

**Paraguay: Third Review Under the Stand-By Arrangement, Request for Extension of the Arrangement, and Request for Waivers 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 third review under the Stand-By Arrangement, request for an extension of the arrangement, and request for waivers of performance criteria, the following documents have been released and are included in this package:

- the staff paper for the Third Review Under the Stand-By Arrangement, Request for Extension of the Arrangement, and Request for Waivers of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on November 12, 2004, 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 December 7, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Press Release summarizing the views of the Executive Board as expressed during its December 20, 2004 discussion of the staff report that completed the request and/or review.
- a statement by the Executive Director for Paraguay.

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

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

\*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

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

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

Approved by Caroline Atkinson and Matthew Fisher

December 7, 2004

- **Arrangement.** A 15-month Stand-By Arrangement (SBA) for SDR 50 million (50 percent of quota) was approved by the Executive Board on December 15, 2003. This was the first Fund arrangement with Paraguay since 1968. The authorities announced their intention to treat the arrangement as precautionary and have made no purchases since its approval. Paraguay has no outstanding Fund credit. The program aims at restoring macroeconomic stability (following an episode of financial turbulence in 2002–03) and beginning a process of structural reform to create conditions for sustained growth. Performance under the program has been generally strong. The first review was completed in April 2004 and the second review in July 2004.
- **Developments.** The program is broadly on track; most quantitative performance criteria for end-August were observed. There are signs of improved macroeconomic conditions. GDP is expected to grow by 2½ percent in 2004 despite a drought. Inflation is expected to be reduced significantly to 6 percent this year. Tax collections continue to grow vigorously, while exports and imports continue to rise. Credit to the private sector is beginning to recover after a long period of contraction. The situation in the foreign exchange market has stabilized. However, there have been significant delays in implementing some structural measures, especially the approval of banking legislation.
- **Extension of Arrangement.** The authorities recognized that there was not enough time to pursue all the reforms they had set out under the arrangement and requested a six-month extension and a rephrasing of the same access. During this period the authorities hope to consolidate macroeconomic stabilization and advance with structural reform, especially in the banking area.
- **Discussions.** These took place in Asunción during October 18–29 and in Washington during November 11–12. The mission met with President Duarte Frutos, Vice-President Castiglioni, Finance Minister Borda, Central Bank President González, other members of the cabinet of ministers, senior officials and members of civil society. The staff team consisted of A. Santos (Head), F. Frantischek, R. Sab, R. Benelli (all WHD), W. Brown (PDR), R. Morales (MFD), and Z. Partow (World Bank). The mission was assisted by L. Durán-Downing, resident representative in Asunción. Mr. Ayala (OED) participated in the discussions. The mission liaised with the Asunción offices of the World Bank and IDB.

### List of Acronyms

|          |   |
|----------|---|
| ANDE     | National Electricity Company                  |
| ANNP     | National Port Authority                       |
| BCP      | Central Bank of Paraguay                      |
| BNF      | National Development Bank                     |
| CONATEL  | National Telecommunications Corporation       |
| COPACO   | Water and Sewage Company                      |
| DINAC    | National Aerospace Authority                  |
| ESSAP    | Water Company                                 |
| FAD      | Fiscal Affairs Department                     |
| FSAP     | Financial Sector Assessment Program           |
| GDP      | Gross Domestic Product                        |
| GFS      | Government Finance Statistics                 |
| GNFS     | Good and Non-factor 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

### Background

- **The program remains on track but there have been delays in implementing structural measures.** Most quantitative performance criteria through end-August were observed, some of them with considerable margins. However, there have been delays in implementing some structural measures, especially related to the approval of banking legislation, due to a shift in the political environment and congressional delays. Macroeconomic performance has been better than envisaged under the program. GDP is expected to grow by 2½ percent, despite a drought, and inflation is declining. The government has the budget under control, confidence in the banking system has been restored, and the situation in the foreign exchange market has stabilized.
- **The authorities believe that there is not enough time under the arrangement to complete the envisaged structural reform agenda.** For that reason, they requested a six-month extension of the SBA to provide a framework for macro stability while reinvigorating the reform agenda and completing key structural measures of the program, especially in the banking area.

### Key Staff Recommendations

- **Move ahead with the reform agenda, especially the public banking reform, a key element of the structural program.** The authorities have adopted a new strategy involving a two-stage approach that they believe is politically feasible to achieve but will require more time to implement. In a first stage, a new bill creates a second-tier bank to deal with the pressing issue of intermediation of external funds. In a second stage, the first-tier public banks—especially the National Development Bank (BNF)—will be restructured.
- **Consolidate the stabilization gains achieved so far and advance structural reform to secure sustainable growth, higher employment, and reduced poverty and inequality over the medium term.** A significantly higher growth in real GDP per annum should be consistent with a manageable balance of payments over the medium term if an adequate structural reform program is adopted, while at the same time stabilization gains are consolidated and institutionalized.

## I. RECENT DEVELOPMENTS

1. **The program remains broadly on track but parts of the structural agenda need strengthening.** Macroeconomic performance continued to be strong with most quantitative performance criteria observed for end-August.<sup>1</sup> However, there were serious delays in implementing the structural reform agenda in the second half of the year as several reforms requiring congressional approval were held up, notably on banking reform.

2. **Macroeconomic performance has been better than envisaged under the program.**

- ***The economy is expected to grow despite a drought.*** Real GDP is expected to grow by 2½ percent in 2004, in line with program projections. It is estimated that, in the absence of the drought, growth would have reached 3–3½ percent.
- ***Inflation is significantly lower than targeted.*** The program aimed at reducing the inflation rate to 8 percent in 2004. The 12-month consumer price inflation in October fell to 3½ percent. However, the staff expects inflation to increase in the last two months of the year, reflecting administered price adjustments, and reach 6 percent by end-2004.
- ***Fiscal policy remains tight and program targets have been observed.*** The targets for the central government and the consolidated public sector surpluses were exceeded by large margins through end-August 2004, reflecting higher than programmed revenues. Capital expenditures were compressed in the 2004 budget as part of the fiscal consolidation effort. A supplementary budget was introduced in July 2004 as it became clear both that higher spending could be accommodated within the program limits, given stronger than anticipated tax receipts, and that earlier cuts were interrupting implementation of priority and high quality projects financed by the World Bank and IDB. In the event, implementation has continued to be slow and staff projections assume that investment spending will end up considerably below budget in 2004.

| Paraguay: Performance Under the Program<br>(In trillions of guaranies, unless indicated) |                 |        |
|--|-----------------|--------|
| Main Targets   | end-August 2004 |        |
|  | Prog            | Actual |
| <b>Fiscal Targets</b>  |                 |        |
| Fiscal balance 1/  | 0.43            | 1.01   |
| Wage bill 1/   | 1.79            | 1.81   |
| Consolidated fiscal balance 2/   | 0.50            | 1.61   |
| <b>Monetary Targets</b>  |                 |        |
| Net international reserves 3/  | 1.06            | 1.14   |
| Net domestic assets  | -4.44           | -5.23  |
| Sources: Paraguayan authorities and Fund staff.  |                 |        |
| 1/ Central administration.   |                 |        |
| 2/ Nonfinancial public sector and Central Bank.  |                 |        |
| 3/ In billions of U.S. dollars.  |                 |        |

<sup>1</sup> There were two quantitative performance criteria not observed for which the authorities are requesting waivers: (i) the ceiling on the end-August wage bill, missed by about 1 percent; and (ii) the non-accumulation of arrears target, breached because of a one-day late payment (over the grace period) to France in September.

- **Capital inflows facilitated the observance of monetary targets.** Targets for net domestic assets and net international reserves were observed with comfortable margins through end-August 2004, supported by favorable external conditions and strong money demand. As the banking situation normalized and confidence improved, private capital returned. The Central Bank took advantage of this to rebuild reserves, with the resulting net inflows being partly sterilized.
- **The financial system continues to be liquid although weaknesses remain.** Banking system deposits continue to rise, and private credit is finally recovering after a long contraction. Overall profitability improved during the first half of 2004 but some banks continue to have losses. The share of nonperforming loans (NPL) declined further, although they remain at over 15 percent of assets.
- **Trade growth remains strong.** Exports grew by almost 30 percent in the first nine months of 2004 due to strong soy prices and access to new export markets for meat. Imports grew by over 40 percent in the same period reflecting in part the economic recovery and higher oil prices.<sup>2</sup>
- **The exchange rate has stabilized.** The *guarani* has remained broadly stable against the dollar during the year, as net central bank purchases of foreign exchange have offset upward pressures from capital inflows. In real effective terms, the *guarani* strengthened by 3 percent since end-December 2003. The current real effective exchange rate is broadly in line with the average of the last five years.

| Paraguay: Recent Developments |       |              |
|-------------------------------|-------|--------------|
| Annual Growth (in percent) 1/ |       |              |
|                               | 2003  | Jan-Sep 2004 |
| <b>Production 2/</b>          |       |              |
| Manufactures                  | -2.4  | 17.8         |
| Agriculture                   | 23.3  | 1.5          |
| Electricity                   | -3.0  | 6.7          |
| <b>Inflation 3/</b>           |       |              |
| Consumer prices               | 9.3   | 3.6 4/       |
| <b>Monetary 3/</b>            |       |              |
| Base money                    | 57.7  | 28.2         |
| Money supply                  | 29.9  | 8.4          |
| <b>Public Finances</b>        |       |              |
| Tax receipts                  | 25.8  | 36.8 4/      |
| <b>External</b>               |       |              |
| Exports                       | 21.8  | 28.5         |
| Imports                       | 18.0  | 42.1         |
| NIR (million US\$)            | 983.0 | 1191.0 4/    |
| Exchange rate (G/US\$)        | -13.3 | -2.3 4/      |

Source: Paraguayan authorities.  
 1/ With respect to same period of previous year unless otherwise specified.  
 2/ Data for 2004 through June.  
 3/ 12-month growth rate e.o.p.  
 4/ Data for 2004 through October.

3. **Structural performance has been significantly weaker than in the first half of the year.** While some progress was made towards meeting the structural conditionality associated with the third review, the two structural performance criteria established for this review were missed, some benchmarks were only partly observed, and those observed were done with a delay.<sup>3</sup> Furthermore, unexpectedly strong political opposition to planned banking legislation made it unlikely that end-year structural targets on banking reform would be met.

<sup>2</sup> Some of the increase in imports this year (as much as about one quarter, according to staff estimates) is due to improvements in customs procedures and, therefore, statistical recording.

<sup>3</sup> There were two structural performance criteria not observed for which the authorities are requesting waivers: (i) audits for three public enterprises (end-September), one of which was recently concluded (prior action); and (ii) approval of the public banking law (end-October), on this issue, the authorities are adopting a new strategy.

4. **In October, congress approved a law broadening the scope of the National Development Bank (BNF).** Pressures to ensure credit availability for the upcoming harvest led to support for legislation that was not coordinated with the government, and in some respects ran counter to the government’s reform efforts. The new law broadened the scope of BNF operations, gave BNF the monopoly for public sector foreign exchange transactions, and increased its credit limits.<sup>4</sup> The authorities are confident that: (i) the law will only be in place temporarily, while new first-tier public banking legislation is prepared; (ii) the amount of additional BNF credit will be limited by current prudential regulations; and (iii) current prudential rules will ensure credit quality of additional BNF loans.<sup>5</sup> The superintendency of banks will continue to monitor BNF and report to the ministry of finance. Nevertheless, the approval of this law before the restructuring of the BNF increases the risks to BNF’s balance sheet.

| Reform Area             | Conditionality (Date)    | Objective  | Status  |
|-------------------------|--------------------------|--|---|
| 1. Accounting Standards | Benchmark (June 04)      | Application of IAS to Central Bank               | <u>Done</u> . IAS applied in July   |
| 2. Central Bank         | Benchmark (July 04)      | Begin implementation of restructuring plan       | <u>Done</u> . BCP restructuring began in September                                  |
| 3. Governance           | PC (September 04)        | Independent audit for ANDE, ESSAP, COPACO        | <u>Partly Done</u> . ANDE and COPACO done in time ESSAP done in December            |
| 4. Transparency         | Benchmark (September 04) | Increase data publication for Government and SOE | <u>Partly Done</u> . Ministry of Finance published some data                        |
| 5. Banking              | PC (October 04)          | Approve public banking law                       | <u>Not Done</u> . Authorities adopt new strategy. Alternative legislation submitted |
| 6. Civil Service        | Benchmark (October 04)   | Develop plan for comprehensive reform            | <u>Partly Done</u> . Census of civil servants completed. Plan well advanced         |

Sources: Paraguayan authorities and Fund staff.

5. **The social situation has deteriorated over the last six months as high poverty and income inequality have led to protests.** After a period of relative calm, there have been several incidents of peasants taking over land since August and some street demonstrations in Asunción and other cities. Rural demands center on land, while urban protests concern wages and employment. Income inequality has been traditionally high, and nearly half of the population lives on less than US\$2 per day. Social spending remains quite low. However, the authorities are seeking to address some of the concerns of the rural poor by introducing a land tax earmarked to buy land to distribute among peasants. The 2005 budget includes a moderate wage increase of about 10 percent after three years of wage freeze. A significant increase in capital expenditure on infrastructure to expand growth potential and employment is also planned.

<sup>4</sup> There is some tension between the temporary legislation approved by congress and the authorities’ planned reform as the new legislation broadens the scope of BNF’s operations whereas the authorities’ reform narrows the scope of such operations. In order to make the law and the strategy more consistent, the President issued a partial veto to the law to take away the monopoly of public sector foreign exchange transactions from BNF (a task conducted by the central bank).

<sup>5</sup> The staff has been reassured by the authorities that the law will not lead to an excessive expansion of BNF credit. All BNF loans over US\$15,000 (the previous credit limit) are subject to an additional layer of risk assessment and credit approval by the BNF. In addition, all credits require 60 percent collateral at “fair values.” The authorities believe that the monetary program is strong enough to deal with any prospective BNF credit expansion but remain committed to take more direct actions if such new net credits compromise the monetary program.

## II. POLICY DISCUSSIONS

6. **In view of the delays in implementing the structural reform agenda, the authorities have requested a 6-month extension to the SBA.** A number of planned reforms require congressional approval and there is a recess scheduled from mid-December to late-February. In order to consolidate the macroeconomic gains and provide a continued framework while the structural agenda is reinvigorated and the planned reforms are completed, the authorities have requested a six-month extension to the SBA until end-September 2005, with no additional access under the arrangement.

### A. Macroeconomic Framework

7. **Macroeconomic policies for 2005 will aim at securing the stabilization achieved during the first year of the program, while allowing for a recovery in public investment and growth.** Policies will be based on a growth rate of about 3¼ percent, supported by a recovery in agricultural output and investment. Inflationary pressures, mostly derived from expected increases in administered prices (diesel and utilities) and regional inflation, should remain modest. The current account balance is expected to deteriorate somewhat to accommodate higher investment (¶15).<sup>6</sup>

|                           | 2002 | 2003 | SBA              |       | Extension     |
|---------------------------|------|------|------------------|-------|---------------|
|                           |      |      | Prog. 1/<br>2004 | Proj. | Proj.<br>2005 |
| (Annual percent change)   |      |      |                  |       |               |
| Real GDP                  | -2.3 | 2.6  | 2.4              | 2.6   | 3.2           |
| Inflation (e.o.p.)        | 14.6 | 9.3  | 8.0              | 6.0   | 6.0           |
| Real exchange rate 2/     | -3.2 | -6.0 | ...              | 5.0   | 2.0           |
| (In percent of GDP)       |      |      |                  |       |               |
| External current account  | 1.7  | 2.4  | 0.4              | 0.9   | -0.4          |
| Primary fiscal balance 3/ | -1.7 | 0.9  | 1.5              | 2.2   | 0.7           |
| Overall fiscal balance 3/ | -2.3 | -0.3 | 0.1              | 1.4   | -0.5          |
| Public sector debt        | 48.4 | 46.8 | 45.6             | 39.0  | 37.9          |

Sources: Paraguayan authorities; and Fund staff estimates.  
1/ Original program (Country Report No. 04/66).  
2/ Minus indicates a real depreciation.  
3/ Central government.

### B. Fiscal Policy <sup>7</sup>

8. **The fiscal program for 2005 aims at broad budget balance, while allowing a significant increase in public investment.** The authorities' fiscal program for the central government incorporates a small deficit of ½ percent of GDP in 2005 as a recovery in public investment from the compressed level of 2004 is largely financed by higher projected revenues. Consistent with this and with projections for the public enterprises, the program fiscal targets for 2005 envisage overall balance for the consolidated public sector. The overall program targets are broadly similar to the targets for 2004, although with higher public investment and higher revenues. Given the fiscal overperformance now projected for 2004,

<sup>6</sup> This corresponds to the paragraph number in the Supplement to the Memorandum of Economic and Financial Policies (SMEFP).

<sup>7</sup> The end-December 2004 indicative target for the central government overall surplus was converted to a performance criterion. The July 2004 letter of intent included only an indicative fiscal target for December 2004 on fears that the supplementary budget approved in July 2004 could be full implemented and the target missed. However, the pace of public expenditures in the second half of 2004 (especially public investment) has been significantly lower than envisaged and the authorities believe now that the indicative fiscal target can be achieved.

the program would allow a relaxation in the overall balance in 2005, almost entirely accounted for by higher capital spending. Staff believes there is sufficient room to absorb the higher investment (mainly on water supply, electricity distribution, highway development, and construction of schools) without creating inflationary pressures or an undue widening of the external current account deficit (¶6):<sup>8</sup>

- **On the revenue side**, the draft budget incorporates conservative assumptions for tax collections, with only modest gains from tax administration and from the implementation of the Fiscal Adjustment Law and the new Customs Code. The authorities are introducing a land tax in 2005 earmarked to cover expenditures related to rural issues.
- **On the expenditure side**, the draft budget contemplates higher spending mainly due to faster implementation of high quality investment projects (mostly financed by the World Bank, the IDB and JBIC). A modest increase in current spending is also planned, reflecting a wage increase of some 10 percent (following a three-year freeze) and the creation of a rural institute (to buy land for peasants, financed by the new land tax) to confront emerging social tensions in rural areas. These additional current expenditures are partly offset by further tightening in other spending categories (mostly goods and services and transfers).

|                        | SBA              |             | Extension     |
|------------------------|------------------|-------------|---------------|
|                        | Prog. 1/<br>2004 | Proj.       | Prog.<br>2005 |
| <b>Revenues</b>        | <b>16.7</b>      | <b>17.6</b> | <b>18.3</b>   |
| <b>Expenditures</b>    | <b>16.5</b>      | <b>16.5</b> | <b>18.8</b>   |
| Current                | 13.1             | 13.0        | 13.7          |
| Non-interest           | 11.7             | 11.9        | 12.4          |
| Interest               | 1.4              | 1.1         | 1.3           |
| Capital                | 3.4              | 3.5         | 5.1           |
| <b>Overall Balance</b> | <b>0.1</b>       | <b>1.4</b>  | <b>-0.5</b>   |
| Memorandum item:       |                  |             |               |
| Primary Savings        | 5.0              | 5.7         | 5.9           |
| Primary Balance        | 1.5              | 2.2         | 0.7           |
| Real GDP growth (%)    | 2.4              | 2.6         | 3.2           |

Sources: Paraguayan authorities; and Fund staff estimates.  
1/ Original program (Country Report No. 04/66).

9. **The small central government deficit for 2005 will be financed primarily by external borrowing.** Already contracted project loans will fully finance the program without net additional recourse to domestic sources. The treasury expects to use a combination of bank deposits and floating debt to cover domestic financing needs arising from domestic bonds falling due.

10. **In the event revenues are higher than anticipated in the program, an automatic adjustor will ensure that a portion is saved.** Since there are upside risks on tax collections, the mission reached understandings on an adjustor on tax revenues so that for each *guarani* of additional tax revenues above program projections, 30 cents would be saved while 70 cents could be used to finance higher expenditures. The authorities intend to use the

<sup>8</sup> The staff's projection for 2004 assumes that additional capital expenditure of some 1½ percent of GDP, approved under the supplementary budget for the central government approved in July 2004, will not materialize. If that budgeted expenditure were to materialize in 2004, there would have been little change in the fiscal position between 2004 and 2005.

additional resources to finance capital expenditures; the staff will monitor this additional spending in close collaboration with the World Bank and the IDB to ensure that the resources are used for high quality projects. This adjutor will not apply in cases where tax revenues fall short from program projections.

11. **Fiscal policy, supported by a policy of a consolidated balanced budget, is consistent with the objective of reducing public debt to 30 percent of GDP over the medium term.** A continuation of the current policy stance will allow the authorities to generate a primary surplus of 1¼ percent of GDP a year on average, and a central government overall balance near zero over the medium term. This fiscal stance, together with faster economic growth, would put the public debt to GDP ratio on a rapidly declining trend, reaching the 30 percent objective by 2009.

### C. Monetary and Exchange Rate Policy

12. **Monetary policy will aim at consolidating inflation during 2005 at 6 percent.** The central bank will accommodate an expected 10 percent increase in the demand for currency. Higher oil prices and, more generally, somewhat higher inflation in the world and the region, will lead to some upward price pressures. Having improved the international reserve position, the authorities agreed to use exchange and interest rates flexibly in the coming year to meet the inflation objective. Some proposed improvements in the implementation of monetary policy have been identified by MFD technical assistance missions, including to: (i) build consistency between inflation and exchange rate projections; (ii) strengthen management and procedures at the decision levels; (iii) strengthen and reorganize the Economics Studies Department of the Central Bank; (iv) improve statistics; and (v) improve public communications. The staff called for the early adoption of these recommendations (¶9).

| Paraguay: Monetary Program<br>(In percent of currency the previous period) |                  |              |               |
|--|------------------|--------------|---------------|
|  | SBA              |              | Extension     |
|  | Prog. 1/<br>2004 | Proj.        | Prog.<br>2005 |
| <b>Currency</b>  | <b>16.5</b>      | <b>16.0</b>  | <b>10.0</b>   |
| <b>Net international reserves</b>  | <b>10.4</b>      | <b>52.4</b>  | <b>9.6</b>    |
| <b>Net domestic assets</b>   | <b>6.1</b>       | <b>-36.4</b> | <b>0.4</b>    |
| Credit to public sector (net)  | -6.3             | -9.9         | 4.1           |
| Credit to banks (net)  | -1.7             | -29.5        | -13.9         |
| Free reserves  | 13.4             | -15.8        | 2.0           |
| BCP bills (LRM)  | -6.3             | -12.5        | -11.0         |
| Other bank credit  | -8.8             | -1.2         | -4.9          |
| Other items net  | 14.1             | 3.0          | 10.2          |
| Memorandum item:   |                  |              |               |
| Base money growth (%)  | 3.2              | 19.0         | 8.2           |
| Money supply growth (%)  | 17.8             | 16.6         | 11.0          |

Sources: Paraguayan authorities; and Fund staff estimates.  
1/ Original program (Country Report No. 04/66).

13. **A modest further buildup of international reserves is projected.** With international reserves well above program projections in 2004, the central bank's objective is to accumulate only US\$40 million during 2005 in order to maintain import coverage of reserves at about 4 months. Lower international reserve accumulation will ease the conduct of monetary policy by the central bank. The program also allows for a reduction in commercial banks' free reserves at the central bank in response to improved credit conditions. To accommodate seasonal factors and a heavy schedule of external payments in March 2005, the program envisages that international reserves will fall temporarily in the first quarter before recovering in June 2005 when exports are seasonally strong.

14. **The authorities do not have a fixed exchange rate target but adjust policies to promote exchange rate stability.** The authorities embrace a flexible exchange rate regime,

recognizing Paraguay's vulnerabilities to exchange rate movements in neighboring countries, but conduct a tight credit policy aim at generating a stable real effective exchange rate. With reserves now at a more comfortable level, the authorities intend to refrain from large-scale foreign exchange purchases in the future. In the event of downward pressures on the *guarani*, the authorities would tighten their monetary policy stance to reduce potential reserve loss.

15. **Interest rates on central bank bills (LRM) are expected to become positive in real terms after declining significantly over the past year.** With high liquidity in the financial system due to capital inflows, nominal interest rates on LRM have fallen to about 5 percent, below the 6 percent inflation rate. The mission proposed a more active interest rate policy, given the increased U.S. interest rates, and the need to establish a positive real interest rate as a benchmark in the financial system.

16. **The central bank has begun to implement a restructuring plan to operate more efficiently and effectively.** The reform is expected to reduce the overall size of the bank, while increasing staff resources dedicated to economic studies and banking supervision. The staff noted that eventually new legislation to give the central bank greater independence would be warranted. The authorities feel that attempts to pass a new law now would hamper the prospects for the approval of other priority legislation. The central bank has published its audited financial statements for end-2003, which report its results based on accounting principles substantially similar to international financial reporting standards (structural benchmark).

#### D. External Issues

17. **A 5 percent worsening in the terms of trade is expected to push the current account slightly into deficit in 2005.** Soy prices are expected to fall and international oil prices are expected to rise in 2005. Exports and imports are expected to continue to grow in volume terms, but at rates closer to historical levels following the recovery in trade this year. The capital account is projected to remain in surplus due to net public sector borrowing, primarily for investment projects. Net private sector foreign currency deposit flows, which had been quite volatile since the 2002 crisis, are projected at zero next year. However, the high level of liquidity in the domestic banking system carries the risk of sudden outflows.

18. **Progress continues to be made in clearing external arrears.** The authorities cleared the remaining arrears to official creditors in September. In addition, arrears owed by the state-owned oil firm PETROPAR to its fuel suppliers are also being cleared in line with the program schedule. Progress is also being made towards resolving disputed arrears.

| Paraguay: Balance of Payments<br>(In percent of GDP) |                  |               |               |
|--|------------------|---------------|---------------|
|  | SBA              |               | Extension     |
|  | Prog. 1/<br>2004 | Proj.<br>2004 | Prog.<br>2005 |
| <b>Current Account</b>                               | <b>0.4</b>       | <b>0.9</b>    | <b>-0.4</b>   |
| Exports  | 30.2             | 39.2          | 37.6          |
| Imports  | -34.4            | -44.3         | -43.7         |
| Other  | 4.5              | 6.0           | 5.8           |
| <b>Capital Account</b>                               | <b>1.6</b>       | <b>3.4</b>    | <b>0.9</b>    |
| Public sector (net)                                  | 1.1              | 0.4           | 0.4           |
| Private sector (net) 2/                              | 0.5              | 3.0           | 0.4           |
| <b>Overall Balance</b>                               | <b>2.0</b>       | <b>4.3</b>    | <b>0.5</b>    |
| <b>Overall Financing</b>                             | <b>-2.0</b>      | <b>-4.3</b>   | <b>-0.5</b>   |
| Net international reserves                           | -0.5             | -3.0          | -0.5          |
| Exceptional financing                                | -1.5             | -1.3          | 0.0           |

Sources: Paraguayan authorities; and Fund staff estimates.  
1/ Original program (Country Report No. 04/66).  
2/ Includes errors and omissions.

### E. Structural Reform Agenda

19. **After significant progress with structural reform in key areas in the first half of 2004, implementation slowed in recent months.** As a result, two structural performance criteria appear likely to be missed by end-December; (i) the comprehensive banking law is still being debated in cabinet and so has not been submitted to congress, making its approval by congress by year-end virtually impossible; and (ii) there have been some delays in completing the independent audits for a few public enterprises, which will not be completed by end-December.<sup>9</sup> Other structural benchmarks also appear unlikely to be met by year-end.

Against that background, the authorities requested a modification of the structural conditionality for end-December, to be completed during the proposed extension of the SBA.

