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December 19, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Paraguay - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Paraguay. A draft decision appears on page 18.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Lachman, ext. (5)8648.

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INTERNATIONAL MONETARY FUND

PARAGUAY

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Consultation with Paraguay

Approved by Eduardo Wiesner and Manuel Guitian

December 18, 1984

I. Introduction

The 1984 Article IV consultation discussions with Paraguay were held in Asuncion from October 24 to November 8, 1984. The representatives of Paraguay included the Ministers of Finance, Agriculture, and Industry and Commerce; the President of the Central Bank; the Executive Secretary of the Technical Planning Office; the Directors of the Itaipu and Yacyreta binational entities;1/ the chief executives of the largest public enterprises; and other senior officials. The mission also met with representatives of the private sector and of the banking system. The staff mission consisted of Desmond Lachman (Head), Lazaros Molho, Cesar L. Ramirez-Rojas, Roberto Ramaciotti (all WHD), Markus Rodlauer (ETR), and Martha Silva de Berta (Secretary-WHD). The mission was assisted by Ivan Bello, the Fund representative in Asuncion.

The previous consultation discussions with Paraguay were held in October 1983. The relevant documents (SM/83/260 and SM/84/1) were considered by the Executive Board on January 16, 1984 (EBM/84/7). In recent years, Paraguay has not made recourse to use of Fund resources. As of November 30, 1984 the Fund's holdings of Paraguayan guaranies amounted to SDR 16.2 million or 33.3 percent of quota, and Paraguay's holdings in the Special Drawing Rights Department stood at SDR 35.0 million or 255 percent of net cumulative allocation. Further information on Paraguay's relations with the Fund is presented in Appendix I.

1/ The Itaipu Binational Entity, jointly owned by Paraguay and Brazil, is entrusted with the construction and operation of the 12.6 million kilowatt Itaipu complex, the world's largest generator of hydroelectricity; the Yacyreta Binational Entity is a Paraguayan-Argentine enterprise in charge of building and eventually operating the 2.7 million kilowatt Yacyreta hydroelectricity project.

II. Economic Background 1/

During the period 1976 to 1981, the Paraguayan economy grew at an annual average rate of around 10 percent while the balance of payments remained strong. This favorable performance occurred under the impetus of the joint construction with Brazil of the Itaipu hydroelectric project and the initiation of the Yacyreta hydroelectric project together with Argentina. In addition, favorable international prices for soybeans and cotton--Paraguay's major agricultural exports--stimulated their production and export.

Since mid-1981, however, there has been a significant deterioration in Paraguay's economic and financial performance. In 1982 and 1983 real GDP registered a cumulative decline of over 5 percent and recorded unemployment rose to over 12 percent (Table 1). The slackening in economic activity stemmed in part from the impact on exports of the worldwide recession and of developments in Argentina and Brazil. In addition, there was the winding down of construction at Itaipu, delays in the Yacyreta project, and heavy flood damage to agriculture in 1983. A further complication was the emergence of an overly appreciated real exchange rate, particularly in relation to the currencies of Brazil and Argentina (Chart 1).

Preliminary indications suggest that real GDP has risen by around 2 1/2 percent in 1984. This recovery was led by an estimated 9 percent rebound in agricultural production, which benefited from more favorable weather conditions and from higher international prices for soybeans and cotton. There was also a revival in the service sector stemming from increased tourism from Argentina.

The slackening in economic activity was initially accompanied by a slowing of inflation. In terms of the consumer price index, the 12-month rate of inflation decelerated from 18.6 percent at the end of 1980 to 8.8 percent by end-1982. However, the easing in credit policy, together with important exchange rate measures in May 1984, resulted in a quickening in the rate of price increase. By September 1984, the 12-month rate of inflation had picked up to over 22 percent with price increases in recent months giving little indication of any deceleration in prospect. Against this background, the minimum wage, which had last been adjusted by 10 percent in July 1983, was increased by 15 percent in June 1984 and by a further 15 percent in September.

1/ Analysis of the Paraguayan economy is rendered difficult by the poor quality of the economic statistics, particularly in regard to the national accounts, the balance of payments, and the public enterprise accounts. The current status of the macroeconomic statistics in Paraguay is outlined in Appendix II.

Table 1. Paraguay: Selected Economic Indicators

	1980	1981	1982	1983	Est. 1984
	(Percent change)				
GDP at constant prices	12.4	8.6	-1.9	-3.3	2.4
Agriculture	9.8	14.6	0.7	-2.9	8.9
Manufacturing	13.3	4.3	-3.7	-4.2	4.1
Construction	35.5	13.6	-14.8	-8.5	-7.9
Price indicators					
GDP deflator	16.8	16.3	5.1	14.5	23.2
Consumer prices (end of period)	18.6	8.7	8.8	14.1	22.1 1/
	(In millions of U.S. dollars)				
Balance of payments indicators					
Overall balance of payments position	163	53	-125	-263	-146
Net international reserves at end of period	772	825	699	634	474 2/
Public and officially guaranteed external debt	709	809	1,037	1,305	1,446

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

1/ 12-month rate through September 1984.
2/ Position as of October 1984.

Following a decade of balance of payments surpluses, since 1982 there has been an appreciable deterioration in Paraguay's external accounts. An important factor in this regard was the lower net foreign exchange inflows associated with the Itaipu and Yacyreta projects. These inflows, which had amounted to US$345 million or 9 percent of GDP in 1982, declined to an estimated US$175 million or around 4 1/2 percent of GDP in 1984.1/ This decline reflected the near completion of

1/ For purposes of this calculation, Paraguay's GDP in terms of U.S. dollars was estimated from a base date of 1970, at which time the official exchange rate appears to have been broadly appropriate. A dollar GDP series was constructed by applying to the 1970 dollar estimate of GDP the real rates of GDP growth as reflected in Paraguay's national accounts and the rate of consumer price inflation in the United States.

the construction phase at Itaipu which was not compensated for by increased activity at Yacyreta due to delays in this project stemming from Argentina's financial difficulties.

Further factors exerting pressure on the external accounts over the past two years were an easing in credit policy and the maintenance of an overly appreciated real exchange rate. Overall export earnings (including unregistered trade) are estimated to have declined significantly since 1980, despite some recovery in 1984 due to higher international prices for soybeans and cotton (Table 2). In response to the increased pressure on the balance of payments, the authorities continued to resort heavily to external borrowing and they appreciably tightened import restrictions. Notwithstanding these actions, Paraguay's balance of payments swung from an overall surplus of US$55 million in 1981 to overall deficits of US$260 million in 1983 and an estimated US$145 million in 1984.

