March 2004
IMF Country Report No. 04/66

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

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

- the staff report for the request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **October 31, 2003,** with the officials of Paraguay on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on December 5, 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 **December 15, 2003** updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its December 15, 2003 discussion** of the staff report that completed the request.

- a statement by the Executive Director for Paraguay.

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

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

*May also be included in Staff Report

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

PARAGUAY

Request for a Stand-By Arrangement

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

Approved by Adrienne Cheasty and Matthew Fisher

December 5, 2003

- **Discussions:** Discussions were held in Asunción during October 15–31 on a program that could be supported by a Stand-By Arrangement. The mission met with Finance Minister Borda, Central Bank President González, Industry and Commerce Minister Bergen, and leaders of Congress, among others.
- **Staff team:** The team included Jeffrey Franks (Head), Valerie Mercer-Blackman, Randa Sab, Roberto Benelli (all WHD), Christian Keller (PDR), Felix Fischer (MFD), and was assisted by the MFD general resident adviser in Asunción, Luis Durán-Downing. Mr. Ayala (OED) accompanied the mission.
- **Proposed SBA:** The authorities have requested that their economic program be supported by a 15-month Stand-By Arrangement (SBA) of SDR 50 million (50 percent of quota). While the structural challenges facing Paraguay can only be fully addressed over a longer term, the staff views an SBA as the appropriate facility to stabilize the economy and begin the reform process, given the existing macroeconomic imbalances and Paraguay's lack of a track record in Fund programs. The authorities have indicated their intention to treat the arrangement as precautionary. Fund support would also unlock important program loans from the World Bank and IDB, allowing them to close financing gaps in 2003 and 2004.
- **Fund relations:** Paraguay has no outstanding Fund credit. A program to be supported by an SBA was agreed in July 2002 (with the letter of intent issued in August), but it could not be brought to the Board as key prior actions were not implemented. The last Article IV consultation was concluded on March 10, 2003. At that time, the Executive Board recommended a comprehensive program of fiscal adjustment and structural reforms. Directors stressed the need to strengthen tax administration, to regularly adjust fuel and electricity prices, and to curb spending. They urged the authorities to reform the public employees' pension plan and the ailing public development bank, and called for improving the operational framework of monetary policy.
- **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. The country has run arrears of up to US$20 million with the World Bank and the IDB over the past year, but as of December 5, 2003, these arrears had been cleared.

Contents

Figures

Annexes

Attachments

Appendix

I. Background

A. A Broad Perspective

1. **Paraguay suffers from serious structural problems which hinder growth and have impeded its ability to adjust to economic shocks**. Real GDP growth was zero between 1997 and 2002, producing a cumulative decline of 15 percent in per capita income (Table 1, Figure 1). Key factors underlying this poor performance include:

- **Political instability**. The previous President was not elected and his government was widely perceived as lacking in legitimacy. Congress was sharply divided. As a result, it proved difficult to carry out needed policy initiatives.

- **Serious governance problems.** Corruption, inefficiency, poor guarantees of property rights, and lack of transparency afflict both the public and private sectors.[1] Tax evasion and smuggling are rampant, and the quality of public expenditure is low. Foreign investment is meager, and local capital spending is depressed by the lack of legal guarantees (Table 2).

- **A weak banking system plagued by periodic crises**. Bank closures affected the system in 1995, 1997, 1998, 2002, and 2003, and significant weaknesses remain. Nonperforming loans exceed 20 percent of total assets, and the highly dollarized nature of the system leaves it vulnerable to exchange rate shocks.

- **Inefficient public enterprises.** Poorly run government firms are a strong presence in key economic activities (water, electricity, transport, telecommunications, banking, and petroleum), hurting growth prospects in the rest of the economy and—in several cases—constituting a drain on the public finances.

- **Low and falling productivity**. This decline reflects poor human capital formation as well as inefficient infrastructure and governance problems. It is also related to government policies, which have sheltered inefficient industries through a variety of tax exemptions and subsidies.

- **High poverty and unemployment with limited social protection.** Income inequality is high, and nearly half the population lives on less than US$2 per day (Table 3). Social spending per capita is one-fourth of the Latin American average.

---

[1] The 2003 Transparency International Index of perceptions of corruption ranked Paraguay as the fourth-worst among countries rated, with a score of 1.6 out of 10. The International Country Risk Guide (October 2003) gave Paraguay scores of 1/6 on corruption, 2/6 on law and order, 2/6 on democratic accountability, and 1/4 on bureaucratic quality.

2. **In 2002, the economy fell into its worst recession in decades.** The slump was brought on by exogenous shocks (the regional crisis and a poor harvest) and weak domestic economic policies. Real GDP fell by nearly 2½ percent, inflation accelerated from 8½ to 14½ percent, and the *guaraní* lost 34 percent of its value (Table 4, Figure 1). The third-largest bank, *Banco Alemán,* collapsed, sparking substantial capital flight. Fiscal problems led to the accumulation of large payments arrears, including to multilateral institutions and default on some domestic bonds. Open unemployment rose from 7.6 percent in 2000 to 10.8 percent in 2002. The authorities attempted to address the macroeconomic imbalances—twice reaching preliminary agreement with Fund missions on programs to be supported by SBAs—but in both cases, political opposition to key proposed measures stymied their efforts.

B. Recent Developments and Outlook

3. **The political environment for reform has improved under the new government.**[2] President Nicanor Duarte-Frutos enjoys a degree of legitimacy and popularity lacking in the previous administration,[3] and in his first months in office, he has moved decisively to attack corruption and begin reforms of several key public sector institutions. In October, the President signed a political agreement with the heads of both houses of Congress and with opposition party leaders to pass a series of economic reform laws, including fiscal adjustment legislation and laws to strengthen the banking system and reorganize public banks, reform the public employees' pension plan, restructure public enterprises, and pass a new customs code. This agreement reflects a nascent partnership of pro-reform forces in the three main political parties to press ahead with stabilization and structural reform. Political life in Paraguay remains fractious, however, and the reformist alliance is fragile. The president's reform agenda may well face considerable opposition from special interests, other political parties, and from elements of his own Colorado Party.

4. **The economic situation has improved in 2003.** A good harvest and the improved regional situation have combined with an improved domestic political environment since the new government took office in August to produce a projected increase of around 2 percent in real GDP for the year; however, the nonagricultural economy remains stagnant, due mainly to a continued decline in private investment. The *guaraní* has appreciated by nearly 15 percent so far this year against the U.S. dollar (Figure 2), reflecting the appreciation of currencies in Brazil and Argentina, rising agricultural exports, and reduced uncertainty following the general elections. Official reserves and bank deposits have also risen (by

---

[2] Mr. Duarte-Frutos won the presidency with 37 percent of the vote, compared to 20 percent for his nearest rival. His Colorado party is the largest political force in Congress, although it lacks a majority in the Senate (where the Colorados control 16 of 45 seats).

[3] Previous President González Macchi was appointed by the Congress after his predecessor resigned in the wake of the assassination of the vice president. He was held back by the lack of an electoral mandate to govern, by accusations of corruption and mismanagement, and—in his final months—by the highly politicized electoral campaign.

36 percent and 23 percent, respectively since end-2002) (Figure 3). Annual inflation was 10 percent in October, down from the peak of 21 percent reached in April. Important economic imbalances remain, however, making renewed deterioration likely unless corrective action is taken. In particular, large financing gaps in the public sector and continued fragility in the banking system leave the economy vulnerable to shocks.

II. The Authorities' Economic Program

5. **The Paraguayan authorities have prepared an economic program to stabilize their macroeconomic situation and begin a process of structural reform.** The government seeks to create conditions for sustained economic growth and poverty reduction and address long-standing governance problems by improving the efficiency and transparency of government operations. In keeping with these overarching objectives, the economic program aims to stabilize the fiscal situation and the banking system and to initiate needed structural reforms. The program will require a sizable fiscal effort to reduce the deficit and clear arrears; a focused, conservative monetary policy to achieve low inflation; and efforts to address the vulnerabilities in the banking system. It will also require an ambitious, and carefully sequenced, effort to initiate reforms of key public institutions (the central bank, public sector pensions, customs, the civil service) to begin the structural transformation needed for sustained growth and poverty reduction over the longer term.

A. Macroeconomic Framework and Key Vulnerabilities

6. **Fiscal adjustment and structural reforms should pave the way for more rapid growth over the medium term.** With the regional economic environment improving, the year ahead presents a unique opportunity to address forcefully the fiscal imbalance and make a strong start on key structural reforms. Growth is conservatively projected to rise to around 2½ percent in 2004 and climb further to around 3½ percent in the medium term, provided the reforms are sustained (see Annex I and Table 15). Underlying inflation should fall from 9 percent in 2003 to 6½ percent in 2004. The headline rate of inflation will only drop to 8 percent, however, due to the price effects of the increases in indirect taxation envisaged under the program. The current account would remain broadly in surplus, and central bank reserves would grow to above 3½ months of imports (Table 13). Key economic objectives for 2003–04 and the medium-term are as follows:

Text Table A. Key Economic Objectives
(In percent of GDP)

		Program			
	2002	2003	2004	2005	2006
Real GDP growth (percent change)	-2.3	2.0	2.4	3.2	3.4
Inflation (cpi, end-of-period)	14.6	8.8	8.0	6.0	6.0
Consolidated public sector balance	-3.2	-0.6	0.3	0.6	0.3
Consolidated primary balance	-1.3	1.2	2.2	2.7	2.3
Current account	1.7	1.4	0.4	0.3	0.1
Reserves (US$ millions)	641	818	855	892	942

7. **Despite these expected improvements in economic policies and performance, Paraguay remains vulnerable to external shocks.** The external sector suffers from the typical vulnerabilities of a small open economy exporting mainly primary products. In particular, fluctuations in commodity prices of Paraguay's main exports could affect the balance of payments and the exchange rate. The agricultural sector is also vulnerable to weather-related shocks. The regional economic environment could impact exports as well as remittance payments from abroad (mainly Argentina). A regional downturn could also spark contagion to local financial markets (as occurred in 2002). Further analysis of the impact of shocks to key macroeconomic variables is presented in Annex I.

B. The Fiscal Program

8. **The fiscal situation has deteriorated sharply in recent years.** The public sector debt-to-GDP ratio rose from under 17 percent in 1997 to 49 percent of GDP in 2002 (Figure 5), and the consolidated public sector deficit reached over 3 percent of GDP in 2002 (Tables 5–7). In the first half of 2003, expenditure compression (mainly reflecting financing constraints) and a temporary improvement in public enterprises[4] helped reduce the deficit, but without the corrective measures taken by the new government it would have remained near 2 percent of GDP for the year, a level inconsistent with available financing. Furthermore, without fiscal adjustment, the deficit would climb above 2½ percent of GDP in 2004. Key factors contributing to the persistent fiscal problems include the following:

- Tax efficiency declined markedly. Collections as a share of GDP fell from 10.1 percent in 2001 to 9.1 percent in 2002, and slumped further in the first half of 2003.

- The public employees' pension plan (caja fiscal) is in substantial deficit. In 2002, it posted a shortfall of 1.9 percent of GDP.

[4] Public enterprises have been favorably affected by the appreciation of the *guaraní* during 2003, as well as by a substantial reduction in the cost of electricity provided to ANDE by the Itaipú hydroelectric consortium.

- Inefficient operations and lags in adjusting tariffs in public enterprises depressed their operating surpluses in 2000–02. Including capital spending, the public enterprises produced a deficit of ½ percent of GDP in 2002.

- Quasi-fiscal losses of the Central Bank of Paraguay (BCP) rose to over 1 percent of GDP in 2002, reflecting the growing stock of central bank bills issued to control the money supply as well as the costs of bank resolution and falling interest earnings on foreign exchange reserves.

9. **Severe financing constraints have produced sizeable public sector payments arrears.** The stock of public sector arrears was nearly 3½ percent of GDP (US$187 million) as of September 30, 2003, mainly to suppliers and bilateral creditors (Table 8). During 2003, there were also recurring arrears to the World Bank and the IDB and arrears on certain treasury bonds held by the banking system which have now been cleared. Without fiscal measures, financing gaps of over 3½ percent of GDP would arise (even assuming no arrears reduction), with virtually no access to local or international capital markets.

10. **The new government has prepared a fiscal policy package to close the fiscal financing gap, pay off arrears, and place the public debt on a more sustainable path.** Fiscal adjustment measures already implemented will produce an improvement of at least 1½ percent of GDP on an annual basis, and measures to be implemented during the program period would yield an additional 2–2½ percent of GDP annually (vis-à-vis the baseline). The authorities explained that the size and timing of the fiscal adjustment was determined by several factors: (i) the need to reduce public debt to a more sustainable level; (ii) the authorities' desire to take advantage of the momentum of the new government's post-election support to front-load the adjustment process; and (iii) the need to close the substantial financing gaps in 2003 and 2004 and eliminate arrears. This adjustment would bring the overall balance into slight surplus and initiate a decline in the debt/GDP ratio from 2004. Over the medium term, it would permit a steady fall in the debt/GDP ratio toward around 30 percent of GDP by the end of the decade (Annex I and Table 15), while accommodating increased capital spending and social investment.

11. **On the revenue side, the government's fiscal strategy is to raise revenues while minimizing increases in tax rates.** The authorities have already begun a major overhaul of tax and customs administration (Box 1) which will yield around 1 percent of GDP in 2003; further reforms will be implemented in 2004 to assure the sustainability of this improvement. The government also raised excise taxes on fuels from 14 to 20 percent in August, generating an estimated ½ percent of GDP annually. Under the program, the following additional steps will be taken (Box 2):

- The government will enact an Administrative Reorganization and Fiscal Adjustment Law that is expected to yield 1.4 percent of GDP annually. The law will broaden the base of

VAT and income taxes,[5] close tax loopholes, strengthen tax enforcement, implement a new vehicles tax and revamp the current agricultural tax. It will also cut the corporate income tax rate and introduce a personal income tax.

- The 2004 budget envisages a further increase in the excise tax on fuel, generating another ½ percent of GDP.

- The authorities will make regular adjustments of fuel and utilities prices to fully reflect changes in the exchange rate and cost structure of the public enterprises.

12. **Key problem expenditure areas will be addressed under the program.** The authorities have committed themselves to continued austerity in current spending in the 2004 budget.[6] They are also auditing employee rolls and eliminating phantom workers and those collecting two salaries. During 2004, the government will implement additional measures to permanently reduce spending, including:

- Ambitious legislation to address the serious imbalance in the *caja fiscal* (Box 3).

- Full implementation of the recently approved procurement reform law, which should facilitate reductions in spending on goods and services and more efficient public investment.

- Preparation of a civil service reform to streamline and improve the efficiency of the central government.

13. **Program financing will be provided primarily by a combination of multilateral program lending and domestic debt restructuring.** The authorities made an important stride in this direction in November when they agreed with bondholders to roll over all domestic debt coming due in the period 2003–05 (some US$138 million), including bonds in default since December 2002. The new bonds carry maturities of 1–5 years and interest rates which imply a slight NPV reduction. Program lending of US$160 million (US$100 million during the program) is expected from the IDB and the World Bank in 2003–05. The IDB support would come from an emergency loan of US$30 million, and a US$50 million public banking reform loan. World Bank support would come from a US$30 million Economic Recovery Adjustment loan and US$50 million from a financial sector loan (Table 9).

14. **Regularization of public sector payments arrears is a key program objective.** The government has already eliminated all arrears to the World Bank and the IDB, as well as cleared arrears on domestic bonds through the rollover agreement. All other external arrears

---

[5] Preferential schemes for VAT and corporate income will be phased out and VAT coverage will be extended to most services and agricultural products.

[6] The budget envisages a real reduction in current expenditures of 6½ percent.

will be eliminated during 2004 as a part of the program[7]. In this context, Paraguay has approached the Paris Club to request the agreement of Club members to the proposed schedule of arrears reduction. Arrears to non-Paris Club member will be treated on a *pari passu* basis. In addition, the government is engaged in good faith efforts to resolve certain external arrears in dispute. Domestic arrears will also be eliminated during the program, leaving only a normal payments float.

C. Monetary and Exchange Rate Policy

15. **Monetary policy has lacked focus and the central bank (BCP) has been subject to political pressures.** The BCP has in practice attempted to pursue multiple targets, sometimes focusing on the exchange rate, at other times pursuing monetary or inflation objectives. Monetary management was complicated in early 2003 by pressures to extend credit to the government and an attempt by the previous government to use public sector deposits to manage monetary policy. While the *guaraní* has appreciated by 15 percent this year and the BCP has recovered around US$180 million in reserves, annual currency issue growth has accelerated from 2.2 percent in December 2002 to 36 percent by September 2003 (Tables 10 and 11, Figure 3). The authorities consider that this sharp rise in currency issue largely reflects remonetization after last year's regional crisis, but there are concerns about future inflation prospects if money growth is not brought under control soon. The recent confirmation of a new Central Bank President should provide the opportunity for clearer definition of monetary policy, but greater operational independence for the BCP will be essential to ensure a coherent monetary policy.

16. **For 2004, the authorities are committed to a monetary policy geared toward controlling inflation while maintaining exchange rate flexibility.** The program establishes targets on net domestic assets (NDA) designed to bring the growth in the money supply down to a rate more consistent with single-digit inflation in the medium term, while allowing for a recovery in private lending. The monetary program also assumes a modest rise in the share of monetary aggregates to GDP. The BCP will also work, with technical assistance from the Fund, to develop the necessary technical and statistical capabilities to move eventually to an inflation targeting regime. To facilitate the implementation of monetary policy, measures will be taken to strengthen the BCP's operational autonomy by implementing the recommendations of the recent safeguards assessment and MFD missions.[8] The Ministry of Finance and other public sector institutions will coordinate the movement of public sector deposits in support of the overall monetary policy objectives.

[7] As of November 30, Paraguay had no outstanding sovereign arrears to private external creditors.

[8] The reforms will give the BCP greater budgetary autonomy, reform accounting practices, require annual external audits, restructure the organization to reduce total staff while dedicating more resources to bank supervision, and improving technical capabilities in preparation for the move to inflation targeting.

17. **Exchange rate policy will allow for a freely floating *guaraní*, with only limited intervention to smooth seasonal fluctuations.** The program establishes international reserves targets that seek to maintain reserve cover above 3½ months of imports during the program, rising from US$818 million in December 2003 to US$855 million in December 2004. Despite the appreciation against the dollar in 2003, the real effective exchange rate has appreciated only slightly, leaving competitiveness at an appropriate level (Figure 2).

D. Financial Sector Issues

18. **The highly dollarized banking system has been through several rounds of crisis in the past decade, and it remains vulnerable to further shocks** (Box 4, Figure 4, and Tables 12 and 14). Among the major problems in the system are:

- The National Development Bank (BNF) has serious liquidity and efficiency problems. The bank was recently recapitalized by a grant of government bonds, and a new team of executives has begun to trim operating costs and increase collections. Nevertheless, over half its loan portfolio is nonperforming, and the bank continues to lose money.

- Commercial banks suffer from increasing nonperforming loans. The recent collapse of a mid-sized locally owned bank highlighted the risks in the system.[9] Three international banks are winding down their operations in Paraguay, reflecting mainly the weakness in the local market as well as these banks' retrenchment in operations throughout the region in the wake of the recent crisis. Several small finance companies are weak and may require intervention in the coming months.

- Bank resolution and supervision need strengthening. The bank superintendency, while competent, lacks sufficient resources and legal protection to fully carry out its functions. The cooperative sector (20 percent of the financial system) is not under the control of the superintendency and is effectively unregulated.

- Some of the previous administration's policies may have exacerbated banking system concerns. The default on some US$22 million in domestic bonds held by the banking system in December 2002 hurt system confidence. In early 2003, attempts to affect the exchange rate via the movement of public sector deposits threatened the liquidity of some banks and contributed to banks' desire to build-up excess liquidity. While these policies have been abandoned, the climate of uncertainty they created continues to affect the system.

19. **Under the program, banking reforms will focus on implementing a permanent solution for the BNF, strengthening the bank resolution framework, and improving bank supervision.** The long-pending bank resolution law has been passed as a prior action

[9] The bank (Multibanco) with around 5 percent of system assets was closed on June 2. Subsequent investigations found evidence of irregularities in its lending operations as well as possible kickbacks paid to attract public sector deposits.

for the proposed SBA. It sets up a deposit guarantee fund and provides the Superintendency with increased ability to deal with banks in trouble (see ¶23 of the MEFP). The Central Bank board also approved strengthened prudential regulations, including higher provisioning requirements.[10] Key measures to be taken under the program include:

- Passage of new comprehensive banking system legislation (see ¶25 of the MEFP).

- Approval of a public banking law to consolidate and restructure the public development banks (see ¶24 of the MEFP).

- A requirement for banks to obtain and publish independent credit ratings.

- Extension of regulatory supervision to financial cooperatives.

E. Other Structural Reforms

20. **Structural reforms under the program are focused on strengthening public sector efficiency and governance.** They will also provide an improved institutional environment for sustained economic stability and growth. Structural performance criteria and benchmarks are summarized in Table 16.

- Central government and BCP. Key reforms include:

    - ➢ Passage of legislation to restructure the *caja fiscal*, and a clean-up of the registry of beneficiaries to reduce false claims.
    - ➢ Implementation of a customs reform program, including passage of a new customs code (with support from the IDB).
    - ➢ Restructuring of the central bank to improve autonomy, transparency, and efficiency.
    - ➢ Development of a comprehensive civil service reform plan.

- **Social security reform.** Beyond restructuring the *caja fiscal* (the public employees' pension plan), there is a need to reform the broader national pension and health system (the *Instituto de* Previsión Social or IPS). The authorities have already replaced IPS management and have begun a drive for increased efficiency (particularly in health care). Under the program, a comprehensive audit will be undertaken as a basis for developing a plan for deeper reforms in the future.

- **Public enterprises.** The authorities are committed to regular price adjustments to place the public enterprises on a sounder footing. The public enterprises will also be subject

[10] The revised regulations will bring asset classification and provisioning levels to standard international practice by the beginning of 2006. As a result, provisions will increase by roughly 20 percent compared to current levels.

to increased data publishing requirements to improve transparency. In 2004, the authorities will study mechanisms to allow participation of private capital and management in these firms.

- **Governance**. The authorities indicated that a number of the measures planned under their program will directly improve transparency and governance in Paraguay, including the closing of tax loopholes and tax administration improvements, customs reform, civil service reform, central bank restructuring and reform, and the public enterprise reforms. Requirements to improve transparency of public sector operations are specifically designed to improve governance in certain areas:

    - Regular independent audits of all public enterprises and regular publication of financial data;
    - Implementation of the procurement reform approved by Congress in 2002;
    - Requirements of improved data publication of all public sector operations.

