

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

MASTER FILES
ROOM C-525

0418

BUFF/ED/92/84

December 22, 1992

Statement by Mr. Breuer on Paraguay
Executive Board Meeting 92/156
December 23, 1992

The related political and economic reforms begun in 1989 have continued in Paraguay despite difficult circumstances.

In the political area, the transition to a democratic system begun by the current Administration has deepened substantially. Elections for a Constitutional Assembly were held in December 1991, and a new Constitution promulgated in July 1992. The final element of the process consists of national elections for the Executive and Legislative branches in May 1993.

In the economic area, progress was achieved in two fronts, despite the presence of a series of exogenous shocks. These include:

(a) External arrears: When the current Administration took over in 1989, it inherited a deteriorated external situation. International reserves were extremely low, and external arrears to commercial and official creditors had been growing since 1985. Moreover, there were delicate political issues, both domestically and internationally, associated with these arrears that had climbed to US\$ 500 million by end 1989.

During the course of 1992, very significant progress has been achieved towards the complete elimination of these arrears. Paraguay reached bilateral agreements with various Paris Club creditors that led to the resumption of debt service and substantial cash payments of arrears. Consequently, arrears with Paris Club creditors were sharply reduced from a peak of US\$ 400 million (including interest on arrears) in May 1992 to US\$ 120 million at the end of November 1992. Moreover, additional payments of around US\$ 90 million have already been authorized by the Finance Ministry and will be made before the end of the current month, in consonance with the agreements mentioned above. Similarly, arrears to commercial creditors, which in May 1992 stood at around US\$ 100 million (including interest on arrears) were virtually eliminated in 1992.^{1/} It is the intention of the Government to eliminate all arrears expeditiously.

The cash payment of arrears to date in 1992 - amounting to close to US\$ 300 million or around 5 percent of GDP - represent a significant effort on the part of the Paraguayan authorities towards the normalization of international financial relations. Moreover, it successfully addresses the last major unresolved economic issue inherited from previous regime.

^{1/} The current level of arrears with commercial banks is US\$ 3,5 million, which are expected to be cleared in the next few weeks, as some creditors requested a brief postponement of negotiations. The refinancing packages are pending Congressional approval.

(b) Structural reforms: Structural reforms have also continued. Prominent among these are the recently approved tax reform and tariff reform, as well as ongoing implementation of financial sector reform.

Congress approved the new tax bill in December 1991, and implementation has been carried out in stages during 1992. The new tax system represents a major and fundamental overhaul, and is centered on the new value added tax. While the initial projections of increased revenues have yet to materialize, it is important to note that overall tax receipts in the period January-November 1992 have had a small real increase relative to the same period in 1991. The Paraguayan fiscal authorities believe that revenues will increase further once agents get used to the functioning of the new system, and once the full effects of current improvements in tax administration are felt.

On the other hand, trade liberalization was enhanced by means of tariff reform approved in July 1992. This reform significantly reduced the average tariff level from 14,8 percent to 7,6 percent, and tariff dispersion. The present system is based on three rates (0 percent, 5 percent and 10 percent) with additional surcharges for automobiles.

Finally, implementation of the ongoing financial sector reform continued. The main measures adopted included unification of reserve requirements for domestic and foreign currency deposits, the extension of reserve requirements to include trust accounts, introduction of improved prudential regulations for financial institutions, and deepening Central Bank open market operations. The proposed new charter of the Central Bank had to be modified to conform with the new Constitution, and is currently being reviewed by the Government.

Exogenous shocks and policy response

Turning to the more conjunctural issues, the Paraguayan economy has been hit by severe exogenous shocks in late 1991 and 1992. Principal among these were widespread floods in mid 1992 and the sharp collapse of international prices for cotton. The floods led to the displacement of around 100,000 people (2,5 percent of the population), and to a decrease in agricultural production as production itself and/or transportation were affected. Moreover, it contributed to the increase in food prices during the second and third quarters of 1992 which, in conjunction with the effects of the introduction of the value added tax in July, led to an increase in the monthly inflation rate during the same period.

Due to the prominent direct and indirect roles that agriculture plays in the economy, the sharp collapse in the international price of cotton dealt a severe blow to the economy. Prices suffered a dramatic drop, going from around 85 cents per pound (ct/lb) in July 1991 to 48 ct/lb in early 1992, and currently stand at around 55 ct/lb. The latter, combined with the effects of the bad weather in 1990 and 1991 and of the appreciation of the

currency, has had negative repercussions on the balance of payments 1/, and, more importantly, on income and employment in the rural economy.

The rural economy in Paraguay provides sustenance to around 50 percent of the population. Like many other developing countries, it is characterized by the coexistence of modern and traditional forms of agriculture. Cotton production is carried out by a large number of small, family-run, and labor intensive units, many of which also engage in subsistence agriculture. Three consecutive years of stagnation or sharp recession in the sector have had a very negative impact on this vulnerable group. 2/

Faced with these temporary shocks to the economy, the Government reacted with a temporary and moderate easing of financial policies during 1992 in an effort to ameliorate the effects on income and production. First, fiscal subsidies amounting to approximately 1 percent of GDP were authorized by the Legislature. These subsidies, directed to the small cotton producers, provided partial compensation for the fall in prices. Second, an emergency financing package for the agricultural sector, amounting to US\$ 146 million (at current exchange rates) and directed specifically at the planting season (September - January), emerged from trilateral negotiations involving government officials and representatives from the financial and agricultural sectors.

