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Supplement 1

CONTAINS CONFIDENTIAL  
INFORMATION

March 8, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Paraguay - Staff Report for the 1989 Article IV  
Consultation

The attached supplement to the staff report for the 1989 Article IV consultation with Paraguay has been prepared on the basis of additional information.

Mr. Neuhaus (ext. 8602) or Mr. Furtado (ext. 8605) is available to answer technical or factual questions relating to this paper prior to the Board discussion, which is tentatively scheduled for Wednesday, March 14, 1990.

Att: (1)

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Department Heads



INTERNATIONAL MONETARY FUND

PARAGUAY

Supplement to the Staff Report for the 1989  
Article IV Consultation

Prepared by the Western Hemisphere and the Exchange and Trade  
Relations Departments

Approved by S.T. Beza and Eduard Brau

March 8, 1990

This supplement updates the information contained in the Staff Report for the 1989 Article IV Consultation with Paraguay (SM/89/274, 12/20/89) and reports on the policy discussions of a staff mission that visited Asunción during the period January 15-February 9. 1/

I. Preliminary Results for 1989

Preliminary data for 1989 tend to confirm the description of developments regarding economic activity, prices, and the balance of payments contained in SM/89/274. Real GDP grew by around 5 1/2 percent, boosted by a strong performance of farm output. The 12-month rate of consumer price inflation rose from 17 percent at end-1988 to 29 percent at end-1989 and 33 percent in February 1990 (Table 1). In particular, the rate of inflation picked up from a monthly average of 1.4 percent in the second half of 1989 to an average of 3.7 percent in January-February 1990, partly in reflection of corrective adjustments in public sector tariffs and an increase in the minimum wage. The external current account deficit narrowed from 12 1/2 percent of GDP in 1988 to 9 1/4 percent of GDP in 1989 as exports rose sharply, and the net international reserves of the Central Bank increased by US\$120 million during 1989, to US\$425 million (Table 2).

The fiscal outturn for 1989 was considerably better than projected at the time of the consultation discussions last October. The overall fiscal deficit (before Itaipu receipts) declined from 4 1/2 percent of GDP in 1988 to just over 1 percent of GDP in 1989, on the strength of

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1/ The mission met with the Minister of Finance, the President of the Central Bank of Paraguay, and other senior government officials. The staff mission consisted of Paulo Neuhaus (Head), Antonio Furtado (both WHD), Augusto López-Claros (ETR), Juan Amieva-Huerta, Mario Garza (both EP-WHD), and Nansihud Lee (Assistant-WHD). Mr. Waldemar de Moraes, the newly designated Fund resident representative in Asunción, assisted the mission. Mr. Pedro Montórfano, Advisor to the Executive Director for Paraguay, participated in the policy discussions.

Table 1. Paraguay: Selected Economic and Financial Indicators

	1986	1987	1988	Prel. 1989	Prog. 1990
<u>(Percentage change)</u>					
<u>Output and prices</u>					
Real GDP	0.5	4.5	6.4	5.3	5.5
Of which: agricultural output	-12.5	9.6	17.9	7.2	8.6
GDP deflator	30.8	30.2	25.3	32.3	22.0-24.4
Consumer prices (end of period)	24.1	31.5	16.9	28.7	15.0-20.0
Consumer prices (average)	31.8	21.8	23.0	25.9	22.0-24.4
<u>Banking system liabilities</u> <u>(end of period)</u>					
Narrow money	27.3	44.8	23.8	44.2	21.3
Broad money	27.1	29.8	20.7	41.2	21.3
Monetary base	37.8	42.1	21.9	24.9	18.4
<u>(In percent of GDP)</u>					
<u>Domestic savings and investment</u>					
Gross domestic investment	23.3	23.2	21.8	18.7	20.3
Gross national savings	9.0	7.3	8.6	8.8	11.9
<u>Fiscal indicators</u>					
Overall position of the nonfinancial public sector	-3.0	-3.1	-3.7	0.3	--
Overall position of the nonfinancial public sector and the Central Bank	-4.7	-3.4	-4.6	0.2	--
<u>(In millions of U.S. dollars)</u>					
<u>External indicators</u>					
Current account deficit	527	635	564	481	444
(in percent of GDP) <u>1/</u>	(15.5)	(16.1)	(12.4)	(9.2)	(7.7)
Net international reserves of the Central Bank at end of period <u>2/</u>	398	437	304	425	445
External public sector payments arrears at end of period <u>3/</u>	112	227	301	309	--
Public and publicly guaranteed external debt at end of period (in percent of GDP) <u>1/</u>	2,010 (59.3)	2,232 (57.2)	2,219 (49.4)	2,307 (44.3)	1,997 (34.8)

1/ U.S. dollar GDP estimated using a shadow exchange rate that maintains the guaraní/dollar real exchange rate constant at its average 1987 value.

