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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/36

3:00 p.m., March 14, 1990

R. D. Erb, Acting Chairman

Executive Directors

Alternate Executive Directors

L. E. N. Fernando
A. Raza, Temporary
C. Enoch
J. Gold, Temporary
Zhang Z.
B. S. Newman, Temporary
J. Prader
J. M. Jones, Temporary
S.-W. Kwon
P. O. Montórfano, Temporary
G. García, Temporary
A. Fanna, Temporary
A. M. Othman
B. A. Christiansen, Temporary
M. A. Ghavam, Temporary
B. Goos
T. T. Do, Temporary
L. I. Jácome, Temporary
J.-L. Menda, Temporary
A. R. Ismael, Temporary
M. Al-Jasser
G. P. J. Hogeweg
S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
D. J. de Vos, Assistant

<u>Also Present</u>
IBRD: W. G. Tyler, Latin America and the Caribbean Regional Office. Exchange and Trade Relations Department: E. Brau, A. López-Claros. External Relations Department: R. R. Brauning. Legal Department: J. K. Oh. Western Hemisphere Department: J. Ferrán, Deputy Director; J. Amieva, A. C. A. R. Furtado, P. Neuhaus, A. M. Wolfe. Advisors to Executive Directors: A. Iqbal, K.-H. Kleine. Assistants to Executive Directors: H. S. Binay, B. R. Fuleihan, S. Gurumurthi, M. Hepp, M. J. Shaffrey.

1. PARAGUAY - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Paraguay (SM/89/274, 12/20/89; and Sup. 1, 3/8/90). They also had before them a background paper on recent economic developments in Paraguay (SM/90/5, 1/8/90).

Mr. Montórfano made the following statement:

The economy of Paraguay was characterized by stagnation, increases in external indebtedness, acceleration of inflation, and a loss of international reserves during the early 1980s. During the past three years, the country recovered from the severe drought of 1986, which had affected seriously the agricultural sector. Real GDP grew at an average rate of 5 1/2 percent in 1987-88, as farm output recovered, and by nearly 6 percent in 1989.

Paraguay is one of the landlocked countries of South America, with its main sectors, agriculture and livestock, depending on fluctuations in climatic conditions and international prices. In the 1970s, the country benefited greatly from the construction with Brazil of the large binational Itaipu hydroelectric project which has generated income for Paraguay since 1988. Another binational hydroelectric project with Argentina is under construction at Yacyreta, on the Parana River.

Since 1982, and in response to the sharp reduction in capital inflows related to the construction of Itaipu, the previous Government accelerated its foreign indebtedness as a means to avoid an adjustment program. The country's external public debt increased sharply from about $1 billion in 1982, or 22 percent of GDP, to over $2 billion in 1988, or about 50 percent of GDP. The sharp increase in debt service payments and the reduction in capital inflows associated with Itaipu created serious disequilibria in the balance of payments and public finances.

The Government that took office on February 3, 1989 and that was confirmed on May 15, 1990 following the general elections, has conceived a development plan and established the guidelines of a new economic policy, based on the economic principles of an efficient free market, with equal opportunities for everyone in an environment of healthy competition.

To this end, it created an adequate judicial/political environment through establishing a regime of political freedom for full representative democracy and respect for human rights. To fulfill the chosen commitments and the fundamental principles of coexistence, the Government has decided to implant freedom in the economic field, where production factors are to be protected by the fair and equitable regulation of the market.

In the economic sphere, there has been a transformation in the norms that guide economic policy. The Government aims at modernizing the public sector and enhancing its accountability. In addition, it will seek to discontinue the financing of inefficient and loss-incurring public enterprises, and to study the elimination of monopolies and the privatization of certain state enterprises. Moreover, the Administration intends to favor private sector initiatives within a framework of competitive markets, greater openness for international trade, and the elimination of the obstacles that prevent sustainable economic development.

Considering the characteristics of the Paraguayan economy and the need to relate short-term to medium- and long-term goals, the economic policy objectives can be summarized as follows: to increase production of goods and services in a regime of free trade so as to achieve a sustained increase in real per capita income; to promote domestic savings and investment; to create jobs; to create an efficient and equitable fiscal structure; to promote internal equilibrium, as reflected in a balanced budget and price stability; to seek external equilibrium, as reflected by equilibrium in the balance of payments and a stable exchange rate; and to begin to implement an integrated agrarian reform in order to ensure greater economic and political participation of the rural population. The main producer of goods and services and main creator of jobs will be the private sector, based on the operation of efficient and competitive markets.

The main changes in exchange rate policy that have been implemented since February 1989 are the following: introduction of a free floating exchange rate system for international trade of goods and services and the movement of capital, including private and public external payments; elimination of minimum export prices and permission for exporting firms to surrender export proceeds directly to the banking system; and determination by the Government that all institutions of the public sector, the central administration, state enterprises, and decentralized institutions, are to buy and sell foreign currency exclusively through the Central Bank. It should be clarified that the exchange rate is currently freely determined by the market.

The substantial increase in exports during 1989 was due fundamentally to the increase in agricultural and industrial production, the increase in the international price of raw materials, and the free exchange rate introduced in February 1989. For example, soybean and cotton exports totaled $742 million, equivalent to 71 percent of total exports. Meat and meat by-products reached an unprecedented level of $103 million or 10 percent of total exports, lumber $32 million (3 percent), leather $28 million (2.4 percent), and other products $145 million (13.6 percent).

The Paraguayan authorities recognize the need to adjust interest rates to positive levels in real terms, while also being mindful of the adverse effects that excessive adjustments in the financial system may have on the productive sector and on inflationary expectations. The envisaged adjustments in the structure and level of interest rates, together with an expected inflation rate of less than 20 percent in 1990, will permit the achievement of positive real interest rates for loans and deposits. The Central Bank has already begun to introduce a more realistic interest rate regime so as to stimulate saving through competition in the financial system, leading eventually to freely determined interest rates. The Central Bank's decision on July 19, 1989, to authorize banks and other financial institutions to issue certificates of deposits with free interest rates, was aimed at the gradual liberalization of interest rates. Moreover, finance company interest rates were freed on January 19, 1990, and the Central Bank's rediscount rates were raised, in February 1990, from 21 percent to 22.75 percent, for commercial banks, and from 18 percent to 19.75 percent, for the National Development Bank.

The elimination of the multiple exchange rate system forced the revision of the 1989 budget. The result was an expansion in the receipts and expenditures of the Central Administration and decentralized institutions. In May 1989, the Government adopted a free floating exchange rate for estimating the tax base for imports. In addition, a new temporary tax on exports, ranging from 1 percent to 10 percent--and averaging 5 percent--was introduced.

Prices of public goods and services, such as water, electricity, telephone, petroleum products, and alcohol were raised in June 1989. Meanwhile, domestic taxes, despite their structural constraints, continue to be the major source of fiscal receipts. To avoid further inflationary pressures and to preserve the purchasing power of salaries, the authorities decided to make periodic adjustments in the prices of public goods and services in order to attain financial equilibrium in certain public enterprises within a reasonable time. Accordingly, during the second week of January 1990, prices of petroleum products, telephone, electricity, and potable water were increased again. In addition, and so as to attain fiscal balance, measures aimed at restraining current expenditures and controlling capital expenditures are being implemented.