Table 2. Paraguay: Summary Balance of Payments

(In millions of U.S. dollars)

	1980	1981	1982	1983	Est. 1984
Overall balance excluding operations of the binational corporations	-243.8	-417.3	-471.0	-578.2	-319.9
Current account balance	-496.7	-528.8	-443.6	-408.9	-300.7
Exports	(687.8)	(668.2)	(564.4)	(490.0)	(534.1)
Imports	(-1,051.6)	(-1,038.3)	(-836.1)	(-710.0)	(-695.8)
Services (net)	(-137.4)	(-164.5)	(-189.1)	(-195.0)	(-145.0)
Transfers (net)	(4.5)	(5.8)	(17.2)	(6.1)	(6.0)
Capital account	249.8	111.5	-27.4	-169.3	-19.2
Private long term	(63.8)	(54.4)	(1.1)	(-13.6)	(-32.8)
Public medium- and long-term borrowing	(120.4)	(101.6)	(233.2)	(268.7)	(144.5)
Short-term borrowing and errors and omissions	(65.6)	(-44.5)	(-261.7)	(-424.4)	(-130.9)
Allocation of SDRs	3.1	--	--	--	--
Net inflows related to operations of the binational corporations	406.8	470.5	345.6	315.2	174.4
Overall balance	163.0	53.2	-125.4	-263.0	-145.5
Reserve increase (-)	-163.0	-53.2	125.4	65.7	170.5
Accumultation of arrears	--	--	--	197.3	-25.0

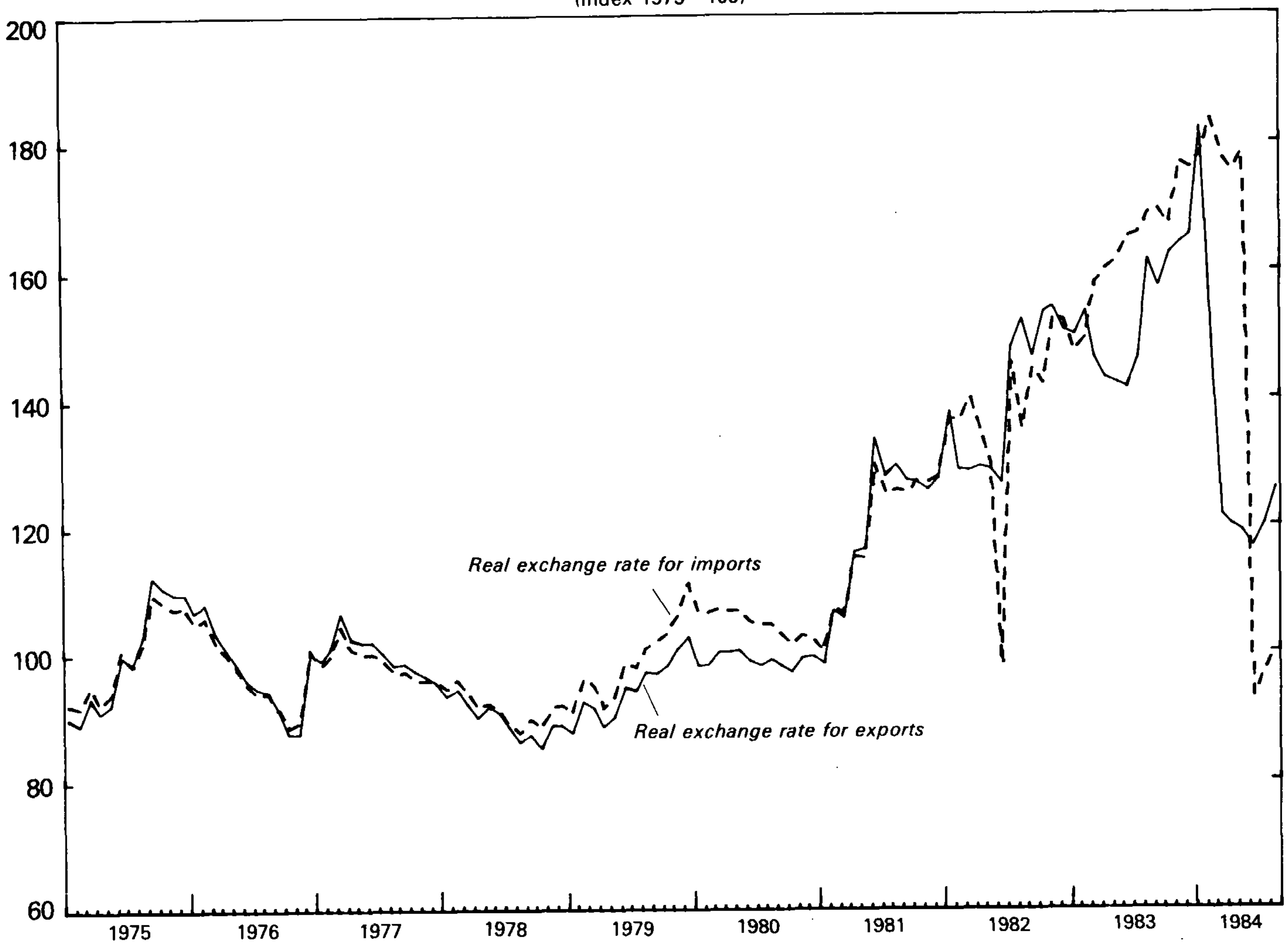
Sources: Central Bank of Paraguay; and Fund staff estimates.

CHART 1

PARAGUAY

REAL EFFECTIVE EXCHANGE RATE[1]

(Index 1975 = 100)



[1] Based on average exchange rates applicable to Paraguay's registered trade in terms of relative consumer prices. An increase in the index reflects a real appreciation of the exchange rate.

Paraguay's net international reserves declined from US$825 million at the end of 1981 to US$470 million by October 1984, or about seven months' import payments. As of the same date Paraguay's commercial arrears were estimated at US$140 million. Since 1979, there has been an approximate doubling in Paraguay's official and officially guaranteed external debt, which is currently estimated at US$1,445 million or about 38 percent of GDP (Table 3). The external debt, however, has a favorable profile and since it was mainly contracted on concessional terms from multilateral and official sources, it bears a relatively low interest rate.

Throughout the second half of the 1970s, the authorities exercised restraint over public expenditures and the overall fiscal position remained broadly in balance. Since 1979, however, there has been a weakening in the public sector's finances, which has stemmed largely from an increase in current expenditures and from the impact of the changed macroeconomic environment on revenue performance. As a result, the overall position of the public sector shifted from a surplus equivalent to 0.2 percent of GDP in 1979 to a deficit of over 5 percent of GDP in 1983 (Table 4 and Chart 2). These figures understate the full extent of the weakening in the public sector's finances over this period because they do not take into account the indirect support the public sector receives from the Central Bank. This support is provided by the maintenance of artificially low interest rates on the public debt held by the Central Bank and by the provision of foreign exchange by the Central Bank at a highly subsidized rate to pay interest on the public sector's external debt. If these factors were taken into account, the consolidated public sector deficit would be estimated at 6 percent of GDP in 1983.

The 1984 budget sought a reduction in the Central Administration's deficit through tight control over current expenditures and through cutbacks in capital expenditure. At the same time, the financial position of a number of public enterprises (notably those providing telephone services and electricity) was strengthened through substantial increases in tariffs. Preliminary data for the first nine months of 1984, suggest that the authorities will succeed in reducing the recorded overall public sector deficit by around 2 1/2 percentage points to the equivalent of 3 percent of GDP in 1984. However, this improvement may be partially offset by an increase in central bank support to the public sector by about 1/2 a percentage point to an estimated 1 1/2 percent of GDP, through the exchange rate and interest rate subsidies referred to above.

