

Paraguay: Fifth Review Under the Stand-By Arrangement and Request for Waiver of Performance Criteria—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Paraguay

In the context of the fifth review under the Stand-By Arrangement and request for a waiver of performance criteria, the following documents have been released and are included in this package:

- the staff report for the Fifth Review Under the Stand-By Arrangement and Request for Waiver of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on July 14, 2005, 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 August 9, 2005. 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 staff supplement of August 19, 2005, updating information on recent economic developments.
- a Press Release summarizing the views of the Executive Board as expressed during its August 22, 2005 discussion of the staff report that completed the review.
- a statement by the Executive Director for Paraguay.

The document listed below has been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Paraguay*

*May also be 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

**Fifth Review Under the Stand-By Arrangement
and Request for Waiver of Performance Criteria**

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

Approved by Caroline Atkinson and Matthew Fisher

August 9, 2005

- **Arrangement.** A 15-month precautionary Stand-By Arrangement (SBA) for SDR 50 million (50 percent of quota) was approved by the Executive Board on December 15, 2003 (the first upper-credit tranche arrangement in 35 years). The SBA was extended for six months (through end-September 2005) on December 20, 2004 (at the time of the third review). Access remained unchanged and the outstanding amounts committed were rephased. No purchases have been made since the SBA approval. The main program objective is to restore macroeconomic stability (following a financial crisis in 2002–03) and to adopt a structural reform agenda to create conditions for sustained growth and poverty reduction. Executive Directors commended the authorities for their policies at the time of the fourth review on March 20, 2005.
- **Performance.** The program remains broadly on track. All quantitative performance criteria for end-March 2005 were observed (no final data for end-June 2005 are available yet). However, there were some delays in implementing the structural reform agenda and two structural performance criteria were not observed (audits of four public entities and approval of the comprehensive banking law). Supply shocks are likely to reduce economic growth to 3 percent in 2005 and have generated inflationary pressures. The overall fiscal position remains in surplus despite adverse conditions. The guaraní depreciated slightly with respect to the U.S. dollar but weakened significantly with respect to the Brazilian real. International reserves continue to rise.
- **Policies.** The main policy challenge is how to respond to a less favorable external environment while at the same time maintaining the momentum on the structural reform agenda. The authorities reaffirmed their commitment to maintain fiscal discipline against the background of an approved budget with a large deficit and weaker economic conditions. The Central Bank is adhering to the broad program objectives, and acknowledged the emergence of inflationary pressures. The mission believes that inflation could be contained to 6 percent with some monetary policy action. On the structural agenda, Congress concentrated its efforts on the treatment of two important pieces of public banking legislation, eventually paving the way for the restructuring of the national development bank (BNF).
- **Discussions.** These took place in Asunción during April 27–May 10 and July 12–14. The mission met with Vice-President Castiglioni, Finance Ministers Bergen and Borda, Central Bank Presidents Pérez dos Santos and Sánchez, other senior officials, and members of civil society. The staff team consisted of A. Santos (Head); F. Frantischek, T. Roy (all WHD); P. Breuer (PDR); and A. Novoa (MFD). Mr. L. Durán-Downing, resident representative in Asunción, assisted the mission. Mr. Ayala (OED) participated in the discussions. The mission liaised with the FSAP mission led by Mr. Majnoni as well as World Bank and the IDB staff.

List of Acronyms

ANDE	National Electricity Company
ANNP	National Port Authority
BCP	Central Bank of Paraguay
BNF	National Development Bank
CONATEL	National Telecommunications Commission
COPACO	Telephone Company
DINAC	National Aerospace Authority
ESSAP	Water and Sewage Company
FAD	Fiscal Affairs Department
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GNFS	Good and Nonfactor Services
IAS	International Accounting Standards
IDB	Inter-American Development Bank
IFS	International Financial Statistics
INC	National Cement Company
INCOOP	National Cooperative Institute
IPS	Social Security System
IT	Indicative Target
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
NPL	Nonperforming loans
PC	Performance Criteria
PDR	Policy Development and Review Department
PETROPAR	Petroleum Company
SBA	Stand-By Arrangement
SMEFP	Supplement MEFP
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

Recent Developments and Program Performance

- **The program remains broadly on track but with delays in the structural reform agenda.** All quantitative performance criteria for end-March 2005 were met, but two structural performance criteria were not observed. Congress' focus on public banking reform delayed discussions on the Comprehensive Banking Law (a structural performance criterion for end-June). There are also delays in conducting audits for four public entities (a structural performance criterion for end-April).
- **The economic outlook for 2005 is less positive than originally anticipated.** Supply shocks including continued high world oil prices, lower export prices, and a drought in the first quarter of 2005, are likely to reduce economic growth to 3 percent in 2005 and inflationary pressures are emerging. Despite these adverse conditions, the overall fiscal position remains in surplus, the exchange rate weakened slightly with respect to the U.S. dollar, but considerably with respect to the Brazilian real, and international reserves continue to rise.

Policy and Program Discussions

- **Fiscal policy was implemented as programmed.** The authorities achieved the demanding March 2005 target against the background of the congressionally approved budget, which envisaged higher expenditures, and some downward pressures on tax collections. The staff urged the authorities to continue their strict application of budget control instruments, namely the financial plan and the operation of the investment coordination unit (UCIP) to prioritize public capital expenditure.
- **Monetary policy needs to be conducted in a more flexible manner.** The Central Bank needs to use interest rate and exchange rate policy more flexibly to better control liquidity, reduce demand pressures, and contain inflation to 6 percent (the mid-point of the inflation target range). The authorities appear to have been using the dollar/guaraní rate as a guide to policy and, given the dollar decline against regional currencies, this has exerted some inflationary pressure.
- **Progress in the structural agenda is critical to reduce economic vulnerabilities.** There have been delays in implementing the structural reform agenda. The authorities need to maintain momentum and deepen the structural agenda to reduce vulnerabilities, strengthen institutions and lay the basis for growth.
- **Staff supports completion of the program review and waiver requests.** In light of the authorities' strong commitment to the program and broadly satisfactory performance, the staff supports the completion of this review, waivers for nonobservance of two structural performance criteria and a waiver of applicability of end-June 2005 quantitative performance criteria.

I. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM ¹

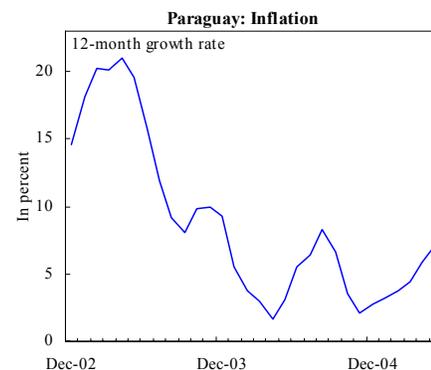
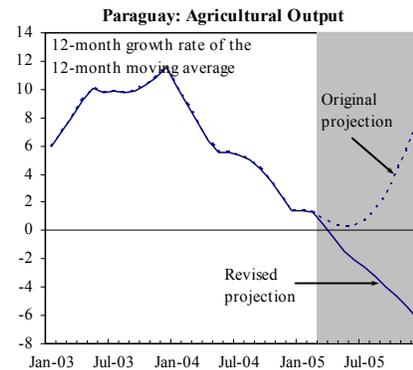
1. **Against the background of a less favorable macroeconomic environment, the program remains broadly on track.** All quantitative performance criteria (PCs) for end-March 2005 were observed. There is no final data yet to assess end-June 2005 quantitative performance criteria, but the authorities and the staff expect that all PCs have been observed. However, there have been delays in implementing some aspects of the structural reform agenda. Two structural performance criteria for this review were not observed (external audits of four public entities and congressional approval of general banking legislation), for which the authorities are requesting waivers.

Paraguay: Performance Under the Program (In trillions of guaraníes, unless indicated)		
Main Targets	end-March 2005	
	Prog	Actual
Fiscal Targets		
Fiscal balance 1/	0.11	0.26
Wage bill 1/	0.75	0.74
Consolidated fiscal balance 2/	0.17	0.36
Monetary Targets		
Net international reserves 3/	1.10	1.19
Net domestic assets	-4.49	-5.25

Sources: Paraguayan authorities and Fund staff.
 1/ Central administration.
 2/ Nonfinancial public sector and Central Bank.
 3/ In billions of U.S. dollars.

2. **Following significant economic achievements in 2004, macroeconomic conditions became more problematic in the first half of 2005.**

- **Exogenous factors reduced growth.** A drought and lower commodity prices have affected key agricultural products (soy, cotton, and cassava), prompting the authorities to reduce their projection for this year's real GDP growth from 3¼ to 3 percent despite a strong recovery in manufacturing production.²
- **Inflationary pressures emerged.** Price pressures re-appeared in the first half of the year, following a 20 percent increase in fuel prices, and a 10 percent increase in the minimum wage in April 2005. The 12-month inflation rate climbed to 7¼ percent in May

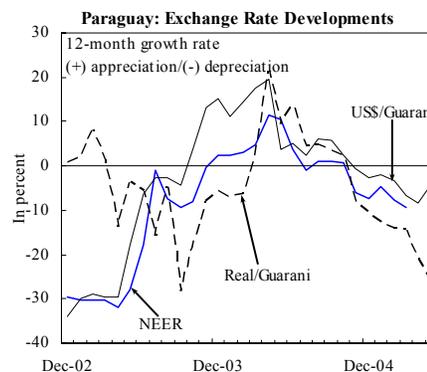
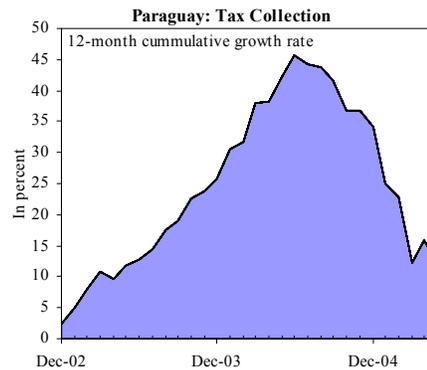


¹ The Central Bank of Paraguay changed its methodology for estimating GDP and has released a new series with 1994 as the base year (the previous base year was 1982). This report incorporates the new GDP figures, which are about 5 percent lower than the previous series. Consequently, most variables appear somewhat higher when expressed as a percent of GDP than those reported in previous documents and those under the program (programmed GDP in 2005 is also higher than now projected).

² Furthermore, Brazil's offensive to crack down on contraband in the border with Paraguay temporarily affected legal border trade.

2005 but fell to about 6 percent in June. An additional 10 percent fuel price adjustment took place in July 2005. The authorities believe that inflationary pressures are due in large part to higher prices of Brazilian goods following a sharp strengthening of the real against the U.S. dollar and higher international fuel prices (Box 1).³

- **Tax collections growth moderated.** After growing by more than 33 percent in 2004, tax receipts increased by only 10 percent in the period January–June 2005, but in line with program projections.
- **The guaraní weakened, fueling inflationary pressures.** Sizable Central Bank intervention in the foreign exchange market led to a depreciation of the guaraní by almost 5 percent against the U.S. dollar and over 35 percent with respect to the Brazilian real in the twelve months to June 2005. Most of the depreciation took place in the second half of that period.



3. **Progress in implementing the structural reform agenda continues to be slower than planned.** Recent delays are due mostly to congressional changes in the sequencing of the legislative agenda.⁴

- **The end-April 2005 structural performance criterion on the accounting audit of four public entities has not been met.** The external audits for ANNP (ports authority), DINAC (aviation authority), INC (cement), and PETROPAR (oil distribution) were delayed following a challenge from the General Comptroller Office to the legality of conducting and paying for external audits.⁵ However, the legal issue

³ Fuel prices in the regional market increased further following Argentina's decision to stop exports of diesel in December 2004. Argentina was Paraguay's main supplier of diesel. The latest deliveries of diesel came from Russia.

⁴ One such congressional change in the legislative agenda was the re-introduction of the privatization bill in April 2005 (the bill allows for the privatization of the telecom, water and railroad companies). This legislation was not part of the program. The privatization bill was originally proposed by the executive branch in 2000, but suspended by Congress in 2002 after strong opposition from vested interests and other segments of society. The Senate approved the privatization bill in May 2005 but the lower house rejected it in June 2005 after renewed opposition from the same groups.

⁵ A legal interpretation from the Attorney General was necessary to resolve the issue. The General Comptroller Office argued that the only body legally authorized to conduct such audits was their office and that external audits were a misuse of public funds.

has been resolved, audit companies selected, and the audits are now underway in three of the four cases.⁶ A waiver is being requested for the nonobservance of this performance criterion.

- ***The end-April 2005 structural benchmark on the plan for the comprehensive civil service reform has been finalized recently.*** The action plan approved by the cabinet

in July aims at creating the conditions for rationalizing the civil service. Among other measures, the plan envisages: (i) the classification of positions and grades and the definition of positions and their occupational requirements in the ministries; (ii) the design of a merit-based remuneration system and of a program for voluntary retirement and labor mobility; (iii) the

Paraguay: Structural Conditionality for the Fifth SBA Review		
Measure	Conditionality (Date)	Status
1. Independent audit for ANNP, DINAC, INC, PETROPAR	PC (Apr 2005)	In progress
2. Finalize plan for comprehensive civil service reform	Benchmark (Apr 2005)	Done (Jul 2005)
3. Approval of public banking law (2nd-tier)	Benchmark (May 2005)	Done (Jul 2005)
4. Approval of comprehensive banking law	PC (Jun 2005)	Law submitted in Dec 2004
5. Submission of public banking law (1st-tier)	PC (Jul 2005)	Done (Mar 2005)

Sources: Paraguayan authorities and Fund staff estimates.

implementation of a system for job selection, training, and promotions; and (iv) the strengthening of the information system by digitalizing civil servants' personnel files.

- ***The end-May 2005 structural benchmark on the approval of the second-tier public banking law was observed with a delay in July.*** The bill was submitted to Congress in late 2004; it was approved by the Senate in early-March 2005 and then approved by the lower house in May 2005. The bill was sent back to the senate for ratification after some modifications and was finally approved by the lower house in July in a form consistent with the program.
- ***The end-June 2005 structural performance criterion on the congressional approval of the Comprehensive Banking Law was not observed.*** The law was submitted to Congress (ahead of schedule) in December 2004. However, Congress has not yet taken up the legislation, because it focused on the first-tier public banking legislation as a priority. A waiver is being requested and a new structural benchmark introduced for mid-September 2005, regarding the authorities' strategy and timetable for addressing the key objectives of the legislation (i.e., strengthening the banking system).
- ***The end-July 2005 structural performance criteria on the submission of the first-tier public banking law to Congress was observed ahead of schedule.*** The bill was

⁶ The audit for INC have not begun yet. The Inter-American Development Bank is financing the audit and it requires a transparent and more rigorous bidding process. The authorities are confident that INC's audit will start by end-August 2005.

approved by the Senate and is now in the lower house.⁷ The bill creates a new consolidated first-tier public bank (BNFD) to which all performing assets and most liabilities are transferred, and closes the old first-tier banks (including BNF). It also provides for the establishment of a trust fund, the transfer of nonperforming loans to that trust fund, and the recapitalization of the new bank. The Senate introduced modifications to the bill, including higher capital requirements, modified loan refinancing rules, and the possibility of BNFD providing guarantees. While the higher capital provisions will strengthen the law, the modified refinancing rules, and extension of BNFD guarantees are problematic. The staff has expressed its concern on these problematic features and the need to rapidly approve the law to allow for an effective restructuring of BNF. The authorities agree and President Duarte-Frutos has personally urged the lower house to reject the problematic modifications introduced by the Senate.

4. **Following a relatively calm social situation in the first half of 2005, tensions intensified lately.** The authorities addressed some of the concerns of the rural poor by buying land and distributing it among rural workers in the first half of the year. However, there have been several demonstrations against the fuel price adjustments of July 2005.