2/ Non-U.S. dollar exchange holdings valued at end-of-period exchange rates.

3/ Includes interest imputed on obligations in arrears.

Table 2. Paraguay: Balance of Payments

(In millions of U.S. dollars)

	1986	1987	1988	Prel. 1989	Prog. 1990
<u>Current account balance</u>	<u>-527</u>	<u>-635</u>	<u>-564</u>	<u>-481</u>	<u>-444</u>
Exports	581	665	857	1,097	1,253
Imports	-890	-989	-1,099	-1,171	-1,294
Services and transfers (net)	-219	-311	-321	-407	-403
Of which:					
Investment income (net)	-119	-157	-146	-145	-126
<u>Capital account</u>	<u>316</u>	<u>416</u>	<u>369</u>	<u>135</u>	<u>84</u>
Private long term (net)	30	1	-4	14	24
Public medium- and long-term borrowing (net)	169	116	-79	-171	-144
Short-term borrowing and errors and omissions	117	298	453	292	204
<u>Overall balance excluding opera- tions of binational corporations</u>	<u>-211</u>	<u>-219</u>	<u>-194</u>	<u>-346</u>	<u>-360</u>
<u>Net inflows related to operations of binational corporations</u>	<u>20</u>	<u>92</u>	<u>22</u>	<u>213</u>	<u>237</u>
<u>Overall balance</u>	<u>-191</u>	<u>-128</u>	<u>-172</u>	<u>-132</u>	<u>-124</u>
Valuation adjustment on central bank reserves <sup>1/</sup>	34	52	-35	-6	--
Exceptional financing	68	115	74	259	...
Arrears	68	115	74	7	...
Refinancing	--	--	--	252	...
Net international reserves of the Central Bank (increase -)	89	-39	133	-121	-20
Financing gap	--	--	--	--	144 <sup>2/</sup>
<u>Memorandum item</u>					
Current account deficit (in percent of GDP)	15.5	16.1	12.4	9.2	7.7

Sources: Central Bank of Paraguay; and Fund staff estimates.

<sup>1/</sup> Reflects valuation adjustment in non-U.S. dollar foreign exchange holdings, IMF reserve position, and SDRs.

<sup>2/</sup> The financing gap is expected to be covered by a rescheduling of Paraguay's external debt to the Paris Club and commercial bank creditors.

increases in tax revenue, adjustments in public enterprise tariffs, improvements in the operational efficiency of public enterprises, and cutbacks in capital expenditure. If the payment by the Itaipu binational entity of royalties and compensation is treated as revenue, the overall fiscal outturn was a surplus of 0.2 percent of GDP. The improvement in the overall fiscal position, together with an increase in net external financing (including a further rise in arrears), resulted in a large net debt repayment to the domestic banking system (Table 3).

Credit policy was tightened somewhat in the latter part of 1989, albeit to a lesser extent than expected at the time of the consultation discussions. The 12-month rate of growth of central bank net domestic assets (with respect to base money outstanding at the beginning of the period) slowed from 27 percent at end-September 1989 to 20 percent at end-February 1990. Moreover, on February 22, 1990, the Central Bank's rediscount rate was raised from 21 percent to 22.75 percent for commercial banks, and from 18 to 19.75 percent for the National Development Bank. In mid-January, the authorities effectively suspended the operations under the temporary swap scheme with central bank foreign exchange guarantees that had been introduced in November 1989, and at the end of February they eliminated the scheme as scheduled. Outstanding swap transactions amount to about US\$40 million.