Over the past two years, credit policy has been loose as evidenced by an expansion of central bank credit at an annual rate of around 70 percent 1/ (see Table 4 and Chart 3). The dominant factor in this regard was a significant acceleration in private sector credit expansion,

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1/ Measured in relation to central bank liabilities to the private sector at the beginning of the period.

Table 3. Paraguay: Summary of External Debt

	1980	1981	1982	1983	Est. 1984
(In millions of U.S. dollars)					
Public sector debt outstanding at end of period	709	809	1,037	1,305	1,446
Central Administration	277	317	370	502	583
Public enterprises	290	342	482	596	640
Rest of public sector	142	150	186	206	223
Private sector nonguaranteed debt	407	436	419	400	359
Total debt service payments					
Public sector and officially guaranteed debt service	88	82	87	92	155
Private sector nonguaranteed debt service	69	82	87	79	77
(In percent)					
Debt service ratio 1/	19.3	21.1	26.5	29.7	34.3
Public sector and officially guaranteed	10.8	10.5	13.3	16.0	22.9
Private sector nonguaranteed	8.5	10.6	13.2	13.7	11.4
Ratio of total debt to GDP 2/	38.6	36.0	40.5	47.6	47.3
Public and officially guaranteed	24.5	23.4	28.9	36.4	37.9
Private sector nonguaranteed	14.1	12.6	11.6	11.2	9.4

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

1/ In relation to exports of goods and services.

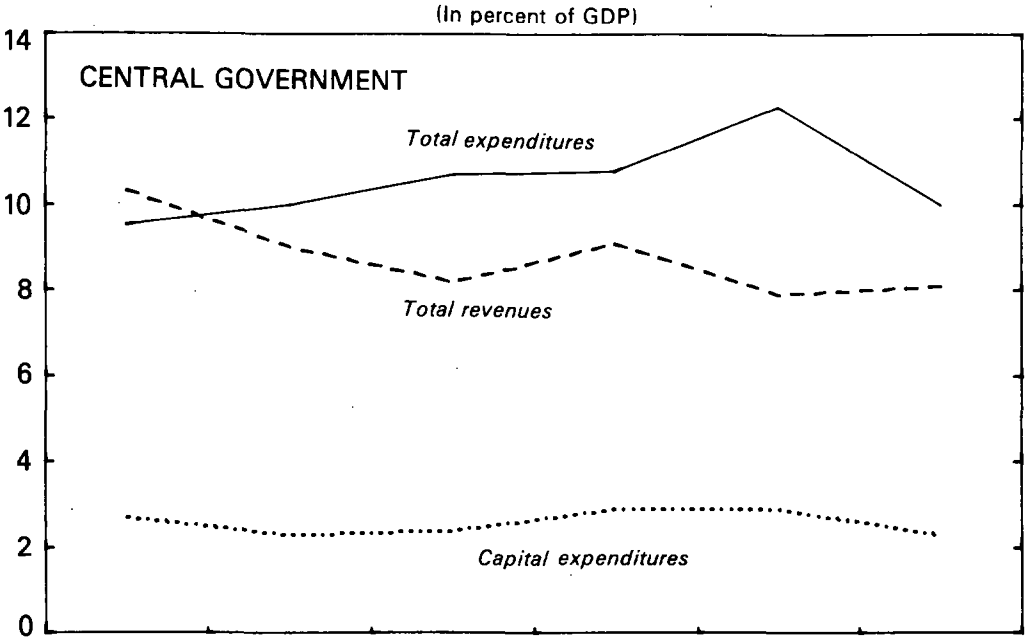
2/ Based on a dollar GDP series calculated using a shadow exchange rate which maintains the real effective exchange rate of the guarani at its 1970 level.

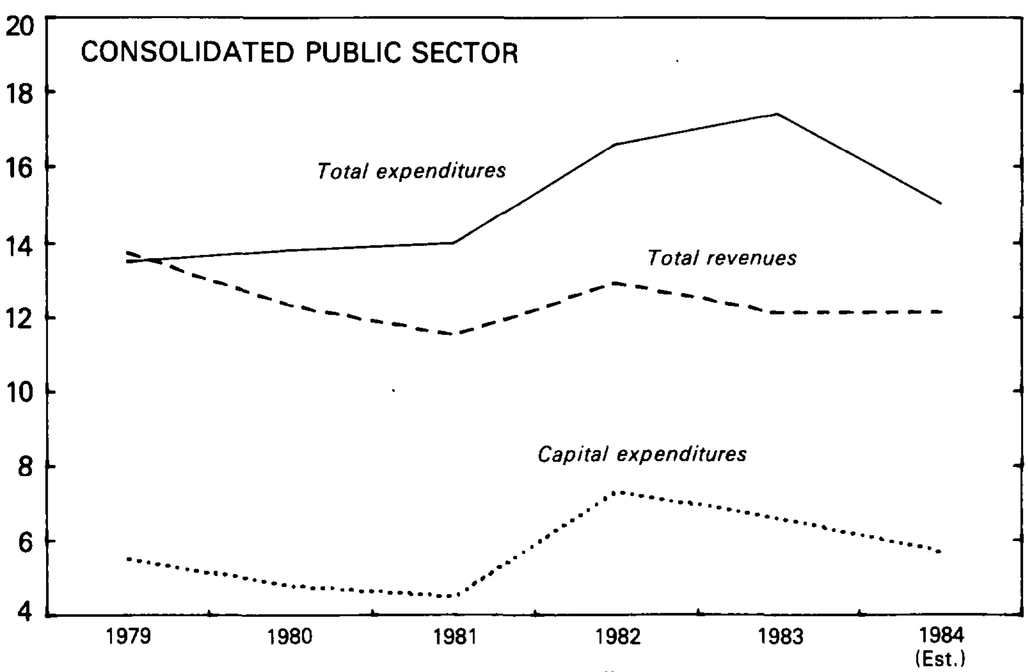
CHART 2

PARAGUAY

PUBLIC SECTOR OPERATIONS

(In percent of GDP)