F. Program Modalities and Risks

21. **Access is proposed at SDR 50 million (50 percent of quota; 40 percent on an annual basis).** The authorities consider that their foreign exchange reserves under the program will be adequate to cover their balance of payments needs, so they intend to treat the arrangement as precautionary. Access under the program would serve to safeguard reserves in the event of an adverse balance of payments shock. It would also catalyze support from other multilaterals (the World Bank and the IDB). Paraguay currently has no credit outstanding to the Fund. Upon Board approval, Paraguay will be able to draw its first credit tranche of SDR 30 million (Table 17). Each subsequent purchase would be for SDR 4 million, subject to quarterly performance criteria as described in the MEFP. Given that Paraguay has a recent history of arrears in payments to other multilateral institutions, there could be some risk of problems in future payments of obligations to the Fund. However, in the staff's view, these risks are small for the following reasons: (i) Paraguay's indebtedness to the Fund would be small (both as a share of GDP and of Central Bank reserves); (ii) overall public debt service to GDP is low; and (iii) the fiscal adjustment contemplated under the program would provide for ample resources to service Fund debt (Table 18).

22. **The program will be monitored through eight quarterly quantitative performance criteria set on fiscal, monetary, debt, and arrears targets.** There are seven structural performance criteria and four prior actions. Of these, five are on measures to improve the public sector's fiscal position; four are on measures to strengthen the banking system to restore confidence and improving domestic financial intermediation; two are on measures to strengthen central bank independence; and one is external audits in public enterprises and agencies, a critical first step to strengthening governance. Given Paraguay's history of weak governance and inconsistent policy implementation, close monitoring will be important. For this reason, the staff feels that quarterly reviews are appropriate. The reviews will, among other things, focus on assessing the implementation of structural benchmarks, all of which constitute further steps towards program objectives.

23. **Main program risks include the potential for negative external shocks, political challenges to the structural reform program, and possible delays in program financing.** While the GDP projections under the program are conservative, a drought, another outbreak of foot and mouth disease, or new regional uncertainties could depress output below the forecast, with adverse effects on the fiscal balance, the balance of payments and the banking system. As noted in paragraph 3, lack of political support for reform could also jeopardize the program. Nevertheless, the front-loading of important fiscal and structural measures and strong ownership of the program by the government should help mitigate this risk. On the other extreme, increased capital flows and higher-than-anticipated economic growth could well lead to excessive growth in monetary aggregates and cause an upturn in inflation.

24. **The program will involve continued close coordination between the Fund, the World Bank, and the IDB.** The Fund is taking the lead on the macroeconomic program, supporting Central Bank reform, and is providing advice on tax and customs administration and banking supervision. The World Bank will take the lead on banking system restructuring, public enterprise reforms, and civil service reform. The IDB is supporting customs reforms, restructuring of the public banks, procurement reform, and will be involved in the reorganization of the *caja fiscal*. The World Bank and IDB will both be involved in initiatives to improve governance and civil service reform.

III. Staff Appraisal

25. **Paraguay is attempting to emerge from a long period of macroeconomic stagnation, compounded by adverse shocks, weak economic policies, and structural rigidities.** The improved regional economic environment, a bumper harvest, and the election of a reformist government have all contributed to an improved macroeconomic outlook for 2003. It is now important to capitalize on this good start by addressing the underlying fiscal imbalance and initiating structural reforms to move the economy onto a path of sustained growth. In the staff's view, the authorities' economic program responds well to this challenge.

26. **The fiscal program relies on improved tax efficiency, broadening the tax base, and expenditure control to achieve a significant improvement in the public sector balance—from a 3 percent of GDP deficit in 2002 to a slight surplus in 2004.** The staff strongly supports this adjustment effort and welcomes the fact that it is underpinned by reforms with lasting effects (reform of public pensions, the fiscal reorganization and adjustment law, civil service reform) rather than temporary revenue enhancements or unsustainable expenditure compression. The size of the adjustment is sufficient to clear accumulated payments arrears and set public indebtedness on a clear downward trend, and should allow for gradual increases in social spending and public investment in the medium term. While encouraged by the ambitious nature of the fiscal reforms contemplated, the staff notes that it may pose challenges to the authorities in their political ability to obtain timely legislative approval for the reform laws, and in their technical ability to implement the changes quickly and effectively.

27. **Monetary policy will regain a clear focus under the program.** After moving among several objectives once Paraguay abandoned its exchange rate peg, the Central Bank policies should now be geared toward achieving the program's inflation objectives and preparing for formal inflation targeting. International reserves will continue to grow so as to maintain adequate coverage of imports and foreign exchange deposits in the banking system. The exchange rate should float freely (with intervention limited to smoothing of seasonal fluctuations), allowing Paraguay to maintain competitiveness and respond flexibly to external shocks. Of particular importance will be structural reforms of the Central Bank to enhance its transparency, efficiency, and its ability to conduct an independent monetary policy. The staff is concerned, however, about the possibility that the BCP will continue to accumulate excessive foreign exchange to the detriment of the program's inflation objectives. In particular, accumulation of reserves well beyond the targeted amounts—unless sterilized—will give rise to excessive growth of the money supply and generate inflation in nontradables.

28. **While remaining private banks are generally liquid and well-capitalized, important banking system reforms must be implemented.** The presence of branches of foreign banks adds strength to the system. However, serious concerns remain, particularly the persistent weakness of the BNF, the high rate of nonperforming loans and the large participation of unregulated cooperatives in the market. The staff welcomes the authorities' plan to address these concerns in the program by restructuring the public banks, strengthening banking supervision and regulation, requiring independent credit ratings of banks, and extending supervision and data collection to cooperatives. These measures will be key in achieving a more resilient and efficient financial sector.

29. **The staff welcomes the authorities' ambitious structural reform agenda under the program.** In particular, the changes in tax administration and customs, the public pension plan, and the central bank will provide a basis for lasting improvement in macroeconomic performance and enhance governance. However, these measures are only initial steps. In order to fully modernize its economy, Paraguay will have to continue the process of structural reform well beyond the current program. Governance will remain a major challenge, and therefore, continuing efforts to improve transparency and reduce corruption will be essential, including judicial reform. The civil service reform plan to be presented in 2004 must be implemented; public enterprises need to be opened to private investment and management; the Social Security Institute requires a profound restructuring; and an in-depth public expenditure review is needed to improve government efficiency.

30. **Sustaining the strong start made by this government in overhauling Paraguay's economy will require continued efforts at building broad domestic consensus on reform.** The authorities are actively seeking support in Congress and in civil society to assure that their policy package will not become bogged down in political infighting and special interest pressures as has happened in the past. Nevertheless, there is a risk that resistance could again scuttle the reform process. The staff encourages the authorities to combine strong leadership with intensive outreach efforts to all stake holders in order to keep the program on track.

31. **The staff supports the authorities' economic program for 2004, and recommends approval of their request for a stand-by arrangement.**

Box 1. Reforms in Tax and Customs Administration

Historically, tax and customs administration in Paraguay has been very weak. Paraguay's rate of tax evasion has been estimated at almost 50 percent despite having the lowest VAT rate in the hemisphere (10 percent, compared to an average of 23 percent of its immediate neighbors), in addition to generous exemptions. Although some of the exemptions are legitimate, many are the result of false claims for exemptions that are never verified by the tax authorities. The customs administration (where more than half of tax revenue is collected) is perceived as one of the most corrupt institutions in Paraguay. Salaries of customs officials are low, there is minimal training, and many employees obtained their posts via patronage rather than qualifications. Misdeeds have traditionally gone unpunished or languished in the courts for years with little action. These conditions, together with antiquated customs legislation and procedures, encourage a culture of inefficiency and corruption. Similar problems exist in the case of the internal taxation department, where problems have been particularly acute in the large taxpayers' unit.

The new administration under President Duarte-Frutos has embarked on a program to revamp tax and customs administration. Reformers with reputations for probity and unaffiliated with the governing Colorado party were named as heads of the Tax Department and Customs and were given the mandate and support to fully restructure the units. Among measures already taken are:

- On site inspections of almost 8,000 businesses to verify compliance with VAT procedures;
- All auditing officials (125) of the Large Taxpayer unit were removed and will be replaced;
- Large taxpayers' statements are more intensively scrutinized, with full audits for those where irregularities appear;
- Some corrupt officials are being prosecuted;
- Auditing and collection processes were streamlined;
- A tax amnesty was instituted until the end of 2003 to encourage firms to pay back taxes;
- Intermediate customs checkpoints were eliminated and access to main entry points was restricted to essential personnel;
- A pilot program for ex-post verification and risk-based examination of imports was initiated;
- Spot checks of customs officials have been instituted to ensure they are properly performing their duties—12 have been dismissed so far.

In the first three months of the new administration, tax revenues rose by 42 percent compared to the previous year. Some 0.9 percent of annual GDP in additional revenues are estimated to be the result of improved efficiency.

Planned structural reforms will further improve tax and customs administration. The draft *Fiscal Reorganization and Adjustment Law* and the new *Customs Code* (in Congress) would introduce these necessary reforms. Under the Fiscal Law, the tax authorities would receive increased resources to finance their operations, allowing them to improve incentives and increase the training level of the workforce. The authorities will also have increased powers to visit and audit establishments and impose penalties. The new *Customs Code* calls for the full digitalization of information and procedures using the currently installed SOFIA system, eliminating the need for paper documents and face-to-face transactions. It also includes rules related to Mercosur and temporary regimes that could reduce the tax evasion related to underinvoicing of goods and smuggling of goods arriving at neighboring countries and declared in transit to Paraguay.

Box 2. Fiscal Policy Measures Under the Program

Under the program, tax and expenditure policy reforms will form an important component in the fiscal adjustment contemplated. Key features include:

The Administrative Reorganization and Fiscal Adjustment Law, to be approved in 2004. The law will:

- Eliminate all exemptions to the profit tax (with a gradual phase-out of the tax holidays), while reducing the tax rate from 30 percent to 10 percent;
- Eliminate exemptions and standardize the small business tax (*'tributo único'*) and land rent tax (*'Imagro'*) to be uniform with profit tax so as to reduce distortions across the tax base.
- Introduce a personal income tax. Initially it is expected to yield very little, as those with income below 10 minimum salaries (about 95 percent of households) are exempt. However, this ceiling will gradually be lowered over time.
- Eliminate all exemptions to the VAT (more gradually for agricultural products);
- Introduce a tax on the value of automobiles (*'patente fiscal'*).
- Widen the base of the excise tax and raise tax rates from 12 percent to up to 20 percent for alcohol and tobacco products.
- Increase the operational transfer to the tax authority to 3.5 percent of tax revenues.

The 'Caja Fiscal' Law, expected to go into effect in early 2004, will generate savings by:

- Increasing contributions to the civil service pension fund by 2 percentage points to 16 percent of wages.
- Reducing benefits by increasing years of service to qualify for a full pension, reducing the replacement ratio, increasing the years of wage over on which pensions are calculated, and indexing pensions to inflation rather than wages.
- Elimination of the 13th month bonus benefit to pensioners.

The 2004 budget includes measures to:

- Increase the fuel tax by 6 percentage points. This is in addition to the diesel fuel excise tax increase of 6 percent instituted in August 2003.
- Rationalize current expenditures (nominal wages will be left unchanged, vacant posts and consultant posts will be cut, human resources will be restructured, and goods and services will be rationalized).
- Institute tighter budgets of the rest of the public sector, in large part by increasing the transfers the public entities make to the central administration. At the same time, the central administration will transfer less to autonomous government agencies.

Other measures include:

- Increasing the price of diesel fuel in July 2004 to give *Petropar* a slightly positive rate of return, and introducing thereafter biannual automatic price adjustments (relative to exchange rate and world oil price changes).
- Raising tobacco duties from 10 to 20 percent.
- Conducting a census of civil servants and public employee pensioners. The authorities expect to cover enough irregularities to significantly reduce the payroll and pension benefits.
- Administrative measures (see box 1).

Box 3. Caja Fiscal

Paraguay's existing pension system is fragmented into eight independent public institutions. About 95 percent of workers contributing to a pension system are covered by two institutions, the *Instituto de Previsión Social*, which covers private sector employees, and the *caja fiscal*, which covers civil servants, teachers, police, the military, justice employees and some non-contributory benefits, such as Chaco war veterans. All systems operate as defined benefit, pay-as-you-go schemes, and together cover less than 8 percent of the labor force.

The *caja fiscal* has been running large operational deficits. In 2002, the deficit amounted to 1.9 percent of GDP, about 60 percent of which is due to pension payments to Chaco war veterans and their survivors. Retirement ages as low as 40 and high replacement rates, applied on the last wage, contribute to the large deficits. The generosity of the pension system is aggravated by the lack of transparency on the legitimacy of claims, especially concerning Chaco war benefits. Although systematic evidence is not available, there is anecdotal evidence of widespread fraud, possibly of the order of 30 to 40 percent of claims.

An ambitious proposal to overhaul the *caja fiscal* was presented to Congress in October. The reform seeks to achieve long-term financial viability by (i) increasing contributions by two percentage points to 16 percent; (ii) broadening the definition of wages over which contributions are computed; (iii) raising the ordinary retirement age to 62 and the early retirement age to 50 years; (iv) computing the pension over the average of the last 10 years' wages (adjusted for inflation) rather than over the last wage; (v) indexing pension growth to inflation rather than to wage growth; (vi) reducing the replacement ratio somewhat; and (vii) explicitly eliminating the year-end bonus payments (*aguinaldo*) for all but Chaco war veterans. In addition to this legislative reform, the government has commissioned an in-depth external audit of the registry of beneficiaries, with a view of eliminating fraudulent claims.

The reform is expected to put the *caja fiscal* on a solid financial footing. In 2004, the reform law will generate net savings for about 0.3 percent of GDP, while the audit will yield additional savings for 0.1 percent of GDP. The reforms will generate substantially higher savings in future years, although an actuarial analysis is pending to assess whether the reform will assure the long-term financial viability of the *caja fiscal*. The relatively young demographic profile of Paraguay may mean that further reform could be needed as the working population ages. Maintaining over time an updated database of pension claims and ensuring the financing of Chaco war pensions will be critical to such viability.

Box 4. The Banking System

The banking system consists of seven foreign banks, six majority foreign-owned banks, two domestic private banks, and a public development bank (BNF). There are a number of small finance companies, exchange houses, and deposit receipt warehouses. In addition, there are a number of cooperatives that act as financial intermediaries, but there is little data on their scope and they are not controlled by the Bank Superintendency. Banks dominate the financial system with about 90 percent of total assets. Foreign banks hold about 49 percent of total assets in the banking system and the majority foreign-owned banks hold 38 percent. The system is highly dollarized, with about 64 percent of deposits and 54 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.

Paraguay experienced successive rounds of banking crisis in 1995, 1997, 1998, 2002, and 2003. The financial liberalization undertaken by Paraguay in the 1990s without adequate banking regulation and supervision, lack of essential banking skills and high level of insider lending, loan concentration, and fraud led to the banking crises of the 1995–98. In June 2002, contagion from the Argentine crisis caused the closure of the country's third-largest bank, *Banco Alemán*, with about 11 percent of banking system assets. More recently, a locally owned bank (Multibanco, with 5 percent of banking system assets) was closed due to illegal operations. Three banks are also voluntarily closing operations, reflecting both the desire of some banks to reduce their exposure in the region and the weak economic environment in Paraguay in 2002 and early 2003..

Loan performance deteriorated in 2003, reflecting the economic slowdown. Excluding the public bank (BNF), the aggregate nonperforming loan (NPL) ratio increased to 17.5 percent in September 2003 (Table 12). Profitability in the banking system has also suffered, with returns on assets and equity declining significantly since December 2001. Credit to the private sector has declined sharply in response to the difficult economic situation and banking sector vulnerabilities.

There are 18 finance companies (*financieras*) in Paraguay with about 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 18). In June 2003, one *financiera* was intervened. As with banks, NPLs in *financieras* have steadily increased from 10.7 percent in December 2001 to 12.3 percent in September 2003. The rate of return on assets has followed a downward trend, falling from 5.1 percent in December 2001 to 1.7 percent in September 2003.

Table 1. Paraguay: Selected Economic Indicators, 1999–2004

				Est.	Proj.	
	1999	2000	2001	2002	2003	2004
	(Annual percent change)					
National accounts and prices						
GDP at current prices	3.0	11.5	4.4	13.7	16.7	9.3
GDP at constant prices	0.5	-0.4	2.7	-2.3	2.0	2.4
Consumption	-3.6	0.8	6.2	-5.1	2.8	2.4
Investment	-3.8	-0.7	-17.5	-11.0	-4.6	7.6
Net exports (contribution to growth)	4.8	-0.9	0.4	4.4	0.0	-0.8
Exports	-27.0	-15.1	-0.4	14.3	2.3	0.2
Imports	-27.1	-6.7	-1.6	-6.3	1.5	3.0
GDP deflator	2.5	11.9	1.7	16.4	14.3	6.7
Consumer prices (average)	6.8	9.0	7.3	10.5	14.1	7.5
Consumer prices (end-of-period)	5.4	8.6	8.4	14.6	8.8	8.0
Real effective exchange rate						
Average (depreciation -)	6.4	-3.1	-1.5	-3.9	...	...
End-of-period (depreciation -)	2.4	4.3	-12.5	-6.6	...	...
	(In millions of U.S. dollars)					
External sector						
Exports, f.o.b.	2,307	2,322	1,876	1,878	2,102	2,111
Imports, c.i.f.	2,750	2,864	2,495	2,159	2,339	2,398
Current account	-165	-163	-278	92	83	26
(in percent of GDP)	-2.1	-2.1	-4.0	1.7	1.4	0.4
Capital account	509	157	152	5	-308	116
Overall balance	87	-254	-50	-123	75	141
Terms of trade (deterioration -)	2.3	-4.6	-0.1	7.4	5.9	-4.8
	(In percent of GDP)					
Public sector						
Central government primary balance	-2.8	-3.1	0.2	-1.7	1.0	1.5
Central government overall balance	-3.6	-4.3	-1.1	-3.1	-0.3	0.2
Consolidated public sector primary balance 1/	-1.8	-2.6	1.0	-1.3	1.2	2.2
Consolidated public sector overall balance 1/	-3.1	-4.0	-0.7	-3.2	-0.6	0.3
Public sector external debt (end-of-year)	28.9	30.6	33.5	42.9	44.3	40.5
Domestic public sector debt 3/	3.1	3.4	4.9	6.8	4.8	5.3
	(Annual percent change)					
Money and credit						
Monetary base	9.5	-1.3	5.8	-1.0	49.9	3.2
M2	10.7	2.2	4.9	-2.2	19.0	17.0
M5 3/	6.4	-0.1	1.5	-18.5	18.4	14.4
Net foreign assets 4/	13.1	-5.4	-5.5	-12.8	25.2	4.8
Net domestic assets 4/	-6.7	5.3	7.0	-5.6	-6.8	9.6
Credit to the public sector 4/	-9.0	2.3	3.5	5.2	2.5	0.7
Credit to the private sector 4/	1.3	-0.8	-0.7	-14.9	-10.7	6.3
Velocity of M2	6.6	7.2	7.2	8.3	8.2	7.6
Memorandum items:						
International reserves (in millions of U.S. dollars)	988	772	723	641	818	855
(in months of imports)	3.6	3.2	3.5	2.8	3.7	3.5
GDP (in billions of guaranies)	24,144	26,921	28,119	31,977	37,302	40,779

Sources: Paraguayan authorities; and Fund staff estimates.

1/ Consolidated public sector, including the quasi-fiscal operations of the BCP.
2/ Includes use of deposits.
3/ Foreign currency items are valued at a constant exchange rate.
4/ Contribution to M5 growth.

Table 2. Paraguay: International Comparison: Indicators of Governance

	Voice and Accountability		Political Stability		Government Effectiveness		Regulatory Quality		Rule of Law		Control of Corruption	
	1998	2002	1998	2002	1998	2002	1998	2002	1998	2002	1998	2002
Paraguay	41	32	35	15	9	7	35	31	23	12	9	4
Uruguay	68	78	63	80	79	69	84	67	70	69	75	76
Brazil	64	58	31	48	48	50	58	63	57	50	69	57
Bolivia	60	50	47	37	55	35	82	51	47	33	42	25
Argentina	60	53	64	24	74	38	81	20	68	28	60	28
Regional averages												
Latin America and the Caribbean	61	61	45	51	50	53	65	58	50	53	51	55
OECD	91	91	88	87	92	92	90	92	92	92	93	91
Sub-Saharan Africa	34	31	33	35	35	29	33	31	32	31	32	32
Eastern Europe	56	65	57	61	52	58	58	63	55	57	56	55
Former Soviet Union	28	23	38	31	22	22	18	25	22	20	18	17
East Asia	50	50	56	55	50	51	41	43	46	48	48	44
South Asia	32	30	27	32	44	48	46	35	40	42	46	41
Middle East and North Africa	29	29	49	40	53	50	45	45	62	54	56	55

Source: D. Kaufmann, A. Kraay, and M. Mastruzzi 2003: Governance Matters III: Governance Indicators for 1996-2002.

Note: Each entry in the table indicates percent of countries worldwide that are below the selected country or region.
Higher scores indicate better governance outcome.

Table 3. Paraguay: International Comparisons: Social Indicators

	Paraguay	Uruguay	Brasil	Bolivia	Argentina	Latin America and the Caribbean
Rank in UNDP Human Development Index	84	40	65	114	34	...
GDP per-capita in PPP U.S. dollars	5,210	8,400	7,360	2,300	11,320	7,234
People not expected to survive to age 40 (in percent of total population)	8.0	4.4	11.5	16.0	5.1	9.7
Life expectancy at birth (years)	70.9	75.3	67.8	63.3	73.9	70.0
Infant mortality (per 1,000 live births)	26	14	31	60	16	30
Population without access to safe water (percent)	22	2	13	17	...	22
Per-capita health expenditure in PPP U.S. dollars (2000)	323	1,007	631	145	1,091	...
Physicians per 100,000 people (1990-2002)	117	375	158	130	294	...
Adult illiteracy (in percent of age and above)	6.5	2.4	12.7	14.0	3.1	11.7
Primary school rate enrollment (2000-2001) (percent of population at relevant age)	92.0	90.0	97.0	97.0	107.0	93.3
Secondary school net enrollment (2000-2001) (percent of population at relevant age)	47.0	70.0	71.0	68.0	79.0	65.3
Ratio of the per-capita income of the richest (1998)						
Richest 10 percent to poorest 10 percent	91.1	21.6	65.8	24.6	...	...
Richest 20 percent to poorest 20 percent	31.8	11.2	29.7	12.3	...	...
Gini index (World Development Report)	57.7	44.8	60.7	44.7	...	...

Source: UNDP Human Development Report 2003.