The financing package responded to two related events. First, commercial banks were very reluctant to lend to the agricultural sector in light of current circumstances which had led to an increase in nonperforming loans. The ensuing credit crunch during the crucial planting season for cotton and soybeans threatened to worsen the crisis.3/ In addition to the Central Bank rediscounts to be channeled through the National Development Bank, selective reduction of reserve requirements were offered to commercial banks in lieu of rediscounts, and contingent on them contributing additional funds of their own. Second, a number of agricultural exporting firms went bankrupt, and the crisis threatened to expand to the financial system. Therefore, interest rates subsidies provided financial relief to these firms.

1/ Cotton exports averaged 35 percent of total exports in 1987-1991.

2/ Growth rates in the agricultural sector during 1990 and 1991 were 0,9 percent and - 4,5 percent, respectively. The most recent projection of the Central Bank of Paraguay for 1992 is - 4,4 percent.

3/ In addition, new regulations introduced as part of the ongoing financial reform program might have aggravated the credit crunch. These regulations strengthened bank supervision and involved provisioning for nonperforming loans, categorization of assets and liabilities, and limits on certain accounting practices. As part of the financing package, they were temporarily relaxed.

Regarding the financing package, it is important to note that Central Bank rediscounts continue to be granted at 18 percent. To the extent that a subsidy is given to the final user, the cost of the latter is covered with Treasury transfers authorized in the budget. Hence, as in the case with fiscal subsidies, the operation is being carried out with complete transparency.

While the relaxation of financial policies was seen as a necessary response to exogenous shocks, the Paraguayan authorities regard them as temporary second best policies that are exceptional in nature. In fact, the sectoral loan recently signed with the Inter American Development Bank recognizes the exceptional nature of these subsidies, reaffirms the market orientation of policies, and deepens the program of structural reforms.

In addition, it is worth noting that fiscal management led to the reduction of the cost of the fiscal subsidies, from the originally authorized Gs. 95.5 billion (or 1 percent of GDP) to Gs. 58.85 billion. Similarly, while the Paraguayan authorities agree with the staff's recommendation regarding the need to adjust the rediscount rate to ensure that the Central Bank is the lender of last resort - and will consider doing so once the planting season is over - it is also worth noting that monetary conditions have remained tight. As evidence, one can point to positive real interest rates in the inter-bank market, and in commercial bank lending and some deposit rates (primarily certificates of deposits), as well as Central Bank intervention in the exchange markets during December to prevent further currency appreciation.

Macroeconomic performance in 1992 and prospects for 1993

Macroeconomic performance during 1992 was not as positive as originally envisioned at the beginning of the year, or in relation to 1991. The exogenous shocks to the agricultural sector are primarily responsible for the reduction in the fiscal surplus, the increase in the external current account deficit, the slight jump in inflation, and the slowing down of growth. On the other hand, the substantial cash payment of external arrears contributed to the reduction of international reserves, and increased government expenditures of around 0,5 percent of GDP.

Notwithstanding this deterioration, the final outcomes appear to be more positive than projected at the time of the staff mission, and quite acceptable given the circumstances. In fact, the latest official projections for 1992 point to fiscal equilibrium or a small surplus, an inflation rate (12 month CPI) of under 18 percent (still one of the lowest in the region), and positive growth of 1,7 percent. The fiscal result is particularly noteworthy as the 1992 budget approved by Congress contained a projected deficit in excess of 5 percent of GDP. The latter was achieved through both very careful control of expenditures and improved tax administration. In addition, substantial capital inflows have continued, albeit at a somewhat slower pace than in 1991, which reflect, among other things, continued business confidence in the program.

Prospects for 1993 are mixed. On the one hand, recent indications with respect to agricultural output in the current cycle are promising, and international prices seem to have bottomed out. In addition, the reduction in external arrears has already led to greater disbursements of bilateral and multilateral loans to support the reform process as well as public investment.

On the other hand, macroeconomic management will be challenged by regional developments given the strong linkages of the Paraguayan economy to that of its neighbors, and by the uncertainties related to the outcome of national elections scheduled for May 1993.

The Paraguayan authorities intend to continue the pursuit of prudent financial policies in 1993, and accelerate a number of structural measures. Public expenditures will continue to be guided by the availability of domestic resources and external financing. Structural reforms will be advanced, and priority will be given to the new charter of the Central Bank, privatization of at least one state enterprise, reform of the pension system and the legal framework surrounding property rights.

Finally, the Paraguayan authorities wish to express their gratitude to the Fund's Board, management, and staff for the support they have received from the Institution during the last three years. In particular, Article IV consultations have presented unique opportunities to assess the overall condition of economy, and engage in fruitful discussions with the staff.