II. POLICY AND PROGRAM DISCUSSIONS⁸

5. **Discussions focused on the policies needed to ensure that the macroeconomic program remains on track and to overcome delays in structural reform.** The mission noted the increasing fiscal pressures under difficult conditions and stressed the importance of continuing to monitor tax collections. The authorities were confident that the weaknesses in tax collections were temporary and that the fiscal objectives of the program could be achieved despite the less favorable environment. The mission expressed concern about the emerging inflationary pressures. The authorities noted that these pressures originated to a large extent externally. The mission pointed to the large scale interventions in the foreign exchange market that the authorities had undertaken to prevent an appreciation of the *guaraní* against the U.S. dollar and which had led to significant depreciation against regional currencies earlier this year.⁹ In this context, the mission recommended raising interest rates

⁷ The program envisaged the creation of a commission to develop a business plan and reorient the operations of the development bank (BNF) in the expectation that there might be delays in congressional consideration of this law. While the commission was created, its role is less important than envisaged, as the draft law incorporated some of the commission's tasks.

⁸ There was a change in the economic team in the middle of the policy dialogue. Discussions began with Finance Minister Borda and Interim Central Bank President Sánchez. However, Mr. Borda resigned in mid-May, and then Minister of Industry Ernst Bergen was appointed as Minister of Finance. Ms. Pérez dos Santos (a former IMF economist) assumed the Presidency of the Central Bank in early-June. Discussions were concluded with the new economic team.

⁹ Paraguay follows a managed float exchange rate regime and intervenes to smooth out exchange rate fluctuations. In practice, the Central Bank follows the exchange rate vis-à-vis the U.S. dollar more closely than other regional currencies (given the high degree of dollarization in the financial system). The authorities

(continued)

and allowing the exchange rate to move more flexibly in response to market pressures, which would help insulate the country from inflationary pressures coming from abroad. The mission also stressed the importance of continuing the momentum on structural reform. The authorities agreed with the mission's assessment, noting that the recent delays in the implementation of the structural agenda were mostly due to factors beyond their control, and did not signal any lack of commitment to the reform agenda.

A. Fiscal Policy

6. **The fiscal program remains broadly appropriate—given the macroeconomic situation and the financing available—and policy is on track.** Budget control has worked well under difficult conditions, suggesting that the financial plan will continue to be useful for the remainder of the year, and that the broad revenue and expenditure targets under the program will be achieved. Part of the fiscal overperformance through March 2005 was due to compression of public investment. The mission stressed the need to contain current spending and to allow public investment to increase.

7. **Strengthened expenditure control mechanisms have effectively contained**

spending pressures. The authorities have been able to impose fiscal discipline during the first half of the year despite the expansionary 2005 budget approved by Congress. Budgetary control instruments discussed during the fourth review, namely the application of a strict financial plan to guide fiscal policy for 2005 and the operation of the investment coordination unit (UCIP) to prioritize public capital expenditure, have worked appropriately and have facilitated achieving the program objectives for March 2005. However, risks remain and the staff recommended that the authorities resist expenditure pressures and be prepared to take additional measures if necessary to ensure the fiscal objectives.

	2003	2004	2005	
	Actual	Actual	Prog. 1/	Proj.
Revenues	16.6	18.9	18.3	19.6
Expenditures	17.0	17.3	18.8	19.9
Current	13.8	13.3	13.7	14.6
Non-interest	12.4	12.1	12.4	13.2
Interest	1.4	1.2	1.3	1.4
Capital	3.2	4.0	5.1	5.3
Statistical Discrepancy	0.1	0.4	--	--
Overall Balance	-0.3	2.0	-0.5	-0.2
Memorandum item:				
Primary Savings	4.2	6.8	5.9	6.0
Primary Balance	1.0	2.8	0.7	1.0
Real GDP growth (%)	3.8	4.0	3.2	3.0

Sources: Paraguayan authorities and Fund staff estimates.
1/ see www.imf.org.

8. **While the fiscal target for the rest of the public sector was also observed with a large margin, PETROPAR continues to have financial difficulties.** The strong overperformance in the overall public sector deficit in the first quarter was due to a higher than projected surplus in the public enterprises. However, this surplus masks financing problems at the petroleum company (PETROPAR), which continued accumulating arrears to suppliers in the first half of 2005.¹⁰ In an effort to tackle these problems, the authorities have adjusted domestic diesel prices four times during 2005 by 29 percent. The authorities believe

stopped intervening in the foreign exchange market after mid-May 2005, and the *guaraní* has strengthened by about 3½ percent against the U.S. dollar since then.

¹⁰ Starting in January 2005, PETROPAR's arrears are excluded from the arrears performance criterion under the program as defined in the technical memorandum of understanding of December 2004 (see www.imf.org).

that these price adjustments would suffice to cover the cost of importing diesel over the medium term but are willing to take additional action if international oil prices continue rising. To address PETROPAR's financial problems in a more permanent manner, the authorities have adopted a twofold approach:

- ***A hydrocarbons law was submitted to Congress in May 2005.*** This law will establish a new regulatory framework for the fuel sector and will liberalize domestic diesel prices, eliminating any implicit subsidy by PETROPAR.¹¹
- ***Congress approved a framework oil agreement with Venezuela in June 2005.*** This agreement will allow PETROPAR to improve gradually the maturity profile of its debt and to eliminate arrears, with favorable longer-term financing terms for the purchase of fuels.¹²

9. **The authorities are taking steps to address the financial problems of the pension fund for bank employees.** This pension fund is on the brink of insolvency, although the authorities do not expect this to affect this year's budget outcome. So far, the fund has been able to pay pensions by liquidating assets, and it appears that funds could last for the rest of the year. Meanwhile, the government has prepared a draft law to liquidate the fund, transfer employees to the private and public pension funds (depending on whether the employees work at a private or public bank), while at the same time reducing benefits and increasing contributions.¹³

B. Monetary Policy

10. **The authorities acknowledged that policy action was needed to counter resurgent inflationary pressures.** While they considered part of these pressures as exogenous and temporary (i.e., oil shock and imported inflation), they intended to send a strong policy signal to anchor inflationary expectations and lock in the stability gains achieved during 2004. In this regard, the authorities have taken measures to tighten policies, in particular by increasing interest rates on Central Bank securities (LRM) by 100 basis points. The

Paraguay: Monetary Program (In percent of currency the previous period)				
	2003	2004	2005	
	Actual		Prog. 1/	Proj.
Currency	29.9	12.7	13.2	10.0
Net international reserves	126.4	52.6	13.2	13.1
Net domestic assets	-96.5	-39.8	0.0	-3.1
Credit to public sector (net)	-20.2	1.8	4.2	-2.3
Credit to banks (net)	-73.6	-46.0	-14.8	-12.5
Free reserves	-19.2	-21.3	6.8	6.0
BCP bills (LRM)	-17.9	-25.8	-13.1	-14.8
Other bank credit	-36.5	1.1	-8.5	-3.7
Other items net	-2.7	4.3	10.6	11.8
Memorandum item:				
Base money growth (%)	57.7	17.6	9.4	4.9
Money supply growth (%)	35.8	24.7	12.0	11.0

Sources: Paraguayan authorities and Fund staff estimates.
1/ Implicit flows from the stock for 2004 in extended SBA program (see www.imf.org) and actuals for 2003.

¹¹ Once the hydrocarbon law is approved and price liberalized, the authorities intend to move from ad-valorem fuel taxes toward specific fuel taxes, which will be indexed to inflation to avoid large fluctuations in revenue collections due to sharp movements in oil prices.

¹² The agreement specifies that Venezuela will sell oil products to Paraguay at market prices, but under favorable financing terms. In particular, PETROPAR could purchase a significant amount of oil products and receive long-term financing (up to 15 years) at an interest rate of 2 percent per year.

¹³ The authorities believe there are enough assets to finance the deficit until the end of the year. They have received technical support from the World Bank to evaluate alternative options to deal with the financial problems of the pension fund for bank employees.

mission stressed the need to conduct exchange rate policy more flexibly to reduce the impact of imported inflation. The authorities reaffirmed their commitment to the program's inflation objective of 6 percent plus/minus 2 percentage points for 2005, but noted that the end-year outcome was now more likely to fall within the upper rather than the lower range of the target.

11. **The authorities made good progress in implementing the recommendations made in the recent MFD Technical Assistance report.** All measures envisaged for the first half of 2005, were either implemented or are in the process of being implemented. In particular, procedures and analysis for open market operations were strengthened, the maturity of monetary policy instruments (LRM) was shortened; and rules related to the collateralization of monetary policy instruments were modified.

Paraguay: Central Bank Operations	
MFD Technical Assistance Recommendations 1/	Status
Monetary Policy	
1. Formalize with a Board directive the frequency, attendance, and matters to be treated of CEOMA meetings. Implement a procedure for the recording and internal drafting of the minutes of the meetings.	A. Done. BCP Board resolution No. 9 (Aug. 23, 2004) and Board resolution No. 12 (Oct. 28, 2004). In addition, internal minutes of CEOMA meetings are being prepared.
2. Construct a standard set of figures and tables, focusing on monetary, price, exchange rate, and external developments.	B. Done. A standard set of tables, including recommendations and conclusions by the Economic Research Department, is now used for CEOMA discussions. A monthly written brief is being developed.
Monetary Operations	
3. Issue shorter-term instruments (including one month).	C. Done. The BCP introduced new LRMs at a maturity of 7 and 14 days, which are offered on a daily basis, and shortened the average maturity of its LRMs.
4. Concentrate the auctions of longer-term instruments and allow their rates to become market-determined.	D. In progress. The BCP envisages this measure once excess liquidity in the banking system has been largely absorbed.
5. Revise RIR rules	E. Done. BCP Board resolution (April 21, 2005). The class of LRMs accepted as collateral has been widened, access for short-term RIR has been made automatic, and the discount on the collateral value has been reduced from 15 to 5 percent.
Sources: Paraguayan authorities and Fund staff. 1/ As scheduled for the first semester of 2005.	

C. External Issues

12. **A more adverse external and domestic environment is likely to lead to a weaker external position for the rest of 2005.** Exports are now expected to fall by almost 5 percent in 2005 due to: (i) stricter customs controls in importing countries in the region; (ii) lower duty-free import limits in Brazil for border trade; (iii) lower export prices (soy prices fell by almost one-third in the year to May 2005); and (iv) lower export volumes due to the drought.¹⁴ The current account is expected to deteriorate by almost 2 percent of GDP in 2005 with respect to the previous year (and 1 percent with respect to program projections for 2005). However, the capital account is projected to strengthen

Paraguay: Balance of Payments (In percent of GDP)				
	2003	2004	2005	
	Actual	Actual	Prog. 1/	Proj.
Current Account	2.2	0.4	-0.4	-1.4
Exports	39.1	40.0	37.6	37.4
Imports	-44.1	-46.1	-43.7	-44.9
Other	7.2	6.5	5.8	6.1
Capital Account	1.6	3.2	0.9	2.4
Public sector (net)	1.7	0.2	0.4	0.5
Private sector (net) 2/	-0.1	3.0	0.4	1.9
Overall Balance	3.8	3.6	0.5	1.0
Overall Financing	-3.8	-3.6	-0.5	-1.0
Net international reserves	-5.4	-2.7	-0.5	-0.7
Exceptional financing	1.6	-0.9	0.0	-0.3
Sources: Paraguayan authorities and Fund staff estimates. 1/ Extended SBA program (see www.imf.org). 2/ Includes errors and omissions.				

¹⁴ Exports as a percent of GDP do not change much with respect to program projections because programmed GDP was higher than the revised estimate under the new BCP methodology.

considerably in response to expected interest rate hikes, allowing the reserves target to be met.

13. **While efforts continue to be made to normalize relations with creditors, PETROPAR accumulated arrears.** Rising diesel prices in the regional and international markets resulted in a further build-up of PETROPAR arrears to suppliers of about US\$30 million as of end-June 2005. However, the expected improvement in PETROPAR's finances will lead to a clearing of existing arrears. The authorities are also engaged in negotiations to normalize relations with all external creditors, including to resolve disputed debts.¹⁵

D. Structural Issues

14. **The authorities reiterated their commitment to structural reform notwithstanding recent delays.** While the authorities submitted to Congress several bills broadly when expected, Congress gave more emphasis to the two public banking laws and less to the comprehensive banking law. As a result, the first-tier public banking law (which was expected to be approved by Congress after September 2005) was approved by the Senate in May 2005, whereas the comprehensive banking law (which was expected to be approved by Congress in June 2005) was not approved.

Paraguay: Structural Conditionality for the Sixth SBA Review		
Measure	Conditionality (Date)	Status
1. Plans for private capital participation ESSAP, COPACO, PETROPAR	Benchmark (Aug 2005)	In progress
2. Plan to strengthen banking system taking into account FSAP recommendations	Benchmark (Sep 2005)	In progress

Sources: Paraguayan authorities and Fund staff estimates.

- **Public banking reform.** The Second-Tier Public Banking law was approved by Congress in July. The First-Tier Public Banking Law was approved by the Senate (ahead of schedule) and is now being considered by the lower house. Congress decided to treat both public banking laws at about the same time, which had not been anticipated under the program.

¹⁵ The status of negotiations on arrears is as follows: (i) Germany's KfW (€ 4 million), a law authorizing payment by ANDE's was promulgated in April 2005; (ii) Belgium's Office National du Ducroire (Ex-Herstal) (US\$8 million), all debts authorized by Congress were paid in November 2004. For past due interest (PDI), the authorities informed staff that negotiations over size and modalities of payment continue; Paraguay has proposed to pay into a fund to improve the environment; (iii) South African supplier D.B. Pty Limited (US\$0.03 million), efforts are being made to locate the supplier; (iv) import inspection firms BIVAC (France) and SGS (Switzerland) (up to US\$77 million), an investigation is being conducted on the nonpayment to these companies for services provided between 1996 and 1999; (v) PETROPAR's suppliers (US\$30 million), as explained before, prices were adjusted, a hydrocarbons law was sent to Congress to liberalize diesel prices, and an agreement was reached with Venezuela to finance future diesel imports, improving the cash flow and payment capacity of PETROPAR; and (vi) the authorities have represented to staff that they are disputing commercial bank claims, involving the conduct of a former Paraguayan diplomat, in relation to which Paraguay has been adjudicated liable in Swiss court proceedings (US\$85 million), the authorities are considering their options in consultation with their professional advisers, the staff will report on further developments at the time of the next review (these claims were not included in the list of disputed claims originally provided by the authorities at the start of the program).

- **Banking system strengthening.** Given the delays in approving the comprehensive banking law, the new economic team intends to develop, by mid-September 2005, an action plan—drawing on the FSAP’s mission recommendations—to achieve the original program objective of strengthening the banking system and any other important concern that may emerge from the FSAP. This will be a structural benchmark.
- **State-owned enterprise reform.** The authorities are designing a plan for private capital participation in ESSAP, COPACO, and PETROPAR, involving outsourcing of the management of these companies to professionals in the private sector under a performance contract. Findings from the forthcoming comprehensive audit of the companies’ performance will also be incorporated into the plan.
- **Debt restructuring issues.** As of end-June 2005, about 96 percent of the debt eligible for the bond exchange was exchanged. The authorities have made progress in identifying the holders of non-participating debt. More than one third of the untendered debt (about 1½ percent of the eligible debt) is with public entities and is expected to be tendered shortly. The authorities hope to conclude the exchange in the coming months.

E. Program Issues

15. **Waivers.** The authorities are requesting waivers for: (i) the non-observance of the end-April 2005 structural performance criterion on the conduct of independent accounting audits for ANNP, DINAC, INC and PETROPAR; three of them are underway and expected to be concluded in the next few months; (ii) the nonobservance of the end-June 2005 structural performance criterion on the approval of comprehensive banking legislation; the authorities remain committed to the objectives of this reform and propose the inclusion of a new structural benchmark (see below); and (iii) the applicability of end-June 2005 quantitative performance criteria as necessary information is not yet available (this is needed because the end-June 2005 quantitative PCs become binding). The staff supports these waiver requests given the temporary nature of the deviations and the corrective actions taken.

16. **New Benchmark.** The authorities propose to introduce a new structural benchmark for mid-September 2005 (to be assessed at the time of the next review) on the development of a plan of action to meet the original program objective of strengthening the banking system, taking into account the recommendations of the FSAP as appropriate.¹⁶

17. **Conditionality.** The attached letter of intent restates the authorities’ commitment to the program and targets, and lays out the additional commitments to bring the program on track in the structural area. There are no prior actions requested to complete this review.

