

**Paraguay: Fourth Review Under the Stand-By Arrangement and Request for Reduction and Rephrasing of Access—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Paraguay**

In the context of the first review under the Stand-By Arrangement and request for reduction and rephrasing of access with Paraguay, the following documents have been released and are included in this package:

- The staff report for the First Review Under the Stand-By Arrangement and Request for Reduction and Rephrasing of Access, prepared by a staff team of the IMF, following discussions that ended on August 8, 2007, 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 October 4, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement of October 15, 2007 updating information on recent developments.
- A Press Release summarizing the views of the Executive Board as expressed during its October 15, 2007 discussion of the staff report that completed the review.
- A statement by the Executive Director for Paraguay.

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

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

\*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

PARAGUAY

**Fourth Review Under the Stand-By Arrangement and  
Request for Reduction and Rephasing of Access**

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

Approved by José Fajgenbaum and Matthew Fisher

October 4, 2007

- **Arrangement.** The Executive Board approved a 27-month Stand-By Arrangement (SBA) for SDR 65 million (65 percent of quota) on May 31, 2006. The second and third SBA reviews were completed on June 29, 2007. The authorities are requesting to reduce access to SDR 30 million (30 percent of quota), and continue to treat the arrangement as precautionary. The supported program aims at consolidating macroeconomic stability and deepening structural reform to create conditions for higher sustained growth and poverty reduction.
- **Developments.** The program remains on track. All performance criteria and structural benchmarks for end-June 2007 were observed. The staff will update the Board on performance for end-September 2007—where available—ahead of the Board meeting. The economic expansion continues and real GDP growth is expected to rise to 5 percent in 2007. Core inflation in August was 5 percent, consistent with the target for end-2007. The fiscal position remains solid. The external situation was stronger than expected and reserves rose to almost US\$2¼ billion at end-August 2007. Implementation of the reform agenda is broadly in line with the program.
- **Policies.** The authorities reiterated their commitment to the program. They continue to resist expenditure pressures, and believe that all program targets for 2007 will be achieved. They presented to Congress the 2008 budget which includes a small overall deficit but is consistent with broad fiscal balance once implemented.
- **Discussions.** These took place from July 25 to August 8, 2007. The mission met with Central Bank President Rojas and members of the Board, Finance Minister Barreto, Industry Minister Ibañez, Education Minister Jimenez, Social Issues Minister Andraschko, Deputy Finance Minister Alarcón, senior government officials, representatives of the banking community, and the private sector. The staff team consisted of A. Santos (head), M. Mlachila, T. Roy, B. Monfort (all WHD), B. Barkbu (PDR), and J. Gasha (MCM). The mission was assisted by L. Durán-Downing, the Fund's senior resident representative in Asunción, and it liaised with World Bank and IDB staff in Asunción. Mr. Salgueiro (OED) participated in the meetings.

### List of Acronyms

ANDE	National Electricity Company
BCP	Central Bank of Paraguay
BCPEBS	Basel Core Principles of Effective Banking Supervision
BNF	National Development Bank
CADEF	Ranking of Financial Institutions
CAR	Capital Adequacy Ratio
CCT	Conditional Cash Transfer
COPACO	Public Telephone Company
DSA	Debt Sustainability Analysis
ESSAP	Public Water and Sewage Company
FAD	Fiscal Affairs Department
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GNFS	Good and Nonfactor Services
IDB	Inter-American Development Bank
INC	National Cement Company
INCOOP	National Institute of Cooperatives
IPS	Social Security System
LEG	Legal Department
LOI	Letter of Intent
LRM	Central Bank Bills
MCM	Monetary and Capital Markets Department
MEFP	Memorandum of Economic and Financial Policies
NDA	Net Domestic Assets
NFPS	Non-Financial Public Sector
NIR	Net International Reserves
NPL	Nonperforming Loans
PC	Performance Criteria
PDR	Policy Development and Review Department
PFM	Public Financial Management
PETROPAR	Public Petroleum Company
ROSC	Report on the Observance of Standards and Codes
SAS	Undersecretary of Social Action
SB	Structural Benchmark
SBA	Stand-By Arrangement
SDR	Special Drawing Rights
TMU	Technical Memorandum of Understanding
VAT	Value Added Tax
WB	World Bank
WHD	Western Hemisphere Department

<b>Contents</b>	<b>Page</b>
Executive Summary .....	5
I. Developments and Performance .....	6
II. Outlook and Risks.....	15
III. Policy Issues.....	16
A. Overview .....	16
B. Policy Framework .....	16
C. Fiscal Policy.....	16
D. Monetary Policy .....	18
E. External Sector Policy and Issues .....	18
F. Structural Policies .....	19
G. Program Issues .....	24
IV. Staff Appraisal .....	24

### **Text Boxes**

1. Enhancing Regulation and Supervision of the Banking System .....	21
2. Strengthening the Central Bank's (BCP) Balance Sheet .....	22

### **Tables**

1. Quantitative Performance Criteria .....	29
2. Structural Conditionality.....	30
3. Selected Economic and Social Indicators .....	31
4. Central Government Operations .....	32
5. Consolidated Public Sector Operations .....	33
6. Summary Accounts of the Central Bank .....	34
7. Summary Accounts of the Banking System .....	35
8. Banking System Indicators .....	36
9. Balance of Payments.....	37
10. Indicators of External Vulnerability .....	38
11. Schedule of Reviews and Purchases.....	39
12. Medium-Term Scenario .....	40

**Figures**

1. Real Sector Developments .....	7
2. Fiscal Developments .....	8
3. Monetary Developments .....	11
4. Financial System Developments .....	12
5. Balance of Payments Developments .....	14

**Appendix**

1. Letter of Intent .....	39
2. Fund Relations .....	41
3. World Bank Relations .....	44
4. Inter-American Development Bank Relations .....	46
5. Statistical Issues .....	47
6. Work Program .....	51

## EXECUTIVE SUMMARY

### Performance and Developments

- **The program is broadly on track.** All quantitative performance criteria and structural benchmarks for end-June 2007 were observed. The benchmarks included: (i) a plan to increase significantly the compliance with Basel regulations; (ii) a business plan for the National Development Bank (BNF); and (iii) a strategy to strengthen the financial position of the Central Bank. Significant progress continues to be made in the macro and structural areas toward observing conditionality for end-September 2007.
- **Macroeconomic conditions are generally good.** The economy grew 4¼ percent in 2006 and is expected to grow at least 5 percent in 2007, well above the historical average of around 2 percent. After a rebound to 12½ percent at end-2006 caused mainly by temporary factors, headline inflation fell to 10½ percent in August 2007, while core inflation fell to 5 percent, consistent with the program target. The overall fiscal balance was close to zero in 2006, and shifted to a surplus of about 1¾ percent of GDP in the first half of 2007. International reserves reached another record high at end-August 2007, at almost US\$2¼ billion, while the *guaraní* remained strong.

### Discussions and Appraisal

- **The authorities reiterated their intention to maintain prudent macroeconomic policies.** Despite expenditure pressures, the newly appointed Minister of Finance, Mr. Barreto, reaffirmed the government's commitment to the program and to adhere to the financial plan of the fiscal budget. Staff expressed concerns about the rapid growth of monetary aggregates and its potential impact on inflation while acknowledging the evidence of stronger domestic money demand. In response to preliminary indications of an uptick in inflation in August 2007 (mostly due to a food supply shock), the authorities raised interest rates on monetary control instruments (LRMs) by 50 basis points in late August 2007.
- **The authorities submitted to Congress a tight budget for 2008.** The staff supported the maintenance of a zero balance position in 2008. The authorities pointed to strong expenditures pressures, especially as the general election (scheduled for April 2008) approaches, but stressed their commitment to the program objective of fiscal balance.
- **Momentum was regained in the implementation of the structural reform agenda.** After an impasse in late 2006 and early 2007, the authorities have begun to implement again structural reforms despite a difficult political environment.
- **Staff supports completion of the review.** In view of Paraguay's strong performance and commitment to the program, the staff supports completion of the fourth SBA review.

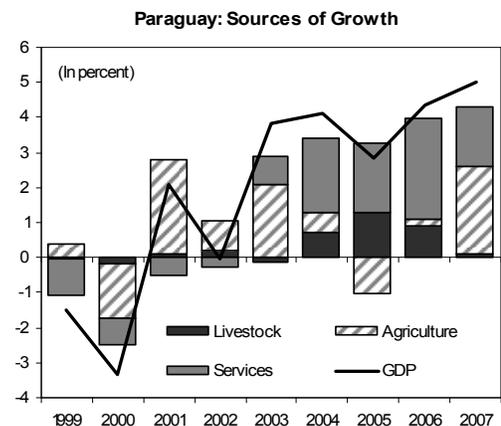
## I. DEVELOPMENTS AND PERFORMANCE

1. **Performance under the program has been good.** All quantitative targets for end-June 2007 have been met with substantial margins. The public finances remain under control with tax revenues improving while expenditures have been contained. Domestic credit and international reserve targets have also been observed, although currency has been growing faster than programmed. The continued favorable external environment has further strengthened the balance of payments. Progress continues to be made toward the implementation of the structural reform agenda, and all benchmarks for end-June 2007 were observed. The staff will update the Board on performance for end-September 2007 ahead of the Board meeting, but all indications are that the performance criteria and most structural benchmarks for end-September 2007 would be observed.

Paraguay: Performance for June 2007		
	Prog.	Actual
(In percent of GDP)		
<b>Fiscal Targets</b>		
Fiscal balance 1/	0.3	1.8 ✓
Wage bill 1/	3.6	3.5 ✓
Consolidated balance	0.4	3.1 ✓
(In percent of currency)		
<b>Monetary Targets</b>		
Net international reserves	29.8	68.1 ✓
Net domestic assets	-39.5	-72.7 ✓
Sources: Paraguayan authorities and Fund staff.		
1/ Central administration.		

2. **The economy is expanding at one of the highest rates in recent history.** Real GDP growth could exceed 5 percent in 2007, supported mainly by a strong agricultural recovery. This would be the highest rate of economic expansion since 1995.

- **Agriculture.** After three years of drought, agriculture recovered and could grow 15 percent in 2007, reflecting the strong performance of soybeans, the main export crop.
- **Livestock.** Following a strong expansion over the past three years, livestock production is likely to moderate in 2007.
- **Industry.** Manufacturing growth is expected to remain low, at around 2 percent in 2007.
- **Services.** With the boom in cellular phone services coming to an end, growth in the service sector is likely to slow to 3½ percent in 2007.

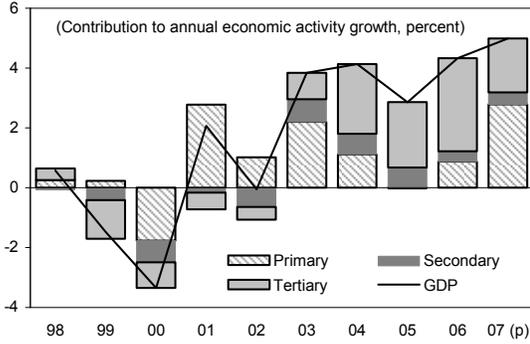


3. **After seven months of deflation, monthly inflation rose to 3½ percent in August 2007.** The bulk of this rise is explained by movements in food prices due to supply disruptions associated with a harsh winter that the authorities expect to be partly reversed in the following months. Despite this jump in inflation, the 12-month rate of non-food inflation was only 2 percent and non-tradeable goods inflation was 3⅓ percent in August 2007.

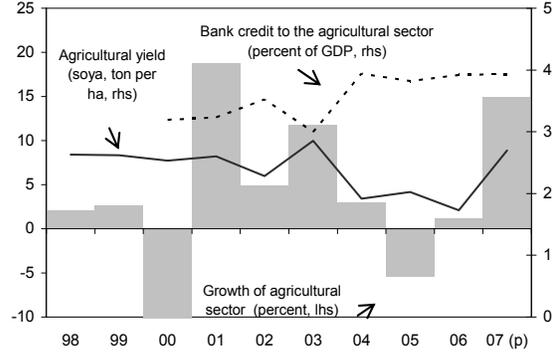
**Figure 1. Paraguay: Real Sector Developments**

Growth is expected to accelerate in 2007, supported mainly by a strong agricultural recovery. The variability of inflation in 2007 reflects the vulnerability to diverse supply shocks.

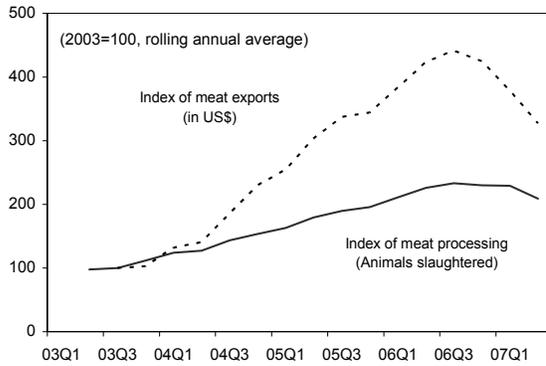
Growth is expected to accelerate to 5 percent in 2007 due mostly to a broad-based agricultural recovery...



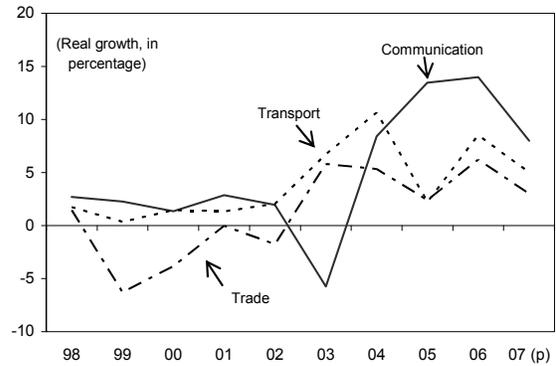
...resulting from a return to average productivity after three years of drought and from higher investment.



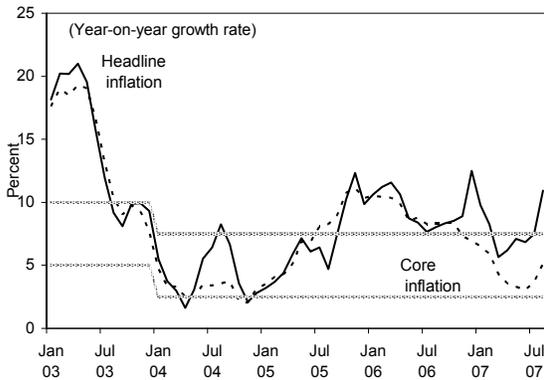
By contrast, growth in the beef sector, a significant engine of growth since 2003, has started to level off...



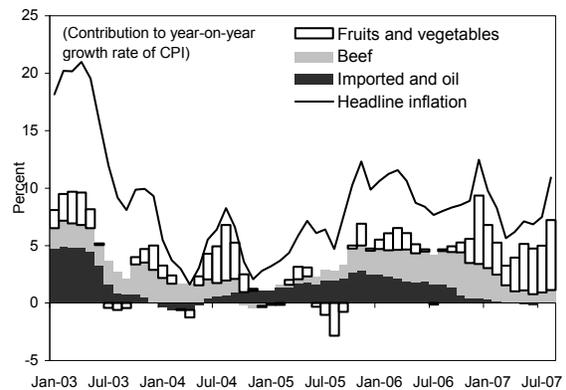
...while growth in the most dynamic service sectors is expected to slow down.



Core inflation has declined, reflecting relative price stability and the unwinding of the supply shock on beef...



... but headline inflation continues to be affected by the volatility of fruits and vegetables.

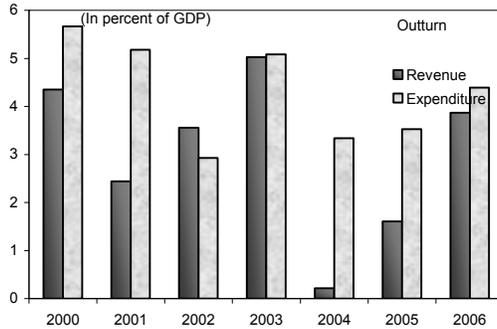


Sources: Paraguayan authorities and Fund staff estimates.

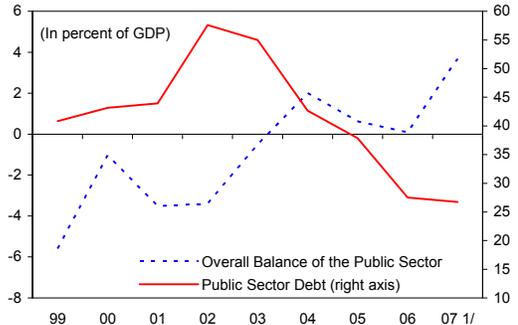
**Figure 2. Paraguay: Fiscal Developments**

*Significant progress has been made in reducing fiscal imbalances. The challenge is to preserve fiscal sustainability and create the fiscal space to meet essential social and infrastructure spending needs.*

*Despite unrealistic budgets,...*

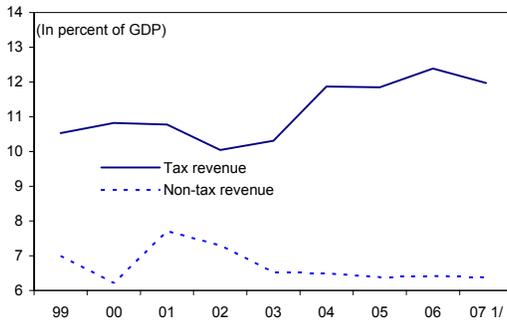


*...fiscal stance has been prudent in recent years, leading to a decline in debt.*



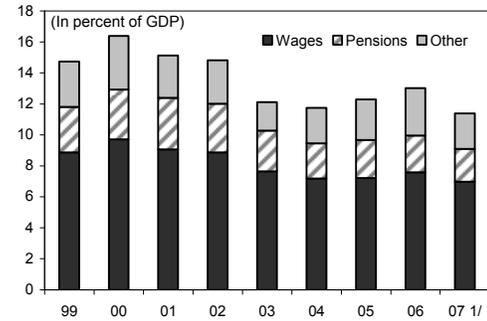
1/ As of June 2007.

*This has been achieved through improved tax collection...*



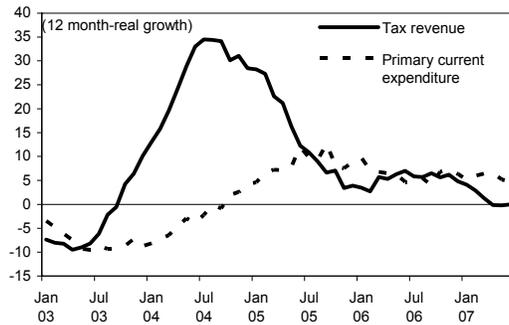
1/ As of June 2007.

