 2 percent deficit foreseen in the approved 2006 budget is inconsistent with the objectives of reducing inflation and the public debt burden. In this regard, the Ministry of Finance will adopt a strict financial plan, in accordance with the financial administration law, to bring the 2006 budget to an executable position. The 2006 financial plan provides for an increase in public investment from about 4 percent of GDP in 2005 to over 4¼ percent of GDP in 2006. In the event of revenue over-performance, additional resources will be directed to increase public investment and social spending to alleviate extreme poverty. The authorities agreed with the staff that fiscal targets could be relaxed in the context of the program reviews, if additional capital spending on high quality projects is identified, provided it is accompanied with adequate financing and does not jeopardize macroeconomic stability.

8. An eventual fall in taxes will be offset by other elements of the fiscal adjustment law, such as the introduction of the personal income tax, which will be implemented gradually over the next few years. Notwithstanding, during the first quarter of 2006 taxes are increasing at rates of 8 percent compared to the same period of 2005. The authorities are committed to achieving the fiscal objectives under the program. Therefore, they will keep a tight control on current expenditure, while protecting social spending and supporting public capital spending. They plan to cut budget expenditures by about 1¾ percent of GDP through the strict implementation of a financial plan. This includes: (i) reducing allowances for senior public servants; (ii) lowering over-time outlays; (iii) eliminating hiring of temporary workers; (iv) freezing positions in the first four months; (v) phasing in salary increases during the year; and (vi) restricting the purchase of goods and services which are not critical.

9. Over the past two years, tax collections have increased by over 1½ percent of GDP. Additional tax collection gains are expected over the medium-term through the full implementation of the 2004 tax reform (fiscal adjustment law) and sustained strengthening of the tax administration office, which should continue to increase revenue collections from Paraguay's large informal sector. The objective of the fiscal adjustment law of 2004 was to simplify the tax system and broaden the tax base. The law eliminated most exemptions from the corporate income tax and reduced its rate, broadened the base of the VAT, introduced a new personal income tax (to be phased in over time), and established a new agricultural income tax to replace the previous IMAGRO tax. It also adjusted certain excise tax rates and strengthened the tax administration's enforcement powers.

10. In order to ease budgetary financing constraints, the public sector faces increasing amortizations in the next few years, arising mostly from the repayment of obligations

restructured in 2004. While deposits at the Central Bank are sufficient to meet these obligations, this would put undue pressure on monetary policy. Therefore, the authorities will explore ways to reorganize the government bond market, which has been closed for some time. The broad objective will be to maintain a sustainable level of public debt and prevent negative net domestic and external financing.

11. In addition, in order to preserve the recent improvements in revenue collections, the authorities will prepare a new tax code to modernize and standardize tax practices and rationalize tax exemptions. They will be a draft code approved by the economic cabinet by end-December 2006, and will request technical assistance from the Fund for this purpose.

12. A realistic price policy for public enterprises, together with efficiency gains, will permit moderate surpluses. These would cover expected losses of the Central Bank, yielding a balanced position for the consolidated public sector. This prudent fiscal stance, together with faster economic growth, would reduce the public debt-to-GDP ratio towards 30 percent by the end of the decade.

13. In order to rationalize budgetary processes by improving planning and design, as well as incorporating macroeconomic constraints, the authorities will design an action plan to strengthen public financial management, including the introduction of a more effective expenditure control system at the commitment level for the Central Administration and the rationalization of the Treasury account system by end-June 2006.

Monetary Policy

14. Although Paraguay is experiencing higher inflationary pressures, the authorities are committed to reducing inflation to a low single digit in 2006 and maintaining a flexible exchange rate regime. In this regard, the monetary program's main objective for 2006 is to bring inflation down to 7 percent. Therefore, they plan to gradually reduce currency growth from 17½ percent in 2005 to 8½ percent at the end of 2006, which is significantly lower than projected nominal GDP growth. The Central Bank of Paraguay has tightened monetary policies during the first quarter of 2006 hiking interest rates further by 375 basis points, to 10½ percent, in two stages, in February and April 2006. To additionally reduce inflationary pressures, foreign exchange policies were adjusted to allow a freer floating of the Guarani. In the first quarter of 2006, the significant and continuous upward trend of year-on-year inflation was due to the meat domestic supply shortage and the increase of very volatile prices of fruits and vegetables. Notwithstanding, during the last months the tighter monetary policies have began to bring results and annual inflation rates have started to converge to the Central Bank's target for 2006.

15. Paraguay's monetary policy framework anticipates a US$20 million increase in net Central Bank international reserves (NIR), equivalent to 4¼ percent of currency. The net domestic assets of the Central Bank (NDA) will expand by about 4¼ percent of currency, as the public sector is expected to use its deposits at the Central Bank, that is to say about 6½ percent of currency. In this context, the authorities will expand open market operations with banks, which will gradually limit currency growth to 8½ percent at the end of 2006.