¹⁶ The objectives of this law in the original SBA (Country Report No. 04/66) included: (i) strengthen the institutional framework for monetary policy management; (ii) upgrade regulatory requirements for risk weighted capital; (iii) bring accounting and prudential standards up to international best practices; (iv) bring regulation and supervision of non-bank deposit-taking institutions up to international best practices; and (v) improve the operational capacity of the Superintendency of Banks.

III. MEDIUM-TERM SCENARIO AND RISKS

18. **There is no material change to the medium-term scenario, or to the risks to the program.** Continued macroeconomic stability and further structural reforms are necessary to secure sustained increases in per-capita income and reduce poverty. Under the baseline scenario, prudent macroeconomic policies and vigorous implementation of structural reforms result in 4 percent annual growth. In this scenario, continued fiscal consolidation would reduce the debt-to-GDP ratio to about 30 percent by 2010. The capacity to repay the Fund remains strong even in the event Fund resources are used. Risks to the program continue to include implementation risks that could threaten continued macro stability; external risks, including worsening terms of trade; and political risks.¹⁷

IV. STAFF APPRAISAL

19. **Performance under the Fund-supported program continues to be broadly satisfactory, although the structural agenda has not advanced as rapidly as planned.** All quantitative performance criteria for end-March 2005 were met and the expectation is that those for end-June 2005 were also observed. While the structural agenda has been subject to changes, often driven by Congress, the authorities have been relatively successful in moving the reform agenda forward in a difficult political environment.

20. **However, the macroeconomic environment has become less favorable, and policies need strengthening to ensure the program objectives are achieved.** External and domestic conditions have worsened somewhat since the last review. The international oil price and the regional diesel price have increased, key export prices continue to decline (especially soybeans), and regional inflation is up. At the same time, a drought—with a more severe impact than originally anticipated—reduced key crops and a source of foreign exchange. In this context, the staff welcomes the authorities' commitment to strengthen policies.

21. **Fiscal policy has been successfully implemented under difficult conditions although risks remain, especially if the economy weakens further.** The staff commends the authorities for the conduct of fiscal policy during the first half of 2005. If economic conditions worsened, it would be imperative to continue to adhere to the financial plan used to conduct fiscal policy against the background of a congressionally approved budget with higher expenditure.

22. **Monetary policy needs to be used more flexibly to minimize the impact of external shocks and to contain inflation.** While an important part of the recent uptick in inflation reflects higher oil prices, adjustments in administered domestic prices, and imported inflation, a more flexible use of exchange rate and interest rate policies could have reduced the impact of these shocks. In this regard, the staff welcomes the recent increases in the interest rates for monetary policy instruments (LRM), and the authorities' intention to tighten monetary policy further if inflationary pressures persist. In this context, the staff welcomes

¹⁷ For the latest debt sustainability analysis, see Country Report No. 05/59. The staff believes that the assessments made then remain valid.

the Central Bank decision to allow the *guarani* to move in response to market pressures which have led to an appreciation of the currency against the U.S. dollar in recent weeks, partially following movement in other regional currencies. The staff also welcomes the authorities' implementation of the MFD short-term recommendations to improve monetary operations, but notes that additional reforms will be necessary to strengthen further the monetary framework and monetary policy management.

23. **With the external current account expected to deteriorate this year, tighter monetary policy will be needed to safeguard international reserves.** The weaker-than-expected crops as well as lower export prices will push up the external current account deficit by some 1 percent of GDP from the program projection. In the absence of measures, there will be pressures on the exchange rate and/or the international reserves. It will be important to move interest rates to foster capital inflows and compensate for the shortfalls in the current account.

24. **The staff urged the authorities to implement corrective measures on the structural front.** The audits of the four public entities need to be finalized and their results used to improve the functioning of public institutions. The authorities are advised to expedite the logistical procedures associated with the bidding for the audit of INC. The staff also stressed the importance of completing in a timely manner the plan for the comprehensive banking reform given the legislative delays in this area (a structural benchmark of the next review). The staff encouraged the authorities to continue supporting in Congress outstanding public banking legislation.

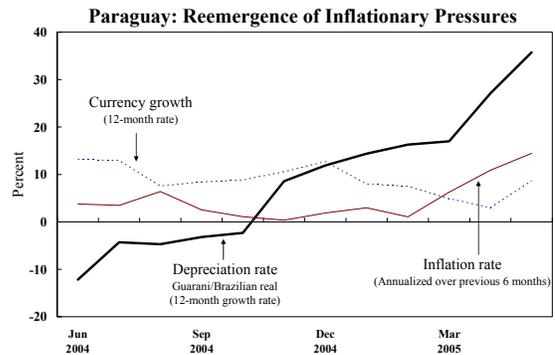
25. **The change in the macroeconomic environment in 2005 highlights the economy's vulnerabilities and the importance of a timely policy response.** While the deterioration in growth and inflation in 2005 partly reflects exogenous factors, it highlights the importance of adjusting macro policy to mitigate the impact of shocks (e.g., on inflation), as well as the need to deepen the structural reform agenda to reduce vulnerabilities and strengthen institutions. In this regard, the staff notes the continued practice of building consensus in Paraguay in favor of the authorities' reform program. This is particularly relevant given the political and social uncertainties, and the lack of a majority in Congress.

26. **The staff supports completion of the fifth review under the SBA as well as the waiver requests.** In light of the authorities' strong commitment to the program, generally good performance, and commitment to additional measures to bring structural reform on track, the staff supports: (i) the completion of the fifth SBA review; (ii) the waiver request on the observance of the end-April 2005 performance criterion on the audits of ANNP, DINAC, INC and PETROPAR; (iii) the waiver request on the observance of the end-June 2005 performance criterion on the approval of the general banking legislation; and (iv) the waiver of the applicability of the end-June 2005 quantitative performance criteria.

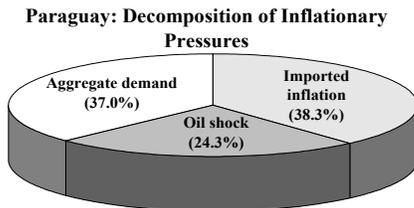
BOX 1. PARAGUAY: INFLATIONARY PRESSURES

Following a sharp disinflation throughout 2004, upward pressures on the CPI reemerged in early 2005. End-year inflation came down to 2.8 percent in 2004, but during December the CPI jumped by 1½ percent. Price pressures subsided somewhat in January and February 2005, but regained strength in March–May 2005, following adjustments in fuel prices and public transport tariffs in April 2005. On an annualized basis, the increases of the CPI between November 2004 and May 2005 would correspond to an inflation rate of 14½ percent.

The recent uptick of inflation exhibits a strongly correlated pattern with the *guarani*'s weakening against the Brazilian real. This depreciation of the *guarani* against the real was reinforced by the real's appreciation *vis-à-vis* the U.S. dollar.¹ In contrast, currency growth has been lower than inflationary developments, displaying a decreasing trend and falling below the program's medium-term target rate of 10 percent, indicating a weaker-than-expected money demand.



Supply factors—especially prices of goods traded with Brazil and oil prices—appear to be the predominant source of the inflationary pressures. To determine these sources, BCP staff decomposed the consumer basket in categories related to trade with Brazil, oil-sensitive goods, and aggregate domestic demand. This exercise implied that more than 60 percent of the price increases during the six months preceding May 2005 were attributable to external factors. Excluding these external causes, the contribution of domestic factors to the annualized November–May inflation rate would amount to 5½ percent, still within the range of the program's inflation objective of 6 percent in 2005.



To combat inflationary pressures and prevent the resurgence of inflationary expectations, the BCP decided to embark on a course of monetary tightening. In mid-May 2005, the BCP's Executive Committee for Monetary Operations (CEOMA) increased two of its key interest rates for Central Bank securities (LRM) by 100 basis points. The BCP also stop intervention in the foreign currency market, allowing for a modest strengthening of the *guarani* with respect to the U.S. dollar and the Brazilian real.

Paraguay: Inflationary Pressures (Annualized rate, Nov 04 -May 05)	
Contributing factors	Incidence
Annualized inflation	14.5
Oil shock	3.5
Imported inflation	5.6
Aggregate demand	5.4

Source: Central Bank of Paraguay

¹ Since May 2004, Brazil's real appreciated over 20 percent against the U.S. dollar. Moreover, a long-term econometric estimate by staff identified a statistically significant pass-through from the Brazilian CPI, to the Paraguayan CPI.

Table 1. Paraguay: Quantitative Performance Criteria

	SBA														
	2003				2004				Extension 2005						
	end-Dec.	Actual	Adj. Target	end-Mar.	Actual	Adj. Target	end-Aug.	Actual	Adj. Target	end-Dec.	Actual	Adj. Target	end-Mar.	Actual	Target
Fiscal targets															
1. Overall balance of the central administration (floor, in billions of guaraníes) 1/ 2/	-125	-100	240	523	430	982	792	55	105	261	111				
2. Wage bill of the central administration (ceiling, in billions of guaraníes) 2/	2,750	2,724	650	668	1,791	1,812	2,984	3,010	754	744	1,525				
3. Overall balance of the public sector (floor, in billions of guaraníes) 1/ 2/	-321	33	250	678	500	1,529	999	130	174	357	310				
Monetary targets															
4. Net international reserves (floor, in millions of U.S. dollars) 3/	812	983	773	1,016	1,057	1,141	1,168	1,059	1,100	1,189	1,180				
5. Net domestic assets (ceiling, in billions of guaraníes) 3/	-2,852	-3,969	-2,839	-4,264	-4,444	-5,231	-4,848	-3,958	-4,488	-5,247	-5,197				
Public debt and arrears targets															
6. Contracting or guaranteeing of nonconcessional external debt by the NFPS (ceiling, in millions of US\$) 2/	50	0	50	0	200	0	200	0	200	0	200	20	200	200	200
7. External payments arrears of NFPS (ceiling, in millions of US\$) 4/	102	91	75	75	5	3	16	0	...	...	...	...	...	...	...
8. <i>Of which:</i> bilateral arrears 4/	51	43	38	12	0	0	0	0	...	...	...	...	...	...	...
9. Central government floating debt (ceiling, in billions of guaraníes) 4/ 2/	360	400	350	228	297	235	134	320	...	...	...	...	...	...	...
Continuous PCs															
10. Contracted or guaranteed short-term external debt by the NFPS	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
11. Non-accumulation of external debt arrears 5/	0	B	0	B	0	B	0	0	B	0	B	0	0	0	0

1/ As specified in the TMU (see www.imf.org), for 2005 this target will be adjusted upward by 30 percent in case of over performance in tax revenues.

2/ Cumulative flows from the beginning of the corresponding calendar year.

3/ 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.

4/ These performance criteria will not apply in 2005.

5/ B = breached.

Table 2. Paraguay: Structural Conditionality Under the Program

Measure	Conditionality 1/	Timing	Status and Comments
Public Sector Reform			
A. Independent audits for ANNP, DINAC, INC, PETROPAR	PC	April 30, 2005	<u>Waiver requested</u> . Audits already began for most entities.
B. Finalize plan for comprehensive civil service reform	SB	April 30, 2005	<u>Done</u> . Plan approved by Cabinet On July 22.
C. Plan for private capital participation ESSAP, COPACO, PETROPAR	SB	August 31, 2005	<u>In progress</u> .
Financial Sector Reform			
D. Introduce prudential regulations to cooperatives	SB	March 31, 2005	<u>Done</u> . Introduced in late December 2004.
E. Approval of public banking law (second tier)	SB	May 31, 2005	<u>Done</u> . Approved by Congress on July 21.
F. Approval of new comprehensive banking legislation	PC	June 30, 2005	<u>Waiver requested</u> . Law submitted to Congress in December 2004.
G. Submission of public banking law (first tier) and adopt commission's recommendations	PC	July 30, 2005	<u>Done</u> . Law submitted to Congress in in February 2005, and approved by the Senate in May 2005.

Sources: Paraguayan authorities; and Fund staff estimates.

1/ SB = structural benchmarks; PC = performance criteria

Table 4. Paraguay: Operations of the Consolidated Public Sector 1/

	2002	2003	2004	2005					
				Jan.-Mar.		Jan.-June		Jan.-Dec.	
				Prog.	Est.	Prog.	Rev. Proj.	Prog.	Rev. Proj.
(In billion of guaraníes)									
Revenue	6,160	7,450	8,952	2,141	2,282	4,494	4,753	9,665	9,858
Tax revenue	2,927	3,676	4,936	1,175	1,111	2,452	2,588	5,098	5,490
Nontax revenue and grants	3,117	3,617	4,003	952	1,167	2,012	2,157	4,505	4,354
Capital revenue	116	157	14	15	4	30	7	62	15
Current expenditure	5,763	6,247	6,802	1,665	1,604	3,491	3,534	7,532	7,729
Wages and salaries	3,095	3,290	3,634	901	913	1,819	1,864	3,957	4,022
Goods and services	572	634	751	153	106	360	368	816	868
Interest payments	603	728	677	136	167	325	365	660	714
Transfers	1,455	1,544	1,699	438	413	913	906	1,952	2,022
Other	39	51	40	37	5	73	31	146	103
Capital expenditure and net lending	1,875	1,819	1,956	591	175	1,313	931	3,217	2,893
Public enterprises' operating surplus	458	801	583	289	479	620	713	1,063	921
Statistical discrepancy 2/	35	-207	232	0	-625	0	-618	0	1
Overall balance	-986	-21	1,010	174	357	310	383	-21	157
Financing	986	17	-1,010	-174	-357	-310	-383	21	-157
External financing net	19	459	-42	-28	-78	83	17	293	299
Domestic financing net	-157	-24	-182	-147	-358	-393	-398	-273	-454
Of which : quasifiscal deficit financing	394	390	182	62	22	126	91	260	226
Net change in arrears	1,124	-417	-787	0	80	0	-2	0	-2
(In percent of GDP)									
Revenue	21.2	20.6	22.2	19.2	21.3	20.2	22.1	21.7	22.9
Tax revenue	10.1	10.2	12.2	10.6	10.5	11.0	12.0	11.5	12.8
Nontax revenue and grants	10.7	10.0	9.9	8.5	10.8	9.0	10.0	10.1	10.1
Capital revenue	0.4	0.4	0.0	0.1	0.0	0.1	0.0	0.1	0.0
Current expenditure	19.8	17.3	16.9	15.0	14.9	15.7	16.4	16.9	18.0
Wages and salaries	10.6	9.1	9.0	8.1	8.5	8.2	8.7	8.9	9.3
Goods and services	2.0	1.8	1.9	1.4	1.0	1.6	1.7	1.8	2.0
Interest payments	2.1	2.0	1.7	1.2	1.5	1.5	1.7	1.5	1.7
Transfers	5.0	4.3	4.2	3.9	3.8	4.1	4.2	4.4	4.7
Other	0.1	0.1	0.1	0.3	0.0	0.3	0.1	0.3	0.2
Capital expenditure and net lending	6.4	5.0	4.8	5.3	1.7	5.9	4.3	7.2	6.7
Public enterprises' operating surplus	1.6	2.2	1.4	2.6	4.3	2.8	3.3	2.4	2.1
Statistical discrepancy 2/	0.1	-0.6	0.6	0.0	-5.7	0.0	-2.9	0.0	0.0
Overall balance	-3.4	-0.1	2.5	1.6	3.3	1.4	1.8	0.0	0.4
Financing	3.4	0.0	-2.5	-1.6	-3.3	-1.4	-1.8	0.0	-0.4
External financing net	0.1	1.3	-0.1	-0.2	-0.7	0.4	0.1	0.7	0.7
Domestic financing net	-0.5	-1.2	-2.0	-1.3	-3.3	-1.8	-1.8	-0.6	-1.1
Of which : quasifiscal deficit financing	1.4	1.1	0.5	0.6	0.3	0.6	0.4	0.6	0.5
Net change in arrears	3.9	-1.2	-2.0	0.0	0.7	0.0	0.0	0.0	0.0
Memorandum item:									
Primary balance	-1.4	2.5	3.6	2.8	10.5	2.9	6.3	1.4	2.0

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 5. Paraguay: Central Government Operations