*...and by efforts to contain current spending below appropriated amounts.*

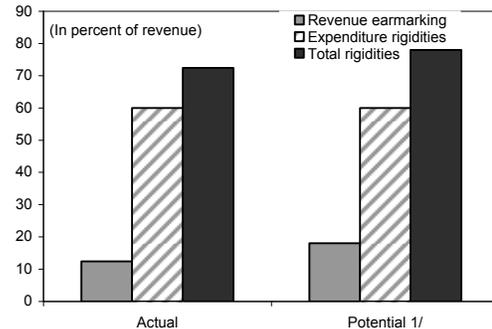


1/ As of June 2007.

*But with tax revenue growth leveling off and renewed current spending pressures ...*



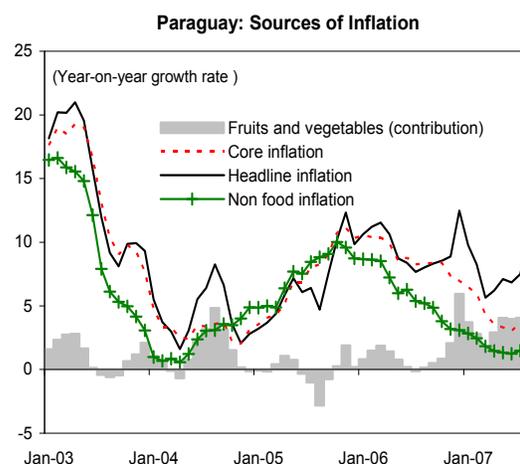
*...the challenge is to step up revenue mobilization and reduce budget rigidities.*



1/ With full implementation of royalties earmarking law.

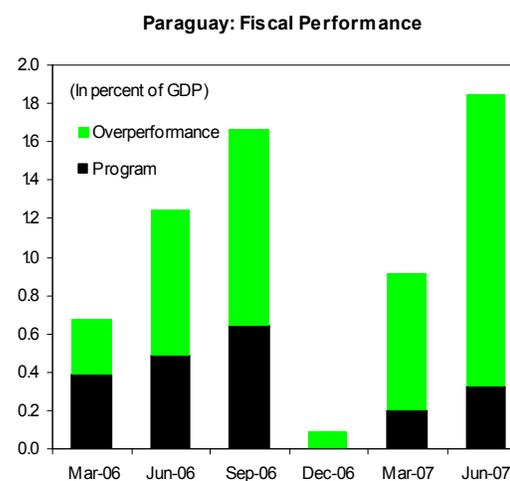
Sources: Paraguayan Authorities and Fund staff estimates.

- **Core inflation** fell from 7 percent at end-2006 to 5 percent at end-August 2007 (in line with the target for 2007) owing to the appreciation of the *guarani*, and the decline of oil prices during the first half of 2007.
- **Headline inflation** declined from 12½ percent at end-2006 to 10½ percent in August 2007, as fruits and vegetables prices remained highly volatile, falling rapidly in the first seven months of the year and then jumping almost 20 percent in August alone.



4. **Public finances have strengthened further.** Estimates through end-June 2007 show a central government surplus of about 1¾ percent of GDP (or about 1½ percent of GDP higher than programmed). The consolidated public sector also recorded a surplus significantly higher than programmed.

- **Revenues** have remained buoyant. The good performance has been sustained by both tax and nontax revenues. Tax collections increased by almost 9 percent through June 2007, driven by the income and value-added taxes, reflecting the expanding economy and the effect of tax reforms put in place over the past few years. Nontax revenues also remained strong, boosted by increased royalties from the bi-national entities (particularly *Yacyretá*).<sup>1</sup>



- **Expenditures** have been well-contained. In fact, most spending categories registered negative growth rates through June 2007, while wages and salaries were limited to program levels. The significant under-execution of the capital budget is mainly a result of a backlog in approval of work orders resulting from changes at the Ministry of Public Works, which the authorities intend to reverse in the second half of the year.

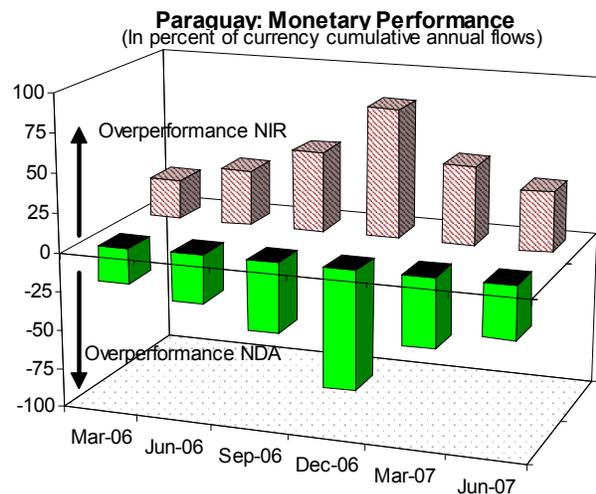
<sup>1</sup> Congress approved a law in July 2007 that delayed, for the second time, the introduction of the personal income tax to 2008. The law was vetoed by President Duarte-Frutos in August 2007, but Congress overrode the Presidential veto.

5. **Following a significant reduction in interest rates earlier in the year to contain large foreign exchange inflows, the Central Bank switched to a tightening stance.**

Considering that the foreign exchange inflows were attracted by high interest rates, the Central Bank lowered the rates on the 3-month monetary control instruments (LRM) from 11 percent to around 4 percent in March 2007. However, LRM rates were adjusted upward to 4½ percent in August 2007 in response to the inflation uptick.

- **International reserves.** Facing the prospect of a strong appreciation of the *guarani*, the Central Bank intervened heavily in the foreign exchange market in the first quarter of 2007. The NIR floor for end-June 2007 was surpassed by some US\$250 million (over 10 percent of the stock of reserves). Foreign exchange inflows have moderated significantly, and Central Bank intervention has virtually stopped since April 2007.

- **Domestic credit.** The Central Bank (BCP) modified the auction system for LRMs, whose supply had been constrained by the BCP, and had increasingly fallen behind demand. With a new interest rate term structure, set at lower levels, the Central Bank has placed large amounts of LRMs, well beyond program projections. In addition, the steeper yield curve, shifted LRM demand to longer maturities; the average LRM maturity increased from about 2½ months (end-April 2007) to over 4 months (end-August 2007).



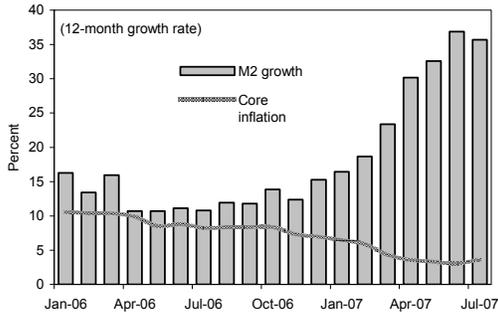
Fiscal over-performance and the associated increase in public deposits at the BCP helped observe the NDA ceiling for end-June 2007.

- **Currency issue.** The large increases in NIR could not be fully offset by the sterilization efforts, and domestic currency growth accelerated to over 25 percent by end-June 2007 (against a program projection of less than 20 percent). The lower core inflation and the reduced level of dollarization (see below) indicate that the acceleration in currency growth is partly due to a higher-than-programmed domestic money demand.

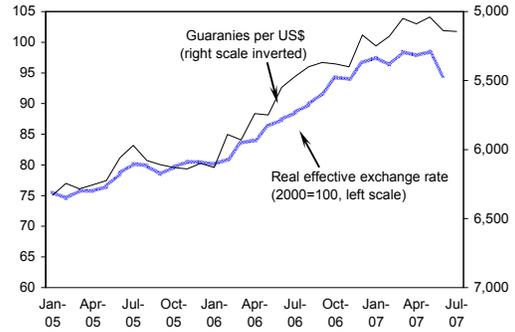
**Figure 3. Paraguay: Monetary Developments**

*The BCP stepped up its foreign exchange purchases earlier in 2007, in a quest to prevent a further appreciation of the guarani. While sterilization efforts continued, the BCP reduced interest rates in an effort to contain foreign-exchange inflows. While money demand has strengthened, the rapid growth in real money balances has raised concerns about a potential monetary overhang.*

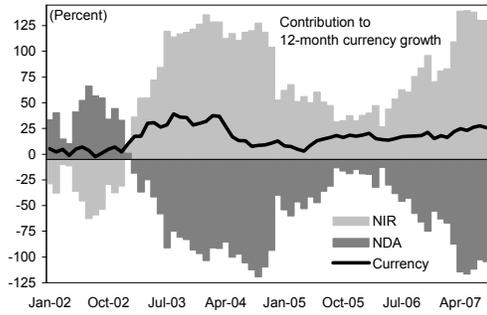
*While guarani-denominated money aggregates grew faster, core inflation continued to fall....*



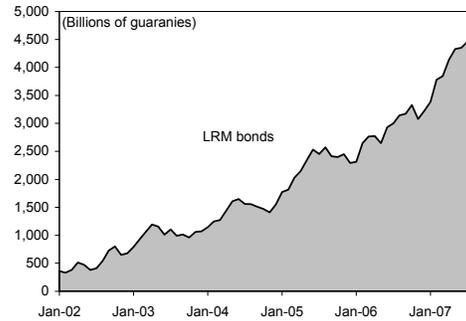
*...supported by a strong guarani both against the dollar and in real terms...*



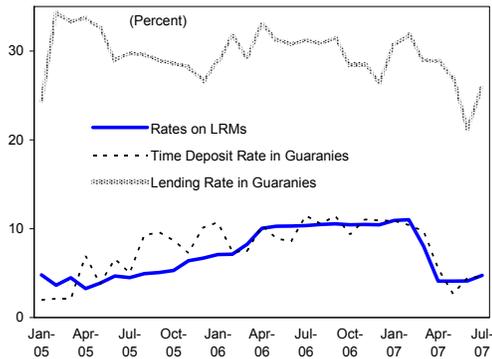
*The central bank lately accelerated its purchase of international reserves...*



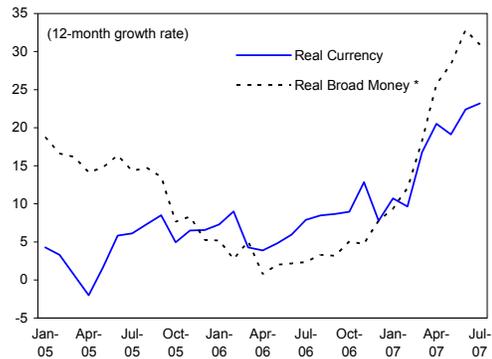
*...and consequently, the stock of sterilization bills rose further.*



*At the same time, the central bank reduced interest rates...*



*...and growth in real monetary aggregates increased.*



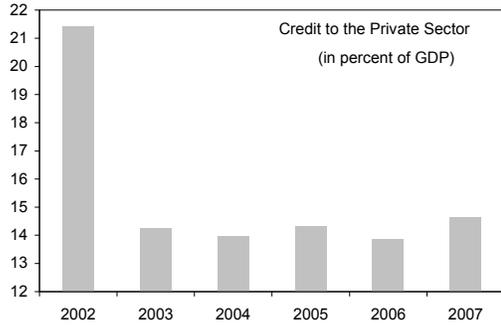
\* Excluding foreign-currency deposits. Series deflated by core CPI.

Sources: Paraguayan Authorities and Fund staff estimates.

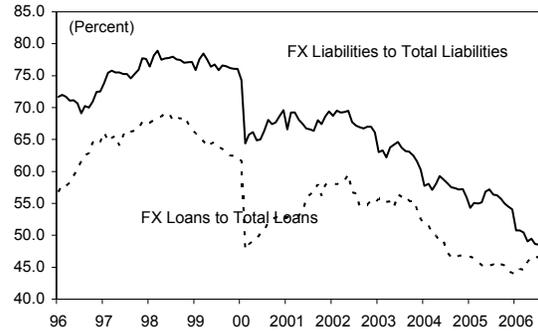
**Figure 4. Paraguay: Financial System Developments**

*Against a favorable macroeconomic background, the banking system continues expanding its operations and strengthening its financial soundness.*

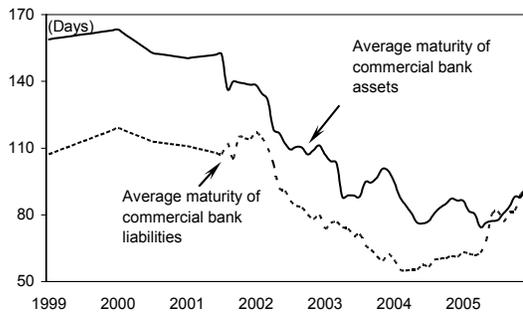
*Banks have increased lending significantly. Credit to the private sector is growing at respectable rates, increasing financial deepening...*



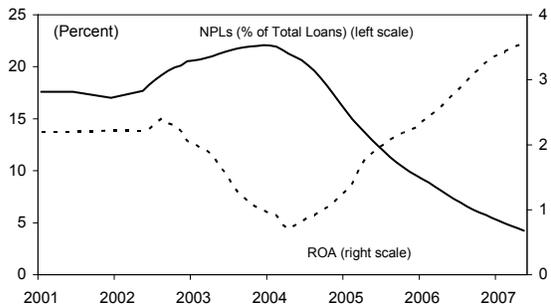
*... at the same time, as the demand for guarani-denominated assets increases, dollarization is declining...*



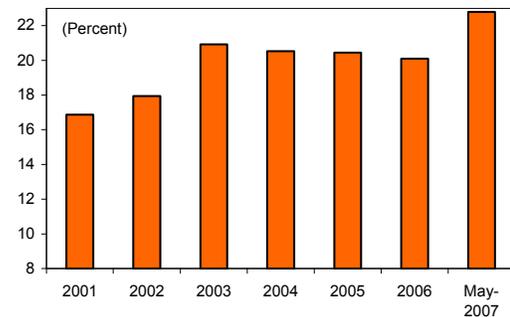
*... and the maturity of assets and liabilities has lengthened...*



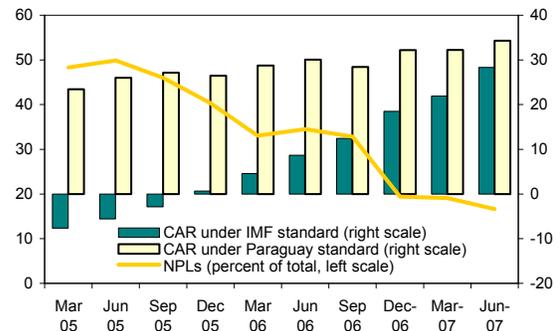
*Projects continue to perform well, contributing to declining nonperforming loans and increased profitability....*



*... as a result, the system remains well-capitalized, with CARs well above the 10 percent regulatory minimum.*



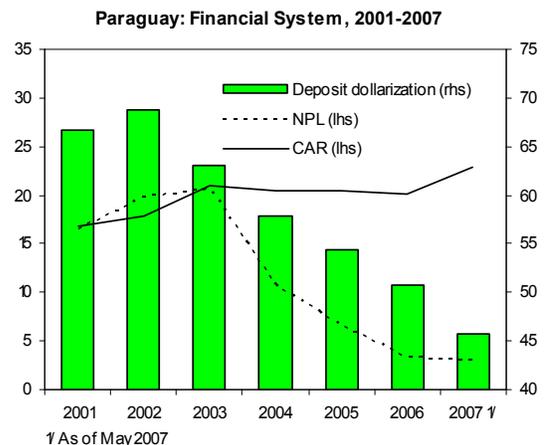
*BNF no longer represents a systemic risk, and its financial soundness has improved dramatically.*



Sources: Paraguayan Authorities and Fund staff estimates.

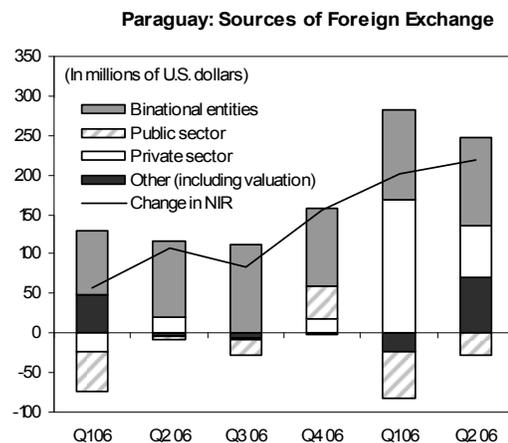
6. **The banking system has continued expanding its operations and improving its financial soundness.** The relatively good conditions have been mostly the result of a strengthening of the economy.

- **Balance sheet.** On the asset side, banks remain liquid with LRMs and deposits abroad representing almost 30 percent of bank's assets while credit to the private sector grew by about 10 percent in June 2007. On the liability side, there has been a shift in the currency composition of deposits, and foreign currency deposits fell from over 50 percent of the total in June 2006 to about 45 percent in June 2007. On the capital side, banks remain well-capitalized with capital adequacy ratios at over 20 percent (well above the regulatory minimum of 10 percent).
- **Income position.** Banks remain profitable. Lending operations continue to perform well, with non-performing loans declining to 3 percent in June 2007. Consequently, return on equity increased to over 35 percent in June 2007.



7. **The external position continues to be strong.** The benign environment persisted in the first half of 2007.

- **Current account.** Higher export growth (due to high commodity prices and bumper crops) and a slowdown in import growth (partly due to lower oil prices in the first half of the year), contributed to a narrowing of the current account deficit, projected at  $\frac{1}{4}$  percent of GDP for 2007 (down from 2 percent in 2006).
- **Capital account.** Higher foreign direct investment (FDI) offset by a slowdown in other private inflows, has reduced the external capital account surplus to a projected  $2\frac{3}{4}$  percent of GDP for 2007 (down from  $6\frac{1}{4}$  percent in 2006).