The Central Bank has been implementing norms to direct and facilitate credit to productive sectors, including through rediscounting facilities for the planting and harvesting of agricultural exports--such as soybeans and cotton, and those that substitute for imports such as wheat and sugarcane; providing funds for the industrial sector to complement those provided by the Development Bank--Banco Nacional de Fomento--which will be allocated by the latter for fixed investment and working capital; establishment of credit ceilings to the public sector to ensure adequate control of the money supply. Moreover, a program of financial liberalization has been started with the authorization for commercial banks and finance companies to issue certificates of deposit at deregulated interest rates.

Exchange subsidies were eliminated, and the demand on the Central Bank for public credit has virtually ceased. This has helped support monetary and exchange rate stabilization. The outstanding loan balance of the Central Bank to the Government dropped by 16 percent in 1989, and the balance of loans to decentralized entities also diminished. This permitted a 37 percent increase in net loans from the banking system to the private sector, providing the economy with sufficient liquidity for promoting production and commerce.

The Central Bank's policy on rediscounts is aimed at maintaining an adequate level of financing. Therefore, the increase in domestic credit in real terms in 1989 was compatible with the level of production, and was an effective means to support farming and harvesting of a larger volume of agricultural production. This resulted in a substantial increase in exports, reflected in an improved balance of payments situation and an increase in net international reserves.

During the past years, Paraguay's monetary system has been characterized by a lack of adequate instruments of monetary control, high legal reserve requirements, mandatory minimum portfolio holdings, and an insufficient supervision of financial institutions. In the near future, the Government will start to implement a comprehensive reform of the financial system on the basis of the technical recommendations of the Fund's Central Banking Department. A first measure in this direction is the introduction of monetary regulation bills that would allow the Central Bank to operate in the open market. Regulations in this respect will be issued shortly.

Owing to the increasing burden of servicing the foreign debt, the Government has adopted a policy in that area that has three main elements, namely, payment of the debt in accordance with the availability of foreign exchange, promotion of exports, and renegotiation of the public foreign debt. The promotion of exports, in turn, has two main elements, namely, the unification and free floating of the exchange rate, the simultaneous elimination of minimum export prices, and the provision of credit for the production of agricultural commodities destined for exports.

The process of renegotiating the foreign debt has begun with the agreement reached with the Government of Brazil in April 1989, whereby Paraguay's public debt to Brazil--to Banco do Brasil and CACEX--was restructured, and will be repaid in 20 years. The agreement includes a provision for swapping Brazilian debt for Paraguayan debt, therefore allowing a sizable reduction in the nominal value of Paraguay's debt to Brazil. Controls over external indebtedness have been strengthened, and the outlook is for a substantial debt reduction in the short term, through the accelerated amortization of debt to Brazil. This reduction of the debt, in turn, would result in lower interest payments and would direct the gains from exports and other foreign exchange earnings toward economic development. At the same time, the negotiation and authorization of new external loans will be scrutinized carefully, and absolute priority will be given to loans conducive to economic and social development.

Net disposable international reserves reached $285 million in December 1989, an increase of $151 million--or 112 percent, from the low of $134.3 million in February 1989. The rise in the level of reserves, originating mainly from the rapid expansion of exports, has become a solid backing for exchange rate stability.

Although the authorities recognize that the inflation rate of 28.7 percent during 1989 is still high, it is worth noting that despite the drastic economic adjustment made, inflation in Paraguay has been maintained at manageable levels. There were encouraging signs of a deceleration in inflation, to an average of 1 percent a month in the last four months of 1989; and notwithstanding the acceleration of inflation during the past two months, an inflation rate of less than 20 percent is expected for the year 1990. The acceleration in the rate of inflation during the first two months of 1990 was due in part to the impact of the adjustment of wages, public sector tariffs, and public transport fares during the second half of January.

With the economic measures adopted by the Government in 1989, there has been a significant progress in the areas of production and trade, an increase in the supply of credit to those areas, an improvement in the public finances, accompanied by the introduction of more realistic interest rates, the control of inflation, the stabilization of exchange rates, the strengthening of foreign trade, the recovery of international reserves, and the control of external debt. The preliminary economic and financial results for 1989 indicate a highly promising prospect for a stable and sustained growth in coming years.

The Paraguayan authorities remain firmly committed to implementing an economic adjustment program that could be supported by the Fund. In this regard, the authorities have held an interesting and useful discussion with a Fund mission, but the Government has decided to postpone the negotiation of a Fund arrangement to mid-1990.

Paraguay has not used the Fund's resources since 1960, and the authorities' decision was based on their need to gain more experience in the implementation and monitoring of a financial program, in order to maintain their credibility. Meanwhile, they will be making every effort to adhere to the indicative quarterly financial targets for 1990, described in SM/89/274, Supplement 1. In particular, the authorities will be taking measures to reduce inflation by pursuing a prudent credit policy, finalizing the draft tax reform bill, encouraging the self-financing of public enterprises, liberalizing interest rates, and strengthening the instruments of monetary control in the context of a comprehensive reform of the financial system. The Government will also seek, in due course, to negotiate a rescheduling of foreign debt with the Paris Club and with Paraguay's commercial bank creditors.

In the area of credit policy, the recent increase in the authorized levels of rediscounts reflects mainly an upward revision of cotton and soybean crop estimates in a situation in which the banking system is still heavily dependent on the provision of rediscounts by the Central Bank. These two crops are the mainstay of Paraguay's export revenues and employment, and the Government's announcement was aimed at reiterating its support for the private sector. At the same time, the Central Bank will continue to implement its rediscount policy in a prudent fashion in the near future, and, over the medium term, it will seek to reduce its role in the provision of rediscounts while raising the rediscount rate to market-related levels.

My Paraguayan authorities wish to thank the staff mission for the constructive Article IV consultation discussions and those on an economic program for 1990, which they regard as a first step toward the negotiation of a Fund arrangement later in 1990. My authorities are also grateful for the useful technical assistance that has been provided by the Fund.

Mr. Newman said that the economic situation and outlook of Paraguay had improved markedly since the previous Article IV consultation. The economy was experiencing a fourth year of solid growth, while impressive fiscal and exchange rate reforms had resulted in substantial reductions in the budgetary and external imbalances. However, inflation appeared to be stuck at unacceptably high levels, pointing to the need for further efforts to strengthen monetary policy and to institute additional structural reforms.

As he supported the broad thrust of the staff appraisal, his remarks would focus on those key issues that should be the central element in any future Fund-supported program, Mr. Newman continued. First, significant progress had been achieved in strengthening the fiscal position through a combination of expenditure restraint, increases in revenue, and improvements in the operating positions of public enterprises. Consolidating those gains would be crucial to avoiding intensifying inflationary pressure, and to placing an excessive burden on monetary policy. In that regard, he welcomed the authorities' intention to introduce a major tax reform with a view to simplifying the current system and to making it more efficient and equitable. In addition, he would urge the authorities to intensify their efforts to improve the financial position of public sector enterprises and to give a higher priority to additional privatization efforts.

