

**Paraguay: 2004 Article IV Consultation and Second Review Under the Stand-By Arrangement and Requests for Waiver and Modifications of Performance Criteria—Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Paraguay**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2004 Article IV consultation with Paraguay and second review under the Stand-By Arrangement and requests for waiver and modifications of performance criteria, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation and second review under the Stand-By Arrangement and requests for waiver and modifications of performance criteria, prepared by a staff team of the IMF, following discussions that ended in June 2004, with the officials of Paraguay on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 16, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of July 30, 2004 updating information on recent developments.
- a Public Information Notice (PIN) and Press Release summarizing the views of the Executive Board as expressed during its July 30, 2004 discussion of the staff report that concluded the Article IV consultation and the IMF arrangement, respectively.
- a statement by the Executive Director for Paraguay.

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

Letter of Intent sent to the IMF by the authorities of Paraguay\*  
Supplementary Memorandum of Economic and Financial Policies by the authorities  
of Paraguay\*  
Technical Memorandum of Understanding  
\*May also be included in the Staff Report

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PARAGUAY

**Staff Report for the 2004 Article IV Consultation and Second Review Under the Stand-By Arrangement and Requests for Waiver and Modifications of Performance Criteria**

Prepared by the Staff Representatives for the 2004 Consultation with Paraguay

Approved by Caroline Atkinson and Matthew Fisher

July 16, 2004

- **Discussions:** Discussions were held in May in Asunción and in June in Washington. The staff team met with President Duarte Frutos, Finance Minister Borda, Central Bank President González, other ministers, senior government officials, and representatives of the private sector.
- **Staff team:** The staff team was led by Mr. Franks and included V. Mercer-Blackman, R. Sab, R. Benelli (all WHD), and W. Brown (PDR). The missions were assisted by Mr. Durán-Downing, IMF representative in Asunción. Mr. Le Fort and Mr. Ayala (OED) participated in some of the discussions.
- **Stand-By Arrangement:** A 15-month SBA in an amount equivalent to SDR 50 million was approved on December 15, 2003. The authorities have announced their intention to treat the arrangement as precautionary and have not made the first purchase. Paraguay has no outstanding Fund credit.
- **Article IV consultation:** 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 utilities 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 and arrears:** 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 cleared all arrears to the World Bank as a prior action for the SBA, and cleared nearly all bilateral arrears in March 2004 (except for some technical amounts and disputed arrears under negotiation).

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## I. INTRODUCTION

1. **After years of economic stagnation and periodic economic crises, the government of President Nicanor Duarte Frutos took office in August 2003 and embarked on an ambitious program of economic reforms.** The staff agreed on a set of policies to be supported by a Fund arrangement in October 2003, and the Board approved a 15-month Stand-By Arrangement on December 15, 2003. Performance under the program thus far has been satisfactory in most areas. The first program review was concluded on April 12, 2004. For the second review, 9 of 11 end-March quantitative performance criteria were observed, including all monetary and fiscal deficit targets (Table 1). Missed PCs included the wage bill ceiling and one missed target on arrears. The Fiscal Adjustment Law (PC for end-May) was approved in a weakened version on June 25; the authorities have committed to a set of compensatory measures to compensate for the reduced revenue yield of the law.

2. **At the time of the last Article IV consultation on March 10, 2003, Directors recommended the adoption of a comprehensive program of fiscal and structural reforms in order to set Paraguay on a path of sustainable growth.** They suggested that the strategy should center on restoring fiscal sustainability, improving the efficiency of the public sector, strengthening the banking sector, and improving governance and fighting corruption. Specifically, they urged the authorities to adopt a comprehensive and balanced fiscal package, including measures to increase tax revenues as well as appropriate spending restraint, and efforts to correct financial problems in certain public enterprises. Directors also emphasized the need to reform the public employees' pension plan. Directors noted that monetary policy had responded pragmatically to the difficulties faced in 2002, but they urged the authorities to strengthen the operational framework of monetary policy, to establish a clear nominal anchor and increase the central bank's operational independence. Directors encouraged the authorities to monitor the situation of banks closely and to take a proactive stance in response to any difficulties. In particular, Directors expressed concern about the precarious financial situation of the National Development Bank (BNF). They urged the authorities to implement without further delay a comprehensive restructuring and reform of the bank, along the lines of the program designed last year with the support of the IDB.

## II. BACKGROUND AND RECENT DEVELOPMENTS

3. **The Paraguayan economy is only beginning to emerge from a long period of slow growth.** Over the two decades to 2002, per capita income fell by an average of 0.6 percent per year (Tables 2 and 3). This stagnation reflected weak macroeconomic management and a series of structural problems, which impeded growth and left the country more vulnerable to the effects of economic shocks. The main structural problems include:

- **Political instability.** During the 1990s, the political system was rocked by a coup attempt, the assassination of a vice-president, the resignation of a president, and a subsequent

period of government by an interim President, González Macchi, who was not popularly elected.

- **Serious governance problems.** Corruption, inefficiency, poor guarantees of property rights, and lack of transparency have afflicted both the public and private sectors. Paraguay has consistently ranked among the worst in the world in surveys of perception of corruption (See Box 1).

- **A weak banking system plagued by a series of crises.** Bank closures affected the financial sector in several rounds from 1995 to 2003, reducing the total number of banks from 35 to 14.

- **Inefficient public enterprises in key sectors.** Government firms are a strong presence in the water, electricity, transport, telecommunications, petroleum, cement, and banking sectors. Many are poorly run and their performance has depressed growth in the rest of the economy.

- **Low and falling productivity.** Poor human capital formation, inefficient public services, and governance problems have contributed to the deterioration.

- **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. Social spending per capita is one-fourth of the Latin American average.

4. **A sharp recession in 2002 was followed by a tentative recovery in 2003.** The regional crisis, problems with drought and foot-and-mouth disease in agriculture, and a banking crisis, all contributed to a drop of 2.3 percent in GDP in 2002 (Tables 2 and 3). There was a sharp depreciation of the exchange rate in 2002 and inflation accelerated, reaching 20 percent in early 2003. A bumper harvest produced positive GDP growth of an estimated 2.6 percent in 2003. The easing of the regional crisis and the clear victory of Nicanor Duarte Frutos in the April 2003 presidential elections provided an increased perception of economic and political stability later in the year. Banking system deposits recovered, the exchange rate appreciated against the dollar, and inflation eased to 9 percent at year-end. The nonagricultural economy remained stagnant, however.

5. **In 2004, the economy has stabilized but growth remains modest (Figures 1 and 2).** A late season drought depressed output of soy, the largest export crop, reducing expected agricultural output growth to near zero. Nonagricultural output is recovering, producing a forecast GDP growth for 2004 slightly above 2 percent. The *guaraní* has strengthened by 4 percent against the dollar so far in 2004, despite strong Central Bank purchases of foreign exchange. The strong *guaraní* contributed to a sharp fall in inflation. Year-on-year inflation through June was 5.5 percent, with inflation for the year as a whole expected at 4–5 percent.

6. **The political environment for reform has improved, but important challenges remain.** President Duarte Frutos has demonstrated an ability to advance important political

and economic reforms, despite not having a majority in the Senate.<sup>1</sup> He has appointed reform-minded people to key positions in the government and retains a high degree of support in public opinion polls. However, the government's support in Congress is fragile, with opposition parties often inclined to oppose government initiatives for political reasons, and increasing resistance from special interests whose privileges are affected by reform measures. There is also pressure from within the president's own Colorado party from factions, which have traditionally benefited from patronage and rent-seeking behaviors. Reform efforts must also confront long-standing and pervasive governance problems that seriously affect the efficiency of the public sector and generally act to undermine change (see Box 1).

7. **The fiscal situation has improved markedly since the new government took office in August 2003.** The consolidated balance of the nonfinancial public sector (NFPS) moved from a deficit of 3.1 percent of GDP in 2002 to balance in 2003 (Table 4). The primary balance improved from a deficit of 1.3 percent of GDP in 2002 to a surplus of 2.4 percent in 2003. The main features of the improvement in 2003 were:

- ***Expenditures were tightly controlled throughout the year in the central government.*** Current spending in the central government fell from 15 percent of GDP to 13½ percent of GDP (Table 5). A wage freeze for public sector employees and pensioners was the biggest factor, but control of goods and services spending and lower interest rates on public debt also contributed. Capital spending fell slightly in nominal terms in 2003, in part as the result of financing constraints on investment projects.
- ***Tax collections increased sharply beginning in August 2003 due to changes in tax and customs administrations.*** In the period August–December, tax collection increased by over 40 percent on 2002, compared to an increase of only 14½ percent during the first seven months of the year. For the year as a whole, tax revenues rose from 9 percent of GDP to 10 percent.
- ***The outturn of public enterprises improved.*** The operating surplus of the enterprises rose from 1.4 percent of GDP in 2002 to 2.1 percent of GDP in 2003, due mainly to the effect of an appreciating exchange rate on dollar costs in key enterprises. Results are expected to improve further as the *guaraní* remains strong and management changes have been made in some of the more problematic firms (Table 6).

8. **For 2004, the public finances are expected to improve further.** The central government will run a slight surplus. The early approval of the Public Pension Reform Law

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<sup>1</sup> Among the most important economic reforms implemented by the Duarte Frutos government so far are: passage of a bank resolution law, a reform of the public sector pension system, the passage of the Fiscal Adjustment law, full implementation of the public procurement law, and the approval of a new customs code.

(the *caja fiscal*) is expected to generate savings on the order of ½ percent of GDP in transfer payments. Continued low international interest rates and the normalization for external payments arrears will cause interest payments to fall slightly compared to 2003. Most importantly, the continued strong performance of revenue collections in the first half of the year suggests that tax revenues as a share of GDP will reach a historical high of near 12 percent of GDP. For the consolidated public sector, the surplus is expected to be around 1.5 percent of GDP, due to further improvements in the outturn of the public enterprises, as well as an improvement in the social security institute (IPS).

9. **The authorities have made significant progress in clearing substantial public sector payments arrears (Tables 7 and 8).** From a stock of over US\$250 million (4½ percent of GDP) at end-2002, arrears were reduced to US\$185 million in 2003 (3 percent of GDP) and have fallen further to US\$128 million by April 2004. Arrears to the World Bank and IDB were cleared in late 2003. The government obtained a short-term loan from the Central Bank in early 2004 to clear arrears to Paris Club countries ahead of the schedule contemplated in the program.<sup>2</sup> Of remaining external arrears, the largest components are those of the state-owned oil firm Petropar with its fuel suppliers.

10. **Domestic arrears have been lowered to a level comfortably below the end-March program target, and stricter conditions for ministries to stay within budget allocations should help maintain this margin.** In November 2003, an agreement was reached with holders of domestic bonds in default since December 2002 to exchange those bonds for new ones with extended maturities and a slight NPV reduction. A Law passed in December determined that the government would honor interest payments after December 26 according to the new terms and dates. There have been delays in completing the technical exchange itself, leading to the accumulation of interest arrears on the new bonds.<sup>3</sup> However, all old bonds that have been submitted by June 15 will be exchanged into new bonds (about 80 percent of the eligible amount), and all overdue interest on these new bonds will be paid (prior action for the review).

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<sup>2</sup> There are several disputed claims remaining, which the government is making good faith efforts to resolve, including US\$40 million in disputed arrears from a contract with customs verification companies SGS and Bivac, US\$16½ million in dispute with the Belgian Office du Ducroire for the construction of an ammunitions factory in the 1980s, and a debt of the electricity company ANDE with the German KFW for which legal authorization to pay is being sought from Congress.

<sup>3</sup> The protracted verification process led to delayed interest payments both on old and new bonds, and raised some technical definitional issues on domestic floating debt. Consequently, the staff opted to widen the definition of the floating debt for the purposes of the program, going forward beyond the authorities' internal definition. Had the broader definition been applied retroactively to the end-March PC on domestic arrears, the target would have still been met.



11. **After climbing to near 50 percent of GDP in 2002 and 2003, the public sector debt-to-GDP ratio is expected to drop sharply to 43 percent in 2004.** The drop is due to the expected fiscal surplus, plus a rise in U.S. dollar GDP (due to economic growth and currency appreciation against the dollar). About 90 percent of the debt is external, half of which is owed to international financial institutions and one-quarter to Taiwan, Province of China. Debt service remains relatively low (external debt service was 4.5 percent of GDP in 2003), because Paraguayan debt is mostly long term and at concessional interest rates.

12. **Monetary policy has been geared toward a flexible exchange rate regime since the *de facto* currency peg was abandoned in 2001 (Figure 3).** Nevertheless, the Central Bank of Paraguay (BCP) has maintained a strong presence in the foreign exchange market, accumulating and selling reserves to resist sharp movements in the *guaraní*. The BCP has limited the growth of the domestic money supply mainly through sales of the bank's *Letras de Regulación Monetaria* (LRMs), the stock of which has grown sharply over the past 3 years, from G/. 300 billion at end-2001 to around G/. 1.6 trillion in mid-2004 (Tables 9 and 10). Interest rates on LRMs have declined from their peak of 33 percent in August 2002, reaching 9½ percent by April 2004. However, the real interest rate has actually risen on LRMs since mid-2003, as inflation has fallen more rapidly than the interest rate. Base money growth accelerated sharply in 2003, as the economy began to remonetize after the banking crises. Base money rose by 58 percent in 2003, but the growth rate has since fallen to below 25 percent, but base money as a share of GDP remains reasonable by historical standards. The appreciation of the *guaraní* in 2003 also contributed to a greater willingness of agents to hold local currency, and as a result, some de-dollarization occurred (from 69 percent of deposits at end-2002 to 64 percent in mid-2004).

13. **The financial system has improved, but weaknesses persist (Figure 4).** In 2003, deposits largely recovered from the sharp drop in the 2002 banking crisis, and they have continued to rise so far this year. Credit to the private sector, in contrast, has continued to fall, down by 4 percent in May 2004. Higher deposits and falling credit has left banks in a highly liquid position. Much of this excess liquidity have been deposited in the Central Bank, contributing to the decline in the growth rate of base money. Nonperforming loan (NPL) ratios have begun to decline, although—at 13 percent for private banks—they remain high while provisioning requirements are still low (Table 11). Profitability of the banking system remains low, with several banks continuing to produce losses. Several banks have also closed or reduced significantly their operations in Paraguay over the past two years. Other risks include problems in some small finance companies (*financieras*)<sup>4</sup> and potential difficulties in the unregulated and largely unmeasured cooperative sector (which may constitute 20 percent of the financial system). (Box 2).

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<sup>4</sup> The Superintendency of Banks closed two small *financieras* so far this year.

14. **The risks in the National Development Bank (BNF) have eased somewhat due to a recapitalization in 2003 and new management, but concerns of its long-term viability remain.** The bank—with 8 percent of system assets—has continued to suffer from high administrative costs and a large stock of NPLs (58 percent of total loans). To implement a permanent solution for the BNF, the government submitted to Congress a public bank reform law expected to be approved by end-October 2004 (a PC under the SBA). The plan, prepared with the assistance of the IDB, contemplates consolidation of the BNF with other (small) public banks, and restructuring it to become a second-tier investment bank.

15. **Exports boomed in 2003 and are expected to increase further in 2004 (Table 12).** The good soy harvest and a rebound in the regional economy contributed to the increase in 2003. For 2004, the volume of soy exports are expected to decline due to the drought, but this is expected to be offset by continued buoyancy in international soy prices. Other agricultural product exports are expected to increase. Imports rose in 2003, although by less than exports, generating a second year of current account surplus.<sup>5</sup> For 2004, the current account is expected to be in slight surplus. The capital account is also expected to be in surplus, generating a large increase in international reserves for the year.

16. **During 2003, the *guaraní* appreciated by 13 percent against the dollar.** The general decline of the dollar in the world left the appreciation of the *guaraní* in real effective terms at 9.5 percent. In the first half of 2004, the currency appreciated somewhat further, despite central bank intervention. However, after the depreciation experienced by the economy in 2001 and 2002, the *guaraní* does not appear overappreciated in real terms when the fundamentals of the economy are taken into account (see Box 2, Figure 2).

17. **Despite some uneven progress, Paraguay will not meet important Millennium Development Goals unless decisive action is promptly taken (Box 3, Table 13).** Progress has been particularly slow on the goals of eradicating extreme poverty, reducing child mortality and improving maternal health.<sup>6</sup> The goal of achieving environmental sustainability is also unlikely to be met, with the country lagging behind on the provision of sanitation, especially in rural areas. Conversely, important advances have been made toward the goals of achieving universal primary education and gender equality and in combating major diseases.

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<sup>5</sup> It should be noted that unregistered trade represents about one-third of total trade, so balance of payments statistics cannot give a precise indication of external sector trends.

<sup>6</sup> In spite of slow progress on these fronts, both the World Bank and the UNDP still assess that the target of halving hunger is still within reach.

### III. OUTLOOK AND VULNERABILITIES

18. **Paraguay's economic outlook has improved markedly.** The new government has applied responsible fiscal and monetary policies, resulting in a sharp improvement in the public finances and the progressive normalization of payments arrears. Inflation has fallen from over 20 percent to around 3–5 percent, and the exchange rate has appreciated modestly. While climatic conditions will adversely affect agricultural GDP growth in 2004, the underlying growth of the nonagricultural economy has improved. The initiation of a process of comprehensive structural reform bodes well for growth prospects over the medium term. The regional economic environment has also improved, with favorable conditions in Argentina and Brazil likely to contribute to Paraguayan growth rather than detract from it, as occurred in 2002.

19. **Despite major improvements, vulnerabilities remain in the macroeconomic outlook.** In particular:

- Further problems in the region could affect trade, worker remittances from Argentina, and capital flows. A sharp rise in world interest rates might also place pressure on the exchange rate.
- Though the banking system is more liquid, high dollarization (over 60 percent of lending) will expose banks to credit risk in the event of a sharp depreciation. Persistent credit stagnation could also hamper medium-term growth prospects. The system is also vulnerable to continued high NPL ratios, and to the persistent weakness of the BNF.
- Policy slippages by the authorities in fiscal or monetary policies could undo the stability achieved over the past year, leading to renewed problems with arrears, inflation, and depreciation.
- Sensitivity analysis (Appendix I) of the medium-term outlook shows that low fiscal primary surpluses and exchange rate depreciation could have adverse effects on debt sustainability, while the scenario is less sensitive to variations in the interest rate.

20. **The medium-term outlook depends crucially on continued prudent macro policies and further structural reforms to boost medium-term growth to a rate consistent with higher per capita income growth.** Appendix I and Table 14 present two scenarios. The main points are:

- The **baseline scenario** assumes continued prudent macroeconomic policies, but does not assume deeper structural reforms in the medium term (Tables 15–17). Under this scenario, growth reaches around 3–3½ percent, and inflation remains in the 4–6 percent range. The fiscal adjustment already undertaken assures fiscal sustainability, with the public accounts remaining near balance and the debt-to-GDP ratio declining to around 25 percent of GDP by 2010. Growth of 3–3½ percent, while

better than that of the last two decades, will allow for only limited growth in per capita income, suggesting that higher growth rates should be targeted.

- Under the **adjustment scenario**, we assume that, in addition to prudent macroeconomic policies, far-reaching structural reforms are undertaken. These would include *inter alia*: privatization or capitalization of the public enterprises, social security system reforms, legal reforms to further reduce corruption and informality, education and health programs to improve the quality of human capital, and increased infrastructure investment. Under this scenario, growth would increase to around 4½ percent in the medium term, producing a larger increase in per capita income and a significant reduction in poverty.

#### IV. POLICY DISCUSSIONS

21. **Discussions with the authorities were focused on reviewing performance under the SBA, assessing fiscal and monetary policies, the advances in the government's structural reform agenda, and prospects for boosting economic growth.** The fiscal outturn, the reduction in inflation and increased central bank international reserves have exceeded program expectations. Important structural reforms have been approved in the face of significant opposition. However, the authorities expressed concern that economic growth was insufficient to generate an increase in per capita income, and worried about the adverse effect continued low growth might have on sustaining political support for the reform process.

##### A. Fiscal Policy

22. **Tax revenue has risen by 42 percent in the first five months of 2004, well ahead of program projections.** With nominal GDP growing on the order of 7 percent, and taxes largely unchanged,<sup>7</sup> the vast bulk of the increase is due to improved collection efficiency. Revenue from trade taxes is up by 46 percent, while VAT has increased by 42 percent, and corporate income tax revenue rose by 40 percent. Fuel tax revenues have risen by only 29 percent, as some excise tax revenues collected by the state oil firm *Petropar* have not been transferred to the government due to its financial difficulties (see ¶23). Nontax revenue has grown less than tax revenue. Social security contributions from public employees have increased sharply with the implementation of the reform of the *caja fiscal*, but royalties from the Itaipú hydroelectric consortium were somewhat lower due to a 2004 payment that was advanced into 2003, and the effect of currency appreciation, which lowered the *guaraní* value of this dollar-denominated income.

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<sup>7</sup> There was a small increase in the fuel tax rate in January 2004.

23. **The authorities noted that central government current expenditures in the first five months of 2004 were roughly as agreed in the SBA, but political pressure is building for increases.** Wages and salaries are slightly above program (leading to non-observance of the end-March PC), as the result of a wage increase granted by Congress for the security services. Interest expenditures, in contrast, are below program, due to continued low interest rates and early clearance of payments arrears. Capital spending has been above program in the first half of 2004, and the authorities indicated their intention to boost it further via a supplementary budget appropriation. The staff agreed that additional capital spending would be appropriate as long as the cost is covered by revenue overperformance, but cautioned that such spending be done efficiently, preferably by focusing it exclusively on projects financed by multilateral institutions. The staff also urged the authorities to resist political pressure to boost current spending in an attempt to artificially boost 2004 economic growth.

24. **Performance in the rest of the public sector has also exceeded the program projections, but there are problems in some public enterprises.** Social security revenues are above forecasts due to the stronger economy, while expenditures remain under control. The financial performance of most public enterprises is also above forecasts. The continued strength of the *guarani* has aided firms whose costs are largely in dollars (the electricity, water, and oil companies). However, significant cash-flow problems exist in the oil company *Petropar* and in the water company ESSAP, impairing their ability to service their debts and pay down arrears. Both *Petropar* and cement company INC accrued new external arrears in 2004 (leading to nonobservance of the continuous PC on no new external arrears); however, INC's accrual was due to a technical problem with its congressionally-approved budget rather than to cash flow problems at the company. *Petropar* has also been adversely affected by higher world oil prices. The authorities noted that they have taken steps to address these difficulties. Management was changed in both *Petropar* and INC in February 2004, working under an inter-ministerial supervision committee. Plans are advancing for a deeper restructuring of the two institutions (with advice from the World Bank on *Petropar*). Diesel prices were raised by 8 percent in April, ahead of the July date for a price adjustment agreed in the program.<sup>8</sup> This increase fully compensated for cost increases in *Petropar* at April world oil prices, though the staff cautioned that it may fall short of what is needed to allow the firm to eliminate payments arrears to suppliers and to the tax authorities. Moreover, continued high world oil prices may require further measures later in the year. The government agreed to assume some multilateral and bilateral debt service payments for water company ESSAP,

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<sup>8</sup> Under the program, fuel and utilities prices must be adjusted semi-annually at least to compensate fully for the effects of changes in input prices and exchange rate variations on costs. As the exchange rate appreciation reduced dollar costs for electricity and water, no price adjustment was required.

to assure timely payment of external obligations. The staff urged the authorities to move quickly on developing a comprehensive strategy for reforming the public enterprises.<sup>9</sup>

25. **On June 25, Congress approved the Administrative Reorganization and Fiscal Adjustment Law**, a performance criterion under the SBA, and a crucial piece of legislation for assuring the continuity of responsible fiscal policy. While certain aspects of the law are weaker than originally envisaged in the version sent to the Congress, it still constitutes a major improvement in the tax code. The potential revenue yield of the law (if all tax were placed at their legal maxima) has been reduced from 2½ percent of GDP to 1½ percent of GDP, but the actual expected yield (based on the authorities' intended tax rates) will be near original estimates.<sup>10</sup> The law eliminates most exemptions to the corporate income tax while reducing the rate, broadens the base of the VAT, institutes a new personal income tax (to be phased in over time), and institutes a new agricultural income tax to replace the previous IMAGRO tax. It also adjusts some excise tax rates, and strengthens legal authority for tax administration. The details of the law, as well as calculations of its yield, are found in Box 4 and Table 16.

26. **The authorities agreed to a series of compensatory measures to further boost revenues and strengthen tax administration in areas where the Fiscal Adjustment Law was modified.** On tax administration, the government will reprogram budget allocations and is using an IDB technical assistance loan to increase funding for the tax authorities in 2004 (prior action) and will submit to Congress a sharply higher budget request for 2005 to compensate for the loss of the 3.5 percent earmarking contemplating in the original draft law. The Undersecretariat for Taxation has launched a strategic plan, which will increase computerization, restructure the organization, and boost training for staff. Additional revenues will be raised from an increase in excise taxes on tobacco and cigarettes to their legal maxima. Further gains in revenue from tax administration will be realized by the full application of a cross-checking system for large taxpayers and an acceleration of enforcement actions. The government is prepared to use its legal authority to begin the reduction in corporate income tax in 2006 (rather than 2005) while starting the reduction in exemptions immediately. Together, these measures should boost annual revenue in 2005–06 by over ½ percent of GDP. Finally, the government is committed to preparing legislation to address remaining weaknesses in the Fiscal Adjustment Law for submission to Congress in 2005.