20. **The authorities have re-phased their reform agenda for the program.**

The staff believes that the new timetable for reforms takes into account the congested agenda of congress

and the recess period while strengthening ownership on the reform process. It includes reforms originally due to be completed under this review as well as the proposed modification of reforms originally scheduled for the fourth review. The main reform areas include:

- **General banking reform.** This is the third phase of a more comprehensive reform that involves (i) bank resolution legislation; (ii) bank deposit guarantee legislation; and (iii) improvements in prudential regulation and bank supervision legislation. The first two elements of the reform were addressed through legislation approved in late 2003. New legislation (either a new law or an amendment) will be submitted to congress by end-March 2005, and is expected to be approved by end-June 2005 (performance criteria).<sup>10</sup> The authorities will also continue making their contributions to the deposit

| Paraguay: Structural Reform Agenda Originally Scheduled for the Fourth SBA Review |                                |  |   |
|---|--------------------------------|--|---|
| Reform Area   | Conditionality (Original Date) | Objective  | Status  |
| 1. Banking  | PC (Dec 2004)                  | Approval of comprehensive banking law                          | <u>Modified.</u> Revised legislation to be approved by June 2005                    |
| 2. Governance   | PC (Dec 2004)                  | Independent audit for ANNP, CONATEL, DINAC, INC, IPS, PETROPAR | <u>Modified.</u> Audit for ANNP, DINAC, INC, PETROPAR to be conducted by April 2005 |
| 3. Public Enterprises   | PC (Dec 2004)                  | Adjustment in fuel and utility prices to reflect costs         | <u>Partly Done.</u> Fuel prices adjusted in October 2004                            |
| 4. Public Enterprises   | Benchmark (Dec 2004)           | Plans for private capital participation                        | <u>Modified.</u> Plans to be presented in August 2005                               |
| 5. Banking  | Benchmark (Dec 2004)           | Introduce prudential regulations to cooperatives               | <u>Modified.</u> Plans to be done by March 2005                                     |
| 6. Banking  | Benchmark (Dec 2004)           | Require all banks to obtain international risk rating          | <u>Modified.</u> To be considered once bank legislation in place                    |

Sources: Paraguayan authorities and Fund staff.

<sup>9</sup> Another end-December structural performance criterion is the adjustment in fuel and utility prices. Fuel prices were adjusted in October by about 11 percent; this was the third time fuel prices were adjusted this year. The staff believes that altogether these adjustments are enough to ensure profitability at PETROPAR and to be consistent with current international oil prices but will press for further domestic fuel price adjustments if world oil prices increase above the end-October 2004 level. The staff will continue monitoring PETROPAR's profitability to avoid a fiscal problem.

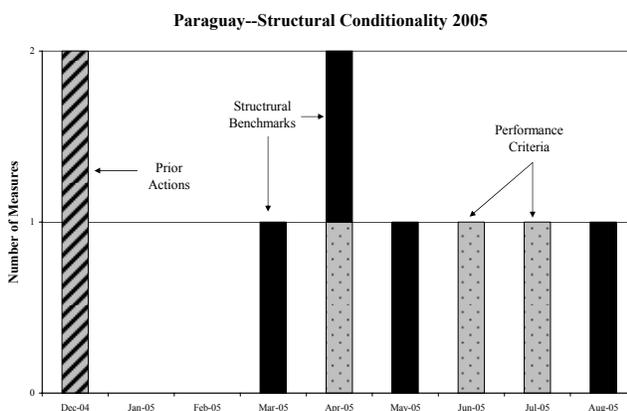
<sup>10</sup> Elements of the general banking legislation (prepared with the assistance of the World Bank) will include: introducing consolidated supervision of financial groups; increase minimum capital to financial institutions;

(continued)

guarantee fund (with a view to an early full capitalization) and will also work towards improving banking standards (§12).

- **Public banking reform.** Proposals to address simultaneously the problems of the first-tier (mostly deposit-taking) and second-tier (mostly nondeposit taking) public banks through an encompassing piece of legislation proved politically very difficult. In response to strong congressional opposition, the authorities have adopted a two-stage approach to public banking reform, which appears to have political support.

➤ *The first stage* involves the creation of a second-tier bank to intermediate external resources. A second-tier public banking law was submitted to congress in November under fast-track procedures and is expected to be approved by mid-December (prior action). This law is expected to be approved by end-May 2005 (structural benchmark).



➤ *The second stage* involves a phased restructuring of the first-tier public banks, in particular BNF. A commission will be created by end-February 2005 to oversee the restructuring process.<sup>11</sup> The commission's recommendations will be adopted by end-July 2005 and a first-tier public bank law will be submitted to congress (to supersede the temporary BNF law approved by congress in October 2004) (performance criteria) (§13).

- **Civil service reform.** The authorities are well advanced towards developing a comprehensive plan for civil reform, which is expected to be finalized by end-April 2005 (structural benchmark). The reform aims at reducing redundant positions and improve hiring practices. A comprehensive census of the public administration has been completed (finding a large number of ghost employees) (§15).

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broadening powers of the Superintendency of Bank to impose sanctions; introduce fit and proper test for bank's managers and directors.

<sup>11</sup> BNF's restructuring involves refocusing operations to rural areas, improving collection of nonperforming loan and reducing operating costs. The commission appointed to oversee its restructuring will also prepare a medium-term business plan. MFD technical assistance has been requested and will be provided for that purpose. Legislation will be drafted in consultation with the Fund and will be submitted to Congress by June 2005.

- **Public enterprise reform.** The authorities intend to complete independent audits for nine public enterprises and entities. Three have already been completed, two more will be completed by end-December 2004 and four by end-April 2005. Furthermore, these enterprises and entities will be subject to management audits to assess their performance by end-June 2005. Three of the enterprises (ESSAP, COPACO, PETROPAR) will be required to present business plans for the participation of private capital in their operations by end-August 2005 (structural benchmark) (¶16).
- **Other reforms.** This involves the recapitalization of the central bank,<sup>12</sup> a continuation of the domestic bond exchange and measures (still to be designed) to improve the investment climate (¶19).

| Paraguay: Revised Structural Reform Agenda |                      |   |
|--|----------------------|---|
| Reform Area                                | Conditionality       | Objective   |
| 1. Banking                                 | Prior Action         | Approve public banking law (2nd-tier) by one chamber                                |
| 2. Governance                              | Prior Action         | Independent audit for ESSAP   |
| 3. Banking                                 | Benchmark (Mar 2005) | Introduce prudential regulations to cooperatives                                    |
| 4. Governance                              | PC (Apr 2005)        | Independent audit for ANNP, DINAC, INC, PETROPAR                                    |
| 5. Civil Service                           | Benchmark (Apr 2005) | Finalize plan for comprehensive reform  |
| 6. Banking                                 | Benchmark (May 2005) | Approval of public banking law (2nd-tier)   |
| 7. Banking                                 | PC (Jun 2005)        | Approval of comprehensive banking legislation                                       |
| 8. Banking                                 | PC (Jul 2005)        | Submission of public banking law (1st-tier). Adopt the commission's recommendations |
| 9. Public Enterprises                      | Benchmark (Aug 2005) | Plans for private capital participation ESSAP, COPACO, PETROPAR                     |

Sources: Paraguayan authorities and Fund staff.

## F. Program Monitoring

21. **Waivers.** The authorities are requesting waivers for four performance criteria (PC) (2 quantitative and 2 structural): (i) the wage bill was missed by a small margin (by about 1 percent) because congress approved a wage increase to the judicial system (after a three year wage freeze); (ii) the continuous non-accumulation of arrears was breached because of a small delay in paying France; (iii) one of the three audits of public enterprises was not completed on time due to legal ambiguities regarding the company's assets (end-September), this has now been resolved; and (iv) the public banking law was not approved (end-October), the strategy has been modified and a new approach adopted, which would achieve the original reform objective.
22. **Conversion.** The authorities request that the indicative target on the fiscal balance of the central administration for end-December 2004 be converted to a performance criterion.
23. **Extension, reviews and rephasing.** The authorities request a six-month extension to end-September 2005 to be able to implement their structural reform agenda. They intend to

<sup>12</sup> This is part of the Memorandum of Understanding between the ministry of finance and the central bank signed in July 2004. Central bank losses are significant and the ministry of finance has agreed to a gradual recapitalization through annual capital injections in the next few years. The first one will take place in 2005.

continue to treat the arrangement as precautionary. This would entail two additional reviews (the fifth and sixth) to be completed by mid-June and mid-September. The two remaining purchases for SDR 6 million are proposed to be rephased to four purchases for SDR 3 million.

24. **Modification.** The authorities are requesting the modification of four performance criteria for end-December 2004: (i) the ceiling on the wage bill from G 2.98 trillion to G 3.01 trillion reflecting the wage increase to the judicial system; (ii) the ceiling on the floating debt from G 0.25 trillion to G 0.32 trillion due to the normal budgetary process which commits all budgeted appropriations by end-year; (iii) approval of the comprehensive banking law, now expected for end-June 2005; and (iv) audits for four public enterprises and entities, now expected for end-April 2005.<sup>13</sup>

25. **Adjustor.** A fiscal adjustor on tax revenue overperformance is being introduced. The fiscal floor will be increased by 30 percent of any tax revenue overperformance.

26. **Conditionality.** There will be 8 quantitative performance criteria each quarter and nine structural measures during the remainder of the arrangement as follows:

- **Prior actions.** There are two: (i) approval of the second-tier public banking law by at least one chamber; and (ii) completion of ESSAP independent audit.
- **Quantitative performance criteria.** With significant progress in normalizing relations with creditors, payment of all external arrears and significant reductions in domestic floating debt, three performance criteria will not apply after end-December 2004: (i) the ceiling on external debt arrears (as it is already zero); (ii) the sub-ceiling on external payments arrears to bilateral sources (also zero); and (iii) the ceiling on central government floating debt (as it reached normal levels). Quantitative performance criteria are established for end-March 2005 and end-June 2005.
- **Structural performance criteria.** There are three structural PCs: (i) independent audits for ANNP, DINAC, INC, PETROPAR by end-April 2005; (ii) approval of the comprehensive banking legislation by end-June 2005; and (iii) submission of the first-tier public banking law by end-July 2005.
- **Structural benchmarks.** There are four benchmarks: (i) introduce prudential regulations to cooperatives (end-March 2005); (ii) finalize the plan for a civil service reform (end-April 2005); (iii) approval of a second-tier public banking law (end-May); and (iv) present plans for private capital participation in ESSAP, COPACO, and PETROPAR (end-August 2005). A former benchmark requiring all banks to obtain international risk rating was dropped as the staff no longer sees a pressing need for this requirement.

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<sup>13</sup> The end-December test date will continue to apply for the other two public entities (CONATEL and IPS).

### III. MEDIUM-TERM SCENARIO, RISKS, AND CAPACITY TO REPAY THE FUND

27. **The medium-term outlook underscores the importance of further structural reforms to secure sustained increases in per capita income growth and reduce poverty.** Under a scenario with continued prudent macroeconomic policies, but with no additional structural reforms beyond this program, growth is projected to be only around 2 percent. This growth rate—similar to that of the last two decades—would result in stagnation in per capita income. Higher growth rates will require further structural reforms. The staff believes that under a scenario of prudent macro policies and deepened structural reform, the growth rate of the economy could be doubled to reach some 4 percent a year. The fiscal adjustment planned under the program would assure fiscal sustainability, with the public accounts remaining near balance and the debt-to-GDP ratio declining to around 30 percent by 2009.

28. **Paraguay's capacity to repay the Fund is strong.** The staff believes the risk of nonpayment to the Fund, in the event purchases are made under the precautionary arrangement, is negligible given the improvements under the program to Paraguay's fiscal and external positions, its payment capacity, and in view of the fact that overall public debt service is low and debt service to the Fund would be small.

29. **Notwithstanding the success of the program so far, risks remain.** Political support for further reform may be waning and could be insufficient to permit passage of key structural reform legislation. There have been some signs of social unrest, which could push policy makers to follow a more expansionary policy and put at risk the macroeconomic stability achieved over the past year. Rising global interest rates, or a slowdown in the U.S. economy, could affect economic activity in Paraguay. Further increases in oil prices would put pressure on the current account. A high level of credit by BNF may undermine the monetary program.

### IV. STAFF APPRAISAL

30. **Paraguay's performance under the program has been strong, despite significant delays in implementing the structural reform agenda in the second half of 2004.** The authorities have met most quantitative performance criteria, and those not observed were missed by narrow margins. On the structural side, despite being in a minority in congress, the authorities have succeeded in winning passage of several key pieces of economic legislation over the last 12 months, including the fiscal adjustment law, the customs code, the bank resolution law, and public pension reform law. The heavy structural reform agenda under the program—combined with a difficult political environment—led to significant delays recently, especially for measures requiring congressional approval.

31. **Macroeconomic performance has been better than anticipated under the program, although domestic concerns continue about slow growth, high unemployment, and continuing high poverty and inequalities.** Economic growth is expected to reach 2½ percent in 2004 despite a drought. The staff estimates that growth would have been ½–1 percent higher in the absence of the drought. At the same time, other key program objectives were comfortably achieved. Inflation was reduced significantly and is expected to

be well below program projections; international reserves increased rapidly beyond program expectations; interest rates fell to pre-crisis levels; and the *guaraní* stabilized. However, the unemployment rate is still almost 20 percent and high poverty is widespread with about half of the population living with less than US\$2 a day.

32. **An extension of the SBA would allow the authorities to consolidate macroeconomic gains achieved so far, while completing key structural measures in the program.** The original SBA was effective in stabilizing the economy but proved too short for completion of the authorities' ambitious reform agenda. It will be important to use the period of the extension to advance that agenda to promote sustainable growth and poverty reduction, while preserving the gains in terms of macroeconomic stability.

33. **In particular, staff urges the authorities to move ahead as planned with public banking reform, a key element of the structural agenda.** There are political challenges involved in this reform. Staff supports the authorities' revised strategy, which is an appropriately flexible response to these challenges, but political risks remain. In addition, while staff acknowledges the benefits of improving credit availability to support growth, staff is concerned that the recently approved legislation for the BNF could allow for a resumption of unsustainable lending practices. There are some mechanisms in place, such as a more intensive review process for larger loans, which can mitigate this risk. It will also be important that the authorities monitor BNF lending particularly closely in the run-up to its reform, aimed at strengthening the bank by refocusing its operations, recovering assets and reducing costs. It will be important for the public bank reform process to move forward expeditiously, since legislation will be required both to override the temporary BNF law and to change its management structure.

34. **Fiscal policy has been placed on a sustainable path.** The fiscal outlook improved significantly following the major improvements in tax administration and the approval of the fiscal adjustment law. The overall fiscal balance will move into surplus in 2004 for the first time in many years. At the same time the government has eliminated sizable arrears, and taken decisive steps toward normalizing relations with all creditors. Tax collections are expected to increase by about 2 percentage points of GDP to 11½ percent in 2004. Expenditures have been kept in check, although capital outlays remain low. The stock of public debt—which had increased rapidly over the past 7 years—is now on a declining trend. For 2005, the authorities are pursuing a balanced overall budget, with an increase in capital expenditure, on high quality investment projects, to be financed by continued high revenues.

35. **Monetary policy has been effective in containing inflation while allowing for rapid reserve accumulation.** The inflation rate is being contained to below the program objective of 8 percent in 2004. Staff estimates that inflation will not be higher than 6 percent this year even after adjustments in administered prices. Monetary management was complicated by large capital inflows, which threatened to generate rapid monetary expansion (and possible inflationary pressures), or a sharp appreciation of the currency, which could jeopardize the fragile recovery. In order to minimize the risks, the central bank has pursued an active sterilization policy, assisted by significant increases in the demand for money, while accumulating international reserves. For 2005, the authorities have established an

inflation objective of 6 percent and intend to use interest and exchange rate policy more flexibly. The staff urges the authorities to monitor closely the credit extended by BNF and be ready to take steps as necessary to contain its expansion so as not to threaten the monetary program.

36. **The government will need to continue building consensus for structural reform and macro stability to safeguard the program and promote sustainable growth.** Lack of political consensus on the direction and speed of structural reform poses the greatest risk to the program. There have also been signs of social unrest in rural and urban areas which could put pressure on the authorities to loosen fiscal policy.

37. **The staff supports completion of the third review under the SBA.** In light of the authorities' strong commitment to the program and relatively good performance so far, the staff supports completion of the review, the request for an SBA extension, the waivers request, and the proposed modifications to the program.

### **Box 1. Paraguay: The Restructuring of the BNF**

**The National Development Bank (BNF) is the largest public financial institution.** Its assets are equivalent to 9 percent of financial sector assets. Over the years, the BNF has incurred losses arising mainly from nonperforming loans to politically-connected borrowers and nonviable sectors, equivalent to 55 percent of the loan portfolio. Liquidity problems have been masked by the transfer of public sector deposits (60 percent of deposits at the BNF), especially from social security funds. Compliance with prudential solvency requirements has been made possible by the absorption by the government of foreign loan obligations, the application of provisions in the BNF charter mandating the coverage by the ministry of finance of losses from agricultural loans (Law 281), and outright government transfers.

**The rationalization of the BNF would help address moral hazard risks and contain fiscal outlays** arising from the cost of the bank's large bureaucracy, inefficiency, and lack of strategic focus. In this regard, the government envisaged implementing a plan aiming at consolidating the eight existing public institutions into two institutions, in line with the World Bank's and the IDB's recommendations: A public second-tier institution that would channel mainly concessional resources from abroad (first stage) and a first-tier public bank (comprising the BNF and the other five public institutions) that would target small borrowers primarily in the agricultural sector without access to credit from private financial institutions, taking advantage of the BNF's extensive branch network (52 branches) (second stage). Loans would be subject to strict ceilings, aggregate nonperforming loans would be liquidated by private contractors, and both first- and second-tier institutions would be subject to stringent corporate governance, with no state guarantees or favorable tax treatment.

**The transition towards public bank reform was supported by Law 2100 of June 2003, which modified some articles of the BNF charter, by establishing credit ceilings.** The ceilings ranged between US\$15,000 and US\$100,000, narrowing the focus of the BNF to agricultural loans and authorizing the ministry of finance to liquidate nonperforming assets by contracting out private asset managers (still not implemented). A new management removed interest rate subsidies, made some effort on loan recovery, and embarked on a drastic reorganization. However, congress approved in October 2004 modifications of key provisions that would expand the scope of BNF operations and raise lending ceilings. These modifications would complicate the banking reform process.

**Before the legal framework for public bank reform is finally enacted, the government can start taking immediate steps toward the restructuring of the BNF.** These measures include consolidating the BNF as a specialized institution providing small credits in rural areas, appointing a commission to study the best way to deal with portfolio recovery, reducing cost and recapitalizing the bank, transferring non-performing assets to a separate management unit through a bidding process, and gradually reallocating public sector deposits at the BNF. The restructuring of the BNF should focus on the rationalization of genuine BNF liabilities and yield-earning assets.

## **Box 2. The Comprehensive Banking Law**

**The government has prepared a draft banking law that upgrades Paraguay's prudential regulatory framework.** Approval of the law would allow a significant improvement of banking supervision in several fronts, namely: (a) it would grant powers to exercise consolidated supervision over members of a financial group by including a legal definition of financial groups; (b) it would upgrade governance rules to enhance accountability of bank managers, directors, shareholders, auditors, attorneys and personnel; (c) it would increase minimum capital requirements in line with international standards, (d) it would allow establishing a higher minimum capital adequacy ratio if it is determined that a particular institution is exposed to higher risk; and (e) it would allow the imposition of sanctions at the initiative of the superintendency for infractions.

**The banking community has expressed a number of concerns with this draft legislation.** Paraguayan financial institutions are apprehensive about (a) their capability to increase their minimum capital from about US\$1.5 million to US\$4.5 million for banks, and to US\$2.3 million for other financial institutions, in the period of five years envisaged in the draft law; (b) the enhanced discretion granted to the superintendency over the central bank board; and (c) the extent of accountability by directors and shareholders. Some members of the cabinet reportedly share these reservations and an updated draft banking law is being prepared at the moment.

**An earlier provision in the draft banking law allowed the superintendency to regulate the cooperatives; however, this provision was subsequently discarded.** The new law ratifies the broad scope for prudential supervision implicit in the current Banking Law (Law 861/96), which allows the superintendency to regulate and supervise all deposit-taking institutions. The authorities attempted to make these provisions explicit for the regulation of large cooperatives, given their systemic importance. However, this measure was strongly opposed by the cooperative sector and was ultimately discarded by the cabinet. Recently, a special law was approved allowing for self-regulation of the cooperative sector under the coordination of the National Cooperative Institute (INCOOP). However, the new banking law would still maintain general provisions to allow the superintendency to undertake prudential action, if necessary, to address problems in any deposit-taking institution.

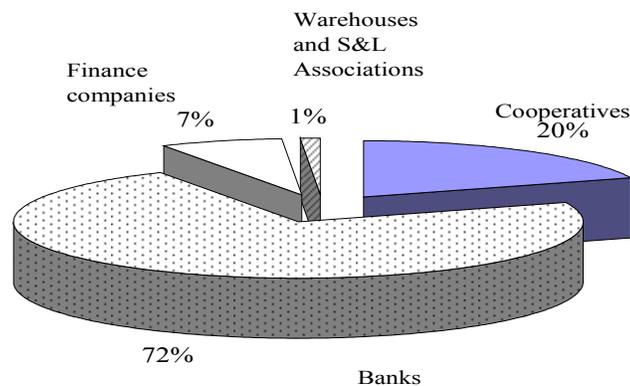
**Bank resolution and deposit insurance had already been dealt with in a separate legislation in December 2003.** An important component of the current Banking Law has already been modified by the approval of a new banking resolution law in 2003 (Law 2334/03). The new law establishes deposit guarantee coverage for up to 75 times the minimum monthly wage (about US\$12,000) for private financial institutions, defines the triggers for the adoption of a regularization plan and describes the steps within the regularization process prior to final resolution. Provisions in the new banking resolution law were tested during the intervention of a small finance company (*Financentro*), whose assets and liabilities would be acquired by a domestic bank. Some implementation problems were associated with the transition to the new scheme, lack of coordination between the central bank and the ministry of finance on the funding of the deposit guarantee, and the pending issuance of regulations on procedures.

### Box 3. Paraguay: The Cooperative Sector

**The cooperative sector, with 20 percent of financial assets, plays an important economic and social role in Paraguay.** Three types of cooperatives—financial, production, and other cooperatives—exist. Financial cooperatives provide micro-credit to its members. The production cooperatives finance agricultural and dairy products, and other cooperatives provide goods, services, and employment. There are about 820 registered cooperatives, out of which 525 are financial cooperatives and 200 are production cooperatives. However, preliminary data show that more than half of the cooperatives have ceased operations.

**The largest 25 financial cooperatives, with 356,000 members, accounted for 80 percent of financial cooperative assets in 2002.** These institutions are highly liquid, with a CAR of 34 percent. With the excess liquidity, financial cooperatives tend to finance production cooperatives.

Figure 1 . Financial Institutions Market Share



Source: INCOOP, Superintendency of Banks, and IMF staff estimates.

**The assets of the largest 25 financial cooperatives have more than doubled since 1998.** Because of several banking crises, the public started to shift savings from the banking system to the cooperative sector. Consequently, some cooperatives began to provide services that previously were offered only by banks, except for checking accounts and foreign exchange operations. In contrast to banks, cooperatives conduct most of their operations in local currency.

**The cooperatives can pay more attractive interest rates than other financial institutions because they are exempt from VAT and from legal reserve requirements.** While cooperatives pay 4–8 percent on sight deposits, banks pay about 2 percent. Moreover, the higher interest rates on fixed-term deposits in the cooperatives encouraged the public to place their financing at longer-term maturities. Only 23 percent of banking deposits are placed at fixed term, whereas 60 percent of cooperative deposits are at fixed terms. Moreover, lending interest rates in the cooperatives are about 10 percentage points lower than in banks.

**Until recently, financial activities of cooperatives have been partially unregulated and unsupervised.** The supervisory authority for cooperatives, INCOOP, has begun to take steps to introduce supervision of cooperatives by March 2005. It has requested assistance from the World Council of Credit Unions, the German Cooperative Federation, the World Bank, and the superintendency of banks on the following issues:

- Implementing prudential norms
- Designing balance sheets
- Incorporating the cooperatives into the credit rating agency
- Providing training
- Implementing money laundering regulations
- Setting a deposit insurance guarantee

INCOOP expects to approve the new regulations and norms in line with international best practices for cooperatives by mid-December and to start their gradual implementation by beginning of 2005.

Table 1. Paraguay: Quantitative Performance Criteria

|   | SBA      |        |          |        |          |        |          |        |          |        |           |        |
|---|----------|--------|----------|--------|----------|--------|----------|--------|----------|--------|-----------|--------|
|   | 2003     |        |          |        |          | 2004   |          |        |          |        | Extension |        |
|   | End-Dec. |        | End-Mar. |        | End-Aug. |        | End-Dec. |        | End-Mar. |        | Jun. 30   |        |
|   | Adj.     | Target | Actual   | Adj.   | Target   | Actual | Adj.     | Target | Actual   | Target | Target    | Target |
| <b>Fiscal targets</b>   |          |        |          |        |          |        |          |        |          |        |           |        |
| Overall balance of the central administration (floor, in billions of guaranies) 1/2/                    | -125     | -100   | 240      | 523    | 430      | 1,010  |          |        | 55       | 105    | 111       |        |
| Wage bill of the central administration (ceiling, in billions of guaranies) 2/                          | 2,750    | 2,724  | 650      | 668    | 1,791    | 1,812  |          |        | 3,010    | 754    | 1,525     |        |
| Overall balance of the public sector (floor, in billions of guaranies) 1/2/                             | -321     | 33     | 250      | 678    | 500      | 1,611  |          |        | 130      | 174    | 310       |        |
| <b>Monetary targets</b>   |          |        |          |        |          |        |          |        |          |        |           |        |
| Net international reserves (floor, in millions of U.S. dollars) 3/                                      | 812      | 983    | 773      | 1,016  | 1,057    | 1,141  |          |        | 1,080    | 1,120  | 1,180     |        |
| Net domestic assets (ceiling, in billions of guaranies) 3/  | -2,852   | -3,969 | -2,839   | -4,264 | -4,444   | -5,231 |          |        | -4,090   | -4,614 | -5,197    |        |
| <b>Public debt and arrears targets</b>  |          |        |          |        |          |        |          |        |          |        |           |        |
| Contracting or guaranteeing of nonconcessional external debt by the NFPS (ceiling, in millions of US\$) | 50       | 0      | 50       | 0      | 200      | 0      |          |        | 200      | 200    | 200       |        |
| External payments arrears of NFPS (ceiling, in millions of US\$) 4/                                     | 102      | 91     | 75       | 75     | 5        | 3      |          |        | 0        | ...    | ...       |        |
| <i>Of which: bilateral arrears 4/</i>   | 51       | 43     | 38       | 12     | 0        | 0      |          |        | 0        | ...    | ...       |        |
| Central government floating debt (ceiling, in billions of guaranies) 4/                                 | 360      | 400    | 350      | 228    | 297      | 235    |          |        | 320      | ...    | ...       |        |
| Contracted or guaranteed short-term external debt by the NFPS 5/  | 0        | 0      | 0        | 0      | 0        | 0      |          |        | 0        | 0      | 0         |        |
| External debt arrears 5/  | 0        | 0      | 0        | 0      | 0        | 0      |          |        | 0        | 0      | 0         |        |

1/ The target is adjusted upward by 30 percent of the overperformance in tax revenues for 2005 as specified in the TMU.