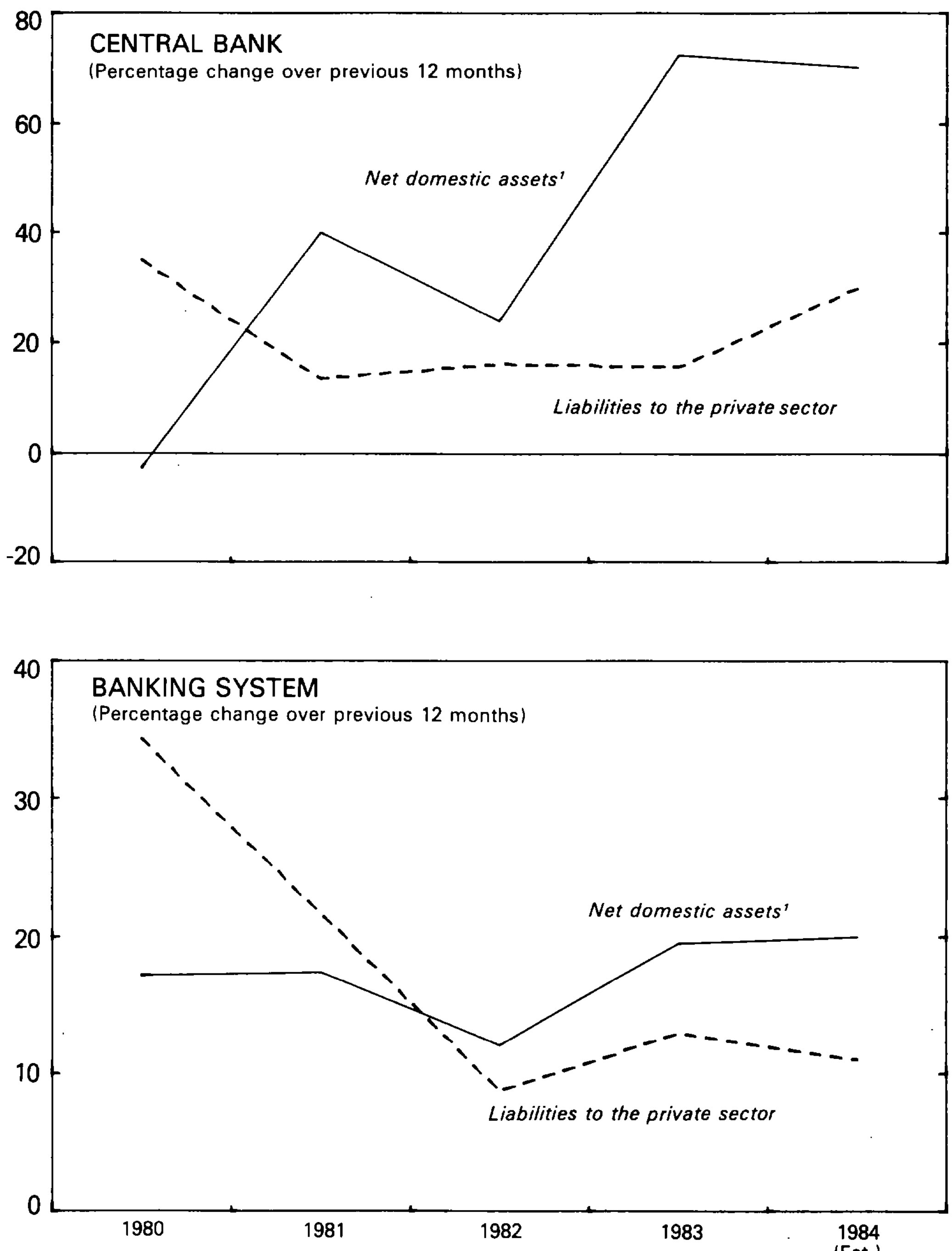


Sources: Ministry of Finance; Technical Planning Secretariat; and Fund staff estimates.

CHART 3

PARAGUAY

MONETARY DEVELOPMENTS



¹Percentage change in relation to liabilities to the private sector at the beginning of the period.

Table 4. Paraguay: Selected Financial Indicators

	1980	1981	1982	1983	Est. 1984
	(As percent of GDP)				
Fiscal indicators					
Central government finances					
Total revenues	9.0	8.2	9.1	7.9	8.1
Total expenditures	10.0	10.7	10.8	12.3	10.0
Of which: capital expenditure	(2.3)	(2.4)	(2.9)	(2.9)	(2.3)
Overall surplus or deficit (-)	-1.0	-2.5	-1.7	-4.3	-1.9
Overall public sector finances					
Total revenues	12.3	11.5	12.9	12.1	12.1
Total expenditures	13.8	14.0	16.6	17.4	15.0
Of which: capital expenditure	(4.8)	(4.5)	(7.3)	(6.6)	(5.7)
Overall surplus or deficit (-)	-1.5	-2.5	-3.7	-5.3	-2.9
Estimated exchange rate and interest rate support to public sector from the Central Bank	...	...	...	-1.0	-1.6
Overall position of public sector including Central bank support	...	...	...	-6.3	-4.5
	(Percentage increase)3/				
Monetary indicators					
Central Bank					
Net domestic assets 1/	-2.6	40.2	23.9	72.4	70.0 2/
Public sector 1/	(6.1)	(34.4)	(13.0)	(43.8)	(18.5)2/
Other	(-8.7)	(5.8)	(10.9)	(28.6)	(51.5)2/
Liabilities to private sector	34.9	13.4	16.2	15.6	30.0 2/
Banking system					
Net domestic assets 3/	17.1	17.4	12.0	19.5	20.0 2/
Public sector 3/	(1.1)	(7.0)	(5.0)	(10.6)	(5.0)2/
Other 3/	(16.0)	(10.4)	(7.0)	(8.9)	(15.0)2/
Liabilities to private sector	34.3	21.7	8.7	12.9	11.0 2/

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

1/ In relation to central bank liabilities to private sector at the beginning of period.
2/ 1984 estimates are based on 12-month period ending September 1984.
3/ In relation to banking system liabilities to private sector outstanding at the beginnig of the period.

although the need to provide financing to the public sector also played a part. Over the past 18 months, the authorities maintained unchanged the system of automatically rediscounting up to 40 percent of the special credits of the commerical banks, thereby rendering monetary policy highly accommodating. These rediscounts are applicable to 50 percent of the commercial banks' loan portfolio and bear an interest rate of only 8 percent. Another factor contributing to the rapid expansion in bank credit was the large exchange losses incurred by the Central Bank, especially in the period through May 1984 when a large negative spread between export and import exchange rates was in effect. Despite the acceleration in inflation, the authorities maintained unaltered the system of maximum interest rates and commissions on the operations of the banking system. In reflection of the increasingly negative real rates offered on bank deposits, real financial savings are estimated to have declined by over 10 percent in 1984.

In the area of exchange rate policy, in July 1982 the authorities established an exchange rate system consisting of seven different exchange rates ranging from ₲ 126 to ₲ 230 per U.S. dollar (as described in SM/83/260, page 9). As pressure continued on international reserves, in May 1984 measures were taken to simplify the system and to move the exchange rate to a more realistic level, while the system of advance import payment deposits then in effect was eliminated (as described in Paraguay--Exchange System, EBD/84/168). The exchange rate for most imports (excluding oil) was freed raising the basic rate for imports (in terms of guaranies per U.S. dollar) by around 50 percent. At the same time, the exchange rate for exports was depreciated by 13 percent. There are now three basic exchange rates: (a) a rate of ₲ 160 per U.S. dollar for transactions with the binational entities, and for official capital and external debt service payments; (b) a rate of ₲ 240 per U.S. dollar for the major part of export receipts, for government imports, and for imports of petroleum, fuel, agricultural, and industrial inputs; and (c) a free exchange rate, currently around ₲ 400 per U.S. dollar for most imports, profit remittances, service payments, and a small proportion of export receipts. Addtional multiple currency practices arise from the taxes and commissions applied to the sale of foreign exchange in the official market and from the exchange taxes on remittances of profits, dividends, and earnings. Moreover, since 1983 there has been a significant accumulation of commercial payment arrears while the trade system is characterized by an array of duties, surcharges, and commissions.

III. Report on the Discussions

The authorities view the deterioration in Paraguay's economic performance since mid-1981 as primarily due to factors beyond their control. They noted in this respect, that the economy had been subjected to exogenous shocks on account of adverse weather conditions in 1983 and substantially reduced foreign exchange inflows from the Itaipu project. Moreover, over the past few years economic management had been severely complicated by the world recession and by the financial difficulties of Brazil and Argentina.