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<sup>9</sup> Presentation of a plan is a SB for end-December under the program.

<sup>10</sup> The authorities originally hoped to apply rates to yield 1.5 percent of GDP. Under the final version, they expect 1.3 percent of GDP. While the original draft law envisaged higher maximum rates on most excise taxes and on a financial transactions tax than the final version, the authorities had never planned to move all rates to those levels.

27. **The authorities have made great strides in normalizing relations with creditors and paying off arrears, but continued efforts are needed (Tables 7–8).** By early April, the government had cleared nearly all bilateral arrears, well ahead of the schedule contemplated in the program. This allowed them to overperform on the end-March program ceiling on official external arrears and also allowed them to meet the ceiling on total arrears despite a sharp increase in Petropar arrears to suppliers. Nevertheless, small arrears needed to be cleared with certain official creditors (e.g. Banque Worms). Their clearance is a prior action for the review. The authorities are making efforts to resolve disputed arrears with Belgium and Germany (KfW). The staff noted that the enhanced monitoring procedures set up by the authorities to improve debt payments were bearing fruit, but additional efforts were needed. Regarding the domestic bond exchange, interest due under the terms of the offer on the bonds not yet submitted for exchange will be held in escrow in the Central Bank. The program ceiling on domestic debt for end-March was observed with a margin.

### **B. Monetary and Exchange Rate Policy**

28. **The staff noted that monetary policy management has improved in 2003–04.** As of August 2003, the new government stopped using the threat of moving government deposits as a tool to manipulate the exchange rate independently of the Central Bank. The Ministry of Finance also signed a memorandum of understanding granting the Central Bank greater operational autonomy. The Central bank authorities have taken advantage of upward pressures on the *guaraní* to accumulate reserves well in excess of the original program targets. Reserves are now expected to be near US\$1.1 billion at end-2004, compared to US\$850 million in the original program. The appreciation of the *guaraní* also helped bring inflation below original projections. The authorities have used open market operations to sterilize the additional reserves accumulation, overperforming on the NDA program target by a similar margin and leaving the growth rate of currency issue in line with the program. Text Table A summarizes key monetary policy variables. Notwithstanding these positive developments, the staff noted that the Central Bank appears to continue to pursue multiple policy objectives—exchange rate, inflation, and quantitative monetary aggregates—shifting from one to another in an *ad hoc* way that may cause problems in future monetary policy management. Staff also observed that, despite falling interest rates on CB monetary notes, the quasi-fiscal costs of continued sterilized purchases of foreign exchange could become an issue.

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

	December				March	April	May
	2000	2001	2002	2003	2004	2004	2004
Effective reserve requirement ratio in local currency 1/	12.8	12.4	11.9	19.5	19.2	14.0	14.1
Effective reserve requirement ratio in fx currency 1/	22.4	22.6	22.8	24.4	24.6	25.1	25.0
Central bank bills (in billions of Guaranies)	45.9	297.5	677.5	1,071.0	1,272.6	1,443.0	1,608.1
Interest rates on central bank bills	5.9	21.0	24.7	12.9	9.5	9.5	7.1
Net foreign exchange intervention (- = sales) cumulative during year (in millions of US\$)	-120.0	-234.0	-186.1	73.2	29.7	57.4	80.3

Source: Central Bank of Paraguay.

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

29. **Interest rates have fallen over the past year, but have risen in real terms.** The average rate on LRMs in April was 9½ percent—higher in real terms than in mid-2003. Given low inflation and the large stock of excess reserves deposited at the Central Bank at zero interest, the staff suggested that there may be scope for an additional decline in rates. The authorities agreed, but noted that they wished to preserve relatively long maturities for LRMs even at the cost of higher interest rates, as a way of insulating monetary policy against sharp movements in excess banking sector deposits in the central bank.

30. **The staff urged the authorities to continue preparations for inflation targeting and to allow for a freely floating exchange rate.** The additional accumulation of Central Bank reserves experienced in recent months is a welcome cushion against future economic shocks in this open, highly dollarized economy. However, there are limits to the BCP's ability to continue to accumulate reserves (while sterilizing the impact on the money supply) without putting pressure on other program objectives. In particular, in the staff's view the *guarani* should be allowed to appreciate if capital inflows continue or depreciate should capital flows reverse. The authorities acknowledged the advantages the flexible exchange rate regime had given Paraguay since the peg was abandoned in 2001, and they reaffirmed their commitment to inflation targeting, but they argued that greater involvement in dampening exchange rate fluctuations is needed in order to stabilize prices and economic activity.

31. **The Central Bank is preparing to overhaul its structure in order to operate more efficiently and effectively.** The restructuring plan will build on advice from an MFD mission early in 2004, as well as advice from private consultants. The plan will outline the strategy for moving to inflation targeting in the medium-term. The reform is expected to reduce the overall size of the bank, while increasing staff resources dedicated to economic studies and banking supervision. The staff agreed with this strategy, but noted that eventually new legislation to give the Central Bank greater formal independence would be in order. The Central Bank completed its annual external audit and is reporting its results in both Paraguay and international accounting standards (SB).



### C. Financial Sector

32. **The recent improvement in the banking system must be continued if financial sector stability is to be sustained.** The Bank superintendency has made progress in applying new supervisory requirements (*Resolución 8*) and implementation of the new bank resolution law has begun, with the deposit guarantee fund scheduled to begin operating soon. The superintendency has also initiated work on applying a requirement for international risk classifications for banks (a SB for end-December). Some progress has been made in improving management and containing losses in the BNF, but more in-depth restructuring is needed. In this context, the staff observed that approval of the new public banking law (now a PC for end-October 2004) will be crucial. The authorities agreed, but noted that there will be strong political opposition, particularly from interest groups favored by the current, inefficient public banks. The staff also stressed the importance of extending regulatory supervision to the large and growing cooperative sector to forestall any financial instability coming from that sector (a PC for January 2005). The authorities noted that the cooperative institute, INCOOP, is legally obliged to begin supervision, but lacks an appropriate regulatory framework and supervisory skills. Efforts to remedy these lacunae are underway, but legal changes to grant regulatory and supervisory responsibility to the Central Bank are also being contemplated. Comprehensive banking system legislation is envisaged for late 2004 under the SBA and is supported by a forthcoming World Bank FSAL. The authorities have welcomed plans to undertake an FSAP.

### D. Other Structural Reforms

33. **Customs reform.** A new Customs code (now an SB for end-July) was approved by Congress on June 30, 2004. The code grants operational and financial autonomy to customs and greatly expand its powers of investigation and enforcement. The authorities are also receiving technical assistance from the IDB, the French government, and from an FAD resident advisor to implement the new law and a reform agenda that includes modernizing customs procedures and operations, improving control over goods and revenue collection, and addressing key human resource issues.

34. **Social security reform.** The authorities reported that new management installed in recent months in the IPS has begun to attack the deep problems in that institution. An external audit is underway, and procedures for handling the IPS's financial assets are being reformed. Nevertheless, the authorities recognized that comprehensive social security reform will be needed, and they are committed to tackling the problem over the medium-term.

35. **Civil service reform.** The government has begun to develop a reform plan for the civil service. A census of employees has been conducted to detect phantom workers and those collecting double salaries. The Ministry of Finance is serving as a pilot Ministry for future restructuring, with support from the World Bank.

36. **Governance.** The authorities indicated progress has been made on a number of measures to improve transparency and governance in Paraguay. The passage of the Fiscal

Adjustment Law, with its elimination of tax loopholes and strengthened tax administration, will reduce corruption in the tax system. The approval to the new customs code should reduce corruption associated with international trade and smuggling. In addition, the following efforts are underway to improve transparency:

- Independent audits of numerous public entities are underway. Most are should be completed by end-September (as originally envisaged) although some may require until year-end.
- The procurement reform approved by Congress in 2002 is fully functioning for all public sector agencies. Purchases must be made through a public web-based bidding process. Some entities are already reporting significant savings in procurement costs.
- Data publication of all public sector operations has already improved notably, although further progress is needed, particularly in Petropar.

#### E. Other Issues

37. **Trade policy.** Paraguay's economy remains relatively open and the authorities reaffirmed their continued commitment to free international trade.<sup>11</sup> In March, all of Paraguay's temporary import surcharges on imports from Mercosur partners expired, which had been imposed in mid-2001 to compensate for extraordinary measures adopted by other Mercosur partners. In December 2003, Mercosur approved several "asymmetry" decisions to give Paraguay special treatment within the trading bloc, including an extension of the deadline to harmonize tariffs with the Common External Tariff to 2010,<sup>12</sup> an extension of the exemptions for Paraguay's duty-free zones until 2014, beneficial "rules of origin" treatment for Paraguay's imports of intermediate goods used in exports, and the establishment of structural funds to channel assistance to less developed regions. The government is making progress in preparations to implement the decisions, which have still to be ratified by each Mercosur member. Paraguay's exchange system is free of restrictions.

38. **Poverty and the Millennium Development Goals (MDGs).** The staff observed that achieving the MDGs will require far-reaching actions. The new government has sought to protect social spending in executing the 2004 budget, with execution of social spending during the first few months of 2004 reaching about 90 percent compared to 60 percent for other spending. However, achieving the MDGs will require substantial investment in

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<sup>11</sup> Paraguay's trade regime is considered moderately restrictive under the Fund's index of trade restrictiveness and its exchange system is free of restrictions.

<sup>12</sup> These exemptions cover three areas: (i) 549 goods chosen by the Paraguayan government, (ii) capital goods, computers and telecommunications; and (iii) intermediate goods.

addition to what is currently spent on social policies.<sup>13</sup> This, in turn, will require strong political and social consensus—not always available in the past—on key areas, which include creating a comprehensive social safety net, expanding coverage of basic social services and social security, and investing in infrastructure (especially in rural areas). Rationalizing the long-term social strategy will also be critical to advance toward the MDGs. With the assistance of multilateral institutions, the government has been developing a National Poverty Reduction Strategy, but little progress has been made in implementing it.

39. **Statistical issues.** The staff considers data provision by the authorities as adequate for surveillance purposes, although important deficiencies remain. The national accounts are based on an outdated conceptual framework and use an outdated base year (1982) for constant prices.<sup>14</sup> Quarterly national accounts are not produced until after each year has concluded, rather than on an ongoing basis. The timeliness and the quality of the fiscal data need to improve, in particular for the rest of the public sector and the social security institute, though substantial improvement have been made in 2004. There are problems in the classification and the Paraguayan GFS is not fully consistent with the methodology of the IMF Government Finance Statistics Manual. Moreover, there is a discrepancy in the fiscal data reported by the monetary and fiscal authorities. On the external side, the data on private capital outflows are weak, and additional efforts need to be made in capturing unregistered trade.

#### F. Program Issues

40. **Nine of eleven end-March quantitative PCs were observed (Table 1).** The wage bill ceiling was not observed by a small margin. The ceiling on external sector arrears and the sub-target on bilateral arrears were observed, as was the ceiling on domestic floating debt and the ceilings on new indebtedness. However, the continuous PC on no new external arrears was missed when cement company INC accumulated new arrears, and Petropar's arrears to suppliers increased (although there were no new Central Government arrears). These have since been cleared (prior action). A supplementary budget for INC will be approved to ensure that no further arrears are accrued. The increased in diesel tariffs will enable Petropar to reduce arrears. The authorities will also submit to Congress a bill to approve payment of the ANDE debts to KFW (prior action). The authorities have requested waivers on the two missed quantitative PCs. In addition, the authorities are requesting a waiver for the Fiscal Adjustment Law, which was approved beyond the end-May PC deadline, and without all of the components originally contemplated. The July 1 performance criterion on adjustment of utility prices was met (see discussion in ¶23 above).

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<sup>13</sup> The UNDP estimates that the average annual additional investment between 2004 and 2015 that would be needed to meet the MDGs amounts to US\$160 million—about 2.4 percent of GDP in 2004.

<sup>14</sup> Efforts are underway to convert to a base of 1994.

41. **New quantitative performance criteria are proposed** (see the SMEFP and TMU). New PCs are proposed for the NDA and NIR targets for end-August and end-December.<sup>15</sup> PCs on arrears, and debt were also agreed for end-August and end-December consistent with the original program.<sup>16</sup> For the fiscal targets, PCs on the consolidated public sector balances were set for end-August and end-December consistent with those of the original program.<sup>17</sup> For the central government target, an end-August PC was agreed in line with the original program, but the end-December PC will be agreed on at the time of the third review. In the meantime, the existing indicative targets for end-June, end-September, and end-December will remain. It is proposed that the wage bill ceiling for end-August be relaxed by G/.40 billion and by G/.80 billion for end-December to allow for the additional security service wages and for a small salary increase granted teachers to resolve a strike in June. In addition, several changes have been made to definitions in the TMU (see footnotes 15–17)

42. **Some structural conditionality will be rephased.** It is proposed that the PC on approval of the public banking law be moved from end-July to end-October, to take into account legislative delays. The SB on approval of the new Customs code, in contrast, was already completed. The PC on audits for some public entities will be moved to end-December, while it would remain at end-October for the remainder.

43. It is proposed that the third review be delayed, and be conducted on the basis of end-August PCs, rather than the intended end-June PCs as originally envisaged. The fourth and fifth reviews of the program would be combined and are expected to be evaluated on the basis of end-December PCs with access rephased accordingly (see Table 17).

## V. STAFF APPRAISAL

44. **Paraguay's economy has made strong progress over the past 12 months.** After the sharp recession and banking crisis suffered in 2002, growth returned in 2003 due to a good agricultural year. In 2003, while the agricultural economy has weakened for climatic reasons, the nonagricultural economy has begun to recover. Inflation, which reached 20 percent in early 2003, has fallen to 5.5 percent and will likely fall to the 4–5 percent range for the remainder of 2004. Vulnerability to future external shocks has been reduced significantly, as the authorities have moved to shore up international reserves, clear external payments difficulties, and begun important fiscal and structural reforms.

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<sup>15</sup> An adjuster was introduced on the NIR and NDA targets to account fully for the possible disbursements of the financial sector loans from the World Bank and IDB for US\$40 million in 2004.

<sup>16</sup> The definition of the domestic arrears target has been expanded and clarified in the revised TMU, as a result of discussions with the authorities on the status of disputed claims and the domestic bond swap. The definition of the continuous PC on no new external arrears has been modified to exclude arrears of Petropar to external suppliers because of monitoring constraints.

<sup>17</sup> A minor revision to the definition of the registry float was also made to enhance monitorability.

45. **The fiscal outlook has improved markedly and it will be important to further institutionalize this progress.** The progress achieved by the authorities in raising the efficiency of tax and customs collections under the new government has been outstanding. Tax revenues for 2004 will likely exceed 12 percent of GDP, compared with only 9 percent of GDP in 2002, with very little of that jump coming from new taxes. It is crucial, however, that the authorities take definitive action to institutionalize these gains by restructuring the tax and customs authorities. They require higher and more secure sources of financing, and as well as new staff, training, procedures, and increased computerization. If this is not done, the gains obtained over the past year could easily slip once the current heads of these units leave.

46. **The authorities have maintained tight control of expenditures in 2003 and 2004, but continued vigilance is needed.** Political pressure for spending increases is mounting in the face of improved revenue performance and weak economic growth. While the staff believes that there is room for some increase in capital and social spending, it cautions that the fundamental restrictions on growth in Paraguay are structural rather than demand-side, so increased spending to stoke demand would likely endanger fiscal stability with very little sustainable increase in growth. Over the medium-term, the authorities should follow up on their success in reducing expenditures on public pensions (through the Public Pension Law) by undertaking a full-fledged public expenditure reform, including civil service reform.

47. **To help secure fiscal sustainability, the government obtained approval of the Fiscal Adjustment Law.** While legislation in its final version is weaker than that sent to Congress, it still raises important new revenue, significantly broadens the tax base for VAT and the income tax, and strengthens tax administration. The law, together with the compensatory measures accepted by the authorities, should provide a sound basis for balanced budgets in the medium-term, and may well provide sufficient resources for a much-needed increase in capital investment and social spending.

48. **Progress has been made in eliminating domestic and external payments arrears.** The only official external arrears outstanding are on disputed claims, and resolution of these issues is advancing. Monitoring of obligations has improved notably in recent months, and the latest arrears accrual was due more to atypical circumstances than to financial or cash management difficulties. Nonetheless, the authorities still face challenges in this area, as evidenced by the need for waivers on some arrears targets in both reviews of the program thus far. Further action is needed to assure that remaining arrears will be completely eliminated. The benefits of normalized payments, in terms of lower country risk, lower interest rates, and increased investment, will only be obtained if the authorities persevere in improving debt monitoring and cash flow and resolve disputed arrears.

49. **While the overall financial picture in public enterprises has improved, acute problems persist in key companies.** Petropar and ESSAP have been of particular concern due to cash flow problems that may affect the fiscal and/or arrears targets. Looking beyond these immediate difficulties, the government should embark on a program to permit private investment and management of the public enterprises. Only sharply higher investment and

private sector incentives can convert these firms into a source of economic growth, rather than a drag on the economy.

50. **Monetary policy management has improved, inflation has fallen and international reserves have increased, but ambiguity of objectives still persists.** While publicly committed to moving to inflation targeting, and observing quantitative monetary targets under the Fund program, the authorities appear reluctant to completely abandon (at least notional) exchange rate targeting. While these objectives have not clashed over the past year, at some point, they may conflict, and the authorities must have a clear monetary policy strategy established well beforehand. The staff urges the authorities to reduce the level of their intervention in the foreign exchange market to give freer play to exchange rate. The staff also believes that, given the strong reserves, low inflation, and fairly weak economic growth, there may be scope for a more rapid reduction in interest rates.

51. **Banking system risks have eased in 2003 and early 2004, but public banking reform remains crucial to ease systemic risks.** The authorities have made satisfactory progress in implementing reforms approved in late 2003. Future challenges include the approval of comprehensive banking legislation, the extension of a supervisory regime to cooperatives, and requiring international risk classifications from all banks.

52. **A range of additional structural reforms is needed to create the conditions for sustained growth and to reduce poverty.** The staff urges the authorities to prepare a second round of reforms on which to work once the SBA is concluded. Only deeper, microeconomic reforms, complementing the macroeconomic reforms underway, can raise the growth rate of potential output to a rate consistent with the reduction of poverty. Further efforts to address corruption will be required, including reforms of the judicial system and a restructuring of the public sector to increase its professionalism, reduce its size and scope and increase transparency. Programs to boost human capital will also play an important role in increasing growth by boosting labor productivity. The restructuring of public banks will also help increase the resources from external donors for needed development projects.

53. The staff welcomes the authorities' commitment to maintaining an open exchange and trade system, and encourages them to seek resolution of trade disputes within existing dispute settlement arrangements.

54. Staff recommends granting the requested waivers for nonobservance and completion of the second review under the Stand-By Arrangement. It is expected that the next Article IV consultation with Paraguay will be held on a 24-month cycle.

### **Box 1. Corruption and Governance Issues**

**Paraguay has long-standing problems with corruption and contraband.** The 2003 Transparency International *Corruption Perception Index* ranks Paraguay 129th out of 133 countries, and it persistently ranks low on other well-known governance indicators. Corruption has had a negative indirect effect on sustainable growth in Paraguay by making policies less effective and creating disincentives for productive investment.

**The current government has made it a priority to attack corruption at the highest levels.** Since taking office, it has replaced the top levels of government with individuals renowned for their integrity and professionalism and independent of the traditional Colorado party apparatus. Changes in the leadership of the institutions with the most serious governance problems, among them the Customs and Tax administrations, and the Social Security Institute (IPS) have had an almost immediate impact, due to steps such as closing collection, auditing units, and placing suspect officials on leave. Specifically:

- Tax and tariff revenues have increased almost 40 percent since August 2003, despite the fact that in-depth restructuring of the Tax Authority and Customs Administration is just beginning.
- Revenue from social security contributions, in particular from employers, has increased by almost 30 percent in recent months, solely as a result of better enforcement.

**Other areas of government are also improving:**

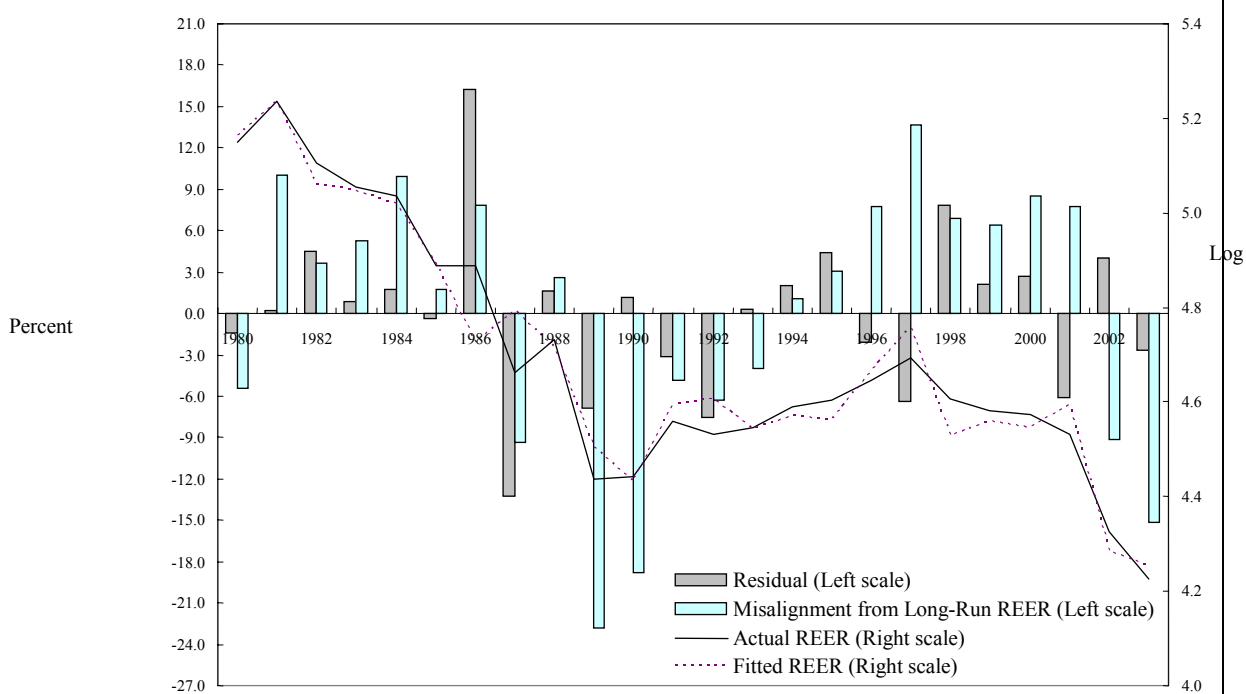
- The Ministry of Finance has set up a pilot project with support from the World Bank to become the 'Ministry of Excellence,' to revamp procedures with a view to improve the accountability of officials, efficiency and transparency of the public service.
- The implementation of the new Procurement Law, which requires government-purchasing bids above US\$60,000 to be made on the internet, has already reduced costs substantially: the Ministry of Health estimates it has saved about 40 percent in health-related purchases since its inception. Cases of phantom contractors are also being tracked down more frequently.
- The replacement of majority Supreme Court justices is a first step toward judicial reform, a large contributor to governance problems.

**Initiatives to increase transparency and the participation of civil society are growing.** An inter-agency commission comprised of an equal number of government and civil society representatives (now known as the *National Integrity Council* (CISNI)) was formed in 2000 to promote the adoption of reform in government entities. It had an important role in shepherding through the approval of the Procurement Law and continues to raise public awareness of the institutional opportunities for corruption. Moreover, a public-private committee chaired by the Ministry of Industry and Commerce, which includes the NGO Transparency Paraguay, has been formed to advise on the contracting procedures and restructuring plans of Petropar and INC.

### Box 2: Estimating the Equilibrium Real Exchange Rate

Staff estimated that the *guaraní* was undervalued in real terms at the end of 2003, although the range of the estimated misalignment is relatively large across empirical models, between 3 to 15, possibly as a consequence of the small size of our sample. Cointegration techniques were used to estimate the long-run equilibrium real exchange rate—defined as the value where the real exchange rate would converge in the absence of new shocks—as a function of several economic fundamentals such as the terms of trade, Brazil’s and Argentina’s real exchange rates, the current account balance, the fiscal balance, net foreign assets, trade openness and relative real GDP per capita. The misalignment in the real exchange rate implied by estimating the long-run equilibrium equation is plotted in the Figure together with the regression residuals.

Fitted Real Exchange Rate and Misalignment from Long-Run Equilibrium



**The statistical procedure used to compute the long-run values of fundamentals tends to overestimate the range for the end-2003 misalignment.** In particular, this procedure neglects the fiscal consolidation started in 2003. If the fiscal balance for 2003 is regarded as more indicative of the future trend in government finances than the recent experience (as it seems likely), then the misalignment of the real exchange rate would be smaller (around 10 percent). Conversely, other factors could, in the near future, raise the long-run value of the real exchange rate and its undervaluation. In the short run, the most important factor is the potential real undervaluation of the Argentine peso, whose recovery would raise the long-term equilibrium value of the *guaraní*. Similarly, persistently high commodity prices and sustained growth in Paraguay would raise the long-term real value of the *guaraní* and its real underappreciation.



