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December 27, 1983

To: Members of the Executive Board

From: The Acting Scretary

Subject: Paraguay - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Paraguay. A draft decision appears on page 18.

This subject has been tentatively scheduled for discussion on Monday, January 16, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Kreis, ext. (5)8640.

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INTERNATIONAL MONETARY FUND

PARAGUAY

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983
Consultation with Paraguay

Approved by Eduardo Wiesner and Manuel Guitian

December 23, 1983

The 1983 Article IV consultation discussions with Paraguay were held in Asuncion during the period October 6-25, 1983.1/ The representatives of Paraguay in these discussions included the Ministers of Finance, Labor and Justice, Industry and Commerce, and Agriculture; the President of the Central Bank; the Executive Secretary of the Technical Planning Office; the President of the National Development Bank; the directors of the Central Bank; the chief executives of the largest public enterprises; and other senior officials. The mission was received by the President of the Republic, and met with representatives of the private sector and the banking system. The staff mission consisted of Eliahu S. Kreis (Head), Jose M.F. Braz, Ronald Johnson, Fredesvinda Pham, Roberto Ramaciotti (all WHD), and Hee Sue Koo (Secretary-WHD). The mission was assisted by Ignacio Tampe, the Fund resident representative in Asuncion.

The previous consultation discussions with Paraguay were held in August-September 1981. The relevant documents (SM/81/213 and SM/81/220) were considered by the Executive Board on November 25, 1981 (EBM/81/147).

I. The Economic Background

During the period 1976-81, real GDP increased at an average annual rate of more than 10 percent, largely as a result of the construction of the Itaipu hydroelectric project (built jointly with Brazil) and the starting of the Yacyreta hydroelectric project (developed jointly with Argentina); demand for Paraguayan goods and services related to these projects induced large private investments (mostly financed from abroad) in agriculture, construction, manufacturing, and services. However, economic activity began to weaken in mid-1981, and in 1982 real GDP declined by 5 percent (Table 1). The recession was in large part the consequence of the worldwide economic slowdown (including the difficulties in neighboring countries), a decline in world prices for Paraguay's exports, decreased activity at Itaipu, and delays in construction at

1/ Paraguay continues to avail itself of the transitional arrangements of Article XIV.

Yacyreta. Real GDP is estimated to have declined by a further 5 percent in 1983, as heavy rains and extensive flooding in May-June caused considerable damage to crops and livestock, destroyed roads and bridges, and hampered economic activity in general.

Table 1. Paraguay: Selected Economic Indicators

(Percentage changes)

	1979	1980	1981	1982	Est. 1983
Gross domestic product					
In current market prices	32.4	30.4	24.0	0.9	11.5
In constant 1977 prices	9.8	11.6	8.4	-5.0	-5.5
GDP deflator	20.6	16.8	14.4	6.2	18.0
Prices					
Consumer prices					
End of period	36.3	18.4	9.9	8.2	19.9
Average	28.8	23.3	14.5	6.5	14.3
Wholesale prices					
End of period	32.9	-1.9	19.6	-6.8	46.1
Average	26.3	7.8	12.2	3.5	20.5
Effective exchange rate 1/					
Nominal rate	-21.9	-28.7	-35.3	-46.7	-46.7 2/
Real rate	-10.0	-10.6	-9.6	-19.0	-22.5 2/

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

1/ Based on official exchange rates, trade weighted; a minus sign means appreciation.
2/ Actual changes during the first nine months of 1983 at annual rates.

Growth in the period 1979-81 was led by domestic investment (including the construction of Itaipu and Yacyreta), which rose in real terms at an annual rate of 15 percent and in relation to GDP from 37 percent in 1979 to 39 percent in 1981 (Table 2). National savings increased from 8 percent of GDP in 1979 to 14 percent of GDP in 1981, and thus the proportion of investment financed from abroad fell; the net use of foreign savings declined from 29 percent to 25 percent of GDP during that period.1/ In 1982 the rate of growth of investment in real terms

1/ In 1981 about 40 percent of total investment, and almost two thirds of the external current account deficit, was attributable to the operations of the binational entities.

Table 2. Paraguay: Savings and Investment

(As percent of GDP)

	1979	1980	1981	1982	Est. 1983
Gross national savings	8.1	11.7	13.8	11.8	6.9
Public sector	5.5	3.6	3.0	2.7	1.5
Private sector	2.2	6.5	10.6	9.4	5.6
Unclassified assets	0.4	1.6	0.2	-0.3	-0.2
Gross domestic investment	37.3	36.5	39.0	41.2	31.7
Public sector 1/	5.1	4.3	4.3	7.6	7.0
Private sector 2/	32.2	32.2	34.7	33.6	24.7
Excess (-) of domestic investment over national savings	-29.2	-24.8	-25.2	-29.4	-24.8
External financing					
Public sector	1.0	2.4	1.6	3.4	3.1
Private sector	32.6	25.8	24.5	24.7	19.7
Binational entities	22.0	20.7	24.5	26.6	21.0
Other 3/	10.6	5.1	-0.2	-2.0	-0.4 4/
Banks	-4.4	-3.4	-0.9	1.3	2.0
Loans and other	0.5	0.2	0.1	-0.9	0.4
Net international reserves (increase -)	-4.9	-3.6	-1.0	2.2	1.6

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

1/ Starting in 1982, the public sector includes operations of the new state petroleum enterprise, PETROPAR, and large investment projects for the construction of ACEPAR (steel plant) and INC (cement plant), both financed with foreign loans.
2/ Including binationals.
3/ Including errors and omissions.
4/ Including arrears.

slackened to only 1 percent, but investment continued to increase in relation to GDP (to more than 41 percent), as real GDP dropped. Investment is estimated to have slumped to less than 32 percent of GDP in 1983 (Chart 1). National savings have fallen sharply in the past two years, particularly in 1983, and the net external current account deficit has remained high.

The rapid increase in economic activity in the late 1970s brought the economy virtually to full employment by 1980-81. The market for skilled labor was very tight and shortages of unskilled workers were reported in certain areas. The economic downturn in the past two years has resulted in a marked deterioration of the employment situation, especially in the industrial and construction sectors. The unemployment rate rose from about 3 percent in 1981 to an estimated 11 percent by mid-1983. The authorities' successful efforts to maintain the domestic inflation rate at a relatively low level during 1981 and 1982 have been frustrated in the past year. The rate of increase in consumer prices exceeded 18 percent during the period September 1982-September 1983, compared with a 6 percent increase for the same period a year earlier.

Confronted with strong demand pressures coming from the binational projects, the Paraguayan authorities generally pursued prudent fiscal policies during the late 1970s. These policies resulted in increased public savings and the accumulation of government deposits in the Central Bank. Since mid-1980, however, the financial performance of the public sector has deteriorated markedly. Public sector savings in relation to GDP have declined from the equivalent of 5 1/2 percent in 1979 to an estimated 1 1/2 percent in 1983 (Table 3 and Chart 2). At the same time, the overall position of the public sector has shifted from a small surplus to a deficit estimated at 5 1/2 percent of GDP. While net foreign borrowing was more than sufficient to finance the overall public sector deficit in 1979-80, starting in 1981 an increasing share of the deficit has been financed by the Central Bank.