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

3/ NIR is adjusted upward (downward) for any increase (decrease) in reserve requirement deposits and upward by the amount of any program disbursements.

4/ Similarly, the NDA target will be adjusted downward (upward) following the adjustment in the NIR.

5/ These performance criteria will not apply in 2005.

6/ Measured on a continuous basis.

Table 2. Paraguay: Structural Conditionality for the Third and Fourth Review Under the Program

| Measure   | Conditionality | Timing             | Status and Comments   |
|---|----------------|--------------------|---|
| <b>I. Third Review</b>  |                |                    |   |
| <b>Financial Sector Reform</b>  |                |                    |   |
| A. Application of international accounting standards to Central Bank    | SB             | June 30, 2004      | <u>Done</u> . IAS applied in July   |
| B. Begin Application of restructuring plan in the Central Bank          | SB             | July 30, 2004      | <u>Done</u> . BCP restructuring began in September  |
| C. Approval of public banking law                                       | PC             | October 31, 2004   | <u>Not done</u> . Waiver requested, change of strategy  |
| <b>Public Sector Reform</b>   |                |                    |   |
| D. Develop a plan for comprehensive civil service reform                | SB             | October 31, 2004   | <u>Partly done</u> . Census of civil servants completed, plan well advanced                           |
| E. Increase data publication for government and state-owned enterprises | SB             | September 30, 2004 | <u>Partly done</u> . Ministry of Finance published some data  |
| <b>Public Enterprises Reform</b>  |                |                    |   |
| F. Independent audit for ANDE, ESSAP, and COPACO                        | PC             | September 30, 2004 | <u>Partly done</u> . Waiver requested, ANDE and COPACO completed in time, ESSAP completed in December |
| <b>II. Fourth Review</b>  |                |                    |   |
| <b>Financial Sector Reform</b>  |                |                    |   |
| G. Approval of new comprehensive banking legislation                    | PC             | December 31, 2004  | <u>Modified</u> . Revised legislation to be approved by June 2005                                     |
| H. Introduce prudential regulations to cooperatives                     | SB             | December 31, 2004  | <u>Modified</u> . Plans to be done by March 2005  |
| I. Require all banks to obtain international risk rating                | SB             | December 31, 2004  | <u>Modified</u> . To be considered once banking legislation is in place                               |
| <b>Public Enterprises Reform</b>  |                |                    |   |
| J. Adjustment in fuel and utility prices to reflect costs               | PC             | January 1, 2005    | <u>Partly done</u> . Fuel prices adjusted in October 2005   |
| K. Independent audit for ANNP, CONATEL, DINAC, INC, IPS, and PETROPAR   | SB             | December 31, 2004  | <u>Modified</u> . Audit for ANNP, DINAC, INC, PETROPAR to be conducted by April 2005                  |
| L. Plan for private capital participation                               | SB             | December 31, 2004  | <u>Modified</u> . Plans to be presented in August 2005  |

Sources: Paraguayan authorities; and Fund staff estimates.

SB = structural benchmarks  
PC = performance criteria

Table 3. Paraguay: Selected Economic Indicators, 2001–05

|  | 2001   | 2002   | 2003   | 2004     |        | Proj.<br>2005 |
|--|--------|--------|--------|----------|--------|---------------|
|  |        |        |        | Prog. 1/ | Proj.  |               |
| (Annual percent change; unless otherwise specified)  |        |        |        |          |        |               |
| <b>National accounts and prices</b>                  |        |        |        |          |        |               |
| GDP at current prices                                | 4.4    | 13.7   | 21.4   | 9.3      | 7.2    | 7.5           |
| GDP at constant prices                               | 2.7    | -2.3   | 2.6    | 2.4      | 2.6    | 3.2           |
| Per capita GDP (U.S. dollars, thousands)             | 1.2    | 1.0    | 1.0    | 1.0      | 1.2    | 1.2           |
| Consumption  | 6.2    | -5.1   | 3.5    | 2.4      | 3.3    | 2.0           |
| Investment   | -17.5  | -11.0  | 7.0    | 7.6      | 1.1    | 13.1          |
| Net exports (contribution to growth)                 | 0.4    | 4.4    | -1.8   | -0.8     | -0.7   | -0.7          |
| Exports  | -0.4   | 14.3   | 13.2   | 0.2      | 4.9    | 5.7           |
| Imports  | -1.6   | -6.3   | 15.4   | 3.0      | 5.5    | 6.0           |
| Consumer prices (average)                            | 7.3    | 10.5   | 14.2   | 7.5      | 5.2    | 6.0           |
| Consumer prices (end-of-period)                      | 8.4    | 14.6   | 9.3    | 8.0      | 6.0    | 6.0           |
| Real effective exchange rate 2/                      |        |        |        |          |        |               |
| Average (depreciation -)                             | -4.4   | -1.2   | -6.6   | ...      | 8.7    | ...           |
| End-of-period (depreciation -)                       | -14.6  | -2.6   | 9.5    | ...      | 3.4    | ...           |
| (In millions of U.S. dollars)                        |        |        |        |          |        |               |
| <b>External sector</b>                               |        |        |        |          |        |               |
| Exports, f.o.b. (percentage change)                  | -18.9  | -1.6   | 21.8   | 4.8      | 21.4   | 3.0           |
| Imports, c.i.f. (percentage change)                  | -12.7  | -14.6  | 18.0   | 3.2      | 22.7   | 6.2           |
| Net oil exports and imports                          | 315    | 243    | 331    | ...      | 410    | 510           |
| Current account                                      | -266   | 97     | 146    | 26       | 63     | -27           |
| (in percent of GDP)                                  | -3.9   | 1.7    | 2.4    | 0.4      | 0.9    | -0.4          |
| Capital account                                      | 150    | 65     | 222    | 116      | 166    | 66            |
| Overall balance                                      | -45    | -83    | 212    | 141      | 302    | 39            |
| Terms of trade (percentage change)                   | -0.3   | 6.9    | 8.4    | -4.8     | 4.4    | -5.4          |
| (In percent of GDP)                                  |        |        |        |          |        |               |
| <b>Savings-investment balance</b>                    |        |        |        |          |        |               |
| Gross domestic investment                            | 19.8   | 19.1   | 19.8   | 18.7     | 20.3   | 21.3          |
| Private sector                                       | 14.7   | 13.2   | 15.1   | 13.1     | 15.8   | 14.1          |
| Public sector  | 5.1    | 5.9    | 4.7    | 5.6      | 4.5    | 7.2           |
| Gross national savings                               | 15.9   | 20.8   | 22.2   | 19.1     | 21.2   | 21.0          |
| Private sector                                       | 14.8   | 18.4   | 18.0   | 13.8     | 14.0   | 14.0          |
| Public sector  | 1.1    | 2.4    | 4.2    | 5.3      | 7.2    | 7.0           |
| <b>Public sector</b>                                 |        |        |        |          |        |               |
| Central government primary balance                   | 0.2    | -1.7   | 0.9    | 1.5      | 2.2    | 0.7           |
| Central government overall balance                   | -4.4   | -2.3   | -0.2   | 0.1      | 1.4    | -0.5          |
| Consolidated public sector primary balance 3/        | 1.0    | -1.3   | 2.4    | 2.2      | 4.4    | 1.4           |
| Consolidated public sector overall balance 3/        | -3.3   | -3.1   | -0.1   | 0.3      | 2.7    | 0.0           |
| Public sector debt (end-of-year)                     | 36.8   | 48.4   | 46.8   | 45.6     | 39.0   | 38.1          |
| External   | 33.5   | 42.9   | 43.5   | 42.6     | 36.5   | 36.0          |
| Domestic   | 3.4    | 5.5    | 3.3    | 3.0      | 2.5    | 2.0           |
| (Annual percent change)                              |        |        |        |          |        |               |
| <b>Money and credit</b>                              |        |        |        |          |        |               |
| Monetary base  | 5.8    | -1.0   | 57.7   | 3.2      | 19.0   | 8.2           |
| M2   | 4.9    | -2.2   | 24.9   | 17.0     | 13.4   | 10.7          |
| M5 4/  | 1.5    | -18.5  | 17.7   | 14.4     | 8.9    | 8.3           |
| Credit to the private sector 4/                      | -1.0   | -21.0  | -18.6  | 12.7     | 15.6   | 10.2          |
| Velocity of M2                                       | 7.3    | 8.2    | 9.0    | 7.6      | 8.1    | 7.8           |
| <b>Memorandum items:</b>                             |        |        |        |          |        |               |
| International reserves (in millions of U.S. dollars) | 723    | 641    | 983    | 855      | 1,180  | 1,220         |
| (In months of imports)                               | 3.5    | 2.7    | 3.4    | 4.5      | 3.9    | 4.0           |
| GDP (in billions of guaranies)                       | 28,119 | 31,977 | 38,806 | 40,779   | 41,601 | 44,516        |
| Population (millions)                                | 5.6    | 5.7    | 5.9    | 6.1      | 6.1    | 6.2           |

Sources: Paraguayan authorities; and Fund staff estimates.

1/ Revised program (Country Report No.05/59).

2/ For 2004, information through August.

3/ Consolidated public sector, including the quasi-fiscal operations of the BCP.

4/ Foreign currency items are valued at a constant exchange rate.

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

|  | 2001         | 2002         | 2003         | 2004         |               |              |               | 2005         |              |              |
|--|--------------|--------------|--------------|--------------|---------------|--------------|---------------|--------------|--------------|--------------|
|  |              |              |              | Jan.-Aug.    |               | Year         |               | Proj.        |              |              |
|  |              |              |              | Prog. 2/     | Actual        | Prog. 1/     | Proj.         | Q1           | Q2           | Year         |
| (In billions of guaranies)                   |              |              |              |              |               |              |               |              |              |              |
| <b>Revenue</b>                               | <b>5,984</b> | <b>6,160</b> | <b>7,450</b> | <b>5,376</b> | <b>5,718</b>  | <b>8,306</b> | <b>8,753</b>  | <b>2,141</b> | <b>2,353</b> | <b>9,665</b> |
| Tax revenue                                  | 2,855        | 2,926.9      | 3,676        | 2,790        | 3,147         | 4,384        | 4,809         | 1,175        | 1,277        | 5,098        |
| Nontax revenue and grants                    | 2,936        | 3,117        | 3,617        | 2,426        | 2,559         | 3,705        | 3,887         | 952          | 1,061        | 4,505        |
| Capital revenue                              | 193          | 116          | 156          | 160          | 13            | 217          | 57            | 15           | 15           | 62           |
| <b>Current expenditure</b>                   | <b>5,464</b> | <b>5,763</b> | <b>6,246</b> | <b>4,125</b> | <b>4,079</b>  | <b>6,626</b> | <b>6,727</b>  | <b>1,665</b> | <b>1,826</b> | <b>7,532</b> |
| Wages and salaries                           | 2,928        | 3,095        | 3,290        | 2,178        | 2,193         | 3,508        | 3,609         | 901          | 918          | 3,957        |
| Goods and services                           | 503          | 572          | 634          | 427          | 371           | 752          | 707           | 153          | 207          | 816          |
| Interest payments                            | 485          | 603          | 728          | 513          | 449           | 776          | 689           | 136          | 189          | 660          |
| Transfers                                    | 1,340        | 1,455        | 1,544        | 986          | 1,049         | 1,492        | 1,669         | 438          | 475          | 1,952        |
| Other  | 209          | 39           | 51           | 23           | 16            | 98           | 53            | 37           | 37           | 146          |
| <b>Capital expenditure and net lending</b>   | <b>1,430</b> | <b>1,875</b> | <b>1,818</b> | <b>1,177</b> | <b>615</b>    | <b>2,231</b> | <b>1,876</b>  | <b>591</b>   | <b>722</b>   | <b>3,217</b> |
| Capital expenditure                          | 1,442        | 1,754        | 1,849        | 1,256        | 761           | 2,350        | 2,074         | 614          | 745          | 3,309        |
| Minus: capital transfers from CG             | -39          | -47          | -48          | -40          | -49           | -60          | -86           | -23          | -23          | -92          |
| Net lending by BCP                           | 27           | 168          | 17           | -40          | -96           | -60          | -111          | 0            | 0            | 0            |
| <b>Public enterprises' operating surplus</b> | <b>712</b>   | <b>458</b>   | <b>801</b>   | <b>429</b>   | <b>578</b>    | <b>680</b>   | <b>951</b>    | <b>289</b>   | <b>331</b>   | <b>1,063</b> |
| Statistical discrepancy 3/                   | -733         | 35           | -207         | 0            | 9             | 0            | 16            | 0            | 0            | 0            |
| <b>Overall balance</b>                       | <b>-931</b>  | <b>-986</b>  | <b>-21</b>   | <b>500</b>   | <b>1,611</b>  | <b>130</b>   | <b>1,116</b>  | <b>174</b>   | <b>136</b>   | <b>-21</b>   |
| <b>Financing</b>                             | <b>931</b>   | <b>986</b>   | <b>21</b>    | <b>-500</b>  | <b>-1,611</b> | <b>-130</b>  | <b>-1,116</b> | <b>-174</b>  | <b>-136</b>  | <b>21</b>    |
| External financing net                       | 20           | 19           | 460          | -96          | -133          | 439          | 111           | -28          | 110          | 293          |
| Domestic financing net                       | 389          | -157         | -24          | 228          | -632          | 224          | -513          | -147         | -246         | -273         |
| Of which: quasi-fiscal deficit financing     | 348          | 394          | 390          | 139          | 87            | 220          | 212           | 62           | 64           | 260          |
| Net change in arrears                        | 522          | 1,124        | -415         | -632         | -846          | -793         | -767          | 0            | 0            | 0            |
| (In percent of GDP)                          |              |              |              |              |               |              |               |              |              |              |
| <b>Revenue</b>                               | <b>21.3</b>  | <b>19.3</b>  | <b>19.2</b>  | <b>19.8</b>  | <b>20.6</b>   | <b>20.0</b>  | <b>21.5</b>   | <b>19.2</b>  | <b>21.1</b>  | <b>21.7</b>  |
| Tax revenue                                  | 10.2         | 9.2          | 9.5          | 10.3         | 11.3          | 10.5         | 11.8          | 10.6         | 11.5         | 11.5         |
| Nontax revenue and grants                    | 10.4         | 9.7          | 9.3          | 8.9          | 9.2           | 8.9          | 9.5           | 8.5          | 9.5          | 10.1         |
| Capital revenue                              | 0.7          | 0.4          | 0.4          | 0.6          | 0.0           | 0.5          | 0.1           | 0.1          | 0.1          | 0.1          |
| <b>Current expenditure</b>                   | <b>19.4</b>  | <b>18.0</b>  | <b>16.1</b>  | <b>15.2</b>  | <b>14.7</b>   | <b>15.9</b>  | <b>16.5</b>   | <b>15.0</b>  | <b>16.4</b>  | <b>16.9</b>  |
| Wages and salaries                           | 10.4         | 9.7          | 8.5          | 8.0          | 7.9           | 8.4          | 8.9           | 8.1          | 8.2          | 8.9          |
| Goods and services                           | 1.8          | 1.8          | 1.6          | 1.6          | 1.3           | 1.8          | 1.7           | 1.4          | 1.9          | 1.8          |
| Interest payments                            | 1.7          | 1.9          | 1.9          | 1.9          | 1.6           | 1.9          | 1.7           | 1.2          | 1.7          | 1.5          |
| Transfers                                    | 4.8          | 4.5          | 4.0          | 3.6          | 3.8           | 3.6          | 4.1           | 3.9          | 4.3          | 4.4          |
| Other  | 0.7          | 0.1          | 0.1          | 0.1          | 0.1           | 0.2          | 0.1           | 0.3          | 0.3          | 0.3          |
| <b>Capital expenditure and net lending</b>   | <b>5.1</b>   | <b>5.9</b>   | <b>4.7</b>   | <b>4.3</b>   | <b>2.2</b>    | <b>5.4</b>   | <b>4.6</b>    | <b>5.3</b>   | <b>6.5</b>   | <b>7.2</b>   |
| <b>Public enterprises' operating surplus</b> | <b>2.5</b>   | <b>1.4</b>   | <b>2.1</b>   | <b>1.6</b>   | <b>2.1</b>    | <b>1.6</b>   | <b>2.3</b>    | <b>2.6</b>   | <b>3.0</b>   | <b>2.4</b>   |
| Statistical discrepancy 3/                   | -2.6         | 0.1          | -0.5         | 0.0          | 0.0           | 0.0          | 0.0           | 0.0          | 0.0          | 0.0          |
| <b>Overall balance</b>                       | <b>-3.3</b>  | <b>-3.1</b>  | <b>-0.1</b>  | <b>1.9</b>   | <b>5.8</b>    | <b>0.3</b>   | <b>2.7</b>    | <b>1.6</b>   | <b>1.2</b>   | <b>0.0</b>   |
| <b>Financing 4/</b>                          | <b>3.3</b>   | <b>3.1</b>   | <b>0.1</b>   | <b>-1.9</b>  | <b>-5.8</b>   | <b>-0.3</b>  | <b>-2.7</b>   | <b>-1.6</b>  | <b>-1.2</b>  | <b>0.0</b>   |
| External financing net                       | 0.1          | 0.1          | 1.2          | -0.4         | -0.5          | 1.1          | 0.3           | -0.2         | 1.0          | 0.7          |
| Domestic financing net                       | 3.2          | 1.6          | -0.8         | 0.6          | -2.3          | 0.5          | -1.1          | -1.3         | -2.2         | -0.6         |
| Of which: quasi-fiscal deficit financing     | 1.2          | 1.2          | 1.0          | 0.5          | 0.3           | 0.5          | 0.5           | 0.6          | 0.6          | 0.6          |
| Net change in arrears                        | 0.0          | 1.4          | -0.3         | -2.1         | -3.0          | -1.9         | -1.8          | 0.0          | 0.0          | 0.0          |
| <b>Memorandum item:</b>                      |              |              |              |              |               |              |               |              |              |              |
| Primary balance                              | 1.0          | -1.3         | 2.4          | 3.7          | 7.4           | 2.2          | 4.4           | 2.8          | 2.9          | 1.4          |

Sources: Ministry of Finance; and Fund staff estimates.

1/ Public sector comprises the nonfinancial public sector and the central bank.

2/ Revised program (Country Report No. 05/59).

3/ Measurement error to reconcile above-the-line estimate with measure of the fiscal balance from the financing side.

4/ Assumes quasi fiscal deficit of central bank entirely financed.

Table 5. Paraguay: Central Government Operations

|   | 2004          |              |              |              |               |              |              | 2005         |              |              |
|---|---------------|--------------|--------------|--------------|---------------|--------------|--------------|--------------|--------------|--------------|
|   | 2001          | 2002         | 2003         | Jan.-Aug.    |               | Year         |              | Proj.        |              |              |
|   |               |              |              | Prog. 1/     | Actual        | Prog. 1/     | Proj.        | Q1           | Q2           | Year         |
| (In billion of guaranies)                       |               |              |              |              |               |              |              |              |              |              |
| <b>Total revenues</b>                           | <b>4,892</b>  | <b>5,048</b> | <b>6,001</b> | <b>4,330</b> | <b>4,853</b>  | <b>6,794</b> | <b>7,320</b> | <b>1,761</b> | <b>1,972</b> | <b>8,137</b> |
| Tax revenues                                    | 2,851         | 2,923        | 3,676        | 2,790        | 3,143         | 4,380        | 4,805        | 1,174        | 1,276        | 5,093        |
| Nontax revenues 2/                              | 1,983         | 2,118        | 2,318        | 1,538        | 1,710         | 2,412        | 2,509        | 585          | 694          | 3,035        |
| Capital revenues                                | 57            | 7            | 7            | 2            | 1             | 3            | 6            | 2            | 2            | 9            |
| <b>Current expenditures:</b>                    | <b>4,378</b>  | <b>4,766</b> | <b>4,981</b> | <b>3,276</b> | <b>3,276</b>  | <b>5,344</b> | <b>5,407</b> | <b>1,318</b> | <b>1,477</b> | <b>6,089</b> |
| Wages and salaries                              | 2,400         | 2,582        | 2,724        | 1,791        | 1,812         | 2,980        | 3,010        | 754          | 771          | 3,328        |
| Goods and services                              | 295           | 373          | 408          | 260          | 246           | 505          | 450          | 83           | 135          | 526          |
| Interest payments                               | 378           | 456          | 489          | 353          | 325           | 562          | 466          | 113          | 166          | 561          |
| Transfers                                       | 1,270         | 1,326        | 1,334        | 860          | 884           | 1,214        | 1,454        | 361          | 398          | 1,647        |
| Other   | 35            | 29           | 26           | 13           | 9             | 83           | 26           | 7            | 7            | 26           |
| <b>Capital expenditures and net lending</b>     | <b>831</b>    | <b>1,281</b> | <b>1,165</b> | <b>623</b>   | <b>590</b>    | <b>1,395</b> | <b>1,464</b> | <b>338</b>   | <b>490</b>   | <b>2,287</b> |
| Statistical discrepancy 3/                      | -910          | 271          | 50           | 0            | 22            | 0            | 125          | 0            | 0            | 0            |
| <b>Overall balance</b>                          | <b>-1,228</b> | <b>-728</b>  | <b>-95</b>   | <b>430</b>   | <b>1,010</b>  | <b>55</b>    | <b>574</b>   | <b>105</b>   | <b>6</b>     | <b>-240</b>  |
| <b>Financing</b>                                | <b>1,228</b>  | <b>728</b>   | <b>89</b>    | <b>-430</b>  | <b>-1,010</b> | <b>55</b>    | <b>-574</b>  | <b>-105</b>  | <b>-6</b>    | <b>240</b>   |
| External debt (increase +)                      | -29           | 118          | 590          | 3            | 10            | 692          | 324          | 10           | 30           | 301          |
| Disbursements                                   | 357           | 738          | 1,156        | 591          | 399           | 1,527        | 939          | 164          | 244          | 1,142        |
| Amortizations                                   | 387           | 619          | 566          | 588          | 389           | 835          | 614          | 154          | 214          | 841          |
| Domestic bonds (increase +)                     | 528           | -26          | -58          | 0            | -47           | -60          | -115         | -167         | 0            | -167         |
| Net credit from the banking system              | 207           | -27          | -308         | -101         | -448          | -148         | -218         | 52           | -36          | 105          |
| Exceptional Financing (incl. change in arrears) | 522           | 663          | -134         | -332         | -525          | -428         | -566         | 0            | 0            | 0            |
| (In percent of GDP)                             |               |              |              |              |               |              |              |              |              |              |
| <b>Total revenues</b>                           | <b>17.4</b>   | <b>15.8</b>  | <b>15.5</b>  | <b>15.9</b>  | <b>17.5</b>   | <b>16.7</b>  | <b>17.6</b>  | <b>15.8</b>  | <b>17.7</b>  | <b>18.3</b>  |
| Tax revenues:                                   | 10.1          | 9.1          | 9.5          | 10.3         | 11.3          | 10.7         | 11.6         | 10.5         | 11.5         | 11.4         |
| Nontax revenues 2/                              | 7.1           | 6.6          | 6.0          | 5.7          | 6.2           | 5.9          | 6.0          | 5.3          | 6.2          | 6.8          |
| Capital revenues                                | 0.2           | 0.0          | 0.0          | 0.0          | 0.0           | 0.0          | 0.0          | 0.0          | 0.0          | 0.0          |
| <b>Current expenditures</b>                     | <b>15.6</b>   | <b>14.9</b>  | <b>12.8</b>  | <b>12.0</b>  | <b>11.8</b>   | <b>13.1</b>  | <b>13.0</b>  | <b>11.8</b>  | <b>13.3</b>  | <b>13.7</b>  |
| Wages and salaries                              | 8.5           | 8.1          | 7.0          | 6.6          | 6.5           | 7.3          | 7.2          | 6.8          | 6.9          | 7.5          |
| Goods and services                              | 1.1           | 1.2          | 1.1          | 1.0          | 0.9           | 1.2          | 1.1          | 0.7          | 1.2          | 1.2          |
| Interest payments                               | 1.3           | 1.4          | 1.3          | 1.3          | 1.2           | 1.4          | 1.1          | 1.0          | 1.5          | 1.3          |
| Transfers                                       | 4.5           | 4.1          | 3.4          | 3.2          | 3.2           | 3.0          | 3.5          | 3.2          | 3.6          | 3.7          |
| Other   | 0.1           | 0.1          | 0.1          | 0.0          | 0.0           | 0.2          | 0.1          | 0.1          | 0.1          | 0.1          |
| <b>Capital expenditures and net lending</b>     | <b>3.0</b>    | <b>4.0</b>   | <b>3.0</b>   | <b>2.3</b>   | <b>2.1</b>    | <b>3.4</b>   | <b>3.5</b>   | <b>3.0</b>   | <b>4.4</b>   | <b>5.1</b>   |
| <b>Overall balance</b>                          | <b>-4.4</b>   | <b>-2.3</b>  | <b>-0.2</b>  | <b>1.6</b>   | <b>3.6</b>    | <b>0.1</b>   | <b>1.4</b>   | <b>0.9</b>   | <b>0.1</b>   | <b>-0.5</b>  |
| <b>Financing</b>                                | <b>4.4</b>    | <b>2.3</b>   | <b>0.2</b>   | <b>-1.6</b>  | <b>-3.6</b>   | <b>0.1</b>   | <b>-1.4</b>  | <b>-0.9</b>  | <b>-0.1</b>  | <b>0.5</b>   |
| External debt (increase +)                      | -0.1          | 0.4          | 1.5          | 0.0          | 0.0           | 1.7          | 0.8          | 0.1          | 0.3          | 0.7          |
| Disbursements                                   | 1.3           | 2.3          | 3.0          | 2.2          | 1.4           | 3.7          | 2.3          | 1.5          | 2.2          | 2.6          |
| Amortizations                                   | 1.4           | 1.9          | 1.5          | 2.2          | 1.4           | 2.0          | 1.5          | 1.4          | 1.9          | 1.9          |
| Domestic bonds (increase +)                     | 1.9           | -0.1         | -0.2         | 0.0          | -0.2          | -0.1         | -0.3         | -1.5         | 0.0          | -0.4         |
| Net credit from the banking system              | 0.7           | -0.1         | -0.8         | -0.4         | -1.6          | -0.4         | -0.5         | 0.5          | -0.3         | 0.2          |
| Exceptional Financing (incl. change in arrears) | 1.9           | 2.1          | -0.3         | -1.2         | -1.9          | -1.1         | -1.4         | 0.0          | 0.0          | 0.0          |
| <b>Memorandum items:</b>                        |               |              |              |              |               |              |              |              |              |              |
| Primary balance                                 | 0.2           | -1.7         | 0.9          | 2.9          | 4.7           | 1.5          | 2.2          | 2.0          | 1.5          | 0.7          |
| Balance of the Caja Fiscal 4/                   | -566          | -603         | -579         | -375         | -315          | -518         | -552         | -166         | -169         | -683         |
| (in percent of GDP)                             | -2.0          | -1.9         | -1.5         | -1.4         | -1.1          | -1.3         | -1.3         | -1.5         | -1.5         | -1.5         |

Sources: Ministry of Finance; and Fund staff estimates.

1/ Revised Program (Country Report No. 05/59).

2/ Includes receipts from the binational hydroelectric plants Itaipu and grants.

3/ Measurement error to reconcile above-the-line estimate with measure of the fiscal balance from the financing side.

4/ Includes pension payments to central government employees and Chaco War veterans.

