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IMF Concludes Article IV Consultation with Paraguay

The IMF Executive Board on October 10, 1997 concluded the 1997 Article IV consultation[1] with Paraguay.

Background

Paraguay generally followed prudent financial policies in recent years, which helped reduce inflation and maintain a comfortable level of international reserves. Nevertheless, and in part due to the slowness to implement structural reforms, growth of real GDP was subdued, barely keeping pace with that of the population.

In 1996, a poor performance in agriculture and the adverse effects on domestic demand of a banking crisis in the previous year resulted in GDP growth of only 1.3 percent, compared with 4.7 percent in 1995. Although agricultural production and therefore economic activity rebounded in the early months of 1997, prospects were dampened by the unfolding of a new banking crisis, as in June the Central Bank intervened in three financial institutions including the largest domestic private bank. GDP growth for 1997 is projected at 3.5 percent. Consumer price inflation declined to 8.2 percent in 1996, and is projected to subside further to 8 percent in 1997.

The overall surplus of the nonfinancial public sector declined by almost 1 percent of GDP to about 1 ½ percent in 1996 and is expected to deteriorate further to zero in 1997. Contributing factors behind the deterioration were a slackening of tax collection in the central government, the growth of the wage bill across the whole public sector, and a decline in 1997 in the surplus of the

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

social security system. The latter was due to financial investments the system made on account of its exposure to banks in difficulties. Public sector savings declined by about 1 ½ percent of GDP in 1996 and are projected to decline by another percentage point in 1997. Although the decline in savings had a dampening effect on public sector investment and net lending in 1996, the authorities project that these outlays will recover in 1997.

In June 1997, the central bank intervened in the largest domestic private bank (with 8 percent of the banking system's deposits) and two other financial institutions. In the resulting upheaval, the banking system experienced a loss of deposits, while there was a significant shift to quality/safety inside the system as depositors moved their funds from domestic to foreign owned banks. During June, the central bank provided assistance to the financial system equivalent to 1.2 percent of GDP, bringing total such assistance since 1995 to 5 percent of GDP. Liquidity conditions were maintained through the use of open market operations and a moderate loss of international reserves. As of October, the payments situation has returned to normal, although no solution has been found for the intervened banks.

Official international reserves remained virtually unchanged in 1996 at about US$1.1 billion, but began to decline in 1997 as the central bank extended support to the financial system. Although it is difficult to analyze external sector developments because of a large volume of unregistered trade and general unreliability of the data, IMF staff estimates show a current account deficit broadly unchanged in 1995-96, at slightly over 2 percent of GDP. Similarly, external public debt remained almost unchanged in 1996 at US$1.3 billion (14 percent of GDP).

Progress in the structural reform area was slow in 1996. Congress approved legislation to modernize capital markets; leasing operations were regulated; and two merchant shipping companies were privatized. Another shipping company was privatized in the early months of 1997. The authorities indicated that further initiatives, including legislation on intellectual property and patents, commodities trading, and reform of the civil service, were being considered in Congress. They also noted that work was fairly advanced on a reform of the public banking sector that would consolidate the public financial institutions, and on a social security reform that would homogenize the retirement age and benefits provisions of the various public sector pension funds.

Executive Board Assessment

Executive Directors commended the authorities for maintaining macroeconomic stability, but stressed that decisive action was needed to reestablish the soundness of the financial sector in order to stop the drain on public resources, restore confidence, and limit the adverse impact on economic activity. More rapid progress in structural reform was needed for Paraguay to reap the benefits of globalization and regional integration so as to achieve higher sustainable growth and alleviation of poverty. Structural reforms would also help to bring the large informal economy above ground, and reduce its negative consequences for economic management. Directors encouraged the authorities to build broad support for the needed adjustment and reforms.