The continuation of inflation at about 30 percent in recent years remained the principle source of weakness in an otherwise positive economic outlook, Mr. Newman remarked. The reduced financing requirements of the public sector would facilitate a more restrained monetary policy while meeting the needs of the private sector. He shared the staff's concern that measures to meet the seasonal needs of the agricultural sector should not result in excessive money creation. In recent years, implementation of monetary policies had been hampered by financial market imperfections, which had forced the authorities to introduce special arrangements to meet the needs of the agricultural sector. He therefore welcomed their intention to implement a comprehensive reform of the financial sector, based on market-determined interest rates.

The adoption of a more flexible, unified exchange rate system had facilitated a reduction of external imbalances, although they remained large, Mr. Newman pointed out. The staff's medium-term adjustment scenario seemed comparatively modest, however, especially as the outturn for 1989 and the projection for the current account deficit in 1990 were already below the trend line in the baseline scenario.

Paraguay had made a significant start in its reform efforts, which augured well for the achievement of sound, stable growth, and reduced domestic and external imbalances, Mr. Newman concluded. He looked forward to considering a comprehensive macroeconomic and structural reform program that would consolidate and extend the gains achieved, and provide the basis for Fund support.

Mr. Goos commented that he could support the thrust of the staff's appraisal and the papers before the Board. It was certainly welcome that the authorities had embarked on a reorientation of their economic policies in close cooperation with the Fund and that they had already taken, in 1989, a number of important steps to tackle the existing financial imbalances and structural rigidity. Those steps were encouraging--especially the adjustment of the exchange rate and the progress made in fiscal consolidation--as was the authorities' intention to build upon the progress made so far on the basis of their program for 1990.

While the program generally seemed to be well directed, Mr. Goos said that he had doubts about the appropriateness of the envisaged pace of adjustment, particularly in regard to inflation, which--according to the program assumptions--would remain at the uncomfortably high level of 15-20 percent by end-1990. He was concerned that the comparatively gradual approach toward domestic price stabilization might complicate, if not jeopardize, the attainment of critical adjustment targets--notably in the areas of gross national savings and the external current account--and that the progress envisaged under the program would appear to represent only an intermediate, although commendable, step toward a more sustainable overall situation.

Against that background, he found the modest inflation rate target in striking contrast with what appeared to be an ambitious target for overall growth, Mr. Goos added. Even in the context of overall financial stability, that growth target might give rise to questions of sustainability. He therefore would strongly recommend aiming at a more balanced policy approach that would be consistent with the great importance that the staff had rightly attached to "a major effort to bring down the rate of inflation." Such a more balanced approach should rely on a tighter stance of credit policy--tighter than the one envisaged under the program--including prompt adjustment of domestic interest rate to positive levels in real terms.

The planned credit expansion to the private sector of some 80 percent in real terms appeared to be on the high side, taking into account, as well, the excessive expansion of liquidity in 1989, Mr. Goos continued. Moreover, he considered that the public sector could also make a stronger contribution to domestic price stabilization by foregoing all central bank financing through reconsidering the envisaged doubling of the investment budget, and also by strengthening public sector enterprise reform. He wondered to what extent the authorities' public sector investment strategy was consistent with their objective of reducing the government share in the economy in favor of a greater role for the private sector.

He welcomed the authorities' intention to reform the financial and tax systems soon, Mr. Goos said. The potential of those reform efforts for strengthening domestic resource mobilization, and hence the prospect for external financial stability and sustained growth, could hardly be overrated. Those reforms therefore merited the highest degree of priority on the Government's policy agenda.

He would be grateful for the staff's elaboration on its advice that the exchange market be kept under close review, in particular, in the light of the situation in neighboring countries and the guarani's recent real appreciation against the Argentine and Brazilian currencies in the parallel markets, Mr. Goos stated. He was concerned that undue focus on exchange rate developments vis-à-vis hyperinflationary countries in the region might draw Paraguay into a vicious circle of devaluation and increasing inflation. Instead of stressing the desirability of a flexible exchange rate policy and focusing on neighboring countries, he strongly supported the authorities' objectives--as mentioned in Mr. Montórfano's opening statement--of stabilizing the currency. Of course, that objective should be supported by prudent financial policies and competitive interest rates.

He would also be grateful for some clarification on two other points, Mr. Goos indicated. First, he was interested in the reasons behind the large and widespread discrepancies in the data presented in the tables of the main and supplementary papers, particularly, the discrepancies relating to external developments. Second, how could one explain the fact that the temporary swap scheme had been announced shortly after the departure of the mission from Paraguay, without having been discussed with the staff? Effective cooperation with the institution hinged critically on the provision of accurate data and a comprehensive disclosure and discussion of the authorities' policy intentions with the staff. He assumed that the period ahead would provide the authorities' with the opportunity to establish a satisfactory track record in regard to the issues just mentioned. He could support the proposed decision.

Mr. Goos continued, in response to a query by the Acting Chairman, that exchange rate policy in Paraguay was probably one of the most critical policy areas, and might have merited further consideration by the staff. If a country focused its exchange rate policy on exchange rate developments in a hyperinflationary neighbor, such as Brazil or Argentina, it would run the risk of destabilizing its own economy. Under current circumstances, the real effective exchange rates of Brazil and Argentina were probably fluctuating widely, making them unreliable guideposts for policy in Paraguay. The Paraguayan authorities would therefore be better advised to orient their exchange rate policy toward relatively stronger currencies, and to secure their objectives in that regard through disciplined financial policy. Such policy discipline was important not only in regard to the exchange rate, but also to inflation, domestic savings, and other areas critical to the achievement of sustained domestic growth and external stability.

Mr. Jácome made the following statement:

On the whole, 1989 was a positive year for Paraguay. Output per capita grew for a third consecutive year; macroeconomic imbalances were reduced significantly--especially in the fiscal sector; and important steps were taken in the structural area, particularly in the external sector. On the negative side, inflation accelerated, owing partly to corrective price increases, excessive monetary expansion, and wage increases. In short, Paraguay was able to start a comprehensive adjustment effort and structural reforms while maintaining a rapid rate of growth.

The rate of inflation is a matter of concern, particularly as it exceeded 30 percent and its historical trend. Therefore, the main objective of short-term economic policy must be the deceleration of the rate of price increases, to bring inflation down to its historically low levels and to avoid pressures for the introduction of widespread indexation mechanisms.

The improvement in the fiscal area during 1989 was noteworthy, as the nonfinancial public sector deficit shifted from its deficit in previous years into a small surplus. However, the deficit of the public enterprises remained at almost 2 percent of GDP, making an additional effort to correct imbalances in the public enterprises a necessity. Besides price corrections, structural measures intended to increase efficiency are appropriate.