The authorities emphasized that despite recent adverse developments, Paraguay's financial position remained sound and was very much better than that of the other countries in the region. They noted that the economy's strong financial position--the result of the favorable economic conditions and the prudent economic management of the late 1970s--still afforded Paraguay considerable room for maneuver. The authorities were nevertheless disturbed by the recent trends in the economy and they recognized that adjustment measures were needed to restore sustained growth within the context of a sound balance of payments and price stability. The consultation discussions with the authorities focused largely on how policies might be best adjusted to secure these objectives.

1. External policies

The authorities recognized that policies needed to be strengthened in order to halt the loss in external reserves, slow the pace of debt accumulation, and reduce the commercial arrears built up over the past two years. In this regard, the authorities acknowledged that policies could not be premised on the basis of any significant rebound in foreign exchange inflows from Itaipu and Yacyreta. Construction at Itaipu in 1985 would proceed at broadly the same pace as it did in 1984, while work at Yacyreta was unlikely to be accelerated in view of Argentina's present financial situation. Beginning on January 1, 1985, the Itaipu binational entity would begin selling electricity to Brazil from the two turbines already installed. However, Paraguay's exchange earnings from royalties on these electricity sales would in the initial stages only be on the order of US$20 million a year. The authorities expected these royalties to increase appreciably over subsequent years as an additional 16 turbines were installed and as modifications were agreed with Brazil on the provisions of the 1973 Itaipu Treaty defining the formula for the determination of royalties. The Paraguayan representatives were of the view that these royalties could amount to between US$100 million and US$200 million a year by the end of the decade.

The authorities indicated that the required adjustment in policies had already been initiated. In this regard, they noted the increased austerity in the public sector's operations in 1984 and they drew attention to the exchange measures introduced in May. These measures had contributed to an appreciable decline in imports. The Paraguayan representatives indicated that while policy for 1985 had yet to be fully defined, it was their intention to tighten demand management policy further with a view to strengthening the external accounts. As regards exchange rate policy, further action had not been ruled out to stimulate the export sector and to reduce the volume of trade being transacted through irregular channels. In this regard, the authorities were aware of the wide spread between the official exchange rate for exports of ₲ 240 per U.S. dollar and the free market rate of ₲ 400 per U.S. dollar at which rate most import transactions take place. However, they were concerned about the possible inflationary consequences of any further measures in the field of exchange rate policy. They were especially wary of igniting inflationary expectations and they wondered whether exchange rate action at this time might not prove counterproductive. In any event, the authorities noted that their calculations of an equilibrium exchange rate, based on considerations of purchasing power parity, would suggest an exchange rate significantly below the ¢ 400 per U.S. dollar rate prevailing in the parallel market.

The authorities acknowledged that Paraguay's complex exchange and trade system had adverse effects on domestic resource allocation, but they noted that this system had evolved in response to external developments, particularly in neighboring countries. It was nevertheless the authorities' intention to simplify this system as external conditions permitted. The authorities noted that as part of the 1985 budget, a new Tariff Law had been presented to Congress. This law aimed at rationalizing Paraguay's tariff structure within a general range of between 5 and 30 percent and at simplifying the many charges and fees to which imports are currently subjected. In addition, the proposed legislation would exempt exports from all taxes and charges. Passage of this law was expected to contribute to a significant reduction in trade flows through irregular channels, which constituted an estimated 60 percent of Paraguay's overall trade.

In 1983, Paraguay accumulated commercial arrears in respect of import payments totaling US$197 million by year end. The authorities noted that during the first nine months of 1984 an effort had been made to settle past arrears but that new arrears had arisen. Currently, the stock of arrears outstanding was estimated at US$140 million. The authorities also indicated that it was not their intention to extend the two-year bilateral agreement pertaining to Itaipu-related payments that they had signed with the Central Bank of Brazil in June 1983.

On the issue of the external debt, the authorities acknowledged that the recent pace of debt accumulation was unsustainable and they agreed with the staff's view, described more fully below, regarding the need for a reduction in the current account deficit of the balance of payments over the medium term. This was particularly so since an increasing proportion of Paraguay's external debt was having to be contracted at market-related terms. The authorities noted, however, that since the bulk of Paraguay's debt had to date been contracted on highly concessional terms, the debt service ratio remained manageable. Thus, whereas the ratio of the public and officially guaranteed external debt to GDP was around 38 percent, the ratio of public debt service payments to overall exports of goods and services was only on the order of 23 percent (see Table 3).

2. Fiscal policy

The authorities indicated that the weakening in the public sector's finances since 1979 had reflected to an important extent a poor revenue performance. This in turn had been mainly due to the weakening in economic activity and to the appreciable drop in imports through official channels. Initially the emerging fiscal deficit had been viewed as a means to counter the softening of economic activity. However, in light of the pickup of inflation and the loss of net international reserves, the authorities had reassessed their aims for public sector policy. Accordingly, measures to restrain both current and capital expenditures were adopted in 1984. The authorities noted that the preliminary results for the first nine months of 1984 would suggest a clear change in the direction of fiscal policy. Compared with the corresponding period of 1983, the Central Administration had substantially reduced its recourse to Central Bank and external financing.

The authorities noted that the 1985 budget, which had recently been presented to Congress, aimed at broadly maintaining the stance of fiscal policy. The main emphasis of the budget would again be on expenditure restraint. The Tariff Law referred to above was the only revenue measure of any substance. The authorities, nevertheless, expected a boost in international trade tax collections from the passage of the Tariff Law. They were of the view that the proposed law, by reducing tariffs and by simplifying the system of import taxes, would significantly increase the proportion of international trade transacted through regular channels. This was expected to more than offset the anticipated loss in revenues on account of the lowering in import tariff rates.

As regards the medium term, the authorities stated that it was their objective to further strengthen the public sector's finances. However, it would not be possible to make further cuts in expenditures. Capital expenditures would be especially difficult to restrict in view of the need to raise infrastructure outlays and to provide counterpart funds required for development projects financed from abroad. The authorities recognized that far reaching revenue measures would be needed but they were reluctant to contemplate such measures at a time when economic activity was sluggish. They agreed that the poor behavior of revenues in recent years had reflected not only a decline in economic activity but also the archaic and complex structure of the tax system, an increasing number of tax exemptions, and the growing incidence of tax evasion.

In regard to the public enterprises, the authorities noted that in 1984 a significant improvement had been secured in the operations of the telephone, electricity, and water enterprises. This had been attained primarily through increases in their tariffs and improved control over their borrowing. The authorities recognized, however, that while the public enterprises' domestic borrowing requirements had been contained to date, continued vigilance over their operations would be required in the future. In particular, they shared the staff's concern about the future situation of the cement and steel enterprises. These enterprises had embarked on large-scale investment projects that were motivated more by national and security reasons than by economic considerations. These projects, which were largely financed from abroad at a total cost of around US$470 million, are expected, when completed by the end of the decade, to have a total productive capacity well in excess of domestic demand for steel and cement. The authorities expected that the financing requirements of these enterprises would exert increased pressure on the Central Bank as the grace periods on the servicing of their external loans came to an end beginning in 1985.

