

Paraguay: 2002 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Paraguay, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 13, 2002**, 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 February 21, 2003.** 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 **March 10, 2003** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its **March 10, 2003** discussion of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Statistical Appendix

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PARAGUAY

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with Paraguay

Approved by Markus Rodlauer and Liam P. Ebrill

February 21, 2003

- **2002 Article IV consultation:** Discussions with the Paraguayan authorities on an economic program that could be supported by a stand-by arrangement lasted for much of 2002, delaying the Article IV consultations. The last consultation was held on May 14, 2001.
- **Discussions:** Discussions were held in April, July, November, and December 2002 in Asunción, and in August and September 2002 in Washington. The staff team met with President González Macchi, Finance Minister Jiménez, Central Bank President Ortiz Vely, former Finance Minister Spalding, former Central Bank President Vera, other ministers, senior government officials, members of Congress, and representatives of the private sector.
- **Staff teams:** The staff for the April mission was led by Mr. Jaramillo. Mr. Reichmann led the July mission. Mr. Franks led the missions in November and December. The staff teams included, at various times, Ms. Cebotari, Ms. Sab, Messrs. Lombardo, Dehesa and Steinberg (all WHD), Messrs. Perone and Walsh (PDR), and Mr. Delgado (MAE). The missions were assisted by Mr. Durán-Downing, MAE resident adviser in Asunción. Ms. Ocampos (OED) participated in some of the discussions.
- **Article VIII status:** Paraguay has accepted the obligations of Article VIII sections 2, 3, and 4 and the exchange system is free of restrictions on the making of payments and transfers for current international transactions.
- **Arrears:** Paraguay has accumulated arrears with both the World Bank and the IDB, and in January 2003, the World Bank and the IDB suspended lending to Paraguay due to arrears greater than 60 days.

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EXECUTIVE SUMMARY

Background:

- **In 2002, the economy fell into its worst recession in decades, reflecting the impact of exogenous shocks as well as weak economic policies.** Attempts to mount a comprehensive adjustment and reform effort were not successful mainly because of lack of domestic political support. Real GDP declined by 4½ percent, the *guarani* depreciated by 34 percent against the U.S. dollar, and inflation rose to 14½ percent.
- **The fiscal situation deteriorated sharply in 2002.** The nonfinancial public sector deficit is estimated at 3.0 percent of GDP, and by end-January 2003, the public sector had accumulated arrears of about 3.7 percent of GDP. Arrears include overdue payments to the World Bank and IDB, which consequently have suspended lending to Paraguay.
- **The banking system was seriously affected by the recession and contagion from the regional crisis in 2002.** In July, the third-largest bank, *Banco Alemán*, collapsed, provoking a major run on deposits. Average nonperforming loan (NPL) ratios have increased to near 20 percent, and the state-owned national development bank (BNF) is insolvent and with increasing liquidity problems.

Policy discussions and staff appraisal

- **Through much of 2002, discussions with the authorities focused on achieving a policy framework that could be supported by a stand-by arrangement.** However, key prior actions (fiscal package and bank resolution law) could not be implemented.
- **As prospects for a comprehensive program faded, the authorities focused on measures to limit the economic deterioration while awaiting a more favorable policy-making environment after the elections.** Those measures included administrative fiscal steps, a tight monetary policy stance, and quick resolution of the failed bank. While the staff welcomes the authorities' efforts to contain the crisis, it stresses that they could not substitute for more permanent adjustment and reforms.
- **Without measures, the public sector faces a financing gap of about 3 percent of GDP in 2003 and an unsustainable medium-term outlook.** To place the public finances on a sustainable path, the staff recommends adoption of measures that would deliver a primary surplus of 3–3½ percent of GDP over the medium term.
- **Prompt action is needed in the banking system to forestall further difficulties.** The staff urges early adoption of two laws (on bank resolution and public banking) that would permit orderly resolution of the BNF and any other bank that might face problems in the future. Close and proactive supervision is crucial to contain future problems early on.
- **A range of other reforms are needed to increase growth and reduce poverty.** These include the restructuring and privatization of public enterprises, efforts to raise labor productivity, and steps to improve governance and reduce corruption.

I. INTRODUCTION

1. **The staff conducted several rounds of negotiations on a possible Fund-supported program during 2002.** It was not possible, however, to bring a program to the Executive Board. In May, preliminary agreement was reached on a program centered on the privatization of several large public enterprises. Political pressures led the government to suspend the privatization program, prompting negotiations in July on a revised program based on a fiscal adjustment package and including measures to address vulnerabilities in the banking system. This program was described in the Policy Memorandum sent to the Executive Board in August (EBS/02/159) and is summarized in Box 1. However, the Paraguayan congress repeatedly postponed action on two key pieces of legislation which were prior actions under the program—a fiscal adjustment package and a banking resolution law. Slippages also occurred in other parts of the program.

2. **Because of the protracted program discussions, the Article IV consultation with Paraguay has been delayed.** Given the continuing obstacles to program implementation, it is proposed to proceed with the Article IV consultation while maintaining an ongoing policy dialogue with the authorities. The last Article IV consultation was concluded on May 14, 2001 (SM/01/125). Box 2 presents a summary of the Fund's policy recommendations in the last consultation and the authorities' response.

II. BACKGROUND AND RECENT DEVELOPMENTS

3. **The Paraguayan economy has long been characterized by slow growth.** Real GDP increased by an average of only 0.8 percent per year between 1995 and 2002, compared to population growth of 2.6 percent per year (Tables 1–2, Figure 1).¹ This stagnation reflects structural impediments to growth, in particular periodic banking sector difficulties, inefficient public enterprises, and serious governance problems, as well as the limited growth prospects of the largely agricultural base of the economy. Real GDP grew by 2.7 percent in 2001 on the strength of a strong agricultural year and growth in private consumption, despite a fall of more than 17 percent in investment.

4. **In 2002, the economy fell into its worst recession in decades.** Several exogenous shocks interacted with domestic vulnerabilities to produce a large decline in output, and a jump in inflation. The regional crisis affected exports, foreign investment and workers' remittances, and contributed to banking sector difficulties in Paraguay. A drought reduced agricultural production, while an outbreak of foot-and-mouth disease hurt beef exports later in the year. Domestic investment and consumption were depressed by concerns generated by the regional economic crisis, political uncertainties, and banking sector problems. Key economic developments in 2002 were as follows:

¹ Over the period 1980–2001, per capita income growth averaged only 0.3 percent per year.

- The staff estimates that real GDP declined by nearly 4½ percent. Investment fell by 7½ percent and consumption was down by about 6 percent.² Credit to the private sector fell by 13 percent in real terms;
- Unemployment has risen, and an increase in poverty is anticipated (Box 3);
- Inflation accelerated, with consumer prices rising 14.6 percent (see Figure 1) and producer prices up by 36.8 percent;
- The *guaraní* depreciated by 34 percent vis-à-vis the U.S. dollar, although the real effective exchange rate depreciated by only 2.6 percent, due to the sharp declines in the Brazilian *real* and the Argentine *peso* (Figure 2).
- Exports were roughly flat, while imports fell sharply, pushing the current account into surplus for the year. Capital flows turned sharply negative, resulting in a decline of US\$82 million in central bank reserves to US\$641 million, the lowest since 1993.

5. **The policy-making environment in Paraguay has become increasingly difficult.** Paraguay suffers from long-standing governance problems which complicate the conduct of economic policy (Box 4). In addition, the current government of President González Macchi faces strong opposition, including in Congress and in the president's own political party.³ The government's ability to build political consensus for economic reforms deteriorated further late in 2002 with the onset of the campaign for presidential and congressional elections⁴ and impeachment proceedings against the president.⁵ In November 2002, the Minister of Finance and Central Bank President resigned because of the government's inability to adopt policies to deal with the deteriorating economic situation. The new team has had to focus on stopgap measures to contain the growing imbalance, hoping that a new government in 2003 will be better placed politically to undertake more far-reaching reforms.

6. **The fiscal situation deteriorated sharply in 2002.** The consolidated deficit of the nonfinancial public sector (NFPS) widened from 0.2 percent of GDP in 2001 to an estimated

² The Central Bank of Paraguay estimates a smaller GDP decline (2.2 percent) for 2002.

³ President Gonzalez Macchi did not win the presidency in a general election. He had been president of the Senate and ascended to the post in March 1999 after then-President Cubas Grau resigned following the assassination of his Vice-President, Luis Argaña.

⁴ Primary elections for the presidency were held in December 2002, with general elections scheduled for April 2003.

⁵ The Senate rejected impeachment of the President on February 11, 2003, as the required two-thirds majority was not reached.

3.0 percent of GDP in 2002 (Table 3). This deterioration reflected mainly a widening central government deficit and growing problems in key public enterprises.

- ***The central government deficit increased by over 2 percent of GDP***, mainly because of weak tax collections, lower transfer receipts from hydroelectric companies,⁶ increased capital spending, and the impact of depreciation on debt service payments (Table 4). Tax receipts rose by only 2 percent in 2002, despite an estimated increase of 11½ percent in nominal GDP. Value added tax rose by 3.8 percent,⁷ while corporate income tax revenue fell by 1½, reflecting both weaker economic activity and lower efficiency. Expenditure rose broadly in line with GDP (up 10.2 percent), with the wage bill 8 percent higher while capital spending and interest payments both increased by over 20 percent, reflecting the depreciation of the currency vis-à-vis the U.S. dollar. The difficult fiscal situation partly reflects the overly generous public employees pension plan (the *caja fiscal*). The *caja fiscal* generated a cash deficit estimated at 1.6 percent of GDP in 2002, roughly two-thirds of the total central government deficit for the year.
- ***Public enterprise operations moved into deficit in 2002***, chiefly due to the failure to fully adjust key prices (including fuel, electricity, and water) and the suspension of the privatization and reform program (Table 5). As a result, the combined balance of public enterprises fell from a surplus of 0.3 percent of GDP to a deficit of 0.3 percent of GDP.
- ***Quasi-fiscal losses by the Central Bank of Paraguay (BCP) rose from 0.7 percent of GDP to 0.9 percent of GDP.***

7. **Severe financing constraints have led to sizable arrears in the public sector** (Tables 6–7).⁸ As of January 31, 2003, the public sector had domestic arrears of US\$117 million (2.1 percent of GDP), including unpaid salaries, overdue supplier credits, and domestic bonds held by the banking system.⁹ On February 13, 2003, Standard & Poor's

⁶ Revenues were lower from the Yacyretá company due to payments problems with Argentina which caused the company to accrue some US\$18 million in arrears with Paraguay. In the case of the Itaipú dam, the authorities had negotiated an advance on an inflation adjustment payment in 2001. This arrangement was not in effect during 2002, causing a reduction of about US\$25 million in revenue.

⁷ The VAT rate in Paraguay is only 10 percent (the lowest in South America) and yielded 4.3 percent of GDP in revenue in 2001.

⁸ More than half the NFPS deficit was financed by arrears.

⁹ These domestic bonds matured in December, and negotiations continue with the banks to roll over at least part of the payments due.

downgraded Paraguayan foreign currency debt to SD (Selective Default) due to nonpayment of these bonds. Arrears on external debt were over US\$86 million, including US\$13 million overdue to the World Bank and US\$5 million to the IDB.¹⁰ The World Bank suspended lending to Paraguay in January 2003 as some arrears exceeded 60 days. After briefly clearing IDB arrears in early January (permitting some disbursements), IDB lending was suspended again late in the month due to new arrears. In addition, several public enterprises have external arrears totaling over US\$28 million to foreign suppliers.

8. **The public debt/GDP ratio has risen sharply** (Table 8). In 1997, public debt amounted to only 17½ percent of GDP, but a combination of higher deficits, slower economic growth, and currency depreciation has raised the ratio to near 50 percent of GDP at end-2002. About 85 percent of the debt is external, half of which is owed to international financial institutions and one-quarter to Taiwan Province of China. Debt service remains relatively low (external debt service represented 9 percent of total exports and 23 percent of government revenues in 2002) because Paraguayan debt is mostly long term and at concessional interest rates.

9. **Monetary policy was reoriented in mid-2001 with the abandonment of the *de facto* exchange rate peg.** The central bank moved to a more flexible management of the *guaraní* and greater reliance on interest rates to manage liquidity in the system. Interest rates on the central bank's *Letras de Regulación Monetaria* (LRMs), which stood at 6 percent at end-2000, were increased gradually to 21 percent by the end of 2001 (Table 9, Figure 3). In the wake of the deposit run associated with the collapse of *Banco Alemán* (see below), in 2002 the central bank raised interest rates on LRMs above 30 percent and temporarily increased reserve requirements (see paragraph 22).

10. **The banking system was seriously affected by the recession and contagion from the regional crisis in 2002** (Box 5). In July, the third-largest bank, *Banco Alemán*, collapsed, provoking a major run on deposits.¹¹ During June–August, dollar deposits declined by US\$231 million (21 percent), with local currency deposits down 12 percent. The central bank responded with speedy liquidation of the closed bank, targeted liquidity support, and a significant tightening of the overall monetary policy stance. As a result, the situation stabilized. About three-fourths of local currency deposits had returned by year-end; however, dollar deposits have remained roughly at their end-August levels. Reflecting the impact of the recession and currency depreciation, average nonperforming loan ratios (NPL) increased

¹⁰ In addition, the central government had US\$40 million in disputed arrears with private companies and US\$16½ million in dispute with the Belgian government Office du Ducroire.

¹¹ *Banco Alemán* was owned by *Grupo Velox*, an Argentine-Uruguayan consortium. Losses in a Paraguayan mutual fund affiliated with the group, together with publicity surrounding problems with *Velox*-owned financial institutions in Uruguay, triggered the run and subsequent intervention and closure of *Banco Alemán*.

from 16.6 percent at end-2001 to 19.7 percent in December 2002 (Table 10, Figure 4). Of particular concern is the situation of the state-owned national development bank (BNF), which is insolvent (with NPLs near 60 percent) and has increasing liquidity problems.

11. Exports and remittances fell, but an even sharper decline in imports generated a current account surplus in 2002 (Table 11). Total exports are estimated to have fallen by some 5½ percent in dollar terms in 2002,¹² with exports of soy and cotton hurt by drought conditions and meat exports affected by an outbreak of foot-and-mouth-disease. The regional crisis also played a role in the export decline—for example, shipments to Argentina fell 34 percent in 2001, and by a further 61 percent in the first half of 2002. Workers' remittances from Argentina also fell by over 1 percent of GDP in recent years. Reflecting weak domestic demand and the impact of currency depreciation, imports declined by an estimated 14 percent, moving the current account balance from deficit to a 1½ percent GDP surplus in 2002. International capital flows turned sharply negative,¹³ resulting in a loss of US\$82 million (1.4 percent of GDP) in international reserves.

12. The exchange rate has continued to float since the crawling peg was abandoned in 2001, although the central bank has intervened frequently in response to pressure on the guaraní. Against the U.S. dollar, the currency depreciated by 34 percent during 2002, but in real effective terms the depreciation was only 2½ percent due to declines in the Argentine *peso* and the Brazilian *real*. Intervention in the foreign exchange market totaled US\$186 million in 2002, reflecting the authorities' attempts to smooth large fluctuations in the exchange rate. The staff considers the present flexible exchange rate regime as appropriate for Paraguay, and views the present level of the real effective exchange rate as broadly consistent with fundamentals in the economy; however, unless structural reforms are implemented low productivity growth in the economy will likely necessitate a further REER depreciation over time to maintain competitiveness (Annex I).

III. OUTLOOK AND VULNERABILITIES

13. Paraguay faces a difficult economic outlook in 2003. While better climatic conditions in agriculture and some stability in Argentina will keep GDP from falling as sharply as in 2002, continuing domestic policy uncertainty and the effects of foot-and-mouth disease are expected to cause another year of negative growth. With the new administration

¹² It should be noted that unregistered trade represents nearly half of total trade; therefore, balance of payments statistics cannot give a precise indication of external sector trends. Estimates of unregistered trade are derived from partner countries' direction of trade statistics.

¹³ The deterioration in the financial account reflected a drop by one-third in direct investment inflows, as well as sizable outflows of foreign currency deposits and lower net lending to the public sector.

scheduled to take office on August 15, the policy-making environment may improve. If the new authorities move decisively to implement sound economic policies, an economic recovery could start late in the year. Inflation will edge up further (the staff projects 17 percent) reflecting pass-through from continued depreciation of the exchange rate.

14. The economy is vulnerable to downside risks in 2003 and beyond. In particular:

- **External shocks.** Further problems in the region could affect trade, remittances, and capital flows, pushing growth down even further (Table 12). A scenario of a global conflict would also reduce output and increase the fiscal deficit due to higher oil prices (see Annex 1).
- **Fiscal gaps.** The staff estimates that, without measures, the public sector could face a financing gap on the order of 3 percent of GDP in 2003 on top of the already substantial arrears accumulated in 2002. This raises a serious risk of default on some public debt obligations, which could cause a prolonged interruption in bilateral and multilateral lending, depressing investment, and further worsening the financing gap.
- **Banking risks.** The high degree of financial dollarization (close to 60 percent of lending) exposes banks to credit risk in the event of a sharp depreciation of the currency. The banking system is also vulnerable to continued fiscal problems. Default on public external debt may provoke further capital outflows, which would affect liquidity in some banks and raise banks' cost of funds.
- **Sensitivity analysis** of the medium-term outlook (see Annex I) shows that a real depreciation or a deterioration in the primary balance could significantly affect the debt and fiscal deficit profile, while the scenario is somewhat less sensitive to variations in the growth rate.