Unfortunately, the fiscal adjustment was not complemented by a consistent monetary policy during the first part of 1989. The slower rate of growth of monetary aggregates and adjustments in interest rates--both adopted in the last quarter of 1989--point in the right direction. But it is clear that the Central Bank has few effective instruments of monetary control. In this connection, therefore, the intended financial reform is all the more necessary, since it will increase the flexibility of monetary management. In addition, we welcome the suspension of the swap scheme introduced to encourage short-term inflows of funds from abroad, which could, if continued, have created additional losses for the Central Bank--arising from the exchange rate guarantee--and thereby have compromised the intended monetary restraint.

Despite the remarkable increase in exports in 1989, there is still a large current account deficit, albeit, it has to be interpreted with caution in Paraguay's case. First, part of the inflows related to the operations of the binational corporations--treated separately in the balance of payments--are in the nature of current account transactions. Second, the sizable positive errors and omissions term appears to reflect, in part, a sizable amount of unrecorded exports. These exports persisted in 1989, despite the substitution of the previous "aforo" system by a temporary export tax for primary goods. In any event, we recommend close surveillance of exchange rate behavior, since floating this price does not guarantee export competitiveness, especially given economic instability in Paraguay's neighboring countries.

The accumulation of external arrears continued during 1989. The staff's medium-term scenarios, nonetheless, show an improved situation in that respect in the assumption that Paraguay could successfully approach its official bilateral and commercial creditors to reschedule its external obligations.

In addition to the proposed financial restraint, a more moderate wage policy may be necessary if inflation is to be reduced significantly and the export expansion is to be consolidated.

With all these factors in mind, 1990 could be another successful year for the Paraguayan economy. At this stage, it is important to consolidate the achievements of the past year, with a view to securing the continuation of output growth and to obtaining a deceleration in the inflation rate. Sound economic policies and gradual implementation of additional structural measures are necessary for the attainment of these targets in 1990. Moreover, these policies will reduce the vulnerability of the external sector and will lay the ground for sustained growth in the next years. In this context, we welcome the staff's cooperation in designing the 1990 economic program, as well as the authorities' intention to negotiate a stand-by arrangement in the near future, which could provide the basis for a normalization of relations with external creditors.

Mr. Menda made the following statement:

Paraguay's economic situation has improved significantly since the new Government came into power in February 1989: output and export growth have been strong; the current account deficit has been reduced; and the fiscal position has improved dramatically. I commend the authorities for the positive measures they introduced in 1989, particularly the unification of the exchange rate, the relaxation of import and price controls, the elimination of foreign exchange subsidies, and the adjustment of public tariffs. I encourage them to pursue and expand this package of structural reforms. However, two major imbalances remain, namely, inflation accelerated to 33 percent in February 1990 and despite a significant improvement, the external position remains fragile, with the current account deficit amounting to 9.2 percent of GDP in 1989.

As I share the thrust of the staff's analysis, I will only offer a few comments. The acceleration in inflation, despite the dramatic reduction of the fiscal deficit, points to the need to strengthen the stance of monetary policy. I fully agree with the staff that much remains to be done in this area. Priority should be given to raising interest rates in order to achieve positive real rates, which should contribute to increasing the level of domestic savings and to stimulating a better allocation of resources. Introducing adequate instruments of monetary control is also vital, and we welcome the technical assistance provided by the Fund in this field, which should also help the authorities to design a reform of the financial sector.

Together with a more realistic interest rate policy, we urge the authorities to reduce as early as possible the subsidized rediscounts to the agricultural sector. In its appraisal in the supplementary paper, the staff expressed disappointment over this issue, and I would appreciate its further comment.

I welcome the remarkable fiscal improvement achieved in 1989. Given the low level of domestic savings, however, and its consequences for the external position, the authorities should seek to raise public savings. To this end, two actions should be given priority. First, the tax reform currently under preparation should aim at raising the ratio of tax revenues to GDP from its current low level; this seems all the more warranted by the fact that external liberalization should be accompanied by a reduction in the taxation of external trade. Second, much can still be done to improve the position of public enterprises, particularly through further tariff adjustments. I also note with some concern that the planned increase in receipts from Itaipu will be translated into further public expenditure, instead of further savings. Given Paraguay's fragile external position, the staff could usefully comment on the chances of Paraguay reaching a fiscal surplus.

In regard to the external sector, I wish to endorse Mr. Goos's remarks on exchange rate policy. Furthermore, notwithstanding the staff's optimistic views concerning external prospects, it is clear that Paraguay's position in that respect remains weak and that it still has substantial amounts of arrears to bilateral and commercial creditors. My authorities wish to express their concern about this issue, and I would appreciate clarification from Mr. Montórfano on his authorities' intentions regarding the elimination of arrears. In this context, we appreciate the authorities' efforts to pursue adequate macroeconomic policies, but encourage Paraguay to conclude, as soon as possible, an agreement with the Fund that could pave the way for further negotiations with international creditors, with a view to normalizing relations with the international financial community.

Mr. Al-Jasser made the following statement:

The new authorities in Paraguay are in the midst of a major overhaul of the economy. The recent unification and floating of the exchange rate, along with the improvement in public sector finances, are encouraging developments. Clearly, these are initial steps that must be followed by a broad-based structural reform effort, which, as Mr. Montórfano indicates in his opening statement, the authorities are indeed planning to undertake. Thus, the authorities are confronted with the challenge of pursuing growth, while maintaining external and internal balance. As I agree with the thrust of the staff report, I will make the following brief comments.

The most disconcerting recent economic development is the persistence of unsustainably high inflation rates. This is a troubling phenomenon, since persistence of high inflation for a substantial period would lead to an internalization of price increases in the economic system, thereby rendering their reduction extremely difficult and terribly costly. This is all the more dangerous, since the authorities are undertaking growth-oriented policies that run the risk of further boosting inflationary pressure. Moreover, persistently high inflation rates could, in and of themselves, compromise the efficacy of growth-oriented policies. Indeed, instability of prices would discourage foreign and domestic private investment, which has recently increased in response to the welcomed liberalization of the investment code. Consequently, I fully endorse the staff's recommendations for a further tightening of credit policy, along with a limitation of rediscounts to the level originally programmed.

It is interesting to note from Table 39 of the background paper that an average of 45 percent of total imports during 1984-88 originated from Argentina and Brazil. Some of the inflationary pressures within Paraguay may therefore have been imported. In this context and, like Mr. Goos, I am somewhat puzzled by the indication in the staff report that both the staff and the authorities were concerned about the recent real appreciation of the guarani against the Argentine austral and the Brazilian cruzado, and that it was agreed to keep exchange rate developments under close scrutiny.