Table 4. Paraguay: GDP and Prices

	1999	2000	2001	2002	Projected 2003	2004
			I. National Accounts			
			(In annual percentage change)			
Real GDP	0.5	-0.4	2.7	-2.3	2.0	2.4
Consumption	-3.6	0.8	6.2	-5.1	2.8	2.4
Investment	-3.8	-0.7	-17.5	-11.0	-4.6	7.6
Exports	-27.0	-15.1	-0.4	14.3	2.3	0.2
Imports	-27.1	-6.7	-1.6	-6.3	1.5	3.0
			(In percent of GDP)			
Gross domestic investment	23.0	21.8	19.8	19.1	18.5	18.9
Private	11.8	14.9	14.7	13.2	13.6	13.3
Public	11.2	7.0	5.1	5.9	4.9	5.6
Gross national savings	20.9	19.7	15.8	20.7	19.9	19.3
Private	18.9	20.7	14.6	19.8	17.5	15.5
Public	2.0	-1.0	1.2	0.9	2.4	3.8
			II. Prices			
			(In annual percentage change)			
GDP deflator	2.5	11.9	1.7	16.4	14.3	6.7
Consumer prices:						
End-of-period	5.4	8.6	8.4	14.6	8.8	8.0
Period average	6.8	9.0	7.3	10.5	14.1	7.5
Guarani/US$ exchange rate						
End-of-period	16.7	6.9	30.7	51.0	...	...
Period average	15.0	11.8	17.8	38.4	...	...
Memorandum items:						
Real GDP per capita (percentage change)	-2.0	-2.8	0.3	-4.6	-0.7	-0.3
Population (percentage change)	2.7	2.6	2.5	2.5	2.7	2.7
GDP (in billions of guaranies)	24,144	26,921	28,119	31,977	37,302	40,779
GDP (in millions of U.S. dollars)	7.756	7.734	6.858	5.633	5.731	6.117

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

Table 5. Paraguay: Central Government Operations

	2000	2001	2002	Proj. 2003	2004 Baseline	Q1	Q2	Q3	Q4	Prog.
	(In billion of guaraníes)									
Total revenues	**4,214**	**4,892**	**5,048**	**5,877**	**6,171**	**1,466**	**1,594**	**1,791**	**1,943**	**6,794**
Tax revenues	2,677	2,851	2,923	3,683	3,846	938	1,026	1,158	1,258	4,379
Value added tax	1,150	1,204	1,235	1,462	1,590	376	409	507	517	1,809
Nontax revenues 1/	1,453	1,983	2,118	2,190	2,322	527	568	632	684	2,412
Capital revenues	84	57	7	4	3	1	0	1	1	3
Current expenditures:	**4,369**	**4,378**	**4,766**	**4,998**	**5,553**	**1,125**	**1,270**	**1,308**	**1,632**	**5,335**
Wages and salaries	2,401	2,400	2,582	2,728	2,938	643	664	679	895	2,882
Goods and services	420	295	373	426	540	43	129	139	193	505
Interest payments	312	378	456	478	579	150	131	143	138	562
Transfers 2/	1,196	1,270	1,326	1,341	1,466	287	343	310	364	1,303
Of which: Pensions and benefits	797	879	913	937	1,009	230	234	211	224	898
Other	39	35	29	26	30	2	3	37	41	83
Capital expenditures and net lending	**994**	**831**	**1,281**	**1,001**	**1,431**	**93**	**246**	**363**	**694**	**1,395**
Of which:										
Net lending	97	-80	-6	-90	-41	6	-1	-19	-27	-41
Primary balance	-836	60	-543	356	-233	398	209	263	-244	626
Overall balance	**-1,149**	**-318**	**-999**	**-122**	**-813**	**248**	**78**	**120**	**-383**	**64**
	(In percent of GDP)									
Total revenues	**15.7**	**17.4**	**15.8**	**15.8**	**14.5**	**3.6**	**3.9**	**4.4**	**4.8**	**16.7**
Tax revenues	9.9	10.1	9.1	9.9	9.0	2.3	2.5	2.8	3.1	10.7
Income taxes	1.8	1.7	1.4	1.6	1.6	0.2	0.4	0.1	0.2	1.0
Excises	1.6	2.0	1.9	2.2	2.1	0.7	0.7	0.9	0.9	3.2
Value added tax	4.3	4.3	3.9	3.9	3.7	0.9	1.0	1.2	1.3	4.4
Import duties	1.8	1.8	1.6	2.0	1.3	0.4	0.4	0.4	0.5	1.7
Other	0.5	0.4	0.4	0.3	0.3	0.1	0.0	0.2	0.2	0.5
Nontax revenues 1/	5.4	7.1	6.6	5.9	5.5	1.3	1.4	1.5	1.7	5.9
Of which: Public pension contributions	1.1	1.1	1.0	0.8	0.8	0.2	0.2	0.2	0.3	0.9
Itaipu-Yacyreta	2.5	4.1	3.9	3.7	3.4	0.8	0.8	0.9	0.9	3.4
Capital revenues	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current expenditures, *of which:*	**16.2**	**15.6**	**14.9**	**13.4**	**13.0**	**2.8**	**3.1**	**3.2**	**4.0**	**13.1**
Wages and salaries	8.9	8.5	8.1	7.3	6.9	1.6	1.6	1.7	2.2	7.1
Goods and services	1.6	1.1	1.2	1.1	1.3	0.1	0.3	0.3	0.5	1.2
Interest payments	1.2	1.3	1.4	1.3	1.4	0.4	0.3	0.4	0.3	1.4
Transfers	4.4	4.5	4.1	3.6	3.4	0.7	0.8	0.8	0.9	3.2
Of which: Public pensions and benefits	3.0	3.1	2.9	2.5	2.4	0.6	0.6	0.5	0.5	2.2
Other	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.1	0.1	0.2
Capital expenditures and net lending	**3.7**	**3.0**	**4.0**	**2.7**	**3.4**	**0.2**	**0.6**	**0.9**	**1.7**	**3.4**
Primary balance	-3.1	0.2	-1.7	1.0	-0.5	1.0	0.5	0.6	-0.6	1.5
Overall balance	**-4.3**	**-1.1**	**-3.1**	**-0.3**	**-1.9**	**0.6**	**0.2**	**0.3**	**-0.9**	**0.2**
Statistical discrepancy	1.4	-3.2	0.8	-0.3	...	...	...	...	...	...
Financing	**2.9**	**4.4**	**2.3**	**0.6**	**1.9**	**-0.6**	**-0.2**	**-0.3**	**0.9**	**-0.2**
External debt (increase +)	1.7	-0.1	0.4	0.6	0.3	0.2	0.2	-0.2	1.4	1.5
Disbursements	2.9	1.3	2.3	2.1	0.3	0.7	0.7	0.5	1.9	3.8
Amortizations 2/	1.2	1.4	1.9	1.6	0.3	0.5	0.5	0.7	0.5	2.2
Domestic bonds (increase +)	-0.5	1.9	-0.1	-0.2	-2.3	0.0	0.0	-0.1	0.0	-0.1
Net credit from the banking system	2.1	0.7	-0.1	0.4	0.0	-0.4	0.0	0.4	-0.3	-0.4
Exceptional Financing (incl. change in arrears) 2/	-0.4	1.9	2.1	-0.3	3.9	-0.3	-0.3	-0.4	-0.1	-1.2
Memorandum Item:										
Balance of the Caja Fiscal 3/	-497	-566	-603	-624	-665	-167	-147	-109	-96	-518
(in percent of GDP)	-1.8	-2.0	-1.9	-1.7	-1.6	-0.4	-0.4	-0.3	-0.2	-1.3

Sources: Ministry of Finance; and Fund staff estimates.

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

2/ In 2004, includes payments of ESSAP (water and sewage company) external obligations.

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

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

					Projections		
						2004	
	1999	2000	2001	2002	2003	Baseline	Program
(In billions of guaranies)							
Revenue	**1,105**	**1,190**	**1,092**	**1,111**	**1,448**	**1,648**	**1,484**
Tax revenue	0	4	3	3	4	6	6
Nontax revenue and grants net of transfers to CG	930	935	953	998	1,288	1,445	1,293
Capital revenue	174	251	135	109	156	197	185
Current expenditure	**841**	**961**	**1,086**	**997**	**1,183**	**1,300**	**1,288**
Wages and salaries	467	519	528	513	573	649	623
Goods and services	184	247	207	199	225	256	247
Interest payments	119	84	107	147	203	214	214
Transfers	54	88	70	128	168	165	188
Other	16	23	174	10	14	16	15
Capital expenditure and net lending	**1,402**	**887**	**599**	**594**	**791**	**914**	**836**
Primary balance	**227**	**144**	**227**	**125**	**92**	**-95**	**255**
Public enterprises' operating surplus 2/	**1,246**	**718**	**712**	**458**	**416**	**257**	**680**
Overall balance	**108**	**60**	**120**	**-22**	**-110**	**-309**	**41**
(In percent of GDP)							
Revenue	**4.6**	**4.4**	**3.9**	**3.5**	**3.9**	**4.0**	**3.6**
Tax revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nontax revenue and grants	3.9	3.5	3.4	3.1	3.5	3.5	3.2
Capital revenue	0.7	0.9	0.5	0.3	0.4	0.5	0.5
Current expenditure	**3.5**	**3.6**	**3.9**	**3.1**	**3.2**	**3.2**	**3.2**
Wages and salaries	1.9	1.9	1.9	1.6	1.5	1.6	1.5
Goods and services	0.8	0.9	0.7	0.6	0.6	0.6	0.6
Interest payments	0.5	0.3	0.4	0.5	0.5	0.5	0.5
Transfers	0.2	0.3	0.2	0.4	0.4	0.4	0.5
Other	0.1	0.1	0.6	0.0	0.0	0.0	0.0
Capital expenditure and net lending	**5.8**	**3.3**	**2.1**	**1.9**	**2.1**	**2.2**	**2.0**
***Of which*:**							
Net lending by the central bank	-0.3	0.1	0.1	0.5	0.1	0.0	-0.1
Primary balance	**0.9**	**0.5**	**0.8**	**0.4**	**0.2**	**-0.2**	**0.6**
Public enterprises' operating surplus	**5.2**	**2.7**	**2.5**	**1.4**	**1.1**	**0.6**	**1.7**
Overall balance	**0.4**	**0.2**	**0.4**	**-0.1**	**-0.3**	**-0.8**	**0.1**
Statistical discrepancy	-2.7	1.7	0.6	-0.7	0.4	...	...
Identified Financing	**2.3**	**-1.9**	**-1.1**	**0.8**	**-0.1**	**0.8**	**-0.1**

Sources: Ministry of Finance; and Fund staff estimates.

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

2/ Assumes quasi fiscal deficit of central bank entirely financed. Excludes quasi-fiscal loss from payments of Multibanco depositors for G123.1 billion.

Table 7. Paraguay: Operations of the Consolidated Public Sector 1/

	2000	2001	2002	Prog. 2003	2004 Baseline	Q1	Q2	Q3	Q4	Prog.
			(In billions of Guaranies)							
Revenue	**5,404**	**5,984**	**6,160**	**7,325**	**7,841**	**1,823**	**2,021**	**2,150**	**2,313**	**8,306**
Tax revenue	2,680	2,855	2,926.9	3,687	3,851	939	1,027	1,159	1,259	4,384
Nontax revenue and grants	2,388	2,936	3,117	3,478	3,767	847	890	954	1,016	3,705
Capital revenue	336	193	116	160	223	38	104	38	38	217
Current expenditure	**5,330**	**5,464**	**5,763**	**6,181**	**6,852**	**1,433**	**1,592**	**1,630**	**1,968**	**6,623**
Wages and salaries	2,920	2,928	3,095	3,301	3,587	797	820	832	1,055	3,505
Goods and services	667	503	572	651	796	103	190	200	258	752
Interest payments	397	485	603	680	794	195	183	200	199	776
Transfers	1,285	1,340	1,455	1,508	1,631	333	391	357	410	1,492
Other	62	209	39	40	45	5	7	40	45	98
Capital expenditure and net lending	**1,881**	**1,430**	**1,875**	**1,792**	**2,345**	**287**	**463**	**573**	**907**	**2,231**
Primary balance	**-692**	**287**	**-418**	**448**	**-305**	**458**	**274**	**344**	**-166**	**909**
Public enterprises' operating surplus	**718**	**712**	**458**	**416**	**257**	**160**	**125**	**197**	**197**	**680**
Overall balance	**-1,089**	**-198**	**-1,021**	**-232**	**-1,099**	**263**	**91**	**144**	**-365**	**133**
			(In percent of GDP)							
Revenue	**20.1**	**21.3**	**19.3**	**19.6**	**18.4**	**4.5**	**5.0**	**5.3**	**5.7**	**20.4**
Tax revenue	10.0	10.2	9.2	9.9	9.0	2.3	2.5	2.8	3.1	10.8
Nontax revenue and grants	8.9	10.4	9.7	9.3	8.8	2.1	2.2	2.3	2.5	9.1
Capital revenue	1.2	0.7	0.4	0.4	0.5	0.1	0.3	0.1	0.1	0.5
Current expenditure	**19.8**	**19.4**	**18.0**	**16.6**	**16.1**	**3.5**	**3.9**	**4.0**	**4.8**	**16.2**
Wages and salaries	10.8	10.4	9.7	8.9	8.4	2.0	2.0	2.0	2.6	8.6
Goods and services	2.5	1.8	1.8	1.7	1.9	0.3	0.5	0.5	0.6	1.8
Interest payments	1.5	1.7	1.9	1.8	1.9	0.5	0.4	0.5	0.5	1.9
Transfers	4.8	4.8	4.5	4.0	3.8	0.8	1.0	0.9	1.0	3.7
Other	0.2	0.7	0.1	0.1	0.1	0.0	0.0	0.1	0.1	0.2
Capital expenditure and net lending 2/	**7.0**	**5.1**	**5.9**	**4.8**	**5.5**	**0.7**	**1.1**	**1.4**	**2.2**	**5.5**
Primary balance	**-2.6**	**1.0**	**-1.3**	**1.2**	**-0.7**	**1.1**	**0.7**	**0.8**	**-0.4**	**2.2**
Public enterprises' operating surplus	**2.7**	**2.5**	**1.4**	**1.1**	**0.6**	**0.4**	**0.3**	**0.5**	**0.5**	**1.7**
Overall balance	**-4.0**	**-0.7**	**-3.2**	**-0.6**	**-2.6**	**0.6**	**0.2**	**0.4**	**-0.9**	**0.3**
Statistical discrepancy	3.1	-2.6	0.1	0.1						
Identified financing 3/	**1.0**	**3.3**	**3.1**	**0.5**	**2.6**	**-0.6**	**-0.2**	**-0.4**	**0.9**	**-0.3**
Memorandum item:										
Overall balance of the social security system (in percent of GDP)	0.3	0.6	0.8	0.7	0.5	0.1	0.1	0.1	0.1	0.5

Sources: Ministry of Finance; and Fund staff estimates.

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

2/ Includes social spending funded by project loans.

3/ Assumes quasi-fiscal deficit of central bank entirely financed. Excludes quasi-fiscal loss from payments of *Multibanco* depositors for G123.1 billion.

Table 8. Paraguay: Summary of Monthly Stock of Arrears
(In millions of U.S. dollars)

	Dec. 2002	2003 Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	September Total	September Adj. 1/
Total public sector arrears	**236**	**217**	**278**	**215**	**203**	**194**	**218**	**226**	**192**	**187**	**146**
(in percent of GDP)	**4.2**	**3.8**	**4.9**	**3.8**	**3.5**	**3.4**	**3.8**	**3.9**	**3.3**	**3.3**	**2.6**
Central government	**155**	**160**	**167**	**170**	**157**	**151**	**175**	**180**	**139**	**127**	**90**
Domestic	98	99	90	130	123	121	121	133	80	58	44
Of which: bonds 2/	22.8	22.5	22.3	19.8	16.4	14.3	14.3	14.3	14.3	14.3	0.0
External 3/	57.5	60.6	76.8	39.4	33.4	30.0	53.9	48	59.6	68.3	45.8
Of which:											
Multilateral	21.3	18.3	26.6	10.5	1.4	0.9	15.0	0.0	0.0	4.1	0.0
World Bank	11.2	4.9	12.2	4.0	1.1	0.6	9.1	0.0	0.0	0.0	0.0
IDB	10.1	13.4	14.4	6.5	0.3	0.3	5.9	0.0	0.0	4.1	0.0
Rest of public sector	**81**	**57**	**111**	**46**	**47**	**43**	**43**	**45**	**52**	**60**	**57**
Domestic	0	0	0	0	0	0	0	0	0	0	0
External	81	57	111	46	47	43	43	45	52	60	57
Of which:											
PETROPAR arrears to foreign suppliers over 90 days	70	45	45	30	30	30	30	35	40	44	44
ESSAP arrears 4/										8.5	8.5
Memorandum items:											
Central government total debt service	216	21	15	14	9	15	21	21	6	2	...
Annual GDP	5,633	5,731	5,731	5,731	5,731	5,731	5,731	5,731	5,731	5,731	...

1/ The program considers as arrears: (i) all payments past due over 30 days; (ii) nondisputed arrears; and (iii) domestic arrears which exclude 'normal' floating debt (about (US$40 million)
2/ An agreement has been reached to pay all remaining arrears on Treasury bonds on November 15.
3/ Includes about US$14 million in disputed arrears, except for the last column (see footnote 1).
4/ Assumed to be paid by the central government under the program.

Table 9. Paraguay: Public Sector Financing
(In milllions of U.S. dollars unless otherwise stated)

	2003						2004					
				Proj.	Total		Projections					
	Q1	Q2	Q3	Q4	(mln US$)	(in % of GDP)	Q1	Q2	Q3	Q4	(mln US$)	(in % of GDP)
Gross financing requirements	**31**	**97**	**16**	**279**	**423**	**7.4**	**30**	**67**	**74**	**117**	**288**	**4.7**
Deficit below the line 1/	-27	68	-43	29	27	0.5	-40	-14	-21	54	-21	-0.3
Of which: statistical discrepancy 2/	-41	56	-23	...	-8	-0.1	...	...	...	...	...	...
Domestic debt amortizations	0	0	4	103	107	1.9	0	0	9	0	9	0.1
External debt amortizations 3/	37	32	24	40	133	2.3	37	45	51	47	180	2.9
Net reduction in arrears	21	-2	31	-13	37	0.6	32	36	36	15	120	2.0
Stock of arrears to be cleared	...	...	...	120	120	2.1	...	...	...	...	...	...
Identified financing	**31**	**97**	**16**	**46**	**189**	**3.3**	**0**	**52**	**74**	**77**	**203**	**3.3**
NFPS net credit from banking system (use of deposits)	-7	48	-31	10	21	0.4	-19	14	30	-15	10	0.2
Financing of the quasi-fiscal deficit	11	16	13	9	50	0.9	7	8	9	9	33	0.5
Project lending	27	32	34	26	119	2.1	12	29	36	83	160	2.6
Financing gap	**0**	**0**	**0**	**233**	**233**	**4.1**	**30**	**15**	**0**	**40**	**85**	**1.4**
Program financing	**0**	**0**	**0**	**233**	**233**	**4.1**	**30**	**15**	**0**	**40**	**85**	**1.4**
Exchange of maturing treasury bonds 4/	0	0	0	98	98	1.7	0	0	0	0	0	0.0
Program lending	0	0	0	15	15	0.3	30	15	0	40	85	1.4
IDB	0	0	0	15	15	0.3	0	15	0	15	30	0.5
World Bank	0	0	0	0	0	0.0	30	0	0	25	55	0.9
Deferral of arrears under program	...	...	...	120	120	2.1	...	...	...	...	...	...
of which: external arrears 5/	...	...	...	102	102	1.8	...	...	...	...	...	...
Residual Financing gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Memorandum item:												
Exchange rate revaluations of Treasury bonds	32	-25	12	...	...	...	...	...	...	...	...	...

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes measures under the program.
2/ Is equal to the difference in measurement of the fiscal deficit above the line and below the line.
3/ Includes amortizations of the financial public sector guaranteed by the Republic of Paraguay.
4/ Part of the rollover of US$138 million in maturing domestic bonds on November 15.
5/ The authorities are seeking forbearance from their external creditors (including from the Paris Club) for this deferral.