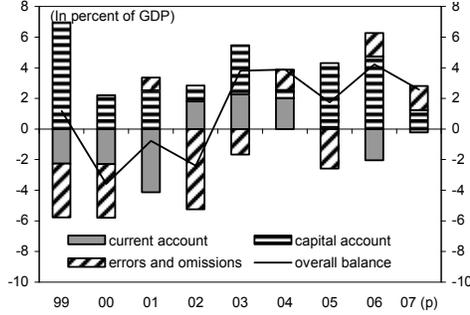


8. **The electoral process intensifies.** The April 2008 general elections are expected to be very competitive. The ruling Colorado Party (PC) will hold primary elections for its presidential candidate in December 2007. An opposition front, which includes several

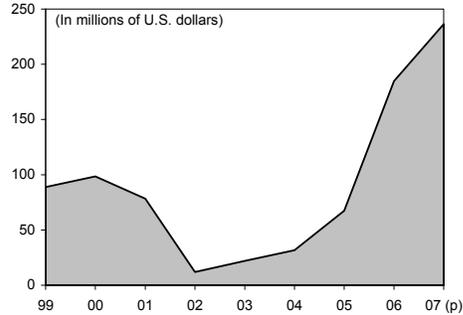
**Figure 5. Paraguay: Balance of Payments Developments**

*The external environment remains favorable and the external position continues to be strong. The outlook for 2007 remains good, with strong exports and foreign direct investment.*

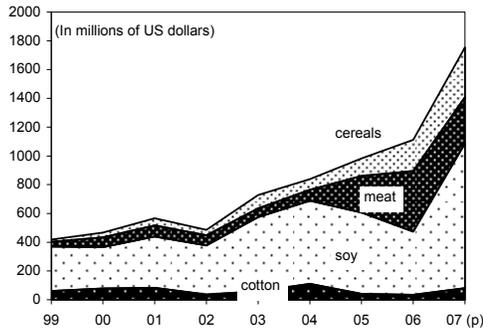
*The BOP will strengthen further in 2007, as the current account deficit shrinks...*



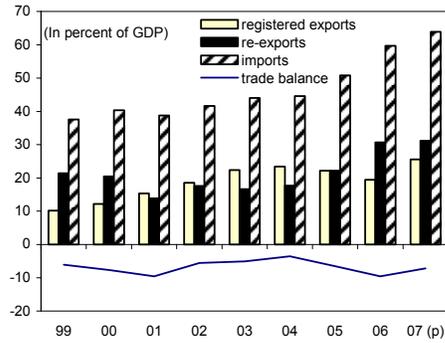
*...the capital account will remain in surplus as FDI continue expanding...*



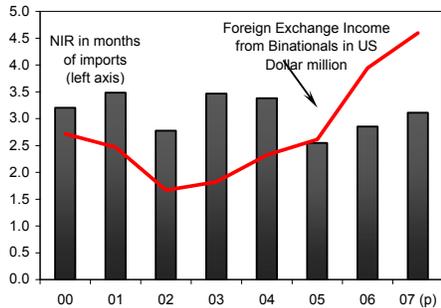
*The current account is expected to improve in 2007, mainly due to a surge in soy exports*



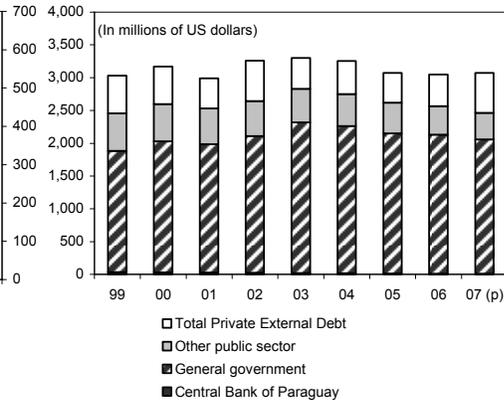
*Re-exports drove imports to a record high...*



*...with NIR increases driven by large inflows from binationals.*



*External debt decreases due slow approval of new public sector loans by Congress.*



Sources: Paraguayan Authorities and Fund staff estimates.

political parties and civil society organizations, has gathered around a Catholic bishop who resigned from priesthood in late 2006 (Mr. Lugo).<sup>2</sup> The Liberal party (PLRA)—the traditional second political force—supports the candidacy of Mr. Lugo. The leader of a smaller party (UNACE), Mr. Oviedo, was released from prison in early September and announced his intention to run for President.<sup>3</sup>

9. **Social tensions continue.** Public sector employees of several ministries (including the Ministry of Finance and the influential teachers' union) went on intermittent strikes in June and July, requesting significant salary increases. The tightening of trade controls at the border town *Ciudad del Este* sparked some social unrest in the south eastern part of the country. In addition, the Supreme Court's overruling of land expropriations in the north eastern part of the country has also created social pressures.

## II. OUTLOOK AND RISKS

10. **Favorable economic outlook.** The outlook continues to be positive for the remainder of 2007. The recent tightening of credit conditions in segments of mature financial markets abroad has not had an impact on Paraguay. Projections for growth in the region, particularly Brazil, remain strong, and there are upside risks that Paraguay would exceed the growth rate of 5 percent projected for 2007. The current mix of macroeconomic policies combined with favorable external conditions and the appreciation of the *guaraní*, have facilitated strong program performance and a decline in core inflation over the past months. However, monetary policy may need to be tightened, as the positive effects of the recent currency appreciation and the strengthening of domestic money demand will taper off.

11. **Increasing risks.** At the international level, there is a risk that a global slowdown associated with the credit tightening could spill over to emerging economies and to Paraguay's neighbors, which could affect Paraguayan exports. In addition, there is a risk that spending pressures would increase in the run-up to the April 2008 congressional and presidential elections, as Congress has the power to approve non-programmed supplementary budgets.

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<sup>2</sup> Political observers have noted a potential complication as the Vatican maintains that a serving bishop cannot resign from his position as a member of the clergy and the Paraguayan Constitution establishes that members of the clergy cannot run for the Presidency.

<sup>3</sup> Mr. Oviedo was granted conditional release by a military tribunal on the grounds of good conduct. He was serving a 10-year sentence given by a military court in 1997 for an alleged coup attempt. Political observers note that the tribunal did not clarify whether the conditional terms of his release made him eligible to run for President.

### III. POLICY ISSUES<sup>4</sup>

#### A. Overview

12. **Policy discussions focused on the adequacy of targets and prospects to achieve program objectives for the rest of the year.** The authorities reiterated their commitment to the program, and Finance Minister Barreto stressed his intention to maintain fiscal discipline. The authorities acknowledged that the underlying macroeconomic situation was better than anticipated in the first half of 2007 but noted that implementation of the program in the remainder of the year would be more challenging given the increasingly complex political situation. Nevertheless, the authorities stressed that every effort will be made to adhere to the program targets. The mission also discussed progress in implementing the structural reform agenda.

#### B. Policy Framework

13. **Improving macroeconomic conditions required minor adjustments to the macroeconomic framework.** Given the strength of the economy in the first half of 2007, the authorities raised their projections for economic growth to 5 percent for 2007; the staff agreed and noted the possibility of some upside risk. Achievement of the core inflation objective of 5 percent (+/- 2 ½ percent) for 2007 remains feasible despite the uptick in inflation in August. For 2008, real GDP growth could moderate to 4 percent, as private investment may decelerate due to political uncertainties, while the core inflation objective of 3 percent for 2008 remains optimistic but feasible.

	2006	Prog. 2007	Proj. 2007	Proj. 2008
(Annual percent change)				
Real GDP	4.3	4.0	5.0	4.0
Inflation (e.o.p.)	12.5	2½-7½	5.0	3.0
(In percent of GDP)				
External current account	-2.0	-1.3	-0.2	-0.3
Overall fiscal balance	0.1	0.0	0.0	0.0
Consolidated public debt	34.6	32.8	32.3	29.5

Sources: Paraguayan authorities; and staff estimates

#### C. Fiscal Policy

14. **The fiscal outlook for 2007 is good, although under increasing stress.** While the outcome for the first half of 2007 relied in part on expenditure compression, outlays are likely to rise during the second half of the year. In fact, Congress approved a 20 percent salary increase for teachers in late September 2007 which will put pressure on the end-December 2007 target on the wage bill. Congress is also considering additional requests for supplementary budgets that, if fully implemented, would compromise the fiscal objective for

<sup>4</sup> Former Finance Minister Bergen resigned in late July 2007 (during the mission) and discussions continued with his successor, Minister Barreto. Subsequently, Deputy Finance Minister von Horoch resigned in late September 2007 and was replaced by Mr. Alarcon.

2007 unless offset by expenditure cuts elsewhere. The authorities are determined to resist these pressures and to meet the program targets.

15. **The authorities submitted to Congress a budget for 2008 that maintains fiscal discipline.** The 2008 budget submitted has a deficit of about ½ percent of GDP, but implementation on the basis of historical rates of execution suggests that the fiscal position in 2008 will be in balance. The budget includes a 10 percent salary increase (0.1 percent of GDP) to about 30,000 civil servants, whose salaries have remained frozen over the past few years. The budget also includes—for the first time—an outline of a multi-year fiscal framework which anchors the concept of fiscal balance over the medium-term. In the past, Congress has loosened the proposed fiscal stance and the authorities resorted to a financial plan to ensure fiscal discipline, and a similar approach may be needed in 2008.

	2006	2007		2008	
		Prog.	Proj.	Budget	Proj.
<b>Total Revenues</b>	<b>18.9</b>	<b>18.2</b>	<b>18.7</b>	<b>19.9</b>	<b>19.0</b>
o/w Tax	12.4	12.1	12.4	12.1	12.4
<b>Total Expenditures</b>	<b>18.3</b>	<b>18.1</b>	<b>18.7</b>	<b>20.6</b>	<b>19.0</b>
o/w Wages	7.6	7.7	7.9	8.1	8.0
o/w Capital	4.3	4.4	4.5	5.6	4.6
<b>Discrepancy</b>	<b>-0.4</b>	--	--	--	--
<b>Overall Balance</b>	<b>0.1</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.6</b>	<b>0.0</b>

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

16. **The rest of the public sector has been performing very well, although PETROPAR's strong financial position has recently been affected by higher international oil prices.** The prospects for achieving the target of an overall balanced budget for the consolidated public sector for 2007 are good. However, there are still uncertainties as some of the public entities—such as local governments and public enterprises—are not under direct control of the central government. While diesel subsidies have been eliminated, PETROPAR has started facing financial pressures as international oil prices have risen recently, thereby endangering the authorities' original intention of clearing PETROPAR's arrears with suppliers by end-September 2007.<sup>5</sup> The mission urged the authorities to maintain their flexible pricing policy in order to enhance PETROPAR's financial position, thus avoiding generalized subsidies. The authorities maintained that given that PETROPAR generated significant profits during the first half of 2007, they were confident that reaching a public sector balanced position for the year as a whole was feasible.

<sup>5</sup> The program's performance criterion on arrears excludes PETROPAR's overdue payments to suppliers as public enterprises are independent and these amounts do not represent sovereign debt. PETROPAR's overdue payments to suppliers amounted to about US\$25 million at end-June 2007.

## D. Monetary Policy

17. **Monetary policies for the remainder of 2007 will be tightened gradually.** The authorities are considering ways to strengthen policies to anchor expectations and prevent a revival of inflationary pressures in the more complicated economic environment of the second half of 2007.

- **Curbing money supply.** The authorities are considering raising gradually the policy rates for short-term LRMs, which would tighten monetary conditions to bring the actual rate of expansion of monetary aggregates to more sustainable rates.
- **Validating a stronger money demand.** The recent decline in dollarization provides evidence of a strengthening of real domestic money demand beyond program expectations. There was agreement that this increase in demand for *guaraní*-denominated assets would warrant a somewhat higher growth rate of monetary aggregates than allowed under the program. Accordingly, the currency growth estimate for end-2007 (consistent with the inflation objective under the program) was raised cautiously from 12 percent to 15 percent. This was accommodated by revising upward the projection for net international reserves while preserving the same level of domestic credit.

	2006	Prog. 2007	Proj. 2007	Proj. 2008
<b>Currency Issue</b>	15.3	12.0	15.0	7.1
<b>Net international reserves</b>	87.1	32.9	35.9	7.1
<b>Net domestic assets</b>	-71.8	-20.9	-20.9	0.0
Credit to public sector	-13.5	-2.7	-5.1	0.2
Credit to banks	-27.4	-33.4	-20.0	-1.6
Other items	-30.9	15.2	4.2	1.4

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

18. **The mission had preliminary discussions on monetary policies for 2008.** There was a common understanding that, for the time being, projections for 2008 remain broadly appropriate. Inflation continues to be targeted at 3 percent. Assuming that the recent shift in money demand is satisfied, currency growth will fall to about 7 percent by end-2008. The mission will discuss the various aspects of the monetary program for 2008 during the next review.

## E. External Sector Policy and Issues

19. **There is increasing evidence about the strengthening of the balance of payments.** The current account deficit is expected to narrow from 2 percent in 2006 to ¼ percent of GDP in 2007 in line with a projected improvement in the trade balance. Exports are expected to remain strong in the second half of the year, supported by continued soy and cereal exports and high commodity prices. The slowdown in the growth rate of imports observed in the first half of 2007 is expected to be sustained after the record growth in 2006. The current account deficit is being more than financed by private capital flows, mainly foreign direct investment

related to increasing the capacity of the *Yacyeretá* hydropower plant and loans to the private sector reflecting high profitability in agricultural exports.

**20. In light of the strengthened external position, the appreciation of the guaraní**

**may continue.** There was agreement that resisting potential market pressures towards an appreciation of the currency could bear significant risks to the inflation outlook. The authorities noted that, following a short period of intervention in March-April, they have not intervened significantly in the foreign exchange market in the last few months. As the external position strengthened further, the *guaraní* appreciated by about 3 percent with respect to the U.S. dollar in September.

Paraguay: Balance of Payments				
(In percent of GDP)				
	2006	Prog. 2007	Proj. 2007	Proj. 2008
<b>Current Account</b>	<b>-2.0</b>	<b>-1.3</b>	<b>-0.2</b>	<b>-0.3</b>
o/w Exports	50.1	52.3	55.5	54.0
o/w Imports	-59.7	-60.9	-63.0	-61.4
<b>Capital Account</b>	<b>6.3</b>	<b>1.4</b>	<b>2.8</b>	<b>0.8</b>
Public sector (net) 1/	-0.2	0.4	0.0	0.2
Private sector (net) 2/	6.5	0.9	2.8	0.5
<b>Overall Balance</b>	<b>4.2</b>	<b>0.0</b>	<b>2.6</b>	<b>0.5</b>

Sources: Paraguayan authorities; and Fund staff estimates.  
1/ General government only.  
2/ Includes errors and omissions

**Efforts continue to resolve issues related to disputed claims.** At end-June 2007, disputed claims amounted to about US\$270 million or about 2½ percent of GDP. Following the submission of claims at the World Bank Settlement Body (ICSID) by the French import verification company (BIVAC) in April 2007, the authorities are assessing the claims of all import verification companies (BIVAC and SGS), and submitted a proposal to resolve the disputed claim to Belgium's Ex-Herstal. They are waiting for a response. In addition, they continue studying solutions to address a Swiss court ruling against Paraguay on a US\$185 million claim in favor of several European and American banks.

## F. Structural Policies

**21. The authorities have complied with the structural conditionality for end-June 2007.** Staff discussed the detail of all the plans involved in observing the three structural benchmarks:

- **Prudential regulations.** The benchmark entailed the design of a plan to achieve at least 80 percent of the Basel Core Principles of banking supervision over the medium term. The authorities presented a timely plan, recognizing that about 40 percent of the principles can only be adopted through legal modifications. The mission urged the authorities to identify additional measures that do not require changes in legislation (Box 1).
- **National Development Bank (BNF).** The benchmark required the development of a medium-term business strategy to refocus the bank's operations, improve its management and reduce its operating costs. The authorities submitted a timely plan, defining the future role of the bank and providing adequate projected cash flows.

- Central Bank (BCP).** The benchmark involved the preparation of a strategy to strengthen the financial position of the Central Bank, addressing the negative income position of the bank. After visits to Brazil and Chile to review their experiences in this area, the authorities submitted a plan that takes into account legal considerations and requires an extensive reconciliation of accounts between the Ministry of Finance and the BCP. The reconciliation would be certified by the Attorney General. As the reconciliation will take some time to complete, the authorities have decided that the government will transfer to the BCP 0.2 percent of GDP a year. In the staff's view, the government should try to finalize the

Paraguay: Structural Conditionality for end-June 2007		
Measure	Conditionality	Status
1. Design plan to increase compliance with Basel Principles	Benchmark	✓ <b>Done.</b> Authorities presented a plan to meet 80% of principles.
2. Develop plan for BNF to improve financial position and management	Benchmark	✓ <b>Done.</b> Authorities presented a medium-term business plan.
3. Design strategy to strengthen financial position of BCP	Benchmark	✓ <b>Done.</b> Authorities presented a plan with transfers to BCP.

Sources: Paraguayan authorities.

reconciliation process as quickly as possible, and the government should increase its annual transfer to BCP to 0.4 percent of GDP to ensure that the Central Bank losses are fully covered. The authorities expect to finalize the reconciliation of undisputed claims (i.e., those claims that are recorded in the Central Bank's balance sheet and the Ministry of Finance debt reporting system) by end-2007. The authorities argued that it was not possible to be more generous with these transfers due to budgetary constraints (Box 2).

22. **The authorities have continued to make progress in observing structural conditionality for end-September 2007.** Four out of the seven benchmarks due in September were observed in a timely manner; of the remainder, an additional two could be met shortly thereafter. However, the third will now be effective only in the latter part of 2008.

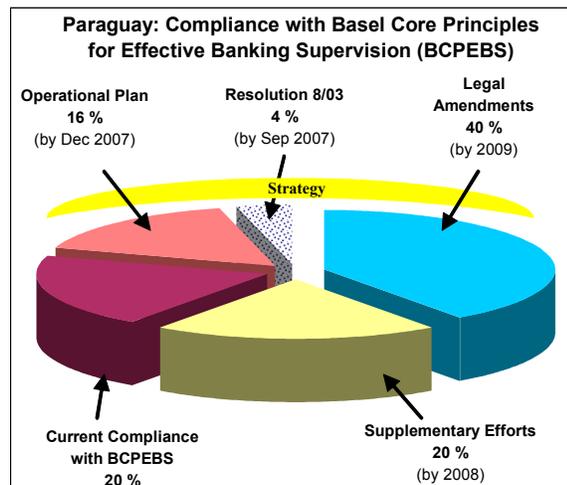
- Tax code regulations.** The benchmark called for the preparation of the implementing regulations for the draft tax procedures code. The authorities have prepared such regulations, and have presented and explained the framework of the code to the public. The reform has come under attack, with opponents arguing that the reforms would give undue power to tax collectors. The authorities are strengthening their information policy to explain the merits of the code. The staff suggested the formation of a committee with broad private sector representation to build consensus in this area.

### Box 1. Paraguay: Enhancing Regulation and Supervision of the Banking System

**After several failed attempts, the authorities have refocused and strengthened their efforts to improve prudential regulation and banking supervision.** In 2005, efforts to address weaknesses in banking regulation faltered as a draft general banking law ran aground in Congress. Subsequently, the authorities developed an alternative strategy, covering sequentially the areas for reform that had been identified in the 2005 FSAP, including legal amendments to the existing law and an action plan for central bank resolutions. However, this strategy also broke down when an important central bank resolution for loan classification and risk provisioning (Resolution 8/03) could not be implemented at end-2006 due to political resistance. Following the advent of a new administration at the BCP in April 2007, the authorities renewed their initiative to move forward in this important reform area, focusing on convergence toward international standards.