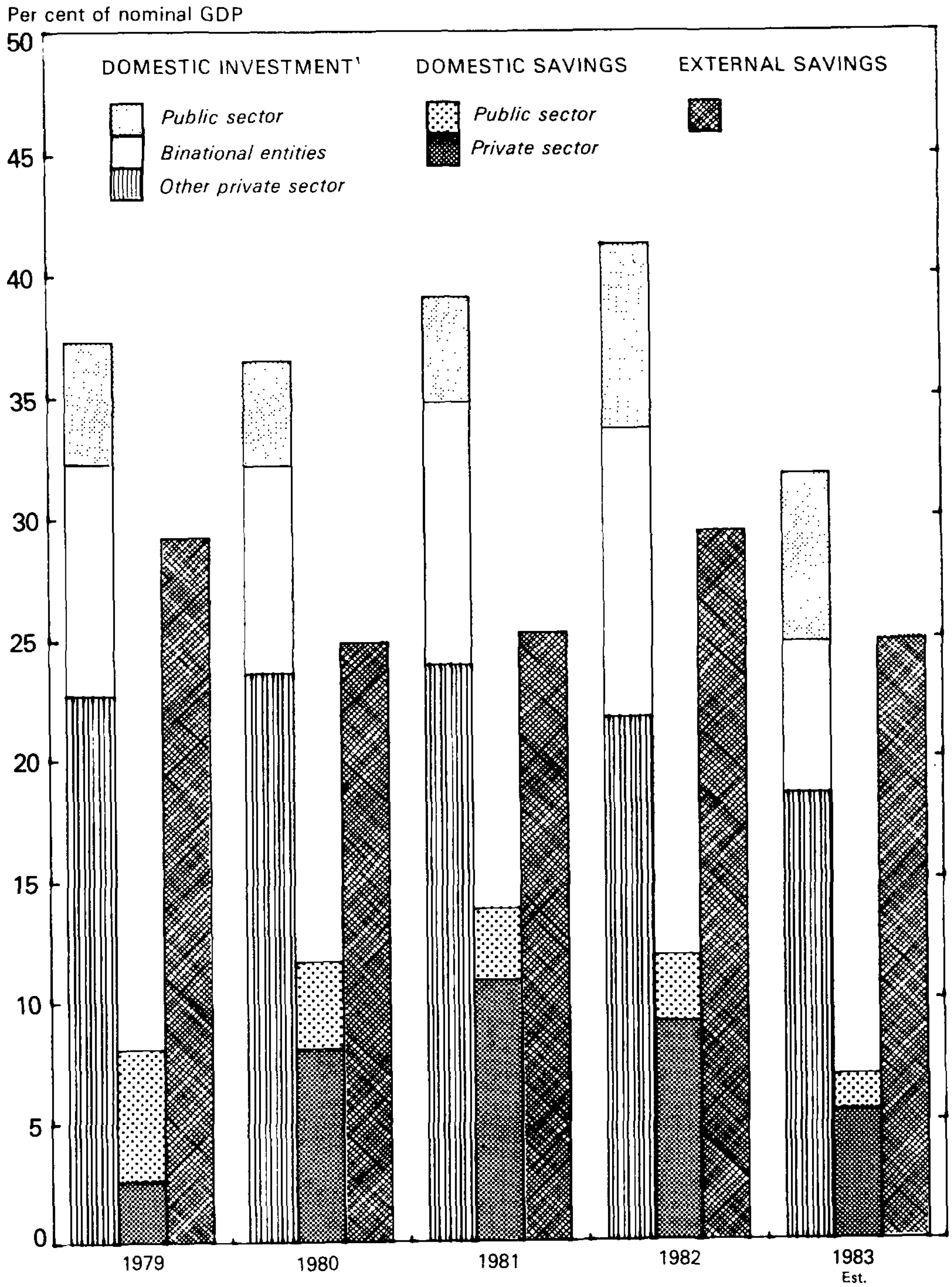
Central government revenue has declined from the equivalent of 10 percent of GDP in 1979 to 7.8 percent of GDP in 1983, while current expenditure has risen from 6 1/4 percent to 8 1/2 percent of GDP. Despite the adoption of a number of revenue measures in the past two years, in 1983 revenue collections are estimated to have fallen by 11 percent and current expenditure to have risen by 11 percent. Consequently, the balance on central government current operations has shifted from a surplus of 1 percent of GDP in 1982 to a deficit of 0.7 percent of GDP in 1983. Notwithstanding a 25 percent cut in capital outlays, the overall deficit is expected to reach almost 4 percent of GDP in 1983--more than double the deficit in 1982. It may be noted that some externally financed investment projects have been brought to a halt because local counterpart funds have not been available.

Paraguay's rapid growth and relative price stability were accompanied by increasing monetization of the economy for several years through 1981. The increase in the supply of loanable funds permitted

CHART 1

PARAGUAY

SAVINGS AND INVESTMENT



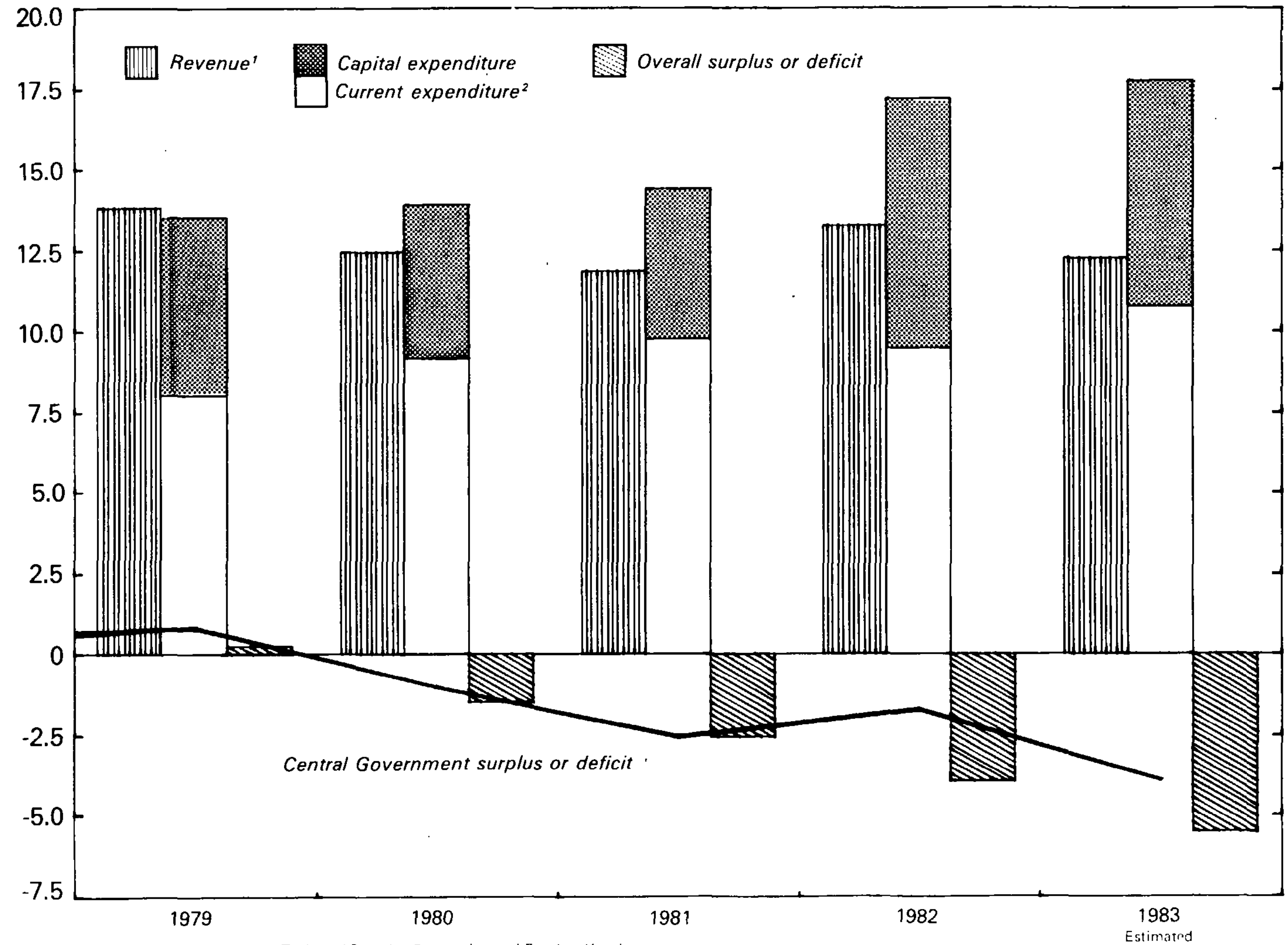
Sources: Central Bank of Paraguay; Itaipu and Yacyreta Binational Entities; and Fund staff estimates.
[1]Includes change in inventories.