Table 10. Paraguay: Monetary Program—Central Bank Balance Sheet
(In billions of guaranies; end-of-period; valued at constant exchange rate)

	Dec.			2004			
	2001	2002	2003	Mar.	Jun.	Sep.	Dec.
Net international reserves	**4,541**	**4,027**	**5,137**	**4,785**	**5,250**	**5,162**	**5,369**
(in millions of U.S. dollars)	723	641	818	762	836	822	855
Program NDA targets	**...**	**...**	**-2,890**	**-2,770**	**-3,085**	**-3,055**	**-2,761**
Net domestic assets (calculated)	**-2,879**	**-2,329**	**-2,898**	**-2,783**	**-3,089**	**-3,055**	**-2,761**
Net nonfinancial public sector	1,176	1,507	1,578	1,385	1,387	1,527	1,438
Net credit to the general government	979	1,291	1,363	1,170	1,172	1,312	1,223
Central Government	978	1,291	1,363	1,170	1,171	1,311	1,222
Credit	1,849	1,938	1,986	1,986	1,986	1,986	1,986
Deposits	871	647	623	816	815	675	764
Rest of general government	1	1	1	1	1	1	1
Credit	1	1	1	1	1	1	1
Deposits	0	0	0	0	0	0	0
Net credit to public enterprises	197	216	215	215	215	215	215
Credit	201	218	232	232	232	232	232
Deposits	4	2	17	17	17	17	17
Net credit to the financial system	-1,139	-485	-1,177	-1,149	-1,178	-1,121	-1,074
Credit	1,308	1,443	1,502	1,502	1,502	1,502	1,502
Deposits	2,446	1,928	2,678	2,651	2,680	2,623	2,576
Net credit to the banking system	-2,293	-1,814	-2,473	-2,445	-2,474	-2,417	-2,370
Total credit to banks	7	4	87	87	87	87	87
Loans and liquidity (+ active call)	0	0	0	0	0	0	0
Other loans to banks	7	4	87	87	87	87	87
Deposits and reserve requirements	2,300	1,818	2,559	2,532	2,561	2,504	2,457
Net credit to the rest of financial entities	1,154	1,328	1,296	1,296	1,296	1,296	1,296
Credit	1,301	1,439	1,415	1,415	1,415	1,415	1,415
Deposits	147	111	119	119	119	119	119
Net credit to the private sector	-63	-87	-103	-103	-103	-103	-103
Credit	28	32	35	35	35	35	35
Deposits and liabilities	0	0	0	0	0	0	0
Restricted deposits	91	120	138	138	138	138	138
Open market operations (LRM and passive call)	297	677	888	653	1,045	1,282	1,045
Medium- and long-term external liabilities	376	460	441	441	423	423	405
Capital and reserves	1,584	2,941	2,695	2,625	2,555	2,485	2,415
Provisions	1,064	1,108	1,102	1,102	1,102	1,102	1,102
Other assets net	469	1,922	1,930	1,906	1,931	1,935	1,945
Currency issue	**1,662**	**1,699**	**2,239**	**2,002**	**2,161**	**2,107**	**2,608**
Growth	6.8	2.2	31.8	29.6	25.0	20.0	16.5

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

Table 11. Paraguay: Summary Accounts of the Banking System Under the Program

(End-of-period; valued at constant exchange rate)

	1999	2000	2001	2002	2003	2004
	(In billions of guaranies)					
	I. Central Bank					
Net external assets	6,206	4,848	4,541	4,027	5,137	5,369
(in millions of U.S. dollars)	988	772	723	641	818	855
Net domestic assets	**-4,618**	**-3,291**	**-2,879**	**-2,329**	**-2,898**	**-2,761**
Credit to public sector, net	181	799	1,176	1,507	1,578	1,438
Credit to banking system, net 1/	-2,368	-2,332	-2,293	-1,814	-2,473	-2,370
Credit	5	7	7	4	87	87
Deposits	2,373	2,339	2,300	1,818	2,559	2,457
Central bank securities	-76	-46	-297	-677	-888	-1,045
Other	-2,355	-1,713	-1,464	-1,345	-1,116	-784
Currency issued	**1,587**	**1,557**	**1,662**	**1,699**	**2,239**	**2,608**
	II. Monetary Survey					
Net external assets	**8,086**	**7,503**	**6,907**	**5,497**	**7,759**	**8,267**
(in millions of U.S. dollars)	1,288	1,195	1,100	875	1,236	1,316
Net domestic assets	**2,756**	**3,331**	**4,093**	**3,473**	**2,864**	**3,883**
Credit to the public sector	-275	-21	358	932	1,160	1,233
Credit to the private sector	8,038	7,951	7,872	6,230	5,272	5,939
Other	-5,006	-4,599	-4,137	-3,689	-3,568	-3,290
Broad liquidity (M5)	**10,842**	**10,834**	**11,000**	**8,970**	**10,623**	**12,150**
Money market funds	0	0	0	0	0	0
Broad liquidity (M4)	10,842	10,834	11,000	8,970	10,623	12,150
Bonds and issued securities	22	23	50	135	31	35
Other monetary liabilities	18	70	16	15	5	5
Central bank securities with private sector	18	8	121	281	497	585
Broad liquidity (M3)	10,785	10,733	10,813	8,539	10,090	11,524
Foreign currency deposits	7,123	6,991	6,886	4,699	5,519	6,176
Money and quasi-money (M2)	3,662	3,742	3,926	3,839	4,570	5,348
Quasi-money	1,561	1,326	1,306	1,198	1,252	1,438
Money (M1)	2,101	2,416	2,621	2,641	3,319	3,910
	(Annual percentage change)					
M0 (Currency issued)	12.7	-1.9	6.8	2.2	31.8	16.5
Credit to the private sector	1.7	-1.1	-1.0	-20.9	-15.4	12.7
M1	9.5	15.0	8.5	0.8	25.6	17.8
M2	10.7	2.2	4.9	-2.2	19.0	17.0
M3	8.5	-0.5	0.7	-21.0	18.2	14.2
Of which: foreign currency deposits	7.4	-1.9	-1.5	-31.8	17.4	11.9
Memorandum items:						
Ratio of foreign currency deposits to M3 (percent)	66.0	65.1	63.7	55.0	54.7	53.6
Ratio of foreign currency deposits to private sector deposits in banks (in percent)	75.6	73.6	72.5	64.9	66.7	66.2

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 12. Paraguay: Evolution of Banking System Indicators

	1999	2000	2001	2002	2003 Mar.	Jun.	Sep.
Total banking system excluding BNF							
Share in assets	87.3	88.6	90.8	92.0	92.4	92.8	93.0
Capital adequacy ratio (percent)	17.2	17.1	16.2	17.9	20.6	21.2	19.8
NPLs (percent) total loans	9.3	12.0	12.3	14.7	17.5	16.2	17.5
Provisions (percent) NPLs	45.1	39.2	39.8	50.2	46.8	51.3	49.2
Rate of return on assets (ROA)	2.5	1.7	2.4	1.5	1.7	0.8	1.2
Rate of return on equity (ROE)	22.7	14.6	24.1	14.3	15.1	7.6	12.0
Liquid assets (percent) of total assets 1/	25.3	22.3	23.2	25.7	27.3	32.7	34.2
Government bond portfolio in assets	3.6	2.2	2.5	4.5	5.4	5.0	5.3
Foreign exchange deposits in percent of total	64.2	62.8	68.0	70.2	67.9	65.9	65.9
Total foreign banks							
Share in assets	48.3	47.0	45.1	48.4	48.3	49.8	48.8
Capital adequacy ratio (percent)	17.0	17.1	16.0	17.6	20.7	21.7	21.4
NPLs (percent) total loans	9.3	14.1	15.3	20.1	21.8	21.1	24.1
Provisions (percent) NPLs	45.7	40.2	42.6	57.5	55.8	55.4	52.6
Rate of return on assets (ROA)	3.4	2.3	3.1	1.6	1.8	0.9	1.6
Rate of return on equity (ROE)	33.5	20.2	30.4	15.0	16.3	7.9	15.5
Liquid assets (percent) of total assets 1/	24.6	21.6	22.2	27.1	25.9	30.1	30.3
Government bond portfolio in assets	3.3	2.6	3.1	4.6	6.4	6.0	6.5
Foreign exchange deposits in percent of total	64.6	63.2	67.8	71.1	68.8	66.6	66.4
Total majority foreign banks							
Share in assets	29.9	34.9	38.3	33.2	33.6	36.4	37.5
Capital adequacy ratio (percent)	17.7	17.7	16.8	19.9	22.8	21.0	18.7
NPLs (percent) total loans	9.8	10.6	10.6	10.4	12.5	12.3	13.4
Provisions (percent) NPLs	46.7	39.7	36.8	43.8	41.4	43.6	43.6
Rate of return on assets (ROA)	1.5	1.0	1.8	1.4	1.5	0.6	0.6
Rate of return on equity (ROE)	12.4	8.6	18.3	13.4	13.5	5.6	6.5
Liquid assets (percent) of total assets 1/	28.2	24.2	25.0	26.2	30.4	33.8	37.9
Government bond portfolio in assets	4.8	1.9	2.1	5.3	4.9	4.1	4.3
Foreign exchange deposits in percent of total	64.9	64.3	69.3	70.7	68.9	65.6	65.9
Total domestic private banks							
Share in assets	9.1	6.8	7.4	10.4	10.5	6.6	6.6
Capital adequacy ratio (percent)	16.6	15.2	14.8	13.6	14.8	17.9	15.5
NPLs (percent) total loans	7.5	7.0	6.5	8.8	16.7	4.7	4.2
Provisions (percent) NPLs	34.9	25.0	30.8	18.7	21.4	43.8	42.5
Rate of return on assets (ROA)	1.2	1.0	1.2	1.1	1.2	1.5	1.5
Rate of return on equity (ROE)	9.7	8.9	13.8	14.3	14.4	17.9	19.0
Liquid assets (percent) of total assets 1/	18.7	17.3	20.1	18.3	23.2	45.7	42.4
Government bond portfolio in assets	0.0	1.0	1.1	1.4	2.2	2.3	2.3
Foreign exchange deposits in percent of total	56.4	49.4	61.8	62.6	58.9	62.2	61.6
National Development Bank (BNF)							
Share in assets	12.7	11.4	9.2	8.0	7.6	7.2	7.0
Capital adequacy ratio (percent)	18.4	21.2	22.9	18.8	9.4	28.3	29.4
NPLs (percent) total loans	49.1	44.6	46.5	56.2	55.6	57.1	58.3
Provisions (percent) NPLs	34.3	38.1	31.7	39.6	42.6	41.9	42.0
Rate of return on assets (ROA)	0.2	-0.5	0.3	-4.7	0.4	0.0	-2.6
Rate of return on equity (ROE)	1.4	-4.2	2.0	-27.3	4.1	0.3	-16.2
Liquid assets (percent) of total assets 1/	24.4	16.7	20.4	17.3	17.3	25.5	27.3
Government bond portfolio in assets	10.9	11.6	0.0	0.2	0.3	0.5	0.6
Foreign exchange deposits in percent of total	21.6	19.3	27.0	42.5	39.3	35.7	38.1

Source: Superintendency of Banks.

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

Table 13. Paraguay: Balance of Payments, 2000-2004

(In millions of U.S. dollars)

	2000	2001	2002	2003	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2004 Year
Current account	-163	-278	92	83	-44	193	9	-133	26
Trade balance	-541	-619	-281	-237	-119	109	-62	-214	-287
Exports	2,322	1,876	1,878	2,102	430	666	581	435	2,111
Exports of domestic goods	869	990	951	1,201	208	455	375	237	1,274
Re-exports	1,453	886	927	901	222	211	206	198	837
Imports	-2,864	-2,495	-2,159	-2,339	-549	-557	-642	-649	-2,398
Registered imports	-2,050	-1,989	-1,510	-1,800	-420	-440	-525	-540	-1,925
Unregistered imports	-813	-506	-649	-539	-129	-117	-117	-109	-473
Services (net)	175	158	196	172	44	39	36	41	161
Transport	-167	-127	-109	-129	-31	-31	-39	-39	-141
Travel	-8	-7	-6	-20	-6	-6	-6	-3	-20
Other	350	292	311	321	81	76	81	84	322
Factor income	22	13	59	25	-2	11	0	6	15
Transfers	177	167	116	122	34	34	34	34	137
Capital and financial account	157	152	5	-308	16	-89	12	176	116
Capital transfers	3	15	4	15	4	4	4	10	21
Direct investment	98	82	-26	14	-2	3	18	16	34
Portfolio investment	3	0	0	0	0	0	0	0	0
Other investment	53	56	27	-337	15	-96	-10	151	60
Assets (increase -)	-212	70	6	-182	-30	-17	-3	-2	-51
Commercial credits	-25	11	-2	5	-20	-7	8	-3	-22
Loans	-236	1	175	-168	-11	-12	-13	-12	-47
Foreign currency deposits	100	-71	-149	-27	0	0	0	10	10
Other	-52	129	-18	8	0	2	2	3	7
Liabilities (increase +)	265	-14	21	-155	45	-79	-7	153	112
Commercial credits	125	-4	25	-57	0	0	0	0	0
Loans	144	9	-7	-98	39	-66	-2	136	107
Of which Gov't disbursements	288	144	146	128	42	30	86	84	242
Of which Gov't payments	-108	-102	-123	-159	-35	-38	-48	-42	-162
Foreign currency deposits	-12	10	8	9	0	0	0	0	0
Other	9	-29	-5	-9	6	-13	-5	17	5
Errors and omissions	-248	76	-220	300	0	0	0	0	0
Overall balance	-254	-50	-123	75	-27	104	21	43	141
Net international reserves (increase -)	215	45	83	-178	55	-74	14	-33	-38
Gross reserves	215	45	84	-177	56	-74	14	-33	-37
Reserve liabilities	0	0	-1	-1	-1	0	0	0	-1
Residual financing gap	...	...	...	103	-28	-30	-35	-10	-103
Arrears deferral (+)/clearance (-)	...	...	...	103	-28	-30	-35	-10	-103
Memorandum items:									
Current account in percent of GDP	-2.1	-4.0	1.7	1.4	...	...	...	...	0.4
Gross reserves (in millions of U.S. dollars)	772	723	641	818	762	836	822	855	855
(in months of imports of GNFS)	3.2	3.5	2.8	3.6	...	...	...	...	3.5
External public debt in percent of GDP	30.6	33.5	44.5	44.3	...	...	...	...	42.6
Debt service in percent of exports GNFS	10.4	10.9	11.6	11.1	...	...	...	...	11.7
Export volume (percentage change) 1/	19.5	18.2	-7.2	12.5	...	...	...	...	4.2
Import volume (percentage change) 1/	15.5	0.6	-21.1	12.4	...	...	...	...	2.7
Terms of trade (percentage change)	-4.6	-0.1	7.4	5.9	...	...	...	...	-4.8

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

1/ Registered trade.

Table 14. Paraguay: Indicators of External Vulnerability

	1996	1997	1998	1999	2000	2001	2002	2003
Monetary and financial indicators								
Broad money (M3), percentage change 1/	19.8	9.8	1.0	8.5	-0.5	0.7	-21.0	18.2
Credit to the private sector, real (percentage change) 1/	8.4	12.8	-20.8	-3.5	-9.0	-8.7	-31.1	-22.3
Share of nonperforming loans in total loans (percent) 2/	11.1	13.1	13.3	16.5	16.6	16.5	19.7	23.2
Average domestic lending rate, real 2/	30.6	18.8	18.3	20.5	16.0	22.5	39.0	24.9
Central Bank bill yield, real 2/	9.5	8.0	13.1	6.0	-2.8	12.8	12.9	-1.6
International reserves (millions of US$)	1,062	846	875	988	772	723	641	818
In months of imports of GNFS	2.5	2.2	3.2	3.6	3.2	3.5	2.8	3.7
Base money to reserves	0.2	0.3	0.3	0.3	0.4	0.5	0.5	0.6
Broad liquidity (M3) to reserves	1.3	1.9	1.8	1.7	2.2	2.4	2.1	2.0
Central bank foreign short-term liabilities (millions of US$	0.5	0.1	0.1	0.0	0.5	0.2	0.5	1.0
External indicators								
Merchandise exports (percentage change)	-10.0	-12.4	6.6	-34.9	0.7	-19.2	0.1	11.9
Merchandise imports (percentage change)	-2.3	-4.4	-6.0	-30.2	4.1	-12.9	-13.5	8.3
Merchandise terms of trade (percentage change)	0.5	-2.5	-1.0	2.3	-4.6	-0.1	7.4	5.9
Real effective exchange rate (percentage change)	4.3	3.4	-8.9	6.4	-3.1	-1.5	-3.9	...
Current account balance (percent of GDP)	-3.7	-6.8	-1.9	-2.1	-2.1	-4.0	1.7	1.5
Capital and financial account (percent of GDP)	0.4	4.5	3.8	6.6	2.0	2.2	0.1	-5.4
Net foreign direct investment (percent of GDP)	1.5	2.4	4.0	1.1	1.3	1.2	-0.5	0.2
Inward portfolio investment (percent of GDP)	0.0	0.0	0.1	-0.1	0.0	0.0	0.0	0.0
Other net investment (percent of GDP)	-1.3	2.1	-0.4	5.3	0.7	0.8	0.5	-5.9
External public debt (percent of GDP)	15.9	16.5	20.4	28.9	30.6	33.5	42.9	44.3
Debt service (in percent of exports GNFS)	4.9	3.7	4.0	4.6	10.4	10.9	11.6	9.2
Gross reserves (in US$)	1,062	846	875	988	772	723	641	818
In months of imports of GNFS	2.6	2.2	3.2	3.6	3.2	3.5	2.8	3.7
Over short-term external debt 3/	2.0	2.1	3.0	1.8	1.1	1.0	1.0	1.2
Over foreign currency deposits in domestic banks	1.1	0.8	0.7	0.8	0.6	0.6	0.7	0.8

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

1/ Foreign currency components are valued at the accounting exchange rate of Gs. 6,280 per U.S. dollar.
2/ Latest available data, September 2003.
3/ Private and public external debt with a residual maturity of one year or less. Excludes foreign currency deposits in banking system.

Table 15. Paraguay: Medium-Term Scenario
(In percent of GDP, unless otherwise specified)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Real sector												
Real GDP growth 1/	0.5	-0.4	2.7	-2.3	2.0	2.4	3.2	3.4	3.4	3.4	3.4	3.4
Consumer prices 1/	5.4	8.6	8.4	14.6	8.8	8.0	6.0	6.0	6.0	6.0	6.0	6.0
Guaraníes per U.S. dollar 1/	16.7	6.9	30.7	51.0	...	...	...	...	...	...	...	...
Real effective exchange rate 1/	2.4	4.3	-12.5	-6.6	...	...	...	...	...	...	...	...
Nominal GDP (billions of Guaranies)	24,144	26,921	28,119	31,977	37,295	40,773	44,512	48,486	52,771	57,442	62,465	67,898
Guaraníes per U.S. dollar (average)	3,113	3,481	4,100	5,676	...	...	...	...	...	...	...	...
Nominal GDP (millions of dollars)	7,756	7,734	6,858	5,633	5,741	6,116	6,461	6,818	7,178	7,554	7,981	8,447
Public finances 2/												
Revenues	21.1	20.1	21.3	19.3	19.6	20.4	21.5	21.4	21.2	21.1	21.0	20.8
Of which: Tax revenues	9.9	10.0	10.2	9.2	9.9	10.8	11.9	11.9	11.9	11.9	11.9	11.9
Current nontax revenues	10.3	8.9	10.4	9.7	9.3	9.1	9.6	9.5	9.4	9.2	9.1	8.9
Public enterprise operating surplus		2.7	2.5	1.4	1.1	1.7	1.7	1.8	1.9	2.0	2.1	2.1
Current primary expenditures	18.1	18.3	17.7	16.1	14.8	14.3	14.3	14.3	14.3	14.3	14.3	14.3
Interest payments	1.3	1.5	1.7	1.9	1.9	1.9	2.1	2.0	2.0	2.0	2.0	1.9
Capital expenditures	11.2	7.0	5.1	5.9	4.8	5.5	6.2	6.5	6.5	6.5	6.5	6.5
Primary balance	-1.8	-2.6	1.0	-1.3	1.2	2.2	2.7	2.3	2.3	2.2	2.2	2.1
Overall balance	-3.1	-4.0	-0.7	-3.2	-0.6	0.3	0.6	0.3	0.3	0.3	0.2	0.2
Nonfinancial public sector debt (in millions of U.S. dollars)	2,478	2,618	2,630	2,801	2,818	2,798	2,760	2,739	2,717	2,697	2,677	2,664
(In percent of GDP)	31.9	33.9	38.4	49.7	49.1	45.8	42.7	40.2	37.8	35.7	33.5	31.5
Balance of payments (in millions of U.S. dollars)												
Exports	2,307	2,322	1,876	1,878	2,102	2,111	2,212	2,334	2,462	2,586	2,699	2,827
Imports	2,750	2,864	2,495	2,159	2,339	2,398	2,551	2,693	2,842	3,000	3,154	3,325
Current account	-165	-163	-278	92	83	26	16	9	-5	-31	-62	-93
(In percent of GDP)	-2.1	-2.1	-4.0	1.7	1.4	0.4	0.3	0.1	-0.1	-0.4	-0.8	-1.1
Capital and financial account	509	157	152	5	-232	116	20	41	73	114	132	161
Net international assets	988	772	723	641	818	855	892	942	1,009	1,092	1,162	1,230
(In months of imports)	3.6	3.2	3.5	2.8	3.6	3.5	3.5	3.5	3.5	3.6	3.6	3.7

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

1/ Annual percentage change.
2/ Includes the BCP and the nonfinancial public sector.

Table 16. Paraguay: Proposed Structural Conditionality Under Program

Measure	Conditionality	Timing	Paragraph in MEFP
Financial Sector			
Approval by Congress of the Bank Resolution law	Prior Action	30 Nov. 2003	23
Approval by Central Bank Board of banking supervision reform (Resolution 8)	Prior Action	30 Nov. 2003	26
Passage by Congress of a public banking law to consolidate and Restructure the public development banks	PC		24
Passage by Congress of new comprehensive banking system legislation	PC	31 Dec. 2004	25
Require all banks to obtain international risk rating	SB	31 Dec. 2004	27
Extension of regulatory supervision to financial cooperatives	SB	1 Jan. 2005	27
Central Government and Central Bank			
Tax and custom administration reform generating 1.0 percent of GDP annually, including: - Replacing Large Taxpayer Unit's auditors and reducing the number of firms in this Unit from 3,500 to 3,000 - Simplifying customs checkpoints; - Conducting on-site tax inspections and follow-ups to commercial establishments to verify compliance with VAT procedures.	Prior Action	30 Nov. 2003	7
Increase in fuel tax from 14 to 20 percent	Prior Action	31 Aug. 2003	7
No accumulation of multilateral arrears	Prior Action/ Continuous PC		9
Passage by Congress of reforms in the *caja fiscal*	PC	8 March 2004	7,15
Passage by Congress of Administrative Reorganization and Fiscal Adjustment	PC		7,16
Passage by Congress of a new customs code and implementation of a customs reform program	SB	31 Aug. 2004	17
Full application of Public Procurement Law	SB	30 June 2004	18
Development of a plan for comprehensive civil service reform	SB	31 Oct. 2004	18
Begin implementation of a central bank restructuring plan	SB	31 July 2004	19
BCP and MOF to sign a memorandum of understanding regularizing financial relationship between the government and the BCP.	PC	28 Feb. 2004	19
Application of international accounting standards and annual external audits of the central bank	SB	30 June 2004	19
Public Enterprises			
Requirement of regular adjustments in fuel and utilities prices to fully reflect input price and exchange rate changes	PC	1 July 2004 1 Jan. 2005	11
Presentation of a plan for the participation of private capital in key public enterprises	SB	31 Dec. 2004	20
Governance			
Regular independent audits of all public enterprises and the Social Security	PC	30 Sept. 2004	18,20
Increased data publication for government and public enterprises	SB	30 Sept. 2004	20

Table 17. Paraguay: Proposed Schedule of Reviews and Purchases

Date	Amount of Purchase (in millions of SDR)	In Percent of Quota	Conditions
December 2003	30.0	30.0	Approval of arrangement
March 16, 2004	4.0	4.0	First review and December 2003 performance criteria
June 16, 2004	4.0	4.0	Second review and March 2004 performance criteria
September 16, 2004	4.0	4.0	Third review and June 2004 performance criteria
December 16, 2004	4.0	4.0	Fourth review and September 2004 performance criteria
March 16, 2005	4.0	4.0	Fifth review and December 2004 performance criteria
Total	**50.0**	**50.0**	

Table 18. Paraguay: Indicators of Capacity to Repay the Fund 1/

	2002	2003	2004	2005	2006	2007	2008	2009
Fund repurchases and charges								
In millions of SDRs	0	0	1	1	1	19	25	7
In millions of U.S. dollars	0	0	1	2	2	26	34	10
In percent of exports of goods and NFS	0.0	0.0	0.0	0.1	0.1	0.8	1.1	0.3
In percent of quota	0.2	0.2	0.8	1.1	1.1	19.0	25.1	7.1
In percent of gross official reserves	0.0	0.0	0.1	0.2	0.2	2.6	3.2	0.9
Fund credit outstanding								
In millions of SDRs	0	30	46	50	50	32	8	1
In millions of U.S. dollars	0	39	60	69	69	44	10	1
In percent of exports of goods and NFS	0	1.5	2.3	2.5	2.4	1.4	0.3	0.0
In percent of quota	0	30	46	50	50	32	8	1
In percent of gross official reserves	0	3.7	5.4	5.6	5.2	3.2	0.7	0.0
Memorandum items:								
Exports of goods and NFS (mlns. of U.S. dollars), baseline	2,418	2,656	2,586	2,778	2,928	3,088	3,256	3,417
Debt service (millions of U.S. dollars)	280	244	308	309	320	333	342	354
Quota (millions of SDRs)	99.9	99.9	99.9	99.9	99.9	99.9	99.9	99.9
Quota (millions of U.S. dollars)	129	129	129	138	138	138	138	138
Gross official reserves (millions of U.S. dollars)	641	818	855	900	956	1,009	1,075	1,142
U.S. dollars per SDR 2/	1.29	1.29	1.30	1.38	1.38	1.38	1.38	1.38

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

1/ Assumes all purchases made as scheduled under current program, and repurchases made on the obligations schedule.