	2002	2003	SBA 2004	2005					
				Jan.-Mar.		Jan.-June		Jan.-Dec.	
				Prog.	Actual	Prog.	Rev. Proj.	Prog.	Rev. Proj.
(In billion of guaraníes)									
Total revenues	5,048	6,001	7,637	1,761	1,905	3,733	4,023	8,137	8,430
Tax revenues	2,923	3,676	4,929	1,174	1,124	2,449	2,584	5,093	5,482
Nontax revenues 1/	2,118	2,318	2,696	585	778	1,280	1,434	3,035	2,942
Capital revenues	7	7	12	2	3	4	4	9	6
Current expenditures:	4,766	4,981	5,363	1,318	1,314	2,795	2,876	6,089	6,263
Wages and salaries	2,582	2,724	2,984	754	744	1,525	1,524	3,328	3,291
Goods and services	373	408	447	83	70	218	252	526	595
Interest payments	456	489	483	113	133	280	301	561	596
Transfers	1,326	1,334	1,431	361	364	759	792	1,647	1,765
Other	29	26	18	7	3	13	7	26	16
Capital expenditures and net lending	1,281	1,165	1,625	338	174	827	706	2,287	2,271
Statistical discrepancy 2/	271	29	143	0	-156	0	-156	0	0
Overall balance	-728	-116	792	105	261	111	284	-240	-104
Financing	728	116	-792	-105	-261	-111	-285	240	104
External debt (increase +)	118	590	103	10	-39	40	10	301	238
Disbursements	738	1,156	763	164	130	408	433	1,142	1,178
Amortizations	619	566	660	154	169	368	423	841	940
Domestic bonds (increase +)	-26	-58	-78	-167	-1	-167	-125	-167	-131
Net credit from the banking system	-27	-308	-124	52	-219	16	-168	105	-1
Other	663	-108	-693	0	-2	0	-2	0	-2
(In percent of GDP)									
Total revenues	17.3	16.6	18.9	15.8	17.7	16.8	18.7	18.3	19.6
Tax revenues:	10.0	10.2	12.2	10.5	10.4	11.0	12.0	11.4	12.7
Nontax revenues 1/	7.3	6.4	6.7	5.3	7.2	5.7	6.7	6.8	6.8
Capital revenues	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current expenditures	16.4	13.8	13.3	11.8	12.2	12.6	13.4	13.7	14.6
Wages and salaries	8.9	7.5	7.4	6.8	6.9	6.9	7.1	7.5	7.6
Goods and services	1.3	1.1	1.1	0.7	0.7	1.0	1.2	1.2	1.4
Interest payments	1.6	1.4	1.2	1.0	1.2	1.3	1.4	1.3	1.4
Transfers	4.6	3.7	3.5	3.2	3.4	3.4	3.7	3.7	4.1
Other	0.1	0.1	0.0	0.1	0.0	0.1	0.0	0.1	0.0
Capital expenditures and net lending	4.4	3.2	4.0	3.0	1.6	3.7	3.3	5.1	5.3
Statistical discrepancy 2/	0.9	0.1	0.4	0.0	-1.5	0.0	-0.7	0.0	0.0
Overall balance	-2.5	-0.3	2.0	0.9	2.4	0.5	1.3	-0.5	-0.2
Financing	2.5	0.3	-2.0	-0.9	-2.4	-0.5	-1.3	0.5	0.2
External debt (increase +)	0.4	1.6	0.3	0.1	-0.4	0.2	0.0	0.7	0.6
Disbursements	2.5	3.2	1.9	1.5	1.2	1.8	2.0	2.6	2.7
Amortizations	2.1	1.6	1.6	1.4	1.6	1.7	2.0	1.9	2.2
Domestic bonds (increase +)	-0.1	-0.2	-0.2	-1.5	0.0	-0.7	-0.6	-0.4	-0.3
Net credit from the banking system	-0.1	-0.9	-0.3	0.5	-2.0	0.1	-0.8	0.2	0.0
Other	2.3	-0.3	-1.7	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Item:									
Primary balance	-1.9	1.0	2.8	2.0	5.1	1.8	3.4	0.7	1.1
Balance of the Caja Fiscal 3/	-2.1	-1.6	-1.2	-1.5	-1.1	-1.5	-1.4	-1.5	-1.6

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 6. Paraguay: Public Sector Arrears 1/
(In millions of U.S. dollars)

	December 2003		December 2004		March 2005
	Target	Actual	Target	Actual	
Total public sector arrears	162	157	51	37	29
(In percent of GDP)	2.8	2.7	0.7	0.5	0.4
Central government	105	123	51	21	0
Domestic	59	66	51	21	0
(In billions of guaranies)	(360)	(400)	(320)	(134)	0
External	46	58	0	0	0
<i>Of which:</i> multilateral	0	0	0	0	0
Rest of public sector	57	34	0	16	29
Domestic	0	0	0	0	0
External	57	34	0	16	29
<i>Of which:</i> PETROPAR arrears to foreign supplier	44	22	0	16	29
ESSAP arrears	9	4	0	0	0

Sources: Ministry of Finance; and Fund staff estimates.

1/ Stock at end of period, Adjusted for program definitions. The program considers as arrears: (i) all payments past due over 30 days; (ii) nondisputed arrears; (iii) domestic arrears which exclude "normal" floating debt (equal to G250 billion, or US\$40 million).

Table 7. Paraguay: Summary Accounts of the Central Bank
(In billions of guaranies; end-of-period; valued at constant exchange rate)

	2002	2003	2004	2005					
				Mar.		Jun.		Dec.	
				Prog.	Actual	Prog.	Rev. Proj.	Prog.	Rev. Proj.
Currency issue	1,699	2,207	2,488	2,422	2,219	2,212	2,153	2,816	2,736
Growth	2.2	29.9	12.7	14.5	4.9	13.0	10.0	10.0	10.0
Net international reserves	4,027	6,175	7,335	7,036	7,466	7,409	7,409	7,660	7,660
(In millions of U.S. dollars)	641	983	1,168	1,120	1,189	1,180	1,180	1,220	1,220
Net domestic assets	-2,329	-3,969	-4,848	-4,614	-5,247	-5,197	-5,256	-4,844	-4,924
Net nonfinancial public sector	1,507	1,163	1,204	1,004	972	968	980	1,058	1,147
Net credit to the central government	1,291	952	947	866	756	829	797	919	964
Net credit to the rest of NFPS	216	211	257	139	217	139	183	139	183
Net credit to the banking system	-2,111	-3,362	-4,376	-4,389	-4,642	-4,996	-4,715	-4,873	-4,688
Reserve requirements	-1,600	-2,219	-2,195	-2,315	-2,184	-2,370	-2,222	-2,413	-2,293
Free reserves	-217	-543	-1,012	-781	-819	-802	-794	-842	-864
Monetary control bills (LRM)	-298	-602	-1,171	-1,302	-1,654	-1,833	-1,707	-1,627	-1,539
Other	4	2	2	9	14	9	7	9	7
Other assets and liabilities (net)	-1,724	-1,770	-1,676	-1,228	-1,578	-1,169	-1,521	-1,029	-1,383
Capital and reserves	-2,941	-1,463	-1,674	-1,188	-1,646	-1,128	-1,617	-988	-1,531
Other assets net	1,216	-308	-2	-40	68	-41	96	-41	148
Memorandum item:									
Monetary base growth	-1.0	57.7	17.6	8.8	5.0	6.7	0.4	8.2	4.9

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

Table 8. Paraguay: Summary Accounts of the Banking System
(End-of-period; valued at constant exchange rate)

	2002	2003	2004	2005					
				Mar.		Jun.		Dec.	
				Prog.	Actual	Prog.	Rev. Proj.	Prog.	Rev. Proj.
(In billions of guaranies)									
I. Central Bank									
Net international reserves	4,027	6,175	7,335	7,036	7,466	7,409	7,409	7,660	7,660
(in millions of U.S. dollars)	641	983	1,168	1,120	1,189	1,180	1,180	1,220	1,220
Net domestic assets	-2,329	-3,969	-4,848	-4,614	-5,247	-5,197	-5,256	-4,844	-4,924
Credit to public sector, net	1,507	1,163	1,204	1,004	972	968	980	1,058	1,147
Credit to banking system, net 1/	-1,814	-2,760	-3,205	-3,087	-2,988	-3,163	-3,008	-3,247	-3,149
Central bank securities	-677	-1,071	-1,552	-1,302	-2,029	-1,833	-2,101	-1,627	-1,881
Other	-1,345	-1,301	-1,295	-1,228	-1,202	-1,169	-1,127	-1,029	-1,040
Currency issue	1,699	2,207	2,488	2,422	2,219	2,212	2,153	2,816	2,736
II. Monetary Survey									
Net foreign assets	5,497	8,405	9,478	9,340	9,779	9,714	9,722	9,965	9,972
(in millions of U.S. dollars)	875	1,338	1,509	1,487	1,557	1,547	1,548	1,587	1,588
Net domestic assets	3,473	2,152	2,292	2,436	1,744	2,143	2,048	2,496	2,412
Credit to the public sector	932	699	369	64	5	-246	11	-261	-177
Credit to the private sector	6,230	5,081	5,788	6,138	5,877	6,136	5,897	6,464	6,453
Other	-3,689	-3,628	-3,866	-3,766	-4,139	-3,748	-3,859 ¹⁴¹	-3,707	-3,863
Broad Liquidity (M4)	8,970	10,558	11,770	11,777	11,522	11,856	11,770	12,460	12,384
Bonds and issued securities	135	31	0	0	0	0	0	0	0
Other monetary liabilities	15	9	125	3	121	3	122	3	122
Central bank securities with private sector	281	469	381	711	375	825	516	713	441
Broad liquidity (M3)	8,539	10,047	11,263	11,063	11,026	11,028	11,132	11,745	11,822
Foreign currency deposits	4,699	5,253	5,310	5,726	5,361	5,726	5,361	5,726	5,361
Money and quasi-money (M2)	3,839	4,794	5,953	5,336	5,664	5,302	5,771	6,018	6,461
Quasi-money	1,198	1,208	1,482	1,282	1,408	1,313	1,437	1,378	1,496
Money (M1)	2,641	3,587	4,471	4,054	4,256	3,988	4,334	4,641	4,965
(Annual percentage change)									
M0 (Currency issued)	2.2	29.9	12.7	14.5	4.9	13.0	10.0	10.0	10.0
Credit to the private sector	-20.9	-18.4	13.9	15.4	10.5	13.1	8.7	10.2	11.5
M1	0.8	35.8	24.7	17.0	22.9	15.3	25.3	11.0	11.0
M2	-2.2	24.9	24.2	12.5	19.4	12.0	21.9	10.7	8.5
M3	-21.0	17.7	12.1	5.3	4.9	4.5	5.4	5.2	5.0
<i>Of which: foreign currency deposits</i>	-31.8	11.8	1.1	-0.7	-7.0	-1.7	-7.9	0.0	1.0
Memorandum items:									
Ratio of foreign currency deposits to M3 (percent)	55.0	52.3	47.1	51.8	48.6	51.9	48.2	48.8	45.4
Ratio of foreign currency deposits to private sector deposits in banks (percent)	64.9	63.5	57.1	63.1	57.3	62.5	56.8	61.4	55.9

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

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

Table 9. Paraguay: Banking System Indicators

	2001	2002	2003	2004	March 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	23.0
NPLs/total loans	16.5	19.7	20.6	10.8	10.6
Provisions/NPLs	37.0	46.6	54.8	54.6	53.9
Rate of return on assets (ROA)	2.2	1.0	0.4	1.7	2.3
Rate of return on equity (ROE)	21.2	9.0	4.5	18.3	22.0
Liquid assets/total assets 1/	23.0	25.1	32.6	30.8	30.4
Foreign exchange deposits/total deposits	65.3	68.6	61.7	55.0	53.9
II. Total foreign-owned banks					
Share in assets	45.1	48.4	47.4	35.8	33.8
Capital adequacy ratio (percent)	16.0	17.6	20.4	26.0	30.4
NPLs/total loans	15.3	20.1	20.8	11.0	11.0
Provisions/NPLs	42.6	57.5	64.2	71.2	73.3
Rate of return on assets (ROA)	3.1	1.6	0.1	1.4	1.8
Rate of return on equity (ROE)	30.4	15.0	1.2	12.0	13.6
Liquid assets/total assets 1/	22.2	27.1	29.8	25.4	26.7
Foreign exchange deposits/total deposits	67.8	71.1	65.6	65.2	64.3
III. Total majority-owned foreign banks					
Share in assets	38.3	33.2	37.2	45.2	46.2
Capital adequacy ratio (percent)	16.8	19.9	21.0	17.7	20.1
NPLs/total loans	10.6	10.4	12.3	3.7	3.8
Provisions/NPLs	36.8	43.8	52.1	56.9	46.4
Rate of return on assets (ROA)	1.8	1.4	1.3	2.2	3.1
Rate of return on equity (ROE)	18.3	13.4	15.5	25.8	32.4
Liquid assets/total assets 1/	25.0	26.2	35.3	28.8	29.7
Foreign exchange deposits/total deposits	69.3	70.7	62.3	53.8	53.4
IV. Total domestic-owned private banks					
Share in assets	7.4	10.4	7.4	8.2	9.2
Capital adequacy ratio (percent)	14.8	13.6	14.1	13.3	14.2
NPLs/total loans	6.5	8.8	2.9	2.1	1.9
Provisions/NPLs	30.8	18.7	46.2	70.3	70.0
Rate of return on assets (ROA)	1.2	1.1	1.6	2.0	2.0
Rate of return on equity (ROE)	13.8	14.3	21.1	28.1	25.2
Liquid assets/total assets 1/	20.1	18.3	38.8	38.1	39.3
Foreign exchange deposits/total deposits	61.8	62.6	60.7	57.6	52.4
V. National Development Bank (BNF)					
Share in assets	9.2	8.0	8.0	10.7	10.8
Capital adequacy ratio (percent)	22.9	18.8	30.0	25.0	23.5
NPLs/total loans	46.5	56.2	56.2	48.9	48.3
Provisions/NPLs	31.7	39.6	47.6	43.1	44.3
Rate of return on assets (ROA)	0.3	-4.7	-2.8	0.5	0.6
Rate of return on equity (ROE)	2.0	-27.3	-18.7	6.8	8.0
Liquid assets/total assets 1/	20.4	17.3	30.7	52.0	37.3
Foreign exchange deposits/total deposits	27.0	42.5	32.7	23.6	23.6

Source: Superintendency of Banks.

