GRAY/07/2177

June 29, 2007

Statement by Mr. Mozhin and Ms. Ustyugova on Paraguay
(Preliminary)
Executive Board Meeting 07/56
June 29, 2007

We thank staff for their assessment of the performance of Paraguay under the SBA and Mr. Silva-Ruete and Mr. Salgueiro for their useful Buff statement. We are especially pleased with the selected issues topics, which provide excellent supplemental information and forestall most of the questions.

We were encouraged to read in the report that Paraguay has continued to demonstrate strong economic performance with accelerating growth, substantially reduced consolidated public debt-to-GDP ratio and increased international reserves, which have reached a record level. A surge in real per capita income marked a progress towards poverty reduction. These achievements can partially be attributed to commendable progress in implementing economic reform agenda, as all the end-April 2007 quantitative and structural performance criteria were met. But significant challenges remain. Inflation pressures pose risks to the overall macroeconomic stability. Financial sector weaknesses remain a clear obstacle to achieving higher growth potential. Paraguay needs to undertake a vast number of structural reforms. Even with substantial progress, Paraguay's social indicators are still weak. In light of the overall positive performance and the authorities' commitment to continuing reforms and maintaining fiscal discipline and macroeconomic stability, we support the completion of the second and third reviews under the Stand-By Arrangement.

A key challenge for the authorities now is to address widespread poverty while raising growth momentum and preserving macroeconomic stability. Against this background the authorities' efforts should be centered around five reform areas, presented by staff. We concur with the proposed structural conditionality under the program for 2007 and we only have a few remarks as follows.

We are especially concerned about institutional weaknesses in the fiscal area. It is extremely unfortunate that for the fourth year in a row fiscal policy is being implemented through the use of financial plan because of the overbudgeting at the budget formulation stage. This not only results in a high degree of uncertainty about the stance of fiscal policy, but greatly disturbs the budgeting process and worsens implementation of the capital budget and thus infrastructure spending, which is essential for Paraguay's development. We strongly support staff's view that it is important to strengthen the budgetary framework in order to enhance transparency, realism and discipline in the fiscal area. We believe that it is critical in the situation where there is a need to provide fiscal compensation for the projected central bank losses associated with the current monetary policy framework. With respect to tax revenues, we note that tax revenue-to-GDP ratio in Paraguay has stayed at the level of 12.1 percent for 2006 and 2007 (according to projections), demonstrating only marginal improvement compared to the figures for 2004-2005. We would like to know how staff assess the progress achieved thus far in the implementation of the authorities' strategy "to increase the tax-to GDP ratio gradually by broadening the tax base and enhancing administrative tax efficiency" (box 2, para 2).

Monetary policy implementation is complicated by large capital inflows, which put pressures on the foreign exchange market and result in liquidity overhang. The central bank measures to withdraw liquidity seem to have been adequate. But to continue with effective monetary policy the PCB should be in a strong financial position and operationally and legally independent. Given the authorities' intentions to compensate the PCB for the projected losses associated with active placement of LRMs, we wonder how it could influence operational and legal independence of the PCB. We also note that in order to discourage further inflows the PCB has recently significantly reduced interest rates on the benchmark LRMs from the level of more than 10 percent to about 4.5 percent. It is interesting that despite this decrease, the demand for the bonds has remained high. We are curious to know to what extent it could be explained by the pace of guarani appreciation, which may offset high inflation of the recent periods and lead to high rates of return, or by shallow local financial markets lacking in investment alternatives, or, perhaps, by prudential regulation constraints. As indicated in the report, nominal interest rates may need to be raised in the next months to maintain domestic credit within program limits and achieve the core inflation objective. How does this volatility of policy interest rates influence the spending and saving decisions of the economic agents and, thus, the overall economic performance? How strong is the link between the financial and real sectors? One can see that the spread between lending and deposit rates in local currency is very high. What is the implication of these high lending rates for investment growth?

We commend the authorities for their performance in implementing the structural reforms and hope that this trend will be sustained. As for the reforms in the banking sector, we note that there has been a substantial delay in many areas, which is disappointing. Without underestimating the significance of other structural reforms, we see urgent measures aimed at strengthening the banking sector and upgrading financial regulation and supervision to be imperative for the successful implementation of the program.

To conclude, we wish the authorities success in the implementation of their program's ambitious reform agenda.