2/ WEO projections (summer 2003).

Table 19. Paraguay: Public Sector Debt Sustainability Framework, 1997-2008
(In percent of GDP, unless otherwise indicated)

	Actual						Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Baseline Medium-Term Projections												
Public sector debt 1/	17.4	22.7	31.9	33.9	38.4	**49.7**	**49.1**	**45.8**	**42.7**	**40.2**	**37.8**	**35.7**
Change in public sector debt	0.7	5.4	9.2	1.9	4.5	11.4	-0.6	-3.3	-3.0	-2.5	-2.3	-2.2
Identified debt-creating flows (4+7+12)	3.4	1.2	6.6	3.1	10.0	16.6	-9.6	-2.6	-3.2	-2.4	-2.3	-2.1
Primary deficit	1.6	-1.8	1.8	2.6	-1.0	1.3	-1.2	-2.2	-2.7	-2.3	-2.3	-2.2
Revenue and grants	30.3	30.9	31.1	31.2	33.6	31.9	33.4	34.8	34.8	34.3	33.9	33.5
Primary (noninterest) expenditure	33.9	32.1	38.1	36.0	33.9	33.9	32.2	32.5	32.1	32.0	31.6	31.2
Automatic debt dynamics 2/	1.8	3.0	4.8	0.5	11.0	15.3	-8.4	-0.3	-0.5	-0.1	0.0	0.1
Contribution from interest rate/growth differential 3/	0.1	-0.4	0.9	-1.6	0.5	-2.4	-5.3	-2.3	-1.7	-1.5	-1.3	-1.1
Of which contribution from real interest rate	0.5	-0.5	1.0	-1.7	1.4	-3.2	-4.4	-1.2	-0.4	-0.1	0.0	0.1
Of which contribution from real GDP growth	-0.4	0.1	-0.1	0.1	-0.9	0.8	-0.9	-1.1	-1.3	-1.3	-1.3	-1.2
Contribution from exchange rate depreciation 4/	1.7	3.5	3.9	2.1	10.5	17.7	-3.1	1.9	1.2	1.4	1.3	1.2
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	-2.6	4.1	2.7	-1.2	-5.5	-5.2	8.9	-0.8	0.2	-0.1	0.0	-0.1
Public sector debt-to-revenue ratio 1/	57.4	73.5	102.8	108.4	114.2	156.1	146.9	131.6	122.7	117.1	111.7	106.6
Gross financing need 5/	3.0	0.8	4.2	7.1	2.7	6.2	3.8	3.3	2.4	2.5	2.5	2.5
(in billions of U.S. dollars)	0.3	0.1	0.3	0.6	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Key Macroeconomic and Fiscal Assumptions												
Real GDP growth (in percent)	2.6	-0.4	0.5	-0.4	2.7	-2.3	2.0	2.4	3.2	3.4	3.4	3.4
Average nominal interest rate on public debt (in percent) 6/	6.3	9.1	6.9	5.8	5.9	6.5	4.3	4.2	5.0	5.2	5.4	5.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.2	-3.4	4.4	-6.1	4.3	-9.9	-10.1	-2.5	-0.7	-0.2	0.1	0.4
Exchange rate (LC per US dollar)	2,330	2,840	3,315	3,545	4,635	7,000	6,500	6,775	6,970	7,206	7,450	7,707
Nominal appreciation (increase in US dollar value of local currency, in percent)	-9.5	-18.0	-14.3	-6.5	-23.5	-33.8	7.7	-4.1	-2.8	-3.3	-3.3	-3.3
Inflation rate (GDP deflator, in percent)	3.0	12.4	2.5	11.9	1.7	16.4	14.3	6.7	5.8	5.3	5.3	5.3
Growth of real primary spending (deflated by GDP deflator, in percent)	25.9	-5.8	19.2	-5.9	-3.3	-2.4	-3.0	3.5	1.8	3.0	2.2	2.2
II. Stress Tests for Public Debt Ratio												
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2004-2008							**49.2**	**49.2**	**49.6**	**49.9**	**50.3**	**50.7**
2. Real interest rate is at historical average plus two standard deviations in 2004 and 2005							**49.2**	**51.1**	**52.8**	**50.2**	**47.9**	**45.8**
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005							**49.2**	**48.3**	**47.9**	**45.1**	**42.5**	**40.1**
4. Primary balance is at historical average minus two standard deviations in 2004 and 2005							**49.2**	**55.6**	**56.8**	**58.1**	**61.6**	**63.5**
5. Combination of 2-4 using one standard deviation shocks							**49.2**	**56.5**	**64.5**	**59.5**	**54.8**	**50.3**
6. One time 30 percent real depreciation in 2004 7/							**49.2**	**70.5**	**67.2**	**64.6**	**62.3**	**60.2**
7. 10 percent of GDP increase in other debt-creating flows in 2004							**49.2**	**55.8**	**52.6**	**50.0**	**47.7**	**45.6**

Table 19. Paraguay: Public Sector Debt Sustainability Framework, 1997-2008
(In percent of GDP, unless otherwise indicated)

	Actual						Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Historical Statistics for Key Variables (past 10 years)		Historical Average		Standard Deviation				Average 2003-08				
Primary deficit		0.2		1.9				-2.2				
Real GDP growth (in percent)		1.6		2.2				3.0				
Nominal interest rate (in percent) 6/		6.9		1.0				5.0				
Real interest rate (in percent)		-4.2		6.6				-10.1				
Inflation rate (GDP deflator, in percent)		11.2		6.9				7.1				
Revenue to GDP ratio		29.6		2.7				33.4				

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; α = 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.

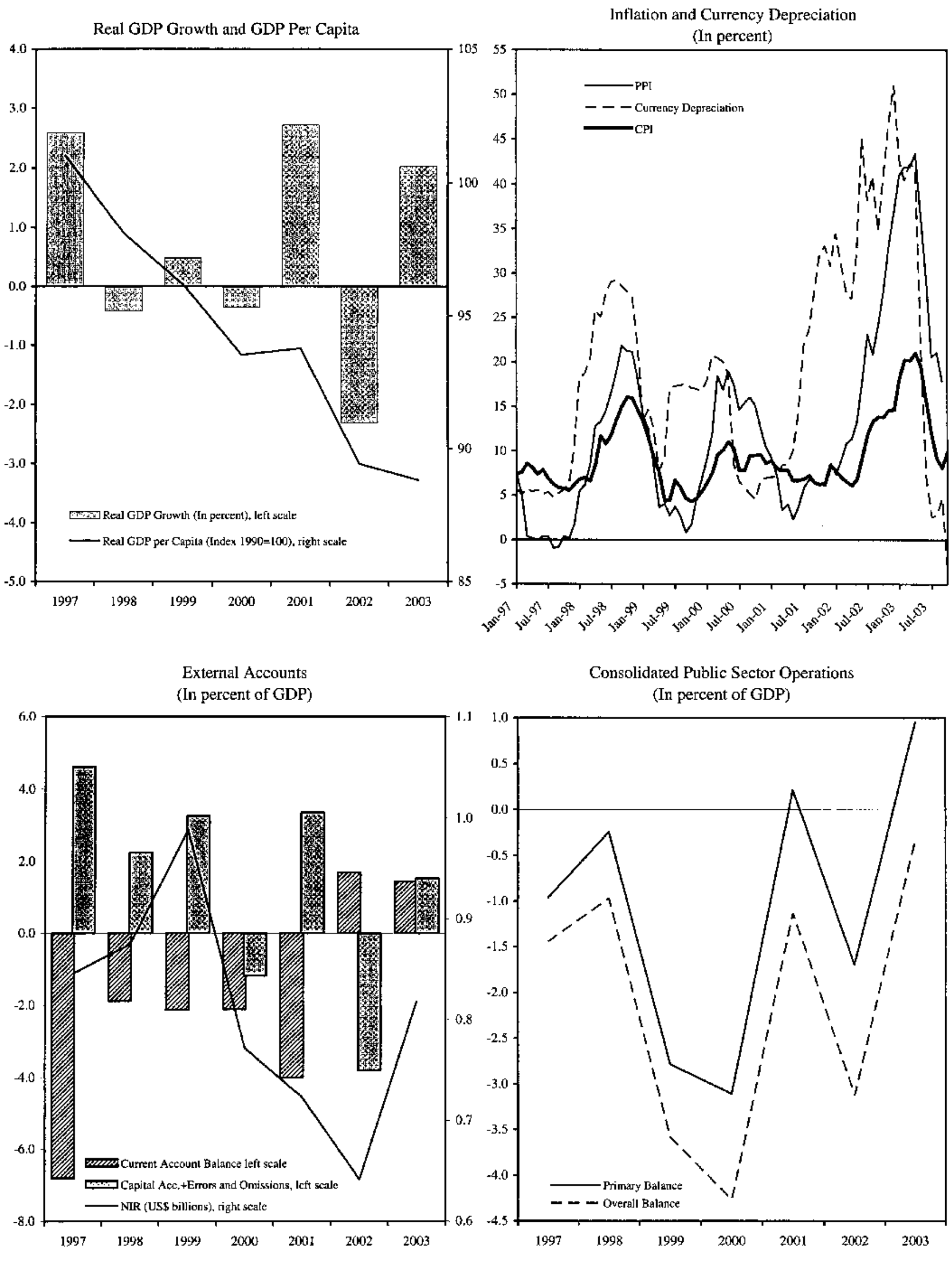
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

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.

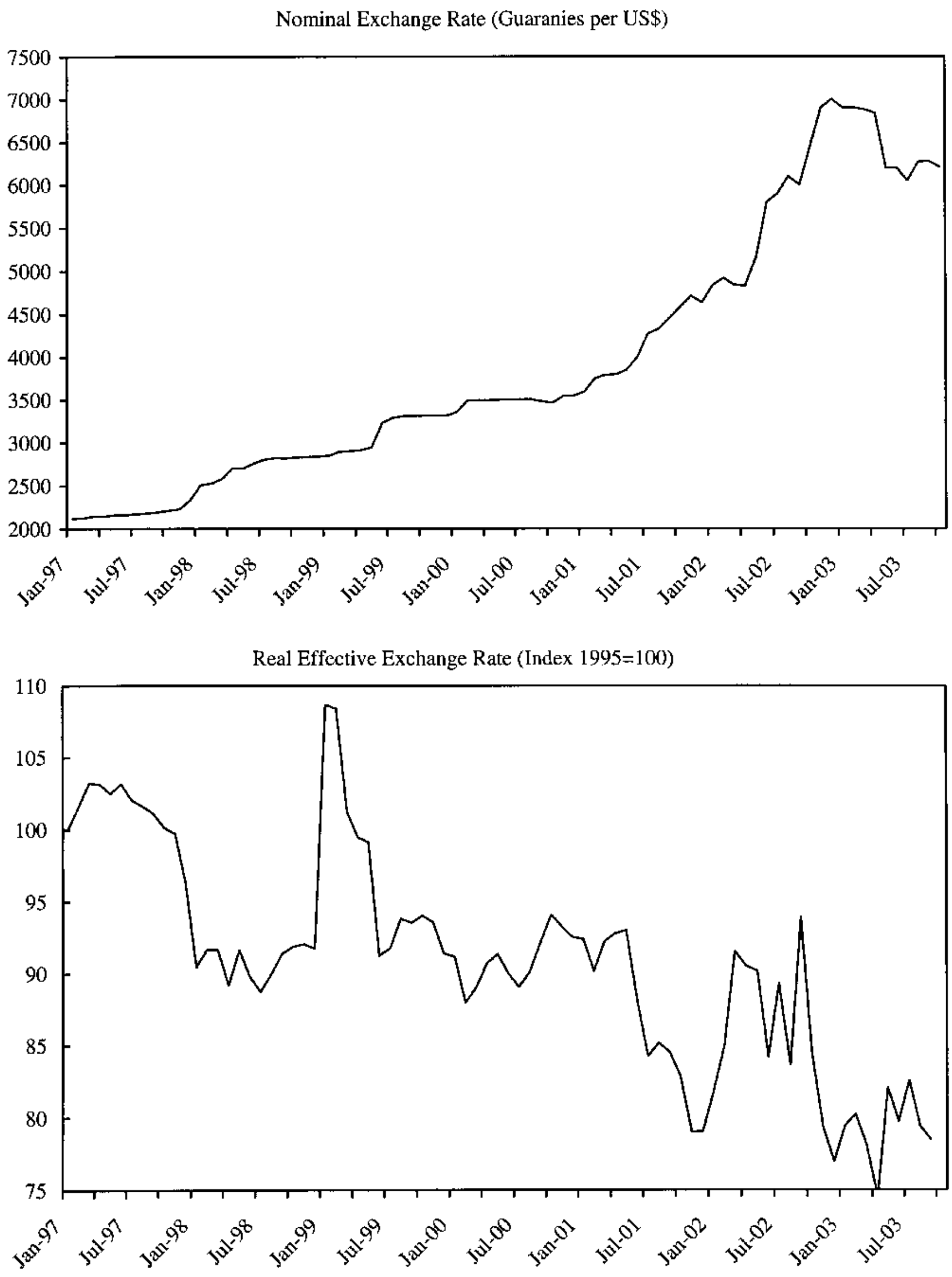
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 1. Paraguay: Selected Economic Indicators



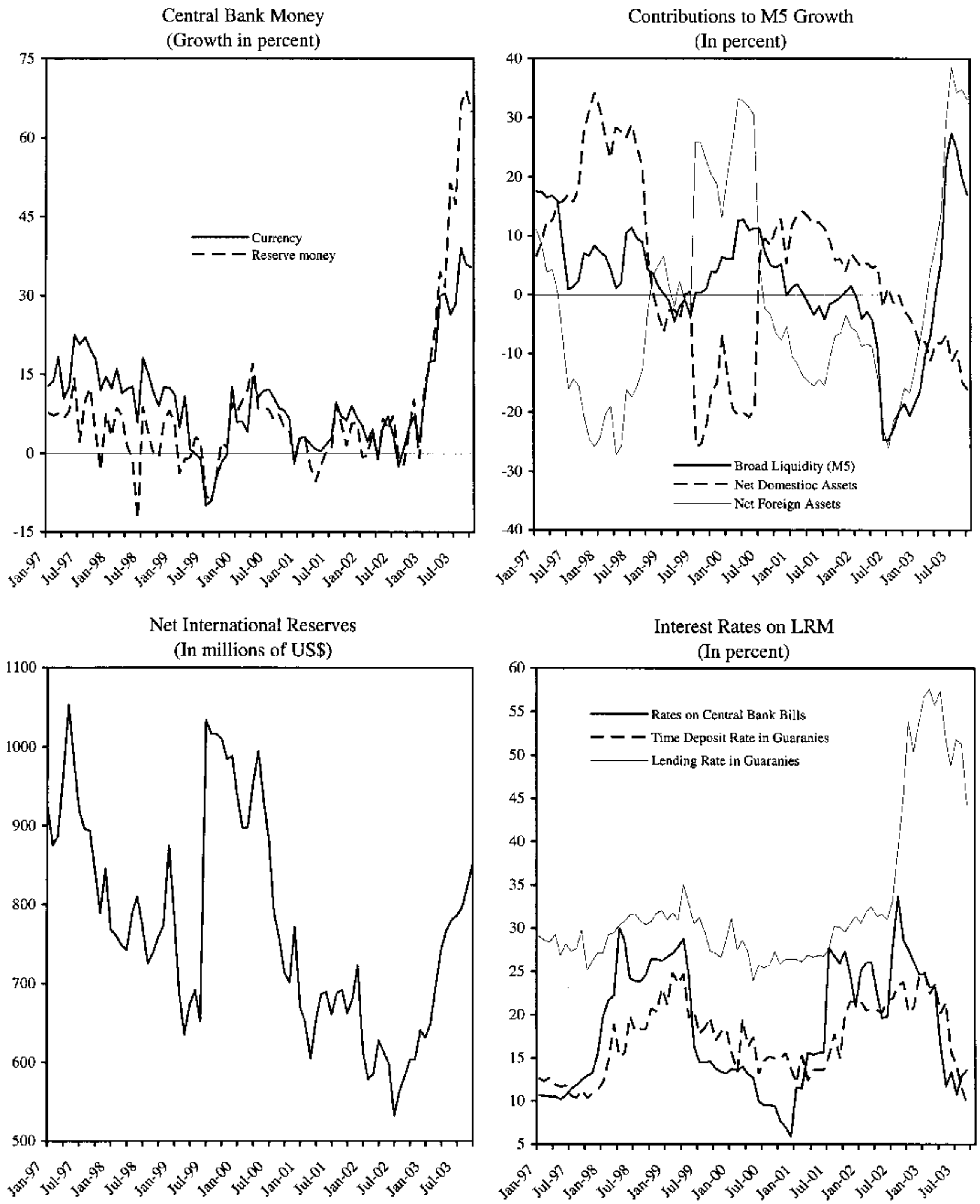
Source: Central Bank of Paraguay.

Figure 2. Paraguay: Exchange Rates



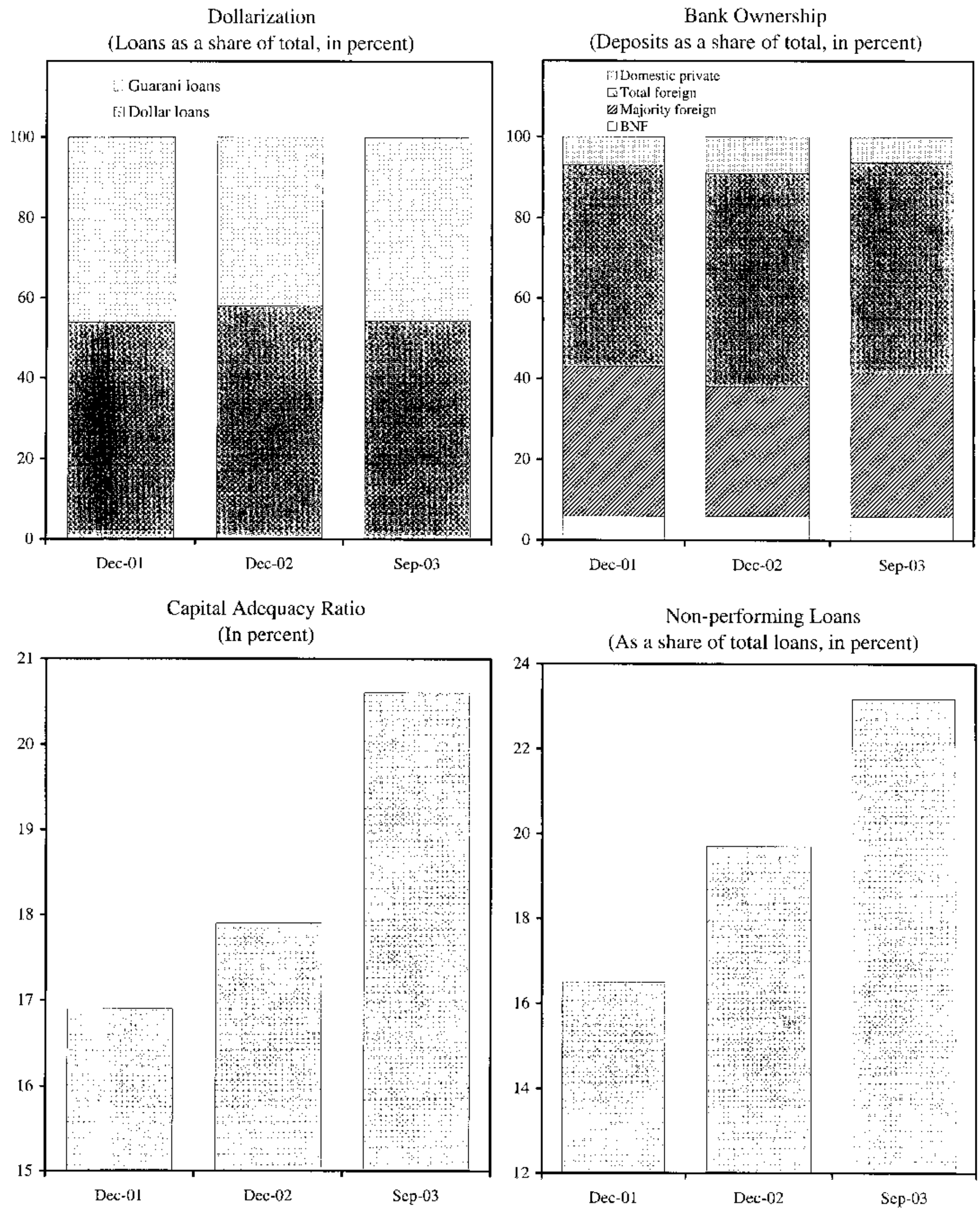
Source: Central Bank of Paraguay.