**The authorities have designed a strategy to increase compliance with the Basel Core Principles for Effective Banking Supervision (BCPEBS).** The strategy seeks to increase compliance with the BCPEBS from about 20 percent currently to at least 80 percent by end-2009, and contemplates the following steps:

- **Banking resolutions.** Approve a modified *Resolucion 8/03* on credit requirements, loan classification and provisioning requirements by September 2007, with effect in January 2008 (4 percent).
- **Operational plan.** Implement those parts of the original 2005 central bank action plan that do not require changes in legislation, including strengthening the coordination between supervisory bodies, strengthening “fit and proper” criteria, and enhancing on-site, off-site, cross-border and consolidated supervision (16 percent).
- **Legal amendments.** Amend, by end-2009, the current legislation, in particular the Banking Law and the Central Bank Law, to improve governance rules, enhance the independence and sanctioning capacity of the Superintendency of Banks, further strengthen “fit and proper” criteria, and strengthen capital requirements (40 percent).



**Additional efforts are being considered to fully meet Basel criteria.** While not part of the strategy, the authorities are studying the possibility of implementing additional regulatory changes by end-2008, including strengthening protection for supervisors, and credit and operational risk management practices aims at increasing further compliance with the BCPEBS.

## Box 2. Paraguay: Strengthening the Central Bank's (BCP) Balance Sheet

**To reduce the BCP's losses and cover its capital shortfall, the authorities have designed a strategy to enhance BCP's balance sheet.** The Paraguayan authorities developed in early August 2007 a strategy to strengthen the financial position of the BCP (end-June 2007 structural benchmark). The strategy will help improve BCP's ability to conduct monetary policy and to achieve its inflation objectives without concern about the consequences of interest rate movements on its balance sheet. The strategy incorporates several due diligence measures to avoid future legal liabilities to either the Ministry of Finance or the BCP. A key feature of the strategy is to effect a capital injection once a comprehensive reconciliation of government debt to the BCP is completed. The authorities believe that without this reconciliation, it would be legally impossible to justify a capital injection in Congress. The strategy contemplates three stages:

### I. Financing Part of BCP Losses

**The Treasury will transfer to the BCP up to 0.2 percent of GDP per year to cover the quasi-fiscal deficit, including the cost of monetary policy.** This transfer will take place whenever the annual net result of BCP's operations is negative, and will involve cash and/or marketable short-term securities. The authorities intend to submit to Congress a draft law with the implications of this stage of the strategy by early-October 2007. This stage would address the "flow problem" related to BCP operational losses. The staff recommended a transfer of 0.4 percent of GDP to avoid further deterioration of BCP's balance sheet, but the authorities did not agree because of budgetary considerations.

### II. Determination of the Real Value of BCP's Balance Sheet

**The Treasury and the BCP will reconcile the government obligations on the BCP balance sheet, and will critically assess the value of all BCP assets.** The reconciliation of accounts between the Treasury and BCP will determine the value of the required capital injection and will need to be approved by the Attorney General. This stage will include all the necessary due diligence measures to avoid future legal liabilities to any party. In the meantime, BCP will implement the necessary measures to strengthen its management practices, and reduce its operating costs. The authorities intend to finalize the reconciliation of accounts and the assessment of BCP's assets value by the end of 2007. This stage would assess the "stock problem" on BCP's balance sheet.

Assets	19.5	Liabilities & Capital	19.5
International reserves	17.3	Base money	7.4
Other assets	2.2	Deposits	8.4
		LRMs	6.3
		Long term liabilities	0.7
		Capital	-3.4

### III. Financial Strengthening of BCP

**Securities will be issued to the Central Bank to cover the balance sheet shortfall.** After finalizing the reconciliation of accounts and determining the true value of all BCP assets, the authorities will recapitalize the BCP by that amount and preserve the net worth of the Central Bank over time ("optimal" BCP capital). To this end, the authorities will send to Congress a draft law authorizing the issuance of marketable government bonds in favor of BCP, which will: (i) settle definitely the outstanding government debt with the BCP that results from the reconciliation process; and (ii) inject any additional capital necessary to cover the difference between the reconciled amount and the "optimal" BCP capital. All the accounts that could not be reconciled in second stage will be written off the balance sheet of BCP. Preliminary estimates suggest that the required injection could amount to about US\$ 600 million (6 percent of GDP). This would address the "stock problem" related to BCP's balance sheet. At this stage a mechanism will also be established to remunerate properly the Treasury accounts at the Central Bank.

- **Pension reform plan.** The benchmark proposed the development of an action plan for a pension reform aimed at consolidating the different funds and ensuring the system's long-term viability. The authorities have prepared a comprehensive plan for pension reform to improve coverage, financial soundness and regulations in the system. The plan aims at the creation of a unified pension fund and is being strengthened, taking into account advice from international experts. The authorities intend to run different parametric reform scenarios to assess the cost of the reform.

- **Resolution 8/03.** The benchmark involved the approval of a modified resolution 8/03 to strengthen bank's loan classification and provisioning requirements to become effective in January 2008. The resolution was approved by the BCP Board in late-September 2007, but with

Paraguay: Structural Conditionality for end-September 2007		
Measure	Conditionality	Status
1. Draft implementing regulations for the tax procedures code	Benchmark	✓ <b>Done.</b> Regulations were prepared
2. Develop an action plan for a comprehensive pension reform	Benchmark	✓ <b>Done.</b> Plan was developed
3. Reinstate modified Resolution 8/03 becoming effective on Jan 1, 2008	Benchmark	X <b>Not observed.</b> Resolution approved, becoming effective after Oct 1, 2008.
4. Send bill with implications of plan to financially strengthen BCP	Benchmark	 <b>Significant progress.</b> Draft law agreed between BCP and MinFin
5. Develop supervisory and regulatory framework for cooperatives	Benchmark	✓ <b>Done.</b> Framework was issued and monitoring system established
6. Develop legal framework to revamp the payment system	Benchmark	 <b>Significant progress.</b> Law was drafted and is being reviewed
7. Implement plan to improve the investment climate	Benchmark	✓ <b>Done.</b> Plan was implemented

Sources: Paraguayan authorities.

implementation deferred until the latter part of 2008. The staff will continue working with the authorities to try to advance the effective date of this resolution.

- **Implications of BCP's financial strengthening.** The benchmark entailed submitting to Congress a bill with the legal and budgetary implications of the BCP financial strengthening strategy. A draft bill has been agreed between BCP and the Ministry of Finance and is being reviewed by legal experts at the Ministry of Finance. The bill would authorize a transfer to the BCP of 0.2 percent of GDP a year to cover its losses. The legislation also asks for authorization to issue bonds following the reconciliation exercise and the attorney general's certification. The bill is expected to be sent to Congress in early-October 2007.
- **Cooperatives regulations.** The benchmark involved the development of a supervisory and regulatory framework for financial cooperatives. The authorities have issued a general regulatory framework to which all large cooperatives, representing 80 percent of the cooperative sector, are already subject to. In addition, a system for monitoring financial indicators has been established. INCOOP, the cooperatives' supervisory body, plans to subject medium-size cooperatives to the general framework by

December 2007 and also started working on the design of a credit registry, and the drafting of the regulation for a deposit insurance fund for the sector.

- **Payment system.** The benchmark required the preparation of a draft payment system law to revamp the system. The Central Bank has prepared a draft law and has selected a private law firm to assess it. The law firm is expected to issue its opinion shortly and thereafter the bill would be considered by the economic cabinet.
- **Investment climate.** The benchmark stipulated the implementation of the authorities' master plan to improve the investment climate and they have done so. In particular, the plan reduced significantly the number of steps taken to open a business in Paraguay.

### **G. Program Issues**

23. **Access.** In the attached letter of intent, the authorities have requested a reduction and re-phasing of access under the SBA in light of the stronger-than-anticipated external position. Based on the current assessment of the potential financing need, staff supports a reduction in access from the current 65 percent of quota to 30 percent, with even phasing (after the first credit tranche).

24. **Data availability.** By the time this review is expected to be considered by the Board, the end-September 2007 performance criteria would have become effective. While the authorities believe that the performance criteria for end-September would be observed, there is not yet sufficient information to formally assess performance. The staff will update the Board on the status of performance criteria for end-September 2007 for which information is available at the time of the Board meeting. The authorities are requesting a waiver of applicability of the end-September 2007 performance criteria.

### **IV. STAFF APPRAISAL**

25. **Overall.** Program implementation continues to be good with all performance criteria and benchmarks for end-June 2007 being met and good prospects for observing end-September 2007 targets. Policies in the first half of 2007 consolidated the macroeconomic achievements of previous years, while deepening structural reforms. The authorities are to be commended for a solid performance, and encouraged to continue with the strong program implementation. While there is still much work to do, Paraguay has made significant progress towards entrenching macroeconomic stability and thereby setting the basis for higher sustainable growth and poverty reduction.

26. **Fiscal policy.** Fiscal performance in the first half of 2007 has been strong despite the difficult policy environment. The authorities have been successful in implementing a financial plan that aligns the main objectives of the budget with the available financing and the quantitative targets of the authorities' program. Anticipating an intensification of

expenditure pressures towards the end of the year, the authorities accumulated large margins in the first half of 2007. With stronger real GDP growth than originally projected, this fiscal stance was appropriately counter-cyclical. The authorities should be commended for these efforts, and encouraged to save part of the overperformance to consolidate such a stance and contain demand pressures. While fuel subsidies have been eliminated thanks to a more flexible domestic pricing policy and lower international oil prices in the past, it would be important to continue with the flexible pricing policy to reflect currently higher oil prices. The 2008 budget submitted to Congress appropriately maintains fiscal discipline but the authorities will need to use a financial plan if the approved budget were to compromise macroeconomic stability and the authorities' fiscal objective.

27. **Monetary policy.** While the Central Bank policy of reducing interest rates might have been successful in discouraging further foreign exchange inflows in the first half of 2007, it led to a significant expansion of liquidity in the banking system. Part of the additional liquidity satisfied a strengthening in domestic money demand, but care should be exercised to avoid a monetary overhang and the consequent inflationary pressures. The staff welcomes the monetary authorities' switch to a more active stance, as indications of price pressures emerged in August, and that envisages gradual increases in interest rates if needed to keep inflation in line with the program target.

28. **Exchange rate policy.** The policy of pursuing large foreign exchange intervention (during March and April 2007) prevented an abrupt appreciation of the *guaraní*, but it highlighted the significant economic costs associated with it, namely the interest cost of conducting large open market operations to sterilize inflows or else the potential inflation and distortions created by the unsterilized inflows. With evidence that the external position has strengthened further, the staff welcomes the authorities' commitment to a policy of limited intervention.

29. **Structural reform.** Progress continued to be made in the financial sector reform in the first half of 2007 with the implementation of three key structural measures related to the business plan of the National Development Bank (BNF), the strategy to strengthen the financial position of the Central Bank (BCP), and the plan to increase the coverage of Basel principles for the banking system. While these actions are encouraging, staff regrets that the authorities were unable to strengthen the strategy to recapitalize the Central Bank's balance sheet in order to more decisively address the cash-flow problem. The staff also regrets that the modified resolution 8/03 will only enter into effect after October 2008 rather than January 2008 as originally envisaged. Furthermore, staff urges the authorities to quickly implement the outstanding structural measures for end-September 2007. Going forward, the authorities will need to persevere in their efforts to keep the momentum, especially given the difficult political environment.

30. **Risks.** There are significant risks to the program in the months ahead, with a budget in Congress subject to political pressures and general elections in April 2008. While the

tightening of credit conditions in mature markets has not had a discernible impact on Paraguay, the situation could deteriorate if emerging economies begin to suffer from those conditions.

31. **Review.** The staff supports completion of the fourth SBA review in light of the strong performance and renewed ownership of the program as well as the authorities request for a reduction in access under the SBA to 30 percent of quota. The staff also supports a request for a waiver of applicability of end-September 2007 performance criteria.

Table 1. Paraguay: Quantitative Performance Criteria

	2006		2007							
	End-September		End-December		End-June		End-Sept		End-Dec	
	Prog.	Actual	Prog.	Actual	Prog.	Actual	Prog.	Actual	Prog.	Actual
<b>Fiscal targets</b>										
1. Overall balance of the central administration (floor, in billions of guaranies) 1/ 2/	325	848 ✓	0	48 ✓	184	1,043 ✓	330	0		
2. Wage bill of the central administration (ceiling, in billions of guaranies) 1/	2,695	2,636 ✓	3,880	3,857 ✓	2,055	1,978 ✓	3,086	4,443		
3. Overall balance of the public sector (floor, in billions of guaranies) 1/	440	1,231 ✓	0	413 ✓	202	1,756 ✓	459	0		
<b>Monetary targets</b>										
4. Net international reserves (floor, in millions of U.S. dollars) 3/	1,319	1,546 ✓	1,329	1,703 ✓	1,900	2,153 ✓	1,915	1,920		
5. Net domestic assets (ceiling, in billions of guaranies) 3/	-5,676	-7,059 ✓	-5,026	-5,312 ✓	-6,645	-7,762 ✓	-6,700	-6,016		
<b>Public debt and arrears targets</b>										
6. Contracting or guaranteeing of nonconcessional external debt by the NFPS (ceiling, in millions of US\$) 1/	500	0 ✓	500	27 ✓	500	0 ✓	500	500		
<b>Continuous PCs</b>										
7. Contracted or guaranteed short-term external debt by the NFPS	0	0 ✓	0	0 ✓	0	0 ✓	0	0		
8. Non-accumulation of external debt arrears	0	0 ✓	0	0 ✓	0	0 ✓	0	0		

Sources: Paraguayan authorities; and Fund staff estimates.

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

2/ For 2007 adjusted downward for any cash transfer or payment of interest costs on securities used to strengthen the financial position of the Central Bank.

3/ Stocks. NIR is adjusted upward (downward) for any increase (decrease) in reserve requirement for foreign currency deposits (above pre-specified amounts)

Table 2. Paraguay: Structural Conditionality Under the Program

Measure	Conditionality <sup>1/</sup>	Timing	Status
<b>Measures due by end-June 2007</b>			
<b>Public Sector Reform</b>			
A. Design of an action plan to develop an effective commitment control system for the public sector and rationalize the Treasury account system	SB	end-Jun 2006	✓ <b>Done.</b>
B. Preparation of a tax code	PC	end-Dec 2006	✓ <b>Done.</b>
<b>Financial Sector Reform</b>			
C. Audited and inspected CAR (fully provisioned) of 5 percent for BNF at end-June 2006	SB	end-Sep 2006	✓ <b>Done.</b>
D. Design an action plan to strengthen financial sector reform and increase compliance with Basel Core Principles to at least 80 percent (in line with regional best practices)	SB	end-Jun 2007	✓ <b>Done.</b>
E. Announce a strategy to strengthen the financial position of the Central Bank and a timetable for its implementation	SB	end-Jun 2007	✓ <b>Done.</b>
F. Audited and inspected CAR (fully provisioned) of 10 percent for BNF at end-December 2006	PC	end-Mar 2007	✓ <b>Done.</b>
G. Develop a medium-term business plan for BNF that includes a strategy to reduce costs, increase asset recovery, and improve credit and risk management	SB	end-Jun 2007	✓ <b>Done.</b>
<b>Pro-Growth Reform</b>			
H. Design a plan to improve business climate	SB	end-Sep 2006	✓ <b>Done.</b>
I. Implement result-oriented management contract for ANDE, COPACO, ESSAP, INC, and PETROPAR	SB	end-Dec 2006	✓ <b>Done.</b>
<b>Social Safety Net</b>			
J. Create a conditional cash transfer mechanism for 7,000 families living under extreme poverty based on contracts with beneficiaries	SB	end-Dec 2006	✓ <b>Done.</b>
<b>Measures due by end-September 2007</b>			
<b>Public Sector Reform</b>			
K. Draft implementing regulations for the tax procedures code	SB	end-Sep 2007	✓ <b>Done.</b>
L. Develop an action plan for a comprehensive pension reform	SB	end-Sep 2007	✓ <b>Done.</b>
<b>Financial Sector Reform</b>			
M. Send a bill to Congress that reflects the legal and budgetary implications of the agreed plan to strengthen the financial position of the Central Bank	SB	end-Sep 2007	⚠ <b>Significant progress.</b> Draft law agreed between MinFin and BCP
N. Develop legal and regulatory framework to revamp the payment system and preparing a draft payment system law	SB	end-Sep 2007	⚠ <b>Significant progress.</b> Law drafted by BCP being reviewed by independent law firm
O. Development of an effective supervisory and regulatory framework for the cooperative sector	SB	end-Sep 2007	✓ <b>Done.</b> General regulatory framework was issued and monitoring system established.
P. Reinstate a modified Resolution 8/03 to become effective on January 1, 2008	SB	end-Sep 2007	✗ <b>Not observed.</b> Resolution was approved on time, but will become effective after October 1, 2008.
<b>Pro-Growth Reform</b>			
Q. Implement the plan to improve the investment climate designed in September 2006	SB	end-Sep 2007	✓ <b>Done.</b>
<b>Measures due by end-December 2007</b>			
<b>Public Sector Reform</b>			
R. Design a public sector investment system	SB	end-Dec 2007	⚠ <b>In progress.</b>
S. Establish a commitment control system	SB	end-Dec 2007	⚠ <b>In progress.</b>
<b>Financial Sector Reform</b>			
T. Design a strategy for the development of capital markets	SB	end-Dec 2007	⚠ <b>In progress.</b>
U. Implement prudential regulations in line with BCP operational plan	SB	end-Dec 2007	⚠ <b>In progress.</b>
<b>Pro-Growth Reform</b>			
V. Observance of targets under the result-oriented management contracts for ANDE, COPACO, ESSAP, INC, and PETROPAR	SB	end-Dec 2007	⚠ <b>In progress.</b>
<b>Social Safety Net</b>			
W. Increase the coverage of the conditional cash transfer program to 15,000 families and establish mechanisms for the evaluation of results	SB	end-Dec 2007	⚠ <b>Almost done.</b> The authorities expect 25,000 families to be covered by end-2007.

Source: Paraguayan authorities.

<sup>1/</sup> SB = structural benchmarks; PC = performance criteria.

