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**Statement by Mr. Kiekens and Mr. Polák on Paraguay
(Preliminary)
Executive Board Meeting 07/56
June 29, 2007**

We thank the staff for a balanced report and a useful set of Selected Issues Papers (SIP). We also appreciate the insightful Buff statement of Messrs. Silva-Ruete and Salgueiro.

Paraguay's economy has recovered significantly since the 2002 crisis and has entered a period of higher economic growth. This development reflects the authorities' sound macroeconomic management and reform endeavor. However, despite favorable domestic and external conditions, some delays in the implementation of reforms could not be avoided primarily because of the complexity of political discussions. The delays resulted in non-observance of three structural benchmarks.

We regret that due to the political situation in the Congress, the authorities have not yet obtained a broad political consensus in support of many important legislative and regulatory proposals. We do believe that all parties in the political spectrum should aim at contributing to macroeconomic consolidation and structural improvements. Making further progress in the reform agenda is essential to put the current pace of growth on a sustainable footing. This, in turn, will enable a greater reduction in the wide-spread poverty. Therefore, we encourage all political parties to take advantage of the current favorable momentum to further step up reforms.

We note that the authorities and the staff agree that the program should be rephased in view of the delays in implementation and the need to benefit from broader political support. We understand the need for such an adjustment, and we urge the authorities and the Congress to work expeditiously on implementing the designed reforms. Otherwise, the delays in implementation might jeopardize the precautionary purpose of the SBA.

In the short run, the main task of macroeconomic management is to reduce the incidence of cyclical swings in economic growth. Chapter I of the SIP clearly shows the pro-cyclical stance of current fiscal policy. Additional fiscal stimulus should be avoided, taking into account the current positive output gap and the higher-than-targeted inflation in 2006. We

urge the Congress to abstain from incurring “ad-hoc” expenditures similar to those in late 2006, lest they undermine the current delicate macroeconomic balance. A prudent budgetary policy would also help the central bank in dealing with monetary expansion due to capital inflows.

Chapter I of the SIP shows that Paraguay’s monetary policy was guided more by exchange rate movements and less by inflation developments. Also, data shows that inflation during 2003 -2006 remained at levels similar to 1996 – 2002. We agree with the staff that monetary policy should be geared exclusively towards inflation. We note the authorities’ ambitious inflation target to reduce core inflation to 5 percent (within ± 2.5 percent range) and 3 percent in 2008. In order to achieve such a reduction and stabilize prices at the targeted level, the authorities should consider following a flexible approach to the exchange rate policy. Although the estimates indicate a possible small overvaluation, the staff argue that the recent appreciation could be attributed to structural changes that are not yet reflected in the data. Also, the staff is of the view that the current account improvements and foreign direct investment may indicate some shift in the equilibrium real exchange rate. It would be useful to know the sectoral composition of foreign direct investment, which is expected to double in 2007. Supply side effects of FDI could align nominal exchange rate appreciation with its equilibrium trend. Further governance and structural reforms will contribute to the sustainability of a nominally appreciated currency. The introduction of result-oriented management contracts in major public enterprises is a step in the right direction. In this context, we would be interested in hearing about the potential for private sector participation in improving the public sector governance.

The level of financial intermediation plays a key role in the effectiveness of the monetary transmission mechanism. Thus, we encourage the authorities to press ahead with financial sector reforms. A more developed financial system would also provide a more efficient allocation of resources.

Over the medium term, the authorities’ main priority is to implement the reform of fiscal institutions and the pro-growth policy agenda. We note Paraguay’s extensive reliance on technical assistance from the international financial institutions, particularly the Fund. Appropriately designed technical assistance appears to be an effective form of cooperation with the IFIs at this stage of the program. In this regard, we found the analysis in the SIP a very useful guide for all major structural reforms. Also, Appendix 6 of the Report provides a tabular survey of the extensive technical assistance scheduled for 2007. We would appreciate any information the staff could provide about the scope and effectiveness of the previous technical assistance used by Paraguay.