CHART 2

PARAGUAY

PUBLIC SECTOR OPERATIONS

(In per cent of GDP)



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

[1] General government revenues plus current account surplus of state enterprises.

[2] Includes net lending.

Table 3. Paraguay: Summary of Public Sector Operations

(As a percent of GDP)

	1979	1980	1981	1982	Est. 1983	Proj. 1984
General government						
Revenue	12.0	11.1	10.4	11.5	10.3	...
Central Government	10.0	9.0	8.3	9.3	7.8	6.6
Rest of general government	2.0	2.1	2.1	2.2	2.5	...
Current expenditure	7.8	8.6	8.7	10.3	10.5	...
Central Government	6.2	7.0	7.1	8.3	8.5	7.6
Rest of general government	1.6	1.6	1.6	2.0	2.0	...
Current account surplus or deficit (-) 1/	4.2	2.5	1.7	1.2	-0.2	...
Central Government	3.8	2.0	1.2	1.0	-0.7	-1.0
Rest of general government	0.4	0.5	0.5	0.2	0.5	...
Consolidated current account public sector enterprises 1/	1.3	1.2	1.2	1.3	1.7	...
Consolidated public sector savings	5.5	3.7	2.9	2.5	1.5	...
Capital expenditure	5.5	4.8	4.6	7.7	7.1	...
Central Government	2.5	2.1	2.2	2.1	1.5	1.6
Rest of general government	0.6	0.6	0.6	0.6	0.6	...
Public enterprises	2.4	2.1	1.8	5.0 2/	5.0 2/	...
Net lending	-0.2	0.3	0.9	-1.2	-0.1	...
Consolidated public sector overall surplus or deficit (-)	0.2	-1.4	-2.6	-4.0	-5.5	...
Central Government 1/	0.8	-1.0	-2.6	-1.7	-3.9	-2.6
Rest of general government 1/	0.2	0.2	0.3	0.2	0.3	...
Public enterprises 1/	-0.8	-0.6	-0.3	-2.5	-1.9	...
Financing	-0.2	1.4	2.6	4.0	5.5	2.6
External	1.0	2.4	1.6	3.3	3.5	0.8
Internal	-1.2	-1.0	1.0	0.7	2.0	1.8

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

1/ After receipts from and transfer to the rest of the public sector.
2/ Includes the construction of the ACEPAR steel plant and INC cement plant, both financed with foreign loans.

a substantial credit expansion and an accumulation of net international reserves. The growing financial needs of the Government, combined with strong credit demands from the private sector, caused an acceleration of bank lending beginning in mid-1980. The annual rate of expansion of the financial system's net domestic assets (relative to the stock of private sector liabilities at the beginning of each year) went up from an average of less than 10 percent during the period 1977-79 to 17 percent during the next four years (Chart 3). Through 1981 the growth of private financial savings exceeded total credit expansion, but in 1982 and 1983 the growth of such savings has slowed sharply and lagged behind the increase in credit; as a result, there has been an erosion of the country's international reserve position.

Paraguay's overall balance of payments position remained strong in the period 1979-81 despite current account deficits averaging more than one fourth of GDP; these were more than covered by the large capital inflows related to the construction of the Itaipu and Yacyreta hydroelectric projects (Table 4). In 1982, for the first time in a decade, Paraguay registered an overall balance of payments deficit (US$70 million), as capital inflows of about US$1.6 billion were not sufficient to cover the increased current account deficit and private capital outflows. The overall balance of payments deficit is expected to widen to some US$1/4 billion in 1983, despite a sizable reduction in the current account deficit.

An important factor behind the recent deterioration of the balance of payments was a large real appreciation of the guarani, particularly in relation to Argentina and Brazil, which contributed to a decline of about 15 percent in total exports from 1979 to 1983. On a real effective trade-weighted basis and using the official exchange rate of ₲ 126 per U.S. dollar, the guarani is estimated to have appreciated by 106 percent from June 1979 to September 1983 (Chart 4). The large foreign exchange inflows associated with construction of the Itaipu project made it possible to maintain a strong balance of payments position, but with the phase-down of construction in this project a severe external payments imbalance has emerged in the past two years. Notwithstanding the increasing complexity of the multiple exchange rate system and the tightening of restrictions on imports in the past year and a half, the merchandise trade deficit has remained high, the official international reserves have declined, and substantial commercial payments arrears have accumulated.