This relative appreciation of the guarani could well be due to the inappropriate policies adopted by Paraguay's neighbors, rather than to Paraguayan policies. If this is the case, I wonder what additional measures the staff would suggest to maintain competitiveness, particularly as an appreciation from that source would help to contain inflationary pressures. To my mind, there is no trade-off between controlling inflation and maintaining export competitiveness vis-à-vis Brazil and Argentina; hence, I would urge the authorities to attach top priority to the inflation issue. This would be appropriate, since inflation control would enhance Paraguay's competitiveness with respect to the rest of the world, which absorbs 70-75 percent of the country's total exports. More interestingly, the recent charts submitted to the Board on exchange market developments indicate that the Brazilian cruzado has been appreciating in real effective terms during 1989. This could lead one to conclude that the fluctuations in exchange rates between Paraguay and its neighbors is frictional in nature, with no bearing on competitiveness. The staff could usefully clarify this point.

It would have been more appropriate for the staff to have followed a regional approach in addressing the issues of inflation and external competitiveness, and, by necessity, the issue of exchange rate policy in Paraguay. Such an approach would be especially pertinent, since Paraguay's experience could benefit other small countries that border larger and more unstable economies.

Mr. Yoshikuni made the following statement:

This year's Article IV consultation with Paraguay merits special attention since it includes an interesting discussion on a possible economic program to be supported by the Fund, which, if approved, will become the first Fund arrangement with the country since 1960.

The authorities have embarked already upon a series of measures aimed at reducing the various imbalances in the economy. In particular, I welcome the unification and the floating of the exchange rate, the favorable effect of which has begun to manifest itself in the improved, although still weak, external position. Furthermore, the authorities have taken various measures to contain the mounting inflationary pressure and to make efficient use of resources. Nonetheless, in view of the substantial distortions that remain in the economy and the persistent inflationary pressure, which could seriously hinder sustainable growth in the medium term, adjustment policies need to be strengthened. Moreover, the precarious external position, giving rise to the overdue obligations to creditors, suggests that Paraguay's adjustment policies need to provide the international financial community with sufficient assurance that the country is committed to securing external viability in the medium term. Under these circumstances, I strongly believe that a formal arrangement with the Fund would underpin the Government's strong will and restore the confidence of external creditors. I encourage the authorities to expedite the process of securing a formal arrangement, particularly as the framework of the arrangement has been worked out already in the form of the 1990 program presented in the staff supplement.

I will limit my intervention to a few specific points, with a view to clarifying the areas that need to be addressed in the context of the discussions with the staff in the coming months. First and foremost, the comprehensive reform of the financial system needs to be accelerated, with the assistance of the Fund's Central Banking Department. In particular, I would attach the utmost importance to unburdening the Central Bank of various obligations that are normally outside the purview of monetary authorities. Specifically, such functions as rediscounting for the agricultural sector, or foreign exchange subsidies, should be streamlined and be replaced preferably by explicit government subsidies in order to enhance the transparency of the public sector. In this connection, I am encouraged to note that the temporary swap scheme was eliminated, although I share Mr. Goos's concern that the scheme was announced just after the departure of the past Fund mission. Equally important, the persistence of negative real interest rates, despite the series of liberalization efforts, remains a particular source of concern. While I welcome the recent increases in the lending rate, one should keep in mind that it has only caught up with the inflation rate, leaving most of the deposit rates negative in real terms. In this connection, I fully agree with the staff that the mobilization of savings should aim at enhancing the attractiveness of domestic currency deposits.

In the fiscal area, I attach importance to the reform of public enterprises. In particular, the large operating losses of the cement and steel plants appear to be structural in nature, and should be addressed in a different manner from those of other public firms, which reflect mainly low tariff rates instead of excess capacity. In view of the low ratio of fiscal revenue to GDP, there seems to be room to raise revenue steadily under the proposed new tax system. In my view, such an increase in revenue would parallel replacement by the Government of various hidden fiscal deficits, which are currently borne by the Central Bank or other public entities.

Given the importance of containing inflationary pressure, I generally associate myself with the points made by Mr Goos, and elaborated strongly by Mr. Al-Jasser, on the exchange rate question.

Last but not least, the problem of insufficient data needs to be addressed immediately. In fact, as Appendix II of the staff report clearly suggests, the problem of data collection is due not only to the inadequate system of statistical compilation, but also to the existence of transactions outside the regular financial system which, in turn, reflect the lack of efficient supervision of the system.

I again stress that early completion of the discussions on a Fund arrangement would go a long way toward securing a successful rescheduling agreement with Paris Club creditors, and to maintaining the confidence of the international financial community as a whole in Paraguay.

Mr. Prader made the following statement:

Despite the existence of structural bottlenecks in several areas and the accumulation of external arrears, the new management of the Paraguayan economy has performed well. Encouraging signs during 1989 include the valiant efforts to unify and float the exchange rate--and to curtail subsidies for imports--and the planned fiscal discipline. Performance in terms of growth, exports, and tax revenues turned out to be better than expected. I can endorse the general thrust of the staff appraisal, but would first like to ask: why the accumulation of arrears and the option of rescheduling were not questioned, but accepted so readily?

The accumulation of external arrears is a critical question at the current stage, especially in connection with the coming consideration of a possible Fund program. With plans under way to improve domestic resource mobilization through reform of the tax and financial systems, and with central bank reserves having grown in 1989 by $100 million, to their existing level of $425 million, is the accumulation of arrears and a possible rescheduling of external debt Paraguay's best or only means to finance structural adjustment and growth of its economy? In light of the substantial share of the arrears attributable to the cement and steel manufacturers, would a debt-equity swap be helpful? How much of the financing gap--visible even after rescheduling--in the medium-term projections can be ascribed to these enterprises? As these plants will have excess capacity even under the most optimistic growth scenario, are larger export opportunities for Paraguayan steel and cement being ruled out by the country's landlocked geographical situation, coupled with deficiencies in transportation, or are there other reasons?

I am heartened by the authorities' efforts to reform the tax system. Paraguay's ratio of tax revenue to GDP is still well below developing country standards, and there is thus much room for its expansion. But given the urgency of the fight against inflation, and the greater weight that popular assessment of the Administration is sure to carry in a democratic society, care must be taken not to lean too heavily on indirect taxation, as the staff points out. Two questions occur to me at this point. First, given the well-known expertise of the Fiscal Affairs Department in tax reform, why do the authorities hesitate to seek technical assistance from the Fund? And second, will the introduction of the new investment code result in differential treatment of tax exemptions for new and old investments?

In the financial area, so long as there are quantitative controls over the allocation of credit and so long as the Government remains involved in credit rationing, setting up a sound institutional framework for surveillance and monitoring the financial system should be given higher priority than liberalizing the interest rate structure. The goals of interest rate liberalization are to encourage capital inflows and to discourage financial disintermediation, but given the current rationing system, liberalization is unlikely to guarantee that the most efficient users will receive the greatest access to resources. Also, to minimize the risk of an increase in nonperforming loans, interest rate liberalization should be considered only in the context of a major overhaul of the financial system.

Even though Paraguay is burdened by distortions created by past investment decisions and by the negative externalities of the current conjuncture of regional circumstances, my chair's hopes for a durable improvement in the economy have been encouraged by the authorities' performance, and by the public's acceptance of the new measures. At the current turning point, the authorities have a clear choice to make between pursuing sound economic policies or financial opportunism, as represented by the accumulation of arrears, rescheduling, and further uncertainty. Either way, the remainder of 1990 will be a period of great challenge.