3. Monetary policy

The authorities indicated that the rapid rate of credit expansion over the past two years had essentially reflected three factors--the continued large borrowing requirements of the public sector, a rapid increase in central bank rediscounts, and the sizable exchange losses incurred by the Central Bank. In addition, there had been increased pressure on the Central Bank stemming from the financing requirements of the public enterprises referred to above, which were not in a position to service their external debt.

With regard to rediscount policy, the authorities observed that over the past 12 months there had been an approximate doubling in central bank credit to the commercial banks. This had reflected an increased demand for agricultural and export credits associated with the recovery in the agricultural sector. Over this period, the Central Bank continued to stand ready to rediscount up to 40 percent of such credits at a rate of 8 percent. The authorities had not tightened rediscount policy since they did not wish to hinder the incipient recovery.

The authorities recognized that their objectives of restoring price stability and strengthening the balance of payments would require a progressive scaling down in the pace of credit expansion. Accordingly the monetary program for 1985, currently being designed jointly by officials of the Central Bank, the Ministry of Finance, and the Planning Secretariat, would seek such a deceleration in credit expansion. Within this context, measures were under consideration to reduce the borrowing requirements of the public sector and to tighten the rediscount policy of the Central Bank.

As regards interest rate policy, the authorities acknowledged that the present structure of interest rates was not suited to the current level of inflation. This was particularly the case with the interest rates charged on special credits to agriculture, manufacturing, and exports. These special credits, which are required to constitute at least 50 percent of the commercial banks' loan portfolio, bear an interest rate (including commissions) of 14 1/2 percent. In contrast, regular credits were extended at an effective interest rate of around 30 percent. The authorities recognized the adverse allocative effects of this system and acknowledged that in practice they could not control the final destination of these special credits. They also noted that the imposition of maximum limits on loan rates effectively constrained the interest rates banks could offer on deposits. These latter rates had in recent years become highly negative in real terms, thereby contributing to a substantial decline in real financial savings. The authorities noted that they were considering measures which would correct the distortions caused by the present structure of interest rates. However, they added that political difficulties would be encountered in any such endeavor especially since interest rate limits are dictated by a long-established anti-usury law.

4. Medium-term prospects

The Paraguayan authorities were aware that the recent pace of external debt accumulation could not be sustained over the medium term. Accordingly, they noted that the policies that were being defined for 1985 would have as a principal objective the containment of the current account deficit of the balance of payments. The authorities recognized that the proposed strengthening of the external accounts for 1985 would have to be maintained over the medium term particularly in view of the depletion that had already occurred in Paraguay's international reserve holdings.

In order to quantify the magnitude of the required external adjustment, the staff prepared an illustrative medium-term balance of payments projection (Table 5). The main underlying assumptions of this projection were that export and import prices in dollar terms would rise by an annual average of 6 percent, that Paraguay's real GDP would rise by 4 percent a year, and that net foreign exchange inflows from Paraguay's hydroelectric projects would remain at around US$175 million a year over the next two years before rising to US$225 million by the end of the decade. In addition, it was assumed that new concessional borrowing would decline gradually from its current level of around US$200 million a year. The terms assumed for the nonconcessional debt that would be needed to cover the balance of payments gap were a two-year grace period, a ten-year maturity, and a real interest rate of around 4 percent.

On the basis of the above assumptions, Paraguay's external debt service ratio could be reduced over the medium term, provided that policies were geared toward promoting export growth and restraining imports. Specifically, the staff estimates that if real export growth were to be raised to around 7 percent a year and real import growth were to be constrained to around 4 percent a year, the ratio of Paraguay's total debt to GDP would decline from 47 percent at the end of 1984 to 40 percent by 1990. Over the same period, the total debt service ratio would decline from 34 1/2 percent to 30 percent.

Table 5. Paraguay: Medium-Term External Debt Projection

	Est. 1984	Projected 1985	1986	1987	1988	1989	1990
I. Balance of Payments Projection							
Overall balance excluding operations of the binational entities	-320	-175	-175	-200	-225	-225	-225
Current account balance	-301	-332	-349	-364	-375	-381	-383
Exports	(534)	(604)	(682)	(771)	(871)	(984)	(1,112)
Imports	(-696)	(-765)	(-842)	(-926)	(-1,019)	(-1,121)	(-1,233)
Interest on external debt	(-112)	(-143)	(-162)	(-182)	(-200)	(-218)	(-235)
Other	(-27)	(-27)	(-27)	(-27)	(-27)	(-27)	(-27)
Capital account	-19	157	174	164	150	156	158
Direct investment	(8)	(9)	(10)	(11)	(13)	(14)	(16)
Net medium- and long-term borrowing	(104)	(148)	(164)	(153)	(137)	(142)	(142)
Other	(-131)	(--)	(--)	(--)	(--)	(--)	(--)
Net inflows related to operations of the binantional entities	174	175	175	200	225	225	225
Overall balance	-146	--	--	--	--	--	--
II. External Debt Statistics							
Total debt outstanding	1,805	1,953	2,117	2,270	2,407	2,549	2,691
(In percent)							
Ratio of total debt to GDP	47.3	46.6	45.9	44.7	43.1	41.5	39.9
Debt service ratio 1/	34.3	36.5	36.5	34.9	33.0	32.1	30.0
Public sector and officially guaranteed	(22.9)	(25.3)	(25.6)	(24.3)	(22.7)	(22.1)	(20.3)
Private sector	(11.4)	(11.2)	(10.9)	(10.6)	(10.3)	(10.0)	(9.7)
Memorandum items							
Assumed real GDP growth	...	4.0	4.0	4.0	4.0	4.0	4.0
Real export growth	...	7.0	7.0	7.0	7.0	7.0	7.0
Real import growth	...	4.0	4.0	4.0	4.0	4.0	4.0
Current account deficit in relation to GDP	7.9	7.9	7.6	7.2	6.7	6.2	5.7

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

1/ In relation to exports of goods and services.

IV. Staff Appraisal

Since 1981, there has been a significant deterioration in the economic performance of Paraguay. Following a boom in the late 1970s associated with the construction of the Itaipu hydroelectric project, real GDP registered a cumulative decline of 5 percent in 1982 and 1983 before staging a modest recovery in 1984. At the same time, the balance of payments weakened considerably and inflation, after initially moderating, accelerated to around 22 percent. External factors, including the winding down of construction at Itaipu and the financial difficulties of Paraguay's neighbors, played an important role in these developments. However, a weakening in economic management must also bear part of the responsiblity.

The key economic policy issue now facing the Paraguayan authorities is how best to adjust policies so as to provide the basis for a lasting reversal of the recent trends in economic performance. In this regard, policies will need to be geared toward strengthening the external accounts. This task will require all the greater effort in light of the anticipated reduction in foreign exchange inflows related to Paraguay's hydroelectric projects and in view of the growing external debt servicing requirements of Paraguay's public enterprises. The relatively sound financial situation inherited from the favorable economic conditions in the late 1970s still allows time for an orderly adjustment of the Paraguayan economy. However, the staff would emphasize that the longer adjustment is delayed, the more painful and disruptive it will be.