Table 6. Paraguay: Operations of the Rest of the Public Sector 1/

|  | 2001         | 2002         | 2003         | 2004         |             |              |              | 2005        |             |              |
|--|--------------|--------------|--------------|--------------|-------------|--------------|--------------|-------------|-------------|--------------|
|  |              |              |              | Jan.-Aug.    |             | Year         |              | Proj.       |             |              |
|  |              |              |              | Prog. 2/     | Actual      | Prog. 2/     | Proj.        | Q1          | Q2          | Year         |
| (In billions of guaranies)                     |              |              |              |              |             |              |              |             |             |              |
| <b>Revenue</b>                                 | <b>1,092</b> | <b>1,111</b> | <b>1,448</b> | <b>1,026</b> | <b>865</b>  | <b>1,514</b> | <b>1,433</b> | <b>381</b>  | <b>381</b>  | <b>1,529</b> |
| Tax revenue                                    | 3            | 3            | 0            | 3            | 4           | 6            | 4            | 1           | 1           | 5            |
| Nontax revenue and grants net of transf. to CG | 953          | 998          | 1,299        | 857          | 849         | 1,293        | 1,378        | 366         | 366         | 1,470        |
| Capital revenue                                | 135          | 109          | 150          | 165          | 12          | 215          | 51           | 13          | 13          | 53           |
| <b>Current expenditure</b>                     | <b>1,086</b> | <b>997</b>   | <b>1,265</b> | <b>842</b>   | <b>804</b>  | <b>1,288</b> | <b>1,319</b> | <b>347</b>  | <b>349</b>  | <b>1,442</b> |
| Wages and salaries                             | 528          | 513          | 565          | 411          | 381         | 623          | 597          | 147         | 147         | 628          |
| Goods and services                             | 207          | 199          | 225          | 161          | 125         | 247          | 256          | 70          | 72          | 290          |
| Interest payments                              | 107          | 147          | 239          | 134          | 125         | 214          | 223          | 23          | 23          | 99           |
| Transfers                                      | 70           | 128          | 211          | 126          | 165         | 188          | 215          | 77          | 77          | 305          |
| Other  | 174          | 10           | 25           | 10           | 7           | 15           | 27           | 30          | 30          | 120          |
| <b>Capital expenditure and net lending</b>     | <b>599</b>   | <b>594</b>   | <b>653</b>   | <b>553</b>   | <b>26</b>   | <b>836</b>   | <b>412</b>   | <b>253</b>  | <b>233</b>  | <b>929</b>   |
| <b>Public enterprises' operating surplus</b>   | <b>712</b>   | <b>458</b>   | <b>801</b>   | <b>441</b>   | <b>578</b>  | <b>680</b>   | <b>951</b>   | <b>289</b>  | <b>331</b>  | <b>1,063</b> |
| Statistical discrepancy                        | -5           | -534         | -236         | 0            | -59         | 0            | -110         | 0           | 0           | 0            |
| <b>Overall balance</b>                         | <b>115</b>   | <b>-556</b>  | <b>95</b>    | <b>72</b>    | <b>555</b>  | <b>71</b>    | <b>543</b>   | <b>69</b>   | <b>130</b>  | <b>220</b>   |
| <b>Financing</b>                               | <b>-115</b>  | <b>556</b>   | <b>-95</b>   | <b>-72</b>   | <b>-555</b> | <b>-71</b>   | <b>-543</b>  | <b>-69</b>  | <b>-130</b> | <b>-220</b>  |
| External financing net                         | 49           | -100         | -130         | -99          | -143        | -253         | -214         | -38         | 80          | -8           |
| Domestic financing net                         | -164         | 196          | 342          | 253          | -137        | 433          | -128         | -32         | -210        | -212         |
| Of which: quasifiscal deficit financing 3/     | 348          | 394          | 390          | 139          | 87          | 220          | 210          | 62          | 64          | 260          |
| Net change in arrears                          | 0            | 461          | -307         | -226         | -274        | -251         | -201         | 0           | 0           | 0            |
| (In percent of GDP)                            |              |              |              |              |             |              |              |             |             |              |
| <b>Revenue</b>                                 | <b>3.9</b>   | <b>3.5</b>   | <b>3.7</b>   | <b>3.8</b>   | <b>3.1</b>  | <b>3.6</b>   | <b>3.4</b>   | <b>3.4</b>  | <b>3.5</b>  | <b>3.5</b>   |
| Tax revenue                                    | 0.0          | 0.0          | 0.0          | 0.0          | 0.0         | 0.0          | 0.0          | 0.0         | 0.0         | 0.0          |
| Nontax revenue and grants                      | 3.4          | 3.1          | 3.3          | 3.2          | 3.1         | 3.2          | 3.3          | 3.3         | 3.3         | 3.3          |
| Capital revenue                                | 0.5          | 0.3          | 0.4          | 0.6          | 0.0         | 0.5          | 0.1          | 0.1         | 0.1         | 0.1          |
| <b>Current expenditure</b>                     | <b>3.9</b>   | <b>3.1</b>   | <b>3.3</b>   | <b>3.1</b>   | <b>2.9</b>  | <b>3.2</b>   | <b>3.2</b>   | <b>3.1</b>  | <b>3.1</b>  | <b>3.2</b>   |
| Wages and salaries                             | 1.9          | 1.6          | 1.5          | 1.5          | 1.4         | 1.5          | 1.4          | 1.3         | 1.3         | 1.4          |
| Goods and services                             | 0.7          | 0.6          | 0.6          | 0.6          | 0.5         | 0.6          | 0.6          | 0.6         | 0.6         | 0.7          |
| Interest payments                              | 0.4          | 0.5          | 0.6          | 0.5          | 0.4         | 0.5          | 0.5          | 0.2         | 0.2         | 0.2          |
| Transfers                                      | 0.2          | 0.4          | 0.5          | 0.5          | 0.6         | 0.5          | 0.5          | 0.7         | 0.7         | 0.7          |
| Other  | 0.6          | 0.0          | 0.1          | 0.0          | 0.0         | 0.0          | 0.1          | 0.3         | 0.3         | 0.3          |
| <b>Capital expenditure and net lending</b>     | <b>2.1</b>   | <b>1.9</b>   | <b>1.7</b>   | <b>2.0</b>   | <b>0.1</b>  | <b>2.0</b>   | <b>1.0</b>   | <b>2.3</b>  | <b>2.1</b>  | <b>2.1</b>   |
| <b>Public enterprises' operating surplus</b>   | <b>2.5</b>   | <b>1.4</b>   | <b>2.1</b>   | <b>1.6</b>   | <b>2.1</b>  | <b>1.7</b>   | <b>2.3</b>   | <b>2.6</b>  | <b>3.0</b>  | <b>2.4</b>   |
| Statistical discrepancy                        | 0.0          | -1.7         | -0.6         | 0.0          | -0.2        | 0.0          | -0.3         | 0.0         | 0.0         | 0.0          |
| <b>Overall balance</b>                         | <b>0.4</b>   | <b>-1.7</b>  | <b>0.2</b>   | <b>0.3</b>   | <b>2.0</b>  | <b>0.2</b>   | <b>1.3</b>   | <b>0.7</b>  | <b>1.2</b>  | <b>0.5</b>   |
| <b>Financing</b>                               | <b>-0.4</b>  | <b>1.7</b>   | <b>-0.2</b>  | <b>-0.3</b>  | <b>-2.0</b> | <b>-0.2</b>  | <b>-1.3</b>  | <b>-0.6</b> | <b>-1.2</b> | <b>-0.5</b>  |
| External financing net                         | 0.2          | -0.3         | -0.3         | -0.4         | -0.5        | -0.6         | -0.5         | -0.3        | 0.7         | 0.0          |
| Domestic financing net                         | -0.6         | 0.6          | 0.9          | 0.9          | -0.5        | 1.1          | -0.3         | -0.3        | -1.9        | -0.5         |
| Of which: quasifiscal deficit financing 3/     | 1.2          | 1.2          | 1.0          | 0.5          | 0.3         | 0.5          | 0.5          | 0.6         | 0.6         | 0.6          |
| Net change in arrears                          | 0.0          | 1.4          | -0.8         | -0.8         | -1.0        | -0.6         | -0.5         | 0.0         | 0.0         | 0.0          |
| <b>Memorandum item:</b>                        |              |              |              |              |             |              |              |             |             |              |
| Primary balance                                | 0.8          | 0.4          | 1.5          | 0.7          | 2.7         | 0.6          | 2.1          | 0.9         | 1.4         | 0.7          |

Sources: Ministry of Finance; and Fund staff estimates.

1/ Defined as the nonfinancial public sector and the BCP, excluding the central government.

2/ Revised Program (Country Report No. 05/59).

3/ Assumes quasi fiscal deficit of central bank entirely financed.

Table 7. Paraguay: Public Sector Arrears 1/  
(In millions of U.S. dollars)

|   | December 2003 |            | March 2004 |            | August 2004 |            |
|---|---------------|------------|------------|------------|-------------|------------|
|   | Target        | Actual     | Target     | Actual 2/  | Target      | Actual     |
| <b>Total public sector arrears</b>  | <b>162</b>    | <b>157</b> | <b>135</b> | <b>114</b> | <b>60</b>   | <b>42</b>  |
| <b>(In percent of GDP)</b>  | <b>2.8</b>    | <b>2.7</b> | <b>2.0</b> | <b>1.7</b> | <b>0.9</b>  | <b>0.6</b> |
| <b>Central government</b>   | <b>105</b>    | <b>123</b> | <b>93</b>  | <b>45</b>  | <b>50</b>   | <b>40</b>  |
| Domestic  | 59            | 66         | 60         | 39         | 50          | 40         |
| (In billions of guaranies)  | 360           | 400        | 350        | 228        | 297         | 235        |
| <i>Of which</i> : bonds   | 0             | 0          | 0          | 0          | 0           | 0          |
| External  | 46            | 58         | 34         | 6          | 0           | 0          |
| <i>Of which</i> : multilateral  | 0             | 0          | 0          | 0          | 0           | 0          |
| <b>Rest of public sector</b>  | <b>57</b>     | <b>34</b>  | <b>42</b>  | <b>69</b>  | <b>10</b>   | <b>2</b>   |
| Domestic  | 0             | 0          | 0          | 0          | 0           | 0          |
| External  | 57            | 34         | 42         | 69         | 10          | 3          |
| <i>Of which</i> : PETROPAR arrears to foreign suppliers over 90 days ESSAP arrears 3/ | 44            | 22         | 32         | 55         | 10          | 3          |
|   | 8.5           | 4.4        | 0          | 0.0        | 0           | 0          |
| <b>Memorandum items:</b>  |               |            |            |            |             |            |
| External public arrears   | 102           | 91         | 75         | 75         | 10          | 3          |
| Central government total debt service   | 18            | 15         | 14         | 44         | 14          | 20         |

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).

2/ For the purposes of the target on domestic floating debt in March, interest on new bonds not yet processed and verified are not part of domestic debt as of March 31, 2004.

3/ Paid by the BCP, the guarantor, under the program.

Table 8. Paraguay: Public Sector Financing  
(In millions of U.S. dollars, unless otherwise stated)

|  | 2004      |            |            |            | 2005       |             |           |           | (In percent of GDP) |            |            |            |
|--|-----------|------------|------------|------------|------------|-------------|-----------|-----------|---------------------|------------|------------|------------|
|  | Q1        | Q2         | Q3         | Q4         | Proj. Year | Projections |           |           |                     |            |            |            |
|  |           |            |            |            |            | Q1          | Q2        | Q3        |                     | Q4         | Year       |            |
| <b>I. Central Government</b>             |           |            |            |            |            |             |           |           |                     |            |            |            |
| <b>Gross financing requirements</b>      | <b>53</b> | <b>-17</b> | <b>-53</b> | <b>135</b> | <b>118</b> | <b>1.7</b>  | <b>35</b> | <b>34</b> | <b>41</b>           | <b>92</b>  | <b>203</b> | <b>2.8</b> |
| Deficit below the line                   | -48       | -91        | -87        | 127        | -100       | -1.4        | -17       | -1        | -1                  | 57         | 39         | 0.5        |
| Amortizations                            | 22        | 34         | 25         | 42         | 123        | 1.8         | 53        | 35        | 42                  | 35         | 164        | 2.3        |
| External debt                            | 22        | 26         | 25         | 31         | 103        | 1.5         | 25        | 35        | 42                  | 35         | 137        | 1.9        |
| Domestic debt                            | 0         | 8          | 0          | 11         | 19         | 0.3         | 27        | 0         | 0                   | 0          | 27         | 0.4        |
| Net reduction of arrears                 | 79        | 40         | 10         | -34        | 95         | 1.4         | 0         | 0         | 0                   | 0          | 0          | 0.0        |
| <b>Gross financing</b>                   | <b>53</b> | <b>-17</b> | <b>-53</b> | <b>135</b> | <b>118</b> | <b>1.7</b>  | <b>35</b> | <b>34</b> | <b>41</b>           | <b>92</b>  | <b>203</b> | <b>2.8</b> |
| External disbursements                   | 18        | 32         | 35         | 72         | 158        | 2.3         | 27        | 40        | 43                  | 75         | 185        | 2.6        |
| Drawdown of deposits in financial system | 35        | -50        | -88        | 63         | -40        | -0.5        | 9         | -6        | -3                  | 17         | 17         | 0.2        |
| Central bank                             | 36        | -47        | -86        | 63         | -34        | -0.4        | 9         | -6        | -3                  | 17         | 17         | 0.2        |
| Commercial banks                         | -2        | -3         | -2         | 0          | -6         | -0.1        | 0         | 0         | 0                   | 0          | 0          | 0.0        |
| <b>II. Public Sector</b>                 |           |            |            |            |            |             |           |           |                     |            |            |            |
| <b>Gross financing requirements</b>      | <b>7</b>  | <b>3</b>   | <b>-51</b> | <b>146</b> | <b>105</b> | <b>1.5</b>  | <b>34</b> | <b>21</b> | <b>28</b>           | <b>120</b> | <b>204</b> | <b>3.0</b> |
| Deficit below the line                   | -79       | -137       | -101       | 125        | -191       | -2.7        | -29       | -22       | -24                 | 77         | 3          | 0.0        |
| Amortizations                            | 36        | 42         | 35         | 52         | 166        | 2.4         | 63        | 43        | 52                  | 43         | 201        | 3.0        |
| External debt                            | 36        | 34         | 35         | 41         | 146        | 2.1         | 36        | 43        | 52                  | 43         | 174        | 2.6        |
| Domestic debt                            | 0         | 8          | 0          | 11         | 19         | 0.3         | 27        | 0         | 0                   | 0          | 27         | 0.4        |
| Net reduction of arrears                 | 50        | 98         | 15         | -32        | 131        | 1.8         | 0         | 0         | 0                   | 0          | 0          | 0.0        |
| <b>Gross financing</b>                   | <b>7</b>  | <b>3</b>   | <b>-51</b> | <b>146</b> | <b>105</b> | <b>1.5</b>  | <b>34</b> | <b>21</b> | <b>28</b>           | <b>120</b> | <b>204</b> | <b>3.0</b> |
| External disbursements                   | 19        | 35         | 37         | 74         | 165        | 2.4         | 31        | 61        | 58                  | 71         | 221        | 3.3        |
| Drawdown of deposits in financial system | -18       | -32        | -101       | 57         | -95        | -1.3        | -7        | -51       | -41                 | 38         | -60        | -0.9       |
| Financing of the quasi-fiscal deficit    | 6         | 1          | 13         | 15         | 35         | 0.5         | 10        | 10        | 11                  | 10         | 42         | 0.6        |

Sources: Ministry of Finance; and Fund staff estimates.

Table 9. Paraguay: Summary Accounts of the Central Bank  
(In billions of guaraníes; end-of-period; valued at constant exchange rate)

|   | 2001          |               |               |               | 2002          |               | 2003          |               | 2004          |               | 2005          |               |               |      |
|---|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|------|
|   | 2001          |               | 2002          |               | 2003          |               | 2004          |               | 2005          |               | 2005          |               | 2005          |      |
|   | 2001          | 2002          | 2003          | 2004          | 2005          | 2005          | 2005          | 2005          | 2005          | 2005          | 2005          | 2005          | 2005          | 2005 |
| <b>Net international reserves</b>             | <b>4,541</b>  | <b>4,027</b>  | <b>6,175</b>  | <b>7,163</b>  | <b>6,699</b>  | <b>7,163</b>  | <b>6,782</b>  | <b>7,413</b>  | <b>7,036</b>  | <b>7,409</b>  | <b>7,660</b>  | <b>7,409</b>  | <b>7,660</b>  |      |
| (In millions of U.S. dollars)                 | <b>723</b>    | <b>641</b>    | <b>983</b>    | <b>1,141</b>  | <b>1,067</b>  | <b>1,141</b>  | <b>1,080</b>  | <b>1,180</b>  | <b>1,120</b>  | <b>1,180</b>  | <b>1,220</b>  | <b>1,180</b>  | <b>1,220</b>  |      |
| <b>Net domestic assets</b>                    | <b>-2,879</b> | <b>-2,329</b> | <b>-3,969</b> | <b>-5,231</b> | <b>-4,507</b> | <b>-4,090</b> | <b>-4,853</b> | <b>-4,614</b> | <b>-4,614</b> | <b>-5,197</b> | <b>-4,844</b> | <b>-5,197</b> | <b>-4,844</b> |      |
| Net nonfinancial public sector                | 1,176         | 1,507         | 1,163         | 876           | 981           | 1,137         | 952           | 1,004         | 1,004         | 968           | 1,058         | 968           | 1,058         |      |
| Net credit to the general government          | 979           | 1,291         | 953           | 670           | 727           | 883           | 814           | 866           | 866           | 830           | 920           | 830           | 920           |      |
| Central government                            | 978           | 1,291         | 952           | 669           | 727           | 883           | 814           | 866           | 866           | 829           | 919           | 829           | 919           |      |
| Rest of general government                    | 1             | 1             | 1             | 1             | 1             | 1             | 1             | 1             | 1             | 1             | 1             | 1             | 1             |      |
| Net credit to public enterprises              | 197           | 216           | 211           | 207           | 254           | 254           | 138           | 138           | 138           | 138           | 138           | 138           | 138           |      |
| Net credit to the financial system            | -1,139        | -485          | -1,393        | -2,114        | -1,901        | -1,930        | -1,873        | -1,790        | -1,790        | -1,865        | -1,949        | -1,865        | -1,949        |      |
| Net credit to the banking system              | -2,293        | -1,814        | -2,760        | -3,409        | -3,247        | -3,276        | -3,171        | -3,087        | -3,087        | -3,163        | -3,247        | -3,163        | -3,247        |      |
| Total credit to banks                         | 7             | 4             | 2             | 18            | 29            | 29            | 9             | 9             | 9             | 9             | 9             | 9             | 9             |      |
| Deposits and reserve requirements             | 2,300         | 1,818         | 2,762         | 3,427         | 3,277         | 3,305         | 3,180         | 3,096         | 3,096         | 3,171         | 3,255         | 3,171         | 3,255         |      |
| Bank deposits in local currency               | 520           | 461           | 1,199         | 1,712         | 1,423         | 1,451         | 1,493         | 1,409         | 1,409         | 1,484         | 1,568         | 1,484         | 1,568         |      |
| Legal reserve requirement                     | 394           | 349           | 748           | 615           | 624           | 669           | 675           | 702           | 702           | 757           | 800           | 757           | 800           |      |
| Other reserve requirement deposits            | 125           | 112           | 452           | 1,097         | 798           | 782           | 818           | 707           | 707           | 727           | 768           | 727           | 768           |      |
| Bank deposits in foreign currency             | 1,780         | 1,357         | 1,562         | 1,715         | 1,854         | 1,854         | 1,687         | 1,687         | 1,687         | 1,687         | 1,687         | 1,687         | 1,687         |      |
| Deposits in current account                   | 16            | 105           | 91            | 91            | 166           | 166           | 74            | 74            | 74            | 74            | 74            | 74            | 74            |      |
| Legal reserve requirement                     | 1,765         | 1,252         | 1,471         | 1,624         | 1,688         | 1,688         | 1,613         | 1,613         | 1,613         | 1,613         | 1,613         | 1,613         | 1,613         |      |
| Net credit to the rest of financial entities  | 1,154         | 1,328         | 1,366         | 1,296         | 1,346         | 1,346         | 1,298         | 1,298         | 1,298         | 1,298         | 1,298         | 1,298         | 1,298         |      |
| Net credit to the private sector              | -63           | -87           | -99           | -85           | -88           | -88           | -85           | -85           | -85           | -86           | -86           | -86           | -86           |      |
| Open market operations (LRM and passive call) | 297           | 677           | 1,071         | 1,310         | 1,310         | 1,165         | 1,346         | 1,302         | 1,302         | 1,833         | 1,627         | 1,833         | 1,627         |      |
| Medium- and long-term external liabilities    | 376           | 460           | 431           | 375           | 395           | 377           | 366           | 366           | 366           | 366           | 366           | 366           | 366           |      |
| Other assets and liabilities (net)            | -2,179        | -2,126        | -2,138        | -1,976        | -1,794        | -1,667        | -2,135        | -2,075        | -2,075        | -2,015        | -1,875        | -2,015        | -1,875        |      |
| <b>Currency issue</b>                         | <b>1,662</b>  | <b>1,699</b>  | <b>2,207</b>  | <b>1,932</b>  | <b>2,192</b>  | <b>2,692</b>  | <b>2,560</b>  | <b>2,422</b>  | <b>2,422</b>  | <b>2,212</b>  | <b>2,816</b>  | <b>2,212</b>  | <b>2,816</b>  |      |
| Growth  | 6.8           | 2.2           | 29.9          | 7.6           | 22.0          | 22.0          | 16.0          | 14.5          | 14.5          | 13.0          | 10.0          | 13.0          | 10.0          |      |
| <b>Memorandum item:</b>                       |               |               |               |               |               |               |               |               |               |               |               |               |               |      |
| Monetary base growth                          | 5.8           | -1.0          | 57.7          | 24.1          | 23.1          | 21.6          | 19.0          | 8.8           | 8.8           | 6.7           | 8.2           | 6.7           | 8.2           |      |

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

1/ Revised program Country Report No. 05/59.

Table 10. Paraguay: Summary Accounts of the Banking System  
(End of period; valued at constant exchange rate)

|  | 2001          | 2002          | 2003          | 2004          |               |               |               | 2005          |               |               |
|--|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
|  |               |               |               | August        |               | December      |               | Proj.         |               |               |
|  |               |               |               | Prog. 1/      | Actual        | Prog. 1/      | Proj.         | March         | June          | December      |
| (In billions of guaranías)   |               |               |               |               |               |               |               |               |               |               |
| <b>I. Central Bank</b>   |               |               |               |               |               |               |               |               |               |               |
| <b>Net international reserves</b>  | 4,541         | 4,027         | 6,175         | 6,699         | 7,163         | 6,782         | 7,413         | 7,036         | 7,409         | 7,660         |
| (in millions of U.S. dollars)  | 723           | 641           | 983           | 1,067         | 1,141         | 1,080         | 1,180         | 1,120         | 1,180         | 1,220         |
| <b>Net domestic assets</b>   | <b>-2,879</b> | <b>-2,329</b> | <b>-3,969</b> | <b>-4,507</b> | <b>-5,231</b> | <b>-4,090</b> | <b>-4,853</b> | <b>-4,614</b> | <b>-5,197</b> | <b>-4,844</b> |
| Credit to public sector, net   | 1,176         | 1,507         | 1,163         | 981           | 876           | 1,137         | 952           | 1,004         | 968           | 1,058         |
| Credit to banking system, net 2/   | -2,293        | -1,814        | -2,760        | -3,247        | -3,409        | -3,276        | -3,171        | -3,087        | -3,163        | -3,247        |
| Central bank securities  | -297          | -677          | -1,071        | -1,310        | -1,557        | -1,165        | -1,346        | -1,302        | -1,833        | -1,627        |
| Other  | -1,464        | -1,345        | -1,301        | -931          | -1,141        | -786          | -1,288        | -1,228        | -1,169        | -1,029        |
| <b>Currency issued</b>   | <b>1,662</b>  | <b>1,699</b>  | <b>2,207</b>  | <b>2,192</b>  | <b>1,932</b>  | <b>2,692</b>  | <b>2,560</b>  | <b>2,422</b>  | <b>2,212</b>  | <b>2,816</b>  |
| <b>II. Monetary Survey</b>   |               |               |               |               |               |               |               |               |               |               |
| <b>Net foreign assets</b>  | <b>6,907</b>  | <b>5,497</b>  | <b>8,405</b>  | <b>9,309</b>  | <b>9,475</b>  | <b>9,393</b>  | <b>9,717</b>  | <b>9,340</b>  | <b>9,714</b>  | <b>9,965</b>  |
| (in millions of U.S. dollars)  | 1,100         | 875           | 1,338         | 1,482         | 1,509         | 1,496         | 1,547         | 1,487         | 1,547         | 1,587         |
| <b>Net domestic assets</b>   | <b>4,093</b>  | <b>3,473</b>  | <b>2,152</b>  | <b>3,318</b>  | <b>1,978</b>  | <b>3,122</b>  | <b>1,783</b>  | <b>2,436</b>  | <b>2,143</b>  | <b>2,496</b>  |
| Credit to the public sector  | 358           | 932           | 699           | -33           | 25            | -136          | 106           | 64            | -246          | -261          |
| Credit to the private sector   | 7,872         | 6,230         | 5,081         | 5,371         | 5,417         | 5,658         | 5,867         | 6,138         | 6,136         | 6,464         |
| Other  | -4,137        | -3,689        | -3,628        | -2,019        | -3,464        | -2,399        | -4,190        | -3,766        | -3,748        | -3,707        |
| <b>Broad liquidity (M5)</b>  | <b>11,000</b> | <b>8,970</b>  | <b>10,558</b> | <b>12,627</b> | <b>11,453</b> | <b>12,515</b> | <b>11,501</b> | <b>11,777</b> | <b>11,856</b> | <b>12,460</b> |
| Money market funds   | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             |
| <b>Broad liquidity (M4)</b>  | <b>11,000</b> | <b>8,970</b>  | <b>10,558</b> | <b>12,627</b> | <b>11,453</b> | <b>12,515</b> | <b>11,501</b> | <b>11,777</b> | <b>11,856</b> | <b>12,460</b> |
| Bonds and issued securities  | 50            | 135           | 31            | 0             | 0             | 0             | 0             | 0             | 0             | 0             |
| Other monetary liabilities   | 16            | 15            | 9             | 7             | 3             | 7             | 3             | 3             | 3             | 3             |
| Central bank securities with private sector                                      | 121           | 281           | 469           | 1,785         | 978           | 1,153         | 337           | 711           | 825           | 713           |
| <b>Broad liquidity (M3)</b>  | <b>10,813</b> | <b>8,539</b>  | <b>10,047</b> | <b>10,836</b> | <b>10,472</b> | <b>11,355</b> | <b>11,161</b> | <b>11,063</b> | <b>11,028</b> | <b>11,745</b> |
| Foreign currency deposits  | 6,886         | 4,699         | 5,253         | 5,898         | 5,739         | 5,898         | 5,726         | 5,726         | 5,726         | 5,726         |
| <b>Money and quasi-money (M2)</b>  | <b>3,926</b>  | <b>3,839</b>  | <b>4,794</b>  | <b>4,937</b>  | <b>4,732</b>  | <b>5,456</b>  | <b>5,435</b>  | <b>5,336</b>  | <b>5,302</b>  | <b>6,018</b>  |
| Quasi-money  | 1,306         | 1,198         | 1,208         | 1,294         | 1,256         | 1,315         | 1,252         | 1,282         | 1,313         | 1,378         |
| Money (M1)   | 2,621         | 2,641         | 3,587         | 3,643         | 3,476         | 4,141         | 4,183         | 4,054         | 3,988         | 4,641         |
| (Annual percentage change)   |               |               |               |               |               |               |               |               |               |               |
| M0 (currency issued)   | 6.8           | 2.2           | 29.9          | 22.0          | 7.6           | 22.0          | 16.0          | 14.5          | 13.0          | 10.0          |
| Credit to the private sector   | -1.0          | -20.9         | -18.4         | 5.9           | 6.8           | 11.3          | 15.5          | 15.4          | 13.1          | 10.2          |
| M1   | 8.5           | 0.8           | 35.8          | 25.4          | 19.6          | 15.4          | 16.6          | 17.0          | 15.3          | 11.0          |
| M2   | 4.9           | -2.2          | 24.9          | 18.4          | 13.5          | 13.8          | 13.4          | 12.5          | 12.0          | 10.7          |
| M3   | 0.7           | -21.0         | 17.7          | 12.1          | 8.4           | 13.0          | 11.1          | 5.3           | 4.5           | 5.2           |
| Of which: foreign currency deposits  | -1.5          | -31.8         | 11.8          | 7.4           | 4.5           | 12.3          | 9.0           | -0.7          | -1.7          | 0.0           |
| <b>Memorandum items:</b>   |               |               |               |               |               |               |               |               |               |               |
| Ratio of foreign currency deposits to M3 (percent)                               | 63.7          | 55.0          | 52.3          | 54.4          | 54.8          | 51.9          | 51.3          | 51.8          | 51.9          | 48.8          |
| Ratio of foreign currency deposits to private sector deposits in banks (percent) | 72.5          | 64.9          | 63.5          | 65.5          | 64.5          | 65.1          | 63.7          | 63.1          | 62.5          | 61.4          |

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

1/ Revised program (Country Report No. 05/59).