Mr. Garcia made the following statement:

Over the past year, the Paraguayan economy has moved in the right direction, with the new Government deciding to embark on a program of fiscal discipline and market-oriented reforms. The indicators of the country's performance are significantly positive: the fiscal deficit was nearly eliminated; the recovery in exports permitted a substantial reduction in the current account deficit; and inflation stayed at manageable levels, even though it has remained persistently at about 30 percent. More importantly, real per capita GDP continues to grow. The authorities should be commended for these results, particularly because their policies have been implemented alongside an accelerated process of democratization.

Despite the progress achieved in 1989, the economy continues to confront structural bottlenecks that pose serious limitations to the achievement of sustainable growth in terms of inflation and balance of payments viability. The agricultural sector, which is highly vulnerable to weather conditions and world prices, represents more than one fourth of real GDP and more than 90 percent of exports; and manufacturing activities account for about 16 percent of real value added. The external sector is still weak: net international reserves of the Central Bank are close to three months' imports of goods; the current account is in substantial deficit; while public and public-guaranteed debt represent almost 45 percent of GDP. Moreover, the financial repression of the past several years has resulted in a weak financial sector structure and a misallocation of resources; but more importantly, an extremely low level of internal saving has been compounded by external indebtedness and losses of international reserves.

The program designed by the authorities tries to address those issues. Fiscal discipline will be complemented with further improvements in the performance of public enterprises and with the privatization of the alcohol enterprise. The projected trade liberalization will enhance the exchange rate policy implemented in 1989. We are encouraged by the Government's decision to join the Multilateral Investment Guarantee Agency and by its application for reinstatement of access to the Generalized System of Preference for Paraguay's exports to the United States.

We also welcome the authorities' commitment to implement the financial sector reform within the guidelines described in the staff report. This reform is probably the most important to be implemented in the near future, given the need to increase substantially the internal rate of saving and to improve resource allocation. These two objectives will require, among other things, the liberalization of interest rates and the elimination of the minimum portfolio requirement for commercial banks. In addition, monetary policy should play a more active role in controlling inflation, while the Central Bank should gradually relax the financing of specific activities to market initiatives. We encourage the authorities to initiate these policies as soon as possible.

Paraguay needs to normalize its relations with the international financial community, particularly as the accumulation of arrears is not the most efficient form of financing. In this sense, we welcome the recent agreement with Brazil that will allow an important debt reduction for Paraguay. Given that most of the country's debt is noncommercial, the authorities should seek to complement the rescheduling of the debt with new financing from multilateral institutions. The authorities' economic program is a good one that will pave the way for new financing from the World Bank, the Inter-American Development Bank, and the Fund. We will gladly be willing to support any request by Paraguay within the current macroeconomic program and structural reforms discussed with the staff at the beginning of 1990. We commend the authorities for the gains achieved already and for their commitment to further reforms, aimed at creating a solid basis for stable and sustainable growth.

Mr. Hogeweg commented that he agreed with most of the staff appraisal and that, like previous speakers, noted that highly commendable actions had been taken in 1989. However, monetary control had been deficient, and required full scrutiny when a Fund-supported program was discussed.

The authorities should realize that subsidies distorted the allocation of resources, Mr. Hogeweg stated. Nevertheless, if they considered that it was necessary or desirable to subsidize a certain activity, those subsidies should be fully budgeted and financed, thus ensuring that they were transparent and entirely subject to budgetary choices. The unification of the exchange rate had eliminated a portion of the hidden subsidies, thereby making more visible the too low level of parastatal tariffs. The structure of preferential interest rates and portfolio requirements were also forms of hidden subsidies that distorted the allocation of resources and seriously hampered the conduct of the monetary policy necessary for good functioning of the market economy. It was essential for the authorities to understand that monetary policy was not an allocative device, but an instrument of macroeconomic management.

He understood the logic of measuring exchange rate developments primarily against close neighbors, yet agreed with the remarks of Mr. Goos--as elaborated by Mr. Al-Jasser and other speakers--on the risk of a feed-through of adverse developments from those neighbors, Mr. Hogeweg continued. Moreover, he recalled the recent discussion on Gabon (EBM/90/17, 2/19/90), a member of the CFA franc zone, where the staff report had shown highly distorted data on the effective exchange rate, owing to Brazil, which had a small share in Gabon's foreign trade. Obviously, Gabon had not geared its exchange rate policy to those figures in any way, but he had mentioned the point only to illustrate the risk of using hyperinflationary countries as a yardstick. Therefore, he would also put the emphasis on domestic financial policy restraint, instead of on bilateral exchange rate relationships, in preserving competitiveness.

Mr. Enoch said that he would join other speakers in endorsing the staff appraisal and in broadly commending the authorities for the policies they had adopted in 1989. He also welcomed their willingness to approach the Fund at a relatively early stage of the reform process. He nevertheless welcomed their, and the staff's, acceptance of the view that a premature program would be counterproductive, and the preference instead for a shadow program over the next six months, so that Paraguay could establish a satisfactory track record. That clearly was an intermediate step, and, as Mr. Newman had stressed, more ambitious targets would be required if a full program was negotiated later in 1990.

Looking at just one aspect of policy, he shared the staff's concern at the increase in the rediscount program reported in SM/89/274, Supplement 1. That increase was especially worrying, given that it had not been envisaged by the staff in its earlier discussions with the Government, the disappointing inflation rate performance in 1989 and, more recently, the persistence of negative real interest rates. The authorities certainly needed to carry out their commitment to accelerate the implementation of open market operations if liquidity pressures emerged. On the positive side, it was encouraging that they envisaged financial sector reform at an early stage of their reform program. Such reform was clearly likely to be central for the achievement of the program's objectives, and he urged the authorities to implement the recommendations of the Central Banking Department mission promptly and in full.

He welcomed the unification of the exchange rate, and endorsed the staff's view that the authorities needed to keep developments in the exchange markets under close review, Mr. Enoch added. However, in view of the imbalances in neighboring countries, Paraguay would be unlikely to be able to follow any fixed, predetermined rule, but would need to use the exchange rate regime flexibly to maintain an adequate degree of external competitiveness. The need to restrain inflation increased the argument for adequately tight monetary and fiscal policies.

Mr. Kwon remarked that he was pleased to note that economic activity in Paraguay had generally grown at a satisfactory pace over the past several years in comparison with other countries in the region. However, he would join other speakers in expressing concern over the growing inflationary pressures and the deterioration in the external accounts, which clearly indicated the need for adjustment. He therefore much welcomed the adjustment effort initiated by the new Government after it took office in 1989. He especially welcomed the additional information contained in the supplement paper in respect of the authorities' 1990 program, which would provide a good basis for negotiations on a possible stand-by arrangement. In light of the progress made, he looked forward to an agreed program being brought before the Board in the not too distant future.