In the staff's view, the adjustment of the external accounts would best be undertaken in the framework of an economic program that focused on the unification of the exchange rate at a realistic level. In this regard, the staff welcomes the modification of the exchange system adopted in May 1984 as an important step in this direction. However, it would stress that further measures are required particularly in relation to the exchange rate for exports. The proposed unification of the exchange rate at a more realistic level would facilitate the development of Paraguay's economy along the lines of its comparative advantage and would permit the progressive dismantling of the current system of import restrictions and exchange controls. In addition, it would greatly reduce the incentives for trade flows through irregular channels. This would not only reduce the economic costs and inefficiencies inherent in such channels of trade, but would also boost the Central Administration's collection of taxes from international trade.

Any steps toward the unification of the exchange rate would need to be accompanied by a tightening in demand management policies. This would be required to provide room for the desired shift of resources to the external sector and to avoid the possibility of triggering an inflationary process. The staff is encouraged by the efforts being made to strengthen the Central Administration's finances. Through stricter control over expenditures, the budget deficit was reduced appreciably in 1984 and it is the authorities' intention to continue with a policy of expenditure restraint in 1985. The staff would encourage the authorities in these efforts. It should be noted, in this regard, that the true size of the fiscal deficit is currently masked by the indirect support the Central Administration receives from the Central Bank through low interest rates on the public debt and through the provision of foreign exchange at subsidized rates.

The staff would agree with the authorities that little room is left for further compressing central administration expenditures and that it would certainly be imprudent to cut back capital outlays any further from their already low levels. In these circumstances, a major effort would be required to reverse the decline of the past few years in Paraguay's tax effort, which currently is among the lowest in Latin America. The staff is of the view that a basic reform of the tax system is required which should aim at the broadening of the tax base and the simplification of the tax structure.

An area of major concern to the staff is the prospective borrowing requirements of the public enterprises. The problem that is emerging stems more from the large scale investment projects of some of these enterprises rather than from inadequate pricing policies. These projects, which were largely financed from abroad will exert considerable pressure on the Central Bank in the immediate future as the grace period on their external loans expires. The staff would urge the authorities to strengthen the existing mechanisms of control over these enterprises and in particular to evaluate more carefully their investment outlays.

In the area of monetary policy, the staff would stress its preoccupation about the recent rapid growth in domestic credit and in particular about the strong expansion in the Central Bank's net domestic assets. The dominant factor in this regard was a significant acceleration in private sector credit expansion, although the need to provide financing to the public sector also played a part. The continued rapid growth of credit would clearly be inconsistent with balance of payments equilibrium, price stability, or sustained economic growth. A strengthening in the public sector's finances would make an important contribution to the required tightening in monetary management. However, a basic change in policy is also required with respect to the Central Bank's rediscounts which over the past 12 months have been an important source of credit expansion.

A further area of monetary policy in need of revision is the structure of interest rates. While the present system of maximum interest rates might not have hampered financial intermediation in a period of price stability, with rising inflation this system causes a widespread misallocation of resources and discourages real financial savings. The staff would suggest that serious consideration be given to the elimination of interest rate ceilings and to the progressive phasing out of the system of subsidized credits currently covering as much as 50 percent of the commercial banks' portfolio.

The staff believes that the authorities would be well advised to dismantle the restrictive trade policies and the exchange controls that have come to characterize the Paraguayan exchange and trade system. The staff would also urge the authorities to eliminate the commercial arrears that have been accumulated over the past two years. The staff welcomes the proposed Tariff Law, now before the Congress, which aims at rationalizing the tariff structure and at appreciably simplifying the regulations pertaining to external trade transactions. However, the staff would note that a basic redirection in macroeconomic policies would be required to provide the basis for a permanent reduction in Paraguay's restrictions. At present, economic policies do not give sufficient assurance that Paraguay's restrictive practices can be regarded as temporary. Accordingly, Fund approval of Paraguay's multiple currency practices and exchange restrictions does not seem warranted and is not being proposed.

The poor quality of Paraguay's economic statistics continues to hinder economic analysis. The deficiencies in the statistical base are most apparent in regard to the national accounts, the balance of payments, and the public enterprise accounts. The staff would encourage the authorities to strengthen their efforts at improving Paraguay's statistical base. In this respect, the unification of the exchange rate at a realistic level would play an important role by reducing the currently high proportion of external trade transacted through irregular channels.

It is recommended that the next Article IV consultation with Paraguay be held on the standard 12-month cycle.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Paraguay's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1984 Article XIV consultation with Paraguay in the light of the 1984 Article IV consultation with Paraguay, conducted under Decision No. 5392-(77/63), adopted April 29, 1977. (Surveillance over Exchange Rate Policies.)

2. The Fund notes the complexity of Paraguay's exchange system and urges the authorities to simplify it by unification of the exchange rate and by the removal of restrictions on payments and transfers for current international transactions.

Paraguay - Fund Relations
(As of November 30, 1984, unless otherwise indicated)

I. Membership status

(a) Date of membership:	December 28, 1945
(b) Status:	Article XIV

A. Financial Relations

II. General department (General Resources Account)

(a) Quota:	SDR 48.4 million
(b) Total Fund holdings of guaranies:	SDR 16.16 million or 33.38 percent of quota

III. SDR department

(a) Net cumulative allocation:	SDR 13.7 million
(b) Holdings:	SDR 35.0 million or 255 percent of net cumulative allocation
(c) Current designation plan:	None

B. Nonfinancial Relations

IV. Exchange rate arrangement: In May 1984, a number of measures were taken, resulting in a sizeable devaluation of the guarani and a simplification of the exchange rate system. As a result, Paraguay now has three different rates: ₡ 160 per U.S. dollar applicable to official capital transactions, ₡ 240 per U.S. dollar applicable to all exports and some basic imports, and a free market rate at which all other transactions take place.

V. Last Article IV consultation: The 1983 Article IV consultation discussion was completed on January 16, 1984 (EBM/84/7 and SUR/84/3) and the following decision was taken:

1. The Fund takes this decision relating to Paraguay's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1983 Article XIV consultation with Paraguay in the light of the 1983 Article IV consultation with Paraguay conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes the complexity of Paraguay's exchange system and urges the authorities to simplify it by unification of the exchange rate and the removal of restrictions on payments and transfers for current international transactions.

The consultation is under the normal 12-month cycle.

VI. Technical assistance: There has been a Fund representative in Paraguay since August 1979; Mr. Bello has been stationed in Paraguay as Fund resident representative since March 1984. Mr. Gutierrez, an advisor on organization and methods hired by the Central Banking Department, has been stationed in Paraguay since June 1983 and his assignment will terminate in June 1985.

Paraguay - Statistical Issues

Paraguay's macroeconomic statistics continue to reflect many of the weaknesses common to the statistics of countries at its stage of development. In particular, the national account statistics are surrounded by a wide margin of uncertainty while surveys on prices, wages, and unemployment are either incomplete or else are based on samples that have become outdated. The difficulties with Paraguay's statistics have been compounded in recent years by the increased proportion of trade transacted through irregular channels. In addition, the financial statistics have not kept pace with the many changes that have occurred in Paraguay's financial system. The status of Paraguay's statistics covering the various sectors of the economy may be described as follows:

1. National accounts

National accounts data are compiled primarily on the basis of production estimates. Particular difficulties are encountered in estimating agricultural production due to the large volume of unregistered agricultural exports. Expenditure estimates of the national accounts are derived indirectly through the financial and balance of payments statistics, and are therefore subject to the same weaknesses as those statistics.