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: Public Debt Shock Analysis
(In percent of GDP)

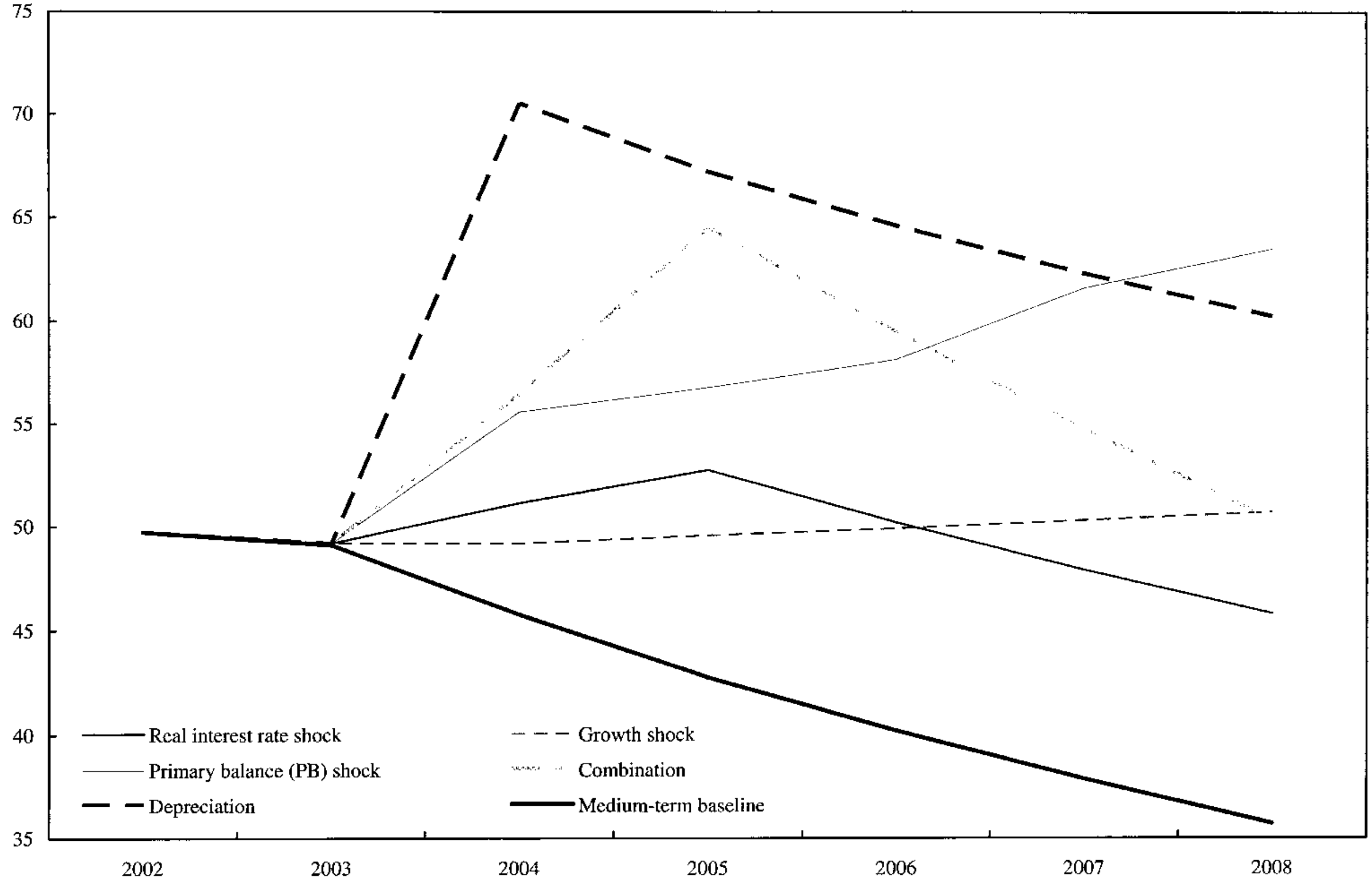
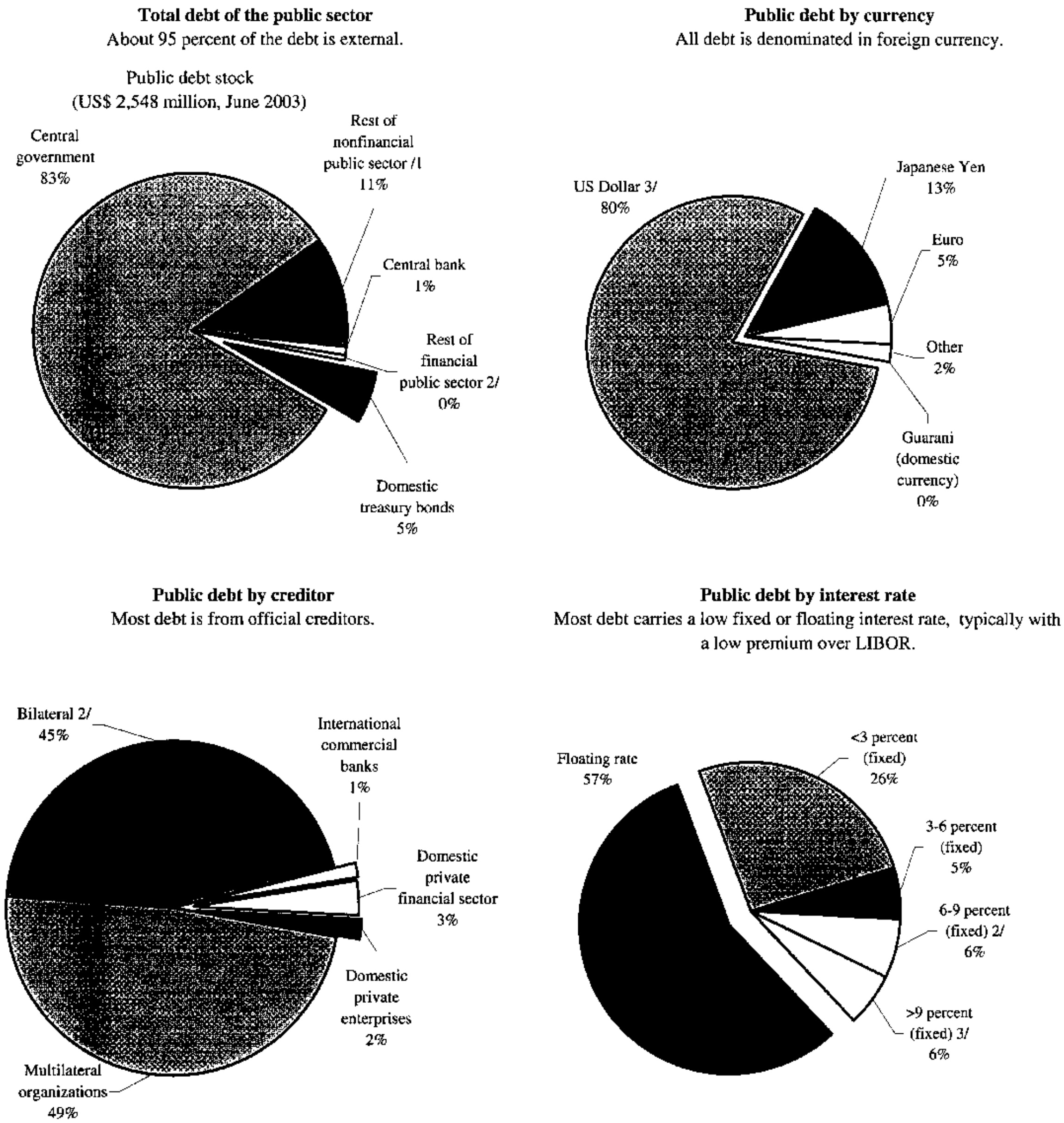


Figure 6. Paraguay: Breakdown of Public Debt



Source: Paraguay's authorities; and staff's estimates.
1/ Public enterprises: ANDE, ANTELCO, CORPOSANA, INC; (excludes PETROPAR).
2/ Includes loan extended to ANDE by Banco do Brazil and Banco de la Nacion Argentina.
3/ Inlcudes domestic treasury bonds denominated in US$.

Medium-Term Framework and Public Debt Sustainability

1. This annex examines Paraguay's medium-term fiscal sustainability and examines the sensitivity of debt dynamics to variations in the key macro assumptions (Table 19 and Figure 5). The baseline scenario is based on the policies in Paraguay's economic program (as outlined in the MEFP), and the assumption that they will be maintained over the medium term. The fiscal adjustment package broadly targets overall balance for the public sector in the medium term. This would result in a drop in the public sector debt-to-GDP ratio to below one-third by 2010.[11]

Macroeconomic framework

2. The macroeconomic framework assumes:

- The structural and fiscal reforms in the program raise the medium-term growth rate to 3.4 percent over the period, compared with 1.9 percent in the past two decades.
- The REER stabilizes in response to improved productivity growth, with inflation to decline to around 6.0 percent.[12]
- Structural reforms, stable international prices, and economic recovery in Paraguay's key export markets result in steady export growth. Strong private sector investment growth results in some decline in the current account balance over the medium term. However, the deficits are expected to be modest and easily financed by increased capital inflows. International reserves are assumed to increase to broadly keep reserves constant as a fraction of imports.

Fiscal adjustment

3. The scenario assumes that a fiscal adjustment package is implemented in late 2003 and early 2004. This is projected to have the following effects:

- Implementation of tax reform measures will permanently increase tax revenues by approximately 2.0 percent of GDP in 2004–05. Non-tax revenues will slowly decline as a share of GDP due to slow growth in hydroelectric royalties at the Itaipú hydroelectric company.

[11] Public sector debt accounts for 85 percent of external debt. Hence external debt dynamics are largely driven by the dynamics of public sector debt. Over the medium term, some increase in private sector external debt is projected to finance the widening of the private sector savings-investment balance. As a result, total external debt is projected to fall to about 38.6 percent of GDP by 2010 from 51.6 percent in 2003.

[12] 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.

- Timely adjustments in fuel and utilities prices, and structural reforms in the public enterprises will keep the operating surplus of public enterprises constant as a share of GDP.
- After some expenditure compression in the short-term, structural reforms, such as those to the pension system and civil service, are expected to keep current expenditures constant in percent of GDP over the medium term, while allowing for some increase in social expenditure.
- The planned adjustment measures are expected to permit needed increases in public sector capital spending over the medium term, while still maintaining overall balance in the public sector fiscal accounts.

Sensitivity analysis

4. **Public sector debt remains sustainable under alternative assumptions regarding GDP growth, interest rates, and the debt stock.**[13] In stress tests 2, 3, and 7, public debt levels are lower in 2008 than in 2003. In particular, debt sustainability is robust to assumptions regarding real GDP growth and interest rates.[14] A shock to the debt stock (test 7) raises debt levels in the year of the shock (in this case, 2004), but the levels fall steadily thereafter.

5. **However, public debt is very sensitive to assumptions on the primary balance, pointing to the importance of meeting the fiscal targets under the program.** Stress tests 4 and 5 include assumptions of significant primary deficits in 2004–05, and in both cases debt levels rise sharply in these two years. It is questionable whether such increases could even be financed in Paraguay. A modest, but sustained, deterioration in the primary balance would also undermine sustainability. Assuming Paraguay's primary deficit reverts to the historical average of 1.6 percent of GDP after the program (from 2005 on) the public debt increases steadily to 52.9 percent of GDP by 2008.[15]

6. **Given that most of the debt stock is in foreign currency, its sustainability is also highly dependent on the exchange rate.** Test 6 shows that a strong depreciation would sharply increase the stock of debt, though this shock alone would not lead to unsustainable debt dynamics. The current level of the exchange rate does not appear to be misaligned relative to Paraguay's key trading partners. However, a sharp depreciation in the *guaraní* could result from a depreciation of the Brazilian and/or Argentine currencies vis-à-vis the U.S. dollar.

---

[13] The scenario was subjected to stress tests, in line with the methodology contained in Assessing Sustainability, May 8, 2002 (www.imf.org).

[14] The stress test on interest rates—two standard deviations above historical averages—is unlikely to occur given the majority of Paraguay's debt is to multilateral and official bilateral creditors.

[15] In stress test 1, the sustainability of the debt is due to the assumption of the historical average for real interest rates, which is sharply negative due to past bouts of inflation.

Fund Relations
(As of September 30, 2003)

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	84.39	616.14

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 September 30, 2003, the average interbank rate for the U.S. dollar was ₲6,300=US$1.

VI. **Article IV Consultation:** The 2002 Article IV consultation was concluded by the Executive Board on March 10, 2003; the documents are IMF Country Reports 03/94 and 03/95.

VII. **Technical Assistance:**

Department	**Purpose**	**Date of Delivery**
MAE	Policy Advisory to the Central Bank	March 1994 – Present
FAD	Tax Policy	February 1999
FAD	Tax Administration	March 1999
STA	Monetary Statistics	February 2000
STA	Balance of Payments Statistics	June 2000
STA	Multisector, GDDS accession	February 2001
MAE	Currency Operations	March through September

Department	Purpose	Date of Delivery
		2002
MAE	Financial Sector Surveillance	July 2002
FAD	ROSC	August 2002
STA	Multisector, follow-up	September 2002
MAE	Banking Supervision	September through November 2002
MAE	Central Bank Operations	November 2002
TRE	Safeguard Assessment	January 2003
MFD	Banking Supervision	January through August 2003
MFD	Currency Handling and Reform	July 2003
MFD	Payment System	July 2003

VIII. **Safeguard Assessment:** Under the Fund's safeguards assessment policy, Central Bank of Paraguay (BCP) is subject to an assessment with respect to the expected arrangement. A safeguards assessment of the BCP was completed on January 31, 2003. The assessment concluded that substantial risks may exist in legal structure and independence of the central bank, and in its control environment. Staff findings, proposed recommendations under program conditionality, and other recommendations are reported in IMF Country Report 03/94. Implementation of the measures by the BCP needs to be monitored by staff.

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

Financial Relations with the World Bank[1]

October 14, 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 in 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, followed by the approval in July 2003 of a $24 million Secondary Education project. The Bank nevertheless maintained an active policy dialogue with Paraguay, and analytical work during 2002 included a poverty 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. A comprehensive Policy Notes document was completed in May 2003 and discussed with the new Administration in June 2003. Preparation of a financial accountability assessment is underway, and it is expected to be completed by December 2003.

Six World Bank-financed projects are presently under implementation, for a total value of $176.3 million, of which $85.1 million are undisbursed as of September 30, 2003. These projects include: Rural Water Supply, Natural Resource Management, Reform of the Water and Telecommunication Sectors, Maternal Health and Child Development, Community Development, and the Secondary Education, which is awaiting approval by Congress in order to become effective.

An Economic Recovery Loan is currently under preparation, in parallel with the new CAS, for a possible presentation to the Board before year-end. A technical assistance loan to assist in the restructuring of the Ministry of Finance and help it become a Ministry of Excellence is also under preparation for FY04 delivery. In addition, a Financial Sector Adjustment Loan and Technical Assistance Loan are at an advanced stage of preparation.

---

[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 September 30, 2003)

	Committed (Net of Cancellations)	Undisbursed	Disbursed
Active loans			
Natural Resource Management	50.0	15.4	34.6
Asunción Sewerage/Reform of Water and Telecommunications Sectors	31.5	8.0	23.5
Maternal Health	21.8	1.9	19.9
Fourth Rural Water Supply	40.0	27.7	12.3
Community development	9.0	8.1	0.9
Education Reform	24.0	24.0	0.0
Total active loans	176.3	85.1	91.2
Total inactive loans	658.1	2.9	655.2
Total IBRD/IDA	**834.4**	**88.0**	**746.4**

II. IFC Operations (as of September 30, 2003)

	Loans	Equity	Total
Commitments	0.0	0.0	0.0
Repayments and cancellations	0.0	0.0	0.0
Now held by IFC	0.0	0.0	0.0
Undisbursed	0.0	0.0	0 0

III. IBRD/IDA Loan Transactions (calendar year) (as of September 30, 2003)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Disbursements	25.7	27.5	41.2	37.7	42.1	46.6	26.8	13.5	10.2
Repayments	42.6	35.2	27.5	24.6	24.6	20.2	15.3	16.8	19.4
Net lending	-16.9	-7.7	13.8	13.1	17.5	26.4	11.5	-3.3	-9.2

Source: World Bank.

1/ After exchange rate adjustment.

PARAGUAY—RELATIONS WITH THE IDB[1]

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. During 2003, up to October, IDB approved two loans: one for Cadastre Registry, for US$9.0 million and one for Initial and Preschool Education, for US$23.4 million. In addition, 2 loans to support the preparation of future operations were approved: Costal Development in Asunción, for US$1.5 million, and Initial and Preschool Education, for US$0.9 million.

4. The active portfolio of loans amounts to US$612. 7 million, of which 35.8 percent have been disbursed. As for Technical Cooperation, the approved total amounts to US$20.0 million, of which 47 percent have been disbursed.

Operations Program

5. Provided an agreement is reached between Paraguay and the IMF, one additional operation might be approved in 2003: an **emergency loan** for US$30 million to protect social expenditure, to be disbursed in two tranches. In the first half of 2004 we expect approval of a policy-based loan for US$50 million for a public financial sector reform, cofinanced with the World Bank, which is being closely coordinated with the IMF with regard to conditionality.

6. Other possible investment loans in 2004 still to be agreed upon with local authorities include:

   a. The Costal Development (Franja Costera) Project for US$55 million. It will help the Municipality of Asunción to solve problems associated with flooding from the

[1] Prepared by the staff of the IDB.

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. TC loan for the Financial System Reform, for US$4.5 million. Modernization of Public Administration, for US$20 million.

c. Reform of the Social Security System, for US$30 million.

d. Professional Technical Education, for US$10 million

7. The Bank's new country strategy with Paraguay is expected to be approved during the first semester of 2004.

Statistical Issues
(As of November 21, 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 BCP, 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 (5^{th} 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 BCP, 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 November 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	11/20/03	11/20/03	11/20/03	11/20/03	09/30/03	09/30/03	M10/03	M10/03	Q2/2003	M10/03	2002	Q2/03
Date Received	11/20/03	11/20/03	11/20/03	11/20/03	11/3/03	11/3/03	11/05/03	10/31/03	07/28/03	11/20/03	7/01/03	07/23/03
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

Asunción, December 5, 2003

Dear Mr. Köhler:

1. The attached Memorandum of Economic and Financial Policies describes the economic program and objectives of the Government of Paraguay for the remainder of 2003 and for 2004. In support of this program, the Government requests a Stand-By Arrangement from the Fund for the period through March 31, 2005 in an amount equivalent to SDR 50 million. The government intends to treat this arrangement as precautionary.

2. The program will strengthen the fiscal balance and permit the elimination of payments arrears, putting the government finances on a sustainable path for the medium term. It will provide for a monetary policy focused on reducing inflation and maintaining a floating exchange rate regime. The program also includes important structural reforms of the state, the Central Bank, and the financial sector. Finally, various measures are contemplated to improve transparency and governance of the public sector's operations.

3. The government believes that the policies set forth in the attached Memorandum of Economic and Financial Policies are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. Paraguay will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultations. The government will provide the Fund with any information it requests to monitor progress in achieving the objectives and policies of the program. The arrangement will include quarterly program reviews to assess overall performance under the program. The program will include quarterly quantitative performance criteria and certain structural performance criteria. These reviews will be completed by March 15, 2004; June 15, 2004; September 15, 2004; December 15 2004; and March 15, 2005.

Yours sincerely,

/s/
Angel Gabriel González Cáceres
President
Central Bank of Paraguay

/s/
Dionisio Borda
Minister of Finance

Attachment

Mr. Horst Köhler
Managing Director
International Monetary Fund

Attachment: Memorandum of Economic and Financial Policies

Memorandum of Economic and Financial Policies

E. Introduction and Recent Developments

32. This memorandum describes the government's economic program for 2003–04 in support of which the government is requesting a 15-month Stand-By Arrangement (SBA) from the Fund.

33. **In 2002, Paraguay suffered a sharp fall in economic activity.** The slump was brought on, in part, by a crisis in the region and a poor harvest, and was exacerbated by weak domestic economic policies. Real GDP fell by nearly 2½ percent, inflation accelerated from 8½ to 14½ percent, and the *guaraní* lost 34 percent of its value. The third-largest bank, *Banco Alemán,* collapsed, sparking substantial capital flight. Fiscal problems led to the accumulation of large payments arrears. Open unemployment rose from 7.6 percent in 2000 to 10.8 percent in 2002.

34. **Modest economic growth has returned in 2003.** A good harvest and the improved regional situation are expected to contribute to growth of around 2 percent in real GDP for 2003; however, the nonagricultural economy is expected to remain stagnant, due mainly to a sharp decline in private investment. The *guaraní* has appreciated by nearly 15 percent so far this year against the U.S. dollar, reflecting the appreciation of currencies in Brazil and Argentina, rising agricultural exports, and reduced uncertainty following the general elections. Official reserves and bank deposits have also risen (by 36 percent and 23 percent, respectively since end-2002). Annual inflation was 10 percent in October, down from the peak of 21 percent reached in April.[1]

35. **Despite the temporary improvement in economic activity, growth cannot be sustained unless serious underlying problems are addressed.** The public sector has large accumulated arrears and faces financing difficulties in 2003 and 2004. The highly-dollarized banking system suffered the collapse of a local bank, Multibanco, early in the year and has high nonperforming loans and an inadequate regulatory framework and resources for bank supervision. The National Development Bank also remains a source of concern, despite its recent recapitalization and management changes. Absent reforms to address structural impediments to growth and to improve the flexibility of the economy, per capita income will continue to decline in the medium term, and Paraguay will remain highly vulnerable to exogenous shocks.

36. **The new government has developed a program to deal with Paraguay's economic difficulties.** An agreement has been signed between the government and political leaders in Congress (including main opposition parties) on initiatives to permanently correct the fiscal imbalance and pay off its arrears, strengthen the banking system, and undertake

[1] For 2004, the macroeconomic framework is based on an expected increase in growth to around 2½ percent, with inflation of around 8 percent.

structural reforms to improve governance, economic growth, and flexibility. This letter of intent reflects the key elements of that agreement. It also reflects the government's commitment to reduce inflation and strengthen Central Bank reserves as an essential element of its macroeconomic strategy.

F. The Fiscal Program

37. **The government's fiscal strategy seeks to contain the central government deficit in 2003 to -0.3 percent of GDP, with adjustment measures designed to generate a surplus of 0.2 percent of GDP in 2004.** This path is consistent with available financing—including the normalization of payments arrears—and sets public debt on a firmly declining path. In contrast, in the absence of measures the deficit would rise to near 2 percent of GDP, with further increases likely in the medium term.

38. **The government's strategy relies on a combination of expenditure reduction and revenue enhancement measures to generate the needed fiscal adjustment.** Key components of the package are:

(i) Tight control on current spending in the 2004 budget, expected to produce savings of 0.2 percent of GDP. The government will use its discretionary powers over spending to assure that any budget increases introduced by the Congress will not affect the program's expenditure targets.

(ii) Increases in the excise tax on diesel fuel (a 6 percentage point hike introduced in August 2003, and another 6 percentage point rise is in the 2004 budget to cover part of the cost of war veterans' pensions). The increases in the fuel tax are expected to yield almost 1 percent of GDP on an annual basis.

(iii) Passage of a law reforming the public employees' pension plan to increase the retirement age, increase years of service for retirement, reduce the replacement ratio, and increase contribution rates. The law would yield 0.2 percent of GDP initially, with substantially higher savings in future years.