## II. The Program for 1990

The mission discussed with the authorities a program for 1990 with quarterly targets (Table 4), on the understanding that an 18-month stand-by arrangement starting in mid-1990 would be negotiated subsequently. The authorities explained that they needed to gain experience in the implementation and monitoring of a program following a 20-year span without a Fund arrangement. Over the coming months they expected to strengthen the instruments of monetary control on the basis of the recommendations of a CBD technical assistance mission, and would seek to improve control over the public enterprises.

The program for 1990 aims at consolidating the gains achieved so far in the areas of fiscal policy and structural reforms in the context of a medium-term growth oriented strategy. The key objectives are a rate of growth of real GDP in the range of 5 to 6 percent, a reduction in the 12-month rate of inflation to below 20 percent by year-end, a US\$20 million increase in net international reserves, and the elimination of the public sector's external payments arrears by year-end on the assumption of a rescheduling with the Paris Club and Paraguay's commercial creditors.

The achievement of the program's objectives is predicated on the maintenance of overall fiscal balance in 1990. This is to be supported by a credit policy consistent with the program's price and balance of payments objectives, and adjustments in the structure and level of

Table 3. Paraguay: Operations of the Public Sector <sup>1/</sup>

(In percent of GDP)

	1986	1987	1988	Prel. 1989	Prog. 1990
<u>Public sector revenue</u>	<u>11.1</u>	<u>11.2</u>	<u>10.6</u>	<u>11.9</u>	<u>12.5</u>
Current revenue	10.8	10.5	9.7	11.6	12.3
Central Government	7.8	8.1	8.0	9.9	10.2
Rest of general government	1.9	2.0	2.0	2.1	2.1
Public enterprises' operating balance	1.1	0.4	-0.3	-0.3	0.1
Capital revenue	0.3	0.7	0.9	0.2	0.2
<u>Public sector expenditure</u>	<u>15.8</u>	<u>14.6</u>	<u>15.1</u>	<u>12.9</u>	<u>14.9</u>
Current expenditure	8.3	8.4	7.3	9.5	9.6
Central Government	6.6	6.7	5.7	8.1	8.0
Rest of general government	1.7	1.6	1.5	1.3	1.6
Capital expenditure	5.6	5.8	6.7	3.2	5.2
Central Government	1.0	1.5	2.0	1.1	2.3
Rest of general government	0.4	0.4	0.3	0.4	0.4
Public enterprises	4.1	3.9	4.4	1.7	2.5
Net lending	0.2	0.2	0.2	0.1	0.1
Adjusted central bank foreign exchange losses <sup>2/</sup>	1.7	0.3	0.9	0.1	--
<u>Overall deficit before Itaipu     receipts <sup>3/</sup></u>	<u>-4.7</u>	<u>-3.4</u>	<u>-4.6</u>	<u>-1.1</u>	<u>-2.5</u>
Itaipu receipts	--	--	--	1.3	2.5
<u>Overall surplus or deficit (-)</u>	<u>-4.7</u>	<u>-3.4</u>	<u>-4.6</u>	<u>0.2</u>	<u>--</u>
Central Government	-0.4	-0.8	-0.7	1.3	1.6
Rest of general government	0.1	0.3	0.8	0.8	0.6
Public enterprises	-2.7	-2.6	-3.8	-1.7	-2.1
Adjusted central bank foreign exchange losses <sup>2/</sup>	-1.7	-0.3	-0.9	-0.1	--
<u>Financing</u>	<u>4.7</u>	<u>3.4</u>	<u>4.6</u>	<u>-0.2</u>	<u>--</u>
External financing (net) <sup>4/</sup>	6.7	5.6	0.5	2.5	-0.6
Domestic financing (net)	-2.0	-2.2	4.1	-2.8	0.5
<u>Memorandum item</u>					
Current account surplus	3.6	2.6	2.1	1.8	2.7

Sources: Ministry of Finance; Central Bank of Paraguay; and Fund staff estimates.

<sup>1/</sup> Partial sums may not add up to totals due to rounding.

<sup>2/</sup> Total foreign exchange losses of the Central Bank minus the losses originating from the exchange rate subsidy to the external debt repayments of the nonfinancial public sector.

<sup>3/</sup> Measure of overall deficit used in SM/89/274.

<sup>4/</sup> Includes exceptional financing.