**Table 3. Paraguay: Selected Economic and Social Indicators**

<b>I. Social and Demographic Indicators</b>							
(thousand sq. km)	407	<b>Income distribution (2002)</b>					
		By highest 20 percent of households (percent)				61	
		By lowest 20 percent of households (percent)				2	
<b>Population (2005)</b>		<b>Health (2004)</b>					
Population (in millions-2004)	5.7	Physicians per 1,000 people				1.1	
Rate of increase (percent a year)	1.9	Hospital beds per 1,000 people				1.3	
Density (per sq. km.)	14.1	Access to a water source (percent)				80	
Employment	10.9	Access to a sanitation facility (percent)				86	
<b>Population characteristics (2004)</b>		<b>Education (2003; in percent)</b>					
Life expectancy at birth (years)	70.6	Male literacy rate (percent)				94	
Crude birth rate (per thousand)	29.7	Female literacy rate (percent)				92	
Crude death rate (per thousand)	5.0	Primary school enrollment (percent)				106	
Infant mortality (per thousand live births)	21.0	Secondary school enrollment (percent)				63	
<b>II. Economic Indicators, 2002-2007</b>							
	2003	2004	2005	2006	2007		2008
					Prog.	Est.	Proj.
<b>Annual percent change; unless otherwise specified</b>							
<b>Real accounts and prices 1/</b>							
GDP at current prices	22.5	16.4	11.2	10.1	10.6	11.4	7.7
GDP at constant prices	3.8	4.1	2.9	4.3	4.0	5.0	4.0
Per capita GDP (U.S. dollars, thousands)	1.0	1.2	1.3	1.6	1.9	1.7	1.8
Consumer price deflator	18.0	11.8	8.1	5.5	6.3	6.1	3.5
Consumer prices (end-of-period)	9.3	2.8	9.9	12.5	2.5-7.5	5.0	3.0
Effective exchange rate 2/							
Change (depreciation -)	-6.7	3.7	-6.5	13.0	...	...	...
End-of-period (depreciation -)	7.9	-8.5	4.5	20.1	...	...	...
<b>In millions of U.S. dollars</b>							
<b>External sector</b>							
Exports, f.o.b. (percentage change)	16.8	32.0	16.2	44.0	13.3	22.9	4.9
Imports, c.i.f. (percentage change)	14.4	27.0	22.5	49.6	10.2	16.3	4.5
Trade exports and imports	-327	-434	-507	-701	-729	-710	-740
Current account	125	139	11	-194	-146	-24	-29
Percent of GDP	2.3	2.0	0.1	-2.0	-1.3	-0.2	-0.3
Capital account	178	38	312	452	257	291	83
Overall balance	211	270	130	402	244	266	54
Terms of trade (percentage change)	1.0	-1.1	-11.2	-3.4	4.8	7.6	-2.1
<b>In percent of GDP</b>							
<b>Savings-investment balance</b>							
Savings domestic investment	19.9	20.8	19.6	20.1	22.8	21.4	21.7
Private sector	14.8	16.1	14.6	15.1	17.2	15.4	15.5
Public sector	5.1	4.7	5.0	5.1	5.6	6.0	6.2
Savings national savings	22.2	22.8	19.7	18.1	21.5	21.2	21.4
Private sector	17.6	16.3	13.9	12.3	15.9	15.2	15.2
Public sector	4.6	6.5	5.8	5.8	5.6	6.0	6.2
<b>Public sector</b>							
Overall government primary balance	1.0	2.7	1.9	1.5	0.9	0.9	1.0
Overall government overall balance	-0.3	2.0	0.6	0.1	0.0	0.0	0.0
Consolidated public sector primary balance 3/	2.5	3.2	2.8	3.9	1.9	1.5	1.5
Consolidated public sector overall balance 3/	0.0	1.8	0.9	0.8	0.0	0.0	0.0
Public sector debt (end-of-year) 4/	52.6	45.1	37.7	28.4	25.4	26.6	24.6
External	47.6	40.9	34.3	25.9	23.1	24.2	22.6
Domestic	5.0	4.2	3.4	2.5	2.3	2.4	2.0
Consolidated public sector debt 5/	55.6	48.8	42.7	34.8	32.8	33.4	30.5
<b>Annual percent change</b>							
<b>Money and credit</b>							
Monetary base	57.7	17.6	4.3	13.0	11.1	12.0	5.2
Reserves	24.9	24.6	16.1	15.3	12.0	15.0	7.1
Money	17.7	11.7	7.7	7.9	11.9	14.6	5.1
Investment to the private sector 6/	-18.4	13.9	14.1	6.8	6.3	13.8	8.2
Velocity of M2	8.3	7.7	7.2	6.8	6.8	6.6	6.4
<b>Prudent items:</b>							
International reserves (in millions of U.S. dollars)	983	1,168	1,297	1,703	1,920	1,940	1,994
Months of imports	3.5	3.4	2.5	2.9	3.2	3.1	3.0
(in billions of guaranías)	35,666	41,522	46,169	50,825	57,520	56,597	60,948
Population (millions)	5.6	5.7	5.8	5.9	6.0	6.0	6.2

Sources: Paraguayan authorities; and Fund staff estimates.

Revised GDP growth rates and GDP ratios reflects the use of a new national account data recently published by the authorities. However, program GDP ratios were not revised.

NS calculations of real effective exchange rates.

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

Nonfinancial Public Sector. Based on end-of-period exchange rate conversion of U.S. dollar-denominated debt. Includes Central Bank Bills (LRMs).

Foreign currency items are valued at a constant exchange rate.

Table 4. Paraguay: Central Government Operations

	2003	2004	2005	2006	2007				2008	
					Jan-Jun		Jan-Dec		Jan-Dec	
					Prog.	Actual	Prog.	Proj.	Proj.	Prop. Budg.
<b>In billion of guaraníes</b>										
<b>Total revenues</b>	<b>6,001</b>	<b>7,637</b>	<b>8,419</b>	<b>9,588</b>	<b>4,809</b>	<b>5,193</b>	<b>10,450</b>	<b>10,570</b>	<b>11,554</b>	<b>12,150</b>
Tax revenues	3,676	4,929	5,471	6,295	3,208	3,388	6,954	7,003	7,541	7,396
Income taxes	624	880	967	1,009	479	698	1,147	1,331	1,415	1,252
Excises	704	1,000	1,007	1,049	578	639	1,165	1,178	1,276	1,363
Value added tax	1,570	1,939	2,372	2,786	1,460	1,511	3,130	3,153	3,386	3,462
Import Duties	665	904	843	938	413	381	910	734	808	1,144
Other	113	205	282	513	278	158	603	607	656	175
Nontax revenues 1/ o/w: Public pension contributions	2,318	2,696	2,946	3,262	1,600	1,804	3,493	3,567	4,012	4,740
Itaipu-Yacyreta	364	440	541	560	317	324	646	646	696	702
Itaipu-Yacyreta	1,456	1,640	1,651	1,883	811	1,046	1,755	1,830	2,054	1,583
Capital revenues	7	12	2	31	2	1	3	1	1	13
<b>Current expenditures:</b>	<b>4,981</b>	<b>5,363</b>	<b>6,231</b>	<b>7,138</b>	<b>3,636</b>	<b>3,467</b>	<b>7,905</b>	<b>8,005</b>	<b>8,751</b>	<b>9,142</b>
Wages and salaries	2,724	2,984	3,334	3,857	2,055	1,978	4,443	4,443	4,882	4,951
Goods and services	408	447	546	674	326	233	784	784	843	973
Interest payments	489	483	560	519	266	244	518	487	594	587
Transfers	1,334	1,431	1,771	2,067	978	1,004	2,141	2,276	2,418	2,597
Of which: pensions and benefits	943	940	1,126	1,207	627	595	1,320	1,336	1,503	1,508
Other	26	18	19	22	10	7	19	14	15	35
<b>Capital expenditures and net lending</b>	<b>1,165</b>	<b>1,625</b>	<b>1,860</b>	<b>2,185</b>	<b>990</b>	<b>669</b>	<b>2,544</b>	<b>2,555</b>	<b>2,802</b>	<b>3,390</b>
Statistical discrepancy 2/	35	181	-39	-216	0	-15	0	-15	0	0
<b>Overall balance</b>	<b>-110</b>	<b>830</b>	<b>289</b>	<b>48</b>	<b>184</b>	<b>1,043</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>-383</b>
<b>Financing</b>	<b>110</b>	<b>-830</b>	<b>-288</b>	<b>-48</b>	<b>-184</b>	<b>-1,043</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>383</b>
External debt (increase +)	588	103	-295	-122	-59	-223	89	85	121	18
Disbursements	1,151	763	658	832	416	232	1,040	1,029	1,151	1,030
Amortizations	563	660	954	954	475	455	950	945	1,029	1,012
Domestic bonds (increase +)	-58	-78	-137	147	-80	-43	2	42	-121	378
Net credit from the banking system 1/ Net credit from Central Bank	-308	-162	-44	-373	-45	-620	-91	-126	-121	0
Net credit from commercial banks	-343	-114	55	-466	-45	-558	-91	-175	-121	0
Net credit from commercial banks	35	-48	-99	93	0	-62	0	50	0	0
Other	-111	-693	188	300	0	-157	0	0	0	-14
<b>In percent of GDP</b>										
<b>Total revenues</b>	<b>16.8</b>	<b>18.4</b>	<b>18.2</b>	<b>18.9</b>	<b>8.4</b>	<b>9.2</b>	<b>18.2</b>	<b>18.7</b>	<b>19.0</b>	<b>19.9</b>
Tax revenues:	10.3	11.9	11.8	12.4	5.6	6.0	12.1	12.4	12.4	12.1
Income taxes	1.7	2.1	2.1	2.0	0.8	1.2	2.0	2.4	2.3	2.1
Excises	2.0	2.4	2.2	2.1	1.0	1.1	2.0	2.1	2.1	2.2
Value added tax	4.4	4.7	5.1	5.5	2.5	2.7	5.4	5.6	5.6	5.7
Import duties	1.9	2.2	1.8	1.8	0.7	0.7	1.6	1.3	1.3	1.9
Other	0.3	0.5	0.6	1.0	0.5	0.3	1.0	1.1	1.1	0.3
Nontax revenues 2/ o/w: public pension contributions	6.5	6.5	6.4	6.4	2.8	3.2	6.1	6.3	6.6	7.8
Itaipu-Yacyreta	1.0	1.1	1.2	1.1	0.6	0.6	1.1	1.1	1.1	1.2
Itaipu-Yacyreta	4.1	3.9	3.6	3.7	1.4	1.8	3.1	3.2	3.4	2.6
Capital revenues	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
<b>Current expenditures</b>	<b>14.0</b>	<b>12.9</b>	<b>13.5</b>	<b>14.0</b>	<b>6.3</b>	<b>6.1</b>	<b>13.7</b>	<b>14.1</b>	<b>14.4</b>	<b>15.0</b>
Wages and salaries	7.6	7.2	7.2	7.6	3.6	3.5	7.7	7.9	8.0	8.1
Goods and services	1.1	1.1	1.2	1.3	0.6	0.4	1.4	1.4	1.4	1.6
Interest payments	1.4	1.2	1.2	1.0	0.5	0.4	0.9	0.9	1.0	1.0
Transfers	3.7	3.4	3.8	4.1	1.7	1.8	3.7	4.0	4.0	4.3
<b>Capital expenditures and net lending</b>	<b>3.3</b>	<b>3.9</b>	<b>4.0</b>	<b>4.3</b>	<b>1.7</b>	<b>1.2</b>	<b>4.4</b>	<b>4.5</b>	<b>4.6</b>	<b>5.6</b>
Statistical discrepancy 3/	0.1	0.4	-0.1	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
<b>Overall balance</b>	<b>-0.3</b>	<b>2.0</b>	<b>0.6</b>	<b>0.1</b>	<b>0.3</b>	<b>1.8</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.6</b>
<b>Financing</b>	<b>0.3</b>	<b>-2.0</b>	<b>-0.6</b>	<b>-0.1</b>	<b>-0.3</b>	<b>-1.8</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.6</b>
External debt (increase +)	1.6	0.2	-0.6	-0.2	-0.1	-0.4	0.2	0.1	0.2	0.0
Disbursements	3.2	1.8	1.4	1.6	0.7	0.4	1.8	1.8	2.0	1.7
Amortizations	1.6	1.6	2.1	1.9	0.8	0.8	1.7	1.7	1.7	1.7
Domestic bonds (increase +)	-0.2	-0.2	-0.3	0.3	-0.1	-0.1	0.0	0.1	0.0	0.6
Net credit from the banking system	-0.9	-0.4	-0.1	-0.7	-0.1	-1.1	-0.2	-0.2	0.0	0.0
Other	-0.3	-1.7	0.4	0.6	0.0	-0.3	0.0	0.0	0.0	0.0
<b>Memorandum Item:</b>										
Primary balance	1.0	2.7	1.9	1.5	0.8	2.3	0.9	0.9	1.0	0.3
Balance of the Caja Fiscal 4/	-1.6	-1.2	-1.3	-1.3	-0.5	-0.5	-1.2	-1.2	-1.3	0.0

Sources: Ministry of Finance; and Fund staff estimates.

1/ Excludes banks' holdings of government bonds.

2/ Includes receipts from the binational hydroelectric plants Itaipu and Yacyreta, 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 5. Paraguay: Consolidated Public Sector Operations 1/

	2003	2004	2005	2006	2007				2008
					Jan-Jun		Jan-Dec		Jan-Dec
					Prog.	Actual	Prog.	Proj.	Proj.
<b>In billion of guaranies</b>									
<b>Revenue</b>	<b>7,450</b>	<b>8,959</b>	<b>10,114</b>	<b>11,821</b>	<b>5,858</b>	<b>6,381</b>	<b>12,702</b>	<b>13,129</b>	<b>14,202</b>
Tax revenue	3,676	4,936	5,483	6,320	3,215	3,398	6,975	7,032	7,571
Nontax revenue and grants	3,617	4,010	4,596	5,469	2,632	2,982	5,714	6,096	6,629
Capital revenue	157	14	35	32	11	1	13	1	1
<b>Current expenditure</b>	<b>6,247</b>	<b>6,959</b>	<b>7,908</b>	<b>9,177</b>	<b>4,519</b>	<b>4,387</b>	<b>10,157</b>	<b>10,278</b>	<b>11,125</b>
Wages and salaries	3,290	3,634	4,087	4,711	2,427	2,405	5,271	5,391	5,904
Goods and services	634	755	994	1,200	489	390	1,235	1,376	1,477
Interest payments	728	678	751	858	480	446	1,103	856	924
Transfers	1,544	1,699	2,048	2,373	1,097	1,134	2,470	2,580	2,772
Other	51	193	27	35	25	12	77	75	48
<b>Capital expenditure and net lending</b>	<b>1,819</b>	<b>1,956</b>	<b>2,306</b>	<b>2,580</b>	<b>1,398</b>	<b>760</b>	<b>3,247</b>	<b>3,388</b>	<b>3,792</b>
<i>Of which</i> : capital expenditure	1,850	2,189	2,550	2,844	1,468	845	3,468	3,692	4,119
<b>Primary balance</b>	<b>909</b>	<b>1,315</b>	<b>1,298</b>	<b>1,960</b>	<b>682</b>	<b>2,202</b>	<b>1,103</b>	<b>856</b>	<b>924</b>
<b>Public enterprises' operating surplus</b>	<b>796</b>	<b>593</b>	<b>646</b>	<b>1,039</b>	<b>260</b>	<b>522</b>	<b>702</b>	<b>537</b>	<b>716</b>
Statistical discrepancy 2/	-198	119	-132	-689	0	0	0	0	0
<b>Overall balance</b>	<b>-17</b>	<b>756</b>	<b>414</b>	<b>413</b>	<b>202</b>	<b>1,756</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Financing</b>	<b>17</b>	<b>-756</b>	<b>-415</b>	<b>-413</b>	<b>-202</b>	<b>-1,756</b>	<b>0</b>	<b>0</b>	<b>0</b>
External financing net	459	-42	-445	-257	-170	-331	-134	-136	91
Disbursements	1,273	808	771	939	416	231	1,040	1,028	1,361
Amortizations	814	850	1,216	1,196	586	562	1,174	1,165	1,271
Domestic financing net	-24	72	-201	-476	-32	-1,268	134	136	-91
Bond financing	-58	-78	-137	147	-80	-43	2	42	-110
Net credit from the banking system	-356	-183	-176	-728	-59	-1,257	-296	-90	-185
Quasifiscal deficit financing	390	333	112	105	107	32	429	185	204
Other	-417	-786	232	320	0	-157	0	0	0
<b>In percent of GDP</b>									
<b>Revenue</b>	<b>20.9</b>	<b>21.6</b>	<b>21.9</b>	<b>23.3</b>	<b>10.2</b>	<b>11.3</b>	<b>22.1</b>	<b>23.2</b>	<b>23.3</b>
Tax revenue	10.3	11.9	11.9	12.4	5.6	6.0	12.1	12.4	12.4
Nontax revenue and grants	10.1	9.7	10.0	10.8	4.6	5.3	9.9	10.8	10.9
Capital revenue	0.4	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0
<b>Current expenditure</b>	<b>17.5</b>	<b>16.8</b>	<b>17.1</b>	<b>18.1</b>	<b>7.9</b>	<b>7.8</b>	<b>17.7</b>	<b>18.2</b>	<b>18.3</b>
Wages and salaries	9.2	8.8	8.9	9.3	4.2	4.2	9.2	9.5	9.7
Goods and services	1.8	1.8	2.2	2.4	0.9	0.7	2.1	2.4	2.4
Interest payments	2.0	1.6	1.6	1.7	0.8	0.8	1.9	1.5	1.5
Transfers	4.3	4.1	4.4	4.7	1.9	2.0	4.3	4.6	4.5
Other	0.1	0.5	0.1	0.1	0.0	0.0	0.1	0.1	0.1
<b>Capital expenditure and net lending</b>	<b>5.1</b>	<b>4.7</b>	<b>5.0</b>	<b>5.1</b>	<b>2.4</b>	<b>1.3</b>	<b>5.6</b>	<b>6.0</b>	<b>6.2</b>
<i>Of which</i> : capital expenditure	5.1	4.9	5.0	5.1	2.4	1.3	5.6	6.0	6.2
<b>Public enterprises' operating surplus</b>	<b>2.2</b>	<b>1.4</b>	<b>1.4</b>	<b>2.0</b>	<b>0.5</b>	<b>0.9</b>	<b>1.2</b>	<b>0.9</b>	<b>1.2</b>
Statistical discrepancy 2/	-0.6	0.3	-0.3	-1.4	0.0	0.0	0.0	0.0	0.0
<b>Overall balance</b>	<b>0.0</b>	<b>1.8</b>	<b>0.9</b>	<b>0.8</b>	<b>0.4</b>	<b>3.1</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Financing</b>	<b>0.0</b>	<b>-1.8</b>	<b>-0.9</b>	<b>-0.8</b>	<b>-0.4</b>	<b>-3.1</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
External financing net	1.3	-0.1	-1.0	-0.5	-0.3	-0.6	-0.2	-0.2	0.1
Disbursements	3.6	1.9	1.7	1.8	0.7	0.4	1.8	1.8	2.2
Amortizations	2.3	2.0	2.6	2.4	0.0	0.0	2.0	2.1	2.1
Domestic financing net	-0.1	0.2	-0.4	-0.9	-0.1	-2.2	0.2	0.2	-0.1
<i>Of which</i> : quasifiscal deficit financing	1.1	0.8	0.2	0.2	0.2	0.1	0.7	0.3	0.3
Other	-1.2	-1.9	0.5	0.6	0.0	-0.3	0.0	0.0	0.0
<b>Memorandum item:</b>									
Primary balance	2.5	3.2	2.8	3.9	1.2	3.9	1.9	1.5	1.5

Sources: Ministry of Finance and Fund staff estimates.