15. **The medium-term outlook depends crucially on prudent macro policies and structural reform to restore sustainability.** Annex 1 and Table 13 present two scenarios. The main points are:

- The **baseline scenario**, assuming no significant structural adjustment, envisions growth settling at the average rate of the past half-decade—1.7 percent—well below population growth. The scenario assumes further depreciation of the *guarani* in view of low productivity growth and weak capital inflows. The fiscal situation is not sustainable in this scenario, with deficits rising steadily due to a deterioration in the primary balance as well as a progressive increase in the debt burden.
- Under the **adjustment scenario**, fiscal sustainability is restored by increasing the primary surplus to 3–4 percent of GDP. This adjustment, together with a comprehensive privatization program and structural reforms to enhance productivity growth, would sharply improve the public debt dynamics, raise GDP growth, and lower inflation. Its implementation will require much greater political cohesion.

IV. POLICY DISCUSSIONS

16. Through most of last year, discussions with the authorities were focused on achieving a policy framework that could be supported by a stand-by arrangement, including fiscal adjustment and significant structural reforms. As prospects for the implementation of key prior actions faded, the discussions turned increasingly to damage-control measures to limit the deterioration of economic and financial conditions while awaiting the elections.

A. Fiscal Policy

17. **The authorities were unsuccessful in their attempts to stem the growing fiscal imbalance with comprehensive policy actions.** Early in 2002, the authorities proposed increases in fuel and utilities prices to raise revenues and facilitate the privatization of state enterprises, particularly the telecommunications company. Privatization would have provided some 2–3 percent of GDP in financing, closing the 2002 financing gap. However, the suspension of the privatization program, partial rollbacks of price adjustments, and a further drop in economic activity worsened the fiscal outlook by mid-year. To contain the increasing imbalance, in August the government submitted a fiscal package to Congress designed to yield 2.1 percent of GDP on an annual basis. The package included cuts in pension payments and other current expenditures, as well as several revenue measures: a hike in the VAT rate from 10 to 11 percent, steps to broaden the VAT base, a new tax on motor vehicles, and increases in excise and fuel taxes. These proposals were repeatedly weakened in Congress before it voted to postpone action until 2003.¹⁴

18. **The government's current strategy is to focus on temporary or stop-gap measures to limit the fiscal deterioration.** The authorities explained they are seeking the payment of royalties arrears owed to the government by the Yacyretá hydroelectric consortium and a speed-up in payments from the Itaipú project in order to improve the short-term cash flow.¹⁵ In addition, the authorities are trying to use administrative measures to reduce tax evasion. They also expect to hold discretionary expenditures in 2003 near last year's nominal levels, which would reduce current spending by about ½ percent of GDP (see Table 4).¹⁶ While recognizing these efforts, the staff regretted the inability to take more sustainable measures to avoid a further accumulation of payments arrears in 2003 (see Table 7). The authorities acknowledged the risk of further arrears accumulation, but argued that little more could be done until a new government takes office later in the year.

¹⁴ While formally postponed until end-February, no action is expected until after general elections scheduled for April 27.

¹⁵ These additional payments could total US\$42 million (0.9 percent of GDP).

¹⁶ In addition, the staff projection assumes a cut in capital expenditures (from 4.1 percent of GDP to 3.4 percent of GDP), reflecting the suspension of external disbursements for many investment projects due to arrears accumulation.

19. **The authorities agreed with the staff that adjustment efforts should also include the public enterprises.** The staff noted that timely adjustment of fuel and electricity prices to fully reflect their dollar costs was key to the health of those enterprises as well as the government's cash flow. For example, whenever the electricity company, ANDE, fails to pay its bills to Itaipú, the latter withholds royalty payments to the government. The government also maintains guarantees on much of the external debt of these enterprises. After suspending some scheduled adjustments in the second half of 2002, the authorities adjusted fuel prices in early 2003 (by an average of 12½ percent) to help reduce public enterprise losses; however, adjustments in electricity and water rates are also needed.

20. **Since the government suspended the privatization program in June 2002, there has been no clear strategy for restructuring the public enterprises.** The staff urged the authorities to consider reviving the privatization program as the political situation permitted. If outright sale of enterprises proves politically impossible, they should explore partial privatization, concessions, or private management contracts as a way to improve operations. In the interim, the authorities should develop reorganization plans for each enterprise to improve efficiency. The authorities recognized the need to address the problems in the enterprises, but said that major restructuring would be impossible before the elections.

21. **The authorities acknowledged the need to address the serious financing problems facing the public sector in 2003.** If fully closing the gap in an orderly way is not feasible, the staff urged the authorities to budget the available cash, with priority on essential services and multilateral debt service so as to prevent the suspension of multilateral lending. The authorities recognized the seriousness of the shortfall, and indicated that part of the gap could be covered by timely public utility tariff adjustments and by the increased royalty payments from the hydroelectric companies. Nevertheless, they acknowledged that a gap would remain unless additional fiscal measures are taken. While the authorities said they would attempt to remain current on external obligations, they face strong political pressures in the run-up to elections to prioritize payments for domestic spending, particularly wages and salaries.

B. Monetary and Exchange Rate Policy

22. **Monetary policy faced a series of challenges in 2002.** The run on deposits associated with the closure of *Banco Alemán*, periodic pressures on the exchange rate, and increasing inflation seriously tested the Central Bank of Paraguay's (BCP) management of monetary policy. As noted, the authorities responded with a tightening of monetary policy, combining open market operations and a temporary increase in reserve requirements to help stem the outflow of deposits in the wake of the *Banco Alemán* collapse. The BCP also intervened frequently in the foreign exchange market during the year to stem rapid depreciation of the *guaraní* (Text Table A).

Text Table A. Paraguay: Central Bank Monetary Policy Indicators
(In percent unless otherwise specified)

	December		March 2002	June 2002	Sept. 2002	Dec. 2002
	2000	2001				
Effective reserve requirement ratio in local currency 1/	13.2	12.8	12.9	14.7	12.9	12.4
Effective reserve requirement ratio in fx currency 1/	22.7	23.3	23.3	28.2	24.2	23.7
Interest rate on LRM (weighted average)	5.9	21.0	26.1	19.8	28.7	24.7
Net foreign exchange intervention (- = sales) cumulative during year (in millions of US\$)	-120.0	-234.0	-120.8	-139.0	-162.3	-186.1

Source: Central Bank of Paraguay.

1/ Effective reserve rate is the average of actual reserves required over total deposits.

23. The staff recommended adoption of a clear framework for monetary policy.

Since the crawling exchange rate peg was abandoned in 2001, monetary policy has lacked a clear anchor as the authorities have alternately focused on monetary aggregates, the exchange rate, and banking system concerns. The staff urged the authorities to develop a clear and consistent framework for monetary policy¹⁷ that would move away from ad hoc interventions in the money and foreign exchange markets. The staff also recommended less intervention in the foreign exchange market. With reserves at relatively low levels and the risk of further difficulties in the banking system, the staff urged the authorities to husband their reserves and allow the flexibility of the exchange rate to help cushion shocks. The monetary authorities accepted the need for a more comprehensive monetary framework, indicating that they would welcome Fund advice on setting specific quantitative targets for a monetary program for 2003. They agreed that intervention in the exchange market should be exceptional, but have continued to use reserves in the face of exchange market pressures.

24. In January 2003, the government issued a decree requiring public sector institutions to move their deposits to the central bank. The authorities explained that this step was taken to facilitate the implementation of a tight monetary policy.¹⁸ While supportive of the drive for a tight monetary policy, the staff pointed out that the measure presented significant risks. In particular, the staff strongly cautioned that the measure could affect the liquidity of commercial banks, and may jeopardize sound financial management of the public institutions whose deposits are to be moved (particularly the social security institute). The

¹⁷ The framework could be based on quantitative targets for monetary aggregates as had been proposed in the program negotiated in August 2002.

¹⁸ At end-2002, public sector deposits constituted 12 percent of banking system deposits.

authorities noted that the BCP would set up a schedule for the transfer of the deposits over time, easing the immediate effect of the move on the banking system.

C. Financial Sector

25. **The remaining private commercial banks are generally well-capitalized and liquid, but concerns remain about the future health of the system.** The authorities indicated that the short-run risk of failure in the major private banks was low, although several are generating losses and will likely require injections of capital during the year. NPL ratios are rising in both domestic and foreign banks, reflecting the weak economic situation and the impact of currency depreciation (Text Table B). Other risk factors include problems in some small finance companies (*financieras*)¹⁹ and the difficulties in the BNF (see paragraph 26).²⁰ Some international banks are contemplating closing their operations in Paraguay, which could renew concerns among nervous depositors.²¹ The Bank Superintendency intends to maintain a proactive regulatory stance in order to defuse potential problems early. The staff commended the authorities for their prompt and effective action in handling the *Banco Alemán* crisis in mid-2002, and urged them to continue to strengthen both regulations and supervisory practices to forestall further banking sector problems. The authorities noted that their efficient handling of the crisis was made possible by the approval of emergency legislation by Congress, and that their ability to respond to future crises would depend upon adoption of permanent bank resolution legislation (see paragraph 27).

¹⁹ The Superintendency closed one small *financiera* in November 2002, and expected that the closure or consolidation of several others might be necessary in 2003. The *financieras* as a group hold around 9 percent of total financial system assets.

²⁰ Direct contagion from the BNF to other banks would likely be limited because of the BNF's relatively small size and limited financial ties to private commercial banks. However, the BNF plays an important role in the payment system (particularly in rural areas) and as a tax and payment agent for the government, which could spark wider problems if the BNF were to close.

²¹ A couple of smaller international banks are expected to withdraw from Paraguay during 2003.

Text Table B. Paraguay: Banking System Indicators

Total banking system	2000	2001	2002
NPLs (in percent)	16.6	16.5	19.7
Dollar loans as a share of total (in percent)	49	54	58
Deposits			
In billions of guaranties	2,934	2,961	2,736
In millions of U.S. dollars	1,227	1,204	852

26. **The National Development Bank (BNF) is insolvent and suffers from increasing liquidity problems.** The bank has a long-standing record of poor quality portfolio and high operating expenses which has been generating significant losses over time. In recent months, the bank has also begun to have problems clearing its outstanding balances in the payments system. The government developed in 2002 a strategy for restructuring the BNF with the support of the IDB and World Bank, but has not been able so far to implement this plan.²² The Bank Superintendency is required by law to recommend intervention in the BNF unless the government can recapitalize the bank. Given the difficult fiscal situation, and the prospects for further losses in the unstructured bank, the staff urged the authorities to make every effort to implement the restructuring scheme designed last year. If that proved impossible, intervention may be the only available option. The authorities agreed on the need to act, although they noted that intervention carries the risk of causing the outflow of deposits which would force the bank to close. The staff agreed that intervention needed to be carefully planned and implemented; staff continue to be in close contact with the authorities on this issue.

27. **The staff urged the authorities to take key policy steps to address the vulnerabilities in the banking system.** In particular, the staff stressed the importance of securing congressional approval of the Bank Resolution Law which is pending in Congress. The law (a prior action under the program negotiated in August 2002) would establish clear procedures for bank intervention and resolution, and introduce a deposit insurance fund. Passage of a draft public banking law (prepared in consultation with the IDB and World Bank) would facilitate a comprehensive approach to reforming the BNF. Measures should also be taken to strengthen the Superintendency, including steps to retain quality staff and provide adequate resources for complete supervision of the financial system. The authorities recognized the importance of the resolution law and stressed their commitment to enhancing bank supervision.

²² The plan contemplated consolidation of the BNF with other (small) public banks and restructuring it to become a second-tier institution. The reform was to be supported by a US\$50 million sectoral loan from the IDB.

D. Other Issues

28. **Trade policy.** Paraguay's economy remains relatively open and the authorities reaffirmed their continued commitment to free international trade.²³ However, they expressed frustration with increased nontariff barriers affecting Paraguayan exports to and through other Mercosur countries. They noted that Paraguay had eliminated tariffs on intra-regional trade except for a surcharge on selected products imposed in mid-2001 to compensate for extraordinary measures adopted by other Mercosur partners. The authorities indicated that they planned to continue the existing surcharges for the time being, and were contemplating additional ones permissible under Mercosur rules, both to counter measures of other countries and as a potential emergency revenue measure. The staff encouraged the authorities to view tariffs as a last resort on the fiscal front, and to work within Mercosur dispute resolution procedures to resolve their trade concerns.

29. **Safeguards assessment.** The safeguards assessment concluded that Banco Central del Paraguay (BCP) has made several improvements in its safeguards since the late 1990s, but lacks operational autonomy from government. In particular, since 1998 the BCP has been required to make annual transfers to the fiscal budget, despite incurring significant losses. The safeguards assessment also identified that (i) the selective application of accounting policies by the BCP inflates income and paints a misleading picture of the BCP's precarious financial condition, and (ii) procedural controls over the compilation of program monetary data require strengthening. To address these vulnerabilities, Fund staff recommended the following priority measures:

- In consultation with the Office of the Comptroller-General of the Republic, the BCP and the MOF should sign a Memorandum of Understanding (MOU) to regularize the relationship between the government and the central bank;
- The BCP Board should adopt a resolution for the application of IAS commencing with the 2004 financial year;
- The BCP Board should issue a resolution specifying that, with effect from 2002, the annual financial statements be audited by an independent private audit firm; and
- The BCP Board should issue a resolution specifying that the audited annual financial statements, including the accompanying audit opinion, will be published in the Annual Report. Staff also recommended that the BCP should establish procedures to ensure that monetary data used for program monitoring purposes under the arrangement are in accordance with the TMU.

²³ Paraguay's trade regime is considered moderately restrictive under the Fund's index of trade restrictiveness and its exchange system is free of restrictions.

The BCP has concurred with the assessment and has passed a resolution to begin to implement the recommendations.

30. **Statistical issues.** The staff considers data provision by the authorities as adequate for surveillance purposes, although important deficiencies remain. The national accounts are based on an outdated conceptual framework and use an outdated base year (1982) for constant prices. Quarterly national accounts are not produced until after each year has concluded, rather than on an ongoing basis. The timeliness and the quality of the fiscal data needs to improve, in particular that on the public enterprises and the social security institute. On the external side, the data on private capital flows are weak, and additional efforts need to be made in capturing unregistered trade.

V. STAFF APPRAISAL

31. **Paraguay suffered large adverse shocks in 2002, which were exacerbated by long-standing domestic vulnerabilities.** A drought, the outbreak of foot-and-mouth disease, and contagion from the regional crisis caused a sharp decline in output, with adverse effects on the public finances and the banking system. Lack of domestic political consensus frustrated efforts by the government to adopt an adjustment program with multilateral support that could have cushioned the effects of the downturn and set the economy on a path toward sustainable growth. Structural weaknesses, such as serious governance problems, inefficient public enterprises, a weak tax effort, and inefficient government spending, are key factors behind Paraguay's record of low growth and its vulnerability to external shocks.

32. **To address these weaknesses and reverse the long trend of declining living standards, the staff recommends adoption of a comprehensive program of fiscal and structural reforms.** The strategy should center on restoring fiscal sustainability, improving the efficiency of the public sector, strengthening the banking sector, and improving governance and fighting corruption. Privatization of key enterprises will generate more efficient services in the economic infrastructure, while banking system reforms will boost growth by permitting increased investment. A crucial prerequisite will be sufficient political consensus and ownership to push reforms forward.

33. **Unless comprehensive adjustment measures are taken, the public sector finances will continue to deteriorate, and the government will likely lose access to financing from its external creditors.** The stop-gap measures being applied by the authorities can at best provide temporary respite—they cannot substitute for more permanent adjustment policies. The staff estimates that a primary surplus on the order of 3–4 percent of GDP would be needed over the next few years to return the public finances to a sustainable debt profile by the end of the decade.

34. **An immediate priority for the new government that will take office in 2003 is to adopt a fiscal program consistent with available financing and medium-term sustainability.** This will require action on both the revenue and expenditure sides. On the expenditure side, reforms of the public sector employees pension plan (the *caja fiscal*) will

be essential. Civil service reforms to improve the efficiency of expenditures and contain the wage bill are also necessary. On the revenue side, improved tax administration should be a priority, complemented by reforms in agricultural property taxes, the implementation of a vehicle tax and adjustments in other excise taxes, and an increase in Paraguay's low VAT rate. Consideration should be given to the introduction of a personal income tax once tax administration has improved.

35. Monetary policy has responded pragmatically to the difficulties faced in 2002, but its operational framework needs to be strengthened to face the renewed challenges expected in 2003. The tightening of monetary policy at the time of the *Banco Alemán* crisis was appropriate and helped contain the loss of confidence and its inflationary impact. However, the authorities should work to strengthen the operational framework of monetary policy, establishing a clear nominal anchor and increased operational independence for the central bank. Last year's pace of frequent intervention in the foreign exchange market cannot be sustained, and the authorities should husband their reserves for the contingency of renewed problems in the highly dollarized banking system. The staff urges the authorities to work toward prudent macroeconomic policies and banking system reforms which would allow for a decline in dollarization over time. The authorities should also revise the requirement to move public sector deposits to the central bank in light of the risks posed to the banking system.

36. Bank supervision performed well during 2002, but further problems could arise in 2003. The staff commends the authorities' speedy and efficient intervention in *Banco Alemán* last year, while noting that gaps remain in the framework for bank resolution. These gaps should be filled through early adoption of the draft bank resolution law sent to Congress in 2002. The staff encourages the authorities to monitor the situation of banks closely and to take a proactive stance in response to any difficulties. In particular, speedy resolution of problems in the BNF is essential to minimize fiscal costs and the risk of contagion to other banks.

37. A range of other structural reforms are necessary to create the conditions for sustained growth and reduce poverty. Important items on the agenda include the restructuring and privatization of public enterprises and efforts to raise labor productivity through improved education and basic training programs. A key overarching goal of reforms must be to improve governance and reduce corruption, by increasing transparency and accountability in both the public and private sectors. In this context, the staff welcomes the authorities' intention to improve statistical information and implement the recommendations of the safeguards assessment mission, and encourages them to continue their efforts to improve economic policy making and enhance transparency. The staff recognizes the authorities' commitment to an open exchange and trade system, and encourages them to seek resolution of trade disputes within existing dispute settlement arrangements.

