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October 12, 2007

**Statement by Mr. Stein and Mr. Brinkmann on Paraguay
(Preliminary)
Executive Board Meeting 07/90
October 15, 2007**

1. We thank the staff for an informative paper and Mr. Silva-Ruete and Mr. Maciel for their helpful Buff statement. We broadly concur with the staff's analysis and recommendations. Given the satisfactory program performance with all end-June performance criteria and structural benchmarks being met, we support the completion of the fourth SBA review, the request for a waiver of applicability of the end-September 2007 performance criteria, and the request to reduce the access under the SBA to 30 percent of quota. We appreciate the authorities' prudent fiscal policy stance, their efforts to enhance financial stability and the renewed structural reform momentum. Looking ahead, it will be crucial to keep inflationary pressures in check and to continue to pursue fiscal consolidation and structural reforms in the run-up to the general elections in 2008 and beyond in order to safeguard macroeconomic stability and to enhance medium-term growth prospects.
2. We share the staff's assessment of the risks to the economic outlook. While international financial market turbulence has not had an impact on Paraguay so far, negative spillover effects on exports stemming from a slowdown in global economic growth cannot be ruled out at this stage.
3. The fiscal performance in the first half of 2007 has been strong, but we note increasing spending pressures going forward. Substantial salary hikes for teachers recently approved by Congress and potential supplementary budgets pose serious risks to the fiscal targets for 2007. While we welcome the introduction of a medium-term fiscal framework, we continue to encourage the authorities to tackle the still high budget rigidity and, furthermore, to avoid the under-execution of capital expenditures in the future.
4. While acknowledging the decline in the core inflation rate to its 2007 target, we welcome the recent monetary tightening by the Central Bank (BCP) given the strong monetary expansion and the recent increase in headline inflation. Further interest rate hikes

might be needed to achieve the inflation targets. Looking ahead, a continued exchange rate appreciation and its dampening impact on inflation cannot be taken for granted as capital inflows and the recent surge in export prices may only be temporary phenomena. *In this context, we would be interested in the sensitivity of inflation towards exchange rate movements. Staff's comments would be welcome.*

5. We share the staff's concerns about the slow progress in strengthening the Central Bank's balance sheet. Recurrent central bank losses hamper the credibility and effectiveness of monetary policy, which might become influenced by financial considerations. Moreover, like the staff, we encourage the authorities to implement the modified regulation for the still highly-dollarized banking sector earlier than currently envisaged.
6. Developing the industrial and service sectors remains a fundamental challenge. At present, economic growth and the current account position are highly dependent on developments in the agricultural sector. This in turn makes Paraguay vulnerable to changes in external demand or weather-related shocks. Therefore, building on recent progress, ongoing improvements in the investment climate are crucial in order to boost private investment, including from abroad, and foster the diversification of the economy.