16. The authorities are aware of the negative impact of Central Bank losses on the effectiveness of monetary policy. These losses are associated with non-performing assets — mostly old Treasury and public companies loans but also the result of rescue operations during the recent financial crises— and the current burden of paying interest rates on *Letras de Regulación Monetaria.* These losses are undermining the balance sheet of the Central Bank. Given these circumstances, the new Central Bank management adopted revenue-enhancing measures and moderated expenditures to reduce losses by 2/3 in 2005. During 2006 increasing sterilization efforts and higher interest rates would lead to more capital losses which are estimated at around ¾ of GDP. The authorities are focusing on designing a strategy to strengthen the Central Bank's financial position by end–2006. They acknowledge the technical assistance already provided by the Fund in this field. The government reform agenda includes to specifically address this issue in order to elaborate a law by end-December 2006 and submit it to Congress in April 2007, at most. This law will strengthen the Central Bank's financial position and guarantee a greater monetary policy soundness for medium and long term prospects.

17. Although external vulnerabilities remain, the authorities are confident that the balance of payments will continue to be under control, since the main part of the deficit will be covered by private capital inflows, mostly foreign direct investment. At the same time, the expected level of net international reserves is envisaged to cover about 3½ months of imports. Despite the remaining vulnerabilities, mainly due to commodity price shocks and drought, there is no impending balance of payment gap.

Structural and Financial Reforms

18. The authorities are clearly committed to move forward with structural reforms with the aim of improving the business climate and promote investment and growth. In this regard, the public sector reform includes a strengthening of the institutional framework for tax collection to safeguard the recent improvements in this area. They will prepare a new tax code to modernize and standardize tax practices, as well as to rationalize tax exemptions. In addition, this will contribute to converting it into an effective financial management tool geared to strengthen public financial management and set up a more effective expenditure control system.

19. On the financial side**,** the government is fully confident that the strengthening and restructuring of the systemically-important state-owned National Development Bank (BNF) will contribute to reducing financial system vulnerabilities. The BNF has been making significant progress over the last two years in improving its financial position through a combination of undistributed profits and recovery of non-performing loans (NPL). In this respect, the BNF should reach a capital-adequacy ratio (CAR) of 5 percent by end-June 2006 and 10 percent by end-December 2006.

20. The monetary authorities recently completed a study that identified the legal weaknesses in banking regulations. The response will be a legal plan —required changes in banking legislation— and an operational plan to be implemented by the Central Bank aiming to correct these loopholes in the prudential regulatory framework.

21. The government will implement close monitoring of management of state-owned enterprises, mainly the National Electricity Company (ANDE), the Petroleum Company (PETROPAR), the Cement Industry (INC), the Telephone Company (COPACO), and the Water and Sewage Company (ESSAP) by end-September 2006, and for the National Aerospace Authority (DINAC) and the National Port Authority (ANNP) during 2007. The strategy will rely on relevant financial and managerial performance indicators, which will be reviewed and published quarterly by the Planning Ministry (STP).

22. The authorities consider that a key element of a better investment climate is having a level playing field for private companies. This idea leads to a strong commitment to fight informality and combat corruption. In order to further improve the investment climate and facilitate higher sustainable growth, the authorities are determined to take the necessary steps to simplify procedures for company registration and licensing regulations, promoting the development of small and medium enterprises, supporting exporters and foreign investors through one–stop shops, improving dispute resolutions and enforcement of judicial decisions, and strengthening public institutions certifying product quality.

23. The government is committed to provide a better infrastructure to increase the medium and long term financing of private companies. To address this important issue, the authorities are planning to mobilize medium and long-term financial resources through a new second-tier Public Financial Institution, the Development Financial Agency (AFD) which recently began its operations.

24. Extreme poverty alleviation is at the top of the authorities' agenda. In this regard, the government intends to improve the quality of social spending by setting up a conditioned cash-transfer system for low-income families. It is expected that this strategy will benefit almost 7,000 families in 2006. In addition, to reach the most vulnerable groups and to avoid indiscriminate subsidies, the government is realigning domestic and international prices and plans to create focalized subsidies for the public transportation system.

Closing Remarks

25. The authorities are strongly committed to achieving further progress towards their ambitious economic objectives. They wish to thank the Fund's continuing support and cooperation in meeting the significant economic and social challenges facing Paraguay. The authorities evaluate the previous precautionary Stand By Agreement as a crucial factor of the success that the macroeconomic management that Paraguay is experiencing and hopes that the joint efforts of the Government of Paraguay and the Fund will bring a sustainable path of greater growth and equity for the nation of Paraguay.