### **Box 3: Millennium Development Goals**

**Paraguay will not meet important Millennium Development Goals (MDG) unless decisive action is promptly taken (Table):**

- The MDG of **eradicating extreme poverty** is unlikely to be reached. According to the last available estimate, extreme poverty increased between 1990 and 2001 and preliminary estimates suggest that it may have further increased since 2001. Poverty and inequality are especially severe in rural areas, compounded by high inequality in income and land distribution. Although child malnutrition has increased recently, the target of halving hunger still appears feasible.
- Slow progress has been made in reducing **child mortality** and improving **maternal health**, jeopardizing these two MDGs. Furthermore, because of substantial under-reporting child and maternal mortality are likely to be greatly under-estimated.
- The MDG of achieving **environmental sustainability** is unlikely to be met. Forest area has shrunk considerably over the last two decades as a result of expanding cultivated area. Considerable progress has been made in providing access to drinking water, except in rural areas, where access remains extremely low. Paraguay appears to be off-track on the target of providing sanitation facilities, especially in rural areas, where sanitation facilities are almost nonexistent.

**Advances have been made towards some MDGs but will require continued efforts for their consolidation:**

- The MDG of achieving **universal primary education** is within reach. Future efforts need to focus on improving education quality and school infrastructure, raising secondary enrollment (which remains low), and reducing child labor (still common in rural areas).
- Progress has been made towards the MDG of achieving **gender equality**, especially in education (both in terms of enrollment and literacy rates). However, far less equality exists in the economic and political spheres—and in education as well in rural areas.
- Although basic health coverage remains low, the MDG of combating **AIDS/HIV and other major diseases** seems attainable. The incidence of HIV/AIDS is low, but likely to be greatly underestimated. Malaria has decreased since 1980, in spite of an epidemic in 1997-99. The incidence of tuberculosis has also fallen since 1990 but still varies across different geographic areas and socio-economic groups.

**Developing institutions to invest efficiently on social policies and achieving political consensus on key priorities will be critical for sustainable progress towards the MDGs.** Budget execution of social spending has been high compared to other areas in 2004, but major efforts in rationalizing social spending and political consensus on raising investment on social policies and infrastructure are needed. The government has been developing a comprehensive National Poverty Reduction Strategy (with assistance from multilateral institutions). To move forward in its implementation, efforts will have to focus on developing procedures and indicators to monitor the efficiency of social spending.

#### Box 4: The Administrative Reorganization and Fiscal Adjustment Law

**After repeated efforts over several years, Paraguay's Congress finally approved a Fiscal Adjustment Law in late June.** The law achieves many of its proposed objectives, including a substantial broadening of the VAT and corporate income taxes, the extension of a more effective tax regime to large producers, the elimination of large exemptions contained in 42 separate laws, and the introduction of a new personal income tax. However, the earmarking of 3.5 percent of tax revenues to the tax authorities to improve tax administration, contemplated in the version submitted to Congress, was eliminated. The main features of the law, whose impact on revenues is shown in Table 16, are as follows:

- The law lowers the rate for the **profit tax** from 30 percent to 20 percent during its first year of application and to 10 percent starting from the second year. The law also eliminates most exemptions, most importantly the 5-year tax holiday on first-time investment. Compared to the original draft, the law reinstates exemptions on education, savings corporations, cooperatives, and interest and capital gains on bonds issued in the stock exchange and on public bonded debt. The also law introduces a new **tax on small businesses** (*Renta del Pequeño contribuyente*) at the uniform tax rate of 10 percent over net income. With respect to the latter tax, the law represents a major improvement over the previous regime, which was considered a serious channel of tax evasion for large companies.
- The law introduces a **vehicles tax** (*patente fiscal*), but is limited to luxury vehicles and only applies for two years, rendering a negligible expected net yield. The Law also substantially narrows the **financial transactions tax** and limits its application to 3 years.
- The law broadens the **value-added tax** by eliminating exemptions under special regimes, introducing the VAT on services, rentals, transport and on previously exempt goods (including basic foods and petroleum products); the tax rate is kept at 10 percent except for some foods and pharmaceuticals, which have a temporarily lower rate.
- The law overhauls the existing **agricultural land tax** (IMAGRO) by distinguishing between large landholders—taxed on their net actual income—and medium-sized landholders—taxed on a presumptive income using productivity coefficients defined in the law. It is expected that, owing to the low values of the productivity coefficients, the tax on medium-size landholdings will not generate significant revenues. Unlike previous versions of the law, the executive loses the discretion to change the productivity parameters of the tax rate, considered a drawback. The richest landholders will continue to contribute to the majority of the revenue from this tax.
- The law introduces a new **personal income tax**. The tax, scheduled to take in effect in 2006, will initially apply only to incomes above ten minimum salaries at a 10 percent rate (less than 5 percent of households) and will be gradually extended (at the lower rate of 8 percent) to all individuals earning more than three minimum wages. The tax allows full deductibility of all personal expenditures supported by VAT receipts, which will likely increase the costs of administering the tax.
- The law sets new maximum rates on **excise taxes of some goods** (some rates are raised and others lowered), and introduces some consumer goods subject to excise taxes at rates of between 1 and 5 percent.

The Law introduces various tax administration reforms, which would improve the accountability of the tax officials and the responsibility of taxpayers. The articles on tax administration are designed to complement the incentives within the Law to present VAT receipts and improve documentation. Nonetheless, unless sufficient additional funds are provided to the tax authorities to enable them to implement the law, they would be unable to do so in their current shape. Moreover, the law falls short of granting more financial and operational autonomy to the tax authority, which would be desirable in the long run.

Table 1. Paraguay: Quantitative Performance Criteria

	2004		Target (Adjusted)	Aug. 31	Dec. 31
	Actual	Target (Unadjusted)			
<b>Monetary targets</b>					
Net international reserves (floor, in millions of U.S. dollars) 1/	1,016	762	773	1,067	1,080
Net domestic assets (ceiling, in billions of guaranies) 1/	-4,264	-2,770	-2,839	-4,507	-4,090
<b>Fiscal targets</b>					
Overall balance of the central administration (floor, in billions of guaranies) 2/	523	240	240	430	55 3/
Wage bill of the central administration (ceiling, in billions of guaranies)	668	650	650	1,791	2,980
Overall balance of the public sector (floor, in billions of guaranies)	678	250	250	500	130
<b>Public debt and arrears targets</b>					
Contracting or guaranteeing of nonconcessional debt by the NFPS (ceiling, in millions of US\$)	0	50	50	200	200
External payments arrears of NFPS (ceiling, in millions of US\$)	75	75	75	5	0
<i>Of which:</i> bilateral arrears 4/	12	38	38	0	0
Central government floating debt (ceiling, in billions of guaranies) 5/	228	350	350	297	250
<b>Continuous PCs</b>					
Contract or guarantee short-term external debt by the NFPS	observed				
No new external debt arrears	not observed				

Sources: IMF Country Report No. 04/66; TMU; and staff estimates.

1/ NIR is adjusted upward (downward) for any increase (decrease) in reserve requirement deposits. Similarly, the NDA target will be adjusted upward (downward) following the adjustment in the NIR.

2/ As measured below the line (it differs from balance in Table 5 where it is measured above the line).

3/ Indicative target.

4/ Targets for end-August 2004 and thereafter have been set to zero, reflecting the authorities' clearance of arrears in advance of the original program schedule.

5/ The ceiling is adjusted downward by any excess in program lending above US\$15 million (expressed in guaranies). The stock of floating debt in September has been revised, due to a mistake in reporting, from G277 billion to G384 billion.

Table 2. Paraguay: Selected Economic Indicators, 2000–04

	2000	2001	2002	Est. 2003	2004	
					Prog.	Proj.
(Annual percent change)						
<b>National accounts and prices</b>						
GDP at current prices	11.5	4.4	13.7	17.5	9.3	7.9
GDP at constant prices	-0.4	2.7	-2.3	2.6	2.4	2.1
Consumption	0.8	6.2	-5.1	5.3	2.4	1.7
Investment	-0.7	-17.5	-11.0	-3.7	7.6	8.5
Net exports (contribution to growth)	-0.9	0.4	4.4	-1.9	-0.8	-0.7
Exports	-15.1	-0.4	14.3	13.1	0.2	4.9
Imports	-6.7	-1.6	-6.3	15.6	3.0	5.5
GDP deflator	11.9	1.7	16.4	14.5	6.7	5.7
Consumer prices (average)	9.0	7.3	10.5	14.2	7.5	4.8
Consumer prices (end-of-period)	8.6	8.4	14.6	9.3	8.0	4.0
Real effective exchange rate						
Average (depreciation -)	-6.1	-3.5	-3.2	-6.0	...	...
End-of-period (depreciation -)	1.2	-14.6	-2.6	9.5	...	...
(In millions of U.S. dollars)						
<b>External sector</b>						
Exports, f.o.b.	2,322	1,883	1,882	2,014	2,111	2,096
Imports, c.i.f.	2,864	2,500	2,086	2,323	2,398	2,395
Current account	-163	-266	130	152	26	91
(In percent of GDP)	-2.1	-3.9	2.3	2.6	0.4	1.3
Capital account	157	150	57	125	116	40
Overall balance	-254	-45	-83	234	141	189
Terms of trade (percentage change)	-5.1	-0.2	6.9	9.4	-4.8	8.8
<b>Public sector</b>						
Central government primary balance	-3.1	0.2	-1.7	0.9	1.5	1.4
Central government overall balance	-2.9	-4.4	-2.3	-0.3	0.2	0.2
Consolidated public sector primary balance 1/	-2.6	1.0	-1.3	2.4	2.2	3.3
Consolidated public sector overall balance 1/	-1.0	-3.3	-3.1	0.0	0.3	1.5
Public sector external debt (end-of-year)	30.6	33.5	42.9	44.9	42.6	39.6
Domestic public sector debt	3.4	4.9	6.8	4.5	5.3	3.6
(Annual percent change)						
<b>Money and credit</b>						
Monetary base	-1.3	5.8	-1.0	57.7	3.2	21.6
M2	2.2	4.9	-2.2	24.9	17.0	13.8
M5 2/	-0.1	1.5	-18.5	17.7	14.4	18.5
Net foreign assets 3/	-5.4	-5.5	-12.8	32.4	4.8	9.4
Net domestic assets 3/	5.3	7.0	-5.6	-14.7	9.6	9.2
Credit to the public sector 3/	2.3	3.5	5.2	-2.6	0.7	-7.9
Credit to the private sector 3/	-0.8	-0.7	-14.9	-12.8	6.3	5.5
Velocity of M2	7.2	7.2	8.3	7.8	7.6	7.4
<b>Memorandum items:</b>						
International reserves (in millions of U.S. dollars)	772	723	641	983	855	1,080
(In months of imports)	3.2	3.6	2.9	4.3	3.5	4.5
GDP (in billions of guaranies)	26,921	28,119	31,977	37,559	40,779	40,529

Sources: Paraguayan authorities; and Fund staff estimates.

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

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

3/ Contribution to M5 growth.

Table 3. Paraguay: GDP and Prices

	2000	2001	2002	Est. 2003	2004	
					Prog.	Proj.
<b>I. National Accounts</b>						
(In annual percentage change)						
Real GDP	-0.4	2.7	-2.3	2.6	2.4	2.1
Contribution to growth:						
Consumption	0.7	5.8	-5.0	5.0	2.2	1.7
Investment	-0.1	-3.5	-1.8	-0.6	1.0	1.2
Exports	-3.2	-0.1	2.5	2.7	0.0	1.1
Imports	2.3	0.5	1.9	-4.6	-0.9	-1.8
(In percent of GDP)						
Gross domestic investment	21.8	19.8	19.1	18.5	18.7	18.4
Private	14.9	14.7	13.2	13.6	13.1	13.0
Public	7.0	5.1	5.9	4.9	5.6	5.4
Gross national savings	19.7	15.9	21.4	21.1	19.1	19.7
Private	14.9	14.8	19.0	16.1	13.8	13.7
Public	4.8	1.1	2.4	5.0	5.3	6.0
<b>II. Prices</b>						
(In annual percentage change)						
GDP deflator	11.9	1.7	16.4	14.5	6.7	5.7
Consumer prices:						
End-of-period	8.6	8.4	14.6	9.3	8.0	4.0
Period average	9.0	7.3	10.5	14.2	7.5	4.8
Guarani/US\$ exchange rate						
End-of-period	6.9	30.7	51.0	-13.3	...	...
Period average	11.8	17.8	38.4	13.3	...	...
<b>Memorandum items:</b>						
Real GDP per capita (percentage change)	-2.8	0.3	-4.6	-0.2	-0.3	-0.6
Population (percentage change)	2.6	2.5	2.5	2.7	2.7	2.7
GDP (in billions of guaranies)	26,921	28,119	31,977	37,559	40,779	40,529
GDP (in millions of U.S. dollars)	7.734	6.858	5.633	5.817	6.117	6.750

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

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

	2001	2002	2003		2004				Prog.	Proj.
			Prog.	Prel.	Prel.	Projections				
						Q1	Q2	Q3		
(In billions of Guaranies)										
<b>Revenue</b>	<b>5,984</b>	<b>6,160</b>	<b>7,325</b>	<b>7,449</b>	<b>1,823</b>	<b>2,283</b>	<b>2,148</b>	<b>2,316</b>	<b>8,306</b>	<b>8,570</b>
Tax revenue	2,855	2,926.9	3,687	3,676	990	1,233	1,240	1,352	4,384	4,814
Nontax revenue and grants	2,936	3,117	3,478	3,616	832	998	855	910	3,705	3,595
Capital revenue	193	116	160	156	0	53	54	54	217	161
<b>Current expenditure</b>	<b>5,464</b>	<b>5,763</b>	<b>6,181</b>	<b>6,246</b>	<b>1,376</b>	<b>1,670</b>	<b>1,707</b>	<b>2,005</b>	<b>6,623</b>	<b>6,758</b>
Wages and salaries	2,928	3,095	3,301	3,290	816	842	847	1,073	3,505	3,578
Goods and services	503	572	651	634	78	221	230	282	752	811
Interest payments	485	603	680	728	162	194	215	210	776	780
Transfers	1,340	1,455	1,508	1,544	319	399	379	407	1,492	1,504
Other	209	39	40	51	1	15	35	33	98	85
<b>Capital expenditure and net lending</b>	<b>1,430</b>	<b>1,875</b>	<b>1,792</b>	<b>1,818</b>	<b>144</b>	<b>428</b>	<b>603</b>	<b>1,041</b>	<b>2,231</b>	<b>2,217</b>
<b>Primary balance</b>	<b>287</b>	<b>-418</b>	<b>448</b>	<b>913</b>	<b>828</b>	<b>536</b>	<b>300</b>	<b>-304</b>	<b>909</b>	<b>1,360</b>
<b>Public enterprises' operating surplus</b>	<b>712</b>	<b>458</b>	<b>416</b>	<b>800</b>	<b>364</b>	<b>156</b>	<b>248</b>	<b>217</b>	<b>680</b>	<b>985</b>
Statistical discrepancy 2/	-733	35	...	-170	12					12
<b>Overall balance</b>	<b>-931</b>	<b>-986</b>	<b>-232</b>	<b>15</b>	<b>678</b>	<b>342</b>	<b>85</b>	<b>-514</b>	<b>133</b>	<b>592</b>
(In percent of GDP)										
<b>Revenue</b>	<b>21.3</b>	<b>19.3</b>	<b>19.6</b>	<b>19.8</b>	<b>4.5</b>	<b>5.6</b>	<b>5.3</b>	<b>5.7</b>	<b>20.4</b>	<b>21.0</b>
Tax revenue	10.2	9.2	9.9	9.8	2.4	3.0	3.1	3.3	10.8	11.8
Nontax revenue and grants	10.4	9.7	9.3	9.6	2.1	2.5	2.1	2.2	9.1	8.8
Capital revenue	0.7	0.4	0.4	0.4	0.0	0.1	0.1	0.1	0.5	0.4
<b>Current expenditure</b>	<b>19.4</b>	<b>18.0</b>	<b>16.6</b>	<b>16.6</b>	<b>3.4</b>	<b>4.1</b>	<b>4.2</b>	<b>4.9</b>	<b>16.2</b>	<b>16.6</b>
Wages and salaries	10.4	9.7	8.9	8.8	2.0	2.1	2.1	2.6	8.6	8.8
Goods and services	1.8	1.8	1.7	1.7	0.2	0.5	0.6	0.7	1.8	2.0
Interest payments	1.7	1.9	1.8	1.9	0.4	0.5	0.5	0.5	1.9	1.9
Transfers	4.8	4.5	4.0	4.1	0.8	1.0	0.9	1.0	3.7	3.7
Other	0.7	0.1	0.1	0.1	0.0	0.0	0.1	0.1	0.2	0.2
<b>Capital expenditure and net lending</b>	<b>5.1</b>	<b>5.9</b>	<b>4.8</b>	<b>4.8</b>	<b>0.4</b>	<b>1.1</b>	<b>1.5</b>	<b>2.6</b>	<b>5.5</b>	<b>5.4</b>
<i>Of which:</i>										
Net lending by the central bank	0.1	0.5	0.1	0.0	-0.1	0.0	0.0	0.0	-0.1	-0.2
<b>Primary balance</b>	<b>1.0</b>	<b>-1.3</b>	<b>1.2</b>	<b>2.4</b>	<b>2.0</b>	<b>1.3</b>	<b>0.7</b>	<b>-0.7</b>	<b>2.2</b>	<b>3.3</b>
<b>Public enterprises' operating surplus</b>	<b>2.5</b>	<b>1.4</b>	<b>1.1</b>	<b>2.1</b>	<b>0.9</b>	<b>0.4</b>	<b>0.6</b>	<b>0.5</b>	<b>1.7</b>	<b>2.4</b>
Statistical discrepancy 2/	-2.6	0.1	...	-0.5	0.0					
<b>Overall balance</b>	<b>-3.3</b>	<b>-3.1</b>	<b>-0.5</b>	<b>0.0</b>	<b>1.7</b>	<b>0.8</b>	<b>0.2</b>	<b>-1.3</b>	<b>0.3</b>	<b>1.5</b>
<b>Financing 3/</b>	<b>3.3</b>	<b>3.1</b>	<b>0.5</b>	<b>0.1</b>	<b>-1.7</b>	<b>-0.8</b>	<b>-0.2</b>	<b>1.3</b>	<b>-0.3</b>	<b>-1.5</b>
Memorandum item										
Overall balance of the social security (percent of GDP)	0.6	0.8	0.7	0.9	0.1	0.1	0.1	1.0	0.5	1.0

Sources: Ministry of Finance; and Fund staff estimates.

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

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

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

Table 5. Paraguay: Central Government Operations

	2004									
	2003			Q1		Q2	Q3	Q4	Prog.	Proj.
	2002	Prog.	Est.	Prog.	Prel.		Proj.			
(In billion of guaraníes)										
<b>Total revenues</b>	<b>5,048</b>	<b>5,877</b>	<b>6,001</b>	<b>1,466</b>	<b>1,496</b>	<b>1,892</b>	<b>1,790</b>	<b>1,917</b>	<b>6,794</b>	<b>7,095</b>
Tax revenues	2,923	3,683	3,676	938	989	1,233	1,240	1,352	4,380	4,813
Value added tax	1,235	1,462	1,570	376	442	503	479	571	1,809	1,995
Import and export duties	507	728	665	154	173	220	217	231	682	841
Other	122	101	113	22	57	26	18	9	203	109
Nontax revenues 1/	2,118	2,190	2,318	527	507	659	550	564	2,412	2,280
Capital revenues	7	4	7	1	0	0	1	1	3	3
<b>Current expenditures:</b>	<b>4,766</b>	<b>4,998</b>	<b>4,981</b>	<b>1,125</b>	<b>1,136</b>	<b>1,278</b>	<b>1,313</b>	<b>1,602</b>	<b>5,335</b>	<b>5,329</b>
Wages and salaries	2,582	2,728	2,724	643	668	680	686	904	2,882	2,938
Goods and services	373	426	408	43	55	134	143	195	505	527
Interest payments	456	478	489	150	120	121	139	128	562	508
Transfers	1,326	1,341	1,334	287	293	337	318	352	1,304	1,299
o/w: pensions and benefits	913	937	943	230	217	225	209	221	899	872
Other	29	26	26	2	1	6	26	24	83	57
<b>Capital expenditures and net lending</b>	<b>1,281</b>	<b>1,001</b>	<b>1,165</b>	<b>93</b>	<b>112</b>	<b>279</b>	<b>436</b>	<b>868</b>	<b>1,395</b>	<b>1,694</b>
<i>Of which:</i>										
Net lending	-6	-90	-88	6	-6	-6	-17	-18	-41	-47
Primary balance	-543	356	344	398	367	457	180	-425	626	580
Statistical discrepancy 2/	271	...	29							
<b>Overall balance</b>	<b>-728</b>	<b>-122</b>	<b>-116</b>	<b>248</b>	<b>248</b>	<b>336</b>	<b>41</b>	<b>-553</b>	<b>64</b>	<b>72</b>
(In percent of GDP)										
<b>Total revenues</b>	<b>15.8</b>	<b>15.8</b>	<b>16.0</b>	<b>14.4</b>	<b>14.8</b>	<b>18.7</b>	<b>17.7</b>	<b>18.9</b>	<b>16.7</b>	<b>17.5</b>
Tax revenues:	9.1	9.9	9.8	9.2	9.8	12.2	12.2	13.3	10.7	11.9
Income taxes	1.4	1.6	1.7	1.0	1.1	2.0	2.1	2.2	1.0	1.9
Excises	1.9	2.2	1.9	2.8	2.0	2.8	3.1	3.1	3.2	2.8
Value added tax	3.9	3.9	4.2	3.7	4.4	5.0	4.7	5.6	4.4	4.9
Import duties	1.6	2.0	1.8	1.5	1.7	2.2	2.1	2.3	1.7	2.1
Other	0.4	0.3	0.3	0.2	0.6	0.3	0.2	0.1	0.5	0.3
Nontax revenues 1/	6.6	5.9	6.2	5.2	5.0	6.5	5.4	5.6	5.9	5.6
o/w: Public pension contributions	1.0	0.8	1.0	0.6	0.9	1.1	1.0	0.9	0.9	1.0
Itaipu-Yacyreta	3.9	3.7	3.9	3.4	2.9	4.1	3.0	3.2	3.4	3.3
Capital revenues	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Current expenditures, of which:</b>	<b>14.9</b>	<b>13.4</b>	<b>13.3</b>	<b>11.0</b>	<b>11.2</b>	<b>12.6</b>	<b>13.0</b>	<b>15.8</b>	<b>13.1</b>	<b>13.1</b>
Wages and salaries	8.1	7.3	7.3	6.3	6.6	6.7	6.8	8.9	7.1	7.2
Goods and services	1.2	1.1	1.1	0.4	0.5	1.3	1.4	1.9	1.2	1.3
Interest payments	1.4	1.3	1.3	1.5	1.2	1.2	1.4	1.3	1.4	1.3
Transfers	4.1	3.6	3.6	2.8	2.9	3.3	3.1	3.5	3.2	3.2
<i>Of which: public pensions and benefits</i>	2.9	2.5	2.5	2.3	2.1	2.2	2.1	2.2	2.2	2.2
Other	0.1	0.1	0.1	0.0	0.0	0.1	0.3	0.2	0.2	0.1
<b>Capital expenditures and net lending</b>	<b>4.0</b>	<b>2.7</b>	<b>3.1</b>	<b>0.9</b>	<b>1.1</b>	<b>2.7</b>	<b>4.3</b>	<b>8.6</b>	<b>3.4</b>	<b>4.2</b>
<i>Of which:</i>										
Net lending	0.0	-0.2	-0.2	0.1	-0.1	-0.1	-0.2	-0.2	-0.1	-0.1
Primary balance	-1.7	1.0	0.9	3.9	3.6	4.5	1.8	-4.2	1.5	1.4
<b>Overall balance</b>	<b>-2.3</b>	<b>-0.3</b>	<b>-0.3</b>	<b>2.4</b>	<b>2.4</b>	<b>3.3</b>	<b>0.4</b>	<b>-5.5</b>	<b>0.2</b>	<b>0.2</b>
<b>Financing</b>	<b>2.3</b>	<b>0.3</b>	<b>0.3</b>	<b>-2.4</b>	<b>-2.4</b>	<b>-3.3</b>	<b>-0.4</b>	<b>5.5</b>	<b>-0.2</b>	<b>-0.2</b>
External debt (increase +)	0.4	0.6	1.6	-1.1	-1.6	-1.0	-0.6	3.6	0.7	0.1
Disbursements	2.3	2.1	3.1	0.7	0.0	0.7	1.8	5.3	3.7	1.9
Amortizations 3/	1.9	1.6	1.5	1.7	1.6	1.7	2.4	1.8	3.2	1.9
Domestic bonds (increase +)	-0.1	-0.2	-0.2	0.0	0.0	0.0	-0.5	0.0	-0.1	-0.1
Net credit from the banking system	-0.1	0.1	-0.8	-3.5	1.1	1.7	0.1	2.1	-0.4	2.0
Exceptional Financing (incl. change in arrears) 2/	2.1	-0.3	-0.3	2.1	-1.9	-4.0	0.6	-0.2	-0.4	-2.1
<b>Memorandum Items:</b>										
Balance of the Caja Fiscal 4/	-603	-624	-579	-167	-125	-113	-107	-127	-518	-472
(in percent of GDP)	-1.9	-1.7	-1.5	-0.4	-0.3	-0.3	-0.3	-0.3	-1.3	-1.2

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes receipts from the binational hydroelectric plants Itaipu and grants. No new revenue from Yacyreta expected beyond April 2004 in projections.

