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Paraguay and the IMF

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June 5, 2006

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Paraguay: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

May 8, 2006

Asunción, Paraguay
May 8, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Rato:

This letter and the attached memorandum of economic and financial policies (MEFP) outline the policies that the Government of Paraguay intends to adopt through the rest of the administration of President Duarte-Frutos (2006-08). Our main objective during this period is to entrench macroeconomic stability and embrace an ambitious structural reform agenda to create conditions for sustainable growth with equity for long-term development. We are requesting a 27-month Stand-By Arrangement (SBA) through August 2008 in an amount equivalent to SDR 65 million (65 percent of quota) in support of the program detailed in the attached MEFP. It is our intention to treat this arrangement as precautionary.

Significant achievements were reached under our economic program for 2004-05, supported by an International Monetary Fund's SBA, particularly in stabilizing the economy, putting the public finances on a sustainable trend and restoring confidence in the financial system, as well as beginning a process of structural reform. We achieved in 2004 some of the best macroeconomic results in a decade, with record high growth and one of the lowest rates of inflation in recent times. The economy continued with a positive performance in 2005 despite significant supply shocks, and the resulting inflationary pressures. By and large, our economic program has been successful.

We would like to build on the success of our recent stabilization efforts. We believe that the time is ripe to refocus our policy agenda on the more ambitious goal of increasing the rate of growth of the economy on a sustainable basis, while at the same time cementing our macroeconomic achievements. We understand that this is a more challenging task and that it will take some time to accomplish our goal, but we are determined to pursue it.

As in the past, the government will maintain a continuous dialogue with the Fund, the government believes that the policies set forth in the MEFP are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. Paraguay will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. We will also provide Fund staff with all the relevant information required to complete program reviews and monitor performance. The government will observe the standard performance criteria against imposing or intensifying exchange restrictions, introducing or modifying multiple currency practices, concluding bilateral payments agreements that are inconsistent with Article VIII of the Fund' Articles of Agreement, and imposing or intensifying restrictions for balance of payments reasons.

There will be quarterly quantitative performance criteria (with a similar structure to that of the previous SBA) and quarterly reviews during the first year, switching to semi-annual reviews later on. There will be six reviews to be completed by mid-September 2006, mid-December 2006, mid-March 2007, mid-June 2007, mid-December 2007, and mid-June 2008. These reviews will be associated with the observance of relevant performance criteria.

We have authorized the Fund to publish this letter and the attached MEFP, to facilitate a wider access and review of our policies among the international community and within Paraguay.

Sincerely yours,

_________/s/_________

Mónica Pérez dos Santos
President
Central Bank of Paraguay

_______/s/________

Ernst Bergen
Minister of Finance

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES OF THE GOVERNMENT OF PARAGUAY

I. BACKGROUND

1. **Paraguay was experiencing one of the most severe economic crises at the time President Duarte-Frutos took office in the second half of 2003.** The country faced an especially difficult fiscal situation and a distressed financial system following the regional financial crisis of 2002. Arrears were accumulating rapidly to creditors and suppliers, banks had failed, credit was shrinking, non-performing assets of the banking system were on the rise, and market confidence was low. There were serious risks of a deeper financial and fiscal crisis.

2. **Decisive policies were adopted in the context of an IMF-supported program in 2004–05 to stabilize the economy and avert further economic difficulties.** Soon after taking office, the government engaged in negotiations with the IMF on a strong program to restore confidence, strengthen the financial system and put the public finances on a sustainable path. A 15-month precautionary Stand-By Arrangement (SBA) for SDR 50 million was approved by the IMF Board in mid-December 2003. The authorities adopted a tight 2004 budget and an appropriate monetary policy that instilled confidence, helped to revert capital outflows and allowed a strengthening of the *guaraní*, while rapidly accumulating international reserves. At the same time, a strong structural reform agenda was adopted to safeguard stability and enhance growth prospects. Congress approved important pieces of legislation, including the banking resolution law, the deposit guarantee law, the fiscal adjustment law, the customs code and the second-tier public banking law. The economy responded rapidly, with 2004 showing the best macroeconomic performance in the recent past; the economy grew by 4 percent, the highest in a decade, and inflation fell below 3 percent, the lowest in a decade. Strong performance continued in 2005 despite supply shocks that have ignited inflationary pressures.