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

Table 10. Paraguay: Balance of Payments, 2001-2005

(In millions of U.S. dollars)

	2001	2002	2003	2004	Est.	2005					
						Jan-Mar		Jan-Jun		Jan-Dec.	
						Prog. 1/	Est.	Prog. 1/	Rev. Proj.	Prog. 1/	Rev. Proj.
Current account	-266	93	122	27	-50	83	126	102	-27	-97	
Trade balance	-618	-283	-279	-413	-133	-8	-4	-28	-460	-527	
Exports	1883	1852	2168	2,700	674	599	826	724	2,820	2,588	
Registered	990	951	1242	1,626	312	413	497	460	1,630	1,585	
Unregistered	893	901	927	1,074	363	186	329	264	1,190	1,003	
Imports	-2500	-2134	-2447	-3,113	-808	-607	-830	-752	-3,280	-3,114	
Registered	-1989	-1510	-1865	-2,652	-585	-520	-674	-634	-2,713	-2,671	
Unregistered	-512	-624	-582	-461	-223	-87	-156	-118	-567	-444	
Services (net)	165	214	237	235	55	63	62	58	214	214	
Factor income	16	43	-4	10	-26	-19	15	20	6	11	
Transfers	167	116	165	194	54	48	54	52	215	205	
Capital and financial account	163	53	222	90	-11	-76	-66	-83	66	163	
General government	150	-4	92	14	-3	-3	2	3	33	36	
Disbursements	144	146	213	139	27	25	40	40	185	183	
Amortization	-102	-123	-130	-133	-32	-30	-40	-39	-161	-156	
Other	108	-27	9	9	2	2	2	2	9	9	
Private Sector 2/	13	57	130	76	-7	-74	-67	-86	33	127	
Direct investment	78	12	30	64	8	8	15	15	83	74	
Foreign currency deposits	-61	-153	344	60	-16	-8	-71	-30	-101	-40	
Other	-4	198	-244	-48	0	-74	-12	-71	51	93	
Errors and omissions	58	-229	-133	127	0	0	0	0	0	0	
Overall balance	-45	-83	211	245	-61	7	60	19	39	66	
Net international reserves (increase -)	45	83	-302	-181	61	-20	-60	9	-39	-51	
Gross reserves	45	84	-301	-179	60	-21	-60	9	-40	-52	
Reserve liabilities	0	-1	-1	-1	1	1	0	0	1	1	
Exceptional financing	...	...	91	-67	0	13	0	-28	0	-15
Arrears deferral (+)/clearance (-)	...	...	91	-67	0	13	0	-28	0	-15
Memorandum items:											
Current account in percent of GDP	-4.1	1.8	2.2	0.4	-2.7	4.9	6.7	5.6	-0.4	-1.4	
Gross reserves (in millions of U.S. dollars)	723	641	982	1,168	1,120	1,189	1,180	1,180	1,220	1,220	
in months of imports of GNFS	3.5	2.7	3.4	4.0	3.6	3.9	3.8	3.9	3.9	4.0	
External public debt in percent of GDP	35.6	47.2	46.5	37.4	37.0	37.0	34.4	35.2	37.4	37.3	
Debt service in percent of exports GNFS	10.8	9.1	11.6	7.8	8.8	7.9	7.9	8.6	8.5	9.0	
Export volume (percentage change) 3/	19.5	-7.6	13.8	14.0	-22.6	5.6	7.2	2.0	5.7	2.8	
Import volume (percentage change) 3/	1.4	-21.4	15.6	17.1	4.2	-9.4	4.2	-1.3	3.3	-3.0	
Terms of trade (percentage change)	-0.3	7.5	7.3	1.8	-5.4	-8.8	-5.4	-8.8	-5.4	-8.8	

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

1/ Revised program (see www.imf.org).

2/ Includes public enterprises and binationals.

3/ Registered trade.

Table 11. Paraguay: Indicators of External Vulnerability

	2000	2001	2002	2003	2004	Proj. 2005
Monetary and financial indicators 1/						
Broad money (M3), percentage change 2/	-0.5	0.7	-21.0	17.7	12.1	4.9
Credit to the private sector, real (percentage change) 2/	-9.0	-8.7	-31.1	-25.5	10.9	5.9
Share of nonperforming loans in total loans (percent)	16.6	16.5	19.7	20.6	10.8	10.6
Average domestic lending rate, real	16.0	22.5	39.0	19.3	17.4	27.8
Central bank bill yield, real	-2.8	12.8	12.9	-1.2	1.0	0.2
Central bank foreign short-term liabilities (millions of US\$) 3/	0.5	0.2	0.5	0.5	0.3	0.3
External indicators						
Merchandise exports (percentage change)	0.7	-18.9	-1.6	17.1	24.5	-4.1
Merchandise imports (percentage change)	4.1	-12.7	-14.6	14.7	27.2	0.0
Merchandise terms of trade (percentage change)	-4.0	-0.3	7.5	7.3	1.8	-8.8
Real effective exchange rate (average; percentage change)	-6.4	-4.4	-1.2	-6.6	5.3	...
Current account balance (percent of GDP)	-2.3	-4.1	1.8	2.2	0.4	-1.4
Capital and financial account (percent of GDP)	2.2	2.5	1.0	4.0	1.3	2.4
Net foreign direct investment (percent of GDP)	1.4	1.2	0.2	0.5	0.9	1.1
Inward portfolio investment (percent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0
Other net investment (percent of GDP)	0.7	1.1	0.7	3.2	0.2	1.1
External public debt (percent of GDP)	33.3	35.6	47.2	46.5	37.4	37.3
Debt service (in percent of exports GNFS)	10.4	10.8	9.1	11.6	7.8	9.0
Gross reserves (in US\$)	772	723	641	982	1,168	1,220
In months of imports of GNFS	3.2	3.5	2.7	3.4	4.0	4.0
Over short-term external debt 3/	1.1	1.1	0.9	1.5	1.7	1.7
Over foreign currency deposits in domestic banks	0.6	0.6	0.7	1.0	1.1	1.0
Over short-term external debt and FX deposits in PRY	0.4	0.4	0.4	0.6	0.7	0.6

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

1/ Actual data for March 2005.

2/ Foreign currency components are valued at the accounting exchange rate of Gs. 6,280 per U.S. dollar.

3/ Private and public external debt with a residual maturity of one year or less. Excludes foreign currency deposits in banking system.

Table 12. Paraguay: Schedule of Reviews and Purchases

Date	Amount of Purchase		Conditions
	Millions of SDRs	Percent of Quota	
Purchases available	44.0	44.0	
December 15, 2003	30.0	30.0	Approval of arrangement
March 16, 2004	4.0	4.0	First review and end-December 2003 performance criteria
July 30, 2004	4.0	4.0	Second review and end-March 2004 performance criteria
December 20, 2004	3.0	3.0	Third review and end-August 2004 performance criteria
March 30, 2005	3.0	3.0	Fourth review and end-December 2004 performance criteria
Purchases to become available	6.0	6.0	
August 22, 2005	3.0	3.0	Fifth review and end-March 2005 performance criteria
September 30, 2005	3.0	3.0	Sixth review and end-June 2005 performance criteria
Total	50.0	50.0	

Source: Fund staff estimates.

Table 13. Paraguay: Indicators of Capacity to Repay the Fund 1/

	2004	Projections					
		2005	2006	2007	2008	2009	2010
Fund repurchases and charges							
In millions of SDRs	0.0	1.2	1.6	1.6	19.1	25.8	7.5
In millions of U.S. dollars	0.0	1.8	2.4	2.4	29.1	39.3	11.4
In percent of exports of goods and NFS	0.0	0.1	0.1	0.1	0.8	1.1	0.3
In percent of quota	0.0	1.2	1.6	1.6	19.1	25.8	7.5
In percent of gross official reserves	0.0	0.1	0.2	0.2	2.2	2.9	0.8
Fund credit outstanding							
In millions of SDRs	0.0	50.0	50.0	50.0	32.4	7.4	0.0
In millions of U.S. dollars	0.0	76.1	76.1	76.1	49.2	11.2	0.0
In percent of exports of goods and NFS	0.0	2.4	2.3	2.2	1.4	0.3	0.0
In percent of quota	0.0	50.1	50.1	50.1	32.4	7.4	0.0
In percent of gross official reserves	0.0	4.1	4.0	3.9	2.5	0.5	0.0
Memorandum items:							
Exports of goods and NFS (mlns. of U.S. dollars), baseline	3,286	3,163	3,326	3,440	3,563	3,684	3,832
Debt service (millions of U.S. dollars)	345	317	311	333	350	333	344
Quota (millions of SDRs)	100	100	100	100	100	100	100
Quota (millions of U.S. dollars)	148	152	152	152	152	152	152
Gross official reserves (millions of U.S. dollars)	1,168	1,220	1,246	1,277	1,307	1,347	1,381
U.S. dollars per SDR (e.o.p.) 2/	1.48	1.52	1.52	1.52	1.52	1.52	1.52

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

1/ Assumes all purchases made as scheduled under current program starting from August 22, 2005, and repurchases made on the obligations schedule.

2/ WEO projections.

Table 14. Paraguay: Medium-Term Scenario

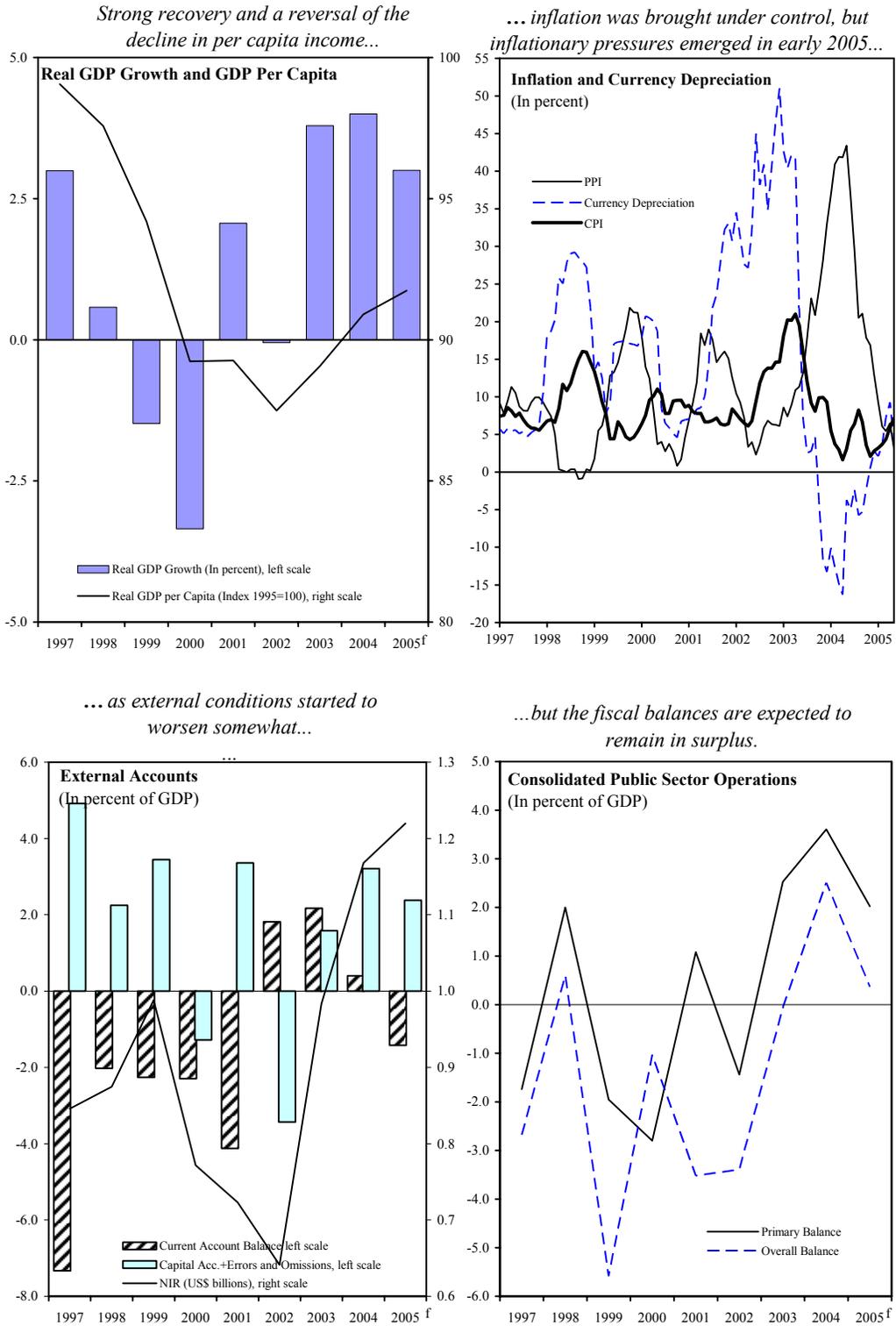
(In percent of GDP, unless otherwise specified)

	Est.	Projections					
	2004	2005	2006	2007	2008	2009	2010
I. Program scenario							
Real sector							
Real GDP growth (annual percentage change)	4.0	3.0	3.5	4.0	4.0	4.0	4.0
Consumer prices (annual percentage change)	2.8	6.0	5.0	4.0	3.0	3.0	3.0
GDP per capita (US dollars)	1,178	1,168	1,225	1,281	1,343	1,408	1,480
Public finances 1/							
Revenues	22.2	22.9	23.2	23.2	23.3	22.9	22.9
Current primary expenditures	15.2	16.3	16.2	16.2	16.1	16.1	16.1
Interest payments	1.7	1.7	1.8	1.7	1.7	1.4	1.4
Capital expenditures	4.8	6.7	6.7	6.7	6.8	6.8	6.8
Public enterprise operating surplus	1.4	2.1	2.1	1.9	1.8	1.7	1.5
Primary balance	3.6	2.0	2.4	2.2	2.1	1.7	1.5
Overall balance	2.5	0.4	0.6	0.5	0.4	0.3	0.2
Public sector debt (in millions of U.S. dollars)	2,799	2,823	2,825	2,835	2,867	2,906	1,932
(In percent of GDP)	41.4	41.3	38.8	36.5	34.5	32.7	30.7
Balance of payments (in millions of U.S. dollars)							
Exports	2,700	2,588	2,737	2,846	2,965	3,080	3,220
Imports	3,113	3,114	3,242	3,360	3,515	3,652	3,826
Current account	27	-97	-59	-66	-95	-106	-130
(In percent of GDP)	0.4	-1.4	-0.8	-0.8	-1.1	-1.2	-1.4
Capital and financial account	90	163	78	90	123	160	181
Gross international reserves	1,168	1,220	1,239	1,264	1,292	1,346	1,397
(In months of imports)	4.0	4.0	4.0	3.9	3.8	3.8	3.8
II. No Reform Scenario							
Real sector							
Real GDP growth (annual percentage change)	4.0	3.0	2.0	2.0	2.0	2.0	2.0
Consumer prices (annual percentage change)	2.8	6.0	6.0	5.0	4.0	4.0	4.0
GDP per capita (US dollars)	1,178	1,168	1,203	1,234	1,269	1,306	1,347
Public finances 1/							
Revenues	21.1	22.9	23.1	23.1	23.1	22.8	22.8
Current primary expenditures	14.4	16.3	16.7	16.9	17.2	17.7	18.3
Interest payments	1.6	1.7	1.9	1.9	2.1	2.2	2.3
Capital expenditures	4.5	6.7	7.0	7.0	7.1	7.0	7.0
Public enterprise operating surplus	1.4	2.1	2.1	1.9	1.8	1.6	1.4
Primary balance	3.6	2.0	1.5	1.0	0.5	-0.4	-1.1
Overall balance	2.4	0.4	-0.3	-0.9	-1.5	-2.5	-3.4
Public sector debt (in millions of U.S. dollars)	2,799	2,823	2,876	2,997	3,166	3,400	3,704
(In percent of GDP)	41.4	41.3	40.1	39.9	40.2	41.1	42.6
Balance of payments (in millions of U.S. dollars)							
Exports	2,700	2,588	2,713	2,797	2,914	3,028	3,147
Imports	3,113	3,114	3,202	3,264	3,359	3,432	3,535
Current account	27	-97	-39	-10	30	95	136
(In percent of GDP)	0.4	-1.4	-0.5	-0.1	0.4	1.1	1.6
Capital and financial account	90	163	78	87	116	149	165
Gross international reserves	1,168	1,220	1,259	1,335	1,480	1,725	2,026
(In months of imports)	4.0	4.1	4.1	4.3	4.6	5.2	6.0