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

3/ Includes payments of ESSAP external debt amortizations for US\$6.3 million in 2003 and US\$11.6 million in 2004, as well as arrears.

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

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

	2000	2001	2002	Projections			
				2003		2004	
				Prog.	Prel.	Prog.	Proj.
(In billions of Guaranies)							
<b>Revenue</b>	<b>1,190</b>	<b>1,092</b>	<b>1,111</b>	<b>1,448</b>	<b>1,448</b>	<b>1,485</b>	<b>1,532</b>
Tax revenue	4	3	3	4	0	6	1
Nontax revenue and grants net of transfers to CG	935	953	998	1,288	1,298	1,293	1,315
Capital revenue	251	135	109	156	150	185	215
Total capital revenue	296	174	156	210	197	246	309
minus: capital transfers from CG	-45	-39	-47	-55	-48	-60	-93
<b>Current expenditure</b>	<b>961</b>	<b>1,086</b>	<b>997</b>	<b>1,183</b>	<b>1,265</b>	<b>1,288</b>	<b>1,429</b>
Wages and salaries	519	528	513	573	565	623	640
Goods and services	247	207	199	225	225	247	284
Interest payments	84	107	147	203	239	214	272
Transfers	88	70	128	168	210	188	205
Other	23	174	10	14	25	15	28
<b>Capital expenditure and net lending</b>	<b>887</b>	<b>599</b>	<b>594</b>	<b>791</b>	<b>653</b>	<b>836</b>	<b>522</b>
<b>Primary balance</b>	<b>144</b>	<b>227</b>	<b>125</b>	<b>92</b>	<b>569</b>	<b>256</b>	<b>837</b>
<b>Public enterprises' operating surplus</b>	<b>718</b>	<b>712</b>	<b>458</b>	<b>416</b>	<b>800</b>	<b>680</b>	<b>985</b>
Statistical discrepancy	458	177	-236	0	6		
<b>Overall balance</b>	<b>518</b>	<b>297</b>	<b>-258</b>	<b>-110</b>	<b>336</b>	<b>42</b>	<b>565</b>
(In percent of GDP)							
<b>Revenue</b>	<b>4.4</b>	<b>3.9</b>	<b>3.5</b>	<b>3.9</b>	<b>3.9</b>	<b>3.6</b>	<b>3.8</b>
Tax revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nontax revenue and grants	3.5	3.4	3.1	3.5	3.5	3.2	3.2
Capital revenue	0.9	0.5	0.3	0.4	0.4	0.5	0.5
<b>Current expenditure</b>	<b>3.6</b>	<b>3.9</b>	<b>3.1</b>	<b>3.2</b>	<b>3.4</b>	<b>3.2</b>	<b>3.5</b>
Wages and salaries	1.9	1.9	1.6	1.5	1.5	1.5	1.6
Goods and services	0.9	0.7	0.6	0.6	0.6	0.6	0.7
Interest payments	0.3	0.4	0.5	0.5	0.6	0.5	0.7
Transfers	0.3	0.2	0.4	0.4	0.6	0.5	0.5
Other	0.1	0.6	0.0	0.0	0.1	0.0	0.1
<b>Capital expenditure and net lending</b>	<b>3.3</b>	<b>2.1</b>	<b>1.9</b>	<b>2.1</b>	<b>1.7</b>	<b>2.0</b>	<b>1.3</b>
<b>Primary balance</b>	<b>0.5</b>	<b>0.8</b>	<b>0.4</b>	<b>0.2</b>	<b>1.5</b>	<b>0.6</b>	<b>2.1</b>
<b>Public enterprises' operating surplus</b>	<b>2.7</b>	<b>2.5</b>	<b>1.4</b>	<b>1.1</b>	<b>2.1</b>	<b>1.7</b>	<b>2.4</b>
Statistical discrepancy	1.7	0.6	-0.7	...	0.0		
<b>Overall balance</b>	<b>1.9</b>	<b>1.1</b>	<b>-0.8</b>	<b>-0.3</b>	<b>0.9</b>	<b>0.1</b>	<b>1.4</b>
<b>Financing 2/</b>	<b>-1.9</b>	<b>-1.1</b>	<b>0.8</b>	<b>0.3</b>	<b>-0.9</b>	<b>-0.1</b>	<b>-1.4</b>

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 quasifiscal loss from payments of Multibanco depositors for G123.1 billion



Table 7. Paraguay: Public Sector Arrears  
(In millions of US\$)

	Arrears more than 1 day overdue 1/						Stock at End-of-Period (Adjusted for Program Definition) 2/			
	2004						December 2003		March 2004	
	2002	2003	Q1	April	May	June 3/	Target	Outcome	Target	Outcome 4/
<b>Total Public sector arrears (in percent of GDP)</b>	<b>253</b>	<b>185</b>	<b>135</b>	<b>130</b>		<b>37</b>	<b>162</b>	<b>157</b>	<b>135</b>	<b>114</b>
	4.5	3.2	2.0	1.9		0.6	2.8	2.7	2.0	1.7
Central government	172	151	71	103	21	32	105	123	93	45
Domestic	115	66	43	82	NA	18	59	66	60	39
(in billions of Guaranies)	643	400	251	468		105	360	400	350	228
Of which: bonds	23	8	0	0		0	0	0	0	0
External 5/	57	86	28	21	21	15	46	58	34	6
Of which:										
Multilateral	21	20	0	0	0	0	0	0.003	0	0
Rest of public sector	81	34	64	27	3	5	57	34	42	69
Domestic	0	0	0	0	0	0	0	0	0	0
External	81	34	64	27	3	5	57	34	42	69
o/w: PETROPAR arrears to foreign suppliers over 90 days	70	22	55	18	NA	4	44	22	32	55
ESSAP arrears 6/							8.5	4.4		
<b>Memorandum items:</b>										
External public arrears	139	119	92	48	24	20	102	91	75	75
Central government total debt service	216	31	13	7	7	15	18	15	14	44
Annual GDP	5,633	5,817	6,750	6,750	6,750	6,750	5,817	5,817	6,750	6,750

Sources: Ministry of Finance; and Fund staff estimates.

1/ Public sector pending obligations more than 1 day overdue, except for last 4 columns (see footnote 2).

2/ The program considers as arrears: (i) all payments past due over 30 days; (ii) nondisputed arrears; (iii) domestic arrears which exclude 'normal' floating debt (equal to G250 billion, or US\$40 million).

3/ Based on preliminary data. The \$1.5 million central government external arrears refer to disputed arrears with Belgium and South Africa, so would be excluded from program targets.

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

5/ Includes about US\$14 million in disputed arrears, except for the last four column (see footnote 2).

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

Table 8. Paraguay: Public Sector Financing  
(In millions of US\$, unless otherwise stated)

	2003				2004					
	Program		Actual		Prel.		Projections			
	(mln US\$)	(in % of GDP)	(mln US\$)	(in % of GDP)	Q1	Q2	Q3	Q4 (mln US\$) (in % of GDP)		
<b>Gross financing requirements</b>	<b>205</b>	<b>3.6</b>	<b>202</b>	<b>3.5</b>	<b>-28</b>	<b>18</b>	<b>51</b>	<b>128</b>	<b>169</b>	<b>2.5</b>
Deficit below the line 1/	27	0.5	-2	0.0	-112	-58	-14	85	-99	-1.5
Net domestic debt amortizations 2/	9	0.2	9	0.2	0	0	9	0	9	0.1
External debt amortizations paid 3/	133	2.3	127	2.2	32	36	51	39	159	2.4
Net reduction in arrears	37	0.6	68	1.2	52	40	5	4	101	1.5
<b>Identified financing</b>	<b>190</b>	<b>3.3</b>	<b>152</b>	<b>2.6</b>	<b>-28</b>	<b>8</b>	<b>30</b>	<b>129</b>	<b>139</b>	<b>2.1</b>
NFPs net credit from banking system (use of deposits)	21	0.4	-51	-0.9	-35	-40	-26	9	-92	-1.4
Financing of the quasi-fiscal deficit	50	0.9	54	0.9	6	15	15	15	51	0.8
Project lending	119	2.1	149	2.6	1	33	41	105	180	2.7
<b>Financing gap</b>	<b>15</b>	<b>0.3</b>	<b>49</b>	<b>0.8</b>	<b>0</b>	<b>10</b>	<b>21</b>	<b>-1</b>	<b>30</b>	<b>0.4</b>
<b>Program financing</b>	<b>15</b>	<b>0.3</b>	<b>49</b>	<b>0.8</b>	<b>0</b>	<b>10</b>	<b>21</b>	<b>-1</b>	<b>30</b>	<b>0.4</b>
Taiwan rescheduling					0	0	18	0	18	0.3
Fonplata rescheduling	0	0.0	0	0.0	0	0	4	-1	3	0.0
Program lending:	15	0.3	49	0.8	0	10	0	0	10	0.1
IDB	15	0.3	20	0.3	0	10	0	0	10	0.1
World Bank	0	0.0	30	0.5	0	0	0	0	0	0.0
<b>Residual financing gap</b>	<b>0</b>	<b>0.0</b>	<b>0</b>	<b>0.0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes measures under the program, as well as an assumption of a US\$33 million BCP loan to the central government.

2/ Includes rollover of \$138 million in maturing domestic bonds on November 15.

3/ Includes amortizations of the financial public sector guaranteed by the Republic of Paraguay.

Table 9. Paraguay: Monetary Program  
(In billions of guaranies; end-of-period; valued at constant exchange rate)

	2001	2002	2003	Rev. Proj. 2004				Prog. 2004
				Mar.	Jun.	Aug.	Dec.	
<b>Net international reserves</b>	<b>4,541</b>	<b>4,027</b>	<b>6,175</b>	<b>6,380</b>	<b>6,784</b>	<b>6,699</b>	<b>6,782</b>	<b>5,369</b>
(In millions of U.S. dollars)	723	641	983	1,016	1,080	1,067	1,080	855
<b>Net domestic assets</b>	<b>-2,879</b>	<b>-2,329</b>	<b>-3,969</b>	<b>-4,264</b>	<b>-4,674</b>	<b>-4,507</b>	<b>-4,090</b>	<b>-2,761</b>
Net nonfinancial public sector	1,176	1,507	1,163	1,292	1,119	981	1,137	1,438
Net credit to the general government	979	1,291	953	1,091	865	727	883	1,223
Central Government	978	1,291	952	1,090	865	727	883	1,222
Credit	1,849	1,938	2,098	2,093	2,040	1,999	1,916	1,986
Deposits	871	647	1,146	1,003	1,175	1,272	1,033	764
Rest of general government	1	1	1	1	1	1	1	1
Credit	1	1	1	1	1	1	1	1
Deposits	0	0	0	0	0	0	0	0
Net credit to public enterprises	197	216	211	201	254	254	254	215
Credit	201	218	240	238	279	279	279	232
Deposits	4	2	29	36	26	26	26	17
Net credit to the financial system	-1,139	-485	-1,393	-1,857	-1,903	-1,901	-1,930	-1,074
Credit	1,308	1,443	1,504	1,491	1,490	1,490	1,490	1,502
Deposits	2,446	1,928	2,897	3,348	3,393	3,391	3,420	2,576
Net credit to the banking system	-2,293	-1,814	-2,760	-3,209	-3,249	-3,247	-3,276	-2,370
Total credit to banks	7	4	2	6	29	29	29	87
Loans and liquidity (+ active call)	0	0	0	0	0	0	0	0
Other loans to banks	7	4	2	6	29	29	29	87
Deposits and reserve requirements	2,300	1,818	2,762	3,215	3,279	3,277	3,305	2,457
Net credit to the rest of financial entities	1,154	1,328	1,366	1,351	1,346	1,346	1,346	1,296
Credit	1,301	1,439	1,502	1,484	1,461	1,461	1,461	1,415
Deposits	147	111	136	133	115	115	115	119
Net credit to the private sector	-63	-87	-99	-91	-88	-88	-88	-103
Credit	28	32	34	35	35	35	35	35
Deposits and liabilities	0	0	0	0	0	0	0	0
Restricted deposits	91	120	133	125	123	123	123	138
Open market operations (LRM and passive call)	297	677	1,071	1,273	1,553	1,310	1,165	1,045
Medium- and long-term external liabilities	376	460	431	404	395	395	377	405
Capital and reserves	1,584	2,941	1,463	1,401	1,339	1,285	1,158	2,415
Provisions	1,064	1,108	1,255	1,251	1,250	1,250	1,250	1,102
Other assets net	469	1,922	580	721	735	742	741	1,945
<b>Currency issue</b>	<b>1,662</b>	<b>1,699</b>	<b>2,207</b>	<b>2,115</b>	<b>2,110</b>	<b>2,192</b>	<b>2,692</b>	<b>2,608</b>
Growth	6.8	2.2	29.9	36.9	22.0	22.0	22.0	16.5
Memorandum item								
Monetary base growth	5.8	-1.0	57.7	61.1	27.0	23.1	21.6	3.2

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

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

	2000	2001	2002	2003	2004
(In billions of guaraníes)					
I. Central Bank					
<b>Net external assets</b>	4,848	4,541	4,027	6,175	6,782
(in millions of U.S. dollars)	772	723	641	983	1,080
<b>Net domestic assets</b>	<b>-3,291</b>	<b>-2,879</b>	<b>-2,329</b>	<b>-3,969</b>	<b>-4,090</b>
Credit to public sector, net	799	1,176	1,507	1,163	1,137
Credit to banking system, net 1/	-2,332	-2,293	-1,814	-2,760	-3,276
Credit	7	7	4	2	29
Deposits	2,339	2,300	1,818	2,762	3,305
Central bank securities	-46	-297	-677	-1,071	-1,165
Other	-1,713	-1,464	-1,345	-1,301	-786
<b>Currency issued</b>	<b>1,557</b>	<b>1,662</b>	<b>1,699</b>	<b>2,207</b>	<b>2,692</b>
II. Monetary Survey					
<b>Net external assets</b>	<b>7,503</b>	<b>6,907</b>	<b>5,497</b>	<b>8,405</b>	<b>9,393</b>
(in millions of U.S. dollars)	1,195	1,100	875	1,338	1,496
<b>Net domestic assets</b>	<b>3,331</b>	<b>4,093</b>	<b>3,473</b>	<b>2,152</b>	<b>3,122</b>
Credit to the public sector	-21	358	932	699	-136
Credit to the private sector	7,951	7,872	6,230	5,081	5,658
Other	-4,599	-4,137	-3,689	-3,628	-2,399
<b>Broad Liquidity (M5)</b>	<b>10,834</b>	<b>11,000</b>	<b>8,970</b>	<b>10,558</b>	<b>12,515</b>
Money market funds	0	0	0	0	0
<b>Broad Liquidity (M4)</b>	10,834	11,000	8,970	10,558	12,515
Bonds and issued securities	23	50	135	31	0
Other monetary liabilities	70	16	15	9	7
Central bank securities with private sector	8	121	281	469	1,153
<b>Broad liquidity (M3)</b>	10,733	10,813	8,539	10,047	11,355
Foreign currency deposits	6,991	6,886	4,699	5,253	5,898
<b>Money and quasi-money (M2)</b>	3,742	3,926	3,839	4,794	5,456
Quasi-money	1,326	1,306	1,198	1,208	1,315
Money (M1)	2,416	2,621	2,641	3,587	4,141
(Annual percentage change)					
M0 (Currency issued)	-1.9	6.8	2.2	29.9	22.0
Credit to the private sector	-1.1	-1.0	-20.9	-18.4	11.3
M1	15.0	8.5	0.8	35.8	15.4
M2	2.2	4.9	-2.2	24.9	13.8
M3	-0.5	0.7	-21.0	17.7	13.0
<i>Of which:</i> foreign currency deposits	-1.9	-1.5	-31.8	11.8	12.3
<b>Memorandum items:</b>					
Ratio of foreign currency deposits to M3 (percent)	65.1	63.7	55.0	52.3	51.9
Ratio of foreign currency deposits to private sector deposits in banks (percent)	73.6	72.5	64.9	63.5	65.1

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

	2000	2001	2002	2003	May 2004
<b>Total foreign banks</b>					
Share in assets	47.0	45.1	48.4	47.4	40.0
Capital adequacy ratio (percent)	17.1	16.0	17.6	20.4	29.8
NPLs (percent) total loans	14.1	15.3	20.1	20.8	20.9
Provisions (percent) NPLs	40.2	42.6	57.5	64.2	62.1
Rate of return on assets (ROA)	2.3	3.1	1.6	0.1	1.6
Rate of return on equity (ROE)	20.2	30.4	15.0	1.2	14.6
Liquid assets (percent) of total assets 1/	21.6	22.2	27.1	29.8	29.1
Government bond portfolio in assets	2.6	3.1	4.6	7.7	6.6
Foreign exchange deposits in percent of total	63.2	67.8	71.1	65.6	68.4
<b>Total majority foreign banks</b>					
Share in assets	34.9	38.3	33.2	37.2	42.2
Capital adequacy ratio (percent)	17.7	16.8	19.9	21.0	18.3
NPLs (percent) total loans	10.6	10.6	10.4	12.3	8.0
Provisions (percent) NPLs	39.7	36.8	43.8	52.1	40.2
Rate of return on assets (ROA)	1.0	1.8	1.4	1.3	2.1
Rate of return on equity (ROE)	8.6	18.3	13.4	15.5	24.0
Liquid assets (percent) of total assets 1/	24.2	25.0	26.2	35.3	35.1
Government bond portfolio in assets	1.9	2.1	5.3	4.0	3.1
Foreign exchange deposits in percent of total	64.3	69.3	70.7	62.3	58.3
<b>Total domestic private banks</b>					
Share in assets	6.8	7.4	10.4	7.4	8.8
Capital adequacy ratio (percent)	15.2	14.8	13.6	14.1	15.8
NPLs (percent) total loans	7.0	6.5	8.8	2.9	2.9
Provisions (percent) NPLs	25.0	30.8	18.7	46.2	79.1
Rate of return on assets (ROA)	1.0	1.2	1.1	1.6	1.7
Rate of return on equity (ROE)	8.9	13.8	14.3	21.1	24.3
Liquid assets (percent) of total assets 1/	17.3	20.1	18.3	38.8	47.0
Government bond portfolio in assets	1.0	1.1	1.4	2.1	1.6
Foreign exchange deposits in percent of total	49.4	61.8	62.6	60.7	62.9
<b>Total banking system excluding BNF</b>					
Share in assets	88.6	90.8	92.0	92.0	90.9
Capital adequacy ratio (percent)	17.1	16.2	17.9	20.1	22.3
NPLs (percent) total loans	12.0	12.3	14.7	15.0	12.5
Provisions (percent) NPLs	39.2	39.8	50.2	59.2	55.2
Rate of return on assets (ROA)	1.7	2.4	1.5	0.7	1.8
Rate of return on equity (ROE)	14.6	24.1	14.3	7.7	19.4
Liquid assets (percent) of total assets 1/	22.3	23.2	25.7	32.8	33.6
Government bond portfolio in assets	2.2	2.5	4.5	5.8	4.5
Foreign exchange deposits in percent of total	62.8	68.0	70.2	63.9	63.4
<b>National Development Bank (BNF)</b>					
Share in assets	11.4	9.2	8.0	8.0	9.1
Capital adequacy ratio (percent)	21.2	22.9	18.8	30.0	23.2
NPLs (percent) total loans	44.6	46.5	56.2	56.2	58.1
Provisions (percent) NPLs	38.1	31.7	39.6	47.6	44.5
Rate of return on assets (ROA)	-0.5	0.3	-4.7	-2.8	-5.7
Rate of return on equity (ROE)	-4.2	2.0	-27.3	-18.7	-59.2
Liquid assets (percent) of total assets 1/	16.7	20.4	17.3	30.7	41.7
Government bond portfolio in assets	11.6	0.0	0.2	0.5	0.4
Foreign exchange deposits in percent of total	19.3	27.0	42.5	32.7	26.6

Source: Superintendency of Banks.

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

Table 12: Paraguay: Balance of Payments, 2001-2004

(In millions of U.S. dollars)

	2001	2002	Est. 2003	Rev. Proj. 2004				Year	Prog. 2004
				Q1	Q2	Q3	Q4		
Current account	-266	130	152	35	150	7	-101	91	26
Trade balance	-618	-204	-309	-67	41	-85	-188	-299	-287
Exports	1,883	1,882	2,014	626	597	477	395	2,096	2,111
Exports of domestic goods	990	951	1,242	413	469	368	270	1,520	1,274
Reexports	893	931	772	213	127	109	125	575	837
Imports	-2,500	-2,086	-2,323	-694	-555	-562	-584	-2,395	-2,398
Registered imports	-1,989	-1,510	-1,862	-553	-497	-505	-515	-2,070	-1,925
Unregistered imports	-512	-576	-461	-141	-58	-57	-69	-325	-473
Services (net)	165	223	267	53	55	54	47	209	161
Transport	-127	-109	-87	-20	-20	-22	-31	-93	-141
Travel	-3	-3	-3	-8	-6	-5	-4	-23	-20
Other	295	335	357	81	81	81	82	325	322
Factor income	16	-8	26	2	11	-3	-4	6	15
Transfers	167	116	165	47	43	41	44	176	137
Capital and financial account	150	57	125	-2	-76	-8	126	40	116
Capital transfers	15	4	15	3	3	3	3	12	21
Direct investment	79	10	45	6	-11	10	31	35	34
Portfolio investment	1	0	0	0	0	0	0	0	0
Other investment	56	43	66	-10	-68	-21	92	-7	60
Assets (increase -)	64	-5	55	10	-47	-27	40	-24	-51
Commercial credits	6	-7	2	5	-1	-12	5	-4	-22
Loans	1	182	-149	-32	-12	-12	0	-56	-47
Foreign currency deposits	-71	-152	195	37	-36	-5	33	29	10
Other	129	-29	7	1	2	2	2	7	7
Liabilities (increase +)	-9	49	11	-21	-21	6	47	17	112
Commercial credits	1	16	-24	-4	-12	-15	35	4	0
Loans	9	30	38	-18	-10	20	16	8	107
<i>Of which: Gov't disbursements</i>	144	146	213	17	34	65	33	148	242
<i>Of which: Gov't payments</i>	-102	-123	-130	-34	-27	-27	-30	-118	-162
Foreign currency deposits	10	8	3	5	0	0	0	5	0
Other	-28	-5	-6	-3	1	1	1	-1	5
Errors and omissions	71	-269	-43	58	0	0	0	58	0
Overall balance	-45	-83	234	92	74	-1	25	189	141
Net international reserves (increase -)	45	83	-326	-37	-62	13	-13	-99	-38
Gross reserves	45	84	-325	-36	-62	13	-13	-98	-37
Reserve liabilities	0	-1	-1	-1	0	0	0	-1	-1
Residual financing gap	...	...	91	-55	-12	-12	-12	-91	-103
Arrears deferral (+)/clearance (-)	...	...	91	-55	-12	-12	-12	-91	-103
<b>Memorandum items:</b>									
Current account in percent of GDP	-3.9	2.3	2.6	...	...	...	...	1.3	0.4
Registered trade balance in percent of GDP	-14.6	-9.9	-10.7	...	...	...	...	-8.1	-10.6
Gross reserves (in millions of U.S. dollars)	723	641	983	1,016	1,080	1,067	1,080	1,080	855
(in months of imports of GNFS)	3.6	2.9	4.3	...	...	...	...	4.5	3.5
External public debt in percent of GDP	33.5	42.9	44.9	...	...	...	...	39.6	42.6
Debt service in percent of exports GNFS	10.8	10.0	10.3	...	...	...	...	15.4	11.7
Export volume (percentage change) 1/	18.6	-7.2	12.8	...	...	...	...	4.9	4.2
Import volume (percentage change) 1/	0.7	-21.5	16.5	...	...	...	...	4.6	2.7
Terms of trade (percentage change)	-0.2	6.9	9.4	...	...	...	...	8.8	-4.8

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

1/ Registered trade.

Table 13. Paraguay: Millenium Development Goals 1/

	1990	1995	1998	2001	2002	2015 Target
<u>Goal 1. Eradicate extreme poverty and hunger</u>						
<b>Target 1:</b> Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day.						
1. Population below extreme poverty line (percent) /2	..	13.9	17.3	15.6	..	7.0
2. Poverty gap at US\$1 a day (percent) 2/	..	...	14.3	13.6	..	...
3. Share of income or consumption held by poorest 20 percent (percent)	..	..	..	3.0	..	...
<b>Target 2:</b> Halve, between 1990 and 2015, the proportion of people suffering hunger						
4. Prevalence of child malnutrition (percent of children under 5)	3.7	..	5.1	4.6	..	1.9
5. Population below minimum level of dietary energy consumption (percent)	18.0	..	..	14.0	..	9.0
<u>Goal 2. Achieve universal primary education</u>						
<b>Target 3:</b> Ensure that, by 2015, children will be able to complete a full course of primary schooling						
6. Net primary enrollment ratio (percent of relevant age group)	92.8	88.4	...	92.1	...	100
7. Percentage of cohort reaching grade 5	70.5	78.4	...	76.4	...	100
8. Youth literacy rate (percent ages 15-24)	95.6	96.4	...	97.2	97.3	100
<u>Goal 3. Promote gender equality and empower women</u>						
<b>Target 4:</b> Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education by 2015						
9. Ratio of girls to boys in primary and secondary education (percent)	94.7	96.2	...	99.1	..	100
10. Ratio of young literate females to males (percent ages 15-24)	99.3	99.7	...	100	100	100
11. Share of women employed in the nonagricultural sector (percent)	...	41.7	40.0	40.3	42.0	...
12. Proportion of seats held by women in national parliament (percent)	6	3	...	3	3	...
<u>Goal 4. Reduce child mortality</u>						
<b>Target 5:</b> Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate						
13. Under 5 mortality rate (per 1,000)	37	34	...	30	29.5	12
14. Infant mortality rate (per 1,000 live births)	30	28	...	26	24.5	10
15. Immunization, measles (percent of children under 12 months)	69	75	...	77	...	...
<u>Goal 5. Improve maternal health</u>						
<b>Target 6:</b> Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.						
16. Maternal mortality ratio (modeled estimate, per 100,000 live births)	341	259	187	...	...	85
17. Proportion of births attended by skilled health staff	...	...	69.4	72.6	...	...