3. **Having successfully stabilized the economy, we intend to focus our attention on the design of policies that will promote growth with equity on a sustainable basis and cement macroeconomic balances.** The successful implementation and conclusion of the SBA in November 2005 marks the completion of the most immediate stabilization efforts. It also paves the way for a new phase in our policy formulation, which emphasizes on the elimination of obstacles to growth and poverty reduction, while maintaining macroeconomic stability. Paraguay experienced one of the lowest growth rates in Latin America over the last 25 years, with economic growth well below the population growth, and the consequent shrinking of per capita income. To reach higher economic growth rates, it will be important to embrace an ambitious structural reform agenda, while pursuing strong macroeconomic policies to safeguard stability. For that purpose, we are requesting a new precautionary SBA to the IMF, which will cover the remainder of the administration of President Duarte-Frutos.

II. RECENT DEVELOPMENTS

4. **While the economy is growing, there are wide disparities in performance across sectors.** There is an uneven pattern of growth. During 2005, livestock, forestry and mining expanded at healthy rates while agriculture, the traditional sector in the economy, remained depressed due to a drought earlier in the year. Other sectors like manufactures and construction are growing at modest rates. We estimate that the economy grew about 3 percent last year.

5. **Inflationary pressures have emerged, partly due to exogenous shocks.** Following one of the best performances in 2004, inflationary pressures emerged in December 2004 due to a temporary liquidity overhang. Since early 2005, the Brazilian currency (real) began to strengthen appreciably, and the price of Brazilian imports began to rise rapidly in *guaranies*. The improved competitiveness vis-à-vis the real also led to a higher Brazilian demand for local goods (mostly dairy products), putting upward pressures on domestic prices. At the same time, meat producers gained access to foreign markets (notably, Chile, Israel and Russia), which also put upward pressure on domestic meat prices. In addition, sharp increases in international oil prices prompted adjustments in the price of hydrocarbons domestically, despite a less than full pass-through on diesel prices. In the end inflation rebounded to almost 10 percent in 2005. We estimate that about one-half of the 2005 inflation is due to exogenous factors.

6. **The fiscal situation remains under tight control.** Mindful of the inflationary pressures, we strengthened our fiscal position relative to program objectives. Despite a reduction in the rate of advances on corporate income tax from 30 to 10 percent in August 2005 (as anticipated in the fiscal adjustment law), we managed to achieve a small surplus in 2005. We tightened fiscal policy towards the end of 2005 to ease inflationary pressures. To that end, we issued a decree in November 2005 to limit public expenditures to those established in the financial plan (approved in early 2005) for the last two months of the year, and prevent reprogramming expenditures not executed in previous months.

7. **A conservative credit policy led to record high international reserves despite less favorable external conditions.** Short-term interest rates on *letras de regulación monetaria* increased by about 400 basis points during 2005 contracting central bank credit and creating room for the accumulation of reserves. The Central Bank purchased foreign exchange in the first half of the year and maintained a more neutral position in the second half. On the external accounts, higher international oil prices and a drought weakened the current account, but private flows offset these developments.

III. Medium-Term Macro Framework and Structural Reforms for 2006-08

8. **The main objective of the medium-term program is to reinvigorate growth and reduce poverty while entrenching macroeconomic stability**. We aim at increasing gradually the growth rate of the economy from the historical average of 2 percent to 4-5 percent over the medium-term. Our poor growth performance in the past has been driven by low or even negative productivity growth in the economy. This suggests that unless we embrace an ambitious structural reform agenda, it will not be possible to break with the vicious circle of the past, which led to perpetuating low growth and a vulnerable economy. We also recognize that without a stable macroeconomic environment, it will not be possible to foster growth. For that reason, we intend to bring inflation down over the next few years to the levels of industrialized countries, by pursuing a combination of prudent fiscal policies and a strengthening of the monetary policy framework.

9. **The cornerstone of our macroeconomic framework is to maintain broad fiscal balance over the medium-term in order to manage the debt burden.** A broad fiscal balance, together with a prudent debt policy will create incentives for private investment and growth. This will also facilitate the conduct of monetary policy.

10. **The structural reform agenda will address four main areas of specific weaknesses in the economy**. We have identified these areas as:

- ***Public sector reform***. The fiscal problems of the past were the result of weaknesses in fiscal institutions and inappropriate policy responses. We will continue the fiscal reform initiated in 2004 to secure our fiscal objectives and correct these weaknesses, including: (i) strengthen the budgetary framework; (ii) build up the institutional framework for tax and customs administration; (iii) strengthen expenditure control mechanisms; (iv) rationalize the civil service; and (v) design a comprehensive reform for public and private pensions and health insurance.