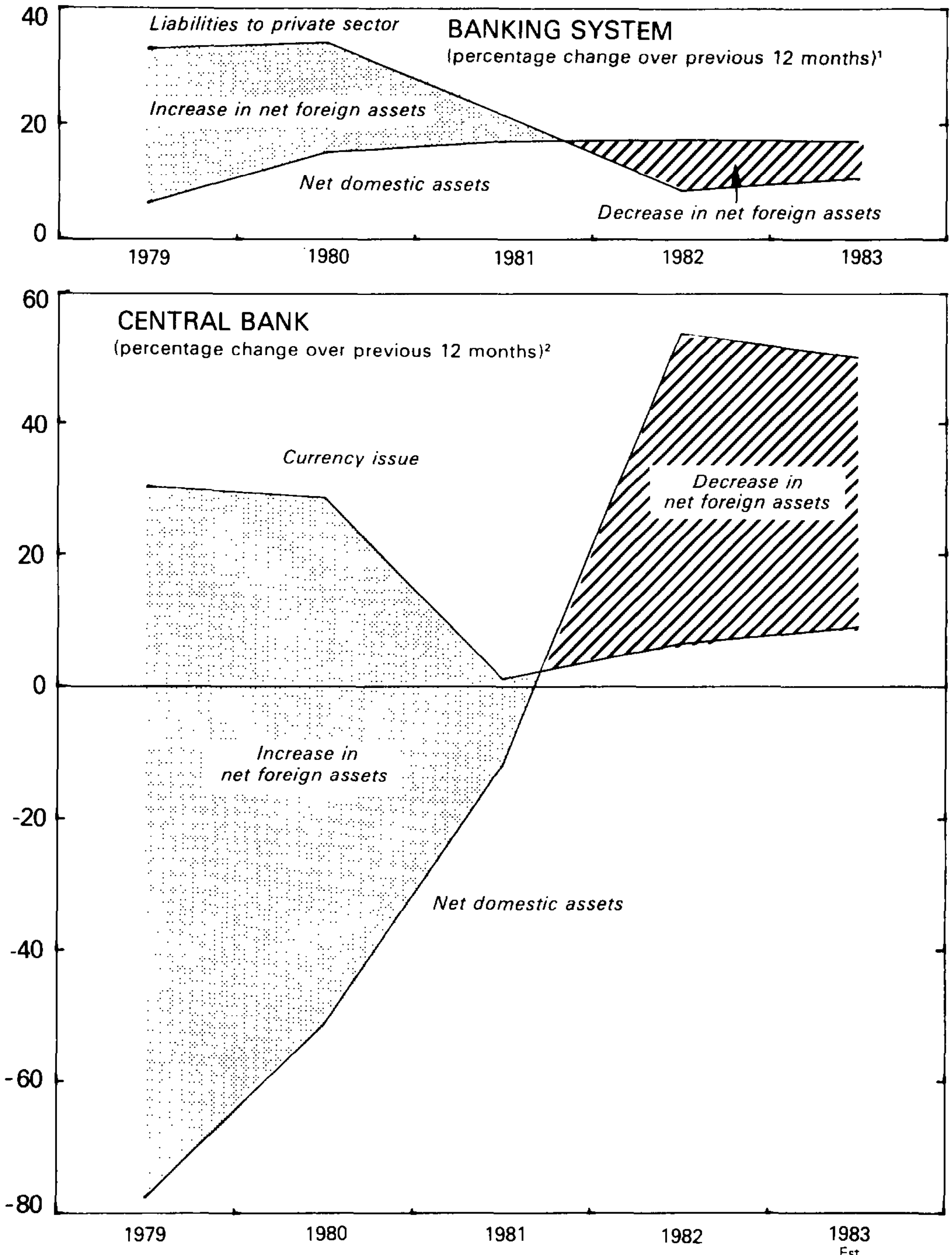
II. Report on Discussions

Paraguay's rapid economic growth during the period 1974-81 caused a major transformation of the economy, with an expansion of the traditional agricultural base and a substantial diversification into industrial, construction, and service activities. However, development of the needed economic and social infrastructure lagged and the policy framework in the fiscal, monetary, exchange and trade areas was not

CHART 3

PARAGUAY

MONETARY DEVELOPMENTS



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

[1]Changes expressed as percentage of liabilities to private sector at the beginning of the period.

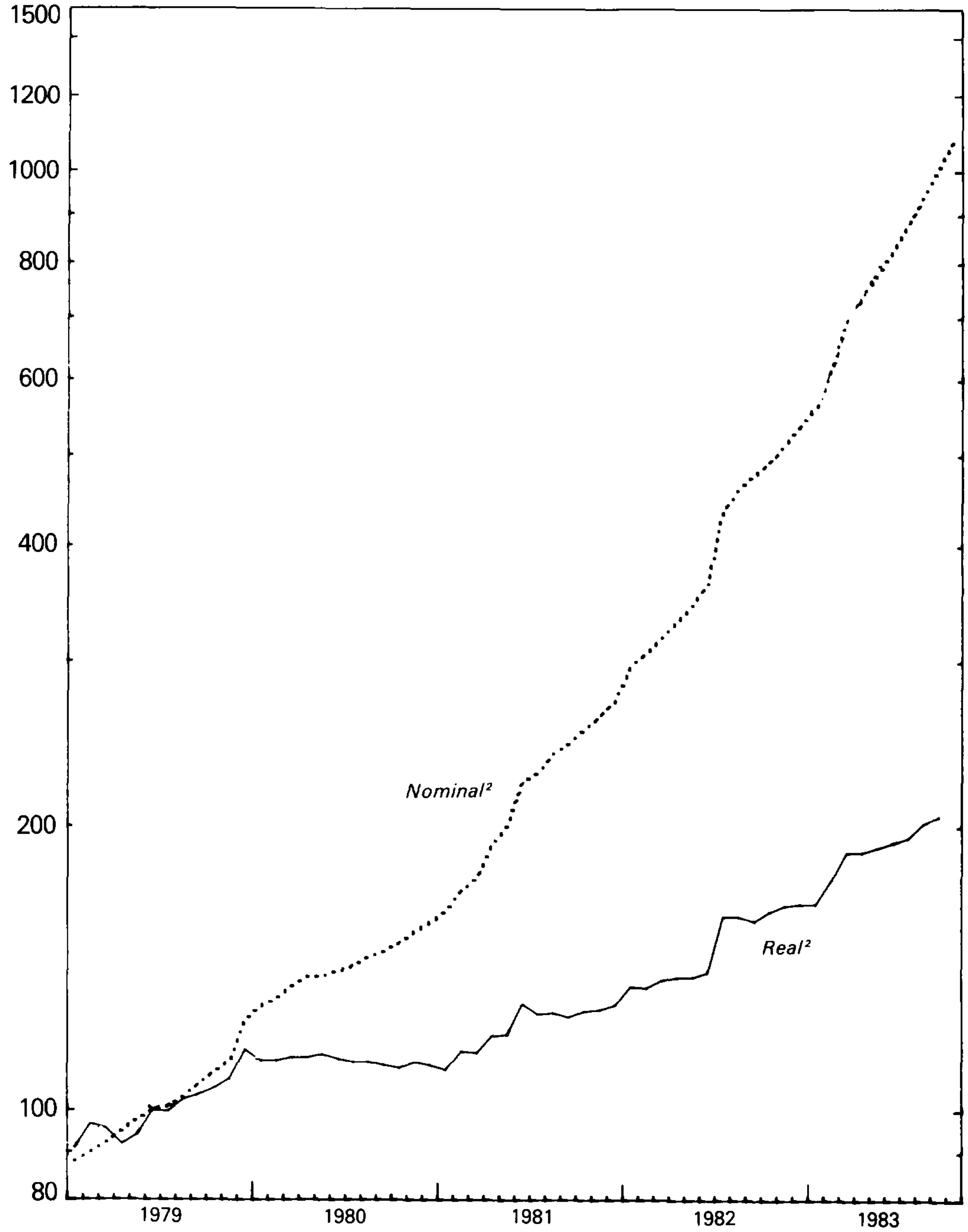
[2]Changes expressed as a percentage of currency issue at the beginning of the period.

CHART 4

PARAGUAY

EFFECTIVE EXCHANGE RATES[1]

(Jun. 1979 = 100)



Sources: Central Bank of Paraguay; and IMF, *International Financial Statistics* and *Direction of Trade.*

[1]Trade weighted.