2. Prices, wages, and unemployment

The consumer price index was revised in 1980 to make it more representative of consumer purchases. The wholesale price index remains restricted to a small and unrepresentative sample of goods making it subject to wide fluctuations. Data on wages and on unemployment are based on small sample surveys largely restricted to Asuncion and are generally accepted to be unreliable.

3. Monetary accounts

Central bank data are current and comprehensive. The data relating to the commercial banks are current but are subject to difficulties owing to the vastly different ways of reporting by individual banks of accounts in foreign exchange. Moreover, the commercial banks' balance sheets are widely believed to understate the true size of the operations of these banks to the extent that they engage in unrecorded transactions induced by high legal reserve requirements and large spreads between interest rates.

4. Fiscal data

Data relating to the Central Administration are current and comprehensive, although the presentation of these data does not easily lend itself to economic analysis. Data on the rest of the public sector, and in particular on the public enterprises, are only available after long lags and are subject to considerable doubt. As a result, the overall position of the public sector cannot be accurately gauged by above-the-line estimates, which tend to differ widely from the corresponding below-the-line estimates.

5. External accounts

Paraguay's official trade statistics do not reflect actual trade flows due to the high degree of unrecorded border trade with neighboring countries and to the respective over- and under-invoicing of import and export transactions. Estimates of such trade have to be made on the basis of direction of trade data of Paraguay's trade partners.

6. Coverage, currentness, and reporting of data in IFS

		Latest Data in November 1984 IFS
Real sector	- National accounts	1982
	- Prices	August 1984
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government finance	- Deficit/surplus	Q4 1981
	- Financing	Q4 1981
	- Debt	1981
Monetary accounts	- Central Bank	May 1984
	- Deposit money banks	May 1984
	- Other financial institutions	May 1984
External sector	- Merchandise trade: values	June 1984
	- Merchandise trade: prices	June 1984
	- Balance of payments	1983
	- International reserves	September 1984
	- Exchange rates	September 1984

During the past year, the reporting of data for inclusion in the IFS has been irregular.

Paraguay: Financial Relations with the World Bank Group

(In millions of U.S. dollars)

	Commitments (Net of Cancel- lations)	Disburse- ments	Undisbursed Amount
I. IBRD Operations (as of Sept. 30, 1984) 1/			
Sectors			
Agricultural and rural development	216.1	132.6	83.5
Industry and industrial credit	41.0	15.2	25.8
Transportation	151.6	111.3	40.3
Education	38.1	28.8	9.3
Water supply	17.8	8.3	9.5
Preinvestment	9.0	4.8	4.2
Total		301.0	
Repayments		36.6	
Total outstanding		264.4	
II. IFC Operations (as of Sept. 30, 1984)			
	Loans	Equity	Total
Commitments	10.3	3.2	13.5
Net held by IFC	5.9	2.3	7.2
Total undisbursed	1.0	--	1.0
III. IBRD Loan Transactions (fiscal year)			
	1982	1983	1984
Disbursements	46.0	34.8	39.9
Repayments	4.4	8.0	11.0
Net lending	41.6	26.8	28.8

Source: World Bank.

1/ These amounts do not include a US$25 million loan for the Seventh Livestock Development Project and a US$5 million loan for the Second Vocational Training Project, approved on January 3, 1984 which are not yet effective.

Paraguay--Basic Data

Area and population	
Area	406,752 sq. kilometers
Population (mid-1984)	3.57 million
Annual rate of population increase (1972-82)	2.9 percent
GDP per capita (1984)	SDR 1,100
Origin of GDP (1984)	(percent)
Agriculture	16.5
Livestock	7.6
Forestry	2.4
Manufacturing	16.3
Construction	6.8
Of which: Itaipu and Yacyreta	0.6
Transportation and communications	4.3
Commerce and finance	26.1
General government	4.5
Other	15.5
Ratios to GDP (1984)	
Exports of goods and nonfactor services 1/	16.1
Imports of goods and nonfactor services 1/	25.9
Central government revenues	8.1
Central government expenditure	10.0
External public and officially guaranteed debt (end of year)	37.9
Money and quasi-money (end of year)	24.7

Annual changes in selected economic indicators	1981	1982	1983	Est. 1984
		(percent)		
Real GDP per capita	5.5	-4.7	-6.0	-0.5
Real GDP	8.6	-1.9	-3.3	2.4
GDP at current prices	26.3	3.1	10.7	26.2
Domestic expenditures (at current prices)	24.5	4.3	3.0	25.4
GDP deflator	16.3	5.1	14.5	23.2
Cost of living (annual averages)	14.0	6.8	13.5	20.0
Central government revenues	14.9	15.0	-3.7	29.0
Central government expenditures	39.2	4.0	25.8	2.9
Money and quasi-money	21.9	6.8	18.1	13.9
Money	1.4	-1.3	22.3	35.8
Quasi-money	35.1	10.8	16.3	5.1
Net domestic assets of the banking system 2/	17.4	12.0	19.5	20.0
Credit to public sector (net)	7.0	5.0	10.6	5.0
Credit to private sector and other assets	10.4	7.0	8.9	15.0
Merchandise exports (f.o.b., in U.S. dollars)1/	-0.9	-18.3	-13.4	3.2
Merchandise imports (f.o.b., in U.S. dollars)1/	14.1	-6.0	-27.3	-19.5

Central government finances	1981	1982	1983	Est. 1984
	(millions of guaranies)			
Revenue	59,359	68,249	65,729	84,798
Expenditure	77,605	80,718	101,550	104,454
Current account surplus	5,392	3,109	-9,842	5,761
Overall surplus or deficit (-)	-18,246	-12,469	-35,821	-19,656
External financing (net)	5,027	6,628	16,758	12,848
Internal financing (net)	13,219	5,841	19,063	6,808
Balance of payments 1/	(millions of U.S. dollars)			
Merchandise exports (f.o.b.)	771.1	630.7	546.8	564.3
Merchandise imports (f.o.b.)	-1,603.4	-1,508.2	-1,097.8	-884.6
Services and transfers (net)	-618.2	-775.3	-680.9	-595.9
Balance on current and transfer accounts	-1,450.5	-1,652.8	-1,231.9	-916.2
Official capital (net)	101.6	233.2	268.7	144.5
Private capital (net)	1,444.6	1,555.9	1,124.6	757.1
Net errors and omissions (including short-term capital)	-44.5	-206.7	-424.4	-130.9
Change in banking system net reserves (increase -)	-53.2	125.4	65.7	170.5
Arrears	--	--	197.3	-25.0

International reserve position	Dec. 1981	Dec. 1982	Dec. 1983	Sept. 1984
	(millions of U.S. dollars)			
Central Bank (gross)	810.0	700.3	684.2	656.3
Central Bank (net)	780.2	663.2	617.0	509.3
Rest of banking system (net)	44.5	36.1	16.7	19.6

1/ Includes transactions related to Itaipu and Yacyreta binational entities and unrecorded trade flows.

2/ In relation to the stock of money and quasi-money at the beginning of the period.