Table 4. Paraguay: Indicative Quantitative Targets  
under the Economic Program for 1990 1/

	1990			
	March	June	Sept.	Dec.
<u>(In billions of guaranies)</u>				
Limit on the borrowing requirements of the nonfinancial public sector <u>2/3/</u>	-97.6	-90.6	-49.6	-1.9
Ceiling on the change in the net domestic assets of the Central Bank of Paraguay <u>2/4/5/</u>	-13.6	-27.6	-16.0	22.1
<u>(In millions of U.S. dollars)</u>				
Target for variation in net international reserves of the Central Bank of Paraguay <u>2/5/</u>	38	64	29	20
Limit on the stock of public and publicly guaranteed external debt	2,250	2,300	2,350	2,400
Limit on the stock of public and publicly guaranteed external debt in maturities of up to 5 years	80	100	120	150

1/ Limits tested at the end of each period.

2/ Cumulative changes since end-1989.

3/ Adjustable downward for any excess from the projected level of inflows of royalties and compensation from the Itaipu Binational Entity.

4/ Defined as the difference between currency issue and the net international reserves of the Central Bank of Paraguay.

5/ Adjustable downward (upward) for any excess (shortfall) from the projected sum of (a) royalties and compensation from the Itaipu Binational Entity, and (b) foreign loan disbursements.

interest rates. These measures are to be complemented by a comprehensive reform of the tax and financial systems and further initiatives to strengthen the operations of the public enterprises.

Despite a doubling of central government capital expenditure, the overall position of the central government is projected to improve slightly to a surplus of around 1 1/2 percent of GDP in 1990. This would result mainly from the increase in receipts of Itaipu royalties and compensation to 2 1/2 percent of GDP (from the equivalent of 1 1/4 percent of GDP in 1989), as well as efforts to improve tax administration through the implementation of a single taxpayer registry and the unification of tax administration under a single agency. The authorities are in the final stages of the preparation of the tax reform bill to be submitted to Congress in April and they expect the new tax code to be in place at the beginning of 1991.

Over the past year the authorities have made significant improvements in the operational efficiency of public enterprises, especially in the case of the steel, cement, petroleum, water and sewerage, and airline companies. Also, they recently announced the privatization of the alcohol enterprise. In mid-January, public enterprise prices were increased by 15 1/2 percent for cement, 12 1/2 percent for petroleum products, and 10 percent for electricity, telephone, and water and sewerage services. At the same time, prices of alcohol, bottled gas (LPG) and jet fuel were freed, resulting in significant increases in the prices charged to distributors; the state petroleum company (PETROPAR) is to leave operations in these products entirely up to the private sector within the next few months. The authorities plan further increases in public tariffs in the course of the year as needed to maintain approximate balance in the operating position of the public enterprises.

The credit program for 1990 was designed to take into account the sharp seasonal fluctuations in crop financing and export receipts. For the year as a whole, with the domestic financing requirements of the public sector being fairly moderate, there would be room for an increase in credit to the private sector by nearly 8 percent in real terms (Table 5). In the period ahead the authorities will be implementing a comprehensive reform of the financial sector on the basis of the recommendations of a recent CBD technical assistance mission. These recommendations include: (a) the early removal of all interest rate controls; (b) a move to a general rediscount window with a rediscount rate appropriately linked to market rates; (c) the introduction of a new short-term liquidity instrument that would allow the Central Bank to conduct open market operations; (d) a substantial reduction in legal reserve requirements on new deposits; (e) the payment of market-related interest on public sector deposits at the Central Bank; (f) the eventual removal of commercial bank minimum portfolio requirements; and (g) the strengthening of prudential controls over financial institutions.