[2]An increase in the value of the index represents an appreciation of the guarani.

Table 4. Paraguay: Balance of Payments

(In millions of U.S. dollars)

	1979	1980	1981	1982	Est. 1983
Current accounts	-1,017	-1,130	-1,423	-1,602	-1,240
Exports, f.o.b.	606	718	753	592	514
Of which: Itaipu and Yacyreta	79	88	103	66	66
Imports, f.o.b.	-1,309	-1,440	-1,559	-1,457	-1,062
Of which: Itaipu and Yacyreta	-332	-353	-565	-632	-323
Investment income (net)	-180	-229	-383	-516	-570
Of which: Itaipu and Yacyreta	-165	-223	-399	-524	-525
Other services (net)	-141	-184	-240	-238	-135
Transfers (net)	7	5	6	17	13
Capital transactions	1,188	1,293	1,476	1,532	977
Private sector	930	1,074	1,474	1,432	758
Direct investment	27	-7	23	32	27
Long-term loans	833	1,012	1,411	1,498	1,046
Of which: Itaipu and Yacyreta	789	969	1,395	1,518	1,057
Trade credit and short term	70	69	40	-98	-315
Public sector	47	119	102	233	219
Allocation of SDRs	3	3	--	--	--
Errors and omissions	208	97	-100	-133	--
Overall balance	171	163	53	-70	-262
Arrears	--	--	--	--	160
Net international reserves (increase -)	-171	-163	-53	70	102
Memorandum items					
(As percent of GDP)					
Current account balance	-29.2	-24.8	-25.2	-29.4	-24.8
Exports, f.o.b.	17.4	15.8	13.4	10.8	10.3
Imports, f.o.b.	-37.5	-31.6	-27.6	-26.7	-21.3
Terms of trade (percentage changes)	-9.1	-10.6	-2.8	-7.1	-4.6
Export prices	8.7	7.0	1.8	-7.6	-6.9
Import prices	19.8	19.5	4.7	-0.6	-2.4

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

adapted to the new economic environment. Moreover, in the past two years economic management has been complicated by the recession and the emergence of severe financial imbalances. In this situation, the discussions focused on how to improve the fiscal and international reserve performance and how to restore the competitive position of Paraguayan producers and improve resource allocation, thereby re-establishing the bases for substained growth.

The authorities felt that the deterioration of the economic situation in the past two years was for the most part the result of developments beyond their control. They explained that they had maintained essentially the policies which had been successful for about a decade, and that changes in external conditions--including lower international prices and reduced foreign demand for Paraguay's exports, construction delays at Yacyreta, and high interest rates in international financial markets--were responsible for the recession in Paraguay. Moreover, the sharp drop of economic activity in Brazil and Argentina and the large real depreciations in these countries had severely eroded the competitiveness of Paraguay's exports and reduced tourism from these countries. The continuation of the downturn into 1983 also reflected the losses of production, especially in the agricultural sector, resulting from extensive flooding in May/June; such losses led to scarcities of foodstuffs, and contributed to a pickup of inflation.

The authorities acknowledged that the worsening in the fiscal performance and the attendant weakening of monetary policy also had contributed to the emergence of internal and external imbalances, including the intensification of inflationary pressures and the drain in the international reserves. Moreover, they recognized that failure to adjust the exchange rate in the face of a fundamental change in external circumstances had compounded the balance of payments problems and had unfavorable effects on domestic production.

The authorities were confident that economic conditions will improve in 1984. Resumption of economic growth was predicated on a rebound in agricultural production, an improvement in the terms of trade, and an increase in exports. The income gains resulting from these developments should increase domestic demand for industrial goods and services and help revive activity in these sectors, as would the expected resumption of construction at Yacyreta. Accordingly, the authorities project a substantial increase of output in 1984. At the same time, the increase in food supplies, the maintenance of a prudent wage policy, and some tightening of fiscal policy are expected to reduce inflation to a moderate level.

1. External sector policies

After three years of rapid increase, the deficit in the current account of the balance of payments narrowed to an estimated US$1 1/4 billion in 1983 from US$1.6 billion in 1982. However, because this reduction resulted entirely from the reduction in imports by the binational entities, which are self-financed, there was an equivalent decline in long-term capital inflows. Excluding the operations of these entities, the current account position deteriorated further in 1983 as export receipts fell by an estimated 15 percent, while imports declined by only 10 percent and net service payments other than those related to the binational entities rose. At the same time, short-term capital outflows intensified substantially, resulting in an overall balance of payments deficit estimated at more than US$1/4 billion, of which some US$160 million took the form of an accumulation of payments arrears.

The authorities expressed concern about the loss of international reserves and recognized that it was in part a result of the overvaluation of the guarani in the official exchange market. It may be noted in this regard that Paraguay has maintained an official exchange rate of ₲ 126 per U.S. dollar since 1960. To be sure, a free exchange market was legalized in March 1973 and an increasing proportion of exchange transactions was handled in this market, in which the rate fluctuated in the range of ₲ 134-145 per U.S. dollar for several years through mid-1981. Following a sharp depreciation of the guarani in the free market, a further transfer of transactions from the official to the free market in September 1981 raised the share of transactions going through the latter to 70 percent of the total.

As the guarani depreciated in the free market to the neighborhood of ₲ 200 per U.S. dollar, in July 1982 the authorities fixed the rate in that market at ₲ 160 per U.S. dollar. Through a series of steps mostly aimed at assisting exports, the exchange system has come to consist in practice of seven different exchange rates ranging from ₲ 126 to ₲ 230 per U.S. dollar. Under a system of reference prices (aforos) for surrendering export receipts, at levels substantially below world market prices, exporters are allowed to sell an increasing share of receipts in the (illegal but tolerated) parallel market, where in recent months the exchange rate reportedly has fluctuated between ₲ 330 and ₲ 430 per U.S. dollar. As the Central Bank's international reserves remained under downward pressure, in September 1982 the authorities established priorities for processing import requests (a de facto system of import and exchange controls), with a foreign exchange rationing scheme which has resulted in a buildup of commercial payments arrears.1/

Additional multiple currency practices exist in the form of taxes and commissions on sales of foreign exchange in the official market and exchange taxes on remittance of profits, dividends, and earnings. Moreover, the trade system is characterized by an array of duties, surcharges, commissions, and advance import deposits. Finally, on July 19, 1983 the Paraguayan authorities signed an agreement with the Central Bank of Brazil, whereby all Itaipu-related payments during the following

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1/ A detailed description of changes in the exchange and trade system since the last consultation discussions is provided in Section V and Appendix C of the recent economic developments paper.

two years are to be denominated in U.S. dollars but tied to purchases of Brazilian exports or the servicing of Paraguay's debt with Brazil. This practice is a bilateral trade and payments agreement and, as such, constitutes an additional payments and trade restriction.