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

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

**Table 6. Paraguay: Summary Accounts of the Central Bank**  
(In billions of guaranies; end-of-period; valued at constant exchange rate)

	2003 1/	2004 1/	2005 1/	2006		2007 2/			2008 2/	
				Dec		Jun		Dec		Dec
				Actual 1/	Actual 2/	Program	Actual	Program	Proj.	Proj.
<b>Currency issue</b>	<b>2,207</b>	<b>2,488</b>	<b>2,925</b>	<b>3,371</b>	<b>3,371</b>	<b>3,045</b>	<b>3,219</b>	<b>3,776</b>	<b>3,877</b>	<b>4,153</b>
Growth	29.9	12.7	17.6	15.3	15.3	19.3	26.2	12.0	15.0	7.1
<b>Net international reserves</b>	<b>6,175</b>	<b>7,335</b>	<b>8,146</b>	<b>10,693</b>	<b>8,684</b>	<b>9,690</b>	<b>10,981</b>	<b>9,792</b>	<b>9,893</b>	<b>10,169</b>
(In millions of U.S. dollars)	983	1,168	1,297	1,703	1,703	1,900	2,153	1,920	1,940	1,994
<b>Net domestic assets</b>	<b>-3,969</b>	<b>-4,848</b>	<b>-5,221</b>	<b>-7,322</b>	<b>-5,312</b>	<b>-6,645</b>	<b>-7,762</b>	<b>-6,016</b>	<b>-6,016</b>	<b>-6,016</b>
Net nonfinancial public sector	1,163	1,366	1,410	1,015	728	375	220	638	557	566
Net credit to the central government	952	967	1,063	703	425	47	-121	334	249	233
Net credit to the rest of NFPS	211	398	347	311	303	328	341	304	308	333
Net credit to the banking system	-3,362	-4,376	-5,026	-5,828	-5,484	-6,558	-7,477	-6,611	-6,158	-6,222
Reserve requirements	-2,219	-2,195	-2,331	-2,535	-2,209	-2,457	-2,653	-2,531	-2,527	-2,650
Free reserves	-543	-1,012	-683	-651	-633	-1,174	-986	-521	-567	-517
Monetary control bills (LRM)	-602	-1,171	-2,014	-2,644	-2,644	-2,942	-3,847	-3,573	-3,076	-3,067
Other	2	2	2	2	2	15	9	15	12	12
Other assets and liabilities (net)	-1,770	-1,838	-1,605	-2,508	-556	-462	-504	-43	-415	-360
Capital and reserves	-1,463	-1,722	-1,368	-141	-116	-94	-192	228	-69	134
Other assets net 3/	-308	-116	-237	-2,367	-440	-368	-312	-271	-346	-494
<b>Memorandum items:</b>										
Total stock of LRMs outstanding	1,071	1,552	2,293	3,224	3,224	3,545	4,354	4,305	3,845	3,566
Quasifiscal balance 4/	-390	-333	-112	-105	-105	-107	-32	-429	-185	-204
in percent of GDP	-1.1	-0.8	-0.2	-0.2	-0.2	-0.2	-0.1	-0.7	-0.3	-0.3
Costs of monetary policy operations 4/	219	181	179	331	331	213	199	583	366	328
in percent of GDP	0.6	0.4	0.4	0.6	0.7	0.4	0.4	1.0	0.6	0.5
Monetary base	3,406	4,006	4,180	4,724	4,724	5,152	5,154	5,248	5,293	5,568
annual growth (in percent)	57.7	17.6	4.3	13.0	13.0	36.3	36.4	11.1	12.0	5.2
Narrow monetary base 5/	2,954	3,122	3,667	4,169	4,169	4,014	4,256	4,762	4,807	5,133
annual growth (in percent)	44.3	5.7	17.5	13.7	13.7	21.3	28.6	14.2	15.3	6.8

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

1/ Foreign-currency denominated items valued at 6,280 *guaranies* per U.S. dollar.

2/ Foreign-currency denominated items valued at 5,100 *guaranies* per U.S. dollar.

3/ Includes LRM held by the nonbanking sector.

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

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

**Table 7. Paraguay: Summary Accounts of the Banking System**  
(In billions of guaraníes; end-of-period; valued at constant exchange rate)

	2003 1/	2004 1/	2005 1/	2006		2007 2/			2008 2/	
				Dec		Jun		Dec		Dec
				Actual 1/	Actual 2/	Prog.	Actual	Prog.	Proj.	Proj.
<b>I. Central Bank</b>										
<b>Net international reserves</b>	<b>6,175</b>	<b>7,335</b>	<b>8,146</b>	<b>10,693</b>	<b>8,684</b>	<b>9,690</b>	<b>10,981</b>	<b>9,792</b>	<b>9,893</b>	<b>10,169</b>
(in millions of U.S. dollars)	983	1,168	1,297	1,703	1,703	1,900	2,153	1,920	1,940	1,994
<b>Net domestic assets</b>	<b>-3,969</b>	<b>-4,848</b>	<b>-5,221</b>	<b>-7,322</b>	<b>-5,312</b>	<b>-6,645</b>	<b>-7,762</b>	<b>-6,016</b>	<b>-6,016</b>	<b>-6,016</b>
Credit to public sector, net	1,163	1,366	1,410	1,015	728	375	220	638	557	566
Credit to banking system, net	-2,760	-3,205	-3,012	-3,185	-2,840	-3,616	-3,630	-3,038	-3,082	-3,155
Central bank securities	-1,071	-1,552	-2,293	-3,224	-3,224	-3,545	-4,354	-4,305	-3,845	-3,566
Other	-1,301	-1,457	-1,326	-1,928	24	141	3	689	354	139
<b>Currency issue</b>	<b>2,207</b>	<b>2,488</b>	<b>2,925</b>	<b>3,371</b>	<b>3,371</b>	<b>3,045</b>	<b>3,219</b>	<b>3,776</b>	<b>3,877</b>	<b>4,153</b>
<b>II. Monetary Survey</b>										
<b>Net foreign assets</b>	<b>8,405</b>	<b>9,478</b>	<b>10,028</b>	<b>12,491</b>	<b>10,140</b>	<b>11,259</b>	<b>12,695</b>	<b>11,469</b>	<b>11,655</b>	<b>12,260</b>
(in millions of U.S. dollars)	1,338	1,509	1,597	1,989	1,988	2,208	2,489	2,249	2,285	2,404
<b>Net domestic assets</b>	<b>2,152</b>	<b>2,313</b>	<b>2,671</b>	<b>2,398</b>	<b>3,564</b>	<b>2,908</b>	<b>2,467</b>	<b>3,859</b>	<b>4,053</b>	<b>4,242</b>
Credit to the public sector	699	531	237	-188	-411	-1,165	-1,647	-700	-270	-497
Credit to the private sector	5,081	5,788	6,601	7,760	7,051	7,155	7,857	7,496	8,023	8,680
Other	-3,628	-4,006	-4,167	-5,174	-3,077	-3,082	-3,743	-2,937	-3,700	-3,941
<b>Broad Liquidity (M4)</b>	<b>10,558</b>	<b>11,791</b>	<b>12,699</b>	<b>14,890</b>	<b>13,704</b>	<b>14,166</b>	<b>15,162</b>	<b>15,328</b>	<b>15,708</b>	<b>16,502</b>
Bonds and issued securities	31	0	0	0	0	0	0	0	0	0
Other monetary liabilities	9	125	85	32	26	55	13	28	29	31
Central bank securities with private sector	469	381	280	580	580	603	507	732	769	499
<b>Broad liquidity (M3)</b>	<b>10,047</b>	<b>11,285</b>	<b>12,334</b>	<b>14,278</b>	<b>13,098</b>	<b>13,509</b>	<b>14,642</b>	<b>14,568</b>	<b>14,910</b>	<b>15,971</b>
Foreign currency deposits	5,253	5,310	5,396	6,280	5,100	5,497	5,739	5,610	5,712	6,119
<b>Money and quasi-money (M2)</b>	<b>4,794</b>	<b>5,974</b>	<b>6,938</b>	<b>7,998</b>	<b>7,998</b>	<b>8,012</b>	<b>8,904</b>	<b>8,958</b>	<b>9,198</b>	<b>9,853</b>
Quasi-money	1,208	1,482	1,472	1,668	1,668	1,840	2,006	1,869	1,919	2,055
Money (M1)	3,587	4,492	5,466	6,330	6,330	6,172	6,898	7,089	7,279	7,797
<b>Annual percentage change</b>										
M0 (Currency issued)	29.9	12.7	17.6	15.3	15.3	19.3	26.2	12.0	15.0	7.1
Credit to the private sector	-18.4	13.9	14.1	17.6	6.8	5.9	27.9	6.3	13.8	8.2
M1	35.8	25.2	21.7	15.8	15.8	22.9	37.3	12.0	15.0	7.1
M2	24.9	24.6	16.1	15.3	15.3	23.2	36.9	12.0	15.0	7.1
M3	17.7	12.3	9.3	15.8	15.7	5.8	26.3	11.2	13.8	7.1
Of which: foreign currency deposits	11.8	1.1	1.6	16.4	16.4	-12.2	12.9	10.0	12.0	7.1
<b>Memorandum items:</b>										
Ratio of foreign currency deposits to M3 (percent)	52.3	47.1	43.7	44.0	38.9	40.7	39.2	38.5	38.3	38.3
Ratio of foreign currency deposits to private sector deposits in banks (percent)	63.5	57.1	54.6	55.4	50.3	50.6	48.3	49.8	49.6	49.6

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

1/ Foreign-currency denominated items valued at 6,280 guaraníes per U.S. dollar.

2/ Foreign-currency denominated items valued at 5,100 guaraníes per U.S. dollar.

**Table 8. Paraguay: Banking System Indicators**

	2002	2003	2004	2005	2006
<b>I. Total banking system (II+III+IV+V)</b>					
Share in assets	100.0	100.0	100.0	100.0	100.0
Capital adequacy ratio (percent) 1/	17.9	20.9	20.5	20.4	20.1
NPLs/total loans	19.7	20.6	10.8	6.6	3.3
Provisions/NPLs	46.6	54.8	54.6	57.7	59.1
Rate of return on assets (ROA)	1.0	0.4	1.7	2.1	3.0
Rate of return on equity (ROE)	9.0	4.5	18.3	22.6	31.7
Liquid assets/total assets 2/	25.1	32.6	30.8	26.6	23.3
Foreign exchange deposits/total deposits	68.6	61.7	55.0	52.7	49.1
<b>II. Total foreign-owned banks</b>					
Share in assets	48.4	47.4	35.8	31.3	29.1
Capital adequacy ratio (percent) 1/	17.6	20.4	26.0	27.2	25.5
NPLs/total loans	20.1	20.8	11.0	6.4	3.6
Provisions/NPLs	57.5	64.2	71.2	63.4	68.6
Rate of return on assets (ROA)	1.6	0.1	1.4	1.4	2.2
Rate of return on equity (ROE)	15.0	1.2	12.0	11.3	18.6
Liquid assets/total assets 2/	27.1	29.8	25.4	29.0	24.5
Foreign exchange deposits/total deposits	71.1	65.6	65.2	65.1	61.2
<b>III. Total majority-owned foreign banks</b>					
Share in assets	33.2	37.2	45.2	48.0	51.4
Capital adequacy ratio (percent) 1/	19.9	21.0	17.7	17.8	17.4
NPLs/total loans	10.4	12.3	3.7	2.3	1.8
Provisions/NPLs	43.8	52.1	56.9	87.2	83.0
Rate of return on assets (ROA)	1.4	1.3	2.2	3.0	3.9
Rate of return on equity (ROE)	13.4	15.5	25.8	35.3	45.8
Liquid assets/total assets 2/	26.2	35.3	28.8	22.6	18.5
Foreign exchange deposits/total deposits	70.7	62.3	53.8	51.7	48.8
<b>IV. Total domestic-owned private banks</b>					
Share in assets	10.4	7.4	8.2	9.4	9.9
Capital adequacy ratio (percent) 1/	13.6	14.1	13.3	13.4	15.6
NPLs/total loans	8.8	2.9	2.1	0.8	1.4
Provisions/NPLs	18.7	46.2	70.3	77.1	78.6
Rate of return on assets (ROA)	1.1	1.6	2.0	2.2	2.9
Rate of return on equity (ROE)	14.3	21.1	28.1	30.8	35.9
Liquid assets/total assets 2/	18.3	38.8	38.1	34.0	34.6
Foreign exchange deposits/total deposits	62.6	60.7	57.6	54.7	51.5
<b>V. National Development Bank (BNF)</b>					
Share in assets	8.0	8.0	10.7	11.3	9.5
Capital adequacy ratio (percent) 1/	18.8	30.0	25.0	26.5	32.2
NPLs/total loans	56.2	56.2	48.9	40.3	19.4
Provisions/NPLs	39.6	47.6	43.1	45.1	31.6
Rate of return on assets (ROA)	-4.7	-2.8	0.5	0.4	0.5
Rate of return on equity (ROE)	-27.3	-18.7	6.8	5.3	5.7
Liquid assets/total assets 2/	17.3	30.7	52.0	31.2	33.8
Foreign exchange deposits/total deposits	42.5	32.7	23.6	20.6	13.1

Source: Superintendency of Banks.

1/ Definition of CAR does not fully comply with international standards.

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

**Table 9. Paraguay: Balance of Payments**  
(In millions of U.S. dollars)

	2003	2004	2005	2006	2007				2008
					Jan-Jun		Jan-Dec		Jan-Dec.
					Prog.	Actual	Prog.	Proj.	Proj.
<b>Current account</b>	<b>125</b>	<b>139</b>	<b>11</b>	<b>-194</b>	<b>-19</b>	<b>24</b>	<b>-146</b>	<b>-24</b>	<b>-29</b>
Trade balance	-280	-248	-484	-911	-319	-253	-886	-744	-754
Exports	2,163	2,854	3,316	4,774	2,833	2,980	5,414	5,869	6,155
Registered	1,242	1,627	1,659	1,850	1,322	1,475	2,513	2,645	2,803
Unregistered	922	1,228	1,657	2,924	1,511	1,505	2,901	3,225	3,351
Imports	-2,443	-3,102	-3,800	-5,685	-3,152	-3,233	-6,300	-6,613	-6,909
Registered	-1,865	-2,658	-3,240	-5,231	-2,930	-3,009	-5,779	-6,114	-6,389
Unregistered	-577	-444	-560	-455	-223	-224	-521	-500	-519
Services (net)	245	327	349	383	136	136	336	366	342
Factor income	-8	-138	-78	-52	42	-47	79	-49	-36
Transfers	165	194	224	386	122	188	325	403	419
<b>Capital and financial account</b>	<b>178</b>	<b>38</b>	<b>312</b>	<b>452</b>	<b>83</b>	<b>214</b>	<b>257</b>	<b>291</b>	<b>83</b>
General government	77	-26	-107	-21	-11	-53	18	4	23
Disbursements	213	139	107	184	82	49	202	198	218
Amortization	-130	-133	-175	-169	-92	-89	-185	-181	-195
Other	-6	-32	-39	-36	0	-13	0	-13	0
Private Sector 1/	101	64	418	473	94	267	240	286	60
Direct investment	22	32	68	185	113	125	236	236	246
Foreign currency deposits	335	30	441	178	0	120	0	120	0
Other	-256	3	-90	110	-19	22	4	-70	-186
Errors and Omissions	-92	93	-193	144	133	162	133	0	0
<b>Overall Balance</b>	<b>211</b>	<b>270</b>	<b>130</b>	<b>402</b>	<b>197</b>	<b>401</b>	<b>244</b>	<b>266</b>	<b>54</b>
Net International Reserves (increase -)	-343	-186	-128	-406	-197	-450	-217	-237	-54
Gross Reserves	-342	-185	-129	-406	-197	-450	-217	-237	-54
Reserve Liabilities	-1	-1	1	0	0	0	0	0	0
Exceptional Financing	132	-84	-1	3	0	50	-27	-29	0
Arrears deferral (+)/clearance (-) 2/	91	-84	-1	3	0	50	-27	-29	0
Reschedulings	0	0	0	0	0	0	0	0	0
<b>Memorandum items:</b>									
Current account in percent of GDP	2.3	2.0	0.1	-2.0	-0.6	0.8	-1.3	-0.2	-0.3
Gross reserves (millions of U.S. dollars)	983	1,168	1,297	1,703	1,900	2,153	1,920	1,940	1,994
in months of imports of GNFS	3.5	3.4	2.5	2.9	3.2	3.5	3.2	3.1	3.0
External public debt in percent of GDP 3/	48.1	41.3	34.6	26.1	22.3	22.7	23.2	23.9	22.3
Debt service in percent of exports GNFS	11.6	7.5	8.8	6.0	5.5	5.1	5.8	5.2	5.3
Export Volume (percentage change) 4/	13.6	16.9	11.1	8.8	35.8	42.3	23.7	24.5	6.5
Import Volume (percentage change) 4/	8.6	17.1	12.5	53.3	21.2	20.2	8.2	11.8	2.8
Terms of trade (percentage change)	1.0	-1.1	-11.2	-3.4	n.a.	2.4	4.8	7.6	-2.1

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

1/ Includes public enterprises and binationals.

2/ Reflects PETROPAR's arrears on suppliers credits, which are not considered sovereign arrears (see definition in the TMU).

3/ Based on end-of-period exchange rate conversion of U.S. dollar-denominated debt.

4/ Registered trade.