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

Table 11. Paraguay: Banking System Indicators  
(End-of period)

|  | 2000 | 2001 | 2002  | 2003  | Sept.<br>2004 |
|--|------|------|-------|-------|---------------|
| <b>I. Total Banking System (II+III+IV+V)</b>   |      |      |       |       |               |
| Capital adequacy ratio (percent)               | 17.6 | 16.9 | 17.9  | 20.9  | 23.8          |
| NPLs/total loans                               | 16.6 | 16.5 | 19.7  | 20.6  | 15.1          |
| Provisions/NPLs                                | 38.8 | 37.0 | 46.6  | 54.8  | 53.1          |
| Rate of return on assets (ROA)                 | 1.4  | 2.2  | 1.0   | 0.4   | 1.7           |
| Rate of return on equity (ROE)                 | 12.4 | 21.2 | 9.0   | 4.5   | 16.4          |
| Liquid assets/total assets 1/                  | 21.7 | 23.0 | 25.1  | 32.6  | 34.6          |
| Foreign exchange deposits/total deposits       | 59.7 | 65.3 | 68.6  | 61.7  | 57.2          |
| <b>II. Total Foreign-Owned Banks</b>           |      |      |       |       |               |
| Share in assets                                | 47.0 | 45.1 | 48.4  | 47.4  | 38.0          |
| Capital adequacy ratio (percent)               | 17.1 | 16.0 | 17.6  | 20.4  | 29.9          |
| NPLs/total loans                               | 14.1 | 15.3 | 20.1  | 20.8  | 17.3          |
| Provisions/NPLs                                | 40.2 | 42.6 | 57.5  | 64.2  | 66.9          |
| Rate of return on assets (ROA)                 | 2.3  | 3.1  | 1.6   | 0.1   | 1.5           |
| Rate of return on equity (ROE)                 | 20.2 | 30.4 | 15.0  | 1.2   | 12.9          |
| Liquid assets/total assets 1/                  | 21.6 | 22.2 | 27.1  | 29.8  | 27.7          |
| Foreign exchange deposits/total deposits       | 63.2 | 67.8 | 71.1  | 65.6  | 66.6          |
| <b>III. Total Majority-Owned Foreign Banks</b> |      |      |       |       |               |
| Share in assets                                | 34.9 | 38.3 | 33.2  | 37.2  | 44.7          |
| Capital adequacy ratio (percent)               | 17.7 | 16.8 | 19.9  | 21.0  | 21.7          |
| NPLs/total loans                               | 10.6 | 10.6 | 10.4  | 12.3  | 6.5           |
| Provisions/NPLs                                | 39.7 | 36.8 | 43.8  | 52.1  | 48.7          |
| Rate of return on assets (ROA)                 | 1.0  | 1.8  | 1.4   | 1.3   | 1.8           |
| Rate of return on equity (ROE)                 | 8.6  | 18.3 | 13.4  | 15.5  | 18.1          |
| Liquid assets/total assets 1/                  | 24.2 | 25.0 | 26.2  | 35.3  | 36.3          |
| Foreign exchange deposits/total deposits       | 64.3 | 69.3 | 70.7  | 62.3  | 55.9          |
| <b>IV. Total Domestic-Owned Private Banks</b>  |      |      |       |       |               |
| Share in assets                                | 6.8  | 7.4  | 10.4  | 7.4   | 7.9           |
| Capital adequacy ratio (percent)               | 15.2 | 14.8 | 13.6  | 14.1  | 14.7          |
| NPLs/total loans                               | 7.0  | 6.5  | 8.8   | 2.9   | 2.8           |
| Provisions/NPLs                                | 25.0 | 30.8 | 18.7  | 46.2  | 66.3          |
| Rate of return on assets (ROA)                 | 1.0  | 1.2  | 1.1   | 1.6   | 1.8           |
| Rate of return on equity (ROE)                 | 8.9  | 13.8 | 14.3  | 21.1  | 24.5          |
| Liquid assets/total assets 1/                  | 17.3 | 20.1 | 18.3  | 38.8  | 40.3          |
| Foreign exchange deposits/total deposits       | 49.4 | 61.8 | 62.6  | 60.7  | 58.1          |
| <b>V. National Development Bank (BNF)</b>      |      |      |       |       |               |
| Share in assets                                | 11.4 | 9.2  | 8.0   | 8.0   | 9.4           |
| Capital adequacy ratio (percent)               | 21.2 | 22.9 | 18.8  | 30.0  | 24.1          |
| NPLs/total loans                               | 44.6 | 46.5 | 56.2  | 56.2  | 55.6          |
| Provisions/NPLs                                | 38.1 | 31.7 | 39.6  | 47.6  | 42.9          |
| Rate of return on assets (ROA)                 | -0.5 | 0.3  | -4.7  | -2.8  | 1.7           |
| Rate of return on equity (ROE)                 | -4.2 | 2.0  | -27.3 | -18.7 | 19.4          |
| Liquid assets/total assets 1/                  | 16.7 | 20.4 | 17.3  | 30.7  | 49.0          |
| Foreign exchange deposits/total deposits       | 19.3 | 27.0 | 42.5  | 32.7  | 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 12. Paraguay: Balance of Payments, 2001-2005  
(In millions of U.S. dollars)

|  | 2001   | 2002   | 2003   | 2004           |        |          |        | 2005  |       |        |
|--|--------|--------|--------|----------------|--------|----------|--------|-------|-------|--------|
|  |        |        |        | January - June |        | Year     |        | Proj. |       |        |
|  |        |        |        | Prog. 1/       | Act.   | Prog. 2/ | Proj.  | Q1    | Q2    | Year   |
| Current account                              | -266   | 97     | 146    | 149            | 211    | 91       | 63     | -50   | 126   | -27    |
| Trade balance                                | -618   | -283   | -264   | -10            | 8      | -299     | -353   | -133  | -4    | -460   |
| Exports                                      | 1,883  | 1,852  | 2,255  | 1,096          | 1,551  | 2,096    | 2,737  | 674   | 826   | 2,820  |
| Imports                                      | -2,500 | -2,134 | -2,518 | -1,106         | -1,543 | -2,395   | -3,090 | -808  | -830  | -3,280 |
| Services (net)                               | 165    | 216    | 241    | 83             | 127    | 209      | 227    | 55    | 62    | 214    |
| Factor income                                | 16     | 45     | 0      | 9              | -16    | 6        | -6     | -26   | 15    | 6      |
| Transfers                                    | 167    | 116    | 165    | 68             | 93     | 176      | 194    | 54    | 54    | 215    |
| Capital and financial account                | 150    | 65     | 222    | -73            | 80     | 40       | 166    | -11   | -66   | 66     |
| General government                           | 150    | -4     | 92     | -1             | -11    | 39       | 28     | -3    | 2     | 33     |
| Disbursements                                | 144    | 146    | 213    | 72             | 54     | 148      | 157    | 27    | 40    | 185    |
| Amortization                                 | -102   | -123   | -130   | -73            | -69    | -118     | -138   | -32   | -40   | -161   |
| Other  | 108    | -27    | 9      | 0              | 4      | 9        | 9      | 2     | 2     | 9      |
| Private sector 3/                            | 0      | 68     | 131    | -72            | 90     | 1        | 138    | -7    | -67   | 33     |
| Direct investment                            | 79     | 13     | 29     | 1              | 13     | 35       | 65     | 8     | 15    | 83     |
| Foreign currency deposits                    | -62    | -153   | 343    | 0              | 181    | 34       | 169    | -16   | -71   | -101   |
| Other  | -18    | 209    | -241   | -73            | -103   | -68      | -96    | 0     | -12   | 51     |
| Errors and omissions                         | 71     | -245   | -157   | 0              | -105   | 58       | 73     | 0     | 0     | 0      |
| Overall balance                              | -45    | -83    | 212    | 77             | 186    | 189      | 302    | -61   | 60    | 39     |
| Net international reserves (increase -)      | 45     | 83     | -302   | -19            | -108   | -99      | -211   | 61    | -60   | -39    |
| Gross reserves                               | 45     | 84     | -301   | -18            | -107   | -98      | -210   | 60    | -60   | -40    |
| Reserve liabilities                          | 0      | -1     | -1     | -1             | -1     | -1       | -1     | 1     | 0     | 1      |
| Exceptional financing                        | ...    | ...    | 91     | -58            | -78    | -91      | -91    | 0     | 0     | 0      |
| Arrears deferral (+)/clearance (-)           | ...    | ...    | 91     | -58            | -78    | -91      | -91    | 0     | 0     | 0      |
| <b>Memorandum items:</b>                     |        |        |        |                |        |          |        |       |       |        |
| Current account in percent of GDP            | -3.9   | 1.7    | 2.4    | 4.9            | 6.1    | 1.3      | 0.9    | -2.7  | 6.7   | -0.4   |
| Gross reserves (in millions of U.S. dollars) | 723    | 641    | 983    | 836            | 1,085  | 1,080    | 1,180  | 1,120 | 1,180 | 1,220  |
| in months of imports of GNFS                 | 3.5    | 2.7    | 3.4    | 2.7            | 3.6    | 4.5      | 3.9    | 3.6   | 3.8   | 3.9    |
| Debt service in percent of exports GNFS      | 10.8   | 9.1    | 11.0   | 10.8           | 10.4   | 15.4     | 10.4   | 8.8   | 7.9   | 8.5    |
| Export volume (percentage change) 4/         | 18.6   | -7.0   | 14.2   | -10.5          | 13.2   | 4.9      | 12.7   | -22.6 | 7.2   | 5.7    |
| Import volume (percentage change) 4/         | 0.7    | -21.4  | 17.0   | 7.4            | 47.5   | 4.6      | 17.1   | 4.2   | 4.2   | 3.3    |
| Terms of trade (percentage change)           | -0.3   | 6.9    | 8.4    | -4.8           | 34.8   | 8.8      | 4.4    | -5.4  | -5.4  | -5.4   |

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

1/ Original program (Country Report No. 04/66).

2/ Revised program (Country Report No. 05/59).

3/ Includes public enterprises and binationals.

4/ Registered trade.

Table 13. Paraguay: Indicators of External Vulnerability

|   | 2000 | 2001  | 2002  | 2003  | Proj.<br>2004 |
|---|------|-------|-------|-------|---------------|
| <b>Monetary and financial indicators</b>                          |      |       |       |       |               |
| Broad money (M3), percentage change 1/ 2/                         | -0.5 | 0.7   | -21.0 | 17.7  | 11.1          |
| Credit to the private sector, real (percentage change) 1/         | -9.0 | -8.7  | -31.1 | -25.5 | 10.1          |
| Share of nonperforming loans in total loans (percent) 3/          | 16.6 | 16.5  | 19.7  | 20.6  | 15.1          |
| Average domestic lending rate, real 3/                            | 16.0 | 22.5  | 39.0  | 19.3  | 19.9          |
| Central bank bill yield, real 3/                                  | -2.8 | 12.8  | 12.9  | -1.2  | -1.1          |
| Central bank foreign short-term liabilities (millions of US\$) 2/ | 0.5  | 0.2   | 0.5   | 0.5   | 0.0           |
| <b>External indicators 2/</b>                                     |      |       |       |       |               |
| Merchandise exports (percentage change)                           | 0.7  | -18.9 | -1.6  | 21.8  | 21.4          |
| Merchandise imports (percentage change)                           | 4.1  | -12.7 | -14.6 | 18.0  | 22.7          |
| Merchandise terms of trade (percentage change)                    | -4.6 | -0.3  | 6.9   | 8.6   | 4.4           |
| Real effective exchange rate (percentage change)                  | -3.1 | -1.5  | -3.5  | -6.6  | 5.1           |
| Current account balance (percent of GDP)                          | -2.1 | -3.9  | 1.7   | 2.4   | 0.9           |
| Capital and financial account (percent of GDP)                    | 2.0  | 2.2   | 1.1   | 3.7   | 2.4           |
| Net foreign direct investment (percent of GDP)                    | 1.3  | 1.2   | 0.2   | 0.5   | 0.9           |
| Inward portfolio investment (percent of GDP)                      | 0.0  | 0.0   | 0.0   | 0.0   | 0.0           |
| Other net investment (percent of GDP)                             | 0.7  | 0.8   | 0.8   | 3.0   | 1.2           |
| External public debt (percent of GDP)                             | 30.6 | 33.5  | 42.9  | 43.3  | 38.0          |
| Debt service (in percent of exports GNFS)                         | 10.4 | 10.8  | 9.1   | 11.0  | 10.4          |
| Gross reserves (in US\$)  | 772  | 723   | 641   | 983   | 1,180         |
| In months of imports of GNFS                                      | 3.2  | 3.5   | 2.7   | 3.4   | 3.9           |
| Over short-term external debt 4/                                  | 1.1  | 1.1   | 0.9   | 1.3   | 1.7           |
| Over foreign currency deposits in domestic banks                  | 0.6  | 0.6   | 0.7   | 1.0   | 1.1           |

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

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

2/ Projection for 2004.

3/ Latest available data, September 2004.

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

Table 14. Paraguay: Proposed Schedule of Reviews and Purchases

| Date                                 | Amount of Purchase |                    | Conditions   |
|--------------------------------------|--------------------|--------------------|--|
|                                      | (Millions of SDRs) | (Percent of Quota) |  |
| <b>Purchases available</b>           | <b>38.0</b>        | <b>38.0</b>        |  |
| 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    |
| <b>Purchases to become available</b> | <b>12.0</b>        | <b>12.0</b>        |  |
| December 20, 2004                    | 3.0                | 3.0                | Third review and end-August 2004 performance criteria    |
| March 15, 2005                       | 3.0                | 3.0                | Fourth review and end-December 2004 performance criteria |
| June 15, 2005                        | 3.0                | 3.0                | Fifth review and end-March 2005 performance criteria     |
| September 15, 2005                   | 3.0                | 3.0                | Sixth review and end-June 2005 performance criteria      |
| <b>Total</b>                         | <b>50.0</b>        | <b>50.0</b>        |  |

Source: Fund staff estimates.

Table 15. Paraguay: Indicators of Capacity to Repay the Fund 1/

|  | Projections |       |       |       |       |       |       |       |
|--|-------------|-------|-------|-------|-------|-------|-------|-------|
|  | 2003        | 2004  | 2005  | 2006  | 2007  | 2008  | 2009  | 2010  |
| <b>Fund repurchases and charges</b>                        |             |       |       |       |       |       |       |       |
| In millions of SDRs  | 0.2         | 0.2   | 1.3   | 1.6   | 1.6   | 24.2  | 25.7  | 2.3   |
| In millions of U.S. dollars                                | 0.2         | 0.3   | 1.9   | 2.4   | 2.4   | 35.6  | 37.9  | 3.4   |
| In percent of exports of goods and NFS                     | 0.0         | 0.0   | 0.1   | 0.1   | 0.1   | 1.0   | 1.0   | 0.1   |
| In percent of quota  | 0.2         | 0.2   | 1.3   | 1.6   | 1.6   | 24.2  | 25.7  | 2.3   |
| In percent of gross official reserves                      | 0.0         | 0.0   | 0.2   | 0.2   | 0.2   | 2.6   | 2.6   | 0.2   |
| <b>Fund credit outstanding</b>                             |             |       |       |       |       |       |       |       |
| In millions of SDRs  | 0.0         | 41.0  | 50.0  | 50.0  | 50.0  | 27.3  | 2.3   | 0.0   |
| In millions of U.S. dollars                                | 0.0         | 60.2  | 73.6  | 73.7  | 73.8  | 40.2  | 3.3   | 0.0   |
| In percent of exports of goods and NFS                     | 0.0         | 1.8   | 2.2   | 2.1   | 2.1   | 1.1   | 0.1   | 0.0   |
| In percent of quota  | 0           | 41.0  | 50.1  | 50.1  | 50.1  | 27.3  | 2.3   | 0.0   |
| In percent of gross official reserves                      | 0.0         | 3.5   | 4.1   | 3.9   | 3.8   | 2.0   | 0.2   | 0.0   |
| <b>Memorandum items:</b>                                   |             |       |       |       |       |       |       |       |
| Exports of goods and NFS (mlns. of U.S. dollars), baseline | 2,845       | 3,316 | 3,407 | 3,449 | 3,540 | 3,634 | 3,732 | 3,836 |
| Debt service (millions of U.S. dollars)                    | 312         | 345   | 291   | 314   | 338   | 347   | 348   | 360   |
| Quota (millions of SDRs)                                   | 100         | 100   | 100   | 100   | 100   | 100   | 100   | 100   |
| Quota (millions of U.S. dollars)                           | 148         | 147   | 147   | 147   | 147   | 147   | 147   | 147   |
| Gross official reserves (millions of U.S. dollars)         | 982         | 1,180 | 1,220 | 1,268 | 1,319 | 1,372 | 1,437 | 1,497 |
| U.S. dollars per SDR (e.o.p.) 2/                           | 1.49        | 1.47  | 1.47  | 1.47  | 1.48  | 1.48  | 1.48  | 1.48  |

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

1/ Assumes all purchases made as scheduled under current program starting from December 15, 2004, and repurchases made on the obligations schedule.

2/ WEO projections.

Table 16. Paraguay: Medium-Term Scenario

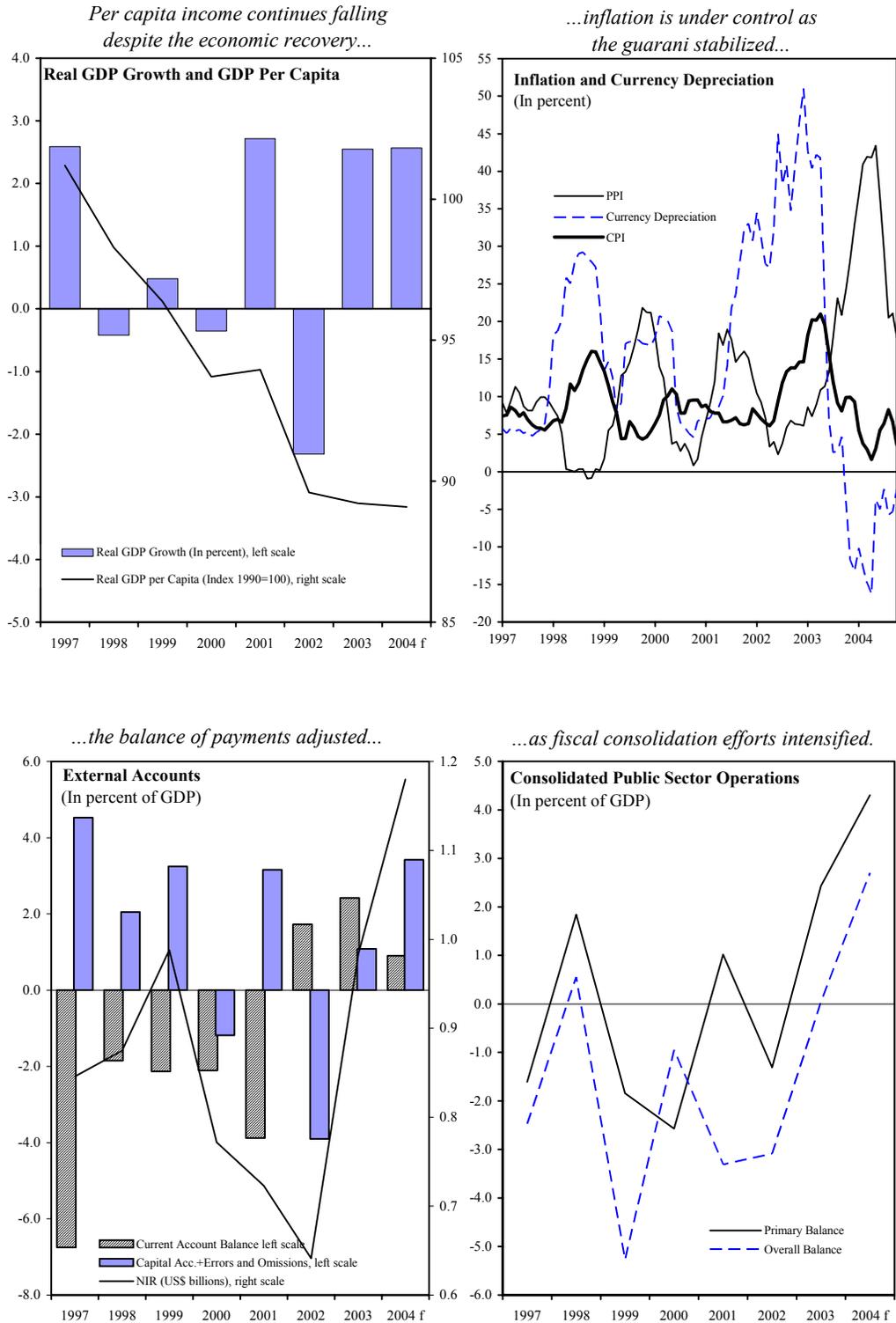
(In percent of GDP, unless otherwise specified)

|  | Est.  |       |       | Projections |       |       |       |       |       |       |
|--|-------|-------|-------|-------------|-------|-------|-------|-------|-------|-------|
|  | 2001  | 2002  | 2003  | 2004        | 2005  | 2006  | 2007  | 2008  | 2009  | 2010  |
| <b>Real sector</b>                                       |       |       |       |             |       |       |       |       |       |       |
| Real GDP growth (annual percentage change)               | 2.7   | -2.3  | 2.6   | 2.6         | 3.2   | 3.4   | 4.0   | 4.0   | 4.0   | 4.0   |
| Consumer prices (annual percentage change)               | 8.4   | 14.6  | 9.3   | 6.0         | 6.0   | 5.0   | 5.0   | 5.0   | 5.0   | 5.0   |
| GDP per capita (US dollars)                              | 1,224 | 981   | 1,024 | 1,152       | 1,160 | 1,209 | 1,247 | 1,291 | 1,333 | 1,377 |
| <b>Public finances 1/</b>                                |       |       |       |             |       |       |       |       |       |       |
| Revenues   | 21.3  | 19.3  | 19.8  | 21.6        | 22.5  | 23.1  | 22.9  | 22.4  | 21.8  | 21.3  |
| Current primary expenditures                             | 17.7  | 16.1  | 14.7  | 14.9        | 16.0  | 16.0  | 15.8  | 15.6  | 15.3  | 15.1  |
| Interest payments  | 1.7   | 1.9   | 1.9   | 1.7         | 1.5   | 1.8   | 1.8   | 1.7   | 1.5   | 1.5   |
| Capital expenditures                                     | 5.1   | 5.9   | 4.8   | 4.6         | 7.5   | 7.6   | 7.5   | 7.5   | 7.3   | 7.2   |
| Public enterprise operating surplus                      | 2.5   | 1.4   | 2.1   | 2.3         | 2.5   | 2.6   | 2.5   | 2.4   | 2.3   | 2.3   |
| Primary balance  | 1.0   | -1.3  | 2.4   | 4.4         | 1.5   | 2.0   | 2.0   | 1.8   | 1.6   | 1.3   |
| Overall balance  | -3.3  | -3.1  | -0.1  | 2.8         | 0.0   | 0.2   | 0.2   | 0.1   | 0.0   | -0.2  |
| Public sector debt (in millions of U.S. dollars)         | 2,526 | 2,728 | 2,814 | 2,723       | 2,751 | 2,718 | 2,709 | 2,753 | 2,838 | 2,863 |
| (In percent of GDP)                                      | 36.8  | 48.4  | 46.8  | 39.0        | 38.1  | 35.6  | 33.2  | 31.6  | 30.4  | 28.6  |
| <b>Balance of payments (in millions of U.S. dollars)</b> |       |       |       |             |       |       |       |       |       |       |
| Exports  | 1,883 | 1,852 | 2,255 | 2,737       | 2,820 | 2,854 | 2,938 | 3,025 | 3,116 | 3,212 |
| Imports  | 2,500 | 2,134 | 2,518 | 3,090       | 3,280 | 3,333 | 3,445 | 3,586 | 3,733 | 3,887 |
| Current account  | -266  | 97    | 146   | 63          | -27   | -39   | -58   | -98   | -140  | -185  |
| (In percent of GDP)                                      | -3.9  | 1.7   | 2.4   | 0.9         | -0.4  | -0.5  | -0.7  | -1.1  | -1.5  | -1.9  |
| Capital and financial account                            | 150   | 65    | 222   | 166         | 66    | 87    | 109   | 151   | 205   | 245   |
| Net international reserves                               | 723   | 641   | 983   | 1,180       | 1,220 | 1,268 | 1,319 | 1,372 | 1,437 | 1,497 |
| (In months of imports)                                   | 3.5   | 2.7   | 3.4   | 3.9         | 3.9   | 4.0   | 4.0   | 3.9   | 4.0   | 4.1   |

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

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

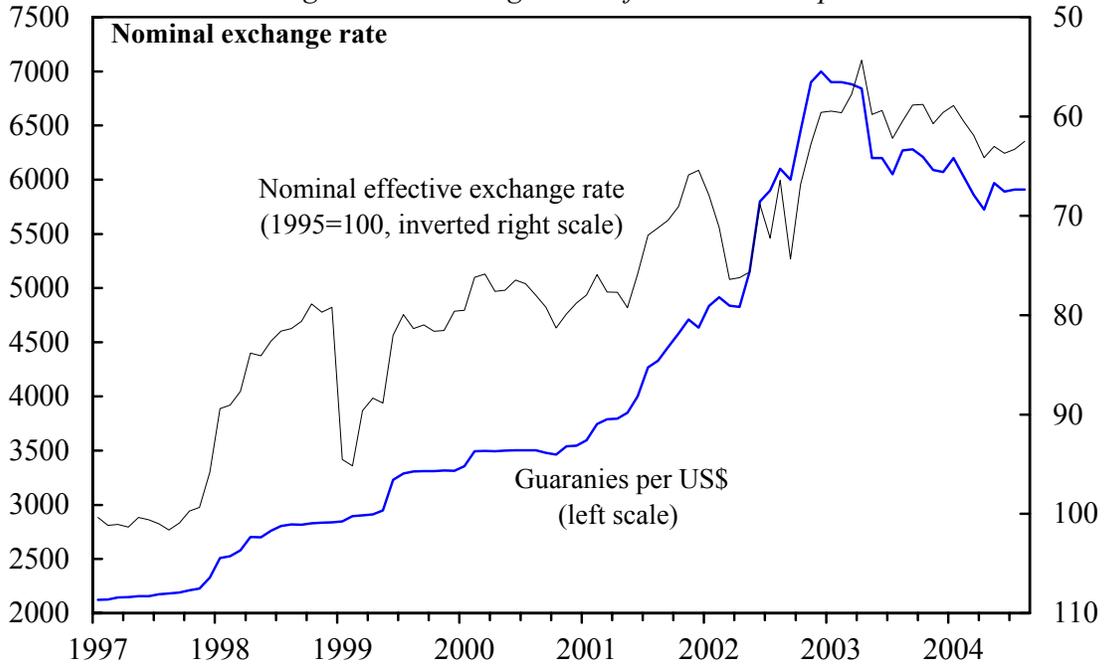
**Figure 1. Paraguay: Selected Economic Indicators**



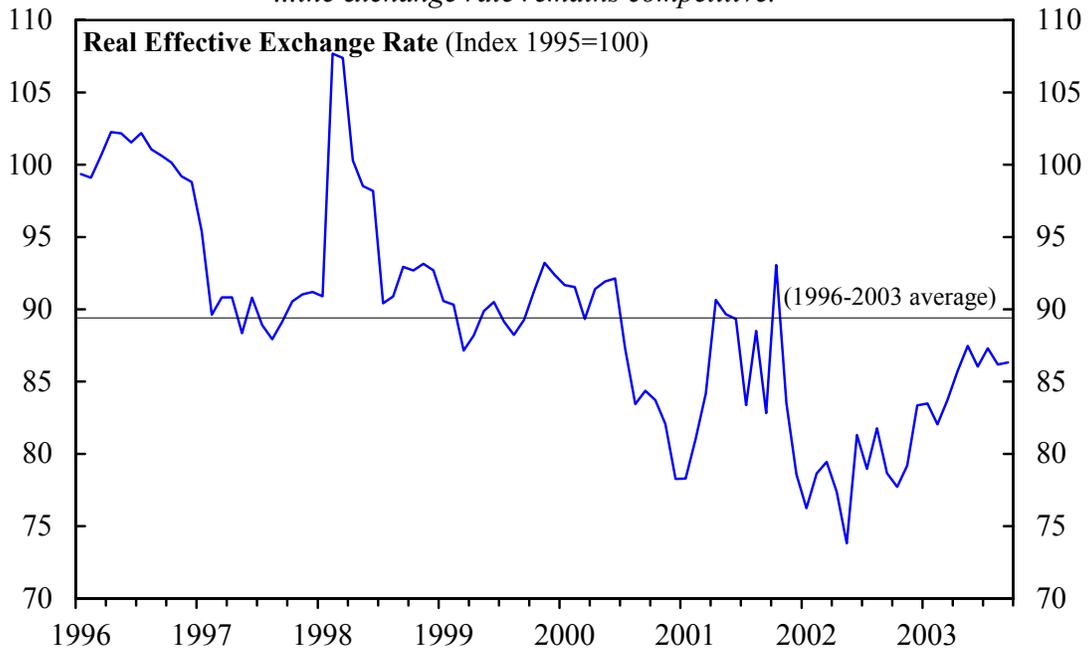
Source: Central Bank of Paraguay.