The authorities acknowledged that Paraguay's complex exchange and trade system and the overvaluation of the currency had adverse effects on economic activity and the balance of payments, but argued that resort to such measures was forced on them by external developments, particularly in neighboring countries. Increased reliance on multiple exchange rates and import restrictions had been an ad hoc response aimed at protecting the domestic economy from disruptions caused by such developments. They also noted that the official exchange rate of ₲ 126 per U.S. dollar had become a symbol of price stability, and adjusting that rate--in the present unsettled economic conditions--would carry the the risk of initiating an inflationary spiral. In any case, it was their intention eventually to unify the exchange rates, to phase out exchange and trade restrictions, and to simplify the system of taxes and levies on external trade.

Nevertheless, the authorities said that under present political circumstances a formal devaluation of the guarani had to be ruled out. Instead, for the time being they would attempt to stem the loss of international reserves by a gradual depreciation through transfers of transactions among the various segments of the exchange market and, if need be, by resorting to a further intensification of imports restrictions and a curtailment of foreign exchange sales by the Central Bank. They expected to be able to maintain the competitiveness of the export sector by relying on the multiple exchange regime and lowering export reference prices.

In any event, the authorities were counting on an improvement in the external environment, including in the terms of trade, to provide relief for the external payments position in 1984. They expected the prices of Paraguay's principal exports (cotton and soybeans) to increase by as much as 30 percent, and noted that the volume of such exports would increase on the basis of expanded plantings. Interest and other net service payments were not expected to rise much, and net capital inflows were projected to increase by about US$180 million. Thus, the authorities thought there were good prospects that the overall balance of payments would be in equilibrium in 1984.

The stock of public sector external debt outstanding at the end of 1983 is estimated to be about US$1 1/4 billion, equivalent to 20 percent of GDP, up from 17 percent at the end of 1979 and less than 15 percent at the end of 1981.1/ The public debt service ratio, which had averaged about 12 percent in 1979-81, rose to 26 percent in 1983 as export earnings declined and greater use was made of loans on commercial terms. Meanwhile, total debt service payments (public and private)

1/ At the official exchange rate.

rose from 19 1/2 percent of total exports of goods and services in 1979 to 41 percent in 1983 (Table 5). Despite the increased reliance on commercial financing, the structure of the debt remains favorable, with only one seventh of the total maturing in less than five years. The authorities said that because of the high debt service burden, they are aiming at curbing new borrowing from commercial banks. However, considering the need for public sector investment in economic and social infrastructure, the country's potential for agricultural production for export, and the expectation of large royalties from Itaipu starting around 1987, they felt that it would be appropriate to resort to additional foreign borrowing, especially from bilateral and multilateral sources.

2. Demand management

a. Monetary policy

The monetary program for 1984 calls for constraining in the increase in net domestic assets of the Central Bank to a level consistent with the objectives of keeping the inflation rate at no more than 15 percent and achieving overall balance of payments equilibrium. Accordingly, Central Bank financing of the Government is to be limited to ₲ 15 billion, and a portion of the public sector's deposits in the commercial banks would be transferred to the Central Bank. As regards credit to the private sector, the program calls for the special rediscount facility for agricultural and industrial loans to be reduced from 40 percent to 30 percent of the outstanding commercial bank's portfolio of such loans; this facility--which carries an interest rate of 8 percent--had been raised from 30 percent to 50 percent in July 1983 and lowered to 40 percent in October.

The authorities expressed concern about the soundness of the financial system. They noted that the increasing balance of payments difficulties have raised fears of a possible nationalization or freezing of bank deposits in foreign currency and have induced withdrawals of such deposits amounting to over US$100 million since August 1982. Furthermore, the economic recession and the recent natural disasters have weakened the financial position of many firms. As a consequence, the ratio of nonperforming loans of the commercial banks has risen from less than 10 percent of the total portfolio at the end of 1981 to almost 25 percent in August 1983, an amount equivalent to 90 percent of the banks' capital and reserves. Banks have restructured a large volume of loans and have been increasingly cautious in extending new credits, with the result that the expansion of credit to the private sector during the first eight months of 1983 was moderate.

Interest rates in Paraguay are subject to a 12 percent limit, but in practice effective loan rates are much higher because financial institutions are permitted to assess commissions, advance interest payments, and service charges, with the result that real effective rates have been generally positive; commissions alone range from 6 percent to

Table 5. Paraguay: Medium- and Long-Term External Public Debt

(In millions of U.S. dollars; end of period)

	1979	1980	1981	1982	Est. 1983	Proj. 1984
Outstanding external public debt 1/	593.7	708.8	808.6	1,037.3	1,253.2	1,425.0
International organizations	262.4	301.3	344.6	391.6	442.9	...
Government loans	136.7	134.2	136.8	243.5	317.8	...
Suppliers' credits	57.0	85.4	82.8	83.1	69.8	...
Other	137.6	187.8	244.4	319.1	422.7	...
Public debt service payments	74.6	87.6	81.5	87.2	135.7	184.6
Amortization	47.0	52.6	46.9	45.4	58.9	96.2
Interest	27.6	35.0	34.6	41.8	76.8	88.4
Ratios (in percent)						
Total debt/GDP 2/	17.0	15.6	14.4	18.2	19.8	17.6
Debt service/exports of goods and nonfactor services	12.0	11.7	10.7	14.1	26.3	24.1
Interest payments/exports of goods and nonfactor services	4.4	4.7	4.6	6.8	14.9	11.6
Memorandum items						
Debt service of private sector 3/	46.8	89.8	121.8	127.5	76.2	79.0
Interest	23.8	33.3	55.6	52.3	35.0	35.0
Debt service of public and private sectors/export of goods and nonfactor services (in percent)	19.5	23.6	26.7	34.7	41.1	34.4
Of which: private sector	7.5	11.9	16.0	20.6	14.8	10.3

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

1/ Outstanding disbursed official and officially guaranteed private debt with maturity exceeding one year.
2/ Debt converted at the official exchange rate.
3/ Registered private sector debt service payments.

12 percent at commercial banks and from 6 percent to 18 percent at finance companies (financieras).1/ However, with the pickup of inflation in 1983, real interest rates--both effective rates on loans to productive sectors and rates paid to savers--became negative. The authorities indicated that they intend to review interest policies in light of developments in domestic prices and economic conditions.

The authorities noted that, even though legal reserve requirements were raised to 12 percent for nonbank financial institutions in 1981, the commercial banks are still at a comparative disadvantage vis-a-vis these institutions, since they are subject to 42 percent legal reserve requirements on sight and savings deposits and 30 percent on time deposits. Thus, the Central Bank is considering raising gradually the minimum reserve requirements on finance companies as economic conditions improve and the growth of financial savings returns to positive real rates.

b. Fiscal policy

The authorities said that the steady weakening of the overall financial position of the public sector in the 1980s reflected mostly a decline in tax collections due to the low level of domestic activity and imports as well as to a spreading of tax evasion. Initially they had viewed the emerging fiscal deficit as a means to counter the softening of economic activity, but had reassessed their aims in light of the acceleration of inflation and the loss of net international reserves. Accordingly, corrective measures were adopted in 1982 and early 1983. These measures had not proved to be sufficient to arrest the increase in the deficit, however, partly because of unforeseen expenditure in 1983 to provide relief in areas affected by natural disasters. The authorities were determined to prevent a further widening of the fiscal deficit and to eliminate domestic financing requirements as economic growth resumes.