Table 13. Paraguay: Millenium Development Goals 1/

	1990	1995	1998	2001	2002	2015 Target
<u>Goal 6. Combat HIV/AIDS, malaria and other diseases</u>						
<b>Target 7:</b> Halt HIV/AIDS, malaria and other diseases						
18. Prevalence of HIV, female (percent ages 15-24)	...	0.0	...	...	0.8	...
19. Contraceptive prevalence rate (percent of women ages 15-49)	1.7	...	6.2	...	...	...
20. Number of children orphaned by HIV/AIDS	...	...	...	400	...	...
<b>Target 8:</b> Halt by 2015, and begin to reverse, the incidence of malaria and other major diseases						
23. Incidence of tuberculosis (per 100,000 people)	51.4	36.1	...	35.2	...	...
24. Tuberculosis cases detected under DOTS (percent)	...	13	...	4	...	...
<u>Goal 7. Ensure environmental sustainability</u>						
<b>Target 9:</b> Integrate the principles of sustainable development into policies and programs. Reverse the loss of environmental resources.						
25. Forest area (percent of total land area) 3/	...	...	7.0	...	...	...
26. Nationally protected areas (percent of total land area)	...	3.5	...	3.5	3.5	...
27. GDP per unit of energy use (PPP \$ per kg oil equivalent)	5.2	5.5	...	6.1	...	...
28. CO2 emissions (metric tons per capita)	0.5	0.8	...	0.9	...	...
<b>Target 10:</b> Halve by 2015 proportion of people without access to safe drinking water						
30. Access to an improved water source (percent of population) 4/	25.4	39.1	43.6	52.4	53.4	62.7
<b>Target 11:</b> Achieve by 2020 significant improvement for at least 100 million slum dwellers						
31. Access to improved sanitation (percent of population) 4/	7.2	9.4	7.1	9.2	8.8	53.6
<u>Goal 8. Develop a Global Partnership for Development</u>						
<b>Target 16:</b> Develop and implement strategies for productive work for youth						
45. Unemployment rate of population ages 15-24 (total)	15.7	6.0	10.3	17.8	18.6	...
<b>Target 18.</b> Make available new technologies, especially information and communications						
47. Households with telephone (percent). 5/	...	...	17.0	38.4	36.9	...
48. Households with personal computers (percent). 6/	...	...	2.1	5.3	5.4	...

Source: World Development Indicators database, April 2003, unless otherwise indicated.

1/ Targets 12-15 and indicators 33-44 are excluded because they cannot be measured on a country specific basis. These are related to official development assistance, market access, and the HIPC initiative.

2/ Data on population living on less than US\$1 per day are not available. Extreme poverty is measured as the fraction of the population that cannot afford a basic basket of food.

3/ Source: Ministry of Agriculture. Reported 1998 figure refers to 1997.

4/ Source: Censo Nacional de Poblacion y Vivienda, and Encuesta Permanente de Hogares, various issues.

5/ Source: Encuesta Permanente de Hogares, various issues. This indicator substitutes "Fixed line and mobile telephones (per 1,000 people)" owing to better data availability.

6/ Source: Encuesta Permanente de Hogares, various issues. This indicator substitutes "Personal computers (per 1,000 people)" owing to better data availability.



Table 14. Paraguay: Medium-Term Scenario  
(In percent of GDP, unless otherwise specified)

	2001	2002	Est.	Projections						
			2003	2004	2005	2006	2007	2008	2009	2010
<b>I. Baseline Scenario</b>										
<b>Real sector</b>										
Real GDP growth 1/	2.7	-2.3	2.6	2.1	3.2	3.4	3.4	3.4	3.4	3.4
Consumer prices 1/	8.4	14.6	9.3	4.0	5.0	5.0	5.0	5.0	5.0	5.0
GDP per capita (US dollars)	1,224	981	987	1,114	1,172	1,209	1,247	1,291	1,333	1,377
<b>Public finances 2/</b>										
Revenues	21.3	19.3	19.8	21.1	21.5	21.6	21.7	21.8	21.9	22.1
Current primary expenditures	17.7	16.1	14.7	14.7	14.8	14.8	14.8	14.8	14.8	14.8
Interest payments	1.7	1.9	1.9	1.9	2.3	1.9	1.8	1.8	1.8	1.8
Capital expenditures	5.1	5.9	4.8	5.5	6.0	6.2	6.3	6.5	6.5	6.5
Public enterprise operating surplus	2.5	1.4	2.1	2.4	2.1	2.0	1.8	1.8	1.7	1.6
Primary balance	1.0	-1.3	2.4	3.4	2.7	2.5	2.4	2.3	2.2	2.3
Overall balance	-3.3	-3.1	0.0	1.5	0.4	0.6	0.6	0.5	0.4	0.5
Public sector debt (in millions of U.S. dollars)	2,630	2,801	2,876	2,920	2,891	2,843	2,798	2,752	2,715	2,666
(In percent of GDP)	38.4	49.7	49.4	43.3	39.6	37.0	34.6	32.2	30.1	28.0
Balance of payments (in millions of U.S. dollars)										
Exports	1,883	1,882	2,014	2,096	2,099	2,127	2,195	2,269	2,349	2,436
Imports	2,500	2,086	2,323	2,395	2,493	2,569	2,671	2,778	2,904	3,022
Current account	-266	130	152	91	-25	-65	-83	-98	-123	-132
(In percent of GDP)	-3.9	2.4	2.6	1.3	-0.3	-0.8	-1.0	-1.1	-1.4	-1.4
Capital and financial account	150	57	125	40	82	85	116	144	174	211
Net international reserves	723	641	982	1,080	1,137	1,157	1,190	1,237	1,288	1,368
(In months of imports)	3.6	2.9	4.3	4.5	4.6	4.5	4.5	4.5	4.5	4.4
<b>II. Higher Growth Scenario</b>										
<b>Real sector</b>										
Real GDP growth 1/	2.7	-2.3	2.6	2.1	3.2	3.4	3.6	3.8	4.1	4.5
Consumer prices 1/	8.4	14.6	9.3	4.0	5.0	5.0	5.0	5.0	5.0	5.0
GDP per capita (US dollars)	1,224	981	987	1,114	1,172	1,209	1,250	1,298	1,350	1,410
<b>Public finances 2/</b>										
Revenues	21.3	19.3	19.8	21.1	21.5	21.6	21.7	21.8	21.9	22.1
Current primary expenditures	17.7	16.1	14.7	14.7	14.8	14.8	14.8	14.8	14.8	14.8
Interest payments	1.7	1.9	1.9	1.9	2.3	1.9	1.8	1.8	1.8	1.8
Capital expenditures	5.1	5.9	4.8	5.5	6.0	6.2	6.3	6.7	6.8	7.1
Public enterprise operating surplus	2.5	1.4	2.1	2.4	2.1	2.0	1.8	1.8	1.6	1.6
Primary balance	1.0	-1.3	2.4	3.4	2.7	2.5	2.4	2.0	1.9	1.8
Overall balance	-3.3	-3.1	0.0	1.5	0.4	0.6	0.6	0.3	0.1	0.0
Public sector debt (in millions of U.S. dollars)	2,630	2,801	2,876	2,920	2,891	2,843	2,798	2,772	2,763	2,760
(In percent of GDP)	38.4	49.7	49.4	43.3	39.6	37.0	34.5	32.2	30.3	28.3
Balance of payments (in millions of U.S. dollars)										
Exports	1,883	1,882	2,014	2,096	2,099	2,129	2,207	2,294	2,391	2,500
Imports	2,500	2,086	2,323	2,395	2,497	2,576	2,687	2,809	2,960	3,117
Current account	-266	130	152	91	-29	-71	-90	-107	-141	-167
(In percent of GDP)	-3.9	2.4	2.6	1.3	-0.4	-0.9	-1.1	-1.2	-1.5	-1.7
Capital and financial account	150	57	125	40	82	85	141	176	222	261
Net international assets	723	641	982	1,080	1,133	1,147	1,199	1,269	1,349	1,443
(In months of imports)	3.6	2.9	4.3	4.5	4.6	4.5	4.5	4.5	4.5	4.5

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

1/ Annual percentage change.

2/ Includes financial and nonfinancial public sector.

Table 15. Paraguay: Structural Conditionality Under Program and Prior Actions for the Second Review

Measure	Conditionality	Timing	Status and Comments
<b>Prior Actions for the Second Review</b>			
- Passage by Congress of Administrative Reorganization and Fiscal Adjustment Law	Prior action		Law approved by Congress on June 25, 2004
- Undersecretariat for Taxation to present a strategic plan to increase computerization, restructure the organization and boost staff training	Prior action		
- Budgetary reallocations to increase funding for tax authorities in 2004	Prior action		
- Submission to Congress of a draft law to regularize disputed arrears on a loan to electricity company ANDE	Prior action		
- Completion of the exchange for all the domestic bonds presented by June 15 and clearance of interest arrears on exchanged bonds.	Prior action		
- Clearance of new bilateral arrears by cement company INC	Prior action		Completed.
- Regularization of arrears on penalty interest to Banque Worms	Prior action		
<b>Financial Sector</b>			
- Passage by Congress of a public banking law to consolidate and restructure the public development banks	PC	31 Oct. 2004	Test date was previously 31 July 2004
- Passage by Congress of new comprehensive banking system legislation	PC	31 Dec. 2004	
- Require all banks to obtain international risk rating	SB	31 Dec. 2004	
- Extension of regulatory supervision to financial cooperatives	SB	1 Jan. 2005	
<b>Central Government and Central Bank</b>			
- No accumulation of new external arrears	Continuous PC		
- Passage by Congress of Administrative Reorganization and Fiscal Adjustment Law	PC	31 May 2004	Law approved by Congress on June 25, 2004
- Full application of Public Procurement Law	SB	30 Jun. 2004	Applied at all government levels.
- Application of international accounting standards and annual external audits of the central bank	SB	30 Jun. 2004	Central bank on track to complete external audit.
- Passage by Congress of a new customs code and implementation of a customs reform program	SB	31 Jul. 2004	Approved by Congress on June 30, 2004.
- Begin implementation of a central bank restructuring plan	SB	31 Jul. 2004	Central bank is developing its restructuring plan.
- Development of a plan for comprehensive civil service reform	SB	31 Oct. 2004	Census of civil servants under way.
<b>Public Enterprises</b>			
- Requirement of regular adjustments in fuel and utilities prices to fully reflect input price and exchange rate changes	PC	1 Jul. 2004 1 Jan. 2005	Price of diesel adjusted in January and April.
- Presentation of a plan for the participation of private capital in key public enterprises	SB	31 Dec. 2004	
<b>Governance</b>			
- Regular independent audits of all public enterprises and the Social Security Institute	PC	30 Sep. 2004 31 Dec. 2004	ANDE, ESSAP and COPACO will conclude their external audit by 30 September 2004; the remaining enterprises and the Social Security Institute by December 31, 2004.
- Increased data publication for government and public enterprises	SB	30 Sep. 2004	

Table 16. Impact of Measures in Administrative Reorganization and Fiscal Adjustment Law  
(Percent of GDP)

	2004 1/	2005	2006	2007	2008	2009	2010	2011
<b>Effect of applying the law and compensatory measures</b>	<b>0.3</b>	<b>1.2</b>	<b>1.3</b>	<b>1.3</b>	<b>1.4</b>	<b>1.5</b>	<b>1.6</b>	<b>1.6</b>
<b>Effect of applying the law</b>	<b>0.1</b>	<b>0.6</b>	<b>0.6</b>	<b>1.0</b>	<b>1.1</b>	<b>1.2</b>	<b>1.3</b>	<b>1.3</b>
Profit tax 2/	0.0	-0.4	-0.7	-0.7	-0.6	-0.6	-0.6	-0.6
Tax on Small Taxpayers 3/	0.0	0.2	0.2	0.2	0.2	0.2	0.2	0.2
VAT changes 4/	0.1	0.3	0.3	0.7	0.7	0.7	0.7	0.7
Vehicle tax	0.0	0.1	...	...	...	...	...	...
Personal income tax 5/	0.0	0.0	0.4	0.4	0.4	0.5	0.5	0.6
Agricultural land tax 6/	0.0	0.4	0.4	0.4	0.4	0.4	0.4	0.4
<b>Compensatory measures</b>	<b>0.2</b>	<b>0.5</b>	<b>0.6</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>
Delay reduction in profit income tax /7	0.0	0.4	0.4	0.0	0.0	0.0	0.0	0.0
Temporary soy export tax	0.2	...	...	...	...	...	...	...
Increase excise tax on tobacco	0.01	0.02	0.02	0.02	0.02	0.02	0.02	0.02
Strategic plan to improve tax administration efficiency	0.0	0.1	0.2	0.3	0.3	0.3	0.3	0.3
<b>Memorandum item</b>								
Effect of applying House of Deputies version	0.01	-0.11	0.09	0.06	0.06	0.07	0.07	0.08

1/ Measures applied in 2004 include: (i) changes in VAT, excluding the elimination of the 'Tourism' regimes (repealed in 2007); (ii) changes in excise taxes.  
2/ Assumes that reduction in tax rate to 20 percent takes place in 2005; rate remains at 10 percent in following years. Effect of eliminating dividend deductions and investment exemptions under Law 60/90 gradually build up over time.  
3/ Assumes that replacement will be in effect in 2005.  
4/ Assumes that: (i) 'Tourism' regime is eliminated in 2007; (ii) tax rate on medicines is gradually rolled back to 10 percent; (iii) exemptions on service providers eliminated in 2007; (iv) investment exemptions under Law 60/90 progressively eliminated.  
5/ Assumes that it will come into effect in 2006 and that the exemption level will be reduced by one minimum wage per year starting in 2007.  
6/ Assumes that it will be fully in effect in 2005.  
7/ Assumes that the tax rate will be lowered to 20 percent in 2006 (rather than in 2005) and to 10 percent in 2007 (rather than in 2006).

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
July 30, 2004	4.0	4.0	Second review and March 2004 performance criteria
November 16, 2004	6.0	6.0	Third review and August 2004 performance criteria
March 16, 2005	6.0	6.0	Fourth review and December 2004 performance criteria
<b>Total</b>	<b>50.0</b>	<b>50.0</b>	

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

	2003	2004	2005	2006	2007	2008	2009	2010
<b>Fund repurchases and charges</b>								
In millions of SDRs	0	1	1	1	6	25	20	0.8
In millions of U.S. dollars	0	1	2	2	9	35	28	1
In percent of exports of goods and NFS	0.0	0.0	0.1	0.1	0.3	1.2	0.9	0.0
In percent of quota	0.2	0.5	1.4	1.5	6.2	25.2	20.3	0.8
In percent of gross official reserves	0.0	0.1	0.2	0.2	0.7	2.8	2.2	0.1
<b>Fund credit outstanding</b>								
In millions of SDRs	0	44	50	50	45	21	1	0
In millions of U.S. dollars	0	57	69	69	62	29	1	0
In percent of exports of goods and NFS	0.0	2.1	2.6	2.5	2.2	1.0	0.0	0.0
In percent of quota	0	44	50	50	45	21	1	0
In percent of gross official reserves	0.0	4.1	4.4	4.3	3.8	1.7	0.1	0.0
<b>Memorandum items:</b>								
Exports of goods and NFS (mlns. of U.S. dollars), baseline	2,609	2,673	2,684	2,718	2,793	2,874	2,962	3,056
Debt service (millions of U.S. dollars)	270	412	314	339	354	364	377	386
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	138	138	138	138	138	138
Gross official reserves (millions of U.S. dollars)	982	1,080	1,137	1,157	1,190	1,237	1,288	1,368
U.S. dollars per SDR 2/	1.29	1.30	1.38	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 starting from July 30, 2004, and repurchases made on the obligations schedule.

2/ WEO projections.

Table 19. Paraguay: Public Sector Debt Sustainability Framework, 1999-2009  
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b>I. Baseline Medium-Term Projections</b>											
Public sector debt 1/ <i>Of which: foreign-currency denominated</i>	31.9	33.9	38.4	49.7	49.4	43.3	39.6	37.0	34.6	32.2	30.1
Change in public sector debt	9.2	1.9	4.5	11.4	-0.3	-6.2	-3.6	-2.6	-2.4	-2.4	-2.1
Identified debt-creating flows (4+7+12)	11.8	5.2	11.3	16.9	-12.0	-3.5	-1.3	-1.8	-1.9	-2.0	-1.9
Primary deficit	7.0	4.7	0.3	2.0	-1.2	-1.8	-1.7	-1.8	-1.9	-2.0	-2.1
Revenue and grants	31.1	31.2	33.6	31.9	32.9	33.1	32.4	32.0	31.9	31.7	31.6
Primary (noninterest) expenditure	38.1	36.0	33.9	33.9	31.7	31.3	30.7	30.3	30.0	29.8	29.5
Automatic debt dynamics 2/ Contribution from interest rate/growth differential 3/ Of which contribution from real interest rate	4.8	0.5	11.0	14.9	-10.8	-1.7	0.4	0.0	0.0	-0.1	0.2
Of which contribution from real GDP growth	0.9	-1.6	0.5	-2.4	-5.5	-1.7	-0.2	-0.7	-0.8	-0.9	-0.6
Contribution from exchange rate depreciation 4/ Denominator = $1+g+r/g$	1.0	-1.7	1.4	-3.2	-4.4	-0.7	1.1	0.5	0.4	0.2	0.4
Other identified debt-creating flows	-0.1	0.1	-0.9	0.8	-1.1	-1.0	-1.3	-1.3	-1.2	-1.1	-1.0
Privatization receipts (negative)	3.9	2.1	10.5	17.3	-5.4	0.0	0.6	0.7	0.8	0.8	0.8
Recognition of implicit or contingent liabilities	1.0	1.1	1.0	1.1	1.2	1.1	1.1	1.1	1.1	1.1	1.1
Other (specify, e.g. bank recapitalization)	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)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	-2.6	-3.3	-6.8	-5.5	11.7	-2.6	-2.4	-0.8	-0.6	-0.4	-0.1
Gross financing need 5/ in billions of U.S. dollars	102.8	108.4	114.2	156.1	150.5	130.5	122.4	115.5	108.5	101.4	95.3
Key Macroeconomic and Fiscal Assumptions	4.2	7.1	5.3	6.1	3.5	2.3	2.6	2.1	2.2	2.2	2.3
Real GDP growth (in percent)	0.3	0.6	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Average nominal interest rate on public debt (in percent) 6/	0.5	-0.4	2.7	-2.3	2.6	2.1	3.2	3.4	3.4	3.4	3.4
Average nominal interest rate on foreign debt (in percent) 6/	6.9	5.8	5.9	6.5	4.6	4.2	5.7	5.2	5.3	5.5	6.1
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.4	-6.1	4.3	-9.9	-10.0	-1.5	2.9	1.5	1.2	0.9	1.4
Inflation rate (GDP deflator, in percent)	2.5	11.9	1.7	16.4	14.5	5.7	2.8	3.7	4.1	4.7	4.7
Growth of real primary spending (deflated by GDP deflator, in percent)	19.2	-5.9	-3.3	-2.4	-4.1	1.0	1.2	1.9	2.4	2.7	2.5

Table 19. Paraguay: Public Sector Debt Sustainability Framework, 1999-2009  
(In percent of GDP, unless otherwise indicated)

	Actual					Projections				
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008

**II. Stress Tests for Public Debt Ratio**

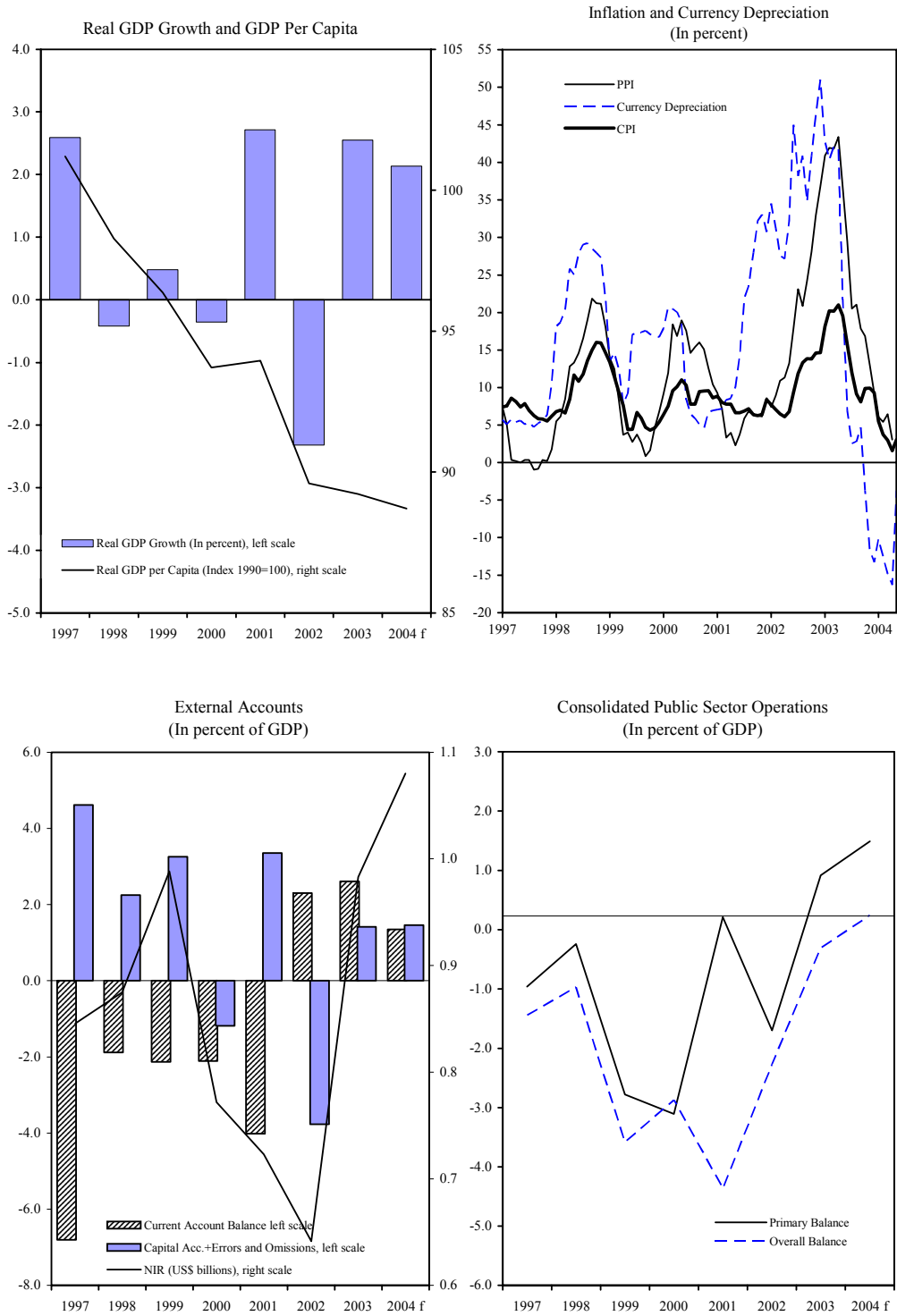
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2004-2008	46.0	43.5	42.9	42.7	42.8	43.3
2. Real interest rate is at historical average plus two standard deviations in 2004 and 2005	47.9	46.9	44.3	41.9	39.4	37.4
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005	45.6	44.6	41.7	39.1	36.5	34.2
4. Primary balance is at historical average minus two standard deviations in 2004 and 2005	52.6	52.4	53.3	49.0	44.5	40.6
5. Combination of 2-4 using one standard deviation shocks	52.8	57.3	52.5	47.9	43.3	39.2
6. One time 30 percent real depreciation in 2004 7/	68.6	65.2	62.6	60.1	57.7	55.8
7. 10 percent of GDP increase in other debt-creating flows in 2004	53.3	49.7	47.1	44.7	42.3	40.2
8. Impact on <b>debt-to-GDP ratio</b> if revenue-to-GDP ratio is at historical average minus two standard deviations in 2004-05	50.9	54.2	51.5	49.1	46.7	44.7
8a. Impact on <b>debt-to-revenue ratio</b> if revenue-to-GDP ratio is at historical average minus two standard deviations in 2004-05	199.1	212.0	160.7	154.0	147.1	141.4

**Historical Statistics for Key Variables (past 10 years)**

	Standard Deviation	Average 2004-09
Primary deficit	2.9	-1.9
Real GDP growth (in percent)	2.1	3.2
Nominal interest rate (in percent) 6/	1.2	5.3
Real interest rate (in percent)	6.3	1.1
Inflation rate (GDP deflator, in percent)	6.4	4.3
Revenue to GDP ratio	2.4	32.1

1/ The public sector includes the central government, the nonfinancial public sector, the central bank, and public enterprises. Gross debt is used for the calculation.  
2/ Derived as  $[(r - \pi(1+g) - g + \alpha\epsilon(1+r))/(1+g+\pi+g\pi)]$  times previous period debt ratio, with  $r$  = interest rate;  $\pi$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;  $\alpha$  = share of foreign-currency denominated debt; and  $\epsilon$  = 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  $\alpha\epsilon(1+r)$ .  
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).