- ***Financial sector reform.*** To ensure an efficient allocation of financial resources and eliminate vulnerabilities, we will: (i) strengthen the financial position of the Central Bank; (ii) improve central bank operations; (iii) upgrade banking supervision; (iv) strengthen prudential regulations; (v) strengthen public banks; (vi) foster capital markets; and (vii) improve the payment system.

- ***Pro-growth agenda***. There are many impediments to growth in diverse areas that need to be addressed, including by improving: (i) the performance of public enterprises; (ii) the investment climate; (iii) the productivity of the agricultural sector; (iv) the efficiency of civil court procedures; and (v) the functioning of the labor market.

- ***Social safety net***. We need to protect the most vulnerable groups of society and strengthen social programs to alleviate widespread poverty, including by:

(i) strengthening social assistance programs with a view to reach the Millennium Development Goals ahead of time; (ii) adopting a poverty reduction strategy; (iii) achieving a better targeting of diesel subsidies by realigning domestic to international prices facilitated by the introduction of a subsidy on public transportation; and (iv) introducing a cash transfer system to the most vulnerable groups conditioned by explicit contracts with beneficiaries. We are confident that these initiatives will contribute to reduce poverty and improve social equity.

IV. Macroeconomic Policies for 2006

11. **A key objective for the 2006 program is to consolidate the significant stabilization gains achieved over the last two years**. The macroeconomic framework for 2006 includes a growth objective of 3½ percent and a significant reduction in the inflation rate. The main elements of the program include a balanced fiscal position, and a tight monetary policy aimed at containing inflation. The Central Bank announced earlier this year the range of 2½ to 7½ percent as the inflation objective for 2006. However, unexpected price pressures in January and February suggest that inflation in 2006 will be at the higher end of the announced range. We believe that the policies described in this memorandum will achieve the objectives of the program. Performance criteria related to these policies are specified in Table 1 and Table 2 and defined in the attached technical memorandum of understanding.

A. Fiscal Policy

12. **We have designed a financial plan for 2006 to make the budget approved by Congress consistent with the available financing and the objective of broad fiscal balance**. The approved 2006 budget for the Treasury envisages a fiscal deficit of almost 2 percent of GDP. However, such fiscal imbalance is not consistent with the objectives of reducing inflation and the debt burden. In addition, there are no suitable sources of financing to cover such a deficit. Revised calculations indicate that revenues are likely to be lower than anticipated by Congress in 2006. For these reasons, the Ministry of Finance will adopt a strict financial plan, in accordance with the financial administration law, to bring the 2006 budget to an executable position. The tax to GDP ratio is expected to fall temporarily in 2006 following the reductions in the corporate income tax rate contemplated in the fiscal adjustment law. This will be offset only in part during 2006 by other elements of the law, such as the introduction of the personal income tax, which will be implemented more gradually over the next few years. The financial plan will be designed to limit current expenditures while allowing for an increase in public investment over the 2005 level.

13. **The program will allow for a higher-than-programmed level of public investment and poverty alleviation programs, provided there are appropriate safeguards**. The 2006 financial plan already provides for an increase in public investment from about 4 percent of GDP in 2005 to over 4¼ percent of GDP in 2006. In the event of

revenue over-performance, additional resources will be directed to increase public investment and social spending to alleviate extreme poverty (especially the conditional cash transfer system mentioned in paragraph 28). The program will also allow to exceed the public investment target and to tolerate a moderate fiscal deficit if the additional investment is growth–enhancing, covered with adequate financing, and does not jeopardize macroeconomic stability. This issue will be addressed in the context of program reviews.

14. **Additional efforts will be needed to reach the objective of fiscal balance for the consolidated public sector in 2006**. Even with a financial plan for the Treasury that would lead to fiscal balance at the Treasury level, there will be a need for further efforts in the rest of the public sector to ensure a zero deficit for the consolidated public sector, as the losses of the Central Bank are likely to rise in 2006. The Central Bank's efforts to fight the recent inflationary pressures are likely to lead to higher interest rates in the short-run, which will impact negatively on its financial position.

15. **We will take measures to ease budgetary financing constraints**. The public sector faces increasing amortizations in the next few years arising mostly from the repayment of obligations restructured in 2004. While our deposits at the Central Bank are sufficient to meet these obligations, this would put undue pressure on monetary policy. For that reason, we will explore ways to reorganize the bond market, which has been closed for some time. The broad objective will be to maintain a sustainable level of debt and prevent negative net domestic and external financing.