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

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

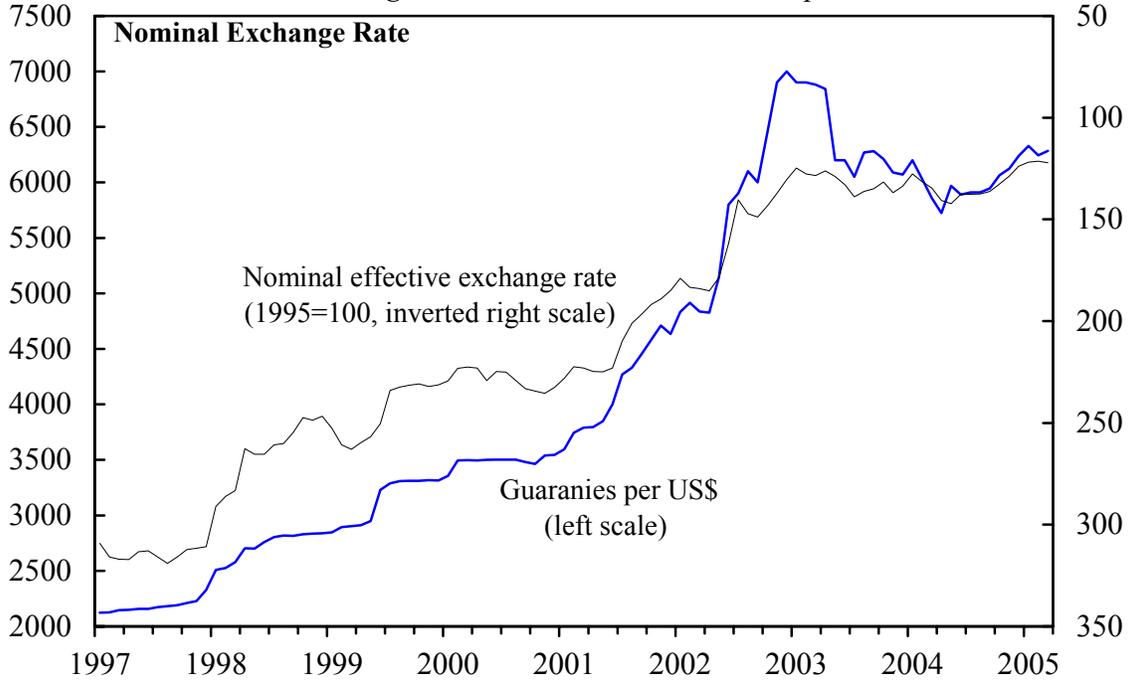
Figure 1. Paraguay: Selected Economic Indicators



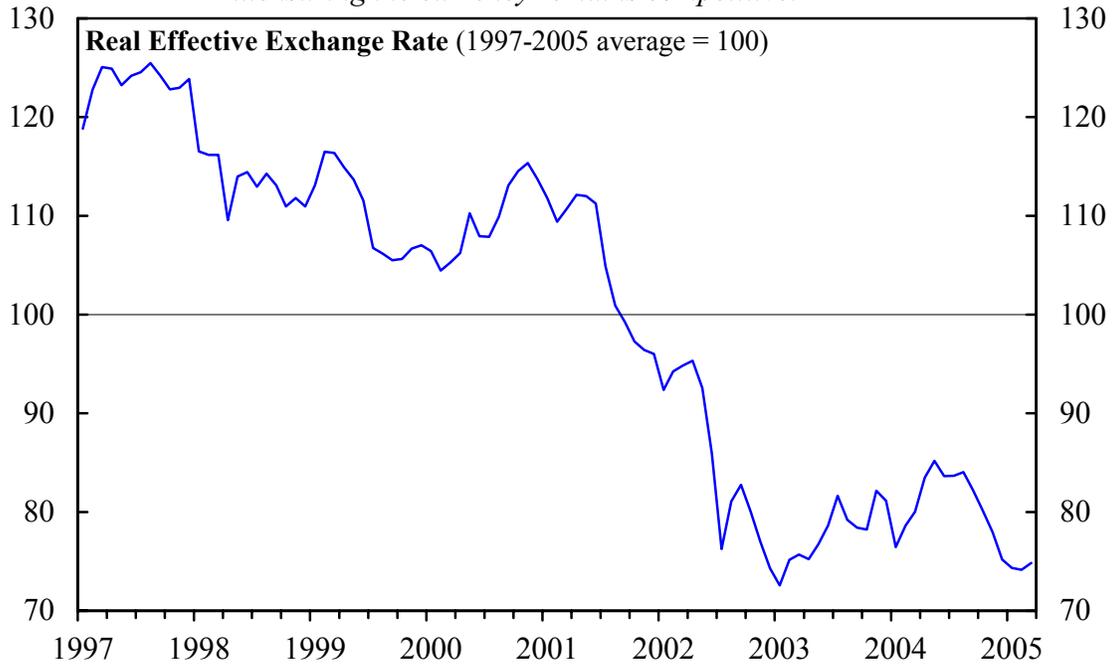
Source: Central Bank of Paraguay and Ministry of Finance.

Figure 2. Paraguay: Exchange Rate Developments

The exchange rate is more stable than in the past...



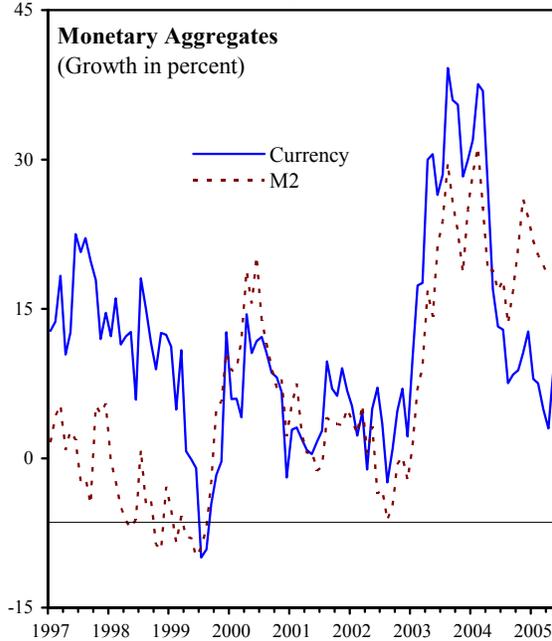
...ensuring the currency remains competitive.



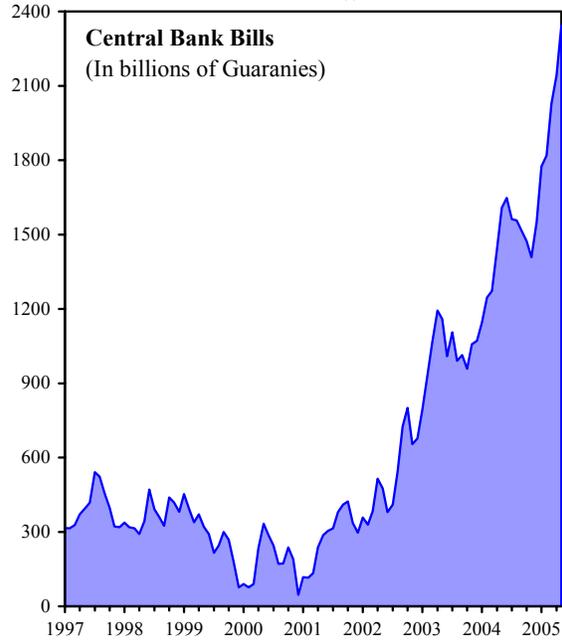
Source: Central Bank of Paraguay and Fund staff estimates.

Figure 3. Paraguay: Selected Financial Indicators

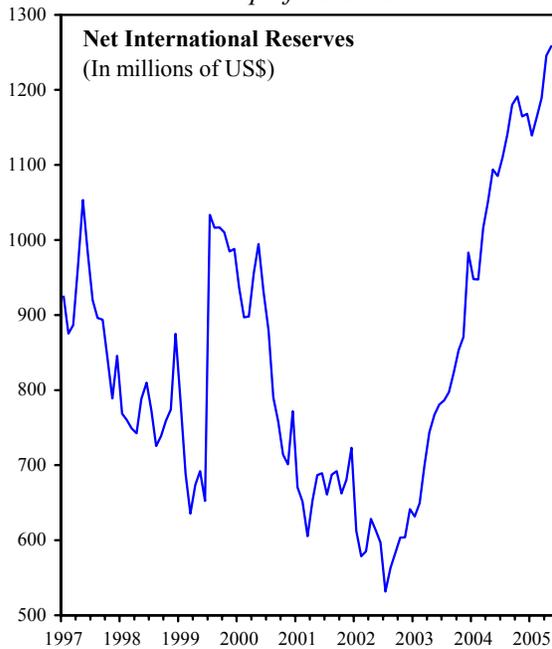
Currency issue is under control, but demand for guaraní deposits holds up growth of M2.



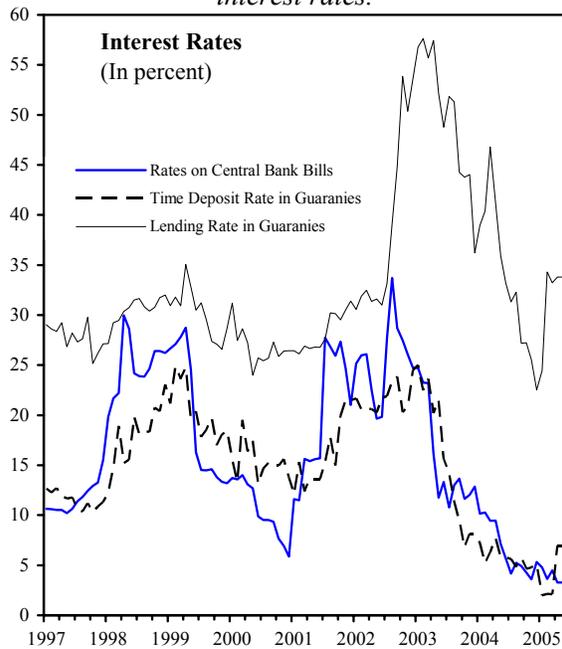
...The Central Bank continues with its stabilization efforts...



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



...and put downward pressure on interest rates.

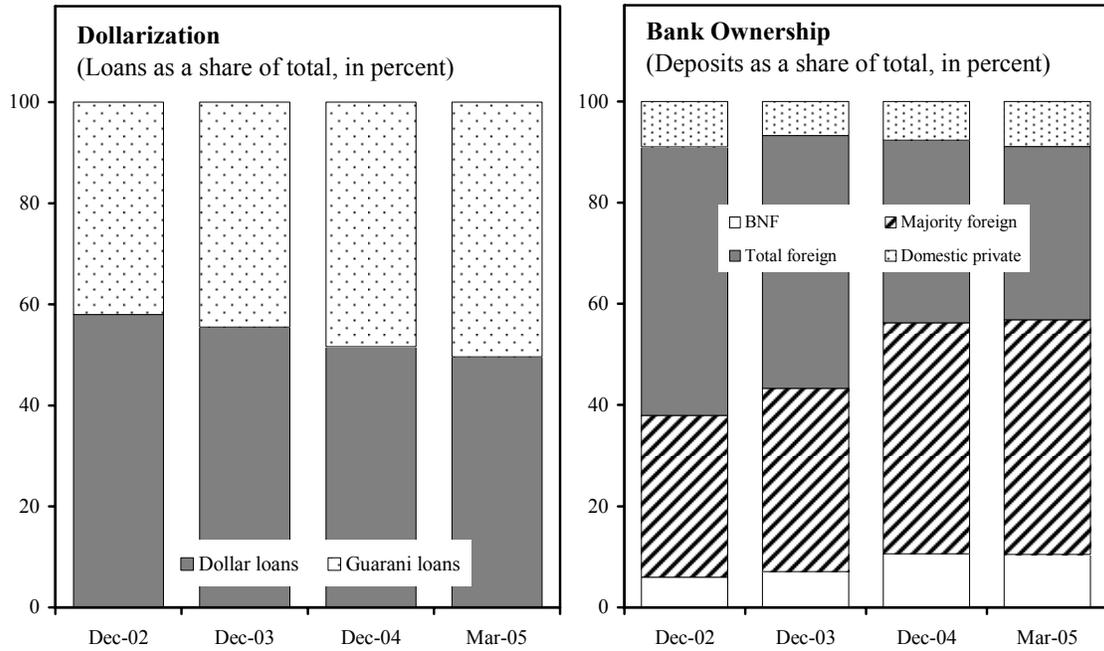


Source: Central Bank of Paraguay.

Figure 4. Paraguay: Selected Banking Indicators

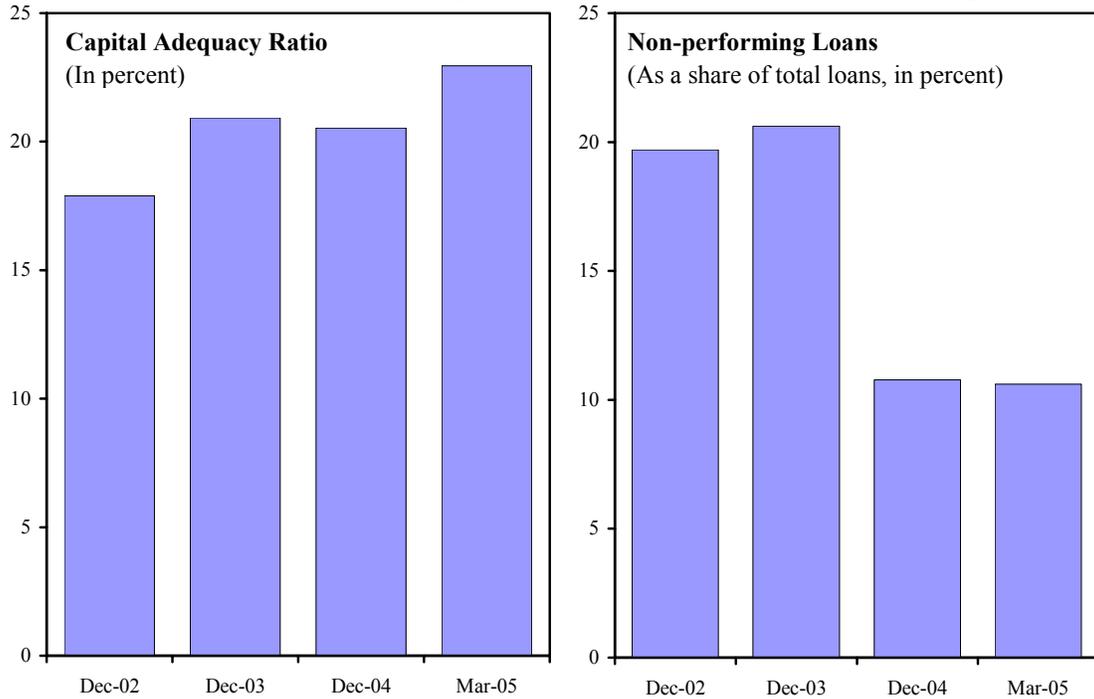
Dollarization remains high but is declining...

...although some foreign banks have left...



...capital asset ratios are rising...

...as non-performing loans keep falling.



Source: Central Bank of Paraguay.

PARAGUAY—FUND RELATIONS
(As of June 30, 2005)

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	86.04	628.18

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

V. **Exchange Rate Arrangement:** The currency of Paraguay is the Paraguayan *guarani*. 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 May 31, 2005, the average interbank rate for the U.S. dollar was $\text{G}6,235 = \text{US}\1 .

VI. **Article IV Consultation:** The 2002 Article IV consultation was concluded by the Executive Board on March 10, 2003; the documents are IMF Country Reports No. 03/94 and 03/95. The 2004 Article IV consultation was concluded by the Executive Board on July 30, 2004; the document is 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

Department	Purpose	Date of Delivery
MAE	Currency Operations	March through September 2002
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

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 of the CBP was completed on January 31, 2003. The assessment concluded that substantial risks might exist in legal structure and independence of the Central Bank, and in its control environment. Staff findings, proposed recommendations under program conditionality, and other recommendations are reported in IMF Country Report No. 03/94. The CBP has

implemented all significant recommendations made in the report. Staff will continue to monitor the implementation of the remaining recommendations.

X. **Resident Representative:** Mr. Luis H. Duran-Downing has been appointed as Representative since February 2004.

PARAGUAY—WORLD BANK RELATIONS¹
(As of June 30, 2005)

A new Paraguay Country Assistance Strategy (CAS) was approved on December 16, 2003, covering the period from mid-FY04 to FY07. The Bank's 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. The proposed base case-lending program for the CAS periods is for US\$325 million, of which US\$80 million, or about 25 percent, are envisaged for adjustment operations. One of them, the Economic Recovery Loan for US\$30 million was approved on December 16, 2003 together with the CAS, and has been fully disbursed.

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 has completed an Institutional and Governance Review. In addition, sector work on a Health Strategy and a Public Expenditure Review (PER) is underway and will be delivered in FY05.

Four World Bank-financed projects are presently under implementation, for a total value of US\$123 million in commitments, of which US\$55.6 million are undisbursed as of April 13, 2005. 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.