Directors stressed the need for a more prudent fiscal policy, as the public sector might have to bear the cost of bank restructuring, and because of the need to increase national saving and assist monetary policy in maintaining macroeconomic stability. Directors noted the authorities' recent efforts to limit public spending, but viewed those efforts as insufficient to prevent a widening of the fiscal deficit or to bring relief to monetary policy. Expressing concern about the continued deterioration of public finances, Directors urged the authorities to go substantially beyond their present intentions of fiscal adjustment. They stressed that fiscal adjustment should be accompanied by restructuring of budgetary priorities, in particular, toward health, education, and basic infrastructure. They urged the authorities to address the legal and administrative rigidities impeding a reduction in the public sector work force. Directors noted that, although progress had been made in recent years, there was still considerable room for strengthening tax administration, broadening the tax base, and undertaking a more comprehensive tax reform.

Directors expressed concerns about current problems in the financial system. They urged the authorities to continue implementing the recently introduced banking legislation strictly and decisively to effect a comprehensive strengthening of the financial system. No delay should be permitted in recapitalizing or closing nonviable banks, while banks that were still considered viable should be put under strictly monitored rehabilitation programs, which included changes in management and operational practices. Privatization of banks was also suggested. The superintendency of the banks should be strengthened further. Directors expressed concern over the use of pension funds to capitalize weak banks and urged the authorities to move expeditiously to create conditions that would allow pension funds to divest their ownership of banks and withdraw from the banking business.

Directors urged the authorities to maintain interest rate flexibility and manage liquidity conditions carefully to foster an adequate level of economic activity while avoiding a rekindling of inflation and further loss of international reserves. They recommended that the exchange rate be managed flexibly to ensure that competitiveness was maintained.

Directors expressed concern over the slow progress of structural reform. While noting that a start had been made with privatization, Directors urged the authorities to accelerate its pace and to extend it to the key public utilities. They also encouraged the authorities to proceed with their plans to consolidate the public financial institutions and to reform the public sector social security system. Directors urged the authorities to address rigidities in present labor market regulations.

Directors urged a closer cooperation among all units of government and the central bank to improve the country's statistical base.

Press Information Notices (PINs) are a new series of IMF press notices (see Press Release 97/21). PINs are issued, at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies.

Paraguay: Selected Economic Indicators

	1992	1993	1994	1995	1996 1/	1997 1/
			Change in percent			
Economic Activity and Prices						
Real GDP	1.8	4.1	3.1	4.7	1.3	3.5
Real GDP per capita	-0.9	1.4	0.3	1.9	-1.3	0.7
CPI (Dec. to Dec.)	17.8	20.4	18.3	10.5	8.2	8.0
			Percent of *GDP 2/*			
External Economy						
Current account balance	-1.6	-0.5	-4.4	-2.1	-2.3	-2.4
Overall balance	-0.2	1.4	3.9	0.2	0.1	0.1
External public debt (in millions of U.S. dollars)	1,249	1,217	1,241	1,328	1,336	1,448
Debt service ratio (in percent of exports of goods and nonfactor services)	49	19	15	12	10	9
Gross international reserves (in months of imports of goods and nonfactor services)	6	6	7	6	6	5
Real effective exchange rate (Index: 1990=100)	109.6	110.0	112.9	113.8	118.8	...
Financial Variables						
Nonfinancial public sector overall balance	0.0	1.1	1.4	2.5	1.7	0.0
Nonfinancial public sector current balance	3.4	4.2	4.9	7.6	5.9	4.9
Central government overall balance	-1.0	0.0	0.1	-0.3	-0.8	-1.5
Gross domestic investment	20.8	19.5	19.8	23.3	22.6	23.0
Gross national savings	19.2	19.0	15.3	21.2	20.2	20.7
Money and quasi-money (M2) (change in percent)	28.4	15.3	38.4	30.5	13.3	16.5
Broad liquidity (M3) (change in percent)	36.4	29.0	23.1	18.6	20.1	19.9

Sources: Paraguayan authorities; and IMF staff estimates.
1/ IMF staff estimates.
2/ Unless otherwise noted.