38. It is expected that the next Article IV consultation with Paraguay will be held on a standard 12-month cycle.

MEDIUM-TERM FRAMEWORK AND DEBT SUSTAINABILITY

39. This annex examines Paraguay's medium-term fiscal sustainability and debt dynamics under alternative scenarios. A baseline scenario assumes current policies, indicating that the outlook is not sustainable. An alternative scenario suggests that comprehensive fiscal and structural adjustments could place Paraguay on a sustainable growth path. Section C examines the sensitivity of the adjustment scenario to variations in the key macro assumptions.

A. Baseline Scenario

40. The baseline scenario assumes that present policies are broadly maintained, with external development in line with WEO assumptions.

Key assumptions include:

- Real GDP recovers somewhat in 2004 and averages 1.7 percent per year thereafter.²⁴ The initial recovery is based primarily on a rebound in key agricultural sectors and a more stable regional environment.
- The real effective exchange rate (REER) depreciates by 5 percent in 2003 reflecting continued economic policy uncertainty. Thereafter, the REER is assumed to decline by 1 percent per year to compensate for lower productivity growth in Paraguay compared to its trading partners.
- As the nominal depreciation slows in 2004, inflation also moderates, settling around 6 percent in the medium term.
- Imports drop sharply in 2003 in response to continued weak economic activity; thereafter, they grow at a slightly faster rate than economic growth. Exports grow slowly in 2003–04 because of low investment and problems with foot-and-mouth disease. Export growth over the medium term is assumed in the 3–5 percent per year range.
- Tax revenues remain constant as a share of GDP, but nontax revenues decline over time as a share of GDP due to capacity limits in the hydroelectric companies. Primary current spending rises gradually, as wages are assumed to return to their 2001 share of GDP. Transfer payments also rise, reflecting existing legal mandates regarding hydroelectric royalties.

²⁴ 1.7 percent is the average potential growth rate generated by applying the Hodrick-Prescott filter to the 1996–2001 period.

- Public utilities and fuel prices are held constant during 2003, but are adjusted in line with the inflation, the exchange rate, and world fuel prices thereafter;
- The fiscal financing gap is covered partly by domestic financing with the rest leading to arrears. The accumulation of external arrears leads to continued suspension of lending from multilateral creditors.

41. **The debt dynamics are not sustainable in this scenario.** The public sector deficit balance rises from 3 percent of GDP in 2003–04 to over 7 percent of GDP in 2010 (see Table 13). The debt-to-GDP ratio climbs from 49 percent in 2002 to 71 percent of GDP, while interest payments rise from 1.9 to 4.8 percent of GDP over the same period. Two main factors drive this increase in debt and the deficit: (i) the primary balance slowly deteriorates over time, from -0.6 percent in 2003 to -2.6 percent in 2010; and (ii) the interest bill balloons as both the stock of debt and the average interest rate increases over time. The financing gap also increases sharply as amortization payments rise beginning in 2003.²⁵

B. Adjustment Scenario

42. The adjustment scenario assumes that a set of comprehensive fiscal and structural adjustments are undertaken to put the economy on a sustainable fiscal path while boosting long-run potential output. The sustainable path was derived using assumptions about financing available from external and domestic sources, and then targeting the primary balance needed to close the financing gap in each year. This sustainable path is geared toward returning the debt-to-GDP ratio back to near 30 percent of GDP by 2010.

The **macroeconomic framework** assumes:

- Structural and fiscal reforms raise the medium-term growth rate from 1.7 percent (under the baseline) to 3.5 percent over the period.
- The REER stabilizes in response to improved productivity growth, which allows inflation to decline to around 4 percent.²⁶
- Export growth increases by ½–1 percent per year compared to the baseline, while import growth increases somewhat more rapidly, generating modest current account

²⁵ The authorities start principal repayments on a US\$400 million loan from Taiwan Province of China in 2003.

²⁶ Although the currencies of Brazil and Argentina could be expected to recover in real terms over the medium term (which would likely result in an appreciation of the *guaraní* relative to the dollar), the staff preferred to be cautious and assume no such nominal appreciation.

deficits by the end of the period. These are easily financed by increased capital inflows, which also permit increased foreign exchange reserves in the central bank.

43. The scenario assumes that a **fiscal adjustment package** is implemented in late 2003 and early 2004, along the lines of the package negotiated between the staff and the authorities in 2002. Specifically, the following components are included:

Timely adjustments in fuel and utilities prices;

- Increase in the VAT rate from 10 to 13 percent, and efforts to widen the base of the VAT and excise taxes;
- An increase in excise and agricultural land taxes, including the implementation of a new vehicles tax;
- An increase in contribution rates to the *caja fiscal*, and a reduction in benefits of around 6 percent;
- A freeze in the wage bill for two years;
- A reduction in public debt due to the privatization of key public enterprises in 2004–05;

44. Implementation of this package would generate a primary surplus of 3–3½ percent of GDP starting in 2004.

45. The **structural adjustments** assumed under the adjustment scenario include:

- Privatization of major public enterprises;
- Further reforms to strengthen the banking system, especially restructuring of the public banks and improvements in the supervision of private banks;
- Comprehensive efforts to improve governance and fight corruption;
- Programs to improve labor market productivity and reduce poverty, including education and training programs and labor market reforms.

C. Sensitivity Analysis

46. **The adjustment scenario was subjected to stress tests, in line with the methodology contained in SM/02/166.**²⁷ The adjustment scenario does prove sensitive to

²⁷ Stress testing was conducted on the adjustment scenario because of the limited value to do so on a baseline scenario which is already unsustainable at the outset.

alternative assumptions about the underlying macroeconomic variables. The use of ten-year historical averages of the key assumptions produces a significantly more modest improvement in the debt-to-GDP ratio than in the adjustment scenario (Table 14, Figure 5)—it would remain at 54 percent of GDP in 2007 versus 40 percent of GDP in the adjustment scenario. Other temporary shocks to the scenario showed varying results:

- **Growth**—A temporary negative shock to GDP growth (-3.6 percentage points in 2003 and 2004 compared with the baseline) does not significantly alter the debt dynamics of the scenario, as the primary surplus is sufficiently high to maintain the downward debt trend.
- **Interest rates**—A shock of two standard deviations in the real interest rate in 2003–04 does generate a significant increase in the debt-to-GDP ratio, which remains at 63 percent of GDP in 2007. This scenario is unrealistic, however; as the vast bulk of Paraguay’s debt is bilateral and multilateral concessional lending which will not vary as sharply as the shock assumes.²⁸
- **Primary balance**—A shock of two standard deviations to the primary balance in 2003–04 raises the debt-to-GDP ratio to 52 percent in 2007 (from 40 percent in the adjustment scenario), illustrating the importance of prompt adjustment in the fiscal balance.
- **Exchange rate**—The adjustment scenario is most sensitive to the assumptions about the exchange rate. A shock of 30 percent in the real exchange rate in 2003 boosts the debt-to-GDP ratio in that year to 93 percent, although it falls fairly rapidly in subsequent years, but it remains at 62 percent of GDP in 2007.
- **Possible global conflict**—Under a scenario where a global conflict breaks out in 2003, leading to reduced world economic growth and higher oil prices (to US\$15 above WEO baseline), real GDP in Paraguay would decline by an additional 1 percentage point and the fiscal deficit would increase by close to 2 percent of GDP.

²⁸ Most of the historical variation in real interest rates is due to volatility in the inflation rate, and not to changes in interest rates. Given the low current and projected inflation rates, such a large increase in real interest rates is not plausible.

Box 1. Key Objectives and Prior Actions for the Program Negotiated in 2002

Objectives

The program negotiated in August 2002 centered on a fiscal adjustment package to clear arrears and put the public finances on a sustainable basis, and structural reforms to forestall further problems in the financial sector and improve efficiency and transparency in the economy. It included measures and reforms to strengthen the revenue performance by eliminating distortions in the tax system and improving tax administration, particularly in customs. It also contemplated a first step toward correcting the financial imbalance in the public sector pension system. In the banking area, the program contemplated legislative and regulatory improvements to handle problems in the BNF and forestall future problems in the rest of the system. Under the program, growth was expected to resume in 2003, eventually reaching around 3 percent per year in the medium term.

Prior Actions

1. Congressional approval of a fiscal emergency law that would have yielded 1.8 percent of GDP on an annual basis. The measures included: an increase in contributions and reduction in benefits of the pension fund for public sector employees (Caja Fiscal); introduction of a 1–5 percent annual tax on motor vehicles; an increase in the base of the VAT to cover professional services, and in the general VAT rate (to 11 percent); increases in excises taxes; and limiting pension payments to those strictly required by law.
2. Enactment of the executive decrees on additional fiscal measures that was expected to yield about 0.3 percent of GDP
3. Congressional approval of the emergency law on bank resolution that would create a deposit insurance fund and a bank recapitalization fund; develop legal tools to facilitate purchase and acquisition operations, and provide adequate legal protection to public servants engaged in the bank resolution process. This was to provide legal authority for the Superintendency to respond to future banking problems with the same efficiency it did in the *Banco Alemán* crisis (where Congress passed emergency legislation to facilitate a speedy resolution).
4. Setting limits on the amount of BNF loans to a maximum of US\$15,000 per individual borrower and US\$60,000 in the case of corporations in order to limit BNF losses until a public bank-restructuring law could be passed. (completed)

Box 2. Surveillance Issues

At the time of the last Article IV consultation discussion on May 14, 2001, the Executive Board was informed of the authorities' intention to implement a Staff Monitored Program (SMP) for 2001. Directors noted that inadequate macroeconomic and structural policies explained much of Paraguay's poor economic performance. They called for a reduction in the overall fiscal deficit and pointed to the need for central government reform, improved tax administration, and for reform in the public employees' pension plan. They also urged the authorities to undertake structural reform measures to improve growth prospects. In particular, they encouraged the authorities to promptly adjust tariffs in the public enterprises and to make progress on their privatization. They welcomed the decision to address the long-standing problems in the National Development Bank (BNF) and encouraged the authorities to pursue the planned central administration reform. They noted that monetary policy should be oriented toward the objective of price stability.

The authorities' performance under the SMP was mixed. In the fiscal area, spending restraint reduced expenditures by 1.3 percentage points of GDP in 2001, but the deeper reforms of the central government and the public employees' pension plan did not occur. Tax efficiency improved marginally in 2001 but fell back in 2002. Monetary policy was less tight than envisaged, with the result that the NDA and NIR targets were missed.

In 2002, while the mid-year banking crisis was handled well by the authorities, policy implementation in most other areas was disappointing. The increasingly difficult political environment complicated further reform efforts and the fiscal situation deteriorated markedly. The privatization process was suspended in June 2002 and reforms in the BNF stalled. Despite the setting of new limits on the amount of BNF loans in 2002, the bank continues to pose severe problems. Adjustments were made in tariffs on fuel and electricity, but they were partially suspended by mid-2002 as well. The authorities sent a fiscal package to Congress in August 2002 to boost revenues and reduce expenditures (including in the public employees' pension plan), but action on the package has been repeatedly postponed. Likewise, a banking resolution law was delayed and planned legislation for reform of the public banks was shelved.

Box 3. Income Distribution and Poverty in Paraguay

Poverty and income inequality are high and have been rising in recent years. According to the national definition,¹ the share of the population in poverty increased from 30.3 percent in 1995 to 33.8 percent in 2001. The percentage in extreme poverty was 15.6 percent in 2001. By international standards, the poverty rate is even higher—according to the World Bank, in 1998 19.5 percent of the population lived on less than US\$1 a day, and 49.3 percent on less than US\$2 a day. The impact on living standards is striking: only one in two households lives in an adequate dwelling; up to one-third of the population does not have access to regular health care; and over 90 percent in the poorest quintile has no access to potable water or piped sanitation. The Gini coefficient (0.53) indicates that income inequality is high relative to the rest of the world (0.39), although it is about average for Latin America.

Poverty and inequality are more pronounced in rural areas. Rural areas—with only 44 percent of the total population—account for three-fourths of the extreme poor and 56 percent of the total poor. In the largely rural north, northeast and central regions approximately 50 percent of the population is classified as poor. The rural poor typically have large households (5.9 members), are poorly educated (3.8 years), and are predominantly *guaraní* speaking (87.5 percent). Furthermore, the high level of inequality in Paraguay is in part due to substantial inequality in the rural regions with some rural Gini estimates reaching 0.57.

The proximate cause of poverty is slow and volatile growth. Structural rigidities, political instability, and severe governance problems retard growth and inhibit recovery from economic shocks, with the result that real GDP growth has dropped below population growth in the last half decade. The poor are predominantly employed in the agricultural sector, which is affected by volatile external agricultural markets, uncertain weather patterns, and an unstable domestic policy environment. This vulnerability underscores the need for a well-functioning social safety net. Yet government spending per capita is less than ¼ of the Latin American average² and the government has yet to develop a comprehensive program to improve social protection.

Key long-run causes of poverty are poorly developed human capital and inefficient land distribution. Paraguay has among the worst education records in Latin America, with 61 percent of the rural poor and 34 percent of the urban poor failing to complete primary education. Close to 100 percent of the poor fail to complete secondary education, and two-thirds of the extreme poor are in the wrong grade for their age. Poor teacher quality, lack of school proximity, inefficient public spending and the potential loss of child income are all likely explanations. In rural areas, the inequality of land distribution is high even for Latin America. Two-thirds of the farmers own less than 5 percent of the land, while the top 1 percent of farmers own two-thirds of the land. Two prominent barriers to a more even land distribution have been the ineffectiveness of traditional land reforms and a deficient land tax system, with the low cost of idle land discouraging its reallocation. Thus, a higher tax reflecting the productive potential of the land may help increase the supply of available land and raise needed funds for social spending.

Sources: Robles, Marcos, "El Empleo en Paraguay. Evidencias de las Encuestas de Hogares" mimeo 2002; Secretaria de Accion Social, Republica del Paraguay. *Estrategia Nacional de Reducción de la Pobreza y la Desigualdad*. Asunción, Paraguay, November 2002; World Bank, *Paraguay: Attacking Poverty*, Washington, DC, November 2002.

¹ Poverty is defined as insufficient income to purchase a basic basket of goods; extreme poverty involves insufficient income even to purchase the food component of the basic basket.

² Paraguay devotes US\$132 dollars per person to the social sector, compared to the Latin American average of US\$540.

Box 4. Governance Issues

Paraguay faces serious governance problems, which are reflected in perceptions of widespread corruption. Transparency International ranked Paraguay tied for 98th out of 102 countries rated in its corruption perception index in 2002, the worst ranking in Latin America. This poor ranking reflects in part the perceived inadequacy of public sector institutions—the country ranked 74th out of 75 in its public institutions. According to the International Country Risk Guide, Paraguay ranked below the Latin American average in bureaucratic quality, democratic accountability, and law and order. A large and highly inefficient public enterprise sector also contributes to a public sector environment where corruption can flourish.

There is a large underground economy which functions largely beyond government taxation and control. Official estimates (based on direction of trade statistics) indicate that around one-third of all Paraguayan imports are unregistered, while over half of exports are unregistered (largely re-exports of imported goods). This large “shadow” economy thrives on evasion of taxes in Paraguay and neighboring countries (chiefly Brazil). Trade tax collection in Paraguay is correspondingly low, suffering from a high level of contraband and underinvoicing of imports. In the domestic economy the efficiency of tax collection is also low: the 10 percent VAT rate yields only 4 percent of GDP in revenue, and a 1999 FAD mission estimated that VAT evasion was on the order of 3 percent of GDP. Another FAD study found that one-quarter of all corporate income taxpayers failed to file tax returns. Controls and sanctions in the tax system are inadequate to exercise effective control.

Governance problems in Paraguay have contributed to its poor economic performance. According to a recent study by the World Bank, the inefficient judicial system, political instability, and corruption have been factors contributing to low growth and high poverty in the country. A three-pronged strategy is needed to attack the main obstacles to improved governance: simplification, transparency, and accountability. In the area of *simplification*, the privatization program (suspended in 2002) would reduce the size and scope of government activity. Simplification of the tax regime would also reduce corruption. On *transparency*, recent Fund ROSC and safeguards assessment missions highlighted the need for improved data reporting and mechanisms to monitor the performance of the public sector. Reforms in hiring procedures for public employment would improve government efficiency and reduce the prevalence of corrupt patronage in government. Clear regulatory frameworks need to be developed for the private sector as well. Improving *accountability* would entail comprehensive efforts to strengthen the rule of law, including reforms of the judiciary and police.

Ongoing reform efforts. In 1999 the government signed an agreement with the World Bank to set up a national office against corruption. However, results thus far have been limited. Investigations are often left uncompleted and are sometimes perceived as politically motivated. Research conducted with the assistance of the World Bank as part of Paraguay’s anti-corruption plan found that the key areas of corruption in Paraguay are associated with customs and public works. As indicated below, the government is strengthening its efforts in these two areas, but progress has been extremely slow. Congress approved a procurement law in December 2002, but other initiatives are jeopardized by the lack of political support and resources in the budget.

Public resource management. Structural fiscal reforms are needed to establish an efficient and modern public administration. These include a proposed fiscal responsibility law, the restructuring of the BNF, and increasing border control to reduce smuggling and tax evasion.

Continued...

Box 4. Governance Issues (concluded)

Modernization of public entities of the central government. Factors impeding an efficient public administration include excess public sector employment, unrealistic price-cost mechanisms, and poor recovery rates due to political clientelism and inefficient judicial system. The Congress approved a law in November 2000 to reorganize and transform public entities and reform and modernize entities of the central administration, but little of the reform envisaged has been carried out: the privatization process was halted in mid-2002 due to lack of transparency, social unrest and lack of political support, and the reform of the state has made little progress.