The proposed 1984 budget--now being considered by Congress--provides for a reduction in the central government deficit from 3.9 percent of GDP in 1983 to 2.6 percent of GDP in 1984. On the revenue side, the budget provides for the unification of the existing three sales tax rates and a broadening of this tax to include services. Moreover, the personal income tax law (which had been approved in 1971 but left in abeyance) would be implemented, at least for self-employed professionals. On the expenditure side, the budget sets a limit of 7 percent to the rise in current expenditure in 1984, with no allowances for increases in wages or in purchases of goods and services, notwithstanding a 20 percent increase in prices in 1983 and a further increase of 15 percent projected for 1984. Most of the projected spending increase is accounted for by interest payments and transfers to decentralized agencies. The operations of public sector enterprises are projected at an overall deficit of about 1 percent of GDP, which will be financed with foreign loans.

1/ Interest charges on loans to the productive sectors are limited by law to 14 1/2 percent, of which 10 percent is interest payments and 4 1/2 percent commission.

The authorities noted that the margin to reduce further current expenditure beyond 1984 will be limited, and the increase in public sector savings that is needed to finance the development of the country's infrastructure over the medium term would seem to require additional measures on the tax side. In this respect, it was noted that Paraguay's tax burden has dropped substantially since 1979 and is one of the lowest in Latin America. To a large extent, the recent behavior of revenue has reflected the archaic and complex structure of the tax system, an increasing number of tax exonerations, and a growing incidence of unregistered trade and tax evasion.

Recognizing these problems, the authorities embarked recently on a comprehensive tax study with the aim of reducing the reliance on external sector taxes and making the tax system more responsive to changing economic conditions. One proposal currently being analyzed is a new customs duty structure that would tax each product according to its use, the degree of industrial processing, and the extent to which it competes with domestic industry. The new tariff schedule would provide Paraguay with a flexible tool to adjust the level of protection and would aim at reducing the steadily growing unregistered border trade. In general, the aim of the overall study would be to simplify the tax structure, broaden the base of certain dometic taxes, and lower the overall rates in order to improve tax administration and increase revenues.

c. The public sector investment program

The stated policy of the Government has been that the main thrust of development should come from the private sector and that the role of the public sector in the economy should be diminished over time. The role of the public sector has been limited to providing social services, basic infrastructure to facilitate private sector development, and technical assistance to the productive sectors, particularly agriculture. Nevertheless, as the expansion of the economy in the 1970s created greater demand for public services and the expansion in the country's infrastructure raised maintenance costs, the central government current expenditure rose from 6 1/4 percent of GDP in 1979 to 8 1/2 percent of GDP in 1983. Since government revenue in relation to GDP fell, as explained above, the brunt of attempts to curb deterioration of the overall fiscal position in the past three years fell principally on capital outlays. As a result, many infrastructure facilities are reported to be lagging behind the rapidly growing needs of the private sector, which invested heavily in agriculture and industry during the 1970s.

At the same time, the public sector has become active in certain directly productive activities and total public sector investment in relation to GDP actually rose significantly in 1982-83. This reflected the expansion of government-owned facilities to produce cement and alcohol, the construction of a charcoal based steel plant, and the takeover of the country's petroleum refining and distribution system.

There are indications that decisions to expand into these activities were not always based on financial and economic criteria, and it appears that the Government's financial resources have been stretched to the point that the ability to undertake other priority investment projects has been impaired. Furthermore, large cost overruns and operational inefficiencies rendered doubtful the contribution of such projects to the economy. The authorities explained that they ventured into these industries because of their strategic significance and after it became evident that the private sector could not raise the large sums needed or was not in a position to keep existing facilities in operation. They added that the private sector has a minority participation in the steel and petroleum industries, and that the Government does not intend to expand further into fields in which the private sector is active.

The mission reviewed with the authorities the policy formulating process in the public investment area. Notwithstanding the support received from international organizations, coordination and implementation of public investment projects appears to be hampered by a shortage of qualified professional staff both in the Planning Office and in the execution agencies. The authorities are aware of these deficiencies and have established a new programing unit at the Ministry of Finance with assistance from the UNDP and the World Bank.

III. Staff Appraisal

Paraguay's economy developed satisfactorily during the period 1976-81 when real GDP grew at an average annual rate of more than 10 percent. However, by mid-1981 economic activity began to slacken, and real GDP declined by about 5 percent in both 1982 and 1983. The deterioration in growth performance was accompanied by a substantial worsening in the fiscal and balance of payments positions and in the behavior of prices.

The authorities expect a substantial economic recovery in 1984, together with a slowing of inflation and some improvement in the central government finances and in the external position. In particular, the authorities expect the deficit in the current account of the balance of payments to narrow, which, together with higher capital inflows related to the resumption of work at Yacyreta, would make it possible to avoid any further decline in net official international reserves. It is the view of the staff that the authorities' expectations with regard to the economy's performance in 1984 are too sanguine. To be sure, if the international environment continues to improve, a recovery of output and real income would be possible. However, achievement of sustained growth will depend on the elimination of major imbalances and distortions in the Paraguayan economy.

There is little doubt that the emergence of internal and external imbalances in the past few years has been a reflection of the worsening fiscal situation, and a substantial improvement in the public finances is therefore essential on both stabilization and growth considerations. In the view of the staff, the measures envisaged in the proposed budget for 1984 are in the right direction but do not go far enough. More decisive action to reduce the fiscal deficit is needed to assure the improvement in credit and monetary control that is essential to deal with the inflation problem and to protect the international reserves.

As regards the growth implications of fiscal policy, it seems that recent cuts in capital outlays by the Central Government--as well as delays in the implementation of foreign-financed investment projects because of insufficient domestic counterpart funds--have had adverse consequences for the development of the country's economic infrastructure, with unfavorable repercussions for private sector growth. The staff believes that a return to the public sector savings performance that Paraguay experienced for several years through 1980 (when such savings were of the order of 4-5 percent of GDP) would be needed to support an increase in productive capacity in accordance with the Government's stated development objectives. Although foreign savings may be expected to finance part of the additional investment, it is obvious that they can only be relied upon to complement domestic resources, not to replace them. It is also important that all public sector investment decisions be subjected to the most rigorous scrutiny.

The staff shares the authorities' view that the scope for a cutback in current government expenditure is limited. Since the tax burden in Paraguay is relatively low, it would seem that the needed improvement in public sector savings should be pursued largely through increases in taxation. Thus, the staff strongly recommends a comprehensive restructuring of the tax system, including the broadening of the base of certain taxes, implementation of the existing income tax legislation, reduction of excessive tax rates, and improved tax administration. One objective of the reform should be the elimination of distortions caused by heavy reliance on the taxation of external transactions. Specifically, export and exchange taxes should be abolished, import taxes consolidated, and a schedule established for the reduction of import duties.

Problems of monetary management have become more acute in recent years because of the rising financial needs of the public sector, the growing financial difficulties of the nonfinancial private sector, and the slowdown in the growth of private sector financial savings that stemmed from the erosion of confidence in the currency. As noted, a reduction of the financial requirements of the public sector would facilitate the tightening of credit policy that is needed to achieve the desired improvement of the balance of payments. Such an objective also would be fostered by the removal of existing interest rate ceilings, which discourage the channeling of savings to the domestic banking system. In addition, the rediscount facilities of the Central Bank should carry interest rates that reflect conditions in the financial markets.