A first Programmatic Financial Sector Adjustment Loan and Technical Assistance Loan were approved on April 5, 2005. A technical assistance loan for the Modernization of the Ministry of Finance was also approved on April 5, 2005. A Maternal Health II project is under preparation for early FY06 delivery. A Social Security Reform Technical Assistance Loan, a Sustainable Rural Investment Project, which will be a follow-up to the ongoing Natural Resource Management Project, and a Road Maintenance Project are also being prepared for delivery in FY06. The FY06 program further includes a second Programmatic Financial Sector Adjustment Loan.

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

	Committed (Net of Cancellations)	Disbursed	Undisbursed
Active loans			
Natural Resource Management	50.0	41.4	8.6
Fourth Rural Water Supply	40.0	23.3	16.7
Community development	9.0	1.7	7.3
Education Reform	24.0	1.0	23.0
Total active loans	123.0	67.4	55.6
Total inactive loans	728.8	728.8	0.0
Total IBRD/IDA	851.8	796.2	55.6
Repaid (incl. Repay to 3rd parties)		548.6	
Total outstanding		261.3	
O/w IBRD		239.4	
O/w IDA		21.9	

II. IFC Operations

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

III. IBRD/IDA Loan Transactions (calendar year)

	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	1.9
Repayments	27.5	24.6	24.6	20.2	15.3	16.8	21.0	34.8	4.1
Net lending	13.8	13.1	17.5	26.4	11.5	-3.3	21.3	-18.6	-2.2

PARAGUAY—RELATIONS WITH THE IDB¹
(As of June 30, 2005)

Portfolio

1. As of May 31, 2005, the active loan portfolio amounts to US\$592.5 million, with an undisbursed balance of US\$315.1 million. In addition, there are 47 active Technical Cooperation operations for US\$20.5 million, of which US\$10.4 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. Given the large active portfolio and the fiscal constraints there were no new loans approved to Paraguay in 2004. IDB concentrated its actions in 2004 mostly in grants for institutional strengthening (13 operations for US\$2.5 million) and in aligning the existing operations to the priorities of the Paraguayan government. Particular mention should be made to a pioneer operation in IDB that promotes civil society participation in programs for combating trafficking of human beings.
4. The lending program for 2005 includes the following operations:
 - a. Strengthening of the Judiciary System II, for US\$10.8 million

¹ Prepared by the staff of the IDB.

- b. Depositary, Compensation and Liquidation System, for US\$2.0 million
- c. Professionalism of the Civil Service, for US\$5.0 million
- d. Asunción Coastal Development Program, for US\$64.0 million
- e. Science and Technology Program, for US\$6.5 million

PARAGUAY: STATISTICAL ISSUES
(As of July 8, 2005)

Paraguay began participation in the General Data Dissemination System in September 2001; metadata was also published on the Fund's Dissemination Standards Bulletin Board at that time.

A. Real Sector Statistics

New national accounts estimates, prepared with the assistance of an IADB-financed expert and following the methodological and conceptual framework of the *System of National Accounts 1993 (1993 SNA)*, have recently been released. The new estimates feature more complete industrial coverage, an input-output matrix, and expanded source data for the compilation of the new benchmark and base year (1994). Quarterly national accounts estimates for 1997–2001 also became available recently.

Both the consumer (CPI) and producer price indices (PPI) are reported on a regular and timely basis. The CPI has a base period of 1992, and the PPI of December 1995. Changes in the base period and basket of the CPI are scheduled to take place after the results of a household income and expenditure survey covering the period 2001–02 become available.

The coverage and quality of employment and unemployment statistics have improved significantly since a regular household survey was introduced in 1998; frequency, however, remains annual and the publication lag is close to one year. Wage indices are updated twice a year.

B. Government Finances Statistics

Reliable monthly data are available on a timely basis for the central government, where considerable improvements have been made over the past years. The asset position of the social security system is available on a daily basis. However, some shortcomings in classification and recording remain and Paraguayan government finance statistics are not considered fully consistent with the methodology of the IMF *Government Finance Statistics Manual 1986 (GFSM 1986)*. For example, nontax revenues include social security contributions and public enterprises and the social security system utilize somewhat different classifications schemes for revenues and expenditures than the central government. A law (*Ley 1535*) that was passed in 2000 should allow closer integration, as it sets uniform standards and creates a database for the entire public sector. Data on medium- and long-term public external debt are reliable and available on a monthly basis. Domestic public debt data are available on request, but should be integrated with the external public debt database. Deficiencies remain in the measurement of short-term supplier and commercial credit to the public sector. Moreover, there are discrepancies between the financing data reported by the monetary and fiscal authorities. On November 2003, the Ministry of Finance (MOF) issued a decree requiring all decentralized entities and public enterprises to provide updated monthly financial and balance sheet data to the MOF. Other measures are being taken to make

reporting more transparent. Under the SBA, all public enterprises and the IPS are required to undergo a complete financial audit by an internationally recognized auditor.

Annual data covering only budgetary central government (central administration) through 2003 have been reported for publication in the *2004 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*. Data on local governments and public enterprises are deficient and not reported regularly. There are no current plans to migrate to the *GFSM 2001*.

C. Monetary Statistics

Monetary statistics are considered broadly reliable. Following the work on methodologies initiated in the 2000 STA missions, Paraguay completed the establishment of a unified compilation and reporting system for the complete range of monetary data. This system harmonizes monetary data for use of the Central Bank of Paraguay (CBP), for reporting to STA for dissemination in the *IFS*, and for Fund surveillance and program monitoring purposes. A revision of the classification criteria has led also to a marked reduction in the discrepancies of interbank positions. A recent STA money and banking statistics mission recommended that (i) institutional coverage of the depository corporations survey be expanded to include financial investment funds and financial cooperatives; (ii) the compilation unit be given on-line access to the database maintained by the superintendency of banks; and (iii) methodological notes be disseminated, including an explanation of improvements and reasons for breaks in the series.

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

D. External Sector Statistics

Quarterly and annual balance of payments (BOP) and the international investment position (IIP) statistics are available from 2001 onwards on the CBP website, and are reported to STA on a regular and timely basis. Annual IIP data have been compiled and disseminated for the period 1995–2003. The classification of the BOP and of the IIP follows the recommendations of the *Balance of Payments Manual 5th edition (BPM5)*. BOP technical assistance by STA has led to improvements in the quality of the data on capital flows, especially in the coverage on foreign direct investment, and in the recording of external debt transactions in the BOP and in the IIP. The CBP now produces a highly informative bulletin on BOP statistics. Special studies by the central bank have improved the estimation methods for remittances of Paraguayans abroad and informal trade transactions, but deficiencies remain in the area of private capital outflows that contribute to the sizable negative errors and omissions in the BOP statistics over the past few years.

Key STA recommendations in the area of BOP statistics include the need to: (i) introduce quarterly surveys for recording services, transfers, and financial transactions of the

nonfinancial private sector; (ii) apply quality control procedures for surveys; (iii) revise and improve the statistical techniques to take into account unrecorded merchandise trade and smuggling; (iv) improve the compilation procedures of services and financial transactions; and (v) institute a system of coordination with other official agencies, and within the CBP, to promote intersectoral data consistency.

PARAGUAY—TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of July 8, 2005)

	Date of latest observation	Date received	Frequency of Data ¹	Frequency of Reporting ¹	Frequency of publication ¹
Exchange Rates	6/30/05	7/7/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ²	5/30/05	5/31/05	D	D	D
Reserve/Base Money	6/30/05	7/7/05	D	D	D
Broad Money	5/31/05	7/7/05	M	M	M
Central Bank Balance Sheet	6/30/05	7/7/05	D	D	D
Consolidated Balance Sheet of the Banking System	5/31/05	7/7/05	M	M	M
Interest Rates ³	5/31/05	7/7/05	M	M	M
Consumer Price Index	Apr. 2005	5/02/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ⁴ – General Government ⁵	Apr. 2005	05/18/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ⁴ – Central Government	Apr. 2005	05/24/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁶	Dec. 2004	2/01/05	Q	Q	Q
External Current Account Balance	Mar 2005	5/01/05	Q	Q	Q
Exports and Imports of Goods and Services	Mar 2005	5/01/05	M	M	M
GDP/GNP	2004	2/01/05	A	A	A
Gross External Debt	Dec. 2004	05/02/05	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.

PARAGUAY—WORK PROGRAM

Mission	Dates
Fifth SBA Review Board Meeting	August 22, 2005
FSAP First Mission Second Mission Board Meeting	April 19–29, 2005 July 5–15, 2005 Mid-October, 2005
Sixth SBA Review and Negotiations on a Successor Arrangement Mission Board Meeting	September 6–13, 2005 September 30, 2005
2006 Article IV Consultation Mission Board Meeting	February 6–17, 2006 March 31, 2006
Memorandum items: Approval of SBA First SBA Review Second SBA Review Third SBA Review (and SBA Extension) Fourth SBA Review	December 15, 2003 April 12, 2004 July 30, 2004 December 20, 2004 March 28, 2005

Asunción, Paraguay
August 8, 2005

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

Dear Mr. de Rato:

1. The Fund-supported program, in place since December 2003, has been remarkably successful in stabilizing the economy and the financial system, and making important inroads towards adopting an ambitious structural reform agenda that will lead to an increase in the potential growth of the economy and a reduction in poverty.
2. Significant accomplishments were achieved in 2004 assisted by a positive external environment. The economy recovered and reached one of the highest growth rates of recent history; inflation was reduced to one of the lowest in decades; the budgetary situation was turned around and the Treasury registered a surplus, the first in a decade; the *guaraní* was stabilized; the situation in the financial system was normalized following the serious crisis of 2002; and important structural reforms were adopted, including the approval of the fiscal adjustment law, the public pension system reform, the new customs code and the second-tier public banking law.
3. In 2005, we are confronting a less favorable external environment with higher oil prices, lower export prices, and upward pressures in global interest rates. In addition, a drought affected several key crops in the first half of the year. As a result, inflationary pressures have emerged and our economic growth objective for 2005 had to be lowered. Notwithstanding these developments, we will continue treating the Stand-By Arrangement (SBA) as precautionary.
4. This letter of intent outlines some additional measures we have adopted recently or intend to adopt in the next few months to confront the new scenario. This letter updates our earlier commitments included in the December 2003 letter with the original request for the Stand-By Arrangement (SBA), the December 2004 letter requesting an extension of the SBA through September 2005 and delineating our economic program for 2005 as well as reaffirming commitments included in the letter of March 2005.
5. Despite adverse external circumstances and difficult domestic conditions, the program remains broadly on track. All quantitative performance criteria for end-March 2005 under the SBA-supported program were observed, assisted by a prudent monetary policy and the application of a strict financial plan to guide fiscal policy.

6. However, there was a delay in conducting the independent audits for ANNP, DINAC, INC and PETROPAR (a structural performance criterion for end-April 2005). The audits for ANNP, DINAC and PETROPAR are already underway. In addition, the contracting process of auditing INC is in its final stages. We request a waiver for this delay, which was due to a legal challenge made by the General Comptroller Office, and the more rigorous procedures followed under the procurement law. In addition, a draft general banking law was submitted to Congress in December 2004 but has not been approved by Congress yet (a structural performance criteria for end-June 2005). We would like to review our strategy on general banking legislation and request a waiver for the non-observance of this target.

7. Progress was made in other aspects of the structural reform agenda: (i) the second-tier public bank law was recently approved by Congress and enacted by the President of the Republic (July 27, 2005); (ii) the plan for the comprehensive civil service reform (a structural benchmark for end-April 2005) has been finalized and a draft law was sent to a commission in the cabinet to study further; (iii) the hydrocarbons law was submitted to Congress in May 2005 with the aim of liberalizing diesel prices; (iv) PETROPAR arrears have been contained; and (v) the inventory of contingent liabilities is underway.

8. Several additional measures are being taken to strengthen our program and ensure that its objectives are achieved.

- In order to contain emerging inflationary pressures, we have increased further the interest rates on our monetary policy instrument (Letras de Regulación Monetaria, LRM) for maturities lower than 91 days. We will tighten monetary policy further in the short-run if expected inflationary pressure persists (and will increase LRM rates over the medium-term to align them with regional rates). We also introduced additional flexibility in our exchange rate policy to ward off imported inflationary pressures.
- The Ministry of Finance is strengthening efforts to strictly apply the approved financial plan for 2005, which will facilitate achieving the program objective of containing the budget deficit to ½ percent of GDP.
- Given the delay in congressional approval of the general banking law (a structural performance criterion for June 2005), we are developing a plan of action, to be completed by mid-September 2005 (structural benchmark), to meet the objectives of strengthening the banking system as outlined in the letter of intent of December 2003, taking into account the recommendations of the FSAP when appropriate.
- Diesel prices were adjusted four times by an accumulated 29 percent in 2005 to ease the financial burden on PETROPAR, reduce distortions and align prices to those in the region. We expect to liberalize diesel prices once Congress sanctions the hydrocarbons bill. In the event Congress does not approve the bill by mid-September 2005, we will revisit our current diesel pricing policy.

- We will finalize the implementation of the (short-term) recommendations made by the technical assistance mission from the IMF's Monetary and Financial Department (MFD) to improve the functioning of monetary operations and the performance of financial and exchange markets.¹
- The first and second legs of the financial sector assessment program (FSAP), including a comprehensive assessment of our financial sector were successfully conducted in April and July 2005. We look forward to the final results of this exercise. Following the detailed review of the FSAP recommendations by the relevant entities, we intend to implement them and address identified problems.
- We are working with the IMF Fiscal Affairs Department to update our report on the observance of standards and codes (ROSC) in the fiscal area, to strengthen budgetary procedures. The conclusions of the report will be analyzed and its recommendations adopted when appropriate.
- Progress continues to be made in other segments of the reform agenda.

9. We reiterate our commitment to the policies described in our letters and memoranda of economic and financial policies of December 2004 and March 2005, and would like to request: (i) a waiver on the nonobservance of the structural performance criterion on the audits of four public entities in April 2005; (ii) a waiver on the nonobservance

¹ Most of these recommendations have already been adopted, the list includes: (i) formalize the frequency, attendance, and matters to be treated of Executive Committee for Monetary Operations (CEOMA) meetings; and implement a procedure for the recording and internal drafting of the minutes of the meetings; (ii) construct a standard set of figures and tables, focusing on monetary, price, exchange rate, and external developments; (iii) issue shorter-term instruments (including one month); (iv) start using the one-month rate as the key policy rate; (v) concentrate the auctions of longer-term instruments and allow their rates to become market-determined; and (vi) revise repo (RIR) rules.

of the structural performance criterion on the approval of the general banking legislation in June 2005; (iii) a waiver on the applicability of the end-June 2005 quantitative performance criteria because some of the relevant information is not yet available; and (iv) completion of the fifth review under the SBA. The Government will continue the usual close dialogue with the Fund and stands ready to adopt the necessary measures to achieve the objectives of the program.

Sincerely yours,

_____/s/_____
Monica Perez dos Santos
President
Central Bank of Paraguay

_____/s/_____
Ernst Bergen
Minister of Finance

INTERNATIONAL MONETARY FUND

PARAGUAY

**Fifth Review Under the Stand-By Arrangement,
and Request for Waivers of Performance Criteria**

Supplementary Information

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

Approved by Caroline Atkinson and Matthew Fisher

August 19, 2005

1. **This supplement provides additional information on developments and performance since the issuance of the staff report for the fifth SBA review (see www.imf.org).** This information does not materially change the staff appraisal but requires amending the proposed decision, as information on end-June 2005 performance criteria became available.

I. RECENT DEVELOPMENTS

2. **The latest information is in line with the trends identified in the staff report.**
 - ***Inflation pressures continued.*** Monthly inflation rose to 0.5 percent in July 2005, mostly due to the adjustments in administered diesel prices. The 12-month rate of inflation reached 6.4 percent in July and the accumulated inflation in the first seven months of the year reached 5.6 percent.
 - ***Fiscal policy remains tight.*** The fiscal surplus at the Treasury and consolidated public sector levels increased in the second quarter of 2005. Higher revenues and low capital expenditures are the main factors behind the improvements in the fiscal accounts. Current expenditures remain under control.
 - ***Monetary policy continues to be conducted in a flexible manner.*** The Central Bank has continued its policy of no intervention in the foreign exchange market, which started in May 2005. The *guaraní* has appreciated by almost 5 percent against the U.S. dollar since May 2005. International reserves continue to grow, reaching a record high of about US\$1.3 billion at end-July.