Table 5. Paraguay: Banking System Accounts

	End of Period			Prel.	Prog.
	1986	1987	1988	1989	1990
<u>I. Central Bank</u>					
(percentage change over the previous 12 months with respect to base money at the beginning of period)					
<u>Net international reserves</u>	<u>-7.8</u>	<u>2.6</u>	<u>-11.3</u>	<u>12.6</u>	<u>5.6</u>
<u>Net domestic assets</u>	<u>45.6</u>	<u>39.4</u>	<u>33.2</u>	<u>12.3</u>	<u>12.8</u>
Credit to the public sector	7.4	8.8	-2.0	-43.2	6.8
Credit to the financial system	26.5	-1.9	9.5	6.5	3.4
Other <u>1/</u>	11.7	32.6	25.7	49.0	2.6
<u>Base money</u>	<u>37.8</u>	<u>42.1</u>	<u>21.9</u>	<u>24.9</u>	<u>18.4</u>
<u>II. Banking System</u>					
(percentage change over the previous 12 months with respect to liabilities to the private sector at the beginning of period)					
<u>Net international reserves</u>	<u>-2.1</u>	<u>2.5</u>	<u>-4.4</u>	<u>10.3</u>	<u>7.0</u>
<u>Net domestic assets</u>	<u>28.4</u>	<u>26.5</u>	<u>24.7</u>	<u>31.4</u>	<u>14.3</u>
Credit to the public sector	3.4	-5.9	-6.5	-21.3	4.2
Credit to private sector	21.3	17.0	15.4	26.7	15.7
Other <u>1/</u>	3.7	15.4	15.8	26.0	-5.6
<u>Liabilities to private sector</u>	<u>26.3</u>	<u>29.0</u>	<u>20.3</u>	<u>41.7</u>	<u>21.3</u>
<u>Memorandum item:</u>					
12-month rate of growth of currency issue	34.9	41.5	24.7	45.0	21.3

Sources: Central Bank of Paraguay; and Fund staff estimates.

1/ Includes foreign exchange losses of the Central Bank.

In late February 1990, the authorities announced the rediscount program for the coming harvest of cotton and soybeans that is some \$ 80 billion higher than had been contemplated during the mission; the excess is equivalent to around 15 percent of base money outstanding as of end-1989. The authorities explained that banks were unlikely to utilize fully all the authorized rediscount lines, particularly in the wake of the recent increase in the central bank rediscount rate. They also said that the Central Bank would seek to compensate for possible pressures on domestic liquidity by expediting the introduction of open market operations.

The outlook for exports in the period ahead remains favorable owing to the continued good prospects for output and world prices of key agricultural commodities; this would lead to a narrowing of the external current account deficit to 7 3/4 percent of GDP in 1990. There was agreement that exchange rate policy should remain flexible and that the authorities would keep developments in the foreign exchange markets under close review in light of the unsettled situation in the region. The guarani remained virtually unchanged in real effective terms during the second half of 1989, and as of November 1989 it was about 27 percent more depreciated than as of end-1988.

The authorities are planning to contact the Paris Club and Paraguay's commercial bank creditors shortly to indicate their intention of seeking a debt rescheduling soon after the negotiation of an arrangement with the Fund. The authorities also plan to effect during the first semester of 1990 buybacks of their US\$435 million debt to Brazil, under the terms of the debt rescheduling with that country agreed upon in April 1989. These terms include an option to cancel both principal and interest obligations at face value against Brazilian external debt instruments, which Paraguay can purchase at a sizable discount in the secondary market.

#### IV. Staff Appraisal

The staff is of the view that in Paraguay's current circumstances the authorities' program provides an adequate framework to consolidate the gains achieved in 1989 and to make further progress in correcting Paraguay's macroeconomic and structural imbalances. Observance of the program would establish a track record that would facilitate the negotiation of an arrangement with the Fund over the coming months.

A key feature of the program is the maintenance of approximate balance in the fiscal accounts, following a major fiscal adjustment effort in 1989. This will require an improvement of controls over the public enterprises and adjustments in their prices and tariffs in the course of the year as needed to maintain their financial integrity.

The relatively disappointing price performance in 1989, notwithstanding the improvement in the fiscal position, and the acceleration of inflation that has occurred over the past two months point to the critical importance of tightening domestic credit and pursuing a prudent wage policy. In this regard, the recently announced rediscount program for the coming harvest is a matter for deep concern. To avoid deviations from the programmed path of adjustment, the staff would urge the authorities to limit rediscounts to the level originally programmed while raising further the central bank rediscount rate.

More generally, it will be important to implement promptly measures aimed at strengthening the Central Bank's instruments of monetary control within the framework of a broad financial sector reform. In this context, adjustments in interest rates of the banking system to positive levels in real terms are needed to help strengthen savings and to improve the allocation of credit.