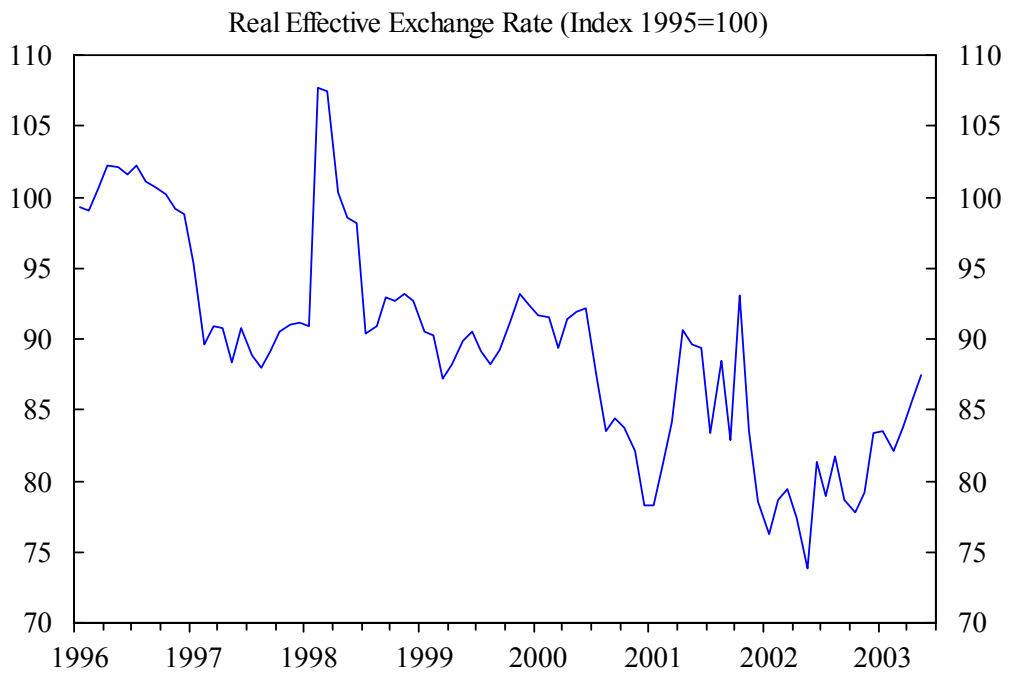
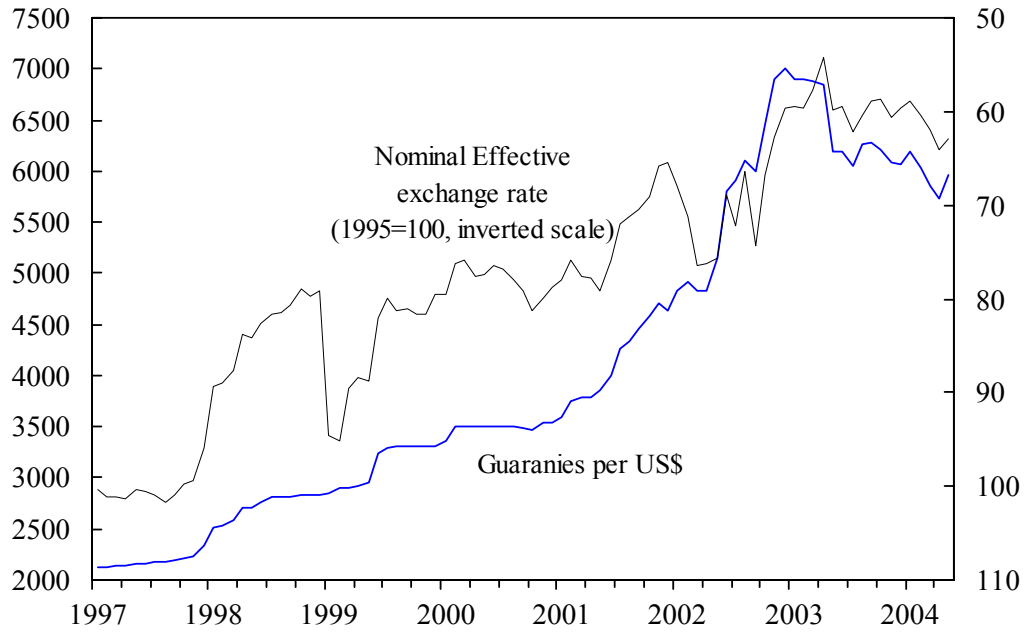
Figure 1. Paraguay: Selected Economic Indicators



Source: Central Bank of Paraguay.

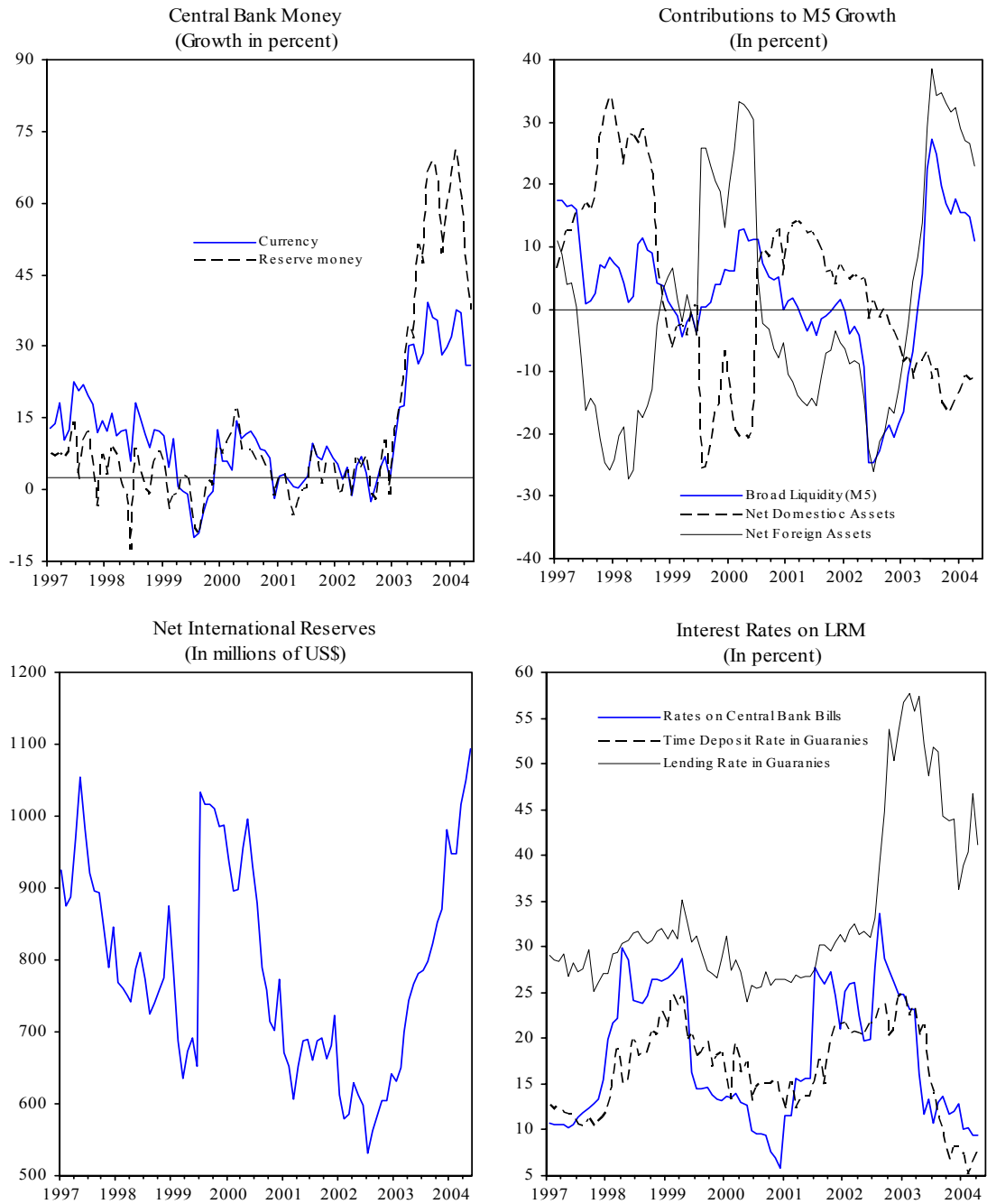


Figure 2. Paraguay: Exchange Rates



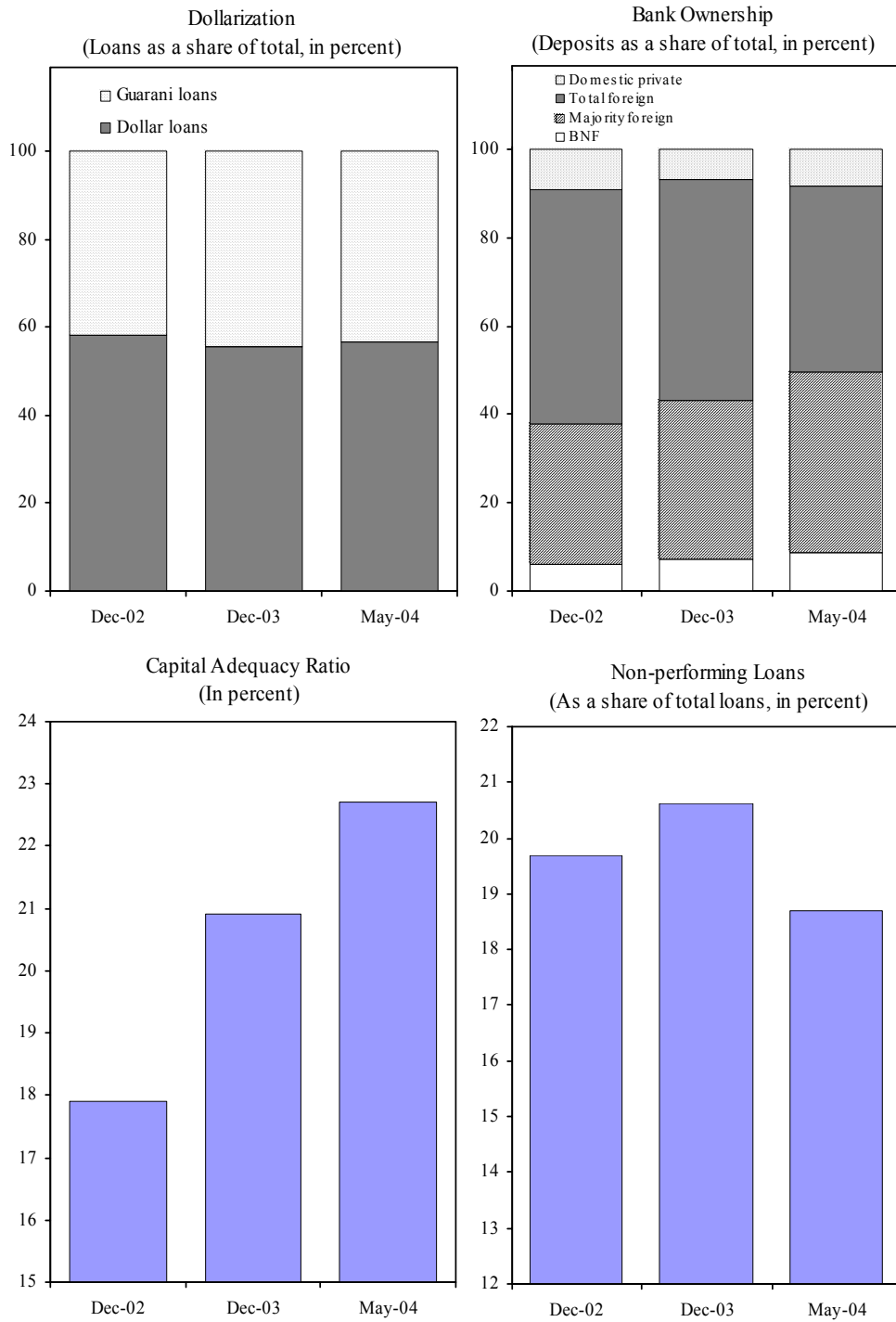
Source: Central Bank of Paraguay.

Figure 3. Paraguay: Selected Financial Indicators



Source: Central Bank of Paraguay.

Figure 4. Paraguay: Selected Banking Indicators



Source: Central Bank of Paraguay.

## MEDIUM-TERM FRAMEWORK AND PUBLIC DEBT SUSTAINABILITY

1. This appendix examines Paraguay's medium-term outlook and updates the public debt sustainability analysis (see IMF Country Report No. 04/66). Two medium-term scenarios are presented: (i) a baseline scenario based on the implementation of policies under the Stand-By Arrangement; and (ii) a higher growth scenario in which a broader range of structural reforms is implemented over the medium term beyond the end of the SBA.

### A. Baseline Scenario

2. The baseline scenario assumes that policies agreed under the Stand-By Arrangement continue to be implemented over the medium term. Key policies include (i) fiscal adjustment, (ii) price stabilization via the adoption of a floating exchange rate and targeting monetary aggregates; and (iii) structural reforms to strengthen the banking and fiscal sectors, and enhance governance.

3. Contingent on these policies, projections of Paraguay's medium-term macroeconomic performance would have the following key features (Table 14):

- *Growth rates* over the medium-term average 3.4 percent over the period, somewhat higher than the average growth rates in the 1990s and 1980s.
- *Inflation rates* remain stable at around 5.0 percent on average, as the REER stabilizes in response to improved productivity growth.
- *The level of public debt* falls to 28.0 percent of GDP by 2010.
- *The current account deficit* widens to 1.4 percent of GDP by 2010, despite continued export growth, as investment levels gradually pick up over the medium term.
- *International reserves* are assumed to increase to broadly keep reserves constant as a fraction of imports, as wider current account deficits are expected to be financed by increased capital inflows.

### B. Higher-Growth Scenario

4. Higher medium-term growth will require further structural reforms to be implemented in addition to the policies in the baseline scenario. The broad objectives of such reforms should be to boost investment levels and, perhaps more importantly, enhance

the efficiency of investment in order to bring about significant improvements in total factor productivity (TFP).<sup>1</sup>

5. A thorough analysis of the reforms needed to boost total factor productivity and growth is beyond the scope of this appendix. However, such reforms would most likely include measures in the following areas: (i) privatization or capitalization of public enterprises, which would increase the efficiency of basic services and attract significant new investment; (ii) an overhaul of the social security system to provide a source of investment funds; (iii) further improvements in governance and the regulatory environment for private sector investment, including legal system reforms; (iv) increased investment in human capital to improve labor productivity (via education and health programs); (v) bringing informal activities into the formal sector; (vi) increased investment in infrastructure; and (vii) measures to support growth and diversification of exports, such as further trade liberalization agreements.

6. Successful implementation of policies in these areas could result in a scenario where growth rates reach 4.5 percent in the medium term. As these higher growth rates would result from increases in efficiency and productive capacity, they would be consistent with continued price stability as in the baseline scenario.<sup>2</sup> Higher growth would increase fiscal revenues. It is assumed these are not spent, resulting in slightly better fiscal balances. This contributes to a larger fall in debt levels than in the baseline, as does the higher GDP growth. The current account deficit would be only modestly larger, and import demand is assumed to increase only slightly (since this scenario is driven by mainly improved TFP) and are offset by higher export growth and higher government saving. The higher current account deficit is more than offset by increased capital flows, resulting in roughly the same level of reserves (in months of imports).

### **C. Public Debt Sustainability**

7. The profile of public sector debt has changed little since last year. A sustainability analysis and sensitivity tests were run for the baseline scenario using the most recent data,

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<sup>1</sup> A recent study of growth in Latin America found that Paraguay's poor growth performance in the 1980s and 1990s was in large part due to negative contribution of TFP to growth. The study also found that most Latin American economies had negative TFP contributions to growth in the 1980s. However, following the implementation of structural reforms in the 1990s, TFP contributions for most of these economies turned positive, with Paraguay one of the exceptions. See Loayza, Fajnzylber, and Calderon, "Economic Growth in Latin America and the Caribbean," mimeo (June 2002).

<sup>2</sup> If productivity growth were to outstrip that of its main trading partners in this scenario, a steady appreciation of the real exchange rate could also result due to the Balassa-Samuelson effect. If this occurred, the projections for inflation and the debt-to-GDP ratio would likely be even more favorable.

which showed the conclusions of the last sustainability exercise remain valid.<sup>3</sup> The main conclusions are (see Table 19).<sup>4</sup>

- Public sector debt remains sustainable under alternative assumptions regarding GDP growth, interest rates, and the debt stock (stress tests 1, 2, 3, and 7).
- However, public debt remains sensitive to assumptions on the primary balance, pointing to the importance of the targeted fiscal adjustment under the program. For example, assuming Paraguay's primary deficit reverts to the historical average of 1.6 percent of GDP after the program (from 2005 on) results in a steady increase in the public debt level to 50.6 percent of GDP by 2008.<sup>5</sup>
- Given that the debt stock is predominantly 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.

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<sup>3</sup> 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 35.4 percent of GDP by 2010 from 51.6 percent in 2003.

<sup>4</sup> The scenario was subjected to stress tests, in line with the methodology contained in *Assessing Sustainability* ([www.imf.org](http://www.imf.org)).

<sup>5</sup> 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 May 31, 2004)

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

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

III. <b>SDR Department:</b>	<b>In millions of SDRs</b>	<b>Percent of Allocation</b>
Net cumulative allocation	13.70	100.00
Holdings	85.31	622.86

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

V. **Exchange Rate Arrangement:** The currency of Paraguay is the Paraguayan *guarani*. The exchange rate regime is a managed float. The exchange rate is determined in the interbank foreign exchange market, but the central bank intervenes in the foreign exchange and monetary markets to smooth out exchange rate fluctuations in real effective terms. The U.S. dollar is the principal intervention currency. On May 31, 2004, the average interbank rate for the U.S. dollar was  $\text{G}5,970 = \text{US}\$1$ .

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

VII. **Technical Assistance:**

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

<b>Department</b>	<b>Purpose</b>	<b>Date of Delivery</b>
		2002
MAE	Financial Sector Surveillance	July 2002
FAD	ROSC	August 2002
STA	Multisector, follow-up	September 2002
MAE	Banking Supervision	September through November 2002
MAE	Central Bank Operations	November 2002
TRE	Safeguard Assessment	January 2003
MFD	Banking Supervision	January 2003 through April 2004
MFD	Currency Handling and Reform	February 2002 through April 2004
MFD	Payment System	July 2003
FAD	Customs and Tax Administration	December 2003
MFD	Reorganization of the Central Bank and Monetary Operations	January 2004

VIII. **Safeguard Assessment:** Under the Fund's safeguards assessment policy, Central Bank of Paraguay (CBP) is subject to an assessment with respect to the expected arrangement. A safeguards assessment of the CBP was completed on January 31, 2003. The assessment concluded that substantial risks may exist in legal structure and independence of the central bank, and in its control environment. Staff findings, proposed recommendations under program conditionality, and other recommendations are reported in IMF Country Report No. 03/94. Implementation of the measures by the CBP needs to be monitored by staff.

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



**FINANCIAL RELATIONS WITH THE WORLD BANK<sup>1</sup>**  
June 21, 2004

A new Paraguay Country Assistance Strategy (CAS) was approved on December 16, 2003, covering the period from mid-FY04 to FY07. The Bank's strategy as outlined in the new CAS aims to restore confidence in the economy and lay the basis for sustainable growth and poverty reduction. To this end, the CAS supports (i) the fiscal and financial reforms the Administration has to send to Congress; (ii) improved governance and transparency in public administration; (iii) sustained growth, particularly in the rural areas where poverty is concentrated and deepest; and (iv) social inclusion, to improve the coverage and efficiency of basic social services to help Paraguay meet the millennium development goals. The proposed base case lending program for the CAS periods is for US\$325 million, of which US\$80 million, or about 25 percent, are envisaged for two adjustment operations. One of them, the Economic Recovery Loan in the amount of \$30 million was approved on December 16, 2003 together with the CAS, and has been fully disbursed.

A comprehensive Policy Notes document was completed in May 2003 and discussed with the new Administration in June 2003. In FY04 the Bank also prepared a Social Protection Study and a Country Financial Accountability Assessment (CFAA), which is expected to be completed by end June 2004. In addition, sector work on health is underway, and a Public Expenditure Review (PER) will be prepared in FY05.

Five World Bank-financed projects are presently under implementation, for a total value of \$144.8 million, of which \$68.2 million are undisbursed as of June 21, 2004. These projects include: Fourth Rural Water Supply, Natural Resource Management, Maternal Health and Child Development, Pilot Community Development, and the Secondary Education Reform, which is awaiting effectiveness. There is also an active program of grants that are currently being implemented.

A Financial Sector Adjustment Loan and Technical Assistance Loan are at an advanced stage of preparation. A technical assistance loan to assist in the restructuring of the Ministry of Finance and help it become a Ministry of Excellence is also under preparation for FY05 delivery. Preparation is also underway for a new Health Project and a Sustainable Rural Investment Project, which are also planned for FY05 delivery.

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

## FINANCIAL RELATIONS WITH THE WORLD BANK

(In millions of U.S. dollars)

### I. IBRD/IDA Operations (as of June 21, 2004)

	Committed (Net of Cancellations)	Disbursed	Undisbursed
<b>Active loans</b>			
Natural Resource Management	50.0	37.1	12.9
Maternal Health	21.8	21.3	0.5
Fourth Rural Water Supply	40.0	17.3	22.7
Community development	9.0	0.9	8.1
Education Reform	24.0	0.0	24.0
<b>Total active loans</b>	<b>144.8</b>	<b>76.6</b>	<b>68.2</b>
<b>Total inactive loans</b>	<b>708.5</b>	<b>708.5</b>	<b>0.0</b>
<b>Total IBRD/IDA</b>	<b>853.3</b>	<b>785.1</b>	<b>68.2</b>
<b>Repaid (incl. Repay to 3<sup>rd</sup> parties)<sup>2</sup></b>		<b>522.2</b>	
<b>Total outstanding</b>		<b>258.6</b>	
O/w IBRD		235.7	
O/w IDA		23.0	

### II. IFC Operations (as of May 31, 2004)

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

### III. IBRD/IDA Loan Transactions (calendar year) (as of June 14, 2004)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Disbursements	27.5	41.2	37.7	42.1	46.6	26.8	13.5	42.3	6.3
Repayments	35.2	27.5	24.6	24.6	20.2	15.3	16.8	21.0	19.5
Net lending	-7.7	13.8	13.1	17.5	26.4	11.5	-3.3	21.3	-13.2

Source: World Bank

<sup>2</sup> As of May 31, 2004

## PARAGUAY—RELATIONS WITH THE IDB<sup>1</sup>

### Portfolio

1. There is close collaboration between the IDB and the IMF, as the IDB had operations contingent on the approval of an agreement with Paraguay, which had been included in the IMF's assessments of the situation. Furthermore, there is close coordination between the IDB and the World Bank in specific issues regarding public banking reform.
2. The operations of IDB, Paraguay's main creditor, have been affected in the past by fiscal constraints and political instability with regard to decisions concerning new loans. As a direct consequence, Paraguay entered in default in 2002 and again in 2003, loans had to be postponed, loan disbursements were slow, and the net cash flow to the country was negative for the third consecutive year.
3. During 2003 IDB approved three loans: for Cadastre Registry, for US\$9.0 million, for Initial and Preschool Education, for US\$23.4 million and an Emergency Loan for Social Expenditure Protection, for US\$30 million. In addition, 3 loans to support the preparation and initial execution of new operations were approved: Costal Development in Asunción, for US\$1.5 million, Initial and Preschool Education, for US\$0.9 million and Social Investment Program, for US\$1.2 million.
4. On April 30, 2004 the active portfolio of loans amounts to US\$657.3 million, of which 43.4 percent have been disbursed. As for Technical Cooperation, the approved total amounts to US\$20.0 million, of which 48.5 percent have been disbursed.

### Operations Program

5. In the second half of 2004 we expect approval of a policy-based loan of US\$50 million for a public financial sector reform, cofinanced with the World Bank. Its conditionality is being closely coordinated with the IMF.
6. Other investment loans with approval expected in 2004 include:
  - a. TC loan for the Public Bank Reform, for US\$4 million.
  - b. Strengthening of the Judiciary System II, for US\$10 million
  - c. Professional Technical Education System, for US\$5 million
  - d. Strengthening Negotiating Skills for Foreign Trade, for US\$2 million
7. The Bank's new country strategy with Paraguay is expected to be approved during the third quarter of 2004.