II. PROGRAM PERFORMANCE

3. **All quantitative performance criteria for end-June 2005 have been observed.** Some of them with large margins. In particular, the large fiscal margins were due in large part to under-spending on public investment. The authorities acknowledged the need to increase public investment to boost growth on a sustainable basis and expressed their intention to raise the rate of project implementation. Because the end-June 2005 data has become available, the authorities no longer request waivers of applicability of the end-June 2005 quantitative performance criteria (Table 1).

Table 1. Paraguay: Quantitative Performance Criteria

	2004				2005					
	end-Mar.		end-Aug.		end-Dec.		end-Mar.		end-June	
	Adj. Target	Actual	Adj. Target	Actual	Adj. Target	Actual	Adj. Target	Actual	Adj. Target	Actual
Fiscal targets										
1. Overall balance of the central administration (floor, in billions of guaraníes) 1/ 2/	240	523	430	982	55	792	105	261	136	652
2. Wage bill of the central administration (ceiling, in billions of guaraníes) 2/	650	668	1,791	1,812	3,010	2,984	754	744	1,525	1,509
3. Overall balance of the public sector (floor, in billions of guaraníes) 1/ 2/	250	678	500	1,529	130	999	174	357	336	678
Monetary targets										
4. Net international reserves (floor, in millions of U.S. dollars) 3/	773	1,016	1,057	1,141	1,059	1,168	1,100	1,189	1,175	1,273
5. Net domestic assets (ceiling, in billions of guaraníes) 3/	-2,839	-4,264	-4,444	-5,231	-3,958	-4,848	-4,488	-5,247	-5,168	-5,782
Public debt and arrears targets										
6. Contracting or guaranteeing of nonconcessional external debt by the NFPS (ceiling, in millions of US\$) 2/	50	0	200	0	200	0	200	10	200	47
7. External payments arrears of NFPS (ceiling, in millions of US\$) 4/	75	75	5	3	0	16	...	...	...	...
8. <i>Of which:</i> bilateral arrears 4/	38	12	0	0	0	0	...	...	...	...
9. Central government floating debt (ceiling, in billions of guaraníes) 4/ 2/	350	228	297	235	320	134	...	...	...	...
Continuous performance criteria										
10. Contracted or guaranteed short-term external debt by the NFPS	0	0	0	0	0	0	0	0	0	0
11. Non-accumulation of external debt arrears 5/	0	B	0	B	0	B	0	0	0	0

1/ As specified in the TMU (see www.imf.org), for 2005 this target will be adjusted upward by 30 percent in case of over performance in tax revenues.

2/ Cumulative flows from the beginning of the corresponding calendar year.

3/ 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.

4/ These performance criteria will not apply in 2005.

5/ B = breached.



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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fifth Review of Paraguay's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) completed the fifth review under an SDR 50 million (about US\$73.3 million) Stand-By Arrangement for Paraguay, originally approved on December 15, 2003 for 15 months (see [Press Release No. 03/218](#)), and extended through September 30, 2005 on December 20, 2004 (see [Press Release No. 04/271](#)).

The completion of this review makes a cumulative amount equivalent to SDR 47 million (about US\$68.9 million) immediately available to Paraguay. However, Paraguay has not made any drawings under the arrangement so far, and the authorities have indicated that they will continue to treat it as precautionary.

In completing the review, the Executive Board also granted waivers for the nonobservance of two performance criteria related to the approval of a new comprehensive banking legislation and the audits in public entities.

Following the Executive Board's discussion of Paraguay's economic performance, Mr. Rodrigo de Rato, Managing Director and Chair, stated:

“Paraguay’s overall performance under the program continues to be satisfactory despite a challenging political and economic environment. Inflationary pressures resurfaced during the first half of 2005, but monetary tightening and a more flexible exchange rate policy are expected to keep inflation under control. The overall fiscal position has remained in surplus, as a strict financial plan was applied successfully to the execution of the budget. Banking system indicators continue to improve, and dollarization has remained at a lower level than in previous years. However, unemployment and poverty levels remain high, underscoring the importance of pressing ahead with the structural reform agenda.

“The authorities have been successful in maintaining fiscal discipline, notwithstanding the higher spending implicit in the budget approved by Congress, in part through improvements in tax administration and effective expenditure control. Continued fiscal discipline will be needed. To consolidate the gains achieved to date, further institutional strengthening will be needed. In this regard the authorities’ recent measures to reduce, and eventually eliminate, the oil company’s financial difficulties are welcome.

“Monetary policy has so far contained resurgent inflationary pressures. The authorities should stand ready to tighten monetary policy further should inflationary pressures continue. It is also important to strengthen further the financial system, building on the insights gained by the ongoing technical assistance from the IMF. In this connection, the authorities have made substantial progress in strengthening public banking legislation. The second-tier public banking law was enacted in July 2005. However, the reform of general banking legislation has fallen behind schedule. The authorities remain committed to the objectives of this reform, and are drawing up an action plan to achieve these objectives,” Mr. de Rato said.

**Statement by Javier Silva-Ruete, Alternate Executive Director for Paraguay
and Dimas Ayala, Advisor to Executive Director
August 22, 2005**

1. On behalf of the Paraguayan authorities, we would like to express our appreciation to the Fund's management and staff for their valuable advice and constant support in the implementation of Paraguay's economic program, which have been crucial for the successful economic outcomes achieved so far. The government that took office in August 2003 has prepared an ambitious economic program to avoid a debt crisis, reverse the serious fiscal deterioration, and address the long-term structural and governance weaknesses that undermined economic management. The authorities aim at stabilizing the economy and implementing structural reforms to lay the foundation for high and sustained growth, reduce unemployment, and alleviate poverty.
2. The Paraguayan authorities' implementation record under the current Fund-supported program—the first in more than three decades—has been outstanding. The government's ability to muster the necessary political consensus for economic reforms has led to congressional approval of key economic legislation over the past two years, including the banking resolution law, the public pension reform law, the fiscal adjustment law, the public procurement law, the customs code, and recently, the second-tier public bank reform law. Even though the pace of reforms was not as fast as originally envisaged, it should be noted that a number of important reforms were made in a short period of time in a country characterized by relatively new democratic institutions, a high poverty level, and strong social pressures.
3. Likewise, permanent efforts to combat corruption and reduce tax evasion, as well as prudent economic policies, have been crucial in reinstating macroeconomic stability and ensuring impressive economic results during the past year. As a result of these first steps, real GDP in 2004 reached 4.1 percent, one of the highest growth rates in recent history, even after a drought that severely affected soy production—Paraguay's main export crop—with an estimated cost of ½ to 1 percent of GDP. In addition, the inflation rate has dropped sharply to its lowest level in 30 years, the guarani has stabilized, a fiscal surplus was achieved for the first time in a decade, public sector external arrears were eliminated, confidence in the financial system has been restored, credit to the private sector is recovering, and the level of international reserves has risen from US\$ 786.1 million in July 2003 to US\$ 1,284 million in June 2005, exceeding program expectations.
4. The new economic authorities are reputed professionals and enjoy a high degree of independence in their decisions. They recognize the difficult challenges that lie ahead, and wish to reassure the Board of their firm commitment to lock in the economic gains achieved so far. They acknowledge the importance of keeping fiscal and monetary discipline to ensure macroeconomic stability, and of implementing the measures and reforms needed to increase transparency, improve the business environment, and pave the way for more rapid growth and higher employment over the medium term. They also consider that efforts aimed at strengthening public and private institutions, as well as enhancing transparency, are key for a further formalization of the economy. In this context, the government's main objective is to

significantly reduce poverty levels and enhance social equity by developing a more productive, competitive, and diversified economy.

5. A more modest pace of expansion in the global economy, a downward pressure on the prices of Paraguayan exports, higher than expected international oil prices (particularly harmful given Paraguay's dependence on imported oil), increasing international interest rates, and another drought that affected some key crops earlier this year, represent considerable threats to the Paraguayan economy in 2005. However, our authorities are monitoring these developments closely and introducing appropriate policies to offset the negative impact these shocks may have.

6. In this context, for the first time since the program was launched, the government successfully fulfilled all quantitative targets for this review. Likewise, all quantitative performance criteria for end-June 2005 were also met. These results reflect the authorities' strong commitment to implementing prudent monetary policies and a strict plan to control fiscal expenditures, as well as their success in avoiding past slippages by enhancing monitoring procedures. Although with some delays, the passage of the second-tier public bank law last month, together with compliance with a structural benchmark for end-May 2005, shows the government's ability to build consensus, as well as continuous congressional support. The ambitious plan for the reform of the civil service (a structural benchmark for end-April 2005) was approved by the cabinet last July. Nevertheless, the authorities request a waiver for the non-observance of two performance criteria, in view of the corrective measures taken. In this regard, we would like to make the following remarks:

➤ The independent audits for four public enterprises (ANNP, DINAC, INC, and PETROPAR), an April 2005 performance criterion, suffered some delays due to an unexpected legal issue raised by the General Comptroller's Office (officially in charge of conducting public entities' audits), and to stricter procedures under the new procurement law. Nevertheless, once legal support was obtained, the authorities stepped up the process, and selected independent audit companies. Audits have already been initiated in three of the companies and the fourth will start in the next few weeks. The authorities are confident that all of them will be finalized in the coming months.

➤ The general banking legislation that was to be approved by end-June 2005 was submitted to Congress in December 2004, ahead of schedule, but has not yet been considered, given that lately the congressional agenda has focused on public banking legislation. Moreover, as the Financial Sector Assessment Program (FSAP) was underway, the new economic authorities considered it important to wait for its results and recommendations, evaluate, and consider them when developing an appropriate framework to confront vulnerabilities and weaknesses in the financial sector. In this vein, a plan to enhance financial sector legislation and further strengthen the banking system is being designed, and is expected to be finalized by mid-September 2005.

7. Our authorities' strong determination to maintain fiscal discipline is reflected in the better than expected fiscal performance so far this year. They are firmly committed to

pursuing their current strategy in order to meet the 2005 fiscal target agreed under the program. The Fiscal Financial Plan, a strong legal and administrative instrument geared to limit spending units' operations to the available resources, is proving to be instrumental again this year in keeping fiscal discipline, in view of the expansionary 2005 budget approved by Congress. Additionally, continuous efforts to improve tax and customs administration, and constant administrative measures to combat tax evasion, have led to increased collections. Government revenues during the first six months of the year rose by 15 percent relative to the same period last year. It is relevant to recall that revenues increased by around 35 percent in 2004 vis-à-vis 2003, while in May 2005 collections reached a historical record —79 percent higher than the total revenues received in August 2003, when the government took office.

8. The authorities acknowledge the importance of ensuring an efficient use of resources in productive public investment with the aim of achieving higher GDP growth. In this regard, they are permanently strengthening the Public Investment Coordination Unit (UCIP) at the Ministry of Finance, which plays a crucial role in prioritizing public capital expenditure, and ensuring an efficient use of external resources and a proper development of projects.

9. The government is confident that the gradual implementation of the Fiscal Adjustment Law, which broadens the tax base and intends to further formalize the economy; the introduction of the new Customs Code in early 2005; and the launching of the public pension system reform early last year, will sustain tax efficiency gains and contribute significantly to long-term fiscal sustainability. The authorities have also been successful in resolving central government domestic and external public debt arrears, and in placing the debt-to-GDP ratio on a declining trend. After having risen to nearly 50 percent in 2002, the debt burden decreased to 39.8 percent at end-December 2004, and it is expected to further diminish to 30 percent by 2009.

10. The government is well aware of the difficult financial situation of the petroleum company (PETROPAR), and of the continued accumulation of arrears with suppliers. In order to confront this problem, the authorities have raised domestic diesel prices several times this year, and are willing to continue to do so in the event of higher international oil prices. At the same time, the government has a strategy for a more permanent solution to PETROPAR's financial problems, including a new regulatory framework for the fuel sector, for which a draft has already been submitted to Congress, proposing the liberalization of diesel prices.

11. Despite stronger inflationary pressures during the first months of 2005, our authorities remain committed to achieving the inflation objective for 2005. The surge in inflation was associated with the decision in April to raise the minimum wage in response to the increase in fuel prices, which particularly affects transport costs. Additionally, a seasonal peak in food prices, together with the sharp real appreciation of the Brazilian real against the domestic currency, has underpinned inflationary pressures. Nevertheless, the Central Bank has been proactive in implementing tighter monetary policies in order to contain pressures and achieve the inflation objectives. In this context, and consistent with staff's recommendations, recently the authorities increased further the rates on Central Bank bills, and are willing to gradually tighten monetary policy over the remainder of the forecast period

to keep up with interest rate developments in neighboring countries and the U.S., while containing eventual inflationary pressures. At the same time, the Central Bank is implementing a more flexible exchange rate policy in line with movements in currencies of other countries in the region, with the aim of reducing imported inflationary pressures. Likewise, the monetary authorities will continue implementing the recommendations made by MFD's technical assistance missions to enhance the conduct of monetary and exchange rate policies.

12. Our authorities acknowledge the importance of an efficient and stable financial system to promote investment and growth. To this end, significant progress has been made in advancing the financial reform agenda, including the implementation of a new framework to supervise financial cooperatives; new legislation for banks' resolution and the deposit guarantee fund; and streamlined regulatory and supervisory regimes for banks' asset classification and provisioning, aimed at providing prudential norms in line with international standards. At the same time, our authorities are convinced that improving the governance structure, risk management, and credit policies in public banks is crucial to achieve efficiency and financial sector stability, as well as to reduce the fiscal burden caused by mismanagement in public banks. The implementation of the new second-tier public bank law will be instrumental in improving management of credit lines, ensuring medium- and long-term credits, and intermediating external resources efficiently, so as to promote production, employment, and growth.

13. It is important to emphasize that the measures and reforms being implemented by the government are improving market confidence, as reflected by the continuous rise in deposits and the de-dollarization process observed lately. Private deposits in the banking system increased by 8.6 percent in June 2005 compared to the same month in 2004, and the structural composition of deposits indicates that 57 percent of them are in foreign currency —5.2 percent lower than in June 2004 and 11 percent lower than the peak of dollarization registered in 2002. At the same time, private banking credit continues to recover, after dropping at an annual rate of more than 20 percent at end-2003. At end-July 2005, private banking credit in local currency grew at an annual rates of around 30 percent. Moreover, the banking system is in better shape to sustain this credit growth, considering that the ratio of non-performing loans dropped to 10.4 percent in June 2005, from 22.7 percent in September 2003 —including BNF which has a more deteriorated loan portfolio vis-à-vis private banks' portfolio.

14. Our authorities wish to express their firm determination to advance steadily with the remaining structural reforms. It is important to emphasize that many elements of the reform program have been achieved in a short period of time, reflecting strong ownership, broad political consensus, and the government's commitment, in contrast with the reluctance to implement reforms that prevailed for many years under previous administrations. Enhancing the efficiency and governance of public institutions by carrying out regular independent audits, improving public procurement, and introducing measures to combat corruption are at the top of the government's agenda. In this connection, the Minister of Finance has recently created an Internal Affairs Unit, a new office whose core responsibility is to investigate and report corruption practices. Likewise, the government is implementing a new initiative entitled "Tools Against Corruption", which will essentially work together with the private

sector to educate the population on combating corruption. Our authorities consider that the comprehensive external audits that are being carried out in public companies will be instrumental in addressing performance weaknesses. At the same time, business plans are being developed to enable private sector participation in some public enterprises with the aim of fostering investment and improving efficiency.

15. Along these lines, the government has a firm determination to implement a strategy to further enhance the investment climate, which is essential to attract investors, reduce unemployment, and improve the country's socio-economic conditions. To this end, an ambitious six-year economic plan has been articulated in consultation with the civil society and the business community in the context of a broad participatory Seminar, aimed at founding the basis for increasing agricultural and agro-industrial production, enhancing competitiveness, diversifying the economy, reducing inequalities, and improving the business environment.

16. The Paraguayan authorities are strongly committed to continuing with their efforts towards ensuring the achievement of their ambitious economic objectives. They consider that support from the international community and the Fund is crucial in this process, and request continued cooperation and support to tackle the difficult challenges ahead.