Money laundering. Paraguay has taken several measures toward the implementation of an anti-money laundering framework. The Central Bank (BCP) serves on the Boards of the Secretariat for the Prevention of Money Laundering and the National Anti-Drug Secretariat, institutions created to detect and prosecute money laundering activities. Laws and regulations require that financial institutions detect suspicious activity by customers and mandate the creation of a monitoring registry. A special unit for analysis and prevention of asset laundering was created within the BCP in October 2001. In addition, there is an agreement with MERCOSUR to define guidelines for controlling money laundering in the MERCOSUR countries and to formalize collaboration among their central banks.

Box 5. The Banking System

The banking system consists of seven foreign banks, seven majority foreign-owned banks, three domestic private banks, and a public development bank (BNF). Banks dominate the financial system with about 90 percent of total assets. Foreign banks hold about 48 percent of total assets in the banking system and the majority foreign-owned banks hold 33 percent. There are also a number of small finance companies, exchange houses, and deposit receipt warehouses.

Paraguay experienced banking crises in 1995, 1997, and 1998. These crises wiped out weak banks from the system, leaving the remaining private banks in a relatively strong position. By end-December 2002, 53 percent of total deposits in the banking system was in branches of foreign banks, 32 percent was in the hands of majority foreign-owned banks, and only 15 percent was in domestic banks. The system is highly dollarized, with about 69 percent of deposits and 58 percent of lending denominated in dollars. Paraguayan private banks are liquid, reflecting the conservative lending position assumed by the banks in case of new macroeconomic or financial sector problems.

Contagion from the Argentine crisis has affected the financial system in Paraguay. There was a slow but steady loss of deposits in the early part of 2002. In June the authorities intervened and closed the country's third-largest bank, *Banco Alemán*, with about 11 percent of banking system assets. The run on the bank—owned by an Argentine-Uruguayan conglomerate—began after the parent institutions run into difficulties. After that, the outflow of foreign currency deposits from the banking system accelerated sharply, with total foreign currency deposits declining by over US\$419 million (33 percent) between end-2001 and end-July 2002. The authorities responded swiftly by intervening in the ailing bank, paying out small deposits with a deposit guarantee provided by the central bank, and transferring most other assets and liabilities to other banks in the system. The bank is currently in liquidation, with remaining deposits of about US\$9 million. Since August 2002, local currency deposits have recovered partially, while dollar deposits have merely stabilized.

Loan performance deteriorated in 2002, reflecting the economic slowdown. Excluding the public bank (BNF), the aggregate nonperforming loan (NPL) ratio increased from 12.3 percent in December 2001 to 14.7 percent in December 2002. Profitability in the banking system has also suffered as a result of the economic situation. Returns on assets and equity declined significantly from July to December 2002. For the BNF, profitability is negative. The high ratio of loans in foreign currency (58 percent), many to borrowers that are not naturally hedged in foreign currency, makes the system vulnerable to exchange rate fluctuations. Consequently, an acceleration in the depreciation of the *guarani* is likely to increase further the ratio of nonperforming loans. Medium- and long-term credit to finance investment is hindered by the high level of bad loans and the lack of long-term financing sources. In addition, the inefficient judicial system is a barrier to the effective resolution of distressed debts, which in turn discourages new lending by banks.

There are 21 finance companies (*financieras*) in Paraguay with 9 percent of total assets. Although they are under the supervision of the Bank Superintendency, they tend to pursue more aggressive practices than banks. As a result they have experienced a greater failure rate: since 1994, the number of *financieras* has dropped by over two-thirds (from 65 to 21). In November 2002, one *financiera* was intervened and closed, and it is expected that several more will close or merge in the coming months. As with banks, NPLs in *financieras* have steadily increased from 10.7 percent in December 2001 to 15.1 percent in December 2002. The rate of return on assets has followed a downward trend, falling from 5.1 percent in December 2001 to 2.3 percent in December 2002.

Table 1. Paraguay: Selected Economic Indicators, 1998-2003

	1998	1999	2000	2001	Est. 2002	Proj. 1/ 2003
(Annual percent change)						
National accounts and prices						
GDP at current prices	12.0	3.0	11.5	4.4	11.5	22.2
GDP at constant prices	-0.4	0.5	-0.4	2.7	-4.4	-1.0
Consumption	-0.7	-3.6	0.8	6.2	-6.1	-1.0
Investment	-4.7	-3.8	-0.7	-17.5	-7.5	-11.1
Net exports (contribution to growth)	1.2	4.8	-0.9	0.4	2.7	1.7
Exports	-7.2	-27.0	-15.1	-0.4	-5.8	-0.3
Imports	-7.0	-27.1	-6.7	-1.6	-12.1	-6.1
GDP deflator	12.4	2.5	11.9	1.7	16.7	23.5
Consumer prices (average)	11.6	6.8	9.0	7.3	10.5	18.9
Consumer prices (end of period)	14.6	5.4	8.6	8.4	14.6	17.0
Real effective exchange rate						
Average (depreciation -)	-9.3	6.9	-3.0	-1.6	-3.4	...
End-of-period (depreciation -)	-6.4	2.4	4.3	-12.6	-2.6	...
(In millions of U.S. dollars)						
External sector						
Exports, f.o.b.	3,548	2,310	2,326	2,463	2,326	2,352
Imports, c.i.f.	3,941	2,750	2,864	2,959	2,546	2,380
Current account	-160	-165	-150	-155	89	166
(In percent of GDP)	-1.9	-2.1	-1.9	-2.3	1.6	3.5
Capital account	325	511	125	313	-53	-269
Overall balance	-29	-129	183	46	-88	-202
Terms of trade (deterioration -)	12.7	-4.2	24.2	-3.1	1.0	0.4
(In percent of GDP)						
Public sector						
Central government primary balance	-0.2	-2.8	-3.1	0.2	-1.8	-0.4
Central government overall balance	-1.0	-3.6	-4.3	-1.1	-3.3	-2.6
Central government financing gap 1/	...	...	...	...	3.0	3.5
Consolidated public sector primary balance 2/	1.5	-1.8	-2.6	0.8	-2.0	-0.6
Consolidated public sector overall balance 2/	0.2	-3.2	-4.1	-0.9	-3.9	-3.1
Public sector external debt (end-of-year)	20.1	28.9	30.5	38.4	49.0	58.6
(Annual percent change)						
Money and credit						
Monetary base	8.1	9.5	-1.3	5.8	-1.0	13.0
M2	-2.9	10.7	2.2	4.9	-2.2	15.4
M5 3/	10.5	14.4	3.9	18.5	3.7	10.4
Net foreign assets 4/	12.5	18.5	-0.3	11.1	11.2	6.2
Net domestic assets 4/	-2.0	-4.1	4.2	7.3	-7.5	4.2
Credit to the public sector 4/	5.7	-6.5	3.1	3.3	9.2	6.1
Credit to the private sector 4/	-1.7	8.6	3.8	10.5	-0.1	9.4
Velocity of M2	7.0	6.9	7.3	7.3	8.1	...
Memorandum items:						
International reserves (in millions of U.S. dollars)	875	988	772	723	641	576
(In months of imports)	2.3	3.7	2.8	2.6	2.6	2.5
GDP (in billions of guaraníes)	23,437	24,144	26,921	28,119	31,365	38,342

Sources: Paraguayan authorities; and Fund staff estimates.

1/ Staff's baseline projection (see Annex I).

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

3/ Foreign currency items are valued at the market exchange rate.

4/ Contribution to M5 growth.

Table 2. Paraguay: GDP and Prices

	1998	1999	2000	2001	Est. 2002	Proj. 2003
I. National Accounts						
(In annual percentage change)						
Real GDP	-0.4	0.5	-0.4	2.7	-4.4	-1.0
Consumption	-0.7	-3.6	0.8	6.2	-6.1	-1.0
Investment	-4.7	-3.8	-0.7	-17.5	-7.5	-11.1
Exports	-7.2	-27.0	-15.1	-0.4	-5.8	-0.3
Imports	-7.0	-27.1	-6.7	-1.6	-12.1	-6.1
(In percent of GDP)						
Gross domestic investment	22.9	23.0	21.8	19.8	21.3	20.7
Private	15.6	11.8	14.9	13.8	15.0	15.4
Public	7.3	11.2	7.0	6.0	6.3	5.3
Gross national savings	21.1	20.9	19.9	17.5	22.9	24.2
Private	13.5	12.9	17.0	12.4	19.5	20.8
Public	7.5	8.0	2.9	5.1	3.4	3.4
II. Prices						
(In annual percentage change)						
GDP deflator	12.4	2.5	11.9	1.7	16.7	23.5
Consumer prices:						
End of period	14.6	5.4	8.6	8.4	14.6	17.0
Period average	11.6	6.8	9.0	7.3	10.5	18.9
Guarani/US\$ exchange rate						
End of period	21.9	16.7	6.9	30.7	51.0	...
Period average	24.5	15.0	11.8	17.8	38.5	...
Memorandum items:						
Real GDP per capita (percentage change)	-2.9	-2.1	-2.9	0.2	-6.7	-3.4
Population (percentage change)	2.6	2.7	2.6	2.5	2.5	2.5
GDP (in billions of guaranies)	23,437	24,144	26,921	28,119	31,365	38,344
GDP (in millions of U.S. dollars)	8,662	7,756	7,734	6,858	5,522	4,734

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

Table 3. Paraguay: Operations of the Consolidated Nonfinancial Public Sector (NFPS)

(In billions of guarani)

	1998	1999	2000	2001	Est. 2002	Baseline 2003
Revenue	4,846	4,982	5,259	6,137	6,309	7,436
Tax revenue	2,729	2,686	2,981	3,168	3,236	3,697
Nontax revenue and grants	1,944	2,084	1,945	2,740	2,874	3,518
Capital revenue	174	213	333	229	200	220
Current expenditure	3,857	4,157	5,105	5,252	5,666	6,675
Wages and salaries	2,210	2,386	2,807	2,852	3,052	3,474
Goods and services	528	417	644	525	562	644
Interest payments	171	193	313	378	457	818
Transfers	826	1,074	1,284	1,442	1,526	1,686
Other	123	86	57	54	70	53
Capital expenditure and net lending	1,814	2,785	1,863	1,664	2,244	2,372
Primary balance	-654	-1,766	-1,396	-402	-1,144	-793
Operational balance of public enterprises	902	1,246	718	712	653	717
Overall balance	78	-714	-991	-68	-948	-894
(In percent of GDP)						
Revenue	20.7	20.6	19.5	21.8	20.1	19.4
Tax revenue	11.6	11.1	11.1	11.3	10.3	9.6
Nontax revenue and grants	8.3	8.6	7.2	9.7	9.2	9.2
Public enterprises' operating surplus						
Capital revenue	0.7	0.9	1.2	0.8	0.6	0.6
Current expenditure	16.5	17.2	19.0	18.7	18.1	17.4
Wages and salaries	9.4	9.9	10.4	10.1	9.7	9.1
Goods and services	2.3	1.7	2.4	1.9	1.8	1.7
Interest payments	0.7	0.8	1.2	1.3	1.5	2.1
Transfers	3.5	4.5	4.8	5.1	4.9	4.4
Other	0.5	0.4	0.2	0.2	0.2	0.1
Capital expenditure and net lending	7.7	11.5	6.9	5.9	7.2	6.2
Primary balance	-2.8	-7.3	-5.2	-1.4	-3.6	-2.1
Operational balance of public enterprises	3.8	5.2	2.7	2.5	2.1	1.9
Overall balance	0.3	-3.0	-3.7	-0.2	-3.0	-2.3
Memorandum Items (in percent of GDP):						
Overall balance of the public enterprises	0.4	-0.3	0.3	0.3	-0.3	-0.4
Central bank balance	-0.1	-0.3	-0.4	-0.7	-0.9	-0.8
Total debt of the NFPS	22.4	31.5	33.4	37.8	48.3	57.8
<i>Of which:</i> external debt	19.7	28.4	30.0	33.0	41.9	51.7

Sources: Ministry of Finance; and Fund staff estimates.

Table 4. Paraguay: Central Government Operations, Accrual Basis

	1998	1999	2000	2001	Est. 2002	Proj. 2003
(In billions of guaranies)						
Total revenues	3,704	3,989	4,214	4,892	5,048	5,901
Tax revenues	2,729	2,686	2,977	3,165	3,233	3,694
<i>Of which</i> : value added tax	1,064	1,048	1,150	1,204	1,235	1,376
Nontax revenues 1/	937	1,260	1,153	1,669	1,809	2,205
Capital revenues	37	43	84	57	7	2
Current expenditures	3,200	3,550	4,369	4,378	4,774	5,574
<i>Of which</i> :						
Wages and salaries	1,818	2,021	2,401	2,400	2,582	2,900
Goods and services	332	250	420	295	353	389
Interest payments	170	193	312	378	456	816
Transfers 2/	775	1,009	1,196	1,270	1,326	1,433
<i>Of which</i> : pensions and benefits	502	669	797	879	913	1,011
Other	104	75	39	35	56	37
Capital expenditures	731	1,305	994	831	1,299	1,308
Primary balance	-57	-672	-836	60	-568	-165
Overall balance	-227	-865	-1,149	-318	-1,025	-981
(In percent of GDP)						
Total revenues	15.8	16.5	15.7	17.4	16.1	15.4
Tax revenues	11.6	11.1	11.1	11.3	10.3	9.6
<i>Of which</i> : value added tax	4.5	4.3	4.3	4.3	3.9	3.6
Nontax revenues 1/	4.0	5.2	4.3	5.9	5.8	5.8
Capital revenues	0.2	0.2	0.3	0.2	0.0	0.0
Current expenditures	13.7	14.7	16.2	15.6	15.2	14.5
<i>Of which</i> :						
Wages and salaries	7.8	8.4	8.9	8.5	8.2	7.6
Goods and services	1.4	1.0	1.6	1.1	1.1	1.0
Interest payments	0.7	0.8	1.2	1.3	1.5	2.1
Transfers 2/	3.3	4.2	4.4	4.5	4.2	3.7
Capital expenditures 3/	3.1	5.4	3.7	3.0	4.1	3.4
Primary balance	-0.2	-2.8	-3.1	0.2	-1.8	-0.4
Overall balance	-1.0	-3.6	-4.3	-1.1	-3.3	-2.6

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes receipts from the binational hydroelectric plants Itaipu and Yacyreta, and grants.

2/ Includes pension and social security payments.

3/ Capital expenditure assumed to decline in 2003 because of a cutoff in disbursement on development loans as a result of payments arrears.

Table 5. Paraguay: Operations of the Public Enterprises

	1998	1999	2000	2001	Est. 2002	Proj. 2003
(In billions of guaranies)						
Revenues	2,287	2,407	3,007	3,461	3,918	4,133
Sales of goods and services	2,279	2,393	2,751	3,433	3,878	4,113
Current transfers from central government	7	9	7	13	9	2
Other current revenues	0	0	249	12	15	15
Capital revenue	1	6	1	3	16	2
<i>Of which:</i> transfers from central government	1	0	0	0	0	0
Current expenditures	1,396	1,197	2,346	2,770	3,299	3,471
Wages and salaries	457	479	480	492	528	614
Goods and services	721	357	1,584	1,903	2,344	2,324
Interest payments	28	55	53	56	79	145
Transfers	35	66	87	98	89	88
<i>Of which:</i> transfers to central government	19	51	64	37	58	59
Other	156	240	143	221	259	300
Capital expenditures	804	1,272	583	618	725	822
Current account balance	890	1,204	661	688	603	660
Overall balance	87	-62	79	73	-106	-160
Financing	-87	62	-79	-73	106	160
External debt (increase +)	49	50	85	49	-147	-197
Disbursements	115	143	204	187	79	790
Amortizations	66	93	119	137	225	986
Internal debt (increase +)	-137	12	-163	-122	253	357
(In percent of GDP)						
Revenues	9.8	10.0	11.2	12.3	12.5	10.8
Current expenditures	6.0	5.0	8.7	9.9	10.5	9.1
Wages and salaries	2.0	2.0	1.8	1.8	1.7	1.6
Goods and services	3.1	1.5	5.9	6.8	7.5	6.1
Interest payments	0.1	0.2	0.2	0.2	0.3	0.4
Transfers	0.1	0.3	0.3	0.3	0.3	0.2
Other	0.7	1.0	0.5	0.8	0.8	0.8
Capital expenditures	3.4	5.3	2.2	2.2	2.3	2.1
Current account balance	3.8	5.0	2.5	2.4	1.9	1.7
Overall balance	0.4	-0.3	0.3	0.3	-0.3	-0.4
Financing	-0.4	0.3	-0.3	-0.3	0.3	0.4
External debt (increase +)	0.2	0.2	0.3	0.2	-0.5	-0.5
Internal debt (increase +)	-0.6	0.1	-0.6	-0.4	0.8	0.9

Sources: Ministry of Finance; and Fund staff estimates.

Table 6. Paraguay: Central Government Financing

	2002 (Preliminary)			2003 (Baseline Projection)		
	(In Billions of Guaranies)	(In Millions of U.S. Dollars)	(In Percent of GDP)	(In Billions of Guaranies)	(In Millions of U.S. Dollars)	(In Percent of GDP)
Gross financing requirements	2,041	370.9	6.5	2,573	318	6.71
Deficit	1,025	186.3	3.3	982	121	2.6
External debt amortizations	596	108.3	1.9	909	112	2.4
Domestic debt amortizations	2	0.3	0.0	682	84	1.8
Reduction in arrears	418	75.9	1.3	...	...	...
Identified financing	2,027	368.4	6.5	1,242	153	3.2
External disbursements	911	165.6	2.9	567	70	1.5
Domestic bond issues	122	22.2	0.4	464	10	1.2
Net credit at the central bank	18	3.3	0.1	211	26	0.6
Net credit at commercial banks	53	9.6	0.2	0	0	0.0
Accumulation of arrears	923	167.8	2.9	...	...	...
Financing gap (residual) 1/	14	2	0	1,331	164	3.47

Sources: Ministry of Finance; and Fund staff estimates.