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

## STATISTICAL ISSUES (As of July 7, 2004)

### 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. Additionally, public enterprises and the social security system have been following somewhat different classifications of revenues and expenditures than the central government. A law (*Ley 1535*) that was passed in 2000, should allow closer integration, as it sets uniform standards and creates a database for the entire public sector. Data on medium- and long-term external debt are reliable and available on a monthly basis. Internal debt data are available on request, but need to be more fully integrated with the external debt database. Deficiencies remain in the registration of short-term supplier and commercial credit of the public sector. Moreover, there is a discrepancy in the fiscal data reported by the monetary and fiscal authorities. On November 2003, the Ministry of Finance issued a decree requiring all decentralized entities and public enterprises to provide updated monthly financial data to the Ministry of Finance, as well as the balance sheet. Other measures are being taken to make reporting more transparent. Under the SBA, all public enterprises and the IPS are required to undergo a complete financial audit by an internationally-recognized auditor.

Annual data covering only budgetary central government through 2001 have been published in the *2002 GFS Yearbook*. However, since 1994 no financing and outstanding debt data, and no breakdowns for expenditure by function data have been provided for publication in the GFSY. Monthly and quarterly data are not reported for publication in *IFS*. The resumption of reporting quarterly and monthly data for the *IFS* is highly recommended. Data on local governments and public enterprises are deficient and not reported regularly.

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

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

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

### **D. External Sector**

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

Deficiencies remain in the area of private capital outflows, which are difficult to register due to Paraguay's liberal capital account. Major recommendations of the multisector statistics mission include the need to: (i) introduce quarterly surveys for recording services, transfers, and financial transactions of the nonfinancial private sector; (ii) apply quality control

procedures for surveys; (iii) revise and improve the statistical techniques to take into account unrecorded merchandise trade and smuggling; (iv) improve the compilation procedures of several services and financial transactions; and (v) institute a system of coordination with other official agencies, and within the CBP, to promote intersectoral data consistency. Sizable negative errors and omissions over the last few years can be attributed mostly to unregistered 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.

**CORE STATISTICAL INDICATORS**  
(As of June 25, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	06/24/04	06/24/04	06/24/04	06/24/04	05/31/04	04/30/04	M05/04	M04/04	Q1/2004	M05/04	2002	Q1/2004
Date Received	06/25/04	06/25/04	06/25/04	06/25/04	06/20/04	05/30/04	06/05/04	05/31/04	04/30/04	06/07/04	7/01/03	04/30/04
Frequency of Data	Daily	Daily	Daily	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Annual	Quarterly
Frequency of Reporting	Daily	Daily	Daily	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Annual	Quarterly
Source of Update	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Ministry of Finance	Central Bank	Central Bank
Mode of Reporting	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-Mail	E-mail	Publication	E-mail
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Daily	Daily	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Annual	Quarterly

Asunción, July 16, 2004

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

Dear Mr. de Rato:

1. The attached Supplement to the Memorandum of Economic and Financial Policies describes the economic program and objectives of the Government of Paraguay for the remainder of 2004. Except as modified by the Supplement, we remain fully committed to achieving the objectives of the program outlined in the original Memorandum of Economic and Financial Policies, dated December 5, 2003.
2. A key goal of the program is to set the stage for medium-term fiscal consolidation. To this end, Congress approved in June 2004 the *Administrative Reorganization and Fiscal Adjustment Law*, a performance criterion for end-May 2004 under the Stand-By Arrangement. We are committed to implementing necessary measures to compensate for elements of the law weakened by the Congress. On this basis, we request a waiver for the approval of the law, which was approved beyond the end-May performance criterion deadline, and without all of the components originally contemplated.
3. Nine of the eleven quantitative performance criteria under the Stand-By Arrangement were met for end-March 2004. Three applicable structural performance criteria, related to application of international accounting standards and annual external audits of the central bank, the full application of the public procurement law, and fuel price adjustment, were observed.
4. The continuous performance criterion for no new external arrears was not observed, due to new arrears accumulated by cement company INC, but they have since been cleared. New procedures to avoid arrears set up earlier in the year were effective in eliminating new arrears of the central government, and these procedure will be extended to other public entities to avoid future problems there. The ceiling on the central government wage bill was also missed by a small margin, but there were savings in other areas of current expenditure. On this basis, we request waivers for the missed continuous performance criterion on no new external arrears and for the missed wage bill ceiling.
5. We request that the third review be delayed and be based on end-August targets, rather than end-June, with the fourth and fifth reviews combined and evaluated based on end-December targets, and that access under the arrangement be rephased accordingly. We have



agreed on remaining targets for August 2004 and December 2004. All December 2004 targets are performance criteria except for the targets on the central government overall balance, which is an indicative target; the performance criterion will be set at the time of the third review. We request that the performance criterion on the approval of the Public Banking Reform Law be modified from end July to end-October because of legislative delays. In contrast, we request that the structural benchmark on the approval of the new Customs Code be end-July 2004. We are making good progress on the audits of public enterprises (*ANDE, ESSAP, and COPACO*). However, for some public enterprises and the Social Security Institute (IPS), the audits will take longer than originally envisaged. We therefore request a modification of the end-September performance criteria on the audits of *Petropar, INC, Conatel, ANNP, Dinac*, and the Social Security Institute to postpone the completion of the audits to end-December.

We hope to maintain a close policy dialogue with the Fund and stand ready to take additional measures, as necessary, to achieve the objectives of the program.

Sincerely yours,

/s/

Angel Gabriel González Cáceres  
President  
Central Bank of Paraguay

/s/

Dionisio Borda  
Minister of Finance

SUPPLEMENT TO THE MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

**A. Introduction and Recent Developments**

1. **Progress has been made in implementing the economic program that has been supported by a Stand-By Arrangement from the IMF since December 2003 (Tables 1 and 2).** This supplementary memorandum of economic and financial policies (SMEFP) describes recent developments and outlines plans for the remainder of 2004. Except as modified in this memorandum, the objectives, policies, targets, and commitments of the economic program remain as described in the original MEFP dated December 5, 2003.
2. **A late season drought in some regions has tempered the growth outlook for 2004.** GDP rose by an estimated 2½ percent in 2003, as a strong agricultural harvest—particularly in soy—compensated for weak domestic demand during the first half of the year. For this year, the nonagricultural economy is expected to accelerate its growth from 0 percent to near 3 percent, but the drought will leave agricultural output flat. Revenue from agricultural exports will remain strong, however, due to high commodity prices.
3. **Inflation has dropped sharply and the *guaraní* has strengthened.** Strong export earnings, a weaker dollar internationally, and a reversal of capital outflows has produced a rise in the *guaraní* against the dollar of 4 percent since end-December 2003. The Central Bank has intervened actively to moderate the appreciation, contributing to a rise in international reserves of US\$90 million to US\$1,073 million as of June 17. Banking system deposits have also continued to rise strongly, up over 7 percent so far this year. Annual CPI inflation has dropped from 9.3 percent in December to 5.5 percent in June. Seasonal factors will produce a slight recovery of inflation to 4–5 percent—still well below our earlier objective of 8 percent. With inflation under control and GDP growth subdued, the balance of risks to the macroeconomic outlook has shifted toward the downside.

**B. Fiscal Policy**

4. **Fiscal policy is in line with the program.** The end-March performance criteria on the central government and consolidated public sector balances were met. Expenditures in the first quarter were broadly as anticipated, though there was a small deviation from the program ceiling on the wage bill. Transfer payments were slightly below program due to savings from the early implementation of the public sector Pension Reform Law. Tax collections have been above projections and are expected to improve further as excise tax arrears from the state-owned oil company, Petropar, are cleared. Once the Administrative Reorganization and Fiscal Adjustment Law is implemented, tax revenues should increase further. Together, the improvements in tax efficiency (with some help from the early effects of the Fiscal Adjustment Law) will produce a substantial cushion for this year's target for the fiscal outturn. Part of this cushion will be used to boost capital spending in key areas (particularly in development projects financed by multilateral organizations). In order to maintain tight control on public spending, the Ministry of Finance is consolidating

all supplementary budget requests into one bill, with strict limits on its overall size. The government will keep the Fund informed on the content of the supplementary budget request, and the increase in capital spending will be closely monitored to assure that the fiscal objectives are maintained.

**5. The Administrative Reorganization and Fiscal Adjustment Law has been approved by Congress. The June 25, 2004 approval was slightly delayed beyond the May 31, 2004 performance criterion date.** The version approved differs in several respects from the version originally sent to Congress: (i) The corporate income tax is lowered to 20 percent in the first year, rather than to 10 percent; (ii) The vehicles tax (*patente fiscal*) is limited to two years and only levied on luxury vehicles; (iii) The financial transactions tax is eliminated after three years; (iv) The VAT is not extended to agriculture and education; (v) A new agricultural income tax was introduced on medium and large farms; (vi) The profits tax is not extended to cooperatives and narrowed for educational institutions; (vii) Certain severe penalties for cross-controls on tax payments were eased; and (viii) The earmarking of 3.5 percent of tax revenues to the tax authorities was eliminated. Together, these measures would reduce the eventual maximum yield of the law from over 2½ percent of GDP to less than 1½ percent of GDP. The government never intended to apply the law at maximum rates, so the actual expected yield has fallen only slightly, from 1.5 percent of GDP to 1.3 percent of GDP. Due to the phase-in of the new personal income tax and the staged elimination of tax loopholes, the short-term yield of the law is also reduced significantly, from 1½ percent of GDP to ½ percent of GDP. However, the law retains many of its main features, including a substantial broadening of the VAT and corporate income taxes, introduction of a new personal income tax, and the extension of a more effective tax regime to large farmers. Final passage of the law was a prior action for the review.

**6. To compensate for weakened features of the Fiscal Adjustment Law, the government will implement a series of compensatory measures to further boost revenue and strengthen tax administration.** On tax administration, the government will reprogram budget allocations and use support from an IDB technical assistance loan to increase funding for the tax authorities in 2004 (prior action for the review) and submit to Congress a sharply higher budget request for 2005 to compensate for the loss of the 3.5 percent earmarking. The Undersecretariat for Taxation has presented a strategic plan which will, among other objectives, increase computerization, restructure the organization, and boost training for staff (prior action for the review). Additional revenues will be raised from an increase in excise taxes on tobacco and cigarettes to their legal maximum. Further gains in revenue from tax administration will be realized by the full application of a cross-checking system for large taxpayers and an acceleration of legal enforcement actions. The government is prepared to use its legal authority to begin the reduction in certain taxes in 2006 (rather than 2005) while starting the reduction in exemptions immediately. Together, these revenue measures should boost annual revenue in 2005–06 by over ½ percent of GDP. A temporary tax on windfall soybean export revenue was introduced earlier in 2004 to compensate for delays in the law, and will be lifted with implementation of the law.

Finally, the government will prepare legislation to address the remaining weaknesses in the Fiscal Adjustment Law for submission to Congress in 2005.

7. **The outturn in public enterprises has been better than expected.** The appreciation of the *guaraní* has played an important role in this improvement, as several firms have a large dollar cost component in their activities. A high-level control committee set up by the government to monitor public enterprise operations has helped instill greater financial discipline. New management in the cement firm, INC, has also contributed. Diesel fuel prices were raised by 8 percent in April, ahead of the July date for a price adjustment agreed in the program. This increase will fully compensate for cost increases in Petropar at current world oil prices, but it may fall short of what is needed to allow the firm to eliminate payments arrears to suppliers and to the tax authorities. Moreover, continued high world oil prices may require further measures later in the year.

8. Performance criteria for the fiscal balance will be set for end-August consistent with the original fiscal objective as follows: central government balance G/.430 billion and consolidated government balance G/. 500 billion. The wage bill ceiling will be modified slightly from its original path to accommodate a wage increase for security services already granted by Congress and permit a small increase in the wage bill for teachers. The end-August wage bill ceiling would be G/. 1791 billion. For end-December, the consolidated public sector balance PC is G/.130 billion and the wage bill ceiling PC is G/. 2980 billion. The indicative fiscal targets of the program remain unchanged for end-June, end-September, and end-December, with performance criteria for end-December for the central government balance to be set at the time of the third review.

9. **The government has worked to reduce payments arrears ahead of the schedule contemplated in the program.** The PCs on overall external arrears, official bilateral arrears, and the short-term contracting of debt were all met, as was the one on domestic floating debt. By end-March arrears to Paris Club creditors have been cleared, with the exception of a few cases where technical problems existed. However, the continuous performance criterion on no new accumulation of arrears was not met due to new arrears by the public enterprises INC and Petropar. The remaining stock of arrears of INC and Petropar have been cleared and those of the government to bilateral creditors will be cleared shortly.<sup>1</sup> Clearance of new bilateral arrears by the cement company INC is a prior action for the review. Petropar arrears to suppliers have also been reduced substantially. The government is committed to accelerating discussions to resolve disputed claims. In particular, a law will be submitted to Congress (prior actions for the review) to begin the process of regularizing disputed arrears on a loan to the public electricity company, ANDE. Principal and regular interest arrears to Banque Worms have been

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<sup>1</sup> This excludes a small amount of arrears to a South African creditor that cannot be located.

cleared and the authorities have initiated negotiations with the French government on penalty interest due. The government is committed to regularizing penalty interest arrears as a prior action for the review. Domestic arrears have also been reduced, though there have been difficulties in fully identifying outstanding arrears and in completing the restructuring of domestic bonds agreed in November 2003. All bonds presented for restructuring by June 15 will be exchanged and interest arrears on all exchanged bonds will be cleared as a prior action for the review. The government has established an escrow account in the Central Bank where funds are deposited for bond not yet presented for exchange.

10. The debt and arrears indicative targets for end-December will be converted into performance criteria, while end-August targets will be set consistent with the original indicative targets, except for the PC on official bilateral arrears, which will be set at zero for the end-August date.

### C. Monetary and Exchange Rate Policy

11. **Performance criteria for end-March have been met with wide margins.** The growth rate of currency issue was somewhat higher than programmed, but by end-May, it had dropped below programmed levels. Sharply higher international reserves were absorbed by a combination of increased Central Bank notes (*letras*) and by excess reserves deposited by the banking system in the Central Bank. Interest rates on *letras* have fallen, but remain high in real terms.

12. **New performance criteria will be set for end-August and end-December.** The reserves target will be adjusted upwards to lock-in the gains in reserves already achieved and further net inflows expected for the remainder of the year, while permitting modest Central Bank sales of foreign exchange should there be a sharp turnaround in capital flows. The new net domestic assets (NDA) performance criteria will also be set allowing for growth in currency issue slightly higher than in the original program to take into account the increased demand for money. The new performance criteria are specified in the following table:

Revised Monetary Program

	NDA		NIR	
	Prog. (Dec. 2003)	Revised	Prog. (Dec. 2003)	Revised
	(in billions of guaranies)		(in millions of U.S. dollars)	
December 31, 2003 (actual)	-2,890	-3,969	818	983
March 31, 2004 (actual)	-2,770	-4,264	762	1,016
August 31, 2004	-2,710	-4,507	775	1,067
December 31, 2004	-2,761	-4,090	855	1,080

For end-December, an adjustor will be incorporated into the target to adjust reserves upwards (and NDA downwards) if additional multilateral program disbursements are received. In the event of a major negative external shock, the targets could be reconsidered at the time of the third review.

#### **D. Structural Policies**

13. **Progress on the structural reform agenda has been good.** In the area of public sector reforms, the new Customs Code was approved by Congress on June 30, 2004. The Public Procurement Law is now being applied at all levels of government, improving the efficiency and transparency of the contracting process, but additional training is needed for users of the system. The Central Bank is on track to complete its external audit by end-June, and will report its results in both Paraguay and international accounting standards. The BCP is also developing a restructuring plan (with technical assistance from the Fund) and the new plan will be approved by end-July, with implementation to begin immediately thereafter. Reform efforts continue in tax administration, with technical assistance from the Fund and IDB, and financing from the IDB. Key public sector institutions are undertaking external audits. While most should be completed by end-September, a few may require until end-2004.

14. **Financial sector reforms are advancing.** In the coming months, banks are required to submit their adjustment plans to meet the tighter provisioning requirements of the new Resolutions 8 approved last November. The deposit guarantee fund established in the Bank Resolution Law will also begin to operate before the end of the year. Comprehensive banking sector legislation is also being prepared for submission to Congress shortly. The Public Banking Law to reform the National Development Bank (BNF) and other public lending institutions is currently in Congress, and approval is expected by end-October. The supervisory body for cooperatives, INCOOP, has begun to develop mechanisms for financial supervision and control of cooperatives, slated to begin in 2005.

Table 1. Paraguay: Quantitative Performance Criteria

	2004		Target (Adjusted)	2004	
	Actual	Target (Unadjusted)		Aug. 31	Dec. 31
<b>Monetary targets</b>					
Net international reserves (floor, in millions of U.S. dollars) 1/	1,016	762	773	1,067	1,080
Net domestic assets (ceiling, in billions of guaranies) 1/	-4,264	-2,770	-2,839	-4,507	-4,090
<b>Fiscal targets</b>					
Overall balance of the central administration (floor, in billions of guaranies) 2/	523	240	240	430	55 3/
Wage bill of the central administration (ceiling, in billions of guaranies)	668	650	650	1,791	2,980
Overall balance of the public sector (floor, in billions of guaranies)	678	250	250	500	130
<b>Public debt and arrears targets</b>					
Contracting or guaranteeing of nonconcessional debt by the NFPS (ceiling, in millions of US\$)	0	50	50	200	200
External payments arrears of NFPS (ceiling, in millions of US\$)	75	75	75	5	0
Of which: bilateral arrears 4/	12	38	38	0	0
Central government floating debt (ceiling, in billions of guaranies) 5/	228	350	350	297	250
<b>Continuous PCs</b>					
Contract or guarantee short-term external debt by the NFPS	observed				
No new external debt arrears	not observed				

Sources: IMF Country Report No. 04/66; TMU; and staff estimates.

1/ NIR is adjusted upward (downward) for any increase (decrease) in reserve requirement deposits. Similarly, the NDA target will be adjusted upward (downward) following the adjustment in the NIR.

2/ As measured below the line (it differs from balance in Table 5 where it is measured above the line).

3/ Indicative target.

4/ Targets for end-August 2004 and thereafter have been set to zero, reflecting the authorities' clearance of arrears in advance of the original program schedule.

5/ The ceiling is adjusted downward by any excess in program lending above US\$15 million (expressed in guaranies). The stock of floating debt in September has been revised, due to a mistake in reporting, from G277 billion to G384 billion.

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

Measure	Conditionality	Timing	Status and Comments
<b>Prior Actions for the Second Review</b>			
- Passage by Congress of Administrative Reorganization and Fiscal Adjustment Law	Prior action		Law approved by Congress on June 25, 2004
- Undersecretariat for Taxation to present a strategic plan to increase computerization, restructure the organization and boost staff training	Prior action		
- Budgetary reallocations to increase funding for tax authorities in 2004	Prior action		
- Submission to Congress of a draft law to regularize disputed arrears on a loan to electricity company ANDE	Prior action		
- Completion of the exchange for all the domestic bonds presented by June 15 and clearance of interest arrears on exchanged bonds.	Prior action		
- Clearance of new bilateral arrears by cement company INC	Prior action		Completed.
- Regularization of arrears on penalty interest to Banque Worms	Prior action		
<b>Financial Sector</b>			
- Passage by Congress of a public banking law to consolidate and restructure the public development banks	PC	Oct. 31, 2004	Test date was previously July 31, 2004
- Passage by Congress of new comprehensive banking system legislation	PC	Dec. 31, 2004	
- Require all banks to obtain international risk rating	SB	Dec. 31, 2004	
- Extension of regulatory supervision to financial cooperatives	SB	Jan. 1, 2005	
<b>Central Government and Central Bank</b>			
- No accumulation of new external arrears	Continuous PC		
- Passage by Congress of Administrative Reorganization and Fiscal Adjustment Law	PC	May 31, 2004	Law approved by Congress on June 25, 2004
- Full application of Public Procurement Law	SB	Jun. 30, 2004	Applied at all government levels.
- Application of international accounting standards and annual external audits of the central bank	SB	Jun. 30, 2004	Central bank on track to complete external audit.
- Passage by Congress of a new customs code and implementation of a customs reform program	SB	Jul. 31, 2004	Approved by Congress on June 30, 2004.
- Begin implementation of a central bank restructuring plan	SB	Jul. 31, 2004	Central bank is developing its restructuring plan.
- Development of a plan for comprehensive civil service reform	SB	Oct. 31, 2004	Census of civil servants under way.
<b>Public Enterprises</b>			
- Requirement of regular adjustments in fuel and utilities prices to fully reflect input price and exchange rate changes	PC	1 Jul. 2004 1 Jan. 2005	Price of diesel adjusted in January and April.
- Presentation of a plan for the participation of private capital in key public enterprises	SB	Dec. 31, 2004	
<b>Governance</b>			
- Regular independent audits of all public enterprises and the Social Security Institute	PC	Sep. 30, 2004 Dec. 31, 2004	ANDE, ESSAP and COPACO will conclude their external audit by 30 September 2004; the remaining enterprises and the Social Security Institute by December 31, 2004.
- Increased data publication for government and public enterprises	SB	Sep. 30, 2004	



**PARAGUAY—TECHNICAL MEMORANDUM OF UNDERSTANDING**

This memorandum presents definitions of the quantitative targets specified in the Memorandum of Economic and Financial Policies, and updates the original Technical Memorandum of Understanding approved on December 15, 2003<sup>1</sup>. Remaining targets are set for August 2004 and December 2004. All December 2004 targets are performance criteria except for the targets on the central government overall balance, which will be set at the time of the third 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:	
December 31, 2003 (actual)	983
March 31, 2004 (actual)	1,016
August 31 2004 (performance criterion)	1,067
December 31, 2004 (performance criterion)	1,080

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

<sup>1</sup> Compared to the original version, this revision: (i) adds and adjustor to the NDA and NIR targets; (ii) takes the registry float of the public sector balance to be zero given the difficulty of monitoring such a number; (iii) updates the list of external disputed arrears; and (iv) expands and changes the definition of the domestic floating debt target of the central government.

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: August 31, 2004: US\$269 million; and December 31, 2004: US\$269 million.

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

**2. Performance Criterion on Net Domestic Assets**

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	Ceiling (In billions of guaraníes)
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Outstanding stock as of:	
December 31, 2003 (actual)	-3,969
March 31, 2004 (actual)	-4,264
August 31, 2004 (performance criterion)	-4,507
December 31, 2004 (performance criterion)	-4,090

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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 <i>guaraníes</i> )
Overall balance of the central administration from January 1, 2003 to	
December 31, 2003 (actual)	-116
From January 1, 2004 to:	
March 31, 2004 (actual measured from the financing side)	523
June 30, 2004 (indicative)	320
August 31, 2004 (performance criterion)	430
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; (v) the change in domestic floating debt (*deuda flotante*) as defined below; and (vi) a registry float. 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 is defined as net increase in arrears between the beginning and the end of the period. Domestic floating debt is defined as the difference between accrued expenditure (*gastos obligados*) and payments transferred (*gastos transferidos*). The registry float is defined as all net payments executed by the Treasury of the CA and payments units but not yet cashed or registered in the accounts of the financial system. 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 <i>guaraníes</i> )
January 1, 2003 to:	
December 31, 2003 (actual)	2,724
From January 1, 2004 to:	
March 31, 2004 (actual)	668
June 30, 2004 (indicative)	1,350
August 31, 2004 (performance criterion)	1,791
September 30, 2004 (indicative)	2,390
December 31, 2004 (performance criterion)	2,980

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

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

Cumulative Balance	Floor (In billions of <i>guaraníes</i> )
January 1, 2003 to:	
December 31, 2003 (actual, measured from the financing side)	15
From January 1, 2004 to:	
March 31, 2004 (actual, measured from the financing side)	678
June 30, 2004 (indicative)	350
August 31, 2004 (performance criterion)	500
September 30, 2004 (indicative)	495
December 31, 2004 (performance criterion)	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;<sup>2</sup> and (iii) the Central Bank of Paraguay (BCP).

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

Net external financing of the public sector is defined as all external disbursements less 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 transferred (*gastos transferidos*) with the private sector. It will be measured as the central government floating debt net of debts with the rest of the public sector as defined herein. External debt arrears are defined as principal and interest 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. 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.

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<sup>2</sup> 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).

### 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 (actual)	0
March 31, 2004 (actual)	0
August 31, 2004 (performance criterion)	200
December 31, 2004 (performance criterion)	200

The nonfinancial public sector (NFPS) is defined as the consolidated public sector (as defined above) excluding the Central Bank of Paraguay. The limit applies to the contracting or guaranteeing by the NFPS 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.<sup>3</sup> For program purposes, a debt is concessional if it includes a grant element of at least 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates (CIRR).<sup>4</sup> Excluded from the limits are credits extended by the IMF and balance of payments support loans extended by multilateral and bilateral creditors. Data will be provided by the Ministry of Finance to the Fund with a lag of not more than 30 days from the test date.

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

<sup>3</sup> The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with respect to Foreign Debt adopted on August 24, 2000 (Board Decision No. 12274-(00/85).

<sup>4</sup> The grant element is calculated as the difference between the net present value (NPV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt (i.e.,  $\text{Grant} = (\text{Nominal Value} - \text{NPV}) / \text{Nominal Value}$ ). The NPV of debt is calculated by discounting the future stream of payments of debt service due on this debt. For debt with a maturity of at least 15 years, the ten-year average CIRR will be used to calculate the NPV of debt. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. For the purposes of the program, the CIRRs published by the OECD in November 2003 will be used.