(iv) Passage of an Administrative Reorganization and Fiscal Adjustment Law, which seeks to substantially widen the tax base from consumption and profits tax, and includes a new vehicles tax, a personal income tax, the closure of most loopholes in VAT and the corporate income tax (along with lower, flat corporate income tax rate), and increases in maximum excise tax rates. Once in effect, the law could produce 1.4 percent of GDP in net revenues on an annual basis.

(v) A major overhaul of tax and customs administration to restore tax collection efficiency at least to 2001 levels. Measures already applied have produced a 1 percent of GDP increase in revenues in the first three months of new government.

The first increase in the fuels tax (from 14 to 20 percent), and the implementation of tax administration reforms, (generating 1½ percent of GDP in annual revenue) are prior actions to Fund Executive Board discussion of Paraguay's SBA request. Passage of the Public Pension Reform Law is a performance criterion for the first review under the program, and approval of the Administrative Reorganization Law is a performance criterion for the second review. The associated targets for the overall balance and the central government wage bill are described in the Technical Memorandum of Understanding (TMU).

39. **The government will take steps to assure that the program will be fully financed in both 2003 and 2004.** In 2003, the fiscal deficit will be financed by: (i) net external debt disbursements for multilateral and bilateral project lending of US$18 million; (ii) the rollover of US$138 million in domestic bonds held by the banking system and suppliers; (iii) multilateral program lending of US$15 million; and (iv) a drawdown of deposits in the banking system of US$25 million. For 2004, the program envisages net project disbursements of US$8 million; program lending from the World Bank and IDB of US$85 million; and additional effects of the domestic debt rollover of US$39 million.

40. **Improving the management of the public debt is a key policy objective.** The government recognizes the need to halt the rapid increase in the stock of public debt that took place in recent years, from under 20 percent of GDP in 1997 to near 50 percent of GDP in 2003. The proposed fiscal adjustment will be crucial in reversing this trend and setting Paraguay on a more sustainable medium-term debt path. Given the significant amounts of contracted but undisbursed debt, the government will further carefully consider the contracting or guaranteeing of any new external debt with a view to ensuring that debt and debt service ratios remain manageable in the future. The program sets limits on the contracting of medium- and long-term external debt of the nonfinancial public sector, and the cumulative change in the short-term debt of the nonfinancial public sector will also be limited, as specified in the TMU (performance criteria). The public sector will accumulate no new external arrears during the program period (continuous performance criterion) and is committed to clearing all public external debt arrears during the program (performance criterion). The government will also eliminate all domestic arrears beyond a normal payments float (performance criterion on domestic floating debt). In cases where payment arrears are in dispute, the government is involved in active negotiations to come to a settlement with the relevant creditors. The government is also approaching the Paris Club to request forbearance from bilateral creditors to permit the gradual clearance of all arrears (including past due interest) during 2004. The relevant quarterly targets for arrears reduction are described in the TMU.

41. **The government's social policy will be directed at implementing the National Strategy for Poverty Reduction,** which encompasses fighting against rural poverty, deepening the educational reform started in 1994, and investing in the country's infrastructure and housing. To that end, the government will protect social expenditure as part of its agreement for economic program support from the World Bank and IDB. Proceeds from the revenue increases in the fiscal strategy will allow the government to maintain social expenditure, including expenditure for health care. The government's priorities include improving the country's infrastructure, particularly in rural areas; promoting rural communities and better directing rural credit to small borrowers through the reform of the public development banks; investing in preschool, primary and secondary education and in health care, particularly in maternal health and child development; improving the efficiency

of social security institutions and guaranteeing their long-term financial viability; and mitigating the effects of river flooding. Several of these projects are to be implemented with support from the IDB and the World Bank.

42. **The government expects that the rest of the consolidated public sector will record a small (0.3 percent of GDP) deficit in 2003.** A cash surplus in the social security institute (the pension and health care plan for private sector employees) and operating surpluses in certain public enterprises will compensate for losses in other firms and for the quasi-fiscal losses of the Central Bank. For 2004, the rest of the public sector will post a slight surplus. To improve the performance of the public enterprises, the government will ensure that their management is improved and that tariffs are adjusted at least to fully cover operating costs. In particular, the government will make regular adjustments in utilities tariffs and fuel prices which fully reflect changes in world prices, costs, and the exchange rate (performance criterion).

G. Monetary and Exchange Rate Policy

43. **Monetary policy will be geared mainly to achieving the inflation target of the program, in the context of a freely floating exchange rate regime.** Achieving this objective rests on containing the public sector's domestic borrowing requirement, the deceleration of growth of the monetary base from the high 2003 levels, and on permitting interest rates to adjust as needed. The program will accommodate a modest expansion in real private sector credit in 2004 to help support the frail economic recovery. To help implement the monetary program, quarterly ceilings on Central Bank net domestic assets (NDA) and quarterly floors on net international reserves (NIR) have been established as described in the attached TMU (performance criteria). The government agrees to coordinate policy on public sector deposits with the Central Bank in support of the monetary policy objectives.

44. **The central bank's international reserves are an important cushion against external shocks and banking system difficulties, particularly given Paraguay's high level of dollarization.** Following the 2002 crisis, there has been a healthy recovery in international reserves. For 2003, reserves are expected to increase by US$177 million, to US$818 million. In 2004, reserves are programmed to strengthen further to US$855 million, maintaining reserves in excess of 3½ months of import cover. The Central Bank will limit foreign exchange market interventions to those strictly necessary to dampen seasonal fluctuations and to achieve the program's NIR targets.

H. Structural Policies

45. **Paraguay suffers from serious structural impediments to growth.** These problems have contributed to zero real GDP growth between 1997 and 2002, which led to a cumulative decline of 15 percent in per capita income and a sharp increase in poverty. Among the key structural challenges are: improving transparency and governance, improving the efficiency of the state and placing the public finances on a more solid and sustainable footing, providing for a more stable and efficient financial sector (see following section), and reforms to reduce

the role of the state in the economy and increase productivity. The government's program will include several important initiatives toward these objectives.

46. **A series of reforms in the fiscal area will be undertaken to place the public finances on a solid footing.** A major proposal to overhaul the **public sector employees' pension plan** (*caja fiscal*) was presented to Congress in October in the Pension Reform Law. This law seeks to eliminate the existing deficit (1.9 percent of GDP) of the fund over time. It includes: (i) a hike in contributions by two percentage points to 16 percent over an increased base wage; (ii) a significant increase in the ordinary retirement (from as low as 40); (iii) the indexation of benefits to projected inflation rather than to salaries; and (iv) the elimination of year-end bonus payments (*aguinaldo*). In addition, the government will conduct a review of beneficiaries with an aim to reducing the rolls of retirees. Approval of the Public Pension Reform Law is a performance criterion for the first review of the program.

47. **The government has sent to Congress a comprehensive fiscal reform, known as the Administrative Reorganization and Fiscal Adjustment Law.** The law: (i) eliminates most exemptions from VAT and broadens the tax base; (ii) lowers the corporate tax rate while eliminating most exemptions and tax holiday regimes; (iii) introduces a new motor vehicle tax (the *patente fiscal*); (iv) introduces a personal income tax, initially applying only to households with income above 10 times the minimum wage, but specifying a declining threshold in future years; (v) raises the ceiling on excise taxes for items like tobacco and alcohol; (vi) modifies and clarifies an existing financial transactions tax; and (vii) redefines the agricultural land tax (*IMAGRO*) and the unified tax for small contributors. Under the program, the government agrees that the financial transactions tax will not be applied. Approval of the Reorganization Law is a performance criterion for the second review.

48. **The government is committed to continuing its efforts to reform tax and customs administration.** In the tax area, the government has, among other measures, began a program of spot checks on VAT compliance, and intends to revive the practice of shutting down businesses if they fail to properly pay; enhance computerized cross check of tax compliance data; strengthen audit units; and improve training and incentives for tax collectors. In customs administration, the government will seek approval by Congress of a comprehensive reform of the Customs Code in line with the requirements of the revised Kyoto convention and the Mercosur Customs Code. The customs authorities will also undertake reforms to simplify import and export procedures; apply risk-based selection criteria for the physical inspection of goods prior to release from customs; institute post-release controls; fully apply the SOFIA computerized system; and reformulate the career system—including hiring, incentives, and promotion—for the Custom Administration staff. Passage of the new Customs Code is a structural benchmark under the program.

49. **During 2004, the government will take steps to streamline the public sector and improve governance by increasing the transparency of its operations.** As part of this effort, the government will approve a plan to **reform the civil service** with a view toward reducing its size and improving hiring practices, training, and working conditions (structural benchmark). The government will increase transparency in public sector contracts and help

reduce spending on goods and services and capital investment by full application in all public agencies of the recently passed **Public Procurement Law** (a structural benchmark under the program). As a first step toward an eventual reform of the **social security institute (IPS)**, an external audit will be required by an internationally recognized accounting firm (structural PC).

50. **Reform of the Central Bank (BCP) is essential to improve its ability to conduct monetary policy.** The Central Bank intends to refocus its monetary policy framework, increase operational autonomy, and improve technical capabilities in order to move toward an inflation targeting regime in the medium term (with technical support from the Fund). As recommended by the 2002 IMF Safeguards Assessment mission, the BCP will undertake a number of reforms. The BCP and the MOF will sign a memorandum of understanding (MOU) regularizing the financial relationship between the government and the BCP (performance criteria), including: (i) a phase-out of the annual contributions to be made by the BCP to the MOF; (ii) granting the BCP autonomy in its monetary policy budget; (iii) facilitating the operational budget and procurement process; and (iv) agreeing on a timetable to normalize the existing stock of government debt, and providing for the orderly recapitalization of the BCP's balance sheet if needed. The BCP will increase its frequency of external audits from bi-annual to annual starting with 2003 and will begin to apply and publish these accounts according to international accounting standards (structural benchmark). It will also begin in 2004 a reorganization process designed to streamline its operations, strengthen the Bank Superintendency, and improve statistical and analytical capabilities (structural benchmark). The BCP will also continue with the modernization of the payment system and banking supervision. As a more permanent mechanism for increased central bank autonomy, a reform to the Central Bank's charter law will be prepared during 2004 for submission to Congress.

51. **Key economic sectors in Paraguay (water, telecommunications, electricity, wholesale fuel distribution, cement) are dominated by public enterprises**. Inefficiencies and lack of investment in these firms constitute a barrier to economic growth and productivity improvements throughout the economy. As a first step, key public institutions (ANDE, COPACO, ESAAP, Petropar, INC and Conatel, ANNP, Dinac) will have external audits of their accounts (performance criterion) and begin publication of monthly cash flow statements. Under the program, the government will develop a plan for the participation of private capital in the public enterprises (structural benchmark).

I. The Banking Strategy

52. **Paraguay's banking sector has shown remarkable resilience in face of the effects of the regional crisis and the economic downturn**. Nevertheless, these stresses uncovered legal rigidities in dealing efficiently with systemic banking problems while the recession exacerbated current structural weaknesses in the system. The correction of these structural weaknesses and legal rigidities will make the banking system more resistant to shocks and enhance the government's ability to confront systemic bank problems.

53. **The government has prepared a strategy to enhance its banking supervision and resolution capabilities, reform the public banks, and modernize regulatory requirements for financial institutions.** Legislative approval of the Bank Resolution Law, submission to Congress of the Public Banking Reform Law and approval by the BCP of the regulation on asset classification and provisioning (*Resolución 8*) are all prior actions and the passage by Congress of a Public Banking Law and of a comprehensive banking system legislation are performance criteria under the program. The government has requested a Financial Sector Assessment Program (FSAP) to take place during 2004.

54. **The Bank Resolution Law** will: (i) create a deposit insurance fund to protect the general public up to a defined limit per individual, (ii) create a bank recapitalization fund to provide additional public capital support to banks in difficulty and that involve systemic risk (on a case-by-case basis, within strict guidelines); (iii) develop legal tools to allow for the quick transfer of deposits to other financial institutions during bank resolutions; (iv) provide adequate legal protection to public officials working in the bank resolution process; and (v) delegate to the BCP the authority to issue regulations related to the deposit guarantee and banking resolution.

55. **The Public Banking Law** (prepared with the assistance of the World Bank and IDB) aims at consolidating several public lending institutions into a retail bank for micro enterprises and small farmers, and a small second tier bank to on-lend resources from bilateral and multilateral development lenders. In the interim, the National Development Bank has been recapitalized and its operations are being modernized and streamlined.

56. **The Comprehensive Banking Law** (prepared with the assistance of the World Bank) will aim to: (i) strengthen the institutional framework for monetary policy management; (ii) upgrade regulatory requirements for risk-weighted capital; (iii) bring accounting and prudential standards up to international best practices; (iv) bring regulation and supervision of nonbank deposit-taking institutions up to international best practices; and (v) improve the operational capacity of the Superintendency of Banks.

57. **The regulations on asset classification, credit risk, provisioning requirements and imputation of accrued interest (*Resolución 8*)** seeks to bring asset classification and provisioning levels to standard international practice. The gradual implementation of this regulation in 2004–6 will lead to a substantial increase in the level of provisions and thus improve the resilience of financial institutions to shocks.

58. **Among other initiatives, the government will extend regulatory supervision to the largest financial cooperatives (currently including over 20 percent of system deposits), applying appropriate prudential standards for their financial operations** (structural benchmark). The Bank Superintendency will implement a requirement that commercial banks be rated by internationally recognized rating agencies (structural benchmark). The Superintendency will also take steps to enhance bank supervision, including more frequent monitoring of banks' deposits and liquidity. The Central Bank will implement a transparent, nondiscriminatory policy of providing Central Bank liquidity

support to solvent banks with preannounced interest rate, including (i) continued use of the Central Bank's lender of last resort (LOLR) facility; and (ii) permitting banks to use, under proper conditionality and within legal limits, required reserves to meet their short-term liquidity needs.

J. External sector

59. **Paraguay is an open economy, with imports and exports each representing over one third of GDP.** Paraguay has eliminated most tariffs on intra-regional trade in MERCOSUR. The special tariffs imposed in mid-2001 on selected products were a response to extraordinary measures adopted by other MERCOSUR members and would be eliminated as soon as these measures are withdrawn. Paraguay is also actively seeking the elimination of nontariff barriers imposed by other countries on Paraguayan exports. The government will also observe the standard performance criterion against imposing or intensifying exchange rate restrictions, introducing or modifying multiple currency practices, concluding bilateral payments agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement, and imposing or intensifying import restrictions for balance of payments reasons.

60. **Paraguay is expected to run current account surpluses in 2003 and 2004.** Repayments of public sector loans (US$200 million, excluding the clearance of external arrears), private sector loans and other capital outflows are projected to result in total financing requirements of about US$315 million in 2004. Financing will come from borrowing of about $225 million (excluding program loans) from multilateral and bilateral creditors, foreign direct investment (US$34 million) and other capital inflows. External arrears will be repaid as described above.

K. Statistics

61. The Paraguayan government will expand coverage of the system of government financial statistics (*Sistema Integrado de Administración Financiera*) to all levels of government. It will also harmonize accounting standards in the public sector and will establish a uniform monthly information system for all entities within the nonfinancial public sector. The government will ensure that monthly financial information on the large public institutions (PETROPAR, ANDE, COPACO, ESSAP, Dinac, ANNP, Conatel, and INC) and on the social security institute (IPS) will be made available to Fund staff with a lag of no longer than 30 days after the end of each quarter. In addition, these enterprises will publish their monthly cash flow statements and their external audit reports via the internet. The government will develop a system for collecting and reporting regular financial data from the largest financial cooperatives and will report these data to the Fund on a monthly basis along with its regular banking system reports.

PARAGUAY—TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum presents definitions of the quantitative targets specified in the Memorandum of Economic and Financial Policies. Targets for December 2003 and March 2004 are performance criteria; for June, September, and December 2004 the targets are indicative, with the performance criteria to be set at the time of the second review.

A. Monetary Targets

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

	Floor (In millions of U.S. dollars)
Outstanding stock as of:	
September 30, 2003 (actual)	824
December 31, 2003	818
March 31, 2004	762
June 30, 2004 (indicative)	836
September 30, 2004 (indicative)	822
December 31, 2004 (indicative)	855

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

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

NIR targets will be adjusted *upward (downward)* for any *increase (decrease)* in reserve requirement deposits (*encaje*) associated with foreign currency deposits in commercial banks, compared to the following levels: December 31, 2003- US$240 million; March 31, 2004- US$247 million; June 30, 2004- US$260 million; September 30, 2004- US$263 million; and December 31, 2004- US$267 million.

2. Performance Criterion on Net Domestic Assets

	Ceiling (In billions of guaraníes)
Outstanding stock as of:	
September 30, 2003 (actual)	-3,416
December 31, 2003	-2,890
March 31, 2004	-2,770
June 30, 2004 (indicative)	-3,085
September 30, 2004 (indicative)	-3,055
December 31, 2004 (indicative)	-2,761

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

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

B. Fiscal Targets

3. Performance Criterion on the Overall Balance of the Central Administration (Financing Side)

Cumulative Balance	Floor (In billions of *guaraníes*)
Overall balance of the central administration from January 1, 2003 to:	
End-September 2003 (actual)	-6
December 31, 2003	-125
From January 1, 2004 to:	
March 31, 2004	240
June 30, 2004 (indicative)	320
September 30, 2004 (indicative)	440
December 31, 2004 (indicative)	55

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

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

4. Performance Criterion on the Wage Bill of the Central Administration

Cumulative Expenditure	Ceiling (In billions of *guaraníes*)
January 1, 2003 to:	
End-September 2003 (actual)	1,891
December 31, 2003	2,750
From January 1, 2004 to:	
March 31, 2004	650
June 30, 2004 (indicative)	1,310
September 30, 2004 (indicative)	1,990
December 31, 2004 (indicative)	2,900

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

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

Cumulative Balance	Floor (In billions of *guaraníes*)
January 1, 2003 to:	
End-September 2003 (actual, measured from the financing side)	-387
December 31, 2003	-321
From January 1, 2004 to:	
March 31, 2004	250
June 30, 2004 (indicative)	350
September 30, 2004 (indicative)	495
December 31, 2004 (indicative)	130

For the purposes of the program, the consolidated public sector comprises: (i) the CA as defined above; (ii) the social security institutes, the provincial governments, autonomous decentralized agencies, and the nonfinancial public enterprises[1]; and (iii) the Central Bank of Paraguay (BCP).

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

Net external financing of the public sector is defined as all external disbursements less amortizations paid of the entities of the public sector as defined above, including any debt of the financial public sector guaranteed by the Republic of Paraguay or the BCP. The change in net credit is defined as the net flow of gross domestic credit (excluding treasury bonds) plus use of deposits by the nonfinancial public sector (excluding the BCP) in the domestic financial system. The change in the stock of government bonds is defined as the net change in public bonded debt held by the financial system (excluding the BCP) and the private sector. It is measured net of valuation changes. Domestic floating debt of the public sector is defined as the difference between accrued expenditure (*gastos obligados*) and payments

[1] Instituto de Previsión Social (IPS), Caja Bancaria, Caja Ande, Caja Ferroviaria, Caja Municipalidades, the public universities (UNA, UNE, UNP, UNI), 17 provinces (*gobiernos departamentales*), 13 autonomous regulatory and development agencies, the public enterprises (PETROPAR, ANDE, ANNP, DINAC, FFCC, INC) and incorporated enterprises owned by the state (ESSAP, COPACO).

transferred (*gastos transferidos*).with the private sector. External debt arrears are defined as principal and interest not paid by the due date of debt guaranteed by the Republic of Paraguay or the BCP as reported by the Ministry of Finance's SIGADE plus the net change in arrears to foreign suppliers of the consolidated public sector. The financing of the quasi-fiscal balance of the BCP is measured as the negative of all administrative and financial revenues minus costs (including costs of monetary policy and interest on BCP external debt), and net capital transfers to other financial institutions, as reported by the BCP. The registry float is defined as all net payments executed by the Treasury of the CA and payments units of the other public sector entities but not yet cashed or registered in the accounts of the financial system. Data will be provided to the Fund by the Ministry of Finance with a lag of not more than three weeks past the test date.

C. Public Debt and Arrears Targets

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

	Ceiling (In millions of U.S. dollars)
Cumulative change in stock from September 30, 2003:	
December 31, 2003	50
March 31, 2004	100
June 30, 2004 (indicative)	150
September 30, 2004 (indicative)	200
December 31, 2004 (indicative)	200

The nonfinancial public sector (NFPS) is defined as the consolidated public sector (as defined above) excluding the Central Bank of Paraguay. The limit applies to the contracting or guaranteeing by the NFPS of net new nonconcessional external debt with an original maturity of more than one year, including commitments contracted or guaranteed for which value has not been received.[2] For program purposes, a debt is concessional if it includes a grant element of at least 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates (CIRR).[3] Excluded from the limits are credits extended by the IMF and balance of payments support loans extended by multilateral and

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

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

bilateral creditors. Data will be provided by the Ministry of Finance to the Fund with a lag of not more than 30 days from the test date.

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

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

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

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

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

	Overall Ceiling	Ceiling on official bilateral arrears
	(In millions of U.S. dollars)	
Outstanding stock of **external arrears** as of:		
September 30, 2003 (actual)	102	51
December 31, 2003	102	51
March 31, 2004	75	38
June 30, 2004 (indicative)	45	22
September 30, 2004 (indicative)	10	5
December 31, 2004 (indicative)	0	0

In addition, the government is engaged in good faith efforts to resolve certain overdue payments in dispute, and will attempt to resolve these disputes as soon as possible. The stock of external arrears will be calculated based on the schedule of forthcoming external payments obligations reported by SIGADE and the BCP's information on which external payments were made. Data on external arrears will be reconciled with the relevant creditors, and any necessary adjustments will be incorporated in these targets at the time of the first review. For the purposes of this performance criterion, an arrear will be defined as when a payment has not been made within 30 days after falling due. In addition, the public enterprises will report to the Ministry of Finance and the BCP arrears on any external debt that is not recorded under SIGADE. The same 30-day grace period will be applied to all external payments of public enterprises, except where explicit agreements exist with creditors on an extended grace period (as the case for some of PETROPAR's external providers). The BCP will provide the final data on the stock of public sector external arrears to the Fund, with a lag of not more than 30 days from the test date.

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

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

	Ceiling (In billions of *guaraníes*)
Outstanding stock of **domestic floating debt** as of:	
September 30, 2003 (actual)	277
December 31, 2003	360
March 31, 2004	350
June 30, 2004 (indicative)	320
September 30, 2004 (indicative)	285
December 31, 2004 (indicative)	250

On the first test date only, the ceiling on central government floating debt will be adjusted upward (downward) by any shortfall (excess) in program lending below (above) US$15 million.