1/ Reflects statistical discrepancies in historical data and the difference between financing requirements and identified financing forecasts.

Table 7. Paraguay: Public Sector Arrears

(In millions of U.S. dollars, as of January 31, 2003)

	Total	Over 30 Days	Over 60 Days	In Percent of 2002 GDP
Total arrears	203.0	97.0	54.1	3.7
Domestic arrears	116.7	21.4	0.0	2.1
Domestic debt	21.8	21.4	0.0	0.4
Other	94.9	...	...	1.7
External debt arrears 1/ 2/	86.3	75.6	54.1	1.6
By debtor:				
Central government 1/	46.7	36.2	15.0	0.8
Central bank	2.0	1.9	1.9	0.0
Rest of public sector 2/	37.7	37.5	37.1	0.7
By lender:				
World Bank	13.3	11.2	0.9	0.2
IDB	4.9	2.7	0.9	0.1
JBIC	16.1	13.0	8.4	0.3
Banque Worms	6.3	6.3	6.3	0.1
KFW	4.5	4.5	3.3	0.1
Eximbank China	3.3	3.3	1.9	0.1
Other private banks	7.9	4.9	3.8	0.1
Other governments	2.0	1.7	0.6	0.0
Other foreign suppliers 2/	28.0	28.0	28.0	0.5
Memorandum item:				
Disputed arrears 3/	56.5	56.5	56.5	1.0

Sources: Ministry of Finance; and Fund staff estimates.

1/ Excludes disputed arrears.

2/ Arrears to foreign suppliers (US\$28 million) are October 31, 2002 figures and are assumed to be over 60 days.

3/ Arrears on a project to improve customs (late 1990s) and a project to build an ammunition factory (late 1980s).

Table 8. Paraguay: Public Sector Debt, 1998-2007

	1998	1999	2000	2001	Est. 2002	Baseline Projections				
						2003	2004	2005	2006	2007
(In millions of U.S. dollars)										
Total public sector debt	1,968	2,478	2,618	2,630	2,706	2,777	2,833	2,685	3,058	3,112
I. External debt	1,732	2,240	2,357	2,296	2,350	2,484	2,357	2,299	2,245	2,200
A. By borrower										
Central government	1,131	1,629	1,737	1,688	1,769	1,927	1,810	1,757	1,702	1,648
Nonfinancial public enterprises	562	576	584	572	546	522	512	506	507	516
Financial public sector	39	35	36	36	36	36	36	36	36	36
B. By lender										
Multilateral organizations	1,002	1,094	1,185	1,173	1,143	1,139	1,062	1,062	1,062	1,062
<i>Of which:</i> IDB	735	802	862	852	836	833	782	782	782	782
World Bank	157	182	215	221	212	210	185	185	185	185
Bilaterals	582	1,000	1,028	981	1,006	1,006	1,006	1,006	1,006	1,006
<i>Of which:</i> Taiwan Province of China	52	448	532	523	548	548	548	548	548	548
Commercial banks	148	146	144	141	201	339	289	231	177	132
II. Domestic debt 1/	236	237	261	334	356	293	476	386	812	912
(In percent of GDP)										
Total debt	22.9	31.9	33.9	38.4	49.0	58.6	58.6	53.8	59.4	58.5
External debt	20.1	28.9	30.5	33.5	42.6	52.5	48.7	46.0	43.6	41.4
Domestic debt	2.7	3.1	3.4	4.9	6.4	6.2	9.8	7.7	15.8	17.2
Memorandum items										
Contribution to change in debt/GDP ratio										
Change in debt stock	3.3	6.4	1.8	0.2	1.3	...	...	...	...	...
Real GDP growth	0.1	-0.1	0.1	-0.9	1.9	...	...	...	...	...
Real depreciation	2.2	2.5	0.0	5.2	7.5	...	...	...	...	...
Total change	5.6	8.8	1.9	4.5	10.7	...	...	...	...	...

Sources: Ministry of Finance; and Fund staff estimates.

1/ Debt of central government, virtually all denominated in dollars.

Table 9. Paraguay: Summary Accounts of the Banking System

(End of period; valued at market exchange rate)

	1998	1999	2000	2001	2002	Proj. 2003
(In billions of guaraníes)						
I. Central Bank						
Net external assets	2,484	3,276	2,736	3,352	4,489	5,078
(In millions of U.S. dollars)	875	988	772	723	641	576
Net domestic assets	-1,075	-1,688	-1,180	-1,689	-2,790	-3,158
Credit to public sector, net	612	61	534	872	1,581	2,112
Credit to banking system, net 1/	-1,229	-1,485	-1,533	-1,827	-1,969	-2,094
Credit	45	5	7	7	4	4
Deposits	1,275	1,489	1,541	1,833	1,973	2,098
Central bank securities	-382	-76	-46	-297	-677	-663
Other	-77	-188	-135	-437	-1,725	-2,513
Currency issued	1,409	1,587	1,557	1,662	1,699	1,920
II. Monetary Survey						
Net external assets	3,051	4,260	4,234	5,096	6,127	6,719
(In millions of U.S. dollars)	1,074	1,285	1,194	1,099	875	763
Net domestic assets	3,469	3,202	3,515	4,083	3,391	3,786
Credit to the public sector	82	-343	-112	141	987	1,565
Credit to the private sector	4,983	5,541	5,823	6,633	6,624	7,524
Other	-1,596	-1,996	-2,195	-2,691	-4,220	-5,302
Broad liquidity (M5)	6,520	7,462	7,749	9,179	9,518	10,505
Money market funds	0	0	0	0	0	0
Broad liquidity (M4)	6,520	7,462	7,749	9,179	9,518	10,505
Bonds and issued securities	15	13	14	37	183	198
Other monetary liabilities	13	9	39	12	17	18
Central bank securities with private sector	182	18	8	121	281	371
Broad liquidity (M3)	6,310	7,422	7,688	9,009	9,037	9,917
Foreign currency deposits	3,001	3,760	3,946	5,082	5,198	5,486
Money and quasi-money (M2)	3,309	3,662	3,742	3,926	3,839	4,431
Quasi-money	1,390	1,561	1,326	1,306	1,198	1,353
Money (M1)	1,919	2,101	2,416	2,621	2,641	3,078
(Annual percentage change)						
M0 (currency issued)	12.4	12.7	-1.9	6.8	2.2	13.0
Banking system credit to the private sector	-2.0	11.2	5.1	13.9	-0.1	13.6
M1	7.5	9.5	15.0	8.5	0.8	16.5
M2	-2.9	10.7	2.2	4.9	-2.2	15.4
M3	8.8	17.6	3.6	17.2	0.3	9.7
Of which: foreign currency deposits	25.5	25.3	5.0	28.8	2.3	5.5
Memorandum items						
Exchange rate	2,840	3,315	3,545	4,635	7,000	...
Ratio of foreign currency deposits to M3 (percent)	47.6	50.7	51.3	56.4	57.5	55.3
Ratio of foreign currency deposits to private sector deposits in banks (percent)	59.1	62.2	61.5	66.2	66.8	65.3

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

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

Table 10. Paraguay: Banking System Indicators

	Dec.		2002							
	2000	2001	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	
Total system										
Share in assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Capital adequacy ratio (percent)	17.6	16.9	17.3	17.4	17.4	18.4	18.6	17.7	17.9	17.9
NPLs (percent) total loans	16.6	16.5	19.3	20.2	21.0	21.7	21.8	21.6	19.7	19.7
Provisions (percent) NPLs	38.8	37.0	37.5	36.4	36.3	39.3	38.8	40.6	46.6	46.6
Rate of return on assets (ROA)	1.4	2.2	2.3	2.6	2.7	2.0	2.1	1.6	1.0	1.0
Rate of return on equity (ROE)	12.4	21.2	19.4	22.4	23.2	17.2	19.7	15.3	9.0	9.0
Liquid assets (percent) of total assets 1/	21.7	23.0	21.4	22.7	24.4	22.8	24.1	25.7	25.1	25.1
Total foreign banks										
Share in assets	47.0	45.1	51.3	49.1	48.9	48.4	48.3	47.8	48.4	48.4
Capital adequacy ratio (percent)	17.1	16.0	16.6	17.9	17.9	18.8	18.8	17.8	17.6	17.6
NPLs (percent) total loans	14.1	15.3	17.7	19.6	20.4	22.1	22.5	21.9	20.1	20.1
Provisions (percent) NPLs	40.2	42.6	39.1	37.8	39.0	41.5	41.4	46.5	57.5	57.5
Rate of return on assets (ROA)	2.3	3.1	3.8	4.3	4.2	3.2	3.4	2.4	1.6	1.6
Rate of return on equity (ROE)	20.2	30.4	32.4	37.3	36.5	28.0	31.5	23.0	15.0	15.0
Liquid assets (percent) of total assets 1/	21.6	22.2	21.3	21.5	25.2	23.3	24.8	26.8	27.1	27.1
Total majority foreign banks										
Share in assets	34.9	38.3	31.4	32.7	33.6	33.0	33.3	33.3	33.2	33.2
Capital adequacy ratio (percent)	17.7	16.8	17.0	18.0	18.0	19.4	20.1	19.2	19.9	19.9
NPLs (percent) total loans	10.6	10.6	11.5	11.5	12.3	12.3	12.1	12.3	10.4	10.4
Provisions (percent) NPLs	39.7	36.8	41.5	40.1	39.1	44.6	45.1	45.2	43.8	43.8
Rate of return on assets (ROA)	1.0	1.8	2.2	2.5	2.2	1.9	1.9	1.7	1.4	1.4
Rate of return on equity (ROE)	8.6	18.3	19.9	22.7	21.2	17.4	18.4	16.6	13.4	13.4
Liquid assets (percent) of total assets 1/	24.2	25.0	23.8	25.5	26.9	25.0	25.3	27.0	26.2	26.2
Total domestic private banks										
Share in assets	6.8	7.4	9.2	9.9	9.4	10.2	10.3	10.3	10.4	10.4
Capital adequacy ratio (percent)	15.2	14.8	14.6	14.1	14.1	14.3	13.7	13.3	13.6	13.6
NPLs (percent) total loans	7.0	6.5	9.2	10.5	10.2	8.9	9.6	9.6	8.8	8.8
Provisions (percent) NPLs	25.0	30.8	19.0	16.9	17.0	22.9	17.7	19.1	18.7	18.7
Rate of return on assets (ROA)	1.0	1.2	1.4	1.5	1.5	1.3	1.2	1.1	1.1	1.1
Rate of return on equity (ROE)	8.9	13.8	17.1	18.1	16.3	15.6	15.4	14.4	14.3	14.3
Liquid assets (percent) of total assets 1/	17.3	20.1	19.5	25.6	20.2	19.4	20.0	20.1	18.3	18.3
Total system excluding BNF										
Share in assets	88.6	90.8	91.9	91.7	91.9	91.6	91.9	91.5	92.0	92.0
Capital adequacy ratio (percent)	17.1	16.2	16.6	17.6	17.6	18.5	18.6	17.7	17.9	17.9
NPLs (percent) total loans	12.0	12.3	14.5	15.5	16.1	16.6	16.8	16.5	14.7	14.7
Provisions (percent) NPLs	39.2	39.8	38.2	36.7	37.2	40.9	40.4	43.8	50.2	50.2
Rate of return on assets (ROA)	1.7	2.4	3.0	3.4	3.2	2.5	2.6	2.0	1.5	1.5
Rate of return on equity (ROE)	14.6	24.1	27.0	30.5	29.4	23.1	25.4	19.9	14.3	14.3
Liquid assets (percent) of total assets 1/	22.3	23.2	22.0	23.4	25.3	23.5	24.4	26.1	25.7	25.7
National Development Bank (BNF)										
Share in assets	11.4	9.2	8.1	8.3	8.1	8.4	8.1	8.5	8.0	8.0
Capital adequacy ratio (percent)	21.2	22.9	23.9	15.6	15.6	18.0	18.9	17.4	18.8	18.8
NPLs (percent) total loans	44.6	46.5	57.0	57.1	58.8	59.5	59.7	59.3	56.2	56.2
Provisions (percent) NPLs	38.1	31.7	36.0	35.8	34.3	36.0	35.2	34.0	39.6	39.6
Rate of return on assets (ROA)	-0.5	0.3	-6.0	-5.8	-3.3	-3.9	-3.3	-2.6	-4.7	-4.7
Rate of return on equity (ROE)	-4.2	2.0	-32.9	-31.8	-18.1	-22.3	-19.0	-16.2	-27.3	-27.3
Liquid assets (percent) of total assets 1/	16.7	20.4	15.1	15.4	14.1	15.9	19.9	21.2	17.3	17.3

Source: Superintendency of Banks.

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

Table 11. Paraguay: Balance of Payments, 1998-2003

(In millions of U.S. dollars)

	1998	1999	2000	2001	Est. 2002	Baseline 2003
Current account	-160	-165	-150	-155	89	166
Trade balance	-393	-441	-537	-496	-220	-28
Exports	3,548	2,310	2,326	2,463	2,326	2,352
Exports of domestic goods	1,014	741	869	1,108	949	969
Reexports	2,530	1,566	1,453	1,355	1,373	1,383
Imports	3,941	2,750	2,864	2,959	2,546	2,380
Registered Imports	...	1,725	2,050	1,989	1,687	1,577
Unregistered Imports	...	1,025	813	970	859	803
Services (net)	50	82	182	170	195	185
Transport	-258	-215	-167	-127	-116	-109
Travel	-31	-28	4	-14	-20	-24
Other	339	326	345	311	331	318
Factor income	6	18	28	4	-2	-42
Transfers	...	175	177	167	116	51
Capital and financial account	325	511	125	313	-53	-269
Capital transfers	5	20	3	15	15	15
Direct investment	336	89	113	74	47	30
Portfolio investment	9	-9	3	0	1	0
Other investment	-26	411	7	224	-115	-313
Assets (increase -)	-5	-118	-211	208	-77	-120
Commercial credits	...	11	-22	15	-11	-16
Loans	...	-138	-236	1	209	5
Foreign currency deposits	...	48	99	62	-279	-120
Other	...	-39	-52	130	3	10
Liabilities (increase +)	-21	529	217	16	-38	-193
Commercial Credits	...	90	71	14	-64	-61
Loans	...	502	144	20	-1	-130
of which Gov't disbursements	...	590	288	144	139	69
of which Gov't payments	...	-4	-2	-2	-55	-87
Foreign Currency Deposits	...	-55	-12	10	23	0
Other	...	-7	16	-28	4	-2
Errors and Omissions	-194	-474	208	-112	-124	-100
Overall Balance	-29	-129	183	46	-88	-202
Financing	0	129	-183	-46	88	202
Net International Reserves (increase -)	29	113	-216	-49	82	65
Financing Gap	0	16	33	3	5	137
Net accumulation of arrears (decrease -)	0	16	33	3	5	137
Memorandum items:						
Current account in percent of GDP	-1.9	-2.1	-1.9	-2.3	1.6	3.5
Gross reserves (in millions of U.S. dollars)	875	988	772	723	641	576
in months of imports of GNFS	2.3	3.7	2.8	2.6	2.6	2.5
External public debt in percent of GDP	20.4	28.9	30.6	33.5	42.3	50.8
Debt service in percent of exports GNFS	...	...	7.0	7.8	8.8	7.8
Export Volume (percentage change)	6.5	-34.9	-22.0	8.8	-9.1	-6.2
Import Volume (percentage change)	-6.0	-30.3	0.2	2.8	-16.3	-13.0
Terms of trade (percentage change)	12.7	-4.2	24.2	-3.1	1.0	0.4

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

1/ Includes credits to Public Sector for purchase of electricity

Table 12. Paraguay: Indicators of External Vulnerability

	1997	1998	1999	2000	2001	Est. 2002
Monetary and financial indicators 1/ 2/						
Broad money (M3), (percentage change)	12.4	8.8	17.6	3.6	17.2	0.3
Credit to the private sector, real (percentage change)	5.9	-14.5	5.5	-3.3	5.1	-12.9
Share of nonperforming loans in total loans (percent)	13.1	13.3	16.5	16.6	16.5	19.7
Average domestic lending rate, real	18.8	18.3	20.5	16.0	22.5	36.7
Central bank bill yield, real	8.0	13.1	6.0	-2.8	12.8	14.6
International reserves (in millions of U.S. dollars)	846	875	988	772	723	641
In months of imports of gnfs.	2.1	2.3	3.7	2.8	2.6	2.6
Base money to reserves	0.9	0.8	0.6	0.8	0.7	0.5
Broad liquidity (M3) to reserves	2.9	2.5	2.3	2.8	2.7	2.0
Central bank foreign short-term liabilities (in millions of U.S. dollars)	0.1	0.1	0.0	0.5	0.2	0.5
External indicators						
Merchandise exports (percentage change)	-12.4	6.6	-34.9	0.7	5.9	-5.6
Merchandise imports (percentage change)	-4.4	-6.0	-30.2	4.1	3.3	-14.0
Merchandise terms of trade (percentage change)	-3.9	12.7	-4.2	24.2	-3.1	1.0
Real effective exchange rate (percentage change)	3.3	-9.3	6.9	-3.0	-1.6	-3.4
Current account balance (percent of GDP)	-6.8	-1.9	-2.1	-1.9	-2.3	1.6
Capital and financial account (percent of GDP)	4.6	3.8	6.6	1.6	4.6	-1.0
Net foreign direct investment (percent of GDP)	2.4	4.0	1.1	1.5	1.1	0.8
Inward portfolio investment (percent of GDP)	0.0	0.1	-0.1	0.0	0.0	0.0
Other net investment (percent of GDP)	2.2	-0.3	5.3	0.1	3.3	-2.1
External public debt (percent of GDP)	16.5	20.4	28.9	30.6	33.5	42.6
Debt service (in percent of exports gnfs.)	n.a.	n.a.	n.a.	7.0	7.8	8.8

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

1/ Foreign currency components are valued at the market exchange rate.