Mr. Newman said that, while his chair rarely agreed with the views of some Directors who cautioned about recommendations for active exchange rate policies, he shared the concern in the current case that the exchange rate not be used as a mechanism for transmitting inflation from hyperinflationary countries. He wondered, nonetheless, whether that would in fact be the risk in the current case. Paraguay was landlocked and 40 percent of its imports were from Brazil and Argentina. Much of these imports were simply transhipments that did not involve any transformation of the products. Therefore, the standard measures of real exchange rates weighted by import patterns might give a misleading perception of Paraguay's competitiveness.

The staff representative from the Western Hemisphere Department said that it had been made clear to the authorities that it was fundamentally important to aim at a substantial, and steady, decline in the inflation rate. Unlike many other economies in Latin America, the Paraguayan economy was not fully indexed, making it critical for the Government to take advantage of that opportunity to stabilize prices quickly before demands from the public, including labor unions and savers, emerged for comprehensive indexation. The staff had referred initially to a target range for inflation of 15-20 percent a year in view of the Government's publicly stated target of reducing the rate to below 20 percent. However, as clearly understood by the authorities, the indicative program had been designed with an inflation rate target of about 15 percent for end 1990, requiring that the rate be below 10 percent in the last quarter of the year. The Government, currently considering an 18 month program through end-1991, regarded the needed reduction in inflation as a longer-term proposition, rather than a one-time-only stabilization of prices in 1990. The reasons for the disappointing inflation rate performance in 1989 had been discussed extensively, including the staff's concern that deviations would continue in 1990 unless credit policy was tightened--which, indeed, would be a necessary complement to the Government's ambitious fiscal policy.

The staff had not been advocating competitive devaluations, the staff representative continued. For many years, Paraguay had had a fixed exchange rate system--accompanied by low inflation--followed by a multiple exchange rate system abolished in 1989. The authorities needed to learn how to operate a floating exchange rate system and to take advantage of its flexibility without either entering a cycle of competitive devaluation or going against market fundamentals. In suggesting that Paraguay monitor exchange rate developments in neighboring countries, the staff had been motivated by the unsettled situation in those countries and by the fact that the Paraguayan economy was very open, having a large share of its trade with its neighbors. The figures for external trade shares derived from the Direction of Trade statistics should not be given undue weight, given that they referred mainly to registered trade. However, as Paraguay's substantial trade with neighboring countries implied possible large swings in competitiveness and in current account transactions, the Government would have to monitor the situation in the region closely.

Monitoring and implementation of financial and economic policies in general were being improved, the staff representative added, and the staff had advised the Government to look at a broad range of indicators of competitiveness, including different currency baskets, the indicators contained in the Fund's information notice system, and the parallel market rate; in any event, the authorities should not oppose market fundamentals. In maintaining competitiveness, the authorities had to strike a balance between considering the official and parallel market rates. They could not, of course, match the swings in the parallel market rates in Brazil and Argentina, which in any event were often not related to economic fundamentals but more to confidence factors. Large increases in the spreads between official and parallel rates in those countries should thus not be mirrored by Paraguay. Nonetheless, the authorities would let the exchange rate drift in a direction not opposed to market fundamentals, and should focus on achieving a low and stable inflation rate.

The Government believed, and its actions demonstrated, that the private sector should play the leading role in the economy, the staff representative remarked. The thrust of its policies had been directed to that end, with the removal of the multiple exchange rate system, liberalization of trade, relaxation of controls, and the formulation of a new investment code. Following the large compression of investment expenditure in 1989--a typical phenomenon in countries in which new governments in office embarked on fiscal adjustment--resulting from short-run postponement and cancellation of certain projects, the authorities had indicated that they would focus selectively on investment projects in profitable enterprises with good rates of return, and avoid investment in the loss-making cement and steel enterprises. The Government was not planning to embark on a major expansion in public investment or public expenditure in general. As a newly elected democratic administration, it would, however, change the composition of expenditure toward meeting social priorities, particularly as health, literacy, and education standards in Paraguay were at low levels. It would also focus on expenditure for agrarian reform, treated by the staff as part of capital expenditure and accounting for the equivalent of about 1/2 percentage point of GDP of the projected increase in such expenditure in 1990.

To meet their expenditure objectives in the areas of social services and agrarian reform, the authorities planned to generate more revenues through tax reform, the staff representative commented. They would submit tax reform legislation to the Congress for approval in April 1990, which--if in place by the envisaged time at the beginning of 1991 and fully operative 2-3 years henceforth--could generate additional revenues equivalent to about 5 percentage points of GDP. In addition to filling gaps in the social and infrastructural areas, those revenues could be used to finance viable and high yielding projects in the public enterprise sector.

The authorities had not taken advantage of the Fund's technical assistance in the area of fiscal and tax reform owing to the help that they had received for several years from a resident technical assistance mission from the Organization of American States and the Inter-American Development Bank, the staff representative informed. That mission had discussed the tax reform in great detail with the authorities. The tax reform had been delayed over the past several years, according to the staff's understanding, mainly because of the political difficulties in introducing a value-added and a personal income tax. More recently, the Government had been fine tuning the details of the proposed reform for the past year or so, before presenting it to the Congress. It had not ruled out a request to the Fund for technical assistance in specific areas, such as the implementation of the value-added tax; and it had benefited, and planned to benefit further, from specific technical assistance from friendly countries such as Germany and Chile.

It was indeed the case that old and new investment were subject to differential tax treatment under the recently approved investment code, the staff representative confirmed. The more favorable treatment of new investment might well create certain distortions to investment decision making, although he would point out that the legislation had essentially been carried over from the old Government and that there were indications that the new Government would, at some stage, be willing to revise or tighten some features of the investment code--particularly the potential tax expenditures or foregone tax revenues that might result from the existing code. Nonetheless, the private sector had responded favorably to the new code, making many applications for benefits under it.

The program's growth rate target of about 5 1/2 percent for 1990 would have to be distinguished from a sustainable growth rate over the long term, the staff representative stated. Given Paraguay's endowment of natural resources, its level of technological development, and the current level of savings, a steady growth rate of about 5 1/2 percent a year over the next 3 to 4 years would probably not be feasible. In the short term, however, overall growth depended heavily on the output of agricultural products. The recent buoyant performance of farm output was explained by the substantial incorporation of previously wooded areas into the agricultural sector over the past two to three years--creating a transitory boost to output through new areas for cultivation of soybeans and cotton--as well as by the response of the agricultural sector to farm mechanization and stimulus provided by the unification of the exchange rate and highly favorable weather. Potential growth of the agricultural sector over the longer term remained constrained by the limited amount of new land available for incorporation into the productive system. Moreover, the authorities were concerned about the ecological effects of rapid deforestation and were planning to address the problem in an orderly fashion. If the expected good crop in the agricultural sector materialized in 1990, achievement of the growth target for the year would be reasonable and feasible. He added that, over the longer term, overall growth performance would depend on a significant increase in domestic savings and in the efficiency of resource use--both of which would be aided by the structural reforms contemplated by the authorities.