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

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

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

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

	Overall level (ceiling)	Ceiling on official bilateral arrears
	(In millions of U.S. dollars)	
Outstanding stock of <b>external arrears</b> as of:		
December 31, 2003 (actual)	91	43
March 31, 2004	73	12
August 31, 2004 (performance criterion)	10	0
December 31, 2004 (performance criterion)	0	0

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

In addition, the government is engaged in good faith efforts to resolve overdue claims in dispute, and will attempt to negotiate and resolve these as soon as possible. For the purposes of the program, debt service due by ANDE to Germany’s KFW (known as loan numbers 9736 and 9737), yet to be legalized by Congress, will be considered claims in dispute. In the meantime, the government will make every effort to speed up their approval in Congress and

transact the payment. Arrears to the South African agency D. B. Pty limited for almost \$22,000 will not be included in the above target unless the appropriate creditor is located. The government will continue searching for the creditor.

**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 <i>guaranies</i> )
Outstanding stock of <b>domestic floating debt</b> as of:	
December 31, 2003 (actual)	400
March 31, 2004 (actual)	228
August 31, 2004 (performance criterion)	297
December 31, 2004 (performance criterion)	250

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

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

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

The Treasury Department of the Ministry of Finance will provide the data to the Fund, including an explanation of the amounts and status of any disputed floating debt, as well as the amounts in the escrow account for domestic bonded debt. This information will be provided no more than 3 weeks after the test date.



#### **D. Reporting**

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

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

**Statement by the IMF Staff Representative**  
**July 30, 2004**

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 staff appraisal.

- **As of Friday, July 23 (one week before the Board meeting), five of seven prior actions were completed for the second review of Paraguay's SBA.** Another prior action (regularization of arrears to Banque Worms) was completed on July 27. Progress on the remaining prior action (completion of the domestic bond exchange) is well advanced, but will not be completed by July 30. The status of the remaining prior actions is as follows:
  - A strategic plan to reform the Undersecretariat for taxation was presented on July 13, 2004.
  - On July 23, 2004 the Minister of Finance communicated that budget funds have been reallocated to increase funding to the tax administration in 2004.
  - The government reached an agreement with the French government on the regularization of its past due interest arrears to Banque Worms, paying the first installment on July 27, 2004.
  - On July 23, 2004 the government submitted to Congress a draft law to regularize disputed arrears on a loan to the electricity company ANDE.
  - Regarding the completion of the domestic bond exchange, as of July 23, 2004 the authorities had cleared all interest arrears. They have completed the exchange process for a total of US\$76.1 million corresponding to bonds owned by the financial sector and some individual bondholders. Logistical bottlenecks in printing and authenticating the new bonds leave the exchange pending for some of the 2,900 individual bondholders for a remaining total of US\$11.5 million still outstanding.
- The authorities have informed staff that completion of the exchange for all domestic bonds presented by June 15 has not been observed, and have indicated their intention to complete the process by August 9, 2004. Notwithstanding the nonimplementation of this prior action, staff recommends the completion of the second review by the Executive Board based on the fact that the delay in implementation arose because the preparation and liquidation of the bonds, despite the authorities' efforts, took longer than originally expected, and that since the finalization of the process will only require the actual printing, authenticating, and distributing of the new bonds, the exchange is expected to be completed soon.

- **Data have become available on performance for three of the end-June indicative targets, all of which were observed.** NIR was US\$1,085 million compared to an adjusted target of US\$843 million; NDA was G/-4,857 billion, well below the G/. 3,129 billion ceiling; and the central government floating debt was G/. 105 million, compared to the target ceiling of G/. 320 billion.
- **On July 26, 2004 the credit rating agency Standard & Poor's raised its sovereign credit rating for Paraguay to B- for long-term foreign currency debt and C for short-term foreign currency debt from selective default.** The upgrade in credit rating was motivated by the improved macroeconomic and fiscal outlook, as well as by the near completion of the domestic debt exchange.
- **Tax revenues in June were 57 percent higher than a year earlier, and have grown 37 percent in the first 21 days of July.** Since August 2003, cumulative tax collections are up 43 percent over the same period in the previous years.
- **The domestic floating debt at end-June was at G/. 105 billion, compared to the PC of G/. 297 billion proposed for end-August.** Arrears of Petropar to suppliers, the only remaining external arrears, were reduced to US\$4 million at end-June.
- **The exchange rate has remained stable, closing at 5,910 guaraníes per dollar on July 23, 2004.** The exchange rate has remained around this level since end-May.
- **Net international reserves have increased to US\$1,102 million on July 23, 2004 from US\$983 million at end-December 2003.** Part of the increase reflects the central bank's interventions amounting to US\$10 million in foreign exchange in July.

**On the basis of the significant progress toward achieving the program objectives and the commitment of the authorities to complete the bond exchange in the coming days, the staff recommends proceeding with the review as scheduled.**



INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL  
RELATIONS  
DEPARTMENT

Public Information Notice (PIN) No. 04/103  
FOR IMMEDIATE RELEASE  
September 16, 2004

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Concludes 2004 Article IV Consultation with Paraguay**

On July 30, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Paraguay.<sup>1</sup>

### **Background**

The Paraguayan economy is beginning to emerge from a long period of slow growth. The regional crisis, problems with drought and foot-and-mouth disease in agriculture, and a banking crisis, all contributed to a drop of 2.3 percent in GDP in 2002. There was a sharp depreciation of the exchange rate in 2002 and inflation accelerated, reaching 20 percent in early 2003. A bumper harvest produced positive GDP growth of an estimated 2.6 percent in 2003. Banking system deposits recovered, the exchange rate appreciated against the dollar, and inflation eased to 9 percent at year-end.

In 2004, the economy has stabilized but growth remains modest. A late season drought depressed output of soy, the largest export crop, reducing expected agricultural output growth to near zero, but nonagricultural output is recovering. The guaraní has strengthened by 4 percent against the dollar so far in 2004. The strong guaraní contributed to a sharp fall in inflation. Year-on-year inflation through June was 5.5 percent, with inflation for the year as a whole expected at around 4–5 percent.

The fiscal situation has improved markedly since the new government took office in August 2003. The consolidated balance of the nonfinancial public sector moved from a deficit of 3.1 percent of GDP in 2002 to balance in 2003. The primary balance improved from a deficit of

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the July 30, 2004 Executive Board discussion based on the staff report.

1.3 percent of GDP in 2002 to a surplus of 2.4 percent in 2003. The government has made significant progress in clearing substantial public sector payments arrears.

Monetary policy has been geared toward a flexible exchange rate regime since the de facto currency peg was abandoned in 2001. Official reserves rose by US\$342 million—to US\$983 million—during 2003. Base money growth accelerated sharply in 2003, as the economy began to remonetize after the banking crises. Interest rates on Central Bank bills have declined from their peak of 33 percent in August 2002, reaching 13 percent by December 2003.

### **Executive Board Assessment**

Directors praised Paraguay's strong economic performance over the past year, with growth rebounding and a sharp decline in inflation. The vulnerability of the economy has been reduced and the country's credit rating improved, as the authorities increased international reserves, resolved external payments difficulties, and embarked on courageous fiscal and structural reforms. In particular, Directors welcomed the approval of the Administrative Reorganization and Fiscal Adjustment Law and the Customs Code, and the government's strong determination to improve governance. They commended the authorities for the remarkable progress in raising the efficiency of tax and customs collections.

Directors agreed that important challenges nevertheless remain. They encouraged the authorities to continue to work for the timely passage of the Public Bank Reform Law, to institutionalize the progress achieved on fiscal sustainability, and to further deepen the reform effort in areas that are critical to raising Paraguay's growth performance.

Directors considered that the Administrative Reorganization and Fiscal Adjustment Law, along with the additional measures announced by the authorities, provides a sound basis for balanced budgets in the medium term by raising new revenue, broadening the value-added tax (VAT) and income tax base, eliminating exemptions, and strengthening tax administration. Full implementation of these measures will also help generate resources for a much-needed increase in capital investment and social spending. Directors commended the authorities for raising the efficiency of tax and customs collections, as evidenced by the strong increase in revenue so far in 2004—with no increase in tax rates. They urged the authorities to institutionalize these gains by restructuring the tax and customs authorities, and ensuring that they have the resources needed to carry out fully their responsibilities as defined in the new law.

Directors welcomed the authorities' tight control of current expenditures and urged continued prudence, in particular on wage increases. They also stressed that new capital investment and social spending should be of high quality and well prioritized. Directors encouraged the authorities to remain firm on resisting pressures for increased spending to stimulate demand, as this would likely endanger fiscal stability without supporting sustainable increases in growth. Looking ahead, the authorities should undertake a full-fledged public expenditure reform, including civil service reform, which will be critical to ensuring long-term sustainability.

Directors welcomed the progress in eliminating domestic and external payments arrears, while urging the authorities to further improve debt monitoring and cash flow procedures, and to resolve disputed arrears. Directors also welcomed the improvement in the outlook for public enterprises, but noted that cash flow problems in some of them underscore the need for continued restructuring. They encouraged the authorities to permit private investment and management of the public enterprises, and take further measures to improve their governance and transparency, including through timely completion of the audits of public entities.

Directors welcomed the improvement in the management of monetary policy, as reflected in the marked decline in inflation and the increase in international reserves. They encouraged the authorities to continue with preparations for inflation targeting while noting that the ground must be well-prepared before a move in that direction. In this context, they urged the authorities to clarify their monetary policy objectives by limiting their interventions in the foreign exchange market and giving freer play to market forces in determining the exchange rate. They also encouraged legislation to strengthen the formal independence of the central bank as well as further development of market-based instruments to facilitate the conduct of monetary policy. Directors noted that banking system risks have eased, although the level of nonperforming loans remains high. They stressed that public banking reform, including passage by congress of the Public Bank Reform Law, remains crucial to further strengthen the system. The authorities also need to work toward approval of comprehensive banking legislation, extension of a supervisory regime to cooperatives, and mandatory introduction of international risk classifications for all banks. Directors supported the authorities' request for an FSAP. They commended the authorities' AML/CFT efforts, and looked forward to the timely enactment of legislation in this area.

Directors observed that a deepening of the reform effort will be needed to raise Paraguay's growth potential and make faster progress, with international support, toward the Millennium Development Goals. Building on recent commendable progress in strengthening governance, further efforts are needed to address corruption, reform the judicial system, and restructure the public sector to increase its professionalism and transparency, and reduce its size and scope. Programs to promote human capital development will also play an important role in increasing productivity and growth. Directors welcomed the authorities' commitment to maintaining an open exchange and trade system, and encouraged them to undertake additional actions to capture unregistered trade.

**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Paraguay: Selected Economic Indicators, 2000-04

	2000	2001	2002	Est. 2003	2004	
					Prog.	Proj.
(Annual percent change)						
<b>National accounts and prices</b>						
GDP at current prices	11.5	4.4	13.7	17.5	9.3	7.9
GDP at constant prices	-0.4	2.7	-2.3	2.6	2.4	2.1
Consumption	0.8	6.2	-5.1	5.3	2.4	1.7
Investment	-0.7	-17.5	-11.0	-3.7	7.6	8.5
Net exports (contribution to growth)	-0.9	0.4	4.4	-1.9	-0.8	-0.7
Exports	-15.1	-0.4	14.3	13.1	0.2	4.9
Imports	-6.7	-1.6	-6.3	15.6	3.0	5.5
GDP deflator	11.9	1.7	16.4	14.5	6.7	5.7
Consumer prices (average)	9.0	7.3	10.5	14.2	7.5	4.8
Consumer prices (end-of-period)	8.6	8.4	14.6	9.3	8.0	4.0
Real effective exchange rate						
Average (depreciation -)	-6.1	-3.5	-3.2	-6.0	...	...
End-of-period (depreciation -)	1.2	-14.6	-2.6	9.5	...	...
(In millions of U.S. dollars)						
<b>External sector</b>						
Exports, f.o.b.	2,322	1,883	1,882	2,014	2,111	2,096
Imports, c.i.f.	2,864	2,500	2,086	2,323	2,398	2,395
Current account	-163	-266	130	152	26	91
(In percent of GDP)	-2.1	-3.9	2.3	2.6	0.4	1.3
Capital account	157	150	57	125	116	40
Overall balance	-254	-45	-83	234	141	189
Terms of trade (percentage change)	-5.1	-0.2	6.9	9.4	-4.8	8.8
<b>Public sector</b>						
Central government primary balance	-3.1	0.2	-1.7	0.9	1.5	1.4
Central government overall balance	-2.9	-4.4	-2.3	-0.3	0.2	0.2
Consolidated public sector primary balance 1/	-2.6	1.0	-1.3	2.4	2.2	3.3
Consolidated public sector overall balance 1/	-1.0	-3.3	-3.1	0.0	0.3	1.5
Public sector external debt (end-of-year)	30.6	33.5	42.9	44.9	42.6	39.6
Domestic public sector debt	3.4	4.9	6.8	4.5	5.3	3.6
(Annual percent change)						
<b>Money and credit</b>						
Monetary base	-1.3	5.8	-1.0	57.7	3.2	21.6
M2	2.2	4.9	-2.2	24.9	17.0	13.8
M5 2/	-0.1	1.5	-18.5	17.7	14.4	18.5
Net foreign assets 3/	-5.4	-5.5	-12.8	32.4	4.8	9.4
Net domestic assets 3/	5.3	7.0	-5.6	-14.7	9.6	9.2
Credit to the public sector 3/	2.3	3.5	5.2	-2.6	0.7	-7.9

Paraguay: Selected Economic Indicators, 2000–04

	2000	2001	2002	Est. 2003	2004	
					Prog.	Proj.
Credit to the private sector 3/	-0.8	-0.7	-14.9	-12.8	6.3	5.5
Velocity of M2	7.2	7.2	8.3	7.8	7.6	7.4
<b>Memorandum items:</b>						
International reserves (in millions of U.S. dollars)	772	723	641	983	855	1,080
(In months of imports)	3.2	3.6	2.9	4.3	3.5	4.5
GDP (in billions of guaranies)	26,921	28,119	31,977	37,559	40,779	40,529

Sources: Paraguayan authorities; and IMF Staff estimates.

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

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

3/ Contribution to M5 growth.





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FOR IMMEDIATE RELEASE  
August 2, 2004

International Monetary Fund  
Washington, D.C. 20431 USA

### **IMF Executive Board Completes Second Review Under Paraguay Stand-By Arrangement**

The Executive Board of the International Monetary Fund (IMF) has completed the second review under a SDR 50 million (about US\$72.9 million) 15-month Stand-By Arrangement for Paraguay (see [Press Release No. 03/218](#)), which the authorities are treating as precautionary.

In completing the second review, the Executive Board agreed to the authorities' request for waivers of the nonobservance of March 2004 quantitative performance criterion on the ceiling of the wage bill, a May 2004 structural performance criterion on the approval by Congress of the Administrative Reorganization and Fiscal Adjustment Law, and a waiver of the continuous performance criterion on the nonaccumulation of new external payments arrears.

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

"Paraguay's economic performance has improved substantially over the past year. Growth rebounded in 2003 due to strength in the agricultural sector, and in 2004 the nonagricultural economy has begun to recover, while inflation has fallen below this year's target. External vulnerability has been reduced significantly as a result of the higher-than-expected accumulation of international reserves, a resolution of the external payments difficulties, and the initiation of important fiscal and structural reforms.

"The Paraguayan authorities have shown their continued strong commitment to follow through on the reform agenda supported by the current Stand-By Arrangement, as evidenced by the recent passage of the Administrative Reorganization and Fiscal Adjustment Law and the Customs Code. This legislation provides a sound basis for fiscal consolidation in the medium term, and will help generate resources for essential capital investment in high-quality projects and increased social spending.

"The authorities have achieved remarkable progress in raising the efficiency of tax and customs collections. They plan to institutionalize these gains by restructuring the tax and customs authorities. Current expenditures have been tightly controlled, and it will be important to continue to resist pressures for increases and maintain prudent wage policies. Steps have been taken to improve the performance of the public enterprises, including the completion of external

audits of the main firms, but further efforts are required. Over the medium term, greater private participation in the investment and management of the public enterprises should be permitted.

“Improved monetary policy management has resulted in lower inflation and higher reserves, and the authorities are encouraged to continue to strengthen their monetary policy strategy with a view to moving to formal inflation targeting. Passage of the Public Bank Reform Law will be a key objective for the authorities in the period ahead as part of their efforts to further strengthen the banking system. Other important goals will be the approval of comprehensive banking legislation, the extension of a supervisory regime to cooperatives, and mandatory introduction of international risk classifications in all banks.

“Continued structural reform and human capital development—along with support from the international community—will be needed to raise GDP growth, reduce poverty, and enable Paraguay to move towards the Millennium Development Goals. The authorities are to be commended for making an impressive start on these endeavors, and have shown strong leadership and commitment in implementing difficult reforms, including in the governance area,” Mr. Kato said.

**Statement by Guillermo Le Fort, Executive Director for Paraguay and  
Dimas R. Ayala, Advisor to Executive Director  
July 30, 2004**

***Key points***

- *The implementation of the ambitious reform program addressing the long-term weaknesses and placing the country in a path of sustainable growth is on track.*
- *Paraguay has made significant progress towards achieving long-term fiscal sustainability and clearing arrears on public debt. Standard and Poor's raised the country's long-term foreign currency credit rating from "SD" to "B-".*
- *The authorities are fully committed to continue with the implementation of sound and prudent policies, as well as to persist advancing with the reform agenda. The enhancement of the institutions' capacity and improvement in governance and transparency are key priorities for the Government.*

1. On behalf of the Paraguayan authorities, we would like to express our appreciation to the staff for the very useful policy discussions and valuable recommendations during this Article IV Consultation and Program Review. As the staff clearly highlights, the ambitious reform program of the new government supported by the SBA, remains on track and is reaching its main objectives to reduce the long-term weaknesses and place the country in a path of sustainable growth. It is important to mention that the authorities are strongly committed to pursue the adjustments and reforms outlined in the program, even against the resistance of powerful vested interests. The high degree of public credibility commanded by the government, and especially its economic team, has been key to attain the necessary support for crucial reforms. The approval of the Bank Resolution Law and the reform of the public sector pension system late last year, and the fiscal adjustment law, and the new customs code this year highlight the government's effective ownership of the program.

2. The outstanding implementation of the economic program, the improvements in the regional and global conditions, a better political environment, and a good harvest in the agricultural sector were the main factors that contributed to the economic recovery in 2003. Real GDP grew by 2.6 percent, after years of stagnation, and inflation fell to 9.3 percent from 14.6 percent in 2002. The continuing authorities' efforts in implementing sound macroeconomic policies and reforms are ensuring a good economic performance again in 2004. Despite the adverse weather conditions that severely affected the soy harvest, the main crop export, GDP growth is projected to be around 2 percent in 2004, within an environment of low inflation, fiscal balance, and a continued improvement in the external position.

3. Almost all end-March quantitative performance criteria were observed. The ceiling on the central government wage bill was missed by a very small margin (Gs. 18MMM above

the program target of Gs. 650MMM) as a result of a decision by Parliament to increase wages for security services; however, there were compensatory savings in other areas of current expenditure. Unfortunately, new debt arrears, that were promptly cleared afterwards, accumulated in the cement company INC and the continuous performance criterion was not observed. The authorities have intensified their efforts to avoid future deviations by enhancing monitoring procedures for debt service and extending its coverage to all the public entities.

4. The Government obtained the necessary political support for the approval of the very ambitious fiscal reform law. The passing of the Fiscal Law that includes the widening of the VAT base, the elimination of exemptions, and the introduction of the personal income tax, is a significant step forward towards the formalization of the economy, the reduction of corruption and tax evasion, and the elimination of distortions. Moreover, our authorities are already implementing compensatory measures for the proposed actions that were not included in the law finally passed by Congress. Other structural performance criteria, such as the application of international accounting standards and annual external audits of the central bank, the full application of the public procurement law, and fuel price adjustment, were also observed. The new Customs code, originally programmed to be approved by Congress on August 31, 2004 was passed on June 30, 2004. In addition, all, but one, of the prior actions for this review were met, again showing the authorities' strong efforts and determination to implement the Fund supported economic strategy. The exchange of all domestic bonds presented by June 15, 2004 is well advanced, but has not yet been fully completed due to logistical reasons (bonds exist in physical form), and the authorities expect the process to be completed in a few days.

5. The elimination of all the arrears is also a central objective of the program and an important reason for the authorities' efforts to achieving long-term fiscal sustainability. In this vein, strong progress has been observed, while bilateral arrears were cleared well in advance of the program's timetable. On the other hand, the authorities are actively maintaining negotiations to resolve any disputed debts with external creditors. Regarding the restructuring of domestic bonds, the government has cleared all the interest arrears for the bonds presented by June 15, and the remaining interest on bonds not yet presented for exchange are deposited in escrow account in the Central Bank. Almost 90 percent of the old bonds already submitted were exchanged for the new ones or are available for the owners. The remaining bonds are in the process of being produced, which entails complicated logistics that takes several days, including the signing of each individual bond by the Minister of Finance, but once completed they will be immediately exchanged. Progress in this regard has been crucial to get Paraguayan long-term foreign currency debt raised from SD (Selective Default) to "B-" (Outlook stable). Standard and Poor's upgraded the rating following the explanation that "the actual exchange bonds is currently taking place and formally cures this government's default", which was the cause of the downgrading on February, 2003.

6. Paraguay has made substantial progress towards achieving a sustainable fiscal position. A combination of measures such as excise tax increases on diesel fuel, improved tax and custom administration, tough spending control, and actions aimed to reduce tax

evasion and combat corruption in the public and private sector, along with the upturn in the economy have contributed to increase revenues and obtain the envisaged reduction of the central government deficit to 0.3 percent of GDP in 2003. Improvement in public enterprises management, timely adjustments of prices for utilities and fuels, as well as the positive effect of the appreciation of the local currency on their financing costs allowed to obtain an operating surplus of 2.1 percent of GDP in public enterprises in 2003, which enabled the consolidated public sector overall balance.

7. The permanent effort in strengthening tax and custom administration has been the main factor for the strong performance in revenues collections again this year. Implementation of the public pension system reform law approved early this year will generate net fiscal savings for about ½ percent of GDP, this as well as the recent approval of the Fiscal Adjustment Law are crucial to place the country in a path of long-term fiscal sustainability, while giving space for the increased allocation of needed capital spending and social investment. The public sector debt to GDP ratio is projected to fall to 43 percent in 2004 from around 50 percent of GDP in 2003.

8. The prudent monetary policy is reflected in the low inflation and the higher than expected accumulation of international reserves obtained so far. Helped by a further appreciation of the guarani in 2004, due to favorable terms of trade, the weakening of the U.S. dollar in international markets, and the reversal of capital outflows, inflation reached only 1.9 percent during the first six months of 2004, annual inflation fell to 5.5 percent, on track for the year-end program target of 8 percent. The authorities have considered appropriate to intervene actively in the foreign market to moderate the appreciation of the guarani. This action enabled the Central Bank to increase the level of international reserves to 1.102 million at July 23, 2004, well above the original program target for end-2004.

9. Given the reduction of inflation and the existing macroeconomic conditions, the Central Bank has lowered interest rates on short-term instruments, and plans to continue moving in that direction to the extent that inflationary pressures permit it. This allows to reduce the Bank's own financing costs while encouraging commercial banks to increase their lending to the private sector. Liquidity is already significant in the banking system and the authorities are also considering incentives to develop longer-term deposit instruments in financial institutions.

10. The authorities intend to continue pursuing their efforts to strengthen the financial system, including the largest financial cooperatives through enhanced supervision and regulations. In this regard, they have requested a FSAP that should contribute significantly in assessing existing vulnerabilities. Their recommendations will be very important, and our authorities would like to consider them in the banking system legislation that they are preparing. Despite some progress observed in the management and the financial conditions of the Public National Development Bank (BNF), our authorities consider imperative the restructuring of the institution to enhance its efficiency and to reduce the fiscal burden it represents. They are strongly committed to obtain approval of the public banking law by end-October 2004.

11. Advancing steadily with the structural reform agenda remains a priority. The authorities are aware that improving the capacity of the institutions and developing a clear and transparent regulatory framework is deemed crucial for laying the basis for sustained growth. At this respect, the authorities agree with the staff that corruption has been an important burden on growth weakening the business environment. Since the new administration took office, strong actions and measures to increase transparency and reduce corruption have been taken. The staff clearly points out the significant advances in that direction, including the appointment in key positions of competent officials knowing for their integrity, professionalism, and independency. Their participation has been crucial for the substantial improvements in tax and tariff revenues recently observed.

12. Likewise, the recently approved Customs Code will be a key element to improve the efficiency of an institution characterized in the past by corruption and mismanagement. Significant steps have also been taken to improve both the legal framework and its enforcement to combat illegal activities. The new procurement system law is implemented in all public sector agencies, and good progress on the independent audits of public enterprises can be observed. In addition, the credibility on the judicial system has improved since the renewal of the Supreme Court early this year.

13. It is important to emphasize that the measures and reforms being implemented by the Government are not easy tasks. Many of those actions have affected powerful vested interests, thus, tough and complex negotiations were and are needed to implement them. The public and political support obtained so far, will be difficult to maintain in case there is no sufficient progress in terms of growth, employment and poverty reduction. To this end, and taking advantage of the revenue over performance, the authorities are developing well-targeted projects to increase capital and social spending. Better employment opportunities, growth prospects, and social indicators are important objectives that the program should also deliver. The authorities consider the support of the international community is crucial in this process and request continued cooperation and support in order to achieve the country's economic objectives.