2/ Monetary and financial data are actual.

Table 13. Paraguay: Medium-Term Scenario

(In percent of GDP, unless otherwise specified)

	1999	2000	2001	Est.	Projections							
				2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Baseline Scenario												
Real sector												
Real GDP growth 1/	0.5	-0.4	2.7	-4.4	-1.0	2.6	1.1	1.7	1.7	1.7	1.7	1.7
Consumer prices 1/	5.4	8.6	8.4	14.6	17.0	10.0	8.0	6.0	6.0	6.0	6.0	6.0
Public finances 2/												
Revenues	26.3	22.7	24.7	22.4	21.5	21.6	21.5	21.3	21.1	20.9	20.6	20.3
Tax revenues	11.1	11.1	11.3	10.3	9.6	9.8	9.8	9.8	9.8	9.8	9.8	9.8
Nontax revenues	15.1	11.7	10.1	9.3	9.4	9.3	9.2	9.0	8.9	8.7	8.6	8.5
Current primary expenditures	18.2	19.8	17.8	17.1	15.8	16.6	16.9	17.0	17.1	17.3	17.5	17.7
Interest payments	1.3	1.5	1.8	1.9	2.6	2.6	2.7	2.9	3.1	3.6	4.2	4.8
Capital expenditures	11.2	7.0	6.0	7.3	6.3	5.7	5.2	5.2	5.2	5.2	5.2	5.2
Primary balance	-1.8	-2.6	0.8	-2.0	-0.6	-0.6	-0.6	-0.9	-1.2	-1.7	-2.1	-2.6
Overall balance	-3.2	-4.1	-0.9	-3.9	-3.1	-3.2	-3.4	-3.7	-4.4	-5.3	-6.3	-7.4
Public sector debt (in millions of U.S. dollars)	2,477.7	2,618.5	2,630.3	2,706.3	2,777.0	2,832.8	2,685.3	3,057.5	3,112.0	3,775.6	3,901.3	4,136.7
(In percent of GDP)	31.9	33.9	38.4	49.0	58.6	58.6	53.8	59.4	58.5	68.7	68.7	70.5
Balance of payments (in millions of U.S. dollars)												
Exports	2,309.7	2,326.4	2,462.9	2,325.5	2,351.7	2,391.3	2,446.6	2,578.3	2,699.6	2,808.4	2,939.3	3,031.7
Imports	2,750.2	2,863.6	2,958.6	2,545.5	2,380.0	2,501.8	2,609.8	2,733.8	2,835.6	2,939.8	3,060.9	3,141.0
Current account	-165.4	-149.8	-155.2	88.8	166.1	83.3	27.8	47.6	86.1	100.9	121.9	142.3
(In percent of GDP)	-2.1	-1.9	-2.3	1.6	3.5	1.7	0.6	0.9	1.6	1.8	2.1	2.4
Capital and financial account	527	158	316	-48	-132	-18	-17	-36	-73	-73	-72	-81
Net international reserves	988.0	772.0	723.0	641.3	576.0	640.8	651.4	663.1	676.4	704.5	754.6	816.1
(In months of imports)	3.7	2.8	2.6	2.6	2.5	2.7	2.6	2.5	2.5	2.5	2.6	2.7
II. Adjustment Scenario												
Real sector												
Real GDP growth 1/	0.5	-0.4	2.7	-4.4	-1.0	2.6	2.0	2.8	3.2	3.5	3.5	3.5
Consumer prices 1/	5.4	8.6	8.4	14.6	17.0	9.0	7.0	5.0	5.0	4.0	4.0	4.0
Public finances 2/												
Revenues	26.3	22.7	24.7	22.4	22.5	24.0	24.5	24.4	24.2	24.0	23.9	23.6
Current primary expenditures	16.9	18.3	17.8	17.1	15.7	15.7	15.6	15.6	15.5	15.5	15.4	15.4
Interest payments	1.3	1.5	1.8	1.9	2.6	2.5	2.4	2.4	2.2	2.2	2.1	2.1
Capital expenditures	11.2	7.0	6.0	7.3	5.5	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Primary balance	-1.8	-2.6	0.8	-2.0	1.3	3.1	3.7	3.7	3.5	3.4	3.3	3.0
Overall balance	-3.2	-4.1	-0.9	-3.9	-1.3	0.6	1.2	1.3	1.3	1.1	1.1	0.9
Public sector debt (in millions of U.S. dollars)	2,478	2,618	2,630.3	2,706.3	2,692	2,520	2,366	2,309	2,256	2,216	2,179	2,160
(In percent of GDP)	31.9	33.9	38.4	49.0	56.8	51.9	46.4	43.1	39.8	36.9	34.2	32.0
Balance of payments (in millions of U.S. dollars)												
Exports	2,309.7	2,326.4	2,462.9	2,325.5	2,351.7	2,391.3	2,455.7	2,598.9	2,736.6	2,866.3	3,019.6	3,136.0
Imports	2,750.2	2,863.6	2,958.6	2,545.5	2,380.0	2,501.8	2,609.8	2,778.2	2,951.4	3,131.4	3,335.7	3,484.7
Current account	-165.4	-149.8	-155.2	88.8	166.1	83.3	38.6	20.8	-3.4	-51.4	-99.5	-130.1
(In percent of GDP)	-2.1	-1.9	-2.3	1.6	3.5	1.7	0.8	0.4	-0.1	-0.9	-1.6	-1.9
Capital and financial account	527	158	316	-48	-132	-5	93	72	162	160	158	174
Net international assets	988.0	772.0	723.0	641.3	576.0	653.8	785.2	878.1	1,036.8	1,145.7	1,204.4	1,248.5
(In months of imports)	3.7	2.8	2.6	2.6	2.5	2.7	3.1	3.3	3.7	3.8	3.8	3.7

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

1/ Annual percentage change.

2/ Includes financial and nonfinancial public sector.

Table 14. Paraguay: Public Sector Debt Sustainability Framework, 1997-2007

(In percent of GDP, unless otherwise indicated)

	Actual					Est. 2002	Projections				
	1997	1998	1999	2000	2001		2003	2004	2005	2006	2007
I. Adjustment Scenario Medium-Term Projections											
1. Public sector debt 1/	17.4	22.7	31.9	33.9	38.4	49.2	56.8	51.9	46.4	43.1	39.8
2. Change in public sector debt	0.7	5.4	9.2	1.9	4.5	10.8	7.7	-5.0	-5.5	-3.3	-3.2
3. Identified debt-creating flows (4+7+12)	3.7	1.4	6.4	2.9	9.9	16.9	2.6	-9.0	-5.9	-3.9	-3.9
4. Primary deficit	2.1	-1.5	1.8	2.6	-0.8	1.1	-1.8	-3.2	-3.7	-3.7	-3.6
5. Revenue and grants	23.3	25.0	26.3	22.7	24.7	22.3	22.5	24.0	24.5	24.5	24.3
6. Primary (noninterest) expenditure	25.3	23.5	28.1	25.3	23.9	23.3	20.7	20.9	20.8	20.8	20.7
7. Automatic debt dynamics 2/	1.6	2.9	4.5	0.3	10.8	15.8	4.4	-2.8	-0.2	-0.2	-0.3
8. Contribution from interest rate/growth differential 3/	0.0	-0.6	0.7	-1.8	0.3	-2.1	-6.4	-5.3	-2.3	-1.4	-1.1
9. Of which contribution from real interest rate	0.4	-0.6	0.8	-1.9	1.2	-3.6	-6.8	-4.1	-1.3	-0.2	0.2
10. Of which contribution from real GDP growth	-0.4	0.1	-0.1	0.1	-0.9	1.5	0.4	-1.3	-0.9	-1.2	-1.3
11. Contribution from exchange rate depreciation 4/	1.7	3.5	3.9	2.1	10.4	17.9	10.8	2.6	2.1	1.3	0.8
12. Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-3.1	-2.0	0.0	0.0
13. Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-3.1	-2.0	0.0	0.0
14. Residual, including asset changes (2-3)	-3.0	4.0	2.8	-1.0	-5.4	-6.1	5.1	4.0	0.4	0.6	0.6
Public sector debt-to-revenue ratio 1/	74.7	90.8	121.6	148.9	155.3	220.8	252.3	215.9	189.1	176.0	164.1
Gross financing need 5/	3.9	1.4	5.1	6.9	3.2	6.0	7.4	5.7	7.9	7.5	8.4
In billions of U.S. dollars	0.4	0.1	0.4	0.5	0.2	0.3	0.4	0.3	0.4	0.4	0.5
Key macroeconomic and fiscal assumptions											
Real GDP growth (in percent)	2.6	-0.4	0.5	-0.4	2.7	-4.4	-1.0	2.6	2.0	2.8	3.2
Average nominal interest rate on public debt (in percent) 6/	5.5	8.3	6.0	5.3	5.4	5.5	6.4	5.0	5.0	5.3	5.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.5	-4.1	3.5	-6.6	3.8	-11.2	-17.1	-8.0	-2.7	-0.4	0.6
Inflation rate (GDP deflator, in percent)	3.0	12.4	2.5	11.9	1.7	16.7	23.5	13.0	7.7	5.7	4.8
Growth of real primary spending (deflated by GDP deflator, in percent)	28.9	-7.6	20.2	-10.2	-3.2	-6.6	-12.1	3.3	1.7	2.5	2.9

Table 14. Paraguay: Public Sector Debt Sustainability Framework, 1997-2007

(In percent of GDP, unless otherwise indicated)

	Actual					Est. 2002	Projections				
	1997	1998	1999	2000	2001		2003	2004	2005	2006	2007
II. Stress Tests for Public Debt Ratio											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-07						49.2	62.6	62.2	58.7	56.6	54.1
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						49.2	69.9	74.9	69.3	65.9	62.5
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						49.2	57.1	54.1	48.3	44.8	41.4
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						49.2	62.6	64.5	58.9	55.6	52.2
5. Combination of 2-4 using one standard deviation shocks						49.2	69.2	76.4	70.5	66.9	63.2
6. One time 30 percent real depreciation in 2003 7/						49.2	93.0	83.5	74.9	68.4	61.7
7. Ten percent of GDP increase in other debt-creating flows in 2003						49.2	66.8	61.4	55.8	52.5	49.2
Historical Statistics for Key Variables (past 10 years)							Historical Average	Standard Deviation		Average 2002-07	
Primary deficit							-0.3	2.1		-2.5	
Real GDP growth (in percent)							2.0	1.8		0.9	
Nominal interest rate (in percent) 6/							5.8	1.1		5.4	
Real interest rate (in percent)							-5.2	7.0		-6.5	
Inflation rate (GDP deflator, in percent)							11.0	6.7		11.9	
Revenue to GDP ratio							21.9	3.0		23.7	

1/ The public sector includes the central government and both the nonfinancial and financial public sector. Gross debt is used for the calculation.

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

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

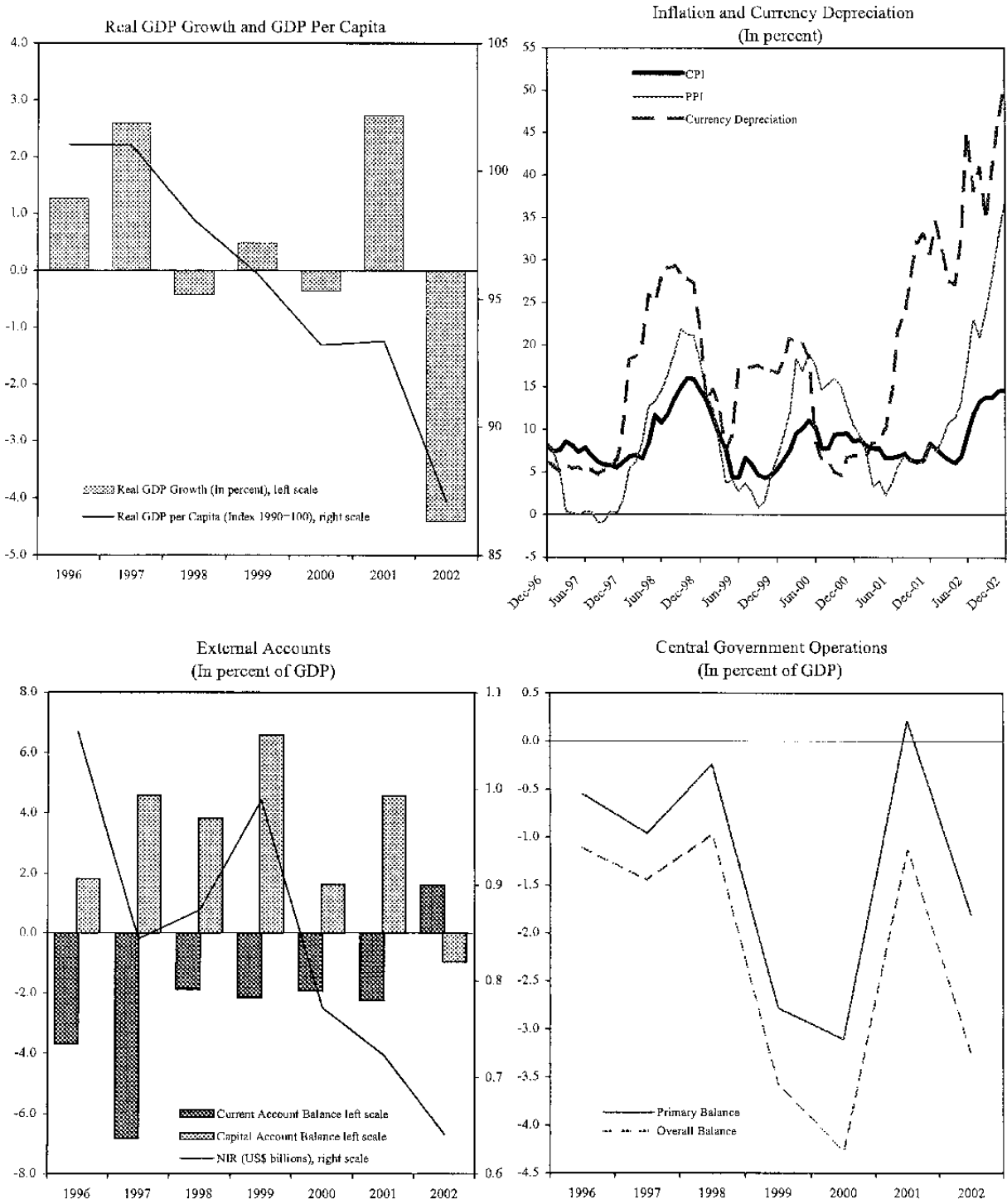
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

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

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

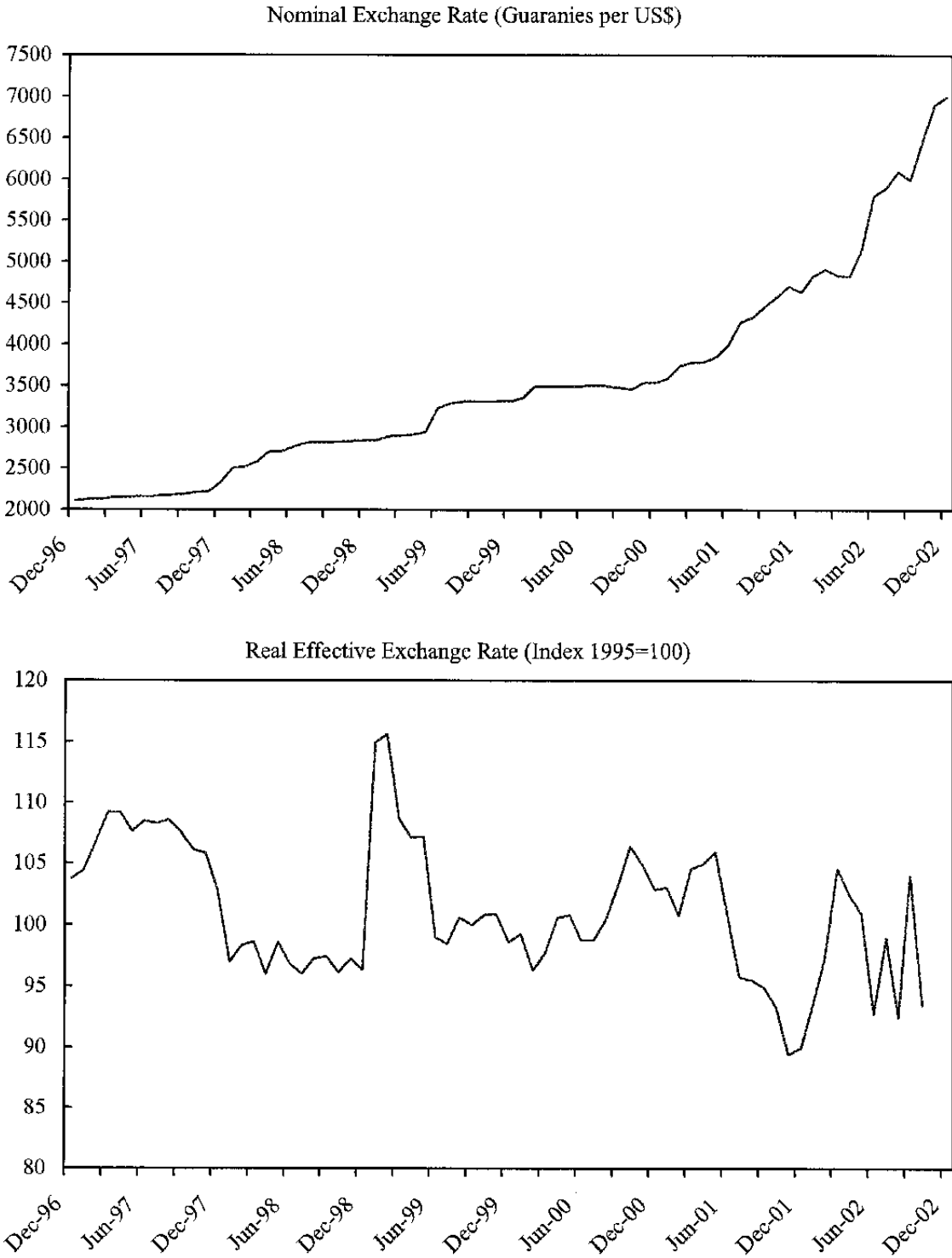
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 1. Paraguay: Selected Economic Indicators