The Paraguayan exchange and trade system is characterized by a multiplicity of overvalued exchange rates and widespread trade and payments restrictions. The staff considers that the best way to deal with Paraguay's balance of payments and economic problems would be the unification of the exchange rate at a level equivalent, as a minimum, to the present average rate for all transactions (including those in the parallel market), together with the removal of all restrictive exchange and trade practices. This is also the ultimate aim of the authorities. Still, the staff would point out that the success of such an approach would be enhanced by implementing it before Paraguay's official international reserves are exhausted. Concerning the fear that currency adjustment would lead to inflation, the staff would note that most domestic prices probably already reflect the exchange rate in the parallel market.

The exchange policy approach that the authorities are inclined to follow in the short run--i.e., a depreciation achieved through the gradual transfer of transactions among segments of the exchange market, accompanied by the maintenance or even the intensification or restrictive practices--might help protect the balance of payments provided that the movement is substantial and is not delayed. However, this approach would not address the problem of distortions in the allocation of resources and thus would not be satisfactory from the viewpoint of economic growth.

In the view of the staff, the authorities would be well advised to begin to dismantle restrictive trade practices. In this respect, an early start should be made toward the abolishment of the system of priorities for import payments and the prior import deposit requirements. Furthermore, the authorities should eliminate external payments arrears and seek to terminate the bilateral agreement which has been introduced recently. There is clear evidence that reliance on these kinds of devices to delay the necessary adjustment measures has not served Paraguay well. At present, economic policies do not give sufficient assurance that the restictions can be regarded as temporary and, therefore, Board approval of Paraguay's multiple currency practices and exchange restrictions does not seem warranted and is not being proposed.

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

IV. 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 1983 Article XIV Consultation with Paraguay in the light of the 1983 Article IV consultations 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.

Fund Relations with Paraguay

Date of membership:	December 28, 1945.		
Status:	Article XIV.		
Quota:	SDR 34.5 million at present, new quota SDR 48.4 million.		
Fund holdings of Paraguayan guaranies:	As of November 30, 1983	Millions of SDRs	Percent of Quota
	Total currency holdings	5.73	16.61
SDR position:	Holdings amount to SDR 33.89 million of 247 percent of net cumulative allocation of SDR 13.70 million.		
Direct distribution of profits from gold sales:	US$0.3 million		
Gold distribution:	16,260.994 fine ounces in four distributions.		
Exchange rate:	Paraguay has a complex multiple exchange rate system, in which there are seven separate exchange rates ranging from ₲ 126 per U.S. dollar, which is the official pegged rate, to ₲ 230 per U.S. dollar, depending on transaction type. In addition to the official market, a significant amount of transactions are channeled through the unofficial market in which the exchange rate fluctuates freely.		
Trust Fund:	Paraguay was eligible to receive Trust Fund assistance but did not qualify for it.		
Last consultation (Article IV):	The last article IV consultation discussions with Paraguay were held in Asuncion from August 25-September 10, 1981 (SM/81/213). The Executive Board's decision in concluding the 1981 Article IV consultation with Paraguay (EBM/81/147) was as follows: 1. The Fund takes this decision relating to Paraguay's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1981 Article XIV consultation with Paraguay, in the light of the 1981		

Article IV consultation with Parguay conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction the authorization for the commercial banks to operate in the free exchange market, the transfer of additional trade transactions to the free market and the elimination of some taxes on exports. The Fund urges the authorities to take further steps toward the unification of the exchange markets and the removal of multiple currency practices as described in SM/81/220.

Paraguay--Basic Data

Area and population	
Area	406,752 sq. kilometers
Population (mid-1982)	3.37 million
Annual rate of population increase (1972-82)	2.9 percent
GDP per capita (1982)	SDR 1,574
Origin of GDP (1982)	(percent)
Agriculture	20.3
Livestock	6.8
Forestry	3.1
Manufacturing	15.7
Construction	7.4
Of which: Itaipu and Yacyreta	1.4
Transportation and communications	3.6
Commerce and finance	25.4
General government	4.4
Other	13.3
Ratios to GDP (1982)	
Exports of goods and nonfactor services 1/	13.0
Imports of goods and nonfactor services 1/	31.5
Central government revenues	9.5
Central government expenditure	11.3
External public debt (end of year)	18.2
Savings	11.8
Investment	41.2
Money and quasi-money (end of year)	26.7

Annual changes in selected economic indicators	1980	1981	1982	Est. 1983
		(percent)		
Real GDP per capita	8.1	5.1	-7.8	-8.3
Real GDP	11.6	8.4	-5.0	-5.5
GDP at current prices	30.4	24.0	0.9	11.5
Domestic expenditures (at current prices)	26.3	22.5	1.2	7.9
Investment	27.7	32.7	6.5	-14.2
Consumption	25.7	18.1	-1.4	19.8
GDP deflator	16.8	14.4	6.2	18.0
Cost of living (annual averages)	23.3	14.5	6.5	14.3
Central government revenues	14.8	15.3	14.6	-8.8
Central government expenditures	38.7	34.9	4.0	15.8
Money and quasi-money	33.7	21.9	6.8	12.9
Money	26.5	1.4	-1.3	10.2
Quasi-money	37.1	32.9	11.7	14.1
Net domestic assets 2/	22.6	22.9	15.1	18.6
Credit to public sector (net)	1.1	6.9	4.9	12.7
Credit to private sector	29.6	17.0	9.1	7.9
Merchandise exports (f.o.b., in U.S. dollars) 1/	18.4	4.8	-21.4	-13.1
Merchandise imports (f.o.b., in U.S. dollars) 1/	10.0	8.3	-6.6	-27.1

Central government finances	1980	1981	1982	Est. 1983
	(millions of guaranies)			
Revenue	51,641	59,539	68,249	62,262
Expenditure	57,520	77,605	80,718	93,464
Current account surplus	9,040	5,392	3,109	-10,198
Overall surplus or deficit (-)	-5,879	-18,246	-12,469	-31,202
External financing (net)	10,508	5,027	6,628	14,364
Internal financing (net)	-4,629	13,219	5,841	16,838
Balance of payments 1/	(millions of U.S. dollars)			
Merchandise exports (f.o.b.)	718	753	592	514
Merchandise imports (f.o.b.)	-1,440	-1,559	-1,457	-1,062
Investment income (net)	-229	-383	-516	-570
Other services and transfers (net)	-179	-234	-221	-122
Balance on current and transfer accounts	-1,130	-1,423	-1,602	-1,240
Official capital (net)	119	102	233	219
Private capital (net)	1,075	1,474	1,432	759
Allocation of SDRs	3	--	--	--
Net errors and omissions (including short-term capital)	98	-100	-133	--
Change in banking system net reserves (increase -)	-165	-53	70	102
Arrears	--	--	--	160

International reserve position	Sept. 30 1982	Dec. 31 1982	Sept. 30 1983
	(millions of SDRs)		
Central Bank (gross)	702.6	634.9	603.2
Central Bank (net)	636.1	601.3	562.8
Rest of banking system (net)	23.9	34.6	42.2

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.