**Figure 2. Paraguay: Exchange Rate Developments**

*The exchange rate has strengthened after a turbulent period...*

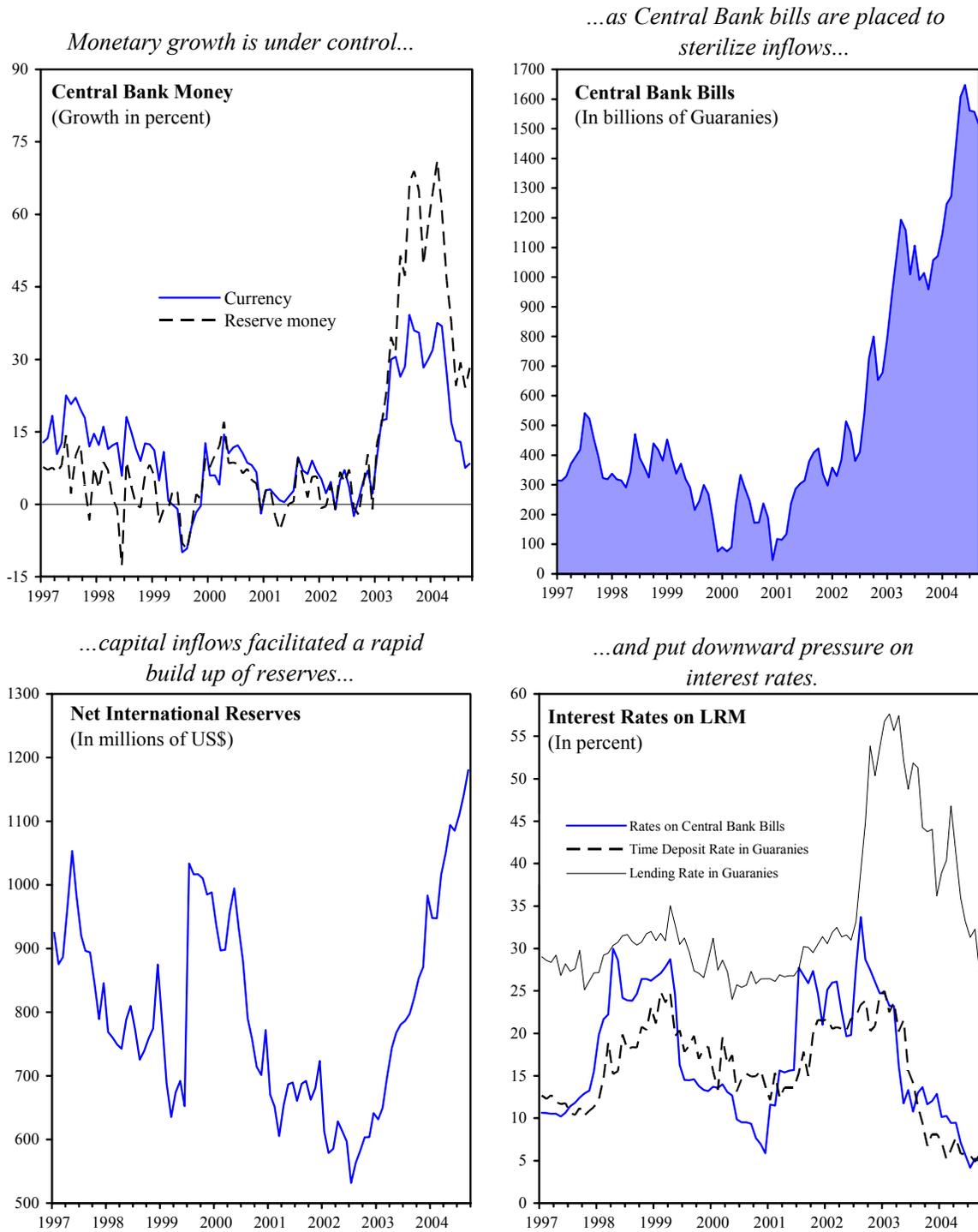


*...the exchange rate remains competitive.*



Source: Central Bank of Paraguay.

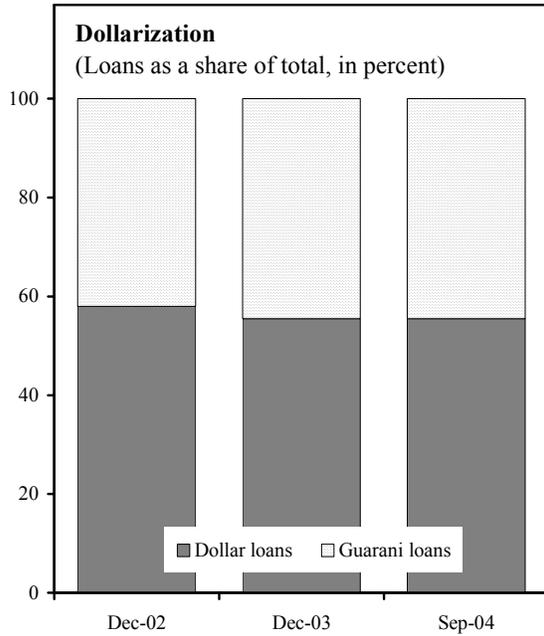
**Figure 3. Paraguay: Selected Financial Indicators**



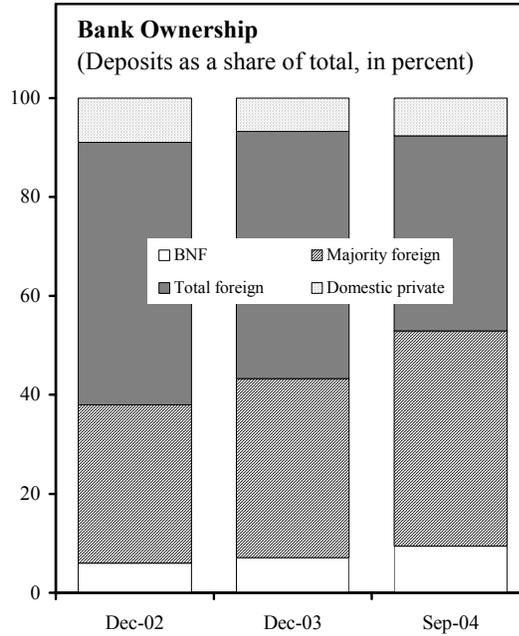
Source: Central Bank of Paraguay.

**Figure 4. Paraguay: Selected Banking Indicators**

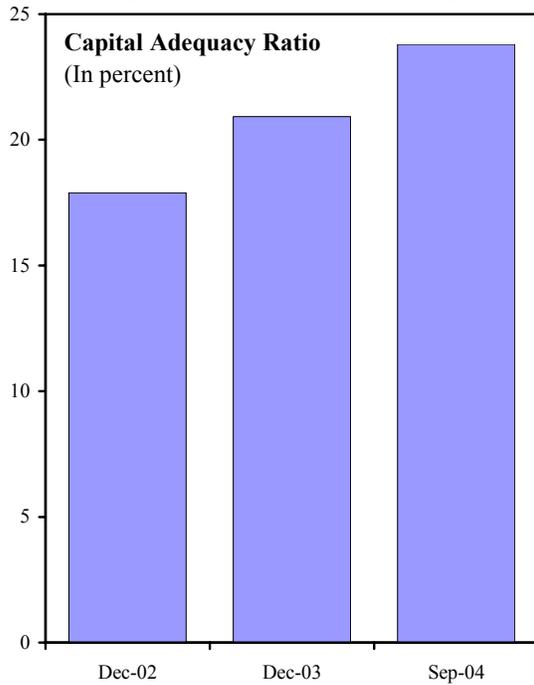
*The banking system is dollarized...*



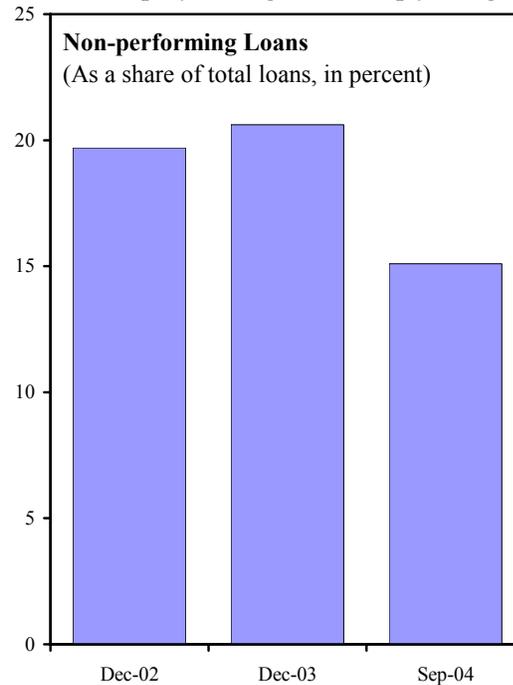
*...but the number of foreign banks in the system is shrinking...*



*...capital asset ratios are rising...*



*...as non-performing loans keep falling.*



Source: Central Bank of Paraguay.

**FUND RELATIONS**  
(As of October 31, 2004)

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

| II. <b>General Resources Account:</b> | <b>In millions<br/>of SDRs</b> | <b>In percent<br/>of Quota</b> |
|---------------------------------------|--------------------------------|--------------------------------|
| Quota                                 | 99.90                          | 100.00                         |
| Fund holdings of currency             | 78.43                          | 78.51                          |
| Reserve position in Fund              | 21.48                          | 21.50                          |

| III. <b>SDR Department:</b> | <b>In millions<br/>of SDRs</b> | <b>Percent of<br/>Allocation</b> |
|-----------------------------|--------------------------------|----------------------------------|
| Net cumulative allocation   | 13.70                          | 100.00                           |
| Holdings                    | 85.70                          | 625.71                           |

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 October 31, 2004, the average interbank rate for the U.S. dollar was G6,065=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:**

| <b>Department</b> | <b>Purpose</b>                      | <b>Date of Delivery</b> |
|-------------------|-------------------------------------|-------------------------|
| 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           |

| <b>Department</b> | <b>Purpose</b>   | <b>Date of Delivery</b>          |
|-------------------|--|----------------------------------|
| MAE               | Currency Operations  | March through September 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               | Safeguard 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                     |
| MFD               | Monetary Operations and Monetary Policy Formulation        | October 2004                     |

VIII. **Safeguard Assessment:** Under the Fund's safeguards assessment policy, Central Bank of Paraguay (CBP) is subject to an assessment with respect to the expected arrangement. A safeguards assessment of the CBP was completed on January 31, 2003. The assessment concluded that substantial risks may 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.

**WORLD BANK RELATIONS<sup>1</sup>**  
(As of October 31, 2004)

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 lay 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 two adjustment operations. One of them, the Economic Recovery Loan in the amount of 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 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\$153 million in commitments, of which US\$66.4 million are undisbursed as of August 31, 2004. These projects include: Fourth Rural Water Supply, Natural Resource Management, Pilot Community Development, and the Secondary Education Reform, which became effective in July 2004. There is also an active program of grants that are currently being implemented.

A Financial Sector Adjustment Loan and Technical Assistance Loan are at an advanced stage of preparation. A technical assistance loan to assist in the restructuring of the ministry of finance and help it become a ministry of excellence is also under preparation for FY05 delivery. Preparation is also underway for a new Maternal Health II Project and a Social Security Reform Technical Assistance Loan, which are also planned for FY05 delivery. 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.

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<sup>1</sup> Prepared by the staff of the World Bank.

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

**I. IBRD/IDA Operations (as of October 31, 2004)**

|   | Committed<br>(Net of Cancellations) | Disbursed    | Undisbursed |
|---|-------------------------------------|--------------|-------------|
| <b>Active loans</b>   |                                     |              |             |
| Natural Resource Management                                       | 50.0                                | 37.7         | 12.3        |
| Maternal Health   | 21.8                                | 21.6         | 0.2         |
| Fourth Rural Water Supply   | 40.0                                | 19.9         | 20.1        |
| Community development   | 9.0                                 | 0.9          | 8.1         |
| Education Reform  | 24.0                                | 0.0          | 24.0        |
| <b>Total active loans</b>   | <b>144.8</b>                        | <b>80.1</b>  | <b>64.7</b> |
| <b>Total inactive loans</b>                                       | <b>708.5</b>                        | <b>708.5</b> | <b>0.0</b>  |
| <b>Total IBRD/IDA</b>   | <b>853.3</b>                        | <b>788.6</b> | <b>64.7</b> |
| <b>Repaid (incl. Repay to 3<sup>rd</sup> parties)<sup>1</sup></b> |                                     | <b>533.4</b> |             |
| <b>Total outstanding</b>  |                                     | <b>252.5</b> |             |
| O/w IBRD  |                                     | 229.8        |             |
| O/w IDA   |                                     | 22.8         |             |

**II. IFC Operations (as of October 31, 2004)**

|                              | 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) (as of October 31, 2004)**

|               | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004  |
|---------------|------|------|------|------|------|------|------|------|-------|
| Disbursements | 27.5 | 41.2 | 37.7 | 42.1 | 46.6 | 26.8 | 13.5 | 42.3 | 9.8   |
| Repayments    | 35.2 | 27.5 | 24.6 | 24.6 | 20.2 | 15.3 | 16.8 | 21.0 | 23.4  |
| Net lending   | -7.7 | 13.8 | 13.1 | 17.5 | 26.4 | 11.5 | -3.3 | 21.3 | -13.5 |

Source: World Bank

<sup>1</sup> As of October 31, 2004

**INTER-AMERICAN DEVELOPMENT BANK RELATIONS<sup>1</sup>**  
(As of October 31, 2004)

**Portfolio**

1. There is close collaboration between the IDB and the IMF, as the IDB had operations contingent on the approval of an agreement with Paraguay, which had been included in the IMF's assessments of the situation. Furthermore, there is close coordination between the IDB and the World Bank in specific issues regarding public banking reform.
2. The operations of IDB, Paraguay's main creditor, have been affected in the past by fiscal constraints and political instability with regard to decisions concerning new loans. As a direct consequence, Paraguay entered in default in 2002 and again in 2003, loans had to be postponed, loan disbursements were slow, the net cash flow to the country was negative for the third consecutive year, and most probably will be negative again in 2004.
3. As of October 31, 2004 the active loan portfolio amounts to US\$657.3 million, of which 46.8 percent have been disbursed. In addition, there are active technical cooperation operations for US\$17.3 million, of which 44.5 percent have been disbursed.

**Operations Program**

4. Given the large active portfolio and the fiscal constraints the lending program for 2004 will have no new operations.
5. The lending program for 2005 includes the following operations:
  - a. TC loan for the Public Bank Reform, for US\$4 million
  - b. Multisector Credit Line Loan, for amount to be determined
  - c. Strengthening of the Judiciary System II, for US\$10 million
  - d. Integration Corridors, Rehabilitation and Maintenance of the Road System, for US\$50 million
  - e. Strengthening Negotiating Skills for Foreign Trade, for US\$2 million
  - f. Depositary, Compensation and Liquidation System, for US\$2,0 million
  - g. Professionalism of the Civil Service, for US\$5,0 million
  - h. Asunción Coastal Development Program, for US\$75 million
6. The Bank's new country strategy with Paraguay was approved in July, 2004.

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<sup>1</sup> Prepared by the staff of the IDB.

**STATISTICAL ISSUES**  
(As of November 15, 2004)

**A. Real Sector**

A new national accounts series has been prepared recently with the assistance of an expert financed by the IDB. It comprises a fuller coverage of industries, an input-output matrix, and expanded data sources for the compilation of the new benchmark and base year (1994). Quarterly information recently became available for 1997–2001.

Both the consumer and producer price indices are reported on a regular and timely basis. The CPI has a base period of 1992, and the PPI of December 1995. A change in the base period and basket of the CPI is scheduled to take place after the results of a new household income and expenditure survey covering the period 2001–02 become available. The coverage and quality of employment and unemployment statistics have improved their coverage and quality significantly since a regular household survey was introduced in 1998. However, frequencies remain at the annual level, and the publication lag is close to one year. Wage indices are updated twice a year.

Paraguay became a GDDS participant in 2001 with the publication of its metadata on the Fund's Dissemination Standards Bulletin Board (DSBB).

**B. Public Finances**

Reliable monthly data are available on a timely basis for the central government, where much improvement has been made over the past years. The asset position of the social security system is available on a daily basis. However, shortcomings in the classification and recording remain and the Paraguayan GFS is not fully consistent with the methodology of the IMF *Government Finance Statistics Manual 1986 (GFSM 1986)*. For instance, nontax revenues include social security contributions. Additionally, public enterprises and the social security system have been following somewhat different classifications of revenues and expenditures than the central government. A law (*Ley 1535*) that was passed in 2000 should allow closer integration, as it sets uniform standards and creates a database for the entire public sector. Data on medium- and long-term external debt are reliable and available on a monthly basis. Internal debt data are available on request, but need to be more fully integrated with the external debt database. Deficiencies remain in the registration of short-term supplier and commercial credit of the public sector. Moreover, there is a discrepancy in the fiscal data reported by the monetary and fiscal authorities. On November 2003, the Ministry of Finance issued a decree requiring all decentralized entities and public enterprises to provide updated monthly financial data to the Ministry of Finance, as well as the balance sheet. 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 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 *GFSY*. Monthly and quarterly data are not reported for publication in *IFS*. The resumption of reporting quarterly and monthly data for the *IFS* is highly recommended. Data on local governments and public enterprises are deficient and not reported regularly.

### **C. Money and Banking**

Money and banking statistics are broadly reliable as a result of the adoption in 1995 of a new accounting plan for commercial banks and finance companies. Following the work on methodologies initiated in the 2000 STA mission, Paraguay completed the establishment of a unified compilation and reporting system for the whole range of monetary data. This new system intends to harmonize monetary data for use of the CBP, for reporting to STA for publication in *IFS*, and for operational and monitoring purposes. A revision of the classification criteria has led also to a marked reduction in the discrepancies of interbank positions. 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**

Quarterly and annual data on balance of payments and the international investment position (IIP) statistics are available from 2001 onwards on the central bank website, and reported to STA. Annual IIP data have been compiled and disseminated for the period 1995–2003. The classification of the balance of payments and of the IIP follows the recommendations of the Balance of Payments Manual (5<sup>th</sup> edition). Technical assistance by STA has led to improvements in the quality of the data on capital flows, especially in the coverage on foreign direct investment, and in the recording of external debt transactions in the balance of payments and in the IIP. The central bank now produces a highly informative bulletin on balance of payments statistics. Special studies by the central bank have improved the estimation methods for remittances of Paraguayans abroad and unregistered trade transactions but serious deficiencies remain.

Deficiencies remain in the area of private capital outflows, which are difficult to register due to Paraguay's liberal capital account. Major recommendations of the multisector statistics mission 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 several services and financial transactions; and (v) institute a system of coordination with other official agencies, and within the CBP, to promote intersectoral data consistency. Sizable negative errors and omissions over the last few years can be attributed mostly to unregistered trade and outflows of portfolio capital.

**CORE STATISTICAL INDICATORS**  
(As of November 15, 2004)

|                            | Exchange Rates | International Reserves | Central Bank Balance Sheet | Reserve/ Base Money | Broad Money  | Interest Rates | Consumer Price Index | Exports/ Imports | Current Account Balance | Central Government Balance | GDP/ GNP     | External Debt/ Debt Service |
|----------------------------|----------------|------------------------|----------------------------|---------------------|--------------|----------------|----------------------|------------------|-------------------------|----------------------------|--------------|-----------------------------|
| Date of Latest Observation | 11/12/04       | 11/12/04               | 11/12/04                   | 11/12/04            | 09/30/04     | 09/30/04       | M10/04               | M09/04           | Q2/2004                 | M10/04                     | 2003         | Q2/2004                     |
| Date Received              | 11/15/04       | 11/15/04               | 11/15/04                   | 11/15/04            | 10/20/04     | 10/20/04       | 11/02/04             | 10/31/04         | 09/30/04                | 11/12/04                   | 7/01/04      | 09/30/04                    |
| Frequency of Data          | Daily          | Daily                  | Daily                      | Daily               | Monthly      | Monthly        | Monthly              | Monthly          | Quarterly               | Monthly                    | Annual       | Quarterly                   |
| Frequency of Reporting     | Daily          | Daily                  | Daily                      | Daily               | Monthly      | Monthly        | Monthly              | Monthly          | Quarterly               | Monthly                    | Annual       | Quarterly                   |
| Source of Update           | Central Bank   | Central Bank           | Central Bank               | Central Bank        | Central Bank | Central Bank   | Central Bank         | Central Bank     | Central Bank            | Ministry of Finance        | Central Bank | Central Bank                |
| Mode of Reporting          | E-mail         | E-mail                 | E-mail                     | E-mail              | E-mail       | E-mail         | E-mail               | E-mail           | E-Mail                  | E-mail                     | Publication  | E-mail                      |
| Confidentiality            | None           | None                   | None                       | None                | None         | None           | None                 | None             | None                    | None                       | None         | None                        |
| Frequency of Publication   | Daily          | Daily                  | Daily                      | Daily               | Monthly      | Monthly        | Monthly              | Monthly          | Quarterly               | Monthly                    | Annual       | Quarterly                   |

Asunción, Paraguay  
December 7, 2004

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

Dear Mr. de Rato:

1. This letter and the attached memorandum supplement our letters dated December 5, 2003, March 26, 2004 and July 16, 2004, describe performance under the Government of Paraguay's economic program for 2004, and propose an economic program for the first half of 2005. The attached memorandum also describes the economic policies that the government intends to implement during the next months. The government aims—through these policies—at consolidating our stabilization efforts, reinvigorating the structural reform and maintaining low inflation, while laying the basis for sustainable growth and employment and for poverty reduction over the medium term.

2. Performance under the program supported by a 15-month Stand-By Arrangement (SBA) has been strong, although there are delays in implementing some elements of the structural reform agenda. Nine of the eleven quantitative performance criteria for end-August 2004 were observed, and the missed quantitative criteria had small deviations. Two structural performance criteria were not observed either (for end-September and end-October) due to a renewed and phased strategy in conducting the public banking reform as well as delays in dealing with the ambitious legislative agenda in congress. However, we remain fully committed to these policies—as well as those in the program—and corrective measures are being adopted.

3. To support our continued efforts, the Government of Paraguay seeks IMF support for the period through September 2005 and hereby requests: (i) completion of the third SBA review; (ii) waivers for the non-observance of two quantitative performance criteria and two structural performance criteria;<sup>1</sup> (iii) modification of four performance criteria for end-

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<sup>1</sup> The quantitative performance criteria missed through end-August 2004 were: (i) the ceiling on the wage bill of the central administration, and (ii) the non-accumulation of arrears target. The structural performance criteria missed were: (i) independent accounting audits for three public corporations by end-September 2004 (of which two were completed in time and one was completed later on); and (ii) congressional approval of the public banking law by end-October 2004.



**SUPPLEMENT TO THE MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES  
OF THE GOVERNMENT OF PARAGUAY**

**V. BACKGROUND**

1. **The government adopted an ambitious economic program since taking office in August 2003.** Against the background of some of the worst economic performance in recent history, delicate economic fundamentals, large vulnerabilities, serious problems in the financial system, a rapidly growing public debt, weaknesses in the fiscal position and a rapid depreciation of the currency, we adopted a stabilization program with international support, including through a 15-month IMF Stand-By Arrangement (SBA). Our economic program aimed at stabilizing the economy and restoring confidence in the financial system, while laying the basis for renewed and sustainable growth and poverty reduction over the medium term through the implementation of sound macroeconomic policies and far-reaching structural reforms geared to bolstering the economy's productive potential.

2. **Program performance continues to be strong, and the main macroeconomic targets are being achieved comfortably.** The economy is expected to grow by 2.6 percent in 2004, slightly more than originally envisaged under the program despite an unexpected drought, with an estimated cost of ½ to 1 percent of GDP. Inflation is expected to reach 6 percent in 2004, significantly lower than the 8 percent originally expected under the program. The budget will be in surplus in 2004 mostly due to significant improvements in tax administration. The currency stabilized rapidly as confidence was restored. The main monetary and fiscal targets under the program have been achieved with comfortable margins. Nine out of eleven quantitative performance criteria for end-August 2004 were observed. There was a minor deviation on the ceiling for the wage bill of the central government, due to a small and unexpected wage increase granted by congress to the judicial system. The non-accumulation of arrears target was also not observed due to a small delay in paying one of our bilateral creditors.