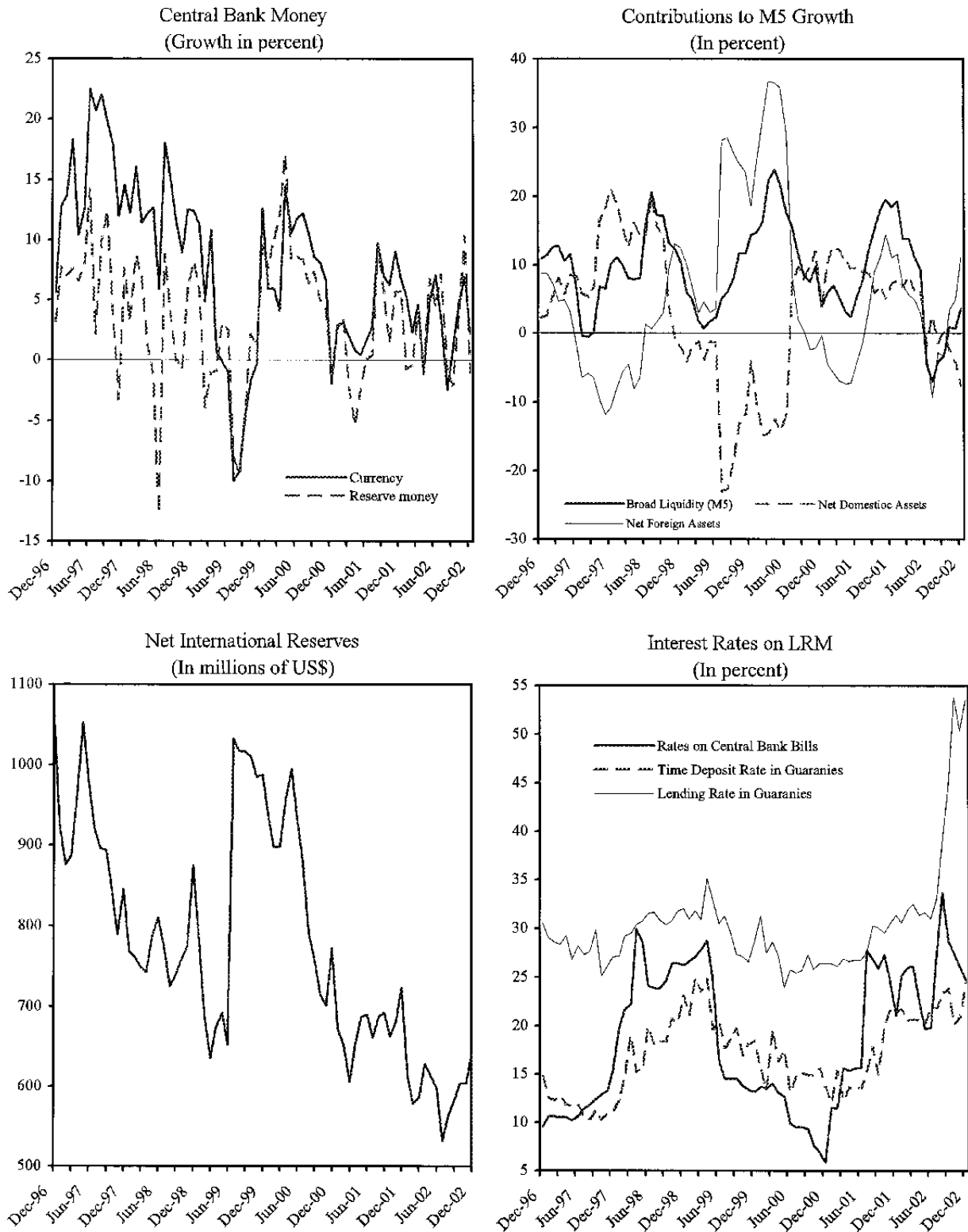
Source: Central Bank of Paraguay.

Figure 2. Paraguay: Exchange Rates



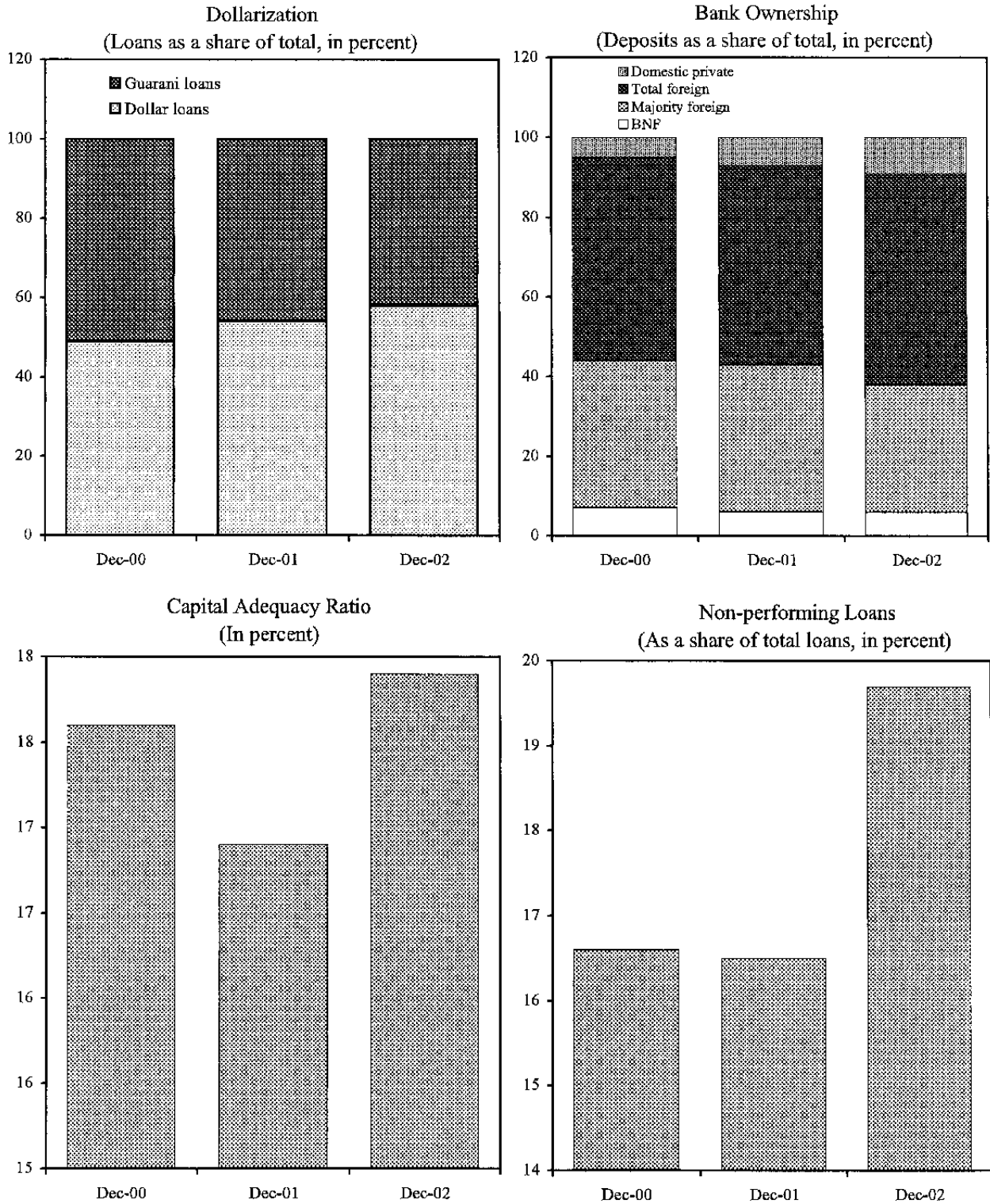
Source: Central Bank of Paraguay.

Figure 3. Paraguay: Selected Financial Indicators



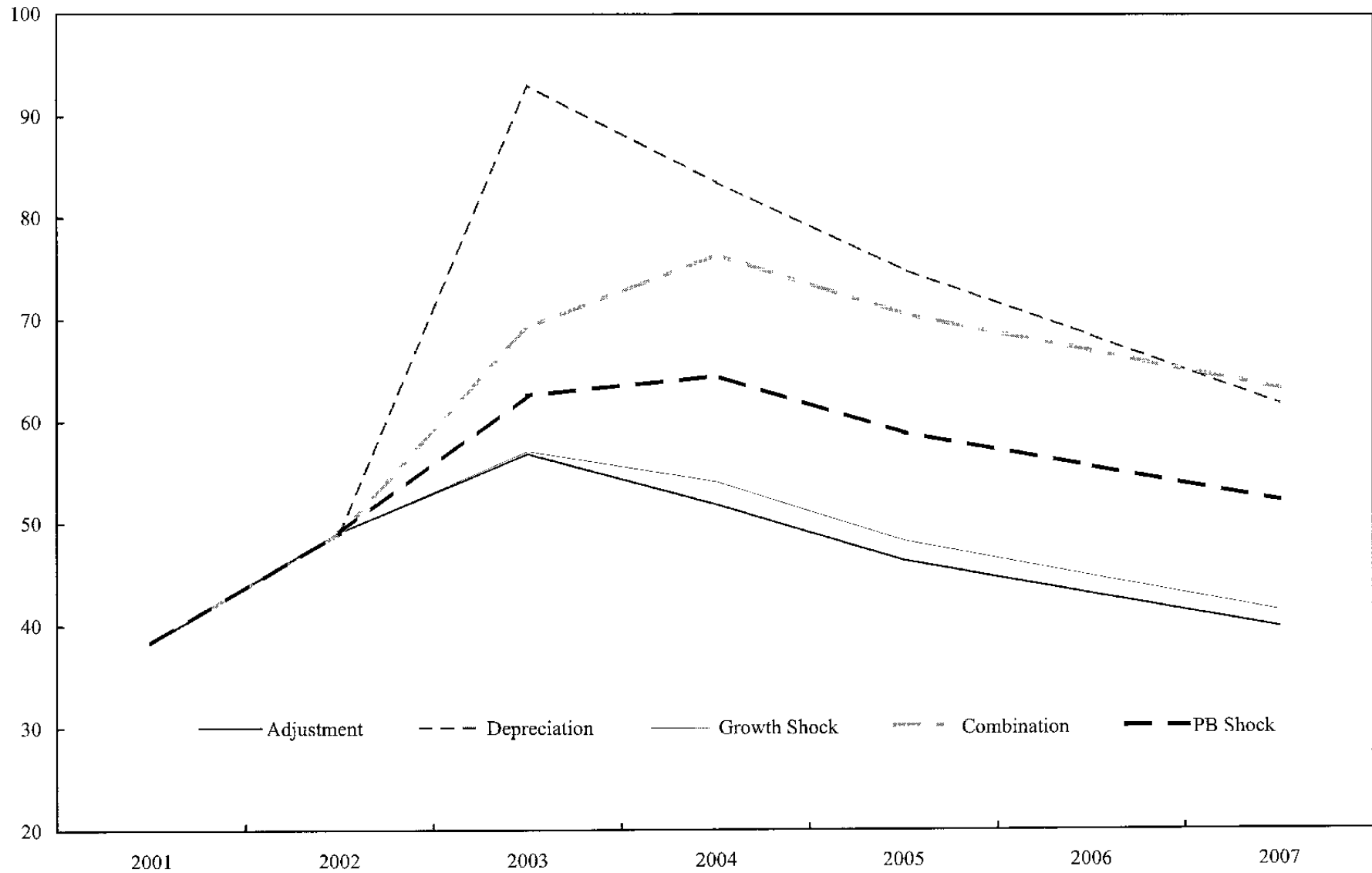
Source: Central Bank of Paraguay.

Figure 4. Paraguay: Selected Banking Indicators



Source: Central Bank of Paraguay.

Figure 5. Paraguay: External Debt
(In percent of GDP)



FUND RELATIONS
(As of December 31, 2002)

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

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

III. SDR Department:	In millions of SDRs	Percent of Allocation
Net cumulative allocation	13.70	100.00
Holdings	83.25	607.81

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

V. **Exchange Rate Arrangement:** The currency of Paraguay is the Paraguayan *guaraní*. The exchange rate regime is a managed float. The exchange rate is determined in the interbank foreign exchange market, but the central bank intervenes in the foreign exchange and monetary markets to smooth out exchange rate fluctuations in real effective terms. The U.S. dollar is the principal intervention currency. On December 31, 2002, the average interbank rate for the U.S. dollar was G7,000=US\$1.

VI. **Article IV Consultation:** The 2001 Article IV consultation was concluded by the Executive Board on May 11, 2001; the documents are SM/01/125 and SM/01/132.

VII. **Technical Assistance:**

Department	Purpose	Date of Delivery
MAE	Policy Advisory to the Central Bank	March 1994 – Present
MAE	Accounting procedures	March 1996
MAE/LEG	Bank Regulations	May 1997
FAD	Tax and Customs Administration	May 1997
FAD	Tax Policy	February 1999
FAD	Tax Administration	March 1999
STA	Monetary Statistics	February 2000

Department	Purpose	Date of Delivery
STA	Balance of Payments Statistics	June 2000
STA	Multisector, GDDS accession	February 2001
MAE	Currency Operations	March 2002 – September 2002
MAE	Financial Sector Surveillance	July 2002
FAD	ROSC	August 2002
STA	Multisector, follow-up	September 2002
MAE	Banking Supervision	September 2002 – November 2002
MAE	Central Bank Operations	November 2002
TRE	Safeguard Assessment	January 2003

VIII. **Safeguard Assessment:** Under the Fund's safeguards assessment policy, Central Bank of Paraguay (CBP) is subject to an assessment with respect to the expected arrangement. A safeguards assessment of the CBP was completed on January 31, 2003. The assessment concluded that substantial risks may exist in legal structure and independence of the central bank, and in its control environment. Staff findings, proposed recommendations under program conditionality, and other recommendations are reported in SM/03/76. Implementation of the measures by the CBP needs to be monitored by staff.

X. **Resident Representative:** None. Mr. Luis H. Duran-Downing has been appointed as MAE Resident General Adviser since February 2002.

FINANCIAL RELATIONS WITH THE WORLD BANK¹

January 24, 2003

A new Paraguay Country Assistance Strategy (CAS) update is currently under preparation. The existing World Bank's Country Assistance Strategy (CAS) for Paraguay, covering the 1998–2000 period, focuses on: (i) human resource development, much of it directed towards addressing the needs of the poor; (ii) agricultural development and natural resource management; (iii) basic infrastructure improvement; and (iv) private sector development, including strengthening of the financial sector. Institutional capacity building was to be an important aspect of World Bank assistance.

The CAS planned for lending on the order of \$50 million per year, subject to improved portfolio performance and keeping the fiscal deficit below 2 percent of GDP. Due to portfolio performance problems, however, the Bank did not approve any new loans until last year, when a \$9 million Community Development project was approved in March 2002. The Bank nevertheless maintained an active policy dialogue with Paraguay, and analytical work during the past year included a poverty assessment, a financial sector assessment, a country procurement assessment, and informal work on public expenditures and pensions. In addition, the World Bank Institute provided technical assistance during 2000 to help a joint Government-Civil Society Commission prepare a National Anti-corruption Plan, which is now being supported by other donors. The Bank together with the UNDP also assisted the government in the preparation of a Poverty Reduction Strategy paper.

Five World Bank-financed projects are presently under implementation with US\$75 million undisbursed as of end-December 2002. These projects include: Rural Water Supply, Natural Resource Management, Reform of the Water and Telecommunication Sectors, Maternal Health and Child Development, and the recently approved Community Development project which is awaiting approval by Congress in order to become effective.

A new secondary education project and a financial sector technical assistance adjustment loan are currently under preparation.

Paraguay entered into suspension of disbursements with the World Bank on December 31, 2002. At the time of writing, outstanding payments to the Bank amounted to US\$13.9 million.

¹ Prepared by the staff of the World Bank.

FINANCIAL RELATIONS WITH THE WORLD BANK

(In millions of U.S. dollars)

I. IBRD/IDA Operations (as of December 31, 2002)

	Committed (Net of Calculations)	Undisbursed	Disbursed
Active loans			
Natural Resource Management	50.0	20.3	29.7
Asunción Sewerage/Reform of Water and Telecommunications Sectors	31.5	8.3	23.2
Maternal Health	21.8	3.3	18.5
Fourth Rural Water Supply	40.0	30.3	9.7
Community development	9.0	9.0	0.0
Total active loans	152.3	71.2	81.1
Total inactive loans	658.1	2.9	655.2
Total IBRD/IDA	810.4	74.1	736.3
Repaid (includes repayment third parties)			488.8
Total outstanding 1/			237.1

II. IFC Operations (as of December 31, 2001)

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

III. IBRD/IDA Loan Transactions (calendar year)

	1995	1996	1997	1998	1999	2000	2001	2002
Disbursements	25.7	27.5	41.2	37.7	42.1	46.6	26.8	13.5
Repayments	42.6	35.2	27.5	24.6	24.6	20.2	15.3	16.8
Net lending	-16.9	-7.7	13.8	13.1	17.5	26.4	11.5	-3.3

Source: World Bank.

1/ After exchange rate adjustment.