D. Reporting

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

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

Table. Paraguay: Structural Conditionality Under Program

Measure	Conditionality	Timing	Paragraph in MEFP
Financial Sector			
Approval by Congress of the Bank Resolution law	Prior Action	30 Nov. 2003	23
Approval by Central Bank Board of banking supervision reform (Resolution 8)	Prior Action	30 Nov. 2003	26
Passage by Congress of a public banking law to consolidate and Restructure the public development banks	PC		24
Passage by Congress of new comprehensive banking system legislation	PC	31 Dec. 2004	25
Require all banks to obtain international risk rating	SB	31 Dec. 2004	27
Extension of regulatory supervision to financial cooperatives	SB	1 Jan. 2005	27
Central Government and Central Bank			
Implementation of tax and custom administration reform generating 1.0 percent of GDP annually, including: - Replacing Large Taxpayer Unit's auditors and reducing the number of firms in 5 this Unit from 3,500 to 3,000 - Simplifying customs checkpoints; - Conducting on-site tax inspections and follow-ups to commercial establishments to verify compliance with VAT procedures.	Prior Action	30 Nov. 2003	7
Increase in fuel tax from 14 to 20 percent	Prior Action	31 Aug. 2003	7
No accumulation of external arrears	Prior Action/ Continuous PC		9
Approval by Congress of the public pension reform law	PC	8 March 2004	7,15
Approval by Congress of Administrative Reorganization and Fiscal Adjustment	PC		7,16
Approval by Congress of a new customs code and implementation of a customs reform program	SB	31 Aug. 2004	17
Full application of Public Procurement Law	SB	30 June 2004	18
Development of a plan for comprehensive civil service reform	SB	31 Oct. 2004	18
Begin implementation of a central bank restructuring plan	SB	31 July 2004	19
BCP and MOF to sign a memorandum of understanding regularizing the financial relationship between the government and the BCP	PC	28 Feb. 2004	19
Application of international accounting standards and annual external audits of the central bank	SB	30 June 2004	19
Public Enterprises			
Government to make regular adjustments in fuel and utilities prices to fully reflect input costs and exchange rate changes	PC	1 July 2004 1 Jan. 2005	11
Presentation of a plan for the participation of private capital in key public enterprises	SB	31 Dec. 2004	20
Governance			
Conduct independent external audits of the accounts of key public institutions and the Social Security Institute	PC	30 Sept. 2004	18,20
Increased data publication for government and public enterprises	SB	30 Sept. 2004	20

Statement by the IMF Staff Representative
December 15, 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 edged higher.** Monthly consumer price inflation in November 2003 was 1.3 percent, bringing the 12-month rate to 9.9 percent. In October, producer prices rose by 2.5 percent, causing the 12-month rate to reach 16.9 percent.

- **The *guaraní* has continued to appreciate against the dollar,** closing at **6,050** per dollar on December 9 (up 16 percent for the year).

- **Net international reserves were US$884 million on December 9.** Although some decline may be expected in the second half of December due to government debt service payments, reserves are likely to remain well above the program target for end-December. These additional reserves will provide an important cushion against any adverse shocks during the program.

- **Tax revenues increased by 39 percent in November, continuing the sharply higher trend since August.** Revenues in the first 10 days of December continued at roughly the same pace.

- **Asset quality of the banking system has begun to improve.** The average nonperforming loan ratio declined from 23.2 percent in September to 22.7 percent in October 2003.

- **The 2004 budget will be approved in the coming days.** A final vote in the Chamber of Deputies was taken on December 9, and the final Senate vote is expected soon. Early pressures in Congress to sharply increase spending have been defeated, and congressional leaders have assured the staff that the final version will be fully consistent with program targets.

- **The Senate and Chamber of Deputies have both passed the Public Pension Reform Law**. Slight differences in the version approved mean the law returns to the Senate for reconciliation. Passage of the law is a condition for the first review under the program.

- **Paris Club creditors have indicated their willingness to consider granting forbearance to permit the clearance of arrears to its members in line with the program.**

Press Release No. 03/218
FOR IMMEDIATE RELEASE
December 15, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves 15-Month US$73 Million Stand-By Arrangement for Paraguay

The Executive Board of the International Monetary Fund (IMF) today approved a 15-month SDR 50 million (about US$73 million) Stand-By Arrangement for Paraguay to support the country's economic program. The approval opens the way for the immediate release of SDR 30 million (about US$44 million). The authorities have indicated their intention to treat the arrangement as precautionary.

Following the Executive Board discussion, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chairman, said:

"Paraguay has launched an ambitious reform program to stabilize the economy and begin a process of structural reform to raise growth, reduce poverty, and improve governance. The government has actively sought broad consensus from political parties and civil society for the key elements of its reform program, and this participatory approach should enhance prospects for successful program implementation.

"The stabilization effort is anchored on an ambitious fiscal agenda. The authorities are committed to eliminating the fiscal deficit in 2004, undertaking lasting reform of the institutions of the public sector, restructuring and reducing debt, and clearing all payment arrears.

"Strengthening revenues is a critical component of the program, and will be achieved through increasing key excise tax rates, broadening the base of the value-added tax and the income tax, implementing a new vehicles tax, and strengthening tax and customs administration.

"Efforts at fiscal consolidation will include spending austerity, redirecting spending to the social sectors and public investment, reforming the public employees' pension plan, and containing the losses of public enterprises through efficiency enhancement and adequate pricing policy for fuel and utilities. Expenditure management will benefit from the implementation of the recently approved Public Procurement Law, and the undertaking of external audits of public institutions.

"To ensure successful medium-term fiscal consolidation, the authorities intend to continue working on normalizing relations with external and domestic creditors, and to prepare reforms of the civil service, the social security system, and public enterprises.

"Paraguay's monetary policy will be geared to controlling inflation and allowing a freely floating exchange rate. The central bank will undertake institutional reforms to improve its ability to conduct an independent monetary policy. The authorities will also take important steps to improve the financial system. These measures include restructuring the public banks, strengthening the bank resolution framework, strengthening regulation and supervision of financial entities, including cooperatives, and requiring independent credit ratings of banks.

"With resolute implementation of the policies contemplated in the program and sustained efforts to improve transparency and governance, Paraguay should move into a period of greater economic stability and more robust growth. This, in turn, will contribute to reducing poverty and providing resources to address the country's social challenges," Mr. Sugisaki stated.

ANNEX

Recent economic developments

In 2002 Paraguay's economy fell into its worst recession in decades as a result of the regional crisis, a poor harvest, and lack of political consensus to implement the necessary reforms. Real GDP fell by nearly 2½ percent, inflation accelerated from 8½ percent to 14½ percent, and the guaraní lost 34 percent of its value in relation to the U.S. dollar. Fiscal problems led to the accumulation of large payment arrears, including to some multilateral institutions, and default on some domestic bonds. Open unemployment rose from 7.6 percent in 2000 to 10.8 percent in 2002.

The economic situation has improved in 2003. A good harvest, the improved regional situation, and first steps towards the implementation of the new authorities' program have combined with a more stable domestic political environment to produce a projected increase of around 2 percent in real GDP for the year. Annual inflation was below 10 percent in October, down from the peak of 21 percent reached in April. However, significant economic imbalances remain. In particular, large financing gaps in the public sector and a recovering banking system leave the economy vulnerable to shocks.

Program summary

Paraguay's economic program, which is supported by the Stand-By Arrangement, seeks to create conditions for sustained economic growth and poverty reduction, and to address long-standing governance problems by improving the efficiency and transparency of government operations. The program aims to stabilize the fiscal situation and to initiate structural reforms in the public sector and the banking system. Growth is projected to rise to around 2½ percent in 2004 and climb to around 3½ percent in the medium term. Underlying inflation should fall from 9 percent in 2003 to 6½ percent in 2004. The current account would remain broadly in surplus.

The **fiscal policy** package prepared by the new government is intended to close the fiscal financing gap, pay off arrears, and place the public debt on a more sustainable path. Fiscal adjustment measures already implemented will produce an improvement of at least 1½ percent of

GDP on an annual basis, and measures to be implemented during the program period would yield an additional 2-2½ percent of GDP annually. The adjustment would bring the overall balance into slight surplus and initiate a decline in the debt/GDP ratio toward around 30 percent of GDP by the end of the decade, while accommodating increased capital spending and social investment. On the revenue side, the government's strategy is to raise revenues while minimizing increases in tax rates.

For 2004 the authorities are committed to a **monetary policy** geared toward controlling inflation while maintaining exchange rate flexibility. The program establishes targets on net domestic assets designed to bring the growth in the money supply down to a rate more consistent with single-digit inflation in the medium term, while allowing for a recovery in private lending. Paraguay's central bank will also work to develop the necessary technical and statistical capabilities to move eventually to an inflation targeting regime.

Financial sector reforms are intended to make the system more resilient and efficient. The authorities have already taken measures to enhance bank supervision and resolution capabilities, as well as pass legislation to introduce a deposit insurance system. Under the program they plan to reform the public banks and modernize regulatory requirements for all financial institutions.

The **structural reform** agenda is focused on strengthening public sector efficiency and governance. Initiation of public sector reform (in particular the public enterprises, the central bank, and the social security institute) and a public banking law, among other measures, will provide an improved institutional environment for sustained economic stability and growth.

Paraguay joined the IMF on December 28, 1945; its quota is SDR 99.9 million (about US$146 million), and it has no outstanding use of IMF credits. Paraguay last had an IMF program in 1960.

Table 1. Paraguay: Selected Economic Indicators, 1999–2004

	1999	2000	2001	Est. 2002	Proj. 2003	2004
	(Annual percent change)					
National accounts and prices						
GDP at current prices	3.0	11.5	4.4	13.7	16.7	9.3
GDP at constant prices	0.5	-0.4	2.7	-2.3	2.0	2.4
Consumption	-3.6	0.8	6.2	-5.1	2.8	2.4
Investment	-3.8	-0.7	-17.5	-11.0	-4.6	7.6
Net exports (contribution to growth)	4.8	-0.9	0.4	4.4	0.0	-0.8
Exports	-27.0	-15.1	-0.4	14.3	2.3	0.2
Imports	-27.1	-6.7	-1.6	-6.3	1.5	3.0
GDP deflator	2.5	11.9	1.7	16.4	14.3	6.7
Consumer prices (average)	6.8	9.0	7.3	10.5	14.1	7.5
Consumer prices (end-of-period)	5.4	8.6	8.4	14.6	8.8	8.0
Real effective exchange rate						
Average (depreciation -)	6.4	-3.1	-1.5	-3.9	...	...
End-of-period (depreciation -)	2.4	4.3	-12.5	-6.6	...	...
	(In millions of U.S. dollars)					
External sector						
Exports, f.o.b.	2,307	2,322	1,876	1,878	2,102	2,111
Imports, c.i.f.	2,750	2,864	2,495	2,159	2,339	2,398
Current account	-165	-163	-278	92	83	26
(in percent of GDP)	-2.1	-2.1	-4.0	1.7	1.4	0.4
Capital account	509	157	152	5	-308	116
Overall balance	87	-254	-50	-123	75	141
Terms of trade (deterioration -)	2.3	-4.6	-0.1	7.4	5.9	-4.8
	(In percent of GDP)					
Public sector						
Central government primary balance	-2.8	-3.1	0.2	-1.7	1.0	1.5
Central government overall balance	-3.6	-4.3	-1.1	-3.1	-0.3	0.2
Consolidated public sector primary balance 1/	-1.8	-2.6	1.0	-1.3	1.2	2.2
Consolidated public sector overall balance 1/	-3.1	-4.0	-0.7	-3.2	-0.6	0.3
Public sector external debt (end-of-year)	28.9	30.6	33.5	42.9	44.3	40.5
Domestic public sector debt 3/	3.1	3.4	4.9	6.8	4.8	5.3
	(Annual percent change)					
Money and credit						
Monetary base	9.5	-1.3	5.8	-1.0	49.9	3.2
M2	10.7	2.2	4.9	-2.2	19.0	17.0
M5 3/	6.4	-0.1	1.5	-18.5	18.4	14.4
Net foreign assets 4/	13.1	-5.4	-5.5	-12.8	25.2	4.8
Net domestic assets 4/	-6.7	5.3	7.0	-5.6	-6.8	9.6
Credit to the public sector 4/	-9.0	2.3	3.5	5.2	2.5	0.7
Credit to the private sector 4/	1.3	-0.8	-0.7	-14.9	-10.7	6.3
Velocity of M2	6.6	7.2	7.2	8.3	8.2	7.6
Memorandum items:						
International reserves (in millions of U.S. dollars)	988	772	723	641	818	855
(in months of imports)	3.6	3.2	3.5	2.8	3.7	3.5
GDP (in billions of guaranies)	24,144	26,921	28,119	31,977	37,302	40,779

Sources: Paraguayan authorities; and IMF staff estimates.

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

2/ Includes use of deposits.

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

4/ Contribution to M5 growth.

Statement by Guillermo Le Fort, Executive Director for Paraguay and Dimas Ayala, Advisor to Executive Director
December 15, 2003

Key Points

- *The authorities are fully committed to address the long-term fiscal and financial weaknesses, by implementing a far reaching economic program based on deep reforms, covering the tax system, public expenditure management, the pension fund, the state bank, and the financial system.*

- *The authorities are strongly committed to combating corruption and increasing transparency. Full implementation of the new public procurement law is included in the program agenda.*

- *The government has achieved broad political support for the economic strategy, clearly demonstrated by the full adoption of the prior actions under the program. A new Banking Resolution Law and a new Regulatory Framework for banks' assets classification and provisioning were introduced.*

- *The monetary authorities will target single digit inflation and a prudent level of official reserves. Fiscal reforms are aimed at restoring discipline, and the central government is projected to post a small surplus in 2004.*

1. On behalf of the Paraguayan authorities, we thank the staff for a well-focused report and for their valuable advice and assistance in the design of a comprehensive reform agenda. Last year, the lack of social and political consensus made it impossible to pass key legislation, thus hindering the possibility of reaching an agreement on a Stand-By Arrangement. However, and as mentioned in our Buff for the last March Consultation, Paraguay is now facing a more conducive political environment that has allowed the necessary political consensus to implement with strong ownership the authorities' economic program. Thus, after 46 years, and for the second time in the country's history, Paraguay is in a position to request the IMF Board for financial support for its economic program, this time in the form of a 15-month Precautionary Stand-By Arrangement.

Background and Recent Developments

2. Adversely affected by severe external and domestic shocks, in 2002 the Paraguayan economy experienced a significant fall in real GDP, by nearly 2 ½ percent, thus aggravating the already high poverty levels. Moreover, inflation jumped to 14 ½ percent, the *guarani* lost 34 percent of its value and the Central Bank reserves

declined to US$ 641 million, the lowest since 1993, while large domestic and external payment arrears were accumulated by the public sector. All these resulted in the downgrading of Paraguayan foreign currency debt to Selective Default. Even more, such results came after nearly 2 decades of economic stagnation and poor macroeconomic performance, due inter alia to structural impediments to growth, banking sector weaknesses, governance problems, and inefficient public enterprises.

3. There has been a slight economic recovery in 2003, particularly due to improvements in the global and regional conditions, a good harvest in the agricultural sector, an improved political outlook, and the first steps towards the implementation of the authorities' program. In addition, the *guarani* has appreciated against the U.S. dollar by nearly 15 percent so far this year, official reserves have risen over 36 percent since end-2002, inflation rate has declined to single digit, and real GDP is projected to grow around 2 percent. However, the authorities recognize that these improvements will not be sustained unless key structural weaknesses are promptly addressed.

4. Since the new government took office, the authorities have focused their efforts on addressing long-term structural weaknesses and implementing adjustment measures towards economic recovery. They propose to reverse the deterioration of public finances and to improve the soundness of the financial system. It is important to mention that the government and all political parties agree on the main measures that should be taken to address the long term weaknesses. Indeed, the agreement signed by the main political leaders backs a series of legal reforms towards the rationalization of public expenditure in the Budget of 2004, restructuring the state pension fund, modification of the tax regime, introduction of a new customs code, restructuring of the public debt, reforming state banking, and reforming publicly owned enterprises. This cross-party agreement opened the way towards defining a strong-ownership reform program. The full observance of the prior actions agreed under the program with the Fund is proof of the political support and the authorities' strong determination.

Monetary and Financial Policies

5. Thanks to the prudent monetary policy implemented by the new authorities, annual inflation has dropped to 9.9 percent in November, after peaking at 21 percent last April, and the *guarani* has partially recovered its value after the sharp depreciation in 2002. Our authorities share the staff's concerns about inflation risks if monetary policy is not conducted appropriately, but they have taken a series of reform measures to make their operations more transparent and independent. The goal is to maintain a single digit annual inflation rate over the program period. At the same time, intervention in the foreign exchange market will be limited, mainly to avoid erratic fluctuations and to achieve the program's NIR targets. The Central Bank is developing the 2004 monetary program, and the government has agreed to coordinate the management of public sector deposits with the Central Bank to avoid generating disturbances in monetary policy or to financial institutions. In addition, the monetary

authorities' will request the Fund's technical assistance for the design and implementation of the inflation targeting regime.

6. Important steps have been taken to reform the financial sector and address its vulnerabilities. A Banking Resolution Law and a new Regulatory Framework for banks' assets classification and provisioning, both prior actions for the program, were recently approved by Congress and the Central Bank respectively. The law establishes clear procedures for bank intervention and resolution, creates a bank recapitalization fund to provide additional financial support to banks in difficulty, develops legal tools to allow quick transfer of deposits to other financial institutions during bank resolutions, and introduces a deposit insurance fund, among others. At the same time, new regulations on banks' assets classification and provisioning have improved prudential norms advancing to international standards. The gradual and consistent implementation of these new regulations will undoubtedly place the financial sector in a better position to confront domestic and external shocks, reinforce confidence, and improve financial intermediation. These measures will also give the supervising authorities additional tools to enhance control and more flexibility in responding to an eventual crisis.

7. Meanwhile, the Superintendence of Banks has been receiving considerable technical assistance from the Fund and other specialized institutions to strengthen its oversight capacity and adapt to changes taking place in the financial system. The monetary authorities are also committed to build the basis for lowering the current high lending spreads, as well as facilitating financial intermediation and the development of credit to the private sector. The authorities are confident that once macroeconomic stability is restored as a consequence of implementing a sound and credible economic policy strategy, an improved investment environment will stimulate financial intermediation by banks, thus contributing to economic recovery. The government has also requested an FSAP mission for next year in order to improve the diagnosis and better define the financial system reforms going forward.

8. Regarding the Public National Development Bank (BNF), the authorities are committed to implement next year a restructuring plan supported by a US$50 million sectoral loan from the IDB. Likewise, the draft public banking law was submitted to Congress at the beginning of this month, and its approval by mid-2004 is a performance criterion under the program. It incorporates the consolidation of several public lending institutions into a retail bank for micro enterprises and small farmers, and a second tier bank to on-lend resources from bilateral and multilateral development lenders. In addition, our authorities intend to continue with additional measures in the short term to further strengthen the overall financial system, including the largest financial cooperatives.

Fiscal Policy

9. The authorities are promptly confronting the difficult financial situation of the public sector. They have already avoided a widening of the central government deficit that,

in absence of measures, would have exceeded 2 percent of GDP and resulted in the accumulation of additional arrears. The authorities' fiscal strategy is already succeeding at containing the central government deficit this year, and the program is targeting a surplus in 2004, an ambitious target that confirms the authorities' determination to restore fiscal discipline. The debt to GDP ratio which has risen to nearly 50 percent is to be gradually reduced beginning in 2004 as a result of the fiscal adjustment and stronger growth.

10. The measures already adopted in 2003 include a 6 percentage point increase in the excise tax on diesel fuel, and administrative measures to reduce tax evasion and fight corruption in the public sector, including enhancing tax audits to large companies, strengthening customs procedures and reducing the number of customs officials at border crossing, and developing a strong public campaign encouraging people's compliance with tax obligations. These measures, along with the improved economic activity, have contributed to a significant increase in tax revenues. According to preliminary data, in September, October and November of this year, government revenues rose sharply by 36 percent, 53 percent, and 39 percent respectively, as compared to the same month in the previous year, while nominal GDP is projected to expand about 16 percent in 2003.

11. To confront the financial difficulties for 2003 and 2004, the authorities have successfully rescheduled with local banks and private creditors US$ 138 millions of domestic public debt. Under the signed agreement, debt maturities due in 2005 were extended to 2008, and interest rates reduced, resulting in a slight NPV reduction. The restructuring of public debt was approved by Congress the first week of December. The Stand-By Arrangement with the IMF will contribute for the disbursement of the World Bank's and the Inter-American Development Bank's loans for US$ 30 million each before the end of this year. The authorities intend to clear all public external debt arrears during the program and all domestic payment arrears that go beyond a normal float. Moreover, the authorities' commitment goes beyond to assess and negotiate any disputed debt and to settle arrangements with eventual creditors. It is important to mention that at the beginning of this month, the authorities addressed a letter to the Paris Club asking for special consideration to any existing arrears, and expressed their firm commitment that, as per the program, the arrears will be gradually cleared during 2004.

12. Major reforms are envisaged in the public sector, including the overhaul of the public employees pension plan (*the caja fiscal*), which currently generates a cash deficit of around 1.9 percent of GDP. Draft legislation was presented to Congress this past October, and has already been approved by the Upper House. This bill will contribute to reducing the existing cash deficit and consolidate its financial position over the medium-term by, among other actions, achieving higher contribution rates, increasing retirement age, and indexing benefits to projected inflation rather than to salaries.

13. Draft legislation has also been sent to Congress to modify the tax regime, aimed at raising revenues, simplifying the tax structure, widening the tax base, and eliminating tax distortions. The introduction of a new customs code was also submitted to Congress this past November. It intends to enhance customs administration by simplifying import and export procedures, improving control procedures, reformulating the employees' career system, and applying the SOFIA computerized import system in full, which will help reduce corruption and improve revenues. In addition, our authorities are committed to taking further measures in 2004 to improve the efficiency of the public sector, increase transparency and combat corruption; proof of such determination is the authorities' firm commitment to fully implement the procurement law in all public agencies by mid-2004. Our authorities have expressed their commitment to strengthen good governance. In this connection, they are making strong efforts to combat money laundering, counterfeiting, and drug-trafficking in Paraguay.

14. The government will also expand coverage of the government's financial statistics system to all levels of government to standardize accounting practices and to establish a timely and quality information system. Public enterprises and the Social Security Institute will provide monthly financial information to the Fund's staff with a lag of no longer than 30 days after the end of each quarter. In addition, these enterprises will publish their external audit reports to enhance transparency and improve management.

Conclusion

15. In sum, the Paraguayan authorities are confident that their policy framework addresses the many challenges that the country faces. Moreover, the broad political and social consensus for implementing the envisaged reforms underlines the strong ownership of the program. The authorities request the support of the international community to complement their efforts in overcoming today's economic difficulties, reinforcing confidence, and laying the basis for high and sustained growth and poverty reduction.