3. **However, there have been delays in implementing some structural measures recently.** Following a strong implementation of the structural reform agenda during the first half of 2004—including by approving the fiscal adjustment law and the customs code—some delays have occurred due to technicalities in conducting audits and the need to further refine our strategy on public banks to avoid the introduction of elements that would have distorted the core intention of the public bank reform. Two structural performance criteria for end-September and end-October were not observed:

- ***Complete accounting audits for three public enterprises (by end-September 2004).*** Only two of the three accounting audits were finalized before end-September (ANDE and COPACO). The audit for the other company (ESSAP) was not finalized on time because the auditor requested further legal clarifications to ascertain that the revenues of the company came from assets belonging to the company and not to the ministry of finance (as was the case prior to the conversion of ESSAP into a corporation in 2003).

We have issued a decree to clarify the legal status of the assets and liabilities of ESSAP. The ESSAP audit has already been finalized (prior action).

- **Congressional approval of the public banking law (by end-October 2004).** After further consultations we determined that it was better to conduct the reforms contained in that law in two stages.
  - *The first stage*, dealing with the creation of a second-tier public bank to intermediate external resources. We have sent a new bill to congress (replacing our original proposal) implementing the first stage of the strategy. We expect that this new bill will be approved, at least by one chamber, by mid-December (prior action).
  - *The second stage*, dealing with further restructuring of the first-tier public banks to better focus their operations. We are preparing a strategy on how best to implement such restructuring. A high-level commission will be appointed in February 2005 to oversee the restructuring process. Legislation to change the framework for first-tier public banks will be drafted in consultation with the Fund and is expected to be submitted to congress by June 2005. We expect this reform to take place during 2005.<sup>1</sup>

## VI. MACROECONOMIC PROGRAM FOR 2005

4. **The key objective of the 2005 program is to consolidate the significant stabilization gains achieved in the past months.** The main elements of the program are: (i) a relatively balanced fiscal position while allowing a significant increase in public investment; (ii) a more balanced monetary policy aimed at containing inflation while supporting an expansion of private credit; and (iii) a gradual implementation of the structural reform measures contained in the program that have been subject to delays. We believe that the policies described in this memorandum will achieve the objectives of the program. Performance criteria related to these policies are specified in Table 1 and defined in the attached technical memorandum of understanding.

5. **The program projects that the economy will continue expanding in 2005 while inflation remains under control.** Economic growth is projected to continue on an upward trend. GDP is expected to increase by about 3¼ percent in 2005, as the effects of the drought are phased out and public and private investment recovers. At the same time, inflation is

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<sup>1</sup> In late-October, congress approved a law which expanded the scope of BNF operations, monopolized public transactions in foreign exchange, and raised lending limits, with the purpose to facilitating credit to the agricultural sector for the next harvest. The president vetoed the law's provision requiring all public sector foreign exchange transactions to go through BNF, instead these transactions will continue to go through the Central Bank of Paraguay. We will instruct BNF to remain vigilant and ensure that all lending operations are guided by sound commercial criteria.

projected to remain at 6 percent in 2005 despite high oil prices and higher inflation rates in neighboring countries.

#### A. Fiscal Policy

6. **The government will conduct policies that will contain the central government fiscal deficit to ½ percent of GDP in 2005.** The fiscal target for the 2005 program is consistent with the 2005 budget that was sent to congress in August. As in the budget proposal, tax collections are expected to continue improving on account of the carry over of measures already taken in the context of the fiscal adjustment law. With this law, we believe our tax code is broadly adequate and will refrain from introducing further tax legislation other than to address remaining weaknesses in the law. We will continue to focus our efforts on further improvements in tax administration. Expenditures are expected to increase more rapidly than GDP to accommodate a moderate wage increase (after a three-year freeze), the creation of the rural institute to deal with emerging social issues, an increase in resources for the tax administration, and a significant increase in public investment to support a higher GDP growth. The fiscal deficit of ½ percent of GDP will be achieved without recourse to additional discretionary fiscal measures. This small deficit will not create undue financing needs. We estimate that external borrowing from already contracted loan projects would be broadly sufficient to cover our budgetary financing needs in 2005 without creating pressures from domestic sources, although there will be a need to roll over domestic debt or use deposits.

7. **In order to consolidate our fiscal efforts, an adjustor will be introduced in the event tax revenues are higher than anticipated to reduce vulnerabilities and support public investment.** In case tax collections surpass program expectations, as in 2004, an adjustor will be applied; for each *guaraní* of additional tax revenues above program projections, 70 percent will be used to finance higher expenditures (preferably capital) while the remaining 30 percent can be used to reduce the fiscal deficit. This adjustor will not apply in cases where tax revenues fall short of program projections. With this adjustor the government tries to balance the need to support the recovery with the need to reduce fiscal vulnerabilities.

8. **To mitigate possible adverse social effects, the government will strengthen its social safety net.** Within the envelope of the allocated public investment program and additional transfers, the government intends to intensify implementation of several projects aimed at reducing the economic burden among the most vulnerable groups in the population, especially by creating a program to purchase land and distribute it among the peasants. There are currently several social safety net programs that need to be consolidated. The government will work closely with the World Bank and IDB's staff to ensure that the social safety net is effective in reaching its objectives.

## B. Monetary Policy

9. **The main monetary policy objective for 2005 will be to keep inflation at 6 percent within a range of 2 percentage points higher or lower.** To that end, the central bank will accommodate an expected 10 percent increase in the demand for currency. The inflation objective for 2005 is similar to the expected inflation rate for 2004 and will require only marginal adjustments in the policy to react to demand conditions. However, with higher oil prices being a more permanent feature in the world economy, the external environment for conducting monetary policy has deteriorated as there are inflationary pressures in the world and in the region. In order to insulate the economy from possible shocks, we will be prepared to use the exchange and interest rates flexibly.

10. **International reserves accumulation will be limited in 2005 to support a higher rate of credit expansion.** We believe our current level of reserves at almost US\$1.2 billion is broadly adequate and intend to accumulate only US\$40 million in 2005 (compared to over US\$200 million this year) to keep with the growth in trade and other external transactions. The lower reserve accumulation target for 2005 would reduce the pressures on placements of monetary control instruments by the central bank, creating an environment more conducive to an expansion in private credit, private investment and economic growth. Similarly, the government will continue to limit bank financing for the budget—although there will be room for bridging short-term delays in external financing and domestic debt roll over—preventing a crowding out of private credit.

## VII. STRUCTURAL REFORM AGENDA

11. **The main structural objectives will be to continue with the reform process.** There have been some delays in implementing our ambitious structural reform agenda, not least because of the demanding legislative proposals. We will take the opportunity provided by the extension of the Fund-supported program to conclude previously announced commitments while at the same time developing new initiatives to advance reforms.

### Financial sector issues

12. **The comprehensive banking legislation reform is expected to be approved by congress in the first half of 2005.** There are several reforms which are needed to upgrade Paraguay's prudential regulatory framework and modernize the supervisory approach. This law was to be approved by end-December 2004, however, the legislative agenda was crowded and the congressional recess is approaching. We will submit a legislative proposal to congress by March 2005 and expect it to be approved before end-June 2005 (structural performance criteria). Once the law is approved, banks will try to obtain international ratings. In continuing with the spirit of improving regulatory and supervisory functions in the financial system, the cooperatives will be introducing prudential regulations and formal supervision by March 2005 (structural benchmark) The Deposit Guarantee Fund is now operational, and the government will continue with its gradual but consistent contributions towards its full capitalization. All banks have now submitted their plans for complying with

Resolution 8. In light of this, we are examining the impact of compliance on bank profitability.

13. **We will initiate the process of restructuring the first-tier public banks.** With the law creating the second-tier bank to intermediate external funds already in congress and expected to be approved by end-May 2005 (structural benchmark), we have designed a plan to restructure the first-tier public banks with a view of consolidating institutions and redefining objectives and operations. In particular, the national development bank (BNF) will take advantage of its large and widespread network of branches to specialize in providing small credits in rural areas on commercial terms. At the same time, a commission will be created by end-February 2005 to prepare a medium-term business plan with a view to reorient the credit operations of the bank towards rural areas, improve portfolio recovery, reduce operating costs, improve control systems, develop an appropriate funding policy, and design an appropriate bank recapitalization scheme which would minimize the cost to the state and prevent incentives for non-payment of loans. The commission could outsource technical analysis and advice as needed and would coordinate with the superintendency temporary provisions on prudential practices. The commission will study ways to maximize recovery of non-performing assets and cost cutting following international best practices, for which technical assistance will be sought. Care will be exercised in designing measures to reduce costs to prevent an undue reduction in positions at a time the unemployment rate is still high. While the process of restructuring is expected to be long, we envisage that the commission's recommendations will be adopted by end-July 2005; including by submitting to congress draft legislation for the first-tier public banks (structural performance criteria). During this period, we will closely monitor BNF lending operations to ensure that they are within reasonable limits and consistent with the monetary program.

14. **The financial position of the central bank will be strengthened through an injection of funds from the ministry of finance.** In order to strengthen the central bank financial independence, the ministry of finance will send to congress a legislative proposal in March 2005 allowing provision of non-negotiable bonds to the central bank for about ½ percent of GDP. We are committed to significantly strengthen the financial position of the central bank and will continue making further financial injections in the future. In parallel, we will continue to implement the Memorandum of Understanding, including debt reconciliation between the central bank and the ministry of finance. The central bank has completed its external audit, and has reported these results in both Paraguay and international accounting standards. To modernize its operations, the central bank will also continue implementing its own restructuring plan (approved in July 2004). The central bank will review the recommendations of the recent MFD technical assistance mission to improve monetary policy operation with a view to incorporating them into its restructuring agenda.

#### **Public sector issues**

15. **The civil service reform will be finalized and implemented with a view to improve the functioning of the state and reduce redundant positions.** Following the completion of the census of civil servants, the development of a plan for civil service reform

is expected to be finalized by end-April 2005 (structural benchmark). The authorities will continue in their efforts to streamline the operations of the state. It is not envisaged at this point in the business cycle to reduce personnel but reductions in employment will take place through attrition and significant reductions in hiring for new positions.

16. **Audits will be conducted for the remaining public enterprises/entities with a view of developing business plans.** The government intends to finalize audits for CONATEL, and the social security institute (IPS) by end-December 2004 and for DINAC, PETROPAR, ANNP, and INC by end-April 2005 (both are structural performance criteria). Management audits will also be conducted by end-June. Public enterprises (including ESSAP, COPACO, and PETROPAR) will be required to present plans for the participation of private capital in their operations by end-August 2005 (structural benchmark).

17. **We remain committed to the policy of regular adjustments in fuel and utility prices.** We raised diesel and utility prices in the recent past. These price adjustments are designed to preserve the profitability of the relevant public enterprises. To the extent that the price of important inputs in these companies change, we would need to transfer those variations to the customer. In order to reduce discretionality on the subject, the government will study the possibility of introducing automatic mechanisms to price adjustments in these areas.

#### **Debt restructuring issues**

18. **Following the successful debt exchange conducted earlier this year, a new phase of the debt exchange is expected in early 2005.** Continuing with our efforts to normalize relations with our creditors, we will continue with the second phase of the bond exchange initiated in early 2004. About three-fourths of the eligible debt about US\$90 million was already exchanged in July-August based on claims presented through mid-June, all interest and principal due on these bonds have been paid. We estimate that following the last exchange, an additional one-eighth of the debt about US\$15 million has already been presented for exchange. We intend to conduct this second phase based on claims presented through mid-November. The central bank will verify this amount and present its report to the ministry of finance by mid-December. The ministry will begin the process of bond issuance and validation, which will be completed by end-March 2005.

#### **Investment climate**

19. **We intend to improve the investment climate to facilitate the economic recovery and lay the foundations for higher sustainable growth.** A significant improvement in the investment climate was identified as a key factor to unlock the growth potential of the economy in our recent growth seminar organized in late November. For that reason we will be adding additional measures related to investment climate at the time of the next review.

### **Social sector issues**

20. **In an effort to ameliorate social tensions in rural areas, we have sent to congress a new tax on rural property to finance social spending in this area.** There are emerging social tensions in rural areas, including through invasions of land. While we recognize the importance of defending property rights, we also recognize the social needs in rural areas. In order to find a balanced solution to the problem, the government has sent to congress a proposal to tax rural property (at a low rate) which will be earmarked to satisfy these social needs. With large amounts of fertile land unutilized in the country, the tax also has the purpose of persuading those owners to sell land to those who have plans to make productive use of the land.

### **VIII. CONTINGENCIES AND MODIFICATIONS**

21. **We remain fully committed to the program, and will take any additional action that is necessary to ensure that the objectives of the program are achieved.** We will remain in contact with the IMF to identify potential problems. We are proposing the introduction of an adjustor to the target on the public sector balance. These changes are reflected in the revised technical memorandum of understanding.

Table 1. Paraguay: Quantitative Performance Criteria

|   | Targets              |  |        |
|---|----------------------|--|--------|
|   | SBA 2004<br>End-Dec. | Extension 2005<br>End-Mar.    End-June |        |
| <b>Fiscal targets</b>   |                      |  |        |
| 1. Overall balance of the central administration<br>(floor, in billions of guaranies) 1/ 2/             | 55                   | 105                                    | 111    |
| 2. Wage bill of the central administration<br>(ceiling, in billions of guaranies) 2/                    | 3,010                | 754                                    | 1,525  |
| 3. Overall balance of the public sector<br>(floor, in billions of guaranies) 1/ 2/                      | 130                  | 174                                    | 310    |
| <b>Monetary targets</b>   |                      |  |        |
| 4. Net international reserves (floor, in millions of U.S. dollars) 3/                                   | 1,080                | 1,120                                  | 1,180  |
| 5. Net domestic assets (ceiling, in billions of guaranies) 3/   | -4,090               | -4,614                                 | -5,197 |
| <b>Public debt and arrears targets</b>  |                      |  |        |
| 6. Contracting or guaranteeing of nonconcessional debt by the NFPS<br>(ceiling, in millions of US\$) 3/ | 200                  | 200                                    | 200    |
| 7. External payments arrears of NFPS (ceiling, in millions of US\$) 4/                                  | 0                    | ...                                    | ...    |
| 8. <i>Of which:</i> bilateral arrears 4/  | 0                    | ...                                    | ...    |
| 9. Central government floating debt (ceiling, in billions of guaranies)                                 | 320                  | ...                                    | ...    |
| 10. No new contracted or guaranteed short-term<br>external debt by the NFPS 5/                          | 0                    | 0                                      | 0      |
| 11. No new external debt arrears 5/   | 0                    | 0                                      | 0      |

1/ The target is adjusted upward by 30 percent of the overperformance in tax revenues as specified in the TMU.

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

3/ NIR is adjusted upward (downward) for any increase (decrease) in reserve requirement deposits and upward by the amount of any program disbursements.

4/ These performance criteria will not apply in 2005.

5/ Measured on a continuous basis.

Table 2. Paraguay: Structural Conditionality Under Program  
and Prior Actions for the Third Review

| <b>Measure</b>  | <b>Conditionality</b> | <b>Timing</b>   |
|---|-----------------------|-----------------|
| <b>Financial Sector Reform</b>                                    |                       |                 |
| A. Approval of public banking law (second tier) by one chamber    | Prior action          |                 |
| B. Introduce prudential regulations to cooperatives               | SB                    | March 31, 2005  |
| C. Approval of public banking law (second tier)                   | SB                    | May 31, 2005    |
| D. Approval of new comprehensive banking legislation              | PC                    | June 30, 2005   |
| E. Submission of public banking law (first tier)                  | PC                    | July 30, 2005   |
| <b>Public Sector Reforms</b>                                      |                       |                 |
| F. Finalize plan for comprehensive civil service reform           | SB                    | April 30, 2005  |
| <b>Public Enterprises Reform</b>                                  |                       |                 |
| G. Completion of independent audit of ESSAP                       | Prior action          |                 |
| H. Adjustment in fuel and utility prices to reflect costs         | PC                    | January 1, 2005 |
| I. Independent audits for ANNP, DINAC, INC, PETROPAR              | PC                    | April 30, 2005  |
| J. Plan for private capital participation ESSAP, COPACO, PETROPAR | SB                    | August 2005     |

Sources: Paraguayan authorities; and Fund staff estimates.

SB = structural benchmarks

PC = performance criteria

## TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum presents definitions of the quantitative targets specified in the Supplement to the Memorandum of Economic and Financial Policies, and updates the original Technical Memorandum of Understanding approved on December 15, 2003<sup>20</sup>. Targets are set for March 2005 and June 2005.

### A. Fiscal Targets

#### 1. Performance Criterion on the Overall Balance of the Central Administration

|  | Floor<br>(In billions of <i>guaraníes</i> ) |
|--|---|
| <b>Cumulative balance (from December 31, 2003)</b> |   |
| End-August 2004 (actual)                           | 1,010                                       |
| End-December 2004 (performance criteria)           | 55  |
| <b>Cumulative balance (from December 31, 2004)</b> |   |
| End-January 2005 (indicative target)               | 87  |
| End-February 2005 (indicative target)              | 144   |
| End-March 2005 (performance criterion)             | 105   |
| End-April 2005 (indicative target)                 | 93  |
| End-May 2005 (indicative target)                   | 199   |
| End-June 2005 (performance criterion)              | 111   |

For the purposes of the program, the overall balance of the central administration (CA) is measured as the sum of the CA's: (i) net external financing; (ii) the change in net credit to the central government from the banking system, excluding government bonds; (iii) the change in the stock of government bonds; and (iv) net financing from all other sources to the government, including by the private sector, asset sales; and (v) the change in domestic floating debt (*deuda flotante*) as defined below. Items denominated in foreign currency will be converted into *guaraníes* at the average exchange rate for each month.

For the purposes of the program, the bonds issued to capitalize the central bank or to constitute the deposit guarantee will not be included in the definition of fiscal deficit.

Net external financing is defined as central government's foreign borrowing, including bonds issued abroad, less amortization payments (including debt prepayments) of foreign debt. Net

<sup>20</sup> Compared to the original version, this revision: (i) adds an ajustor to the NDA (ii) adds an ajustor to the fiscal balance for higher tax revenue performance; (iii) takes the registry float of the public sector balance to be zero; (iv) updates the list of external disputed arrears; and (v) expands and changes the definition of the domestic floating debt target of the central government.

credit from the financial system is defined as the change in net credit to government, as reported in the monetary accounts of the BCP, excluding government bonds. The change in the stock of government bonds will be defined net of valuation changes as reported by the ministry of finance. Net change in arrears is defined as net increase in arrears between the beginning and the end of the period. Domestic floating debt is defined as the difference between accrued expenditure (*gastos obligados*) and payments transferred (*gastos transferidos*). External arrears are as reported by the ministry of finance's SIGADE system. Data will be provided to the Fund by the ministry of finance with a lag of not more than three weeks past the test date.

An adjustor will be introduced in the event tax revenues are higher than programmed. The adjustor will establish that for each *guaraní* of additional tax revenues above program projections, 30 percent will go to reduce the fiscal deficit. This adjustor will not apply in cases where tax revenues fall short of program projections. The adjustor will only apply to 2005. The quarterly baseline for tax revenues to be used in calculating the magnitude of the adjustment for end-March 2005: G 1,174 billion; June 2005: G 2,450 billion. This adjustment by extension will also apply for the overall fiscal deficit.

## 2. Performance Criterion on the Wage Bill of the Central Administration

| Cumulative Expenditure                           | Ceiling<br>(In billions of <i>guaraníes</i> ) |
|--|---|
| <b>Cumulative flows (from December 31, 2003)</b> |   |
| End-August 2004 (actual)                         | 1,812   |
| End-December 2004 (performance criterion)        | 3,010   |
| <b>Cumulative flows (from December 31, 2004)</b> |   |
| End-January 2005 (indicative target)             | 247   |
| End-February 2005 (indicative target)            | 499   |
| End-March 2005 (performance criterion)           | 754   |
| End-April 2005 (indicative target)               | 1010  |
| End-May 2005 (indicative target)                 | 1266  |
| End-June 2005 (performance criterion)            | 1525  |

For the purposes of the program, the central administration includes the executive, judicial and legislative branches. The wage bill is defined as the accrued remuneration to all central administrations employees (*servicios personales*), including overtime and effective social contributions (budget line items 100–199), as reported in by the ministry of finance's monthly *Situación Financiera de la Administración Central*. Data will be provided to the Fund by the ministry of finance with a lag of not more than three weeks past the test date.

### 3. Performance Criterion on the Overall Balance of the Public Sector (Financing Side)

|  | Floor<br>(In billions of <i>guaraníes</i> ) |
|--|---|
| <b>Cumulative flows (from December 31, 2003)</b> |   |
| End-August 2004 (actual)                         | 1,611                                       |
| End-December 2004 (performance criterion)        | 130   |
| <b>Cumulative flows (from December 31, 2004)</b> |   |
| End-January 2005 (indicative target)             | 91  |
| End-February 2005 (indicative target)            | 161   |
| End-March 2005 (performance criterion)           | 174   |
| End-April 2005 (indicative target)               | 214   |
| End-May 2005 (indicative target)                 | 370   |
| End-June 2005 (performance criterion)            | 310   |

For the purposes of the program, the consolidated public sector comprises: (i) the CA as defined above; (ii) the social security institutes, the provincial governments, autonomous decentralized agencies, and the nonfinancial public enterprises;<sup>21</sup> and (iii) the Central Bank of Paraguay (BCP).

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

Net external financing of the public sector is defined as all external disbursements less amortization paid of the entities of the public sector as defined above, including any debt of the financial public sector guaranteed by the Republic of Paraguay or the BCP. The change in net credit is defined as the net flow of gross domestic credit (excluding treasury bonds) plus use of deposits by the nonfinancial public sector (excluding the BCP) in the domestic financial system. The change in the stock of government bonds is defined as the net change

<sup>21</sup> Altogether they include: Instituto de Previsión Social (IPS), Caja Bancaria, Caja Ande, Caja Ferroviaria, Caja Municipalidades, the public universities (UNA, UNE, UNP, UNI), 17 provinces (*gobiernos departamentales*), 13 autonomous regulatory and development agencies, the public enterprises (PETROPAR, ANDE, ANNP, DINAC, FFCC, INC) and incorporated enterprises owned by the state (ESSAP, COPACO).

in public bonded debt held by the financial system (excluding the BCP) and the private sector. It is measured net of valuation changes. Domestic floating debt of the public sector is defined as the difference between accrued expenditure (*gastos obligados*) and payments transferred (*gastos transferidos*) with the private sector. It will be measured as the central government floating debt net of debts with the rest of the public sector as defined herein. External debt arrears are defined as principal and interest accrued and not paid by the due date of debt guaranteed by the Republic of Paraguay or the BCP as reported by the ministry of finance's SIGADE plus the net change in arrears to foreign suppliers of the consolidated public sector. The financing of the quasi-fiscal balance of the BCP is measured as the negative of all administrative and financial revenues minus costs (including costs of monetary policy and interest on BCP external debt), and net capital transfers to other financial institutions, as reported by the BCP.<sup>22</sup> Data will be provided to the Fund by the ministry of finance with a lag of not more than three weeks past the test date.

As in the performance criterion on the overall balance of the central administration, an adjustor will be introduced in the event tax revenues are higher than programmed (see last paragraph of section 1 of this TMU).

## B. Monetary Targets

### 4. Performance Criterion on Net International Reserves of the Central Bank of Paraguay (BCP)

|   | Floor<br>(In millions of U.S. dollars) |
|---|--|
| <b>Outstanding stock as of:</b>           |  |
| End-August 2004 (actual)                  | 1,141                                  |
| End-December 2004 (performance criterion) | 1,080                                  |
|   |  |
| End-March 2005 (performance criterion)    | 1,120                                  |
| End-June 2005 (performance criterion)     | 1,180                                  |

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

Gross foreign assets are defined consistent with SDDS and include all liquid foreign currency-denominated claims of BCP, including monetary gold, holdings of SDRs, the reserve position in the IMF, and foreign currency in the form of cash, deposits abroad, and

<sup>22</sup> From January 1, 2005, net capital transfers to other financial institutions will be excluded from the measurement of quasi-fiscal balance.

Paraguay's net cash balance within the Latin America Trade Clearing System (ALADI). Excluded from gross foreign assets are participations in international financial institutions (including *Corporación Andina de Fomento* (CAF), IDB, IBRD, *Asociación Internacional de Fomento*, and *Banco de Desarrollo del Caribe*), the holdings of nonconvertible currencies, and holdings of precious metals other than gold. Gross foreign liabilities are all foreign currency denominated BCP liabilities of contracted maturity up to and including one year plus the use of Fund credit. Non-U.S. dollar denominated foreign assets and liabilities will be converted into U.S. dollars at the market exchange rates of the respective currencies as of September 30, 2003.

NIR targets will be adjusted *upward* (*downward*) for any *increase* (*decrease*) in reserve requirement deposits (*encaje*) associated with foreign currency deposits in commercial banks, compared to the following levels: December 31, 2004: US\$269 million; March 31, 2005: US\$257 million; and June 30, 2005: US\$257 million.

For end-June 2005, NIR targets will also be adjusted *upward* by the corresponding amount up to no more than US\$40 million for any program disbursements.

## 5. Performance Criterion on Net Domestic Assets

|   | Ceiling<br>(In billions of <i>guaraníes</i> ) |
|---|---|
| <b>Outstanding stock as of:</b>           |   |
| End-August 2004 (actual)                  | -5,231  |
| End-December 2004 (performance criterion) | -4,090  |
| End-March 2005 (performance criterion)    | -4,614  |
| End-June 2005 (performance criterion)     | -5,197  |

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

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

### C. Public Debt and Arrears Targets

#### 6. Performance Criterion on Contracting or Guaranteeing of New Nonconcessional External Debt by the Nonfinancial Public Sector

|   | Ceiling<br>(In millions of U.S. dollars) |
|---|--|
| <b>Cumulative flows (from December 31, 2003):</b> |  |
| End-August 2004 (actual)                          | 0  |
| End-December 2004 (performance criterion)         | 200                                      |
| <b>Cumulative flows (from December 31, 2004)</b>  |  |
| End-March 2005 (performance criterion)            | 200                                      |
| End-June 2005 (performance criterion)             | 200                                      |

The nonfinancial public sector (NFPS) is defined as the consolidated public sector (as defined above) excluding the Central Bank of Paraguay. The limit applies to the contracting or guaranteeing by the NFPS in the calendar year of net new nonconcessional external debt with an original maturity of more than one year, including commitments contracted or guaranteed.<sup>23</sup> For program purposes, a debt is concessional if it includes a grant element of at least 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates (CIRR).<sup>24</sup> Excluded from the limits are credits extended by the IMF and balance of payments support loans extended by multilateral and bilateral creditors. Data will be provided by the ministry of finance to the Fund with a lag of not more than 30 days from the test date.

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

<sup>23</sup> The term “debt” has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with respect to Foreign Debt adopted on August 24, 2000 (Board Decision No. 12274-(00/85).

<sup>24</sup> The grant element is calculated as the difference between the net present value (NPV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt (i.e.,  $\text{Grant} = (\text{Nominal Value} - \text{NPV}) / \text{Nominal Value}$ ). The NPV of debt is calculated by discounting the future stream of payments of debt service due on this debt. For debt with a maturity of at least 15 years, the ten-year average CIRR will be used to calculate the NPV of debt. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. For the purposes of the program, the CIRRs published by the OECD in November 2003 will be used.