PARAGUAY—RELATIONS WITH THE IDB¹

Portfolio

1. There is close collaboration between the IDB and the IMF, as the IDB has operations contingent on the approval of an agreement with Paraguay, which had been included in the IMF's assessments of the situation. Furthermore, there is close coordination between the IDB and the World Bank in specific issues regarding financial sector reform.
2. The operations of IDB, Paraguay's main creditor, have been affected by fiscal constraints and political instability with regard to decisions concerning new loans. As a direct consequence, Paraguay entered in default in 2002 and again in 2003, loans had to be postponed, loan disbursements were slow, and the net cash flow to the country was negative for the second consecutive year.
3. In 2002 IDB approved two loans. One, Program for Social Investments II - PROPAIS II for US\$28.4 million to finance a social investment fund, and another one, for US\$1 million to support the preparation of a public sector bank reform.
4. The active portfolio of loans amounts to US\$646.5 million, of which 40.7 percent have been disbursed. As for Technical Cooperation, the approved total amounts to US\$32.6 million, of which 66.6 percent have been disbursed. Even though loan disbursements in 2002 totaled US\$52 million, the net cash flow was negative US\$25.5 million.

Operations Program

5. Provided an agreement is reached between Paraguay and the IMF, the following two operations might be approved in 2003: (i) an **emergency loan** for US\$50 million to protect social expenditure, to be disbursed in two tranches; and (ii) a policy-based loan for a public bank financial reform, cofinanced with the World Bank, for US\$50 million, which is being closely coordinated with the IMF with regard to conditionality.
6. Other possible investment loans in 2003 include:
 - a. The Franja Costera Project for US\$55 million. It will help the Municipality of Asunción to solve problems associated with flooding from the river with disastrous social consequences every year, at the same time that it will revitalize the downtown area of the city and facilitate its access from the suburbs.
 - b. Modernization of the Cadastral System for US\$9 million, approved in early January.

¹ Prepared by the staff of the IDB.

- c. Improvement of initial education for US\$30 million.
 - d. TC loan for the Financial System Reform, for US\$4.5 million.
 - e. Modernization of Public Administration, for US\$20 million.
 - f. Reform of the Social Security System, for US\$20 million.
7. Moreover, technical cooperation operations are in preparations that aim at improving the private participation in urban development, the legislative and judicial system, the management of underground waters in Asunción, and the use of music to include youngsters in societal activities.
8. The Bank's new country strategy with Paraguay is expected to be approved during the first semester of 2004.

STATISTICAL ISSUES
(As of January 13, 2003)

A. Real Sector

National accounts have a number of shortcomings, including the use of an outdated conceptual framework and an outdated base year for constant prices (1982). The data are, however, currently being made compatible with international standards (*1993 SNA*) with the assistance of an expert financed by the IDB. This entails a fuller coverage of industries, an input-output matrix, and an expansion of data sources for the compilation of the 1994 new benchmark and base year. Quarterly information recently became available for 1997–2001.

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

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

B. Public Finances

Reliable monthly data are available on a timely basis for the central government, where much improvement has been made over the past years. The asset position of the social security system is available on a daily basis. However, shortcomings in the classification and recording remain and the Paraguayan GFS is not fully consistent with the methodology of the IMF *Government Finance Statistics Manual 1986 (GFSM 1986)*. For instance, nontax revenues include social security contributions; transfers and grants are not separately classified; and debt data are not classified by type of holder and by debt instrument. Additionally, public enterprises and the social security system have been following somewhat different classifications of revenues and expenditures than the central government. A law (*Ley 1535*) that was passed in 2000, should allow closer integration, as it sets uniform standards and creates a database for the entire public sector. Data on medium- and long-term external debt are reliable and available on a monthly basis. Internal debt data are available on request, but need to be more fully integrated with the external debt database. Deficiencies remain in the registration of short-term supplier and commercial credit of the public sector. Moreover, there is a discrepancy in the fiscal data reported by the monetary and fiscal authorities.

Annual data covering only budgetary central government through 2001 have been published in the *2002 GFS Yearbook*. However, since 1994 no financing and outstanding debt data, and no breakdowns for expenditure by function data have been provided for publication in the GFSY. Monthly and quarterly data are not reported for publication in *IFS*. The

resumption of reporting quarterly and monthly data for the *IFS* is highly recommended. Data on local governments and public enterprises are deficient and not reported regularly.

C. Money and Banking

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

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

D. External Sector

Quarterly and annual balance of payments data are available on the central bank website, and reported to STA. Data for the international investment position (IIP) have been compiled and disseminated for the period 1995–2001. In 1992, Paraguay compiled and disseminated quarterly balance of payments and IIP data for 1991. The classification of the balance of payments and of the IIP follows the recommendations of the Balance of Payments Manual (5th edition). Technical assistance by STA has led to improvements in the quality of the data on capital flows, especially in the coverage on foreign direct investment, and in the recording of external debt transactions in the balance of payments and in the IIP. The central bank now produces a highly informative bulletin on balance of payments statistics. Special studies by the central bank have improved the estimation methods for remittances of Paraguayans abroad and unregistered trade transactions, but serious deficiencies remain.

Deficiencies remain in the area of private capital outflows, which are difficult to register due to Paraguay's liberal capital account. Major recommendations of the multisector statistics mission include the need to: (i) introduce quarterly surveys for recording services, transfers, and financial transactions of the nonfinancial private sector; (ii) apply quality control procedures for surveys; (iii) revise and improve the statistical techniques to take into account unrecorded merchandise trade and smuggling; (iv) improve the compilation procedures of several services and financial transactions; and (v) institute a system of coordination with other official agencies, and within the CBP, to promote intersectoral data consistency. Sizable negative errors and omissions over the last few years can be attributed mostly to unregistered outflows of portfolio capital and the lack of coordination between customs, the central bank, and Ministry of Finance in the compilation of basic trade data.

PARAGUAY: CORE STATISTICAL INDICATORS
(As of January 21, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	1/10/03	1/10/03	1/10/03	1/10/03	11/31/02	11/31/02	M12/02	M11/02	Q3/2002	M12/02	2001	Q4/02
Date Received	1/13/03	1/13/03	1/13/03	1/13/03	1/2/03	1/7/03	12/31/02	12/26/02	11/26/02	12/23/02	7/01/02	1/4/03
Frequency of Data	Daily	Daily	Daily	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Annual	Quarterly
Frequency of Reporting	Daily	Daily	Daily	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Annual	Quarterly
Source of Update	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Ministry of Finance	Central Bank	Central Bank
Mode of Reporting	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-Mail	E-mail	Publication	E-mail
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Daily	Daily	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Annual	Quarterly



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March 27, 2003

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

IMF Concludes 2002 Article IV Consultation with Paraguay

On March 10, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Paraguay.¹

Background

Paraguay's economic performance in recent years has been characterized by slow economic growth and increasing unemployment and poverty rates. This stagnation reflects structural impediments to growth, exacerbated by external and domestic shocks. In 2002, the economy fell into its worst recession in decades, with real GDP down by 2½ percent, according to official estimates, or 4½ percent, according to staff estimates, while inflation accelerated to 14½ percent. The decline reflected a combination of factors, including the worsening external environment, a drought and the outbreak of foot-and-mouth disease, and political uncertainties which hampered economic policy making. The banking system was seriously affected by the recession and by contagion from the regional crisis, with the collapse of the third-largest bank triggering sizable deposit outflows. The *guarani* depreciated by 34 percent vis-à-vis the U.S. dollar, although in real effective terms it declined by only 2½ percent due to the sharp decline of neighboring currencies.

The public finances also deteriorated sharply in 2002. The consolidated public sector deficit increased to 3 percent of GDP, mainly because of weak tax revenues, higher capital spending, and financial difficulties in key public enterprises. Severe financing constraints led to sizable

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

arrears by early 2003, including to multilateral lenders. Repeated attempts by the government to adopt a comprehensive adjustment and reform program with multilateral support failed, mainly because of the lack of domestic consensus in the increasingly politicized environment before national elections scheduled for April 2003.

Paraguay faces a difficult economic outlook in 2003. While better climatic conditions in agriculture and some stability in Argentina will keep GDP from falling as sharply as in 2002, continuing domestic policy uncertainty and the effects of foot-and-mouth disease are expected to depress growth.² With the new administration scheduled to take office on August 15, the policy making environment may improve. If the new authorities move decisively to implement sound economic policies, an economic recovery could start late in the year. Inflation will edge up further reflecting pass-through from continued depreciation of the exchange rate.

Executive Board Assessment

Executive Directors observed that Paraguay had suffered large adverse shocks in 2002, which had been exacerbated by long-standing domestic vulnerabilities and impediments to growth. A drought, the outbreak of foot-and-mouth disease, and contagion from the regional crisis had caused a sharp decline in output, with adverse effects on the public finances and the banking system. Structural weaknesses, including serious governance problems, inefficient public enterprises, a weak tax effort, and inefficient government spending are key factors behind Paraguay's record of low growth and its vulnerability to external shocks.

To address these structural weaknesses, restore macroeconomic stability, and set Paraguay on a path of sustainable growth, Directors recommended the adoption of a comprehensive program of fiscal and structural reforms. The strategy should center on restoring fiscal sustainability, improving the efficiency of the public sector, strengthening the banking sector, and improving governance and fighting corruption. Directors encouraged the new government following the April 2003 elections to garner the broad political consensus and ownership required to formulate a strong adjustment program and push forward the reform process. However, given the very difficult present economic situation, policy efforts should get under way even before the election.

Directors expressed concern about the sharp deterioration of Paraguay's fiscal situation and rising public debt burden, which has resulted, inter alia, in the accumulation of large payments arrears. While Directors took note of the authorities' efforts to limit the deterioration through administrative means, they urged the authorities to adopt a comprehensive and balanced package of measures to correct the fiscal imbalance on a sustainable basis. Such a package would have to include measures to strengthen tax administration and the revenue effort more generally, as well as appropriate spending restraint. Directors also emphasized the need to

² While staff estimates some decline in GDP, the authorities believe that there might be a small pickup in activity in 2003.

reform the public employees' pension plan. Directors regretted Paraguay's build up of arrears with the Inter-American Development Bank and the World Bank, and encouraged the authorities to quickly normalize relations with the international financial community.

Directors observed that the adjustment effort should also include the public enterprises. They noted that timely adjustment of fuel and electricity prices to fully reflect their dollar costs is key to the health of those enterprises as well as to the government's cash flow. Directors stressed the need to consider reviving the privatization program as soon as a transparent framework can be put in place. They suggested that, if outright sale of enterprises proves difficult in the near term, the authorities should explore other means to improve public enterprises' operations, such as better pricing structures and private management contracts. Directors also suggested that the authorities develop reorganization plans for each enterprise to improve efficiency, in order to pave the way for eventual privatization.

Directors noted that monetary policy had responded pragmatically to the difficulties faced in 2002. They urged the authorities to strengthen the operational framework of monetary policy, establish a clear nominal anchor, and increase the central bank's operational independence. Directors recommended less intervention by the central bank in the foreign exchange market, to allow the flexibility of the exchange rate to help cushion shocks and to husband reserves for backing up deposits in the highly-dollarized banking system. Directors encouraged the authorities to work toward prudent macroeconomic policies and banking system reforms, which would allow for a decline of dollarization over time. Directors recommended that the authorities review the requirement to move public sector deposits to the central bank in light of the risks posed to the banking system. A few Directors noted, however, that consolidation of public sector balances at the central bank could be considered desirable, and that any liquidity issues that might arise would need to be addressed through other instruments.

Directors commended the authorities for their prompt and effective intervention in Banco Alemán, while noting that important gaps remain in the framework for bank resolution. They recommended that these gaps be filled through early adoption of draft laws on bank resolution and on public banking. Directors encouraged the authorities to strengthen regulation and supervisory practices, monitor the situation of banks closely, and more generally take a proactive stance in response to any difficulties. In particular, Directors expressed concern about the precarious financial situation of the National Development Bank (BNF). They urged the authorities to implement, without further delay, a comprehensive restructuring and reform of the bank, along the lines of the program designed last year with the support of the Inter-American Development Bank and the World Bank. Directors urged the authorities to step up their efforts to address money laundering and terrorist financing.

Directors encouraged the authorities to maintain Paraguay's relatively open trade regime. They stressed that tariff increases should be viewed only as a last resort on the fiscal front, and recommended that trade concerns be resolved within Mercosur and WTO dispute resolution procedures.

Directors noted the improvements made in operational safeguards at the central bank, and encouraged the authorities to implement the recommendations set forth in the recent safeguards assessment report prepared by IMF staff.

Directors considered data provision by the authorities as adequate for surveillance purposes, although they noted that important data deficiencies remain. They urged the authorities to address those deficiencies, especially in the national accounts, the public enterprise, and social security sectors, and in the data on external trade and capital flows.

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

Table 1. Paraguay: Selected Economic Indicators, 1998-2003

	1998	1999	2000	2001	Est. 2002	Proj. 1/ 2003
(Annual percent change)						
National accounts and prices						
GDP at current prices	12.0	3.0	11.5	4.4	11.5	22.2
GDP at constant prices	-0.4	0.5	-0.4	2.7	-4.4	-1.0
Consumption	-0.7	-3.6	0.8	6.2	-6.1	-1.0
Investment	-4.7	-3.8	-0.7	-17.5	-7.5	-11.1
Net exports (contribution to growth)	1.2	4.8	-0.9	0.4	2.7	1.7
Exports	-7.2	-27.0	-15.1	-0.4	-5.8	-0.3
Imports	-7.0	-27.1	-6.7	-1.6	-12.1	-6.1
GDP deflator	12.4	2.5	11.9	1.7	16.7	23.5
Consumer prices (average)	11.6	6.8	9.0	7.3	10.5	18.9
Consumer prices (end of period)	14.6	5.4	8.6	8.4	14.6	17.0
Real effective exchange rate						
Average (depreciation -)	-9.3	6.9	-3.0	-1.6	-3.4	...
End-of-period (depreciation -)	-6.4	2.4	4.3	-12.6	-2.6	...
(In millions of U.S. dollars)						
External sector						
Exports, f.o.b.	3,548	2,310	2,326	2,463	2,326	2,352
Imports, c.i.f.	3,941	2,750	2,864	2,959	2,546	2,380
Current account	-160	-165	-150	-155	89	166
(In percent of GDP)	-1.9	-2.1	-1.9	-2.3	1.6	3.5
Capital account	325	511	125	313	-53	-269
Overall balance	-29	-129	183	46	-88	-202
Terms of trade (deterioration -)	12.7	-4.2	24.2	-3.1	1.0	0.4
(In percent of GDP)						
Public sector						
Central government primary balance	-0.2	-2.8	-3.1	0.2	-1.8	-0.4
Central government overall balance	-1.0	-3.6	-4.3	-1.1	-3.3	-2.6
Central government financing gap 1/	...	...	...	...	3.0	3.5
Consolidated public sector primary balance 2/	1.5	-1.8	-2.6	0.8	-2.0	-0.6
Consolidated public sector overall balance 2/	0.2	-3.2	-4.1	-0.9	-3.9	-3.1
Public sector external debt (end-of-year)	20.1	28.9	30.5	38.4	49.0	58.6
(Annual percent change)						
Money and credit						
Monetary base	8.1	9.5	-1.3	5.8	-1.0	13.0
M2	-2.9	10.7	2.2	4.9	-2.2	15.4
M5 3/	10.5	14.4	3.9	18.5	3.7	10.4
Net foreign assets 4/	12.5	18.5	-0.3	11.1	11.2	6.2
Net domestic assets 4/	-2.0	-4.1	4.2	7.3	-7.5	4.2

Credit to the public sector 4/	5.7	-6.5	3.1	3.3	9.2	6.1
Credit to the private sector 4/	-1.7	8.6	3.8	10.5	-0.1	9.4
Velocity of M2	7.0	6.9	7.3	7.3	8.1	...
Memorandum items:						
International reserves (in millions of U.S. dollars)	875	988	772	723	641	576
(In months of imports)	2.3	3.7	2.8	2.6	2.6	2.5
GDP (in billions of guaranies)	23,437	24,144	26,921	28,119	31,365	38,342

Sources: Paraguayan authorities; and IMF staff estimates.

1/ Staff's baseline projection (see Annex I).

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

3/ Foreign currency items are valued at the market exchange rate.

4/ Contribution to M5 growth.

Statement by the IMF Staff Representative
March 10, 2003

Since issuance of the staff report, the following additional information on recent developments has become available. This information does not alter the thrust of the appraisal.

- **Inflation has accelerated further.** Monthly consumer price inflation in February was 1.8 percent, bringing the 12-month rate to 20.2 percent. In January, producer prices rose by 14.8 percent, raising the 12-month rate to 56.6 percent.
- **While gross reserves have remained at around \$650 million since end-2002, public sector arrears have risen to an estimated \$290 million as of end-February** (up from \$175 million at end-2002). Nearly US\$100 million of total arrears are external. Arrears to the IDB and World Bank were nearly US\$20 million, while the bulk of the rest were to bilateral lenders and foreign suppliers.
- **Banking system deposits have been stable, but credit and asset quality continue to decline.** Credit to the private sector fell by 3.2 percent in January (year-on-year), and the average nonperforming-loan ratio rose to 20.6 percent in January, from 19.7 percent in December.
- **The central bank in late February approved a loan to the government to clear some payments arrears.** The loan of \$39 million, which is within the statutory limits of government borrowing from the central bank, is to be used to clear arrears with the World Bank and the IDB and to redeem part of overdue government bonds with domestic banks (with the rest to be rescheduled to 2005).
- **Congress is currently considering a draft law to recapitalize the National Development Bank (BNF)** with around US\$70 million in government bonds and to require that a more comprehensive public banking reform law be submitted within 180 days. President González Macchi had announced last week that a comprehensive public banking reform would not be undertaken until a new government takes office.