**Table 10. Paraguay: Indicators of External Vulnerability**

	2002	2003	2004	2005	2006
<b>Monetary and financial indicators</b>					
Broad money (M3), percentage change 1/	-21.0	17.7	12.3	9.3	15.7
Credit to the private sector, real (percentage change) 1/	-31.1	-25.5	10.9	3.9	-4.9
Share of nonperforming loans in total loans (percent) 2/	19.7	20.6	10.8	6.6	3.3
Average domestic lending rate, real 2/	39.0	19.3	17.4	18.6	15.4
Central Bank bill yield, real 2/	12.9	-1.2	1.0	-0.1	0.8
International reserves (millions of US\$)	641	983	1,168	1,297	1,703
Central bank foreign short-term liabilities (millions of US\$)	0.5	0.5	0.3	0.7	0.0
<b>External indicators</b>					
Merchandise exports (percentage change)	-1.6	16.8	32.0	16.2	44.0
Merchandise imports (percentage change)	-14.6	14.4	27.0	22.5	49.6
Merchandise terms of trade (percentage change)	2.1	1.0	-1.1	-11.2	-3.4
Real effective exchange rate (percentage change)	11.1	-6.6	3.7	-6.5	13.0
Current account balance (percent of GDP)	1.8	2.3	2.0	0.1	-2.0
Capital and financial account (percent of GDP)	1.0	3.2	0.5	4.2	4.7
Net foreign direct investment (percent of GDP)	0.2	0.4	0.5	0.9	1.9
Inward portfolio investment (percent of GDP)	0.0	0.0	0.0	0.0	0.0
Other net investment (percent of GDP)	0.7	2.6	-0.1	3.0	2.5
External public debt (percent of GDP) 3/	63.6	48.1	41.3	34.6	26.1
Debt service (in percent of exports GNFS)	9.1	11.6	7.5	8.8	6.0
Gross reserves (in US\$)	641	983	1,168	1,297	1,703
In months of imports of GNFS	2.8	3.5	3.4	2.5	2.9
Over short-term external debt 4/	1.0	1.6	1.7	1.9	...
Over foreign currency deposits in domestic banks	0.7	1.0	1.1	1.1	...

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

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

2/ Latest available data, September 2005.

3/ Based on end-of-period exchange rate conversion of U.S. dollar-denominated debt.

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

Table 11. Paraguay: Schedule of Reviews and Purchases

Date	June 2007 Phasing		Conditions
	New Access and Phasing	Amount of Purchase	
		Percent of Quota 1/	
May 31, 2006	25.0	...	Approval of arrangement
September 29, 2006	6.0	...	First review and end-June 2006 performance criteria
June 29, 2007	12.0	...	Second and third reviews and end-September and end-December 2006 performance criteria
October 15, 2007	6.0	26.0	Fourth review and end-September 2007 performance criteria
December 15, 2007	6.0	1.0	Fifth review and end-September 2007 performance criteria
March 15, 2008	5.0	1.0	End-December 2007 performance criteria
June 15, 2008	2.5	1.0	Sixth review and end-March 2008 performance criteria
August 28, 2008	2.5	1.0	End-June 2008 performance criteria
<b>Total</b>	<b>65.0</b>	<b>30.0</b>	

Source: Fund staff estimates.

1/ Since Paraguay's quota is SDR 99.9 million, the percent of quota is almost equivalent to the amount of the purchase in SDR. For instance, the first credit tranche is 25 percent of quota or about SDR 25 million.

Table 12. Paraguay: Medium-Term Scenario

	2004	2005	2006	2007	2008	2009	2010	2011	2012
	Projections								
<b>Real sector</b>									
Real GDP growth (annual percentage change)	4.1	2.9	4.3	5.0	4.0	4.5	5.0	5.0	5.0
Consumer prices (annual percentage change)	2.8	9.9	12.5	5.0	3.0	3.0	3.0	3.0	3.0
GDP per capita (US dollars)	1,220	1,289	1,611	1,715	1,809	1,888	1,978	2,059	2,159
	(In percent of GDP)								
Gross domestic investment	20.8	19.6	20.1	21.4	21.7	22.3	22.5	22.8	23.1
Private sector	16.1	14.6	15.1	15.4	15.5	15.5	15.5	15.7	15.6
Public sector	4.7	5.0	5.1	6.0	6.2	6.8	6.9	7.1	7.4
Gross national savings	22.8	19.7	18.1	21.2	21.4	22.1	22.5	23.2	23.9
Private sector	16.3	13.9	12.3	15.2	15.2	15.3	15.5	16.1	16.4
Public sector	6.5	5.8	5.8	6.0	6.2	6.8	6.9	7.1	7.4
<b>Public finances 1/</b>									
Revenues	21.6	21.9	23.3	23.2	23.3	23.3	23.2	23.4	23.3
Current primary expenditures	15.1	15.5	16.4	16.6	16.7	16.5	16.3	16.3	16.2
Interest payments	1.6	1.6	1.7	1.5	1.5	1.5	1.4	1.3	1.2
Capital expenditures	4.7	5.0	5.1	6.0	6.2	6.8	6.9	7.1	7.4
Public enterprise operating surplus	1.4	1.4	2.0	0.9	1.2	1.6	1.4	1.4	1.5
Primary balance	3.2	2.8	3.9	1.5	1.5	1.5	1.4	1.3	1.2
Overall balance	1.8	0.9	0.8	0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt 2/ 3/	45.1	37.7	28.4	26.6	24.6	24.0	23.4	22.8	22.1
Consolidated public sector debt 3/	49.2	43.0	35.0	33.5	30.6	28.5	26.4	24.6	22.5
	(In millions of U.S. dollars)								
Public sector debt 2/	3,027	2,876	2,807	2,751	2,740	2,841	2,955	3,060	3,170
<b>Balance of payments</b>									
Exports	2,854	3,316	4,774	5,869	6,155	6,612	7,124	7,680	8,260
Imports	3,102	3,800	5,685	6,613	6,909	7,390	7,900	8,446	9,032
Current account	139	11	-194	-24	-29	-32	-2	59	116
(In percent of GDP)	2.0	0.1	-2.0	-0.2	-0.3	-0.3	0.0	0.4	0.8
Capital and financial account	38	312	452	291	83	94	73	18	-32
Gross international reserves	1,168	1,297	1,703	1,940	1,994	2,056	2,128	2,205	2,288
(In months of imports)	3.4	2.5	2.9	3.1	3.0	2.9	2.9	2.9	2.8

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

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

2/ Nonfinancial public sector debt; excludes Central Bank bills.

3/ Based on end-of-period exchange rate conversion of U.S. dollar-denominated debt.

**APPENDIX I. PARAGUAY—LETTER OF INTENT**

Asunción, Paraguay  
October 2, 2007

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

Dear Mr. de Rato:

1. This letter updates our previous correspondence (of May 8, 2006, September 12, 2006, and June 15, 2007), describes performance under our economic program, and reiterates our commitment to the program. The program's objectives remain the same, namely, to entrench stabilization while reducing poverty and increasing the potential growth of the economy by adopting an ambitious reform agenda.
2. The program remains on track. Performance under our economic program, supported by a 27-month Stand-By Arrangement (SBA), has been very good. All quantitative and structural performance criteria as well as all structural benchmarks through end-June 2007 have been observed by now, some by large margins.
3. Macroeconomic conditions have improved markedly since the adoption of the program in May 2006. Economic growth accelerated and inflation fell significantly in the first half of 2007. The public finances remain on a strong footing anchored by the financial plan and international reserves reached another record high in June 2007. While there was an uptick in inflation in August due to supply shocks, we will remain vigilant and will ensure adequate policies to achieve our inflation objective.
4. Contrary to our initial concerns, our external position has strengthened beyond expectations, and external vulnerabilities have reduced significantly. Against this background, and with the aim of strengthening our reform agenda, we believe it is appropriate to request: (i) reducing our access under the SBA—which we intend to continue treating as precautionary—from 65 percent (SDR 65 million) to 30 percent of quota (SDR 30 million); (ii) maintaining the same timing and number of program reviews as specified before; (iii) granting a waiver of applicability on the end-September 2007 performance criteria as the relevant data is not yet available; and (iv) completing the fourth review under the SBA supported program.

5. We will continue the productive dialogue we have maintained with the Fund in the past. The government believes that the policies under the program are adequate to achieve the program objectives, but we will take additional measures, if necessary, to achieve those objectives. We will consult and provide Fund staff with all the relevant information required to complete program reviews and monitor performance.

6. As it is customary now, we intend to publish this letter in the websites of the Ministry of Finance and Central Bank to maintain our citizens informed about our policy intentions. We also authorize the Fund to publish this letter.

Sincerely yours,

\_\_\_\_\_/ s /\_\_\_\_\_  
Germán Rojas  
President  
Central Bank of Paraguay

\_\_\_\_\_/ s /\_\_\_\_\_  
César Barreto  
Minister of Finance

**APPENDIX 2. PARAGUAY—FUND RELATIONS**  
(As of August 31, 2007)

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

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

<b>III. SDR Department:</b>	<b>In millions of SDRs</b>	<b>Percent of Allocation</b>
Net cumulative allocation	13.70	100.00
Holdings	93.41	681.94

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

**V. Latest Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	May 31, 2006	Aug 31, 2008	65.00	0.00
Stand-By	Dec 15, 2003	Nov 30, 2005	50.00	0.00

**VI. Projected Payments to Fund**

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming			
	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Principal				
Charges/Interest	0.00	0.00	0.00	0.00
<b>Total</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>

**VII. 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 August 31, 2007, the average interbank rate for the U.S. dollar was G5,090 =US\$1. Paraguay has accepted the obligations of Article VIII, Sections 2(a), 3 and 4 of the Fund's Articles of Agreement. Staff is considering whether the application of the income tax regime and the new Law of Administrative Reorganization and Financial Adequacy (Ley No. 2421/04) may give rise to exchange restrictions subject to Fund jurisdiction.

**VIII. Article IV Consultation:** The Executive Board concluded the 2007 Article IV consultation on June 29, 2007.

**IX. Technical Assistance:**

<b>Department</b>	<b>Purpose</b>	<b>Date of Delivery</b>
MAE	Policy Advisory to the Central Bank	March 1994–2004
FAD	Tax Policy	February 1999
FAD	Tax Administration	March 1999
STA	Monetary Statistics	February 2000
STA	Balance of Payments Statistics	June 2000
STA	Multisector, GDDS accession	February 2001
MAE	Currency Operations	March–September 2002
FAD	Customs Administration	May 2002
MAE	Financial Sector Surveillance	July 2002
FAD	ROSC	August 2002
STA	Multisector, follow-up	September 2002
MAE	Banking Supervision	September–November 2002
MAE	Central Bank Operations	November 2002
TRE	Safeguards Assessment	January 2003
MFD	Banking Supervision	January 2003–April 2004
MFD	Currency Handling and Reform	February 2002–April 2004
MFD	Payment System	July 2003
FAD	Customs and Tax Administration	December 2003
MFD	Reorganization of the Central Bank and Monetary Operations	January 2004
FAD	Customs Administration Advisor	July 2004–May 2005
MFD	Monetary Operations and Monetary Policy Formulation	October 2004
MFD	Public Banking Restructuring	February 2005
FAD	Customs and Tax Administration	February 2005
MFD and WB	FSAP Mission	April 2005 and July 2005

<b>Department</b>	<b>Purpose</b>	<b>Date of Delivery</b>
FAD	Update of ROSC	September 2005
STA	ROSC	January–February 2006
MFD	Central Bank Recapitalization	March 2006
MFD	Peripatetic Banking Expert	October 2005, February and August 2006.
FAD	Public Financial Management	March 2006
FIN	Safeguards Assessment	March 2006
STA	Consumer Price Index	April –May 2006
FAD and LEG	Tax Procedure Code	May 2006
LEG	Money Laundering	July 2006
STA	Monetary and Financial Statistics	August–September 2006
MCM	Payments System	October 2006
STA	Balance of Payments	November 2006
FAD	Revenue Administration	December 2006
FAD	Peripatetic Customs Advisor	May 2007
FAD	Tax Code Regulations	June 2007
MCM	Development of Local Capital Markets	June 2007
MCM	Banking Regulation and Supervision	June 2007
STA	Quarterly National Accounts	August 2007
STA	Consumer Price Index	August 2007

**X. Safeguards Assessment:** Under the Fund's safeguards assessment policy, Central Bank of Paraguay (CBP) is subject to a full safeguard assessment in respect to the arrangement approved on May 31, 2006. A safeguards assessment of the CBP was completed in October 2006. The report states that while the CBP has made some progress in strengthening the safeguards framework since the 2003 safeguards assessment, vulnerabilities remain in certain areas such as financial reporting and program data reporting to the Fund.

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

**APPENDIX 3. PARAGUAY—WORLD BANK RELATIONS<sup>1</sup>**

(As of September 10, 2007)

The Country Assistance Strategy (CAS) was approved on December 16, 2003, aiming at restoring confidence in the economy and to support reforms in areas, such as the financial sector, rural development, health, and education. At the moment the portfolio of the Bank consist of three operations, of which two are projects under implementation:

- Pilot Community Development (\$9m, approved in FY00); and
- Secondary Education Reform (\$24m, approved in FY02).

And one project awaiting Parliament approval:

- Road Maintenance Project (\$74m, approved on August 24, 2006)

The three World Bank-financed projects presently under implementation or awaiting ratification by parliament have a total value of US\$107 million in commitments, of which US\$87.6 million remain undisbursed as of September 10, 2007.

In addition to loans, the Bank has mobilized grants for the institutional strengthening of Congress (\$0.4m) and the Ministry of Finance (\$0.3m); to improve management of indigenous lands (\$1.7m); to support social development in two municipalities (\$0.9m); to promote development in indigenous communities (\$1.6), and to improve biodiversity and forestry (\$0.3m from the Institutional Development Fund, and \$0.3m and \$0.9m from the Global Environment Fund).

On the analytical, in FY07 the Bank has recently completed a Land Tax Study, and is preparing an Integrated Fiduciary Framework (jointly with the Interamerican Development Bank) and Education Attainment Assessment.

Projects under preparation include an additional financing for the Pilot Community Development Project, a Sustainable Rural Investment project, a Modernization of the Water Sector project, a Private Sector Development project, and a Forestry Project.

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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 Active Operations (as of September 10, 2007)

	Committed (Net of Cancellations)	Disbursed	Undisbursed
<b>Active loans</b>			
Community development	9.0	7.4	1.6
Education Reform	24.0	12.0	12.0
Road Maintenance*	74.0	0.0	74.0
<b>Total active loans</b>	<b>107.0</b>	<b>19.4</b>	<b>87.6</b>
<b>Total IBRD/IDA<sup>1</sup></b>		<b>1,046.3</b>	
<b>Repaid</b>		<b>602.0</b>	
<b>Total outstanding</b>		<b>252.8</b>	
O/w IBRD (including exchange rate adjustment)		234.3	
O/w IDA		18.5	

### II. IFC Operations (as of September, 2007)

	Loans	Equity	Total
Commitments	15.0	0.0	15.0
Held by IFC	15.0	0.0	15.0
Undisbursed	0.0	0.0	0.0

### III. IBRD/IDA Loan Transactions (calendar year)<sup>2</sup>

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Disbursements	37.7	42.1	46.6	26.8	13.5	42.3	16.2	16.7	31.9
Repayments	24.6	24.6	20.2	15.3	16.8	21.0	34.8	26.6	27.5
Net lending	13.1	17.5	26.4	11.5	-3.3	21.3	-18.6	-9.9	4.4

<sup>1</sup> As of June, 2007

<sup>2</sup> As of September 30, 2007.

\* Not yet effective.

**APPENDIX 4. PARAGUAY—INTER-AMERICAN DEVELOPMENT BANK RELATIONS<sup>1</sup>**  
(As of August 31, 2007)

**Portfolio**

As of August 31, 2007, the active loan portfolio amounts to US\$788.6 million, with an undisbursed balance of US\$468.8 million. In addition, there are 65 active Technical Cooperation operations (regular TCs, MIF, and Small Projects) for US\$24.1 million, of which US\$15.4 million are undisbursed. Loan approvals in 2006 reached a new record level of US\$251.4 million.

**Strategy**

A review of IDB's Country Strategy with Paraguay was approved in November, 2006. The main focus of IDB's actions for 2007-2008 will be the support of economic growth and poverty alleviation.

**Pipeline**

The lending program for 2007 includes the following operations:

- a. Program to Support the Economic Census of Paraguay , US\$5.0 million
- b. Program to Support Paraguayan Exports - REDIEX, US\$10 million

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

## APPENDIX 5. PARAGUAY—STATISTICAL ISSUES

While data provision is broadly adequate for program purposes, there is a need to improve the timeliness and accurate reporting of statistics. Paraguay became a GDDS participant in September 2001 with the publication of its metadata on the Fund's Dissemination Standards Bulletin Board (DSBB). A data ROSC mission visited Paraguay in January–February 2006; the authorities' response to the report and the mission's recommendations were published on the Fund's website on June 30, 2006.

### A. Real Sector

A new national accounts series—broadly consistent with the guidelines of the *1993 SNA*—was released in 2005. It was prepared with the assistance of an expert financed by the IDB and comprises a more complete coverage of industries, an input-output matrix, and expanded data sources for the compilation of the new base year (1994). However, no comprehensive regular program for data collection of economic censuses and surveys exists (an industrial survey was conducted in 2002) and source data for nonfinancial services, household consumption, and changes in inventories are insufficient. Major areas of concern include: (i) the 1994 reference year is becoming obsolete; (ii) excessive use is made of fixed coefficients for value added and household consumption; (iii) changes in inventories are obtained residually; (iv) informal activities are not monitored; and (v) supply and use tables have been compiled only until 1997. While the periodicity of annual GDP meets GDDS recommendations, timeliness does not because data are disseminated with a lag of 11 months. An exploratory TA mission on the compilation of quarterly national accounts was fielded in August 2007.

Both the consumer (CPI) and producer price indices (PPI) are reported on a regular and timely basis. The geographic coverage of the CPI is limited to Asunción (the capital) and expenditure weights are representative of the consumption patterns of urban households. The CPI has a base weight period of 1992, and the PPI of December 1995. The household budget survey 2005–2006, for which information has already been gathered and analyzed, will be used for updating the CPI basket and weights and for developing the index in accordance with the classification and valuation systems established in the *1993 SNA*. The new CPI is scheduled for publication by January 2008. Preparation of the index is receiving technical advice from the IMF Statistics department. The latest IMF price statistics mission was conducted in July–August 2007. The mission concluded that the authorities are largely on target to meet the referred publication schedule. The PPI basket (150 items) is not fully representative of current national output; electricity, water, gas, and services are not covered.