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

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

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

**The NFPS, excluding PETROPAR, will accumulate no new external arrears during the program period. It will maintain zero arrears with the World Bank and IDB throughout the program period.** In addition, existing arrears will be reduced according to the following performance criterion:

|   | Overall level (ceiling)       | Ceiling on official bilateral arrears |
|---|-------------------------------|---------------------------------------|
|   | (In millions of U.S. dollars) |                                       |
| <b>Outstanding stock as of:</b>           |                               |                                       |
| End-August, 2004 (actual)                 | 3                             | 0                                     |
| End-December 2004 (performance criterion) | 0                             | 0                                     |

The stock of external arrears of the NFPS will be calculated based on the schedule of external payments obligations reported by SIGADE. The arrears of PETROPAR will be included in the stock targets shown in the table. Data on external arrears will be reconciled with the relevant creditors, and any necessary adjustments will be incorporated in these targets as they occur. For the purposes of this performance criterion, an arrear will be defined as a payment which has not been made within 30 days after falling due. In addition, the public enterprises will report to the ministry of finance and the BCP arrears on any external debt that is not recorded under SIGADE. The same 30-day grace period will be applied to all external payments of public enterprises, except where explicit agreements exist with creditors on an extended grace period (as the case for some of PETROPAR’s external providers). The ministry of finance will provide the final data on the stock of public sector external arrears to the Fund, with a lag of not more than 30 days from the test date.

In addition, the government is engaged in good faith efforts to resolve overdue claims in dispute, and will attempt to negotiate and resolve these as soon as possible. For the purposes of the program, debt service due by ANDE to Germany’s KFW (known as loan numbers 9736 and 9737), yet to be legalized by congress, will be considered claims in dispute. In the meantime, the government will make every effort to speed up their approval in congress and transact the payment. Arrears to the South African agency D. B. Pty limited will not be included in the above target unless the appropriate creditor is located. The government will continue searching for the creditor.

The performance criterion on the stock of external arrears will no longer apply after December 31, 2004, but the continuous performance criterion on no new arrears will continue to apply.

### 9. Performance Criterion on Central Government Floating Debt

During the program period, floating debt will be reduced according to the schedule below. The ministry of finance will provide the data to the Fund, with a lag of not more than three weeks from the test date.

|   | Ceiling<br>(In billions of <i>guaraníes</i> ) |
|---|---|
| <b>Outstanding stock of as of:</b>        |   |
| End -August 2004 (actual)                 | 235   |
| End-December 2004 (performance criterion) | 320   |

Floating debt is defined as the difference between ‘*gasto obligado*’ and ‘*gasto transferido*’ of the central administration. *Gasto obligado* is as defined in Article 22 of Law No. 1535 (Financial Administration Law). The commitment to make expenditure (*gasto obligado*), for the purposes of the program, will originate at the point at which the relevant unit of the line ministry or public entity of the central administration receives the claim or bill, provided the expenditure in question has a budget appropriation or has been authorized by the treasury. Disputed bills (where there may be questions of legality or amounts) will not be included until the dispute has been resolved.

*Gasto transferido* is defined as the full payment of the commitment (where the payment process is outlined in Article 37 of Law No. 1535). For the purposes of the program, the payment is assumed to be made at the point that the treasury of the ministry of finance makes the order to transfer the funds to the payee’s bank account.

For the case of domestic bonds, any amount placed in a special escrow account available for use by the BCP (or the payment agent) for transferring to bondholders will be considered a ‘*gasto transferido*.’ If owners of old bonds eligible for an exchange according to the terms of Law No. 2336 on public debt restructuring have not submitted the bonds for exchange, the amount of principal and interest payments due but not paid *under the new terms* is considered a ‘*gasto obligado*.’ The amount of principal and interest payments due but not paid *under the old terms* is not considered a ‘*gasto obligado*.’ The difference between what is due to bondholders implied by the new terms, and the amount in the escrow account will be considered part of floating debt.

The treasury department of the ministry of finance will provide the data to the Fund, including an explanation of the amounts and status of any disputed floating debt, as well as the amounts in the escrow account for domestic bonded debt. This information will be provided no more than three weeks after the test date.

The performance criterion on central government floating debt will only apply until December 31, 2004.

#### **D. Reporting**

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

The ministry of finance will be responsible for gathering data on a monthly basis from all the institutions that comprise the consolidated public sector, including the incorporated enterprises (*Sociedades Anónimas*) COPACO and ESSAP. It will compile this information according to the standard format of the Ministry of Finance's monthly financial situation report (*Situación Financiera*). The data will be supplied to the Fund and published on the ministry of finance's external website within 30 days of each test date. In addition, specific public sector institutions (IPS, ANDE, COPACO, ESSAP, Petropar, INC and Conatel, ANNP, Dinac) will be required to provide to the Fund and publish on the internet monthly cash flow statements and the full external audit reports of their accounts beginning no later than June 30, 2004.

INTERNATIONAL MONETARY FUND

PARAGUAY

**Third Review Under the Stand-By Arrangement, Request for Extension of the 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

December 16, 2004

1. **This supplement provides additional information on developments since the issuance of the staff report for the third review under the Stand-By Arrangement for Paraguay (see [www.imf.org](http://www.imf.org)).** This supplement provides background information, reports on the status of prior actions, and includes a supplementary letter of intent and a letter of political support from the President of Paraguay.

**I. RECENT DEVELOPMENTS**

2. **The most recent information confirms earlier trends.**

- ***Inflation continues to decline.*** Despite adjustments in fuel prices at end-October, the price level declined slightly in November driven by lower prices of food items. The monthly inflation rate was -0.1 percent and the 12-month inflation rate temporarily fell to only 2.1 percent in November, the lowest rate in 40 years.
- ***Monetary policy has been tightened to maintain stability in the foreign exchange market.*** The central bank recently increased the interest rate on its main monetary control instrument (letras de regulacion monetaria) from 5 to 7 percent (for one-year instruments).
- ***The fiscal situation appears stronger than anticipated.*** Preliminary information for November indicates that central government revenues were higher than programmed and expenditures lower, resulting in a stronger fiscal position. Tax collection grew at a rate of 37 percent in the 12 months to November.

3. **Congress has approved the 2005 budget with higher spending and a larger fiscal deficit than incorporated in the program, but the authorities remain committed to achieving the program targets.** The authorities share staff concern about the risk of overspending and, plan to take additional steps to ensure that the fiscal targets for 2005 are

met (i.e., a deficit of ½ percent of GDP for the central government). Firstly, the President is expected to issue a partial veto to the 2005 budget. Most of the additional spending in the congressionally approved version relates to capital spending, which was already due to increase significantly in the budget proposed by the government. The authorities believe that the budget now assumes an unrealistic pace of implementation of investment projects, and would apply the veto to specific items where they believe expenditure estimates are inflated.<sup>1</sup> Secondly, the authorities will implement a strict cash management system to ensure achievement of the program objectives, as occurred during 2004.

## II. PRIOR ACTIONS

4. **Of the two prior actions for the third SBA review, one has been observed, while the other has been delayed.**

- ***Completion of ESSAP independent audit.*** This audit was originally scheduled for end-September (together with ANDE and COPACO). The audit has been completed in late November following the issuance of a decree by the government clarifying the asset and liability situation of the company.
- ***Submit to Congress alternative public banking legislation to create a second-tier public bank and its approval by at least one chamber.*** The bill was submitted to Congress under fast-track procedures on November 5, and was scheduled for discussion on December 9. However, unexpected political disagreements during the December 9 session prompted the Senate to postpone the discussion until the last week of February 2005, when it will be taken up in an extraordinary session.<sup>2</sup>

5. **The authorities propose to convert the prior action into a performance criterion for mid-March 2005.** The prior action involved approval of the second-tier public banking law by one chamber, the program envisaged approval of the law (by both chambers) by end-May 2005. In order to advance with this reform, the government intends to proceed expeditiously with the restructuring of the first-tier public banks and possibly dealing with both pieces of legislation (first- and second-tier public bank) at about the same time in late February. The attached letter from the President provides political support to these efforts.<sup>3</sup>

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<sup>1</sup> Congress requires an absolute majority to overcome the presidential veto. If the presidential veto prevails, the vetoed expenditure lines would revert to the level in the 2004 budget. The authorities intend to submit a supplementary budget during 2005 to ensure that these expenditure items are in line with their original intentions for the 2005 budget. If the veto is overturned by congress, the authorities would need to rely entirely on their financial plan to achieve the program objectives.

<sup>2</sup> Congress recess begins on December 20 and concludes in early March.

<sup>3</sup> The program envisaged submitting legislation to Congress on the first-tier public banks by end-July 2005 (performance criterion for the sixth and last SBA review).

Approval of the second-tier public banking law by at least one chamber will become a performance criterion for March 15, 2005.

### III. STAFF ASSESSMENT

6. **The staff recommends completion of this review despite the non observance of a prior action on public banking reform.** In recommending going ahead with this review, the staff looked at a number of considerations. Firstly, the authorities have reaffirmed their commitment to advance on public banking reform, including the attached letter from the President. Secondly, the timeframe for completion of the second-tier public banking legislation remains unchanged. Thirdly, failure to complete the prior action reflected political complications regarding an unrelated issue and not a lack of commitment to reform; in fact the non-observed prior action is now a performance criterion for mid-March. Therefore, against the background of the authorities' good performance under the program and strong commitment to reform, the staff recommends completion of this review notwithstanding non-observance of one prior action.



Table 1. Paraguay: Structural Conditionality Under Program  
for the Third Review

| Measure   | Conditionality | Timing          |
|---|----------------|-----------------|
| <b>Financial Sector Reform</b>                                    |                |                 |
| A. Approval of public banking law (second tier) by one chamber    | PC             | March 15, 2005  |
| B. Introduce prudential regulations to cooperatives               | SB             | March 31, 2005  |
| C. Approval of public banking law (second tier)                   | SB             | May 31, 2005    |
| D. Approval of new comprehensive banking legislation              | PC             | June 30, 2005   |
| E. Submission of public banking law (first tier)                  | PC             | July 30, 2005   |
| <b>Public Sector Reforms</b>                                      |                |                 |
| F. Finalize plan for comprehensive civil service reform           | SB             | April 30, 2005  |
| <b>Public Enterprises Reform</b>                                  |                |                 |
| G. Completion of independent audit of ESSAP                       | Prior action   | Done            |
| H. Adjustment in fuel and utility prices to reflect costs         | PC             | January 1, 2005 |
| I. Independent audits for ANNP, DINAC, INC, PETROPAR              | PC             | April 30, 2005  |
| J. Plan for private capital participation ESSAP, COPACO, PETROPAR | SB             | August 2005     |

Sources: Paraguayan authorities; and Fund staff estimates.

SB = structural benchmarks

PC = performance criteria

President of the Republic of Paraguay

Asunción, December 13, 2004

No. 76

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

Dear Mr. de Rato:

It is with pleasure that I write to you to ratify the commitment undertaken by the government of the Republic of Paraguay in the letters of intent of December 5, 2003, March 26, 2004, July 16, 2004, and December 7, 2004 regarding the adoption of a program designed to preserve macroeconomic stability and lay the foundation for sustainable growth. This will be achieved, inter alia, by adopting measures aimed at fiscal consolidation, eliminating debt service arrears, putting government finance on a sustainable footing in the medium term, developing a monetary policy to reduce inflation and maintain a freely floating exchange rate; facilitate major structural reforms in the government, the central bank, and the financial sector; and promote a package of measures aimed at achieving transparency and good governance in public sector operations.

However, owing to the changing political scene and the recent break-up of the opposition block, the initially proposed parliamentary agenda has been disrupted, to the point that the discussion and approval of the Law on "Second-Tier Public Banking" has been postponed until February 2005.

We regret this unexpected development, but the national government, under the personal and direct leadership of its president, will launch a new political initiative to accelerate discussion of the Law on Second-Tier Banking, and possibly also the Law on First-Tier Banking, in February 2005. To that end, we will work with technical assistance from the Fund. The national government is committed to promoting the reform of first- and second-tier public banking in order to strengthen the financial system and facilitate lending to the productive sector.

Regarding the General Budget of the Nation for fiscal 2005, the Executive Branch is taking all the necessary steps to ensure that fiscal policy is consistent with medium-term viability and the resources available to the public treasury. Consequently, in addition to implementing a strict financial plan, once the law is approved, we will promote constitutional initiatives to make whatever adjustments are necessary to support a fiscal policy that is sound, consistent, and tailored to the established objectives.





*El Presidente de la República del Paraguay*

Asunción, 13 de Diciembre de 2004

Nº 76

SEÑOR  
**RODRÍGO DE RATO, DIRECTOR GERENTE**  
**FONDO MONETARIO INTERNACIONAL (FMI)**  
**WASHINGTON, DC 20431, USA**

*Tengo el agrado de dirigirme a usted con el objeto de ratificar el compromiso asumido por el Gobierno de la República del Paraguay en las Cartas de Intención de fecha 5 de diciembre de 2003, 26 de marzo de 2004, 16 de julio de 2004 y 7 de diciembre de 2004 en el sentido de adoptar un programa destinado a mantener la estabilidad macroeconómica para sentar las bases del crecimiento sostenible adoptando, entre otras, medidas destinadas a fortalecer las finanzas públicas, eliminar los atrasos en el servicio de la deuda, colocar las finanzas del Estado en condiciones sostenibles en el mediano plazo, desarrollar una política monetaria que reduzca la inflación y mantenga una tasa de cambio libre y fluctuante, impulsar importantes reformas estructurales en el Estado, el Banco Central, y el sector financiero, y promover un conjunto de medidas orientadas a lograr la transparencia y el buen gobierno en las operaciones del sector público.*

*Sin embargo, por la dinámica política y la reciente ruptura del bloque opositor la agenda parlamentaria prevista en principio se ha trastornado, al extremo de la postergación del tratamiento y sanción de la Ley "Banca Pública de Segundo Piso" para febrero próximo.*

*Lamentamos, esta contingencia, no obstante, el Gobierno Nacional, bajo el liderazgo personal y directo de su Presidente, relanzará una iniciativa política con el objetivo de acelerar el tratamiento de la Ley de Banca de Segundo Piso y posiblemente también la de Primer Piso en el mes de Febrero de 2005. Para este efecto trabajará conjuntamente con la asistencia técnica del Fondo. El Gobierno Nacional está comprometido a impulsar la reforma de la banca pública de primer y segundo piso para fortalecer el sistema financiero y facilitar líneas de crédito al sector productivo.*

*Con relación al Presupuesto General de la Nación para el Ejercicio Fiscal 2005 el Poder Ejecutivo está tomando todas las providencias para asegurar que la política fiscal sea congruente con la viabilidad a mediano plazo y con los recursos con que cuenta el erario público. Para ello, además de la aplicación de un estricto Plan Financiero, una vez sancionada la ley, impulsaremos los resortes constitucionales a fin de corregir lo que sea necesario para sostener una política fiscal seria, coherente y adecuada a los objetivos definidos.*



*El Presidente de la República del Paraguay*

-2-

Nº 76

*Por las razones arriba expresadas el Gobierno considera que sería muy importante, para apuntalar los esfuerzos que el Poder Ejecutivo paraguayo se encuentra realizando, que la gerencia del Fondo presente a la consideración del Directorio Ejecutivo la revisión del programa tal como está agendada para el 20 de Diciembre para considerar la extensión del programa por 6 meses más.*

*Como en el pasado, el Gobierno del Paraguay continuará el estrecho y productivo diálogo con el Fondo y se mantendrá firme su decisión de adoptar las medidas necesarias para alcanzar el objetivo del programa.*

*Hago propicia esta oportunidad para saludarle con mi distinguida consideración.*



NICANOR DUARTE RUTOS  
PRESIDENTE DE LA  
REPÚBLICA DEL PARAGUAY

c.c.: Sr. Takatoshi Kato, Sub Director, Fondo Monetario Internacional (FMI)

AG/SG/omg.



Press Release No. 04/271  
FOR IMMEDIATE RELEASE  
December 20, 2004

International Monetary Fund  
Washington, D.C. 20431 USA

### **IMF Executive Board Completes Third Review Under Paraguay's Stand-By Arrangement**

The Executive Board of the International Monetary Fund (IMF) today completed the third review under an SDR 50 million (about US\$76.2 million) Stand-By Arrangement for Paraguay, originally approved on December 15, 2003 for 15 months (see [Press Release No. 03/218](#)), and granted an extension of the arrangement by six months, through September 30, 2005.

In completing the review, the Executive Board also granted the Paraguay authorities' request for waivers of the nonobservance of two quantitative performance criteria and two structural performance criteria, and the modification of four performance criteria.

The remaining amounts available under the arrangement were also rephased in four equal tranches in an amount equivalent to SDR 3 million each (about US\$4.6 million). However, Paraguay has not made any drawings under the arrangement so far, and the authorities have indicated that they continue to treat the arrangement as precautionary.

Following the Executive Board's discussion of Paraguay's economic performance, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

"Paraguay's macroeconomic performance has improved significantly under the program supported by the Stand-By Arrangement. Economic growth has been sustained in 2004 despite a drought, inflation has declined significantly, international reserves have increased, and the exchange rate has stabilized.

"Overall, Paraguay has performed well under the program. On the structural side, the authorities have approved key pieces of economic legislation over the last 12 months, including the fiscal adjustment law, the customs code, the bank resolution law, and the public pension reform law. The authorities will need to press ahead with the reform agenda in order to reduce unemployment and poverty, which remain stubbornly high.

"Reform of public banks remains a critical component of the program. It is important that this process move forward expeditiously, and that the authorities carefully monitor lending by the public banks in the run-up to their reform in order to prevent the resumption of unsustainable lending practices.

“Fiscal policy has been placed on a sustainable path and the authorities’ 2005 program is aimed at maintaining this improved performance. The fiscal outlook has improved significantly following the improvements in tax administration and the approval of the fiscal adjustment law. Tax collections have increased while expenditures have been kept in check, although capital outlays remain low. The government has eliminated sizable arrears and taken decisive steps toward normalizing relations with all creditors. The stock of public debt is now on a declining trend. For 2005, the authorities intend to pursue a balanced overall budget, with higher projected revenues allowing for a significant increase in capital expenditure in needed infrastructure. It will be important to have mechanisms in place to limit expenditure to programmed levels, and to ensure that investment spending supports high quality projects.

“Monetary policy has been effective in containing inflation while allowing for rapid reserve accumulation. However, monetary management has been complicated by large capital inflows, which threatened to generate rapid monetary expansion or a sharp appreciation of the currency. In order to minimize these risks, the central bank has pursued an active sterilization policy while accumulating international reserves. In 2005 the authorities intend to use interest rate and exchange rate policies more flexibly in order to stabilize inflation,” Mr. Kato said.

**Statement by Javier Silva-Ruete, Alternate Executive Director for Paraguay  
and Dimas Ayala, Advisor to Executive Director  
December 20, 2004**

1. On behalf of the Paraguayan authorities, we would like to express our appreciation to the staff and management for their valuable advice and support in the design and implementation of Paraguay's economic program. The comprehensive staff report provides a candid assessment of the program and the challenges ahead regarding macroeconomic policy and structural reforms.
2. Performance under the ambitious program initiated by the new government and supported by a 15-month Stand-By Arrangement (SBA) has been strong, albeit some delays in implementing the structural reform agenda in recent months. The strong ownership of the program and the broad political consensus obtained during the Government's first year were important in passing key reforms, including the restructuring of the public sector's pension fund, the modification of the tax and customs systems, the reprofiling of the public debt, and the introduction of a banking resolution law. In addition, prudent economic policies, and the permanent fight against corruption and tax evasion, were crucial in reinstating macroeconomic stability, laying the foundation for sustained GDP and employment growth, and significantly reducing poverty in the medium term.
3. Our authorities fully recognize the importance of implementing the remaining measures agreed with the Fund in order to consolidate the gains obtained so far and strengthen domestic and international confidence. To this end, the Government requests the extension of the Stand-By Arrangement after its expiration in March 2005, in order to allow more time for reforms to take place, and remains firmly committed to concluding the first phase of the reform agenda before September 2005.
4. Paraguay's economic situation has improved markedly since the Government began implementing the program in December 2003, after a long period of economic stagnation. As in 2003, real GDP is also anticipated to grow in 2004, this time to an estimated 2.9 percent, even after suffering an unexpected drought early this year, which severely affected soy production—Paraguay's main export crop—with an estimated cost of ½ to 1 percent of GDP. In addition, the external position continues to improve, and credit to the private sector is recovering.
5. Nine of the eleven quantitative performance criteria for end-August 2004 were met. Inflation has further decelerated, and the yearly figure is expected to be substantially below the 8 percent rate envisaged under the program. The fiscal surplus will be well above program targets. The authorities regret the non-observance of two performance criteria, and are taking corrective measures to avoid these kinds of deviations in the future. The slippages were (i) a delay in paying a bilateral creditor (by one day); and (ii) a very small deviation from the ceiling for the central administration's wage bill, due to an unexpected wage increase granted by Congress to the judicial system. However, the

greater-than-programmed central government surplus (3.6 percent of GDP as of August, vis-à-vis 1.6 percent envisaged under the program), thanks to strong revenue performance, more than offset the small deviation from the wage bill target.

6. Regarding structural performance criteria:

- The audit of three public enterprises—an end-September performance criterion—was partially met. Two audits were completed, and the remaining one was subsequently established as a prior action for this review. The latter was met, although with some delay, given that the auditor requested a legal clarification; this, in turn, required an additional government assessment and a presidential decree.
- The state banking system's reform, originally set for October 2004, was postponed due to congressional delays. The strategy adopted henceforth by the Government has aimed at preventing a watering-down of the proposed legislation or wholesale rejection by Congress, where the ruling party lacks a majority. Thus, the authorities have considered it prudent to conduct the reform in two stages, beginning with the immediate restructuring of the second-tier public banks to improve the intermediation of external resources, followed by the restructuring of first-tier public banks. Regretfully, early this month, due mainly to political problems, Congress postponed again the approval of the first stage of the reform—a prior action for this review—until the third week of February 2004. However, Congressmen expressed their intention to consider both the first and second-tier public bank reform at the same time, in an extraordinary session. They believe reforming the state banking system is crucial to improve resource allocation. At the same time, they see the need for a wider assessment to ensure the success of this sensitive reform. Our authorities, and in particular President Duarte-Frutos, renew their firm commitment to the reform agenda, and in particular to conclude the public banking reform as envisaged. The authorities' determination is reflected in their ability to muster consensus for several key policies introduced since they took office 15 months ago.

7. Fiscal performance has been better than envisaged under the program, resulting especially from responsible policies—in particular, higher than programmed revenues due to a substantial improvement in tax and customs administration. The appointment of highly-qualified professionals to key government positions, as well as the implementation of wide-ranging administrative measures to combat tax evasion, have resulted in a sharp increase in collections. According to preliminary information, government revenues during the first ten months of this year rose by 32 percent, as compared to the same period last year. Moreover, the recently enacted Fiscal Reform law and Customs Code will be instrumental in further curtailing tax evasion and formalizing the economy, which are crucial elements for achieving greater revenue mobilization.
8. The 2005 fiscal budget submitted to Congress considers an increase in public investment—reduced substantially in 2004 as a result of fiscal consolidation efforts—to support higher GDP growth. However, the Government will carefully control expenditure to ensure an efficient use of resources and fiscal sustainability. In addition, a

moderate wage increase after a three-year freeze, and the creation of the Rural Institute—aimed at addressing long-standing rural problems—are among a number of actions implemented by the Government to reduce poverty and raise living standards. At the same time, to partly offset these increases, the Government will streamline expenditures in other areas of the budget.

9. The Central Government's 2005 fiscal deficit—projected to be around ½ percent of GDP—will be largely financed by already contracted external borrowing, while the balance for the consolidated public sector will be close to zero. Even though Congress passed additional expenditures earlier this month, the authorities express their commitment to adopt the necessary measures to maintain the original fiscal targets, which is consistent with the objective of significantly improving the debt structure over the medium term. A partial Presidential veto of measures approved by Congress as well as the implementation of a Fiscal Financial Plan—as in 2004—are among the alternatives the authorities are considering to make the budget consistent with their fiscal program.
10. The authorities' program and policies have also been successful in solving 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 would decline to 39 percent at end-December 2004, and it is expected to reach 30 percent by 2009. On the other hand, the authorities are actively maintaining negotiations to resolve disputes with eventual creditors.
11. The continued implementation of prudent monetary policy has resulted in low inflation and higher than expected accumulation of international reserves. Twelve-month inflation as of November has dropped to 2.1 percent, from 9.9 percent a year earlier; and accumulated inflation stood at 1.1 percent, vis-à-vis 8.3 percent in the same period of last year. The yearly figure is expected to be around 2 percent, significantly below the program target of 8 percent. Inflation will pick up slightly in 2005, given higher oil prices, tariff increases, and eventual wage adjustments. However, our authorities expect inflation to remain below 6 percent. Given the high level of international reserves, which enhances the Central Bank's ability to intervene in the market, and the historically low interest rates on Central Bank bills, our authorities concur with the staff in using exchange and interest rates flexibly to meet the inflation objective next year. Likewise, we would like to emphasize the Central Bank's continuous efforts to implement the recommendations identified by MFD's technical assistance missions to enhance the conduct of monetary and foreign exchange policies.
12. Our authorities continue to make progress in strengthening the financial system. The Deposit Guarantee Fund, approved in late 2003 as a prior action for the program, is now operational, while the new bank resolution legislation is being successfully implemented, after the recent intervention of a small financial institution by the supervisory authorities. Furthermore, important steps have been taken to implement the new regulations on banks' asset classification and provisioning, aimed to bring prudential norms in line with international standards. In addition, just recently our authorities submitted to Congress a comprehensive legislative proposal to further improve banking supervision. Confidence

in the banking system is improving, as evidenced by the continuous rise in deposits. Private credit is finally recovering, while the ratio of non-performing loans has dropped to 13.1 percent in October 2004, the lowest in 5 years, from 22.6 percent a year earlier. These factors have contributed to enhancing substantially the profitability of the banking system.

13. The reform of public banks include the *Banco Nacional de Fomento* (BNF), a state development institution that accumulated a high level on non-performing loans over several years of mismanagement. Thanks to the new management's efforts, the bank's financial health is already improving, and the Superintendence of Banks will continue to closely monitor its lending operations until completion of the reform.
14. On the structural front, albeit some delays in recent months, most of the elements of the reform program have been achieved in a short period of time, reflecting strong ownership and the Government's commitment, in contrast with the lack of direction that unfortunately prevailed for many years. Our authorities renew their commitment to make steady progress with the remaining structural reforms, which lie at the core of their agenda. They concur with the staff that the new timetable for reforms would be more appropriate given Congress' heavy agenda, but especially to provide more time to build the social and political consensus needed for the approval of sensitive and complex measures. Meanwhile, our authorities are consistently working to improve the efficiency and governance of public institutions through regular independent audits, improvements in public procurement, and measures to combat corruption. Likewise, they are actively developing a comprehensive plan for civil reform, and are committed to developing plans to enable private sector participation in some public enterprises by end-August 2005.
15. The Government acknowledges that its biggest challenge is to improve the country's socio-economic conditions. In this vein, an ambitious economic strategy is being developed in consultation with the civil society, aimed at laying the basis for increasing agricultural and agro-industrial production, enhancing competitiveness, diversifying the economy, reducing inequalities, and improving the business environment. A broad participatory seminar was held last November, aimed at building consensus on the need to develop a sound economic program. In addition, our authorities will continue their efforts towards ensuring long-term macroeconomic stability, which they regard as crucial to achieve high and sustained growth, improve employment opportunities, and alleviate poverty. Continuous support from the Fund and the international community will be essential to underpin this process.