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Corruption, Reform, and the Financial System

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Abbreviations

BACE	Bayesian averaging of classical estimates
BCP	Central Bank of Paraguay
BNF	Public development bank
CAR	Capital adequacy ratio
CIRD	Centro de Información y Recursos para el Desarrollo
CPI	Consumer price index
DMS	Doppelhoffer, Miller, and Sala-i-Martin
DW	Durbin-Watson
ECM	Error correction model
FSAP	Financial system assessment program
GDP	Gross domestic product
GNI	Gross national income
HP	Hodrick-Prescott
IDB	Inter-American Development Bank
INCOOP	Supervisory authority of the cooperatives
IPS	Social security institute
LRM	Central bank bills
N	Number of observations
NPL	Nonperforming loan
OLS	Ordinary least squares
REER	Real effective exchange rate
ROA	Returns on assets
ROE	Returns on equity
SIC	Schwartz criterion
TFP	Total factor productivity
TOT	Terms of trade
VAR	Vector autoregression
VAT	Value-Added Tax
VECM	Vector error correction model

Preface

The material presented in this Special Issue was originally prepared as background for discussion at the IMF Executive Board. The authors are grateful to the Paraguayan authorities for extensive discussions and comments and for their assistance in providing data and other source material.

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The opinions expressed are solely those of the authors and do not necessarily reflect the views of the IMF, its Executive Directors, or the Paraguayan authorities.

Overview

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 new administration agreed on a set of policies to be supported by a Fund arrangement and signed a 15-month Stand-By Arrangement on December 15, 2003.

The authorities adopted a comprehensive program of fiscal and structural reforms to set Paraguay on a path of sustainable growth. The strategy centered on restoring fiscal sustainability, improving the efficiency of the public sector, strengthening the banking sector, improving governance, and fighting corruption. Specifically, they adopted a comprehensive and balanced fiscal package, including measures to increase tax revenues and appropriate spending restraint, as well as efforts to correct financial problems in certain public enterprises. They also reformed the public employees' pension plan. The monetary policy had responded pragmatically to the difficulties faced in 2002.

The Paraguayan economy is emerging from a long period of slow growth. Over the two decades before 2002, per capita income fell by an average of 0.6 percent per year. 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.
- 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.

A sharp recession in 2002 was followed by a recovery in 2003 and 2004. 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. 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's end. The nonagricultural economy remained stagnant, however. In 2004, the economy continued its recovery and, despite a drought that affected soy, the largest export crop, the economy grew by almost 3 percent, significantly above the average in the past 10 years.

The political environment for reform has improved. President Duarte Frutos has demonstrated an ability to advance important political and economic reforms, despite not having a majority in the Senate. 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. Against this background, Chapter 1 examines how corruption in Paraguay contributed to slow economic growth.

Monetary policy has been geared toward a flexible exchange rate regime since the de facto currency peg was abandoned in 2001. The Central Bank of Paraguay (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 three years, from PARG 300 billion at end-2001 to around PARG 1.6 trillion in mid-2004. Interest rates on LRMs have declined from their peak of 33 percent in August 2002, reaching 9½ percent by April 2004. Base money growth accelerated sharply in 2003 as the economy began to remonetize after the banking crises. 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).

The financial system has improved, but weaknesses persist. In 2003, deposits largely recovered from the sharp drop in the 2002 banking crisis, and they continued to rise in 2004. 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 has 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. 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. Chapter 2 examines the impact of the financial crises on private sector credit.

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 and a higher-than-expected surplus of 2½ percent of GDP in 2004. The primary balance also improved markedly, as interest payments as a percent of GDP stabilized, owing to the sharp reduction in debt-service payments arrears and low international interest rates. The main features of the improvements in 2003 were (1) expenditures were tightly controlled throughout the year in the central government, and (2) tax collections increased sharply beginning in August 2003, owing to leadership changes in tax and customs administrations. And the recovery of the exchange rate from the steep decline in 2002 contributed to an improvement of public enterprises' outlook. In the medium term, the public finances are expected to improve further. The approval of the Public Pension Reform Law (the *caja fiscal*) is expected to generate savings on the order of ½ percent of GDP in transfer payments. Chapter 3 assesses the reform of the caja fiscal.

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. Chapter 4 estimates the long-term equilibrium real exchange rate at the end of 2003 and the misalignment in the real exchange rate.

Structural reform remained a key priority in the government's program. The government has reformed the public sector pension system and 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 authorities have taken 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 of the new customs code should reduce corruption associated with international trade and smuggling. The code grants operational and financial autonomy to customs and greatly expands its powers of investigation and enforcement. In addition, efforts are being made to improve transparency. Independent audits of numerous public entities are under way. 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. In the financial sector, the Bank Superintendency has made progress in applying new supervisory requirements, and implementation of the new bank resolution law has begun, with the deposit guarantee fund operating.