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

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

### **B. Fiscal Sector**

For surveillance purposes, the government finance statistics (GFS) are broadly consistent with the recommendations of the *Manual on Government Finance Statistics 1986 (GFSM 1986)*. The authorities have not yet prepared a plan to migrate to the *Government Finance Statistics Manual 2001 (GFSM 2001)*. Monthly data are available for the central administration (budgetary central government). Data on the operations of the local governments are not included in the GFS. The asset position of the social security system is available on a daily basis. Statistics on the central administration include data of the Postal Service Directorate (a nonfinancial public corporation) and the statistics of the nonfinancial public sector include data of financial public corporations (four employer social insurance schemes). These social insurance schemes are treated as financial corporations in the monetary and financial accounts. Data on medium- and long-term external debt are reliable and available on a monthly basis. Domestic debt data are available on request, but need to be fully integrated with the external debt database. Deficiencies remain in recording short-term supplier and commercial credit of the public sector. Moreover, there is a discrepancy in the fiscal data reported by the monetary and fiscal authorities. Measures are being taken to make reporting more transparent.

Annual data covering general government for 2005 have been reported for publication in the *2006 edition of the GFS Yearbook*. However, since 1994 no outstanding debt data and no breakdowns for expenditure by function have been provided for publication in the *GFS Yearbook*. Monthly and quarterly data are not reported for publication in *IFS*.

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

Money and banking statistics are broadly reliable because of the adoption of a new accounting plan for commercial banks and finance companies in 1995. Following the work on methodologies initiated by a 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 within the Central Bank (CBP), for reporting to STA for publication in *IFS*, and for operational and monitoring purposes. A revision of the classification criteria has led also to a marked reduction in the discrepancies of interbank positions. However, the lack of coverage of the credit cooperatives remains a matter of concern since they account for around 25 percent of deposits and loans of the banking sector.

The superintendency of banks publishes a detailed and informative report on the soundness of the financial system. The authorities have commenced submission of monetary statistics based on standardized report forms.

#### **D. External Sector**

Quarterly and annual data on balance of payments and the international investment position (IIP) are available from 2001 onwards on the central bank website, and are reported to STA. In October 2006, Paraguay became the first non-SDDS participant that reported quarterly external debt data to the World Bank's Quarterly External Debt Statistics (QEDS) database. The classification of the balance of payments and the IIP follows the recommendations of the *Balance of Payments Manual*, 5th edition. Improvements have been made in the quality of the data on capital flows, especially in the coverage of foreign direct investment, and in the recording of external debt transactions in the balance of payments and in the IIP. The central bank now produces a highly informative bulletin with balance of payments statistics. Special studies by the central bank have improved the estimation methods for remittances of Paraguayans abroad and unregistered trade transactions, but serious deficiencies remain.

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

A follow up technical assistance mission in November 2006 assisted the BCP in implementing recommendations of the ROSC mission. In particular, the follow up mission focused on: (1) assessing the surveys used to capture data on services, direct investment, nonfinancial private sector portfolio investment, and other investment; (2) reviewing and updating the statistical techniques used to calculate unrecorded trade; (3) reassessing the treatment of the binational hydroelectric energy enterprises in the external sector accounts; and (4) reviewing and preparing a preliminary template for reporting data on international reserves and foreign currency liquidity.

**Paraguay: Table of Common Indicators Required for Surveillance**  
(As of September 19, 2007)

	Date of latest observation	Date received	Frequency of Data <sup>1</sup>	Frequency of Reporting <sup>1</sup>	Frequency of publication	Memo Items:	
						Data Quality Methodological soundness <sup>7/</sup>	Data Quality Accuracy and reliability <sup>8/</sup>
Exchange Rates	09/18/07	09/19/07	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>2</sup>	Aug. 2007	09/11/07	D	M	D		
Reserve/Base Money	Aug. 2007	09/11/07	D	M	D	O, LNO, LO, O	O, O, O, LO, LO
Broad Money	May 2007	06/29/07	M	M	M		
Central Bank Balance Sheet	Aug. 2007	09/11/07	D	M	D		
Consolidated Balance Sheet of the Banking System	Jul. 2007	09/11/07	M	M	M		
Interest Rates <sup>3</sup>	Jul. 2007	09/11/07	M	M	M		
Consumer Price Index	Aug. 2007	09/03/07	M	M	M	O, LO, O, O	O, LO, LNO, O, LO
Revenue, Expenditure, Balance and Composition of Financing <sup>4</sup> —General Government <sup>5</sup>	Jun. 2006	08/03/07	M	M	M	LO, LO, LO, LO	LO, LNO, O, LO, LO
Stocks of Central Government and Central Government-Guaranteed Debt <sup>6</sup>	Q1 2007	07/19/07	Q	Q	Q		
External Current Account Balance	Q1 2007	07/19/07	Q	Q	Q	O, LO, LO, LO	LO, O, LO, LO, LO
Exports and Imports of Goods and Services	Jun. 2006	08/03/07	M	M	M		
GDP/GNP	2006	08/03/07	A	A	A	O, LO, LO, LO	LO, O, LNO, O, LO

<sup>1</sup> Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

<sup>2</sup> Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>3</sup> Both market-based and officially-determined, including discounts rates, money market rates, rates on treasury bills, notes and bonds.

<sup>4</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>5</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>6</sup> Including currency and maturity composition

<sup>7</sup> Reflects the assessment provided in the data ROSC published on June 30, 2006 and based on the findings of the mission that took place during January 25–February 8, 2006. For the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

<sup>8</sup> Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

**APPENDIX 6. PARAGUAY—WORK PROGRAM**

Mission	Dates
<b>Fourth SBA Review</b>	
Mission	Jul 25–Aug 8, 2007
Board Meeting	October 15, 2007
<b>Fifth SBA Review</b>	
Mission	Nov 7–20, 2007
Board Meeting	December 21, 2007
<b>Memorandum items:</b>	
Approval of SBA	May 31, 2006
First SBA Review	September 29, 2006
Second and Third SBA Reviews and 2007 Article IV Consultation	June 29, 2007

**Statement by the IMF Staff Representative**  
**October 15, 2007**

*This statement provides additional information on developments since the issuance of the staff report for the fourth review under the Stand-By Arrangement for Paraguay. This information does not materially change the staff appraisal.*

**I. RECENT DEVELOPMENTS**

**Inflationary pressures moderated while food prices continued to rise.** Headline inflation fell to 0.9 percent in September 2007 (from 3.4 percent in August), reducing the 12-month rate of inflation to around 10 percent (from 10½ percent). Higher food prices explain the whole inflation rate of September. Core inflation was 5½ percent in September (against a 5 percent target). The 12-month rate of non-food inflation was only 1¾ percent in September 2007.

**Monetary policy was tightened further in response to inflationary developments.** As a precautionary measure, the Central Bank raised interest rates again in early October 2007; the 3-month rate on central bank liquidity control instruments (LRM) was increased from 4½ percent to 5 percent and the 12-month rate from 7 percent to 8 percent.

**The fiscal position remains strong.** Preliminary information for August 2007 indicates a strengthening of the fiscal position as central government revenues were higher than programmed while expenditures continued to be contained. Tax collection grew at 11 percent in the 12 months to August, while expenditures grew by 8 percent. As a result, a sizeable overall surplus of 2 percent of GDP was recorded in the first eight months of the year.

**II. PERFORMANCE CRITERIA**

**Two performance criteria (PC) for end-September 2007 were observed.** Although there is no sufficient information available to assess the remaining end-September 2007 PCs, staff and authorities expect that they have been met (the authorities have requested a waiver of non-applicability).

- ***International reserves.*** In the absence of significant intervention in the foreign exchange market, the PC on net international reserves of the Central Bank was met by a margin of US\$265 million.
- ***Domestic credit.*** With a better functioning LRM market and higher rates in the last few weeks, placements of LRMs have been higher than programmed and the PC on the net domestic assets of the Central Bank was met by a margin of G 1.0 trillion.

### III. STRUCTURAL BENCHMARKS

**As noted in the staff report, the authorities met four out of the seven benchmarks for end-September 2007.** The measure related to a fifth benchmark—the approval of a modified resolution 8/03—was implemented but its effectiveness was delayed by several months.

- ***Resolution 8/03.*** The authorities approved this resolution at end-September 2007 as envisaged in the program. They stressed that it was difficult to reach consensus with the financial community and the banks' borrowers, and argued that they preferred to ensure support from all stakeholders by delaying the resolution's date of effectiveness from January to October 2008 rather than risking another confrontation (as in December 2006 when the resolution had to be postponed). The authorities feel that this delay is necessary to provide financial institutions with the time needed to adjust their accounting systems to the reporting requirements established by the new resolution. Staff sees merit in these arguments, and acknowledge that in reality the broad majority of banks and financial entities already comply with the resolution, but regrets the delay as it gives no legal backing to the Superintendency of Banks to enforce the higher standards during the interim period. The staff will continue working with the authorities to try to advance the schedule for the implementation of prudential regulations.

**The situation with the remaining benchmarks is as follows:**

- ***Legislation to partially cover Central Bank losses.*** There is agreement between the Ministry of Finance and the Central Bank to transfer 0.2 percent of GDP to the Central Bank on an annual basis to cover its losses, but the draft law that contains this element of the authorities' strategy continues to be subject to internal legal review and has not yet been sent to Congress. It is expected that this legislation will be sent to Congress by end-October 2007.
- ***Legislation to improve payment system.*** While the legislation was drafted, it is still being reviewed by a private law firm. It is expected that this draft law will be approved by the economic cabinet by end-November 2007.



Press Release No.07/231  
FOR IMMEDIATE RELEASE  
October 15, 2007

International Monetary Fund  
Washington, D.C. 20431 USA

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

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of Paraguay's economic performance under a 27-month Stand-By Arrangement originally approved in the amount equivalent to SDR 65 million (about US\$101 million).

In completing the review, the Executive Board also approved the country's request for a reduction and rephasing of access under the Stand-By Arrangement. In light of Paraguay's stronger than expected external position, the overall size of the Arrangement will be reduced— at the authorities' request— from SDR 65 million to SDR 30 million (about US\$46.6 million). This will make SDR 26 million (about US\$40.4 million) available to Paraguay immediately. However, the Paraguayan authorities intend to continue treating the arrangement as precautionary. The Stand-By Arrangement was approved May 31, 2006 (see [Press Release No. 06/117](#)).

Following the Board discussion on the fourth review, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, said:

“Paraguay's economic performance, supported by a Stand-By Arrangement with the Fund, continues to be strong. Macroeconomic policy implementation has been solid and, despite difficulties in implementing some aspects of the authorities' policy agenda, structural reforms have deepened in many areas. Paraguay has made significant progress towards entrenching macroeconomic stability and thereby setting the basis for accelerated sustainable growth and poverty reduction.

“Fiscal performance remains strong and the outlook for public finances is good, despite a difficult policy environment. A larger than anticipated fiscal surplus for the first eight months of 2007 has created margins for the expenditure pressures that may intensify during the remainder of the year. With economic growth more robust than originally projected, the strong fiscal position is appropriately counter-cyclical. In line with the encouraging fiscal

discipline reflected in the 2008 budget submitted to congress, prudent fiscal policies during the rest of 2007 and 2008 will be key to sustaining macroeconomic stability and meeting Paraguay's fiscal objectives.

“Paraguay's monetary policy, which aims to strike a balance between containing currency growth in the face of large foreign-exchange inflows and satisfying an increase in real domestic money demand, will need to avoid the development of a monetary overhang and consequent inflationary pressures. In this regard, the recent switch to a more active stance in the wake of international and regional price pressures is welcome.

“Progress on financial sector reforms is encouraging. The preparation of a business plan for the National Development Bank, a plan for enhancing Paraguay's coverage of Basle Core Principles for Banking Supervision, and a strategy to strengthen the financial position of the Central Bank are commendable. Looking forward, the further implementation of structural reforms will include a bill to Congress that will reflect the legal and budgetary implications of the strategy for strengthening the financial position of the Central Bank, and of completing work on the draft payments system law.

“The authorities are encouraged to continue defending the hard-won macroeconomic stability through appropriate fiscal and monetary policies. Maintaining and, where possible, accelerating the pace of structural reforms will contribute importantly to sustaining economic growth and poverty reduction,” Mr. Kato said.

**Statement by Javier Silva-Ruete, Executive Director for Paraguay  
and Jose H. Maciel, Senior Advisor to Executive Director  
October 15, 2007**

On behalf of the Paraguayan authorities, we would like to thank the staff for a comprehensive report, which highlights Paraguay's efforts to pursue their macroeconomic objectives. They wish to express their commitment to the program targets in order to consolidate stability and ensure sustainable growth.

**Real Sector Developments**

Paraguay's economic performance continued to show strong results as of end-June 2007, with solid growth, moderate inflation, and a higher-than-programmed public surplus. All performance criteria and benchmarks for this review were met, and the authorities expect to achieve the year-end program goals comfortably. According to new projections made by the authorities, and supported by the staff, real GDP growth could exceed 5 percent in 2007, due mostly to agriculture growth projected at 15 percent—with soybean as the main driving force—despite a declining contribution of livestock and services to growth. As emphasized in the staff report, this would be the highest rate of economic expansion since 1995.

The recent tightening of credit conditions in advanced economies did not have an impact on Paraguay, and the favorable outlook for growth in neighboring countries and the region suggests that present conditions will remain in place. Under these circumstances, the country's expectations are to achieve sustainable growth and reduce poverty over the medium and long term, as a result of the authorities' efforts to improve the investment climate and preserve macroeconomic stability.

**Fiscal Developments**

The good performance of fiscal revenue, sustained by both tax and non-tax revenues, will lead to a central government surplus of nearly 2 percent of GDP, well above expectations, according to end-June estimates. The surplus reflects the expansion of the economy, increased inflows from the hydroelectric bi-national entities, and a reduction in spending—mainly due to under-execution of the capital budget, which is expected to be reversed in the second half of the year. Despite some sources of concern for the second half of the year, notably the Congressional approval of salary increases for teachers and public sector employees, the newly appointed fiscal authorities have firmly declared their commitment to the program goals. In this regard, the large margins accumulated during the first semester of 2007 will be used to override expenditure pressures.

The 2008 budget submitted by the authorities to Congress maintains fiscal discipline, in spite of a slight deficit of about 0.5 percent of GDP, which according to historical rates of expenditure execution will not affect budgetary equilibrium. The budget includes a 10 percent increase for public employees whose salaries have remained stagnant over the past

years. Another issue highlighted by the Paraguayan authorities and the staff is the inclusion in the budget—for the first time—of a multi-year fiscal framework, aimed at achieving fiscal balance over a mid-term period.

Regarding public enterprises, most of them were well-managed, which contributed to an overall good performance. However, the strong financial position of the oil refinery PETROPAR was adversely affected by the rise in international oil prices. However, the authorities declared that the profits generated by this entity during the first half of the year will offset the financial stress, and it will not compromise the commitment to reach a public sector balance by end-2007.

### **Monetary and Financial Developments**

Headline inflation has been continuously dropping from 12.5 percent in 2006, although it remains volatile due to supply shocks. Nevertheless, core inflation fell to 5 percent at end-June 2007, in line with the program target. Following a spike in August 2007, the Central Bank reacted by increasing the interest rate by 50 basis points of its monetary instruments (LRM) to control monetary expansion. Nevertheless, as noted in the staff report, the recent decline in dollarization provides evidence of greater domestic money demand, surpassing program expectations. Accordingly, the estimate for currency growth by end-2007 was increased from 12 to 15 percent. In addition, demand has shifted to longer-maturity Central Bank monetary control instruments, reflecting greater confidence in the Paraguayan economy.

By the end of August 2007, international reserves rose to an unprecedented peak, despite the almost null intervention of the Central Bank in the foreign exchange market—a different behavior than in the first semester of the year, mainly because of moderating capital inflows. It is expected that the level of international reserves will remain strong, reaching more than \$2.25 billion, equivalent to more than 3 months of imports.

Another outcome from the strengthening of the economy is the continued improvement of the financial system, which has expanded its operations and improved its performance. Capital adequacy ratios are around 20 percent, twice the minimum regulatory requirements. Banks' profits increased over 35 percent by end-June 2007, due largely to the decline of non-performing loans, which currently are close to international standards.

### **External Developments**

The current account deficit narrowed as of end-June 2007, thanks to higher export growth—mainly from high prices of agricultural commodities—and a slowdown in import growth. The strengthening of the balance of payments is in line with the projected improvement in the trade balance. The current account deficit is largely financed by a capital account surplus due to higher foreign direct investments, most of them related to inflows from the hydroelectric bi-national plants.

Regarding the exchange rate, the appreciation of the guaraní is expected to continue. Although the Central Bank may intervene in the foreign exchange market to avoid fluctuations, significant interventions are not foreseen in the near future, except to prevent an abrupt appreciation of the currency. It is worth mentioning that in September, the guaraní appreciated by approximately 3 percent with respect to the U.S. dollar.

We would also like to inform that the authorities continue to assess international disputed claims and work on resolution proposals.

### **Structural Reforms**

The structural conditionalities for end-June were observed. The authorities submitted in a timely manner a medium-term strategy for the National Development Bank, aimed at reorienting its operations, improving its management, and reducing its operational costs. The plan will define the future of the bank and provide adequate cash flows to meet its goals. The authorities also presented a plan to adopt at least 80 percent of the Basel Core Principles of banking supervision over the medium term, acknowledging that about 24 percent of the principles are already in place, and 16 percent would be adopted by end-2007. For the remaining 40 percent, changes in the legal framework would be needed.

Another benchmark fulfilled was the presentation of a plan for strengthening the financial position of the Central Bank, including legal considerations, which require a reconciliation of accounts between the Ministry of Finance and the Central Bank, and a transfer to the latter equivalent to 0.2 percent of GDP per year to cover eventual losses derived from the use of monetary policy tools. Completion of this agreement has required extensive work and compromise from the fiscal and monetary authorities.

At the same time, we would like to comment on the benchmark regarding the approval of a modified prudential rule for banks' loan classification and provisioning. Although the Central Bank resolution was approved on September 28, 2007, in a timely manner, the staff assesses this benchmark as non-observed, because its implementation was delayed until October 2008. The authorities do not concur with the staff's appraisal, taking into account that the decision to defer the date for full implementation was taken after protracted negotiations with the productive and financial sectors, in order to ensure consensus and muster adequate support from these groups. Moreover, following technical procedures, since January 2008 the Superintendency of Banks will begin partial implementation of the norm and will require banks' information disclosures and forms associated with the new resolution.

### **Changes to the Program/Closing Remarks**

Taking into account that the external position of the country has been consistently strengthened and that external vulnerabilities have been reduced, the Paraguayan authorities have deemed it appropriate to request a reduction of access under the SBA, from 65 to 30

percent of quota. They also request a waiver of applicability for the end-September 2007 performance criteria.

The authorities are determined to continue working towards the completion of structural reforms aimed at improving the business climate, in order to promote investment and growth and reduce poverty. Also, Paraguay's recent economic outcomes stand as evidence of the authorities' commitment to macroeconomic discipline and coordination. Finally, they would like to thank the staff and Management for their continuous support and advice during the implementation of the program, and commit to keep the usual policy dialogue.