The Government considered that debt rescheduling would be helpful to Paraguay, because maturities on past loans were bunched temporarily and the amount of arrears accumulated so far was relatively large, the staff representative continued. Significant debt relief had been obtained through rescheduling of debt with Brazil in 1989, an agreement that had included a clause allowing Paraguay to benefit from debt discount in the secondary market through debt buy-backs with Brazil, in effect transfering the resulting benefits to Paraguay. Whether there was scope for similar debt-reduction operations on remaining debt would yet have to be seen. The staff had suggested that the authorities should begin a dialogue with their external creditors and establish an agenda for those discussions. Some sectors of the Paraguayan economy were calling for debt-reduction operations of some type with commercial banks, but discussions had not yet advanced to that stage. There might be some scope for debt-equity swaps, although one had to keep in mind that the country's debt to commercial banks was not as large as in other middle-income countries, and that much of the external debt was of a bilateral or multilateral nature. As Paraguay did not have a large overhang of commercial debt, its situation was different from that of other countries considering the Brady initiative. Debt-equity swaps had not specifically been envisaged in the new investment code, but the authorities might at some point wish to consider them in that context.

It had been somewhat discouraging that the swap scheme had been announced after the departure of the recent mission, the staff representative stated. While such schemes did have monetary and other implications, he would note that the amount of such transactions in Paraguay's case had been relatively small, at just under $40 million. Given plausible assumptions about the exchange rate for the rest of 1990, the scheme would probably not give rise to substantial foreign exchange losses, as had been feared initially. In any event, the staff had pointed out to the authorities that full disclosure would be crucial in the current closer relationship between the Fund and Paraguay. Closer dialogue would be facilitated by two developments, namely, the staff's suggestion to the Government that it establish a task force made up essentially of the Central Bank and Ministry of Finance to monitor the macroeconomic situation closely--including compliance with the indicative targets agreed with the Fund--and the appointment by the Fund of a resident representative in Paraguay.

A Central Banking Department mission had recently visited Paraguay, recommending that bank financial system supervision be strengthened, the staff representative said. The staff had stressed that such supervision had to be accompanied soon by the liberalization of interest rates, which would help to dampen inflationary expectations. In that regard, the staff and the Central Banking Department mission had stated that credit policy should be made fully transparent, and be used mainly as a macroeconomic tool instead of a discretionary means to allocate credit or provide transfers or subsidies with social objectives in mind. For instance, while the rediscount rate for commercial banks had been increased to nearly 23 percent, the rate for the National Development Bank--an institution that absorbed a large share of the rediscounts--was 3 percentage points lower, in view of the authorities' aim to provide substantial services to the rural sector via that Bank, including research and extension. The National Development Bank should pay the same market-related rates as commercial banks; if it needed to fund its operations through fiscal transfers, those should be reflected fully in the budget.

External sector data had been revised because of the new information that had become available on merchandise trade and transactions at the time of the second staff mission in January 1990, and owing to the changes in the imputations for penalty interest payments accrued on external arrears, the staff representative from the Western Hemisphere Department explained. In reviewing with the authorities the estimates for these penalty interest payments, the staff had decided to make a downward revision in the interest rates applicable to those arrears in finding out that, contrary to the earlier assumption, the penalty rates were in many cases somewhat lower than market interest rates. Moreover, as foreign private sector debt had been overestimated to some extent, the staff had revised the flow of interest payments in line with its revision to the stock of debt.

Mr. Montórfano remarked that the staff had covered Directors' inquiries comprehensively, but he would point out briefly that it was difficult for a country such as Paraguay to effect economic and political change simultaneously. The authorities were committed to those changes in process.

The Acting Chairman made the following summing up.

Directors were in broad agreement with the thrust of the staff appraisal. They commended the Paraguayan authorities for their reorientation of economic policies, and referred especially to the initiatives taken to improve the public finances, unify the exchange rate system, simplify and liberalize the trade regime, and adjust interest rates. While noting with satisfaction the continued buoyancy of economic activity--with rapid growth of GDP now in its fourth year--and also noting the strong response of exports to the new exchange rate regime, Directors expressed concern about the acceleration of inflation in 1989 and early 1990 and the persistence of sizable external payments arrears.

Directors noted that the authorities' program for 1990 provided a suitable framework to consolidate the progress made in 1989 in addressing Paraguay's macroeconomic and structural imbalances. However, several speakers believed that the authorities would be well advised to accelerate the pace of adjustment. In particular, concern was expressed that the inflation rate target for end-1990 was not sufficiently ambitious, and that monetary policy should be tightened further. Speakers urged the authorities to make every effort to observe the program so as to establish a positive track record that would lay a stronger basis for a growth-oriented adjustment program, which could be supported by a Fund arrangement. In this connection, Directors encouraged close and open dialogue with the Fund.

Directors were encouraged by the stance of fiscal policy, which sought approximate balance in the public finances in 1990, after a major fiscal adjustment in 1989. While noting that the proposed tax reform is expected to raise revenue considerably over the medium term, and thus contribute to the much needed strengthening of domestic savings, they stressed that the achievement of the fiscal objectives for 1990 would require continued expenditure restraint and additional efforts to improve tax administration. It was also important to strengthen further the financial position of public enterprises and to adjust their prices and tariffs during 1990 as needed.

Directors were of the view that pursuit of a prudent wage policy and monetary restraint would be needed to achieve the programmed reduction of inflation and to set the stage for a further decline of inflation in the future. Concern was expressed about the newly announced rediscount program for the coming harvest. More generally, the authorities were urged to tighten credit policy further and to raise interest rates to positive levels in real terms. Directors supported the authorities' intention to embark on a broad reform of the financial sector. In this connection, they emphasized the need to strengthen the Central Bank's instruments of monetary control and to allow greater flexibility in interest rates in the banking system, as well as to avoid the use of monetary policy to serve allocative purposes.

Directors welcomed the exchange rate reform introduced in early 1989, and noted that the unified exchange rate is now freely determined by the market. Several speakers referred to the difficulty of formulating exchange rate policy in a small country whose major trading partners suffered from hyperinflation. The maintenance of strong monetary and fiscal discipline, supported by wage restraint, was seen as the best way both to eliminate inflation and to promote exchange rate stability at a competitive level.

The authorities were encouraged to normalize their relations with foreign creditors and to pursue an early elimination of external payments arrears. In this connection, several Directors supported the authorities' plan to approach the Paris Club and Paraguay's commercial bank creditors to indicate their intention of seeking a debt rescheduling soon after the envisaged negotiation of an arrangement with the Fund.

Directors welcomed the measures adopted so far to streamline customs duties and to relax import controls. They encouraged the authorities to launch a comprehensive liberalization of Paraguay's trade system with the aim of reducing the average, and the dispersion of, the effective protection rates. In this process, the temporary export levies imposed early in 1989 would need to be phased out as new domestic revenues were identified.

It is expected that the next Article IV consultation with Paraguay will be held on the standard 12-month cycle.

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LEO VAN HOUTVEN
Secretary