B. Monetary Policy

16. **Our main monetary objective for 2006 will be to reduce inflation significantly to within the 2½–7½ percent inflation range**. Inflationary pressures in the first quarter of the year indicate that inflation for 2006 as a whole will likely be in the higher end of our range. We believe that maintaining low inflation is a necessary condition for higher sustainable growth. While we estimate that an important part of the inflationary pressures is exogenous, as a precaution, we started tightening monetary policy in the last few months. Interest rates on "*letras de regulación monetaria"* were raised by 250 basis points in the last quarter of 2005, and by some 400 basis points in the first four months of 2006. We are prepared to tighten monetary policy further if necessary. We expect that the tightening in monetary policy will reduce inflationary pressures and contain inflationary expectations. For 2006, the central bank will accommodate an expected 8½ percent increase in the demand for currency, consistent with our inflation and growth objectives. Looking ahead, we will continue to use the exchange and interest rates flexibly to meet our inflation objectives.

17. **We expect to accumulate about US$20 million in international reserves in 2006, supported by a tight credit policy from the Central Bank**. While international reserves reached almost US$1.3 billion at end-2005, an all time high, we will continue strengthening our reserve position by conducting purchases of foreign exchange in 2006 to satisfy the demand for *guaranies*. In order to facilitate the reserve accumulation, the Central Bank will

limit the expansion of its net domestic assets (NDA). Use of deposits by the government will be sterilized with placements of *"letras de regulación monetaria"* to maintain the NDA target in 2006.

V. STRUCTURAL REFORMS FOR 2006

18. **The main structural objectives will be to modernize institutions and remove impediments to growth**. Our reform agenda is ambitious and aims at providing the conditions for sustainable growth. We will work with the National Congress to facilitate approval of legislation for those reform initiatives that require legislative modifications.

A. Public Sector Reform

19. **We will strengthen the institutional framework for tax collection to safeguard the recent improvements in revenue collections**. In particular, we will prepare a new tax code to modernize and standardize tax practices, as well as to rationalize tax exemptions. We will have a draft code approved by the economic cabinet by end-December 2006 (structural performance criterion). We have requested technical assistance from the IMF for this purpose.

20. **The budgetary framework will be strengthened to convert it into an effective financial management tool that reflects policy priorities**. We intend to rationalize the budgetary processes by improving planning and design as well as incorporating macroeconomic constraints. We will design an action plan to strengthen public financial management, including the introduction of a more effective expenditure control system at the commitment level for the Central Administration and the rationalization of the Treasury account system by end-June 2006 (structural benchmark). In order to strengthen the Treasury's liquidity management and control, we will adopt the long-term objective of having a Treasury single account. We have requested technical assistance from the IMF for these purposes.

B. Financial Sector Reform

21. **We will strengthen and restructure the National Development Bank (BNF) within the current legal framework to reduce vulnerabilities in the system**. The BNF is an important bank with systemic implications that needs to be financially strengthened, and restructured to improve its efficiency and ensure good performance. BNF has been making significant progress over the last two years to improve its financial position through a combination of undistributed profits and recovery of non-performing loans (NPL). We believe that a continuation of these efforts for about G 50 billion in 2006 will lead to a significant improvement in its balance sheet. The restructuring will proceed in two steps: (i) we will focus on strengthening the bank's balance sheet in 2006, to ensure it meets strict prudential norms and presents indicators consistent with a sound bank; and (ii) we will

pursue a comprehensive operational restructuring in 2007-08 to ensure the bank's future viability by reducing operating expenses and improving its credit risk management, lending practices and internal controls. In particular, the capital-adequacy ratio (CAR) measured under full classification and provisioning rules of the Central Bank Regulation 8/2003, for the purposes of this program, should reach 5 percent by end-June 2006 (structural benchmark) and 10 percent by end-December 2006 (performance criterion). BNF will be subject to audits for end-June and end-December 2006 as well as on-site inspections by the Superintendency of Banks. In the event these audits/inspections reveal shortfalls with respect to the CAR target, the government will cover those shortfalls promptly. BNF will maintain a CAR of 10 percent after end-December 2006 and will meet all other prudential regulations of the Central Bank. In order to focus on the strengthening of BNF's balance sheet, the increase in credit in 2006 will be limited to 10 percent over the end-2005 level. In an effort to strengthen NPL collection, BNF will also create a subsidiary or hire an independent firm by end–2006 to transfer all the NPL during the first quarter of 2007. We will also design an action plan on how to streamline the cost structure of BNF. We will request technical assistance from the IMF for this purpose.

22. **An action plan designed by the Central Bank to strengthen the functioning of the financial system will be implemented**. The Central Bank recently completed a study that identified the most immediate weaknesses in the financial system as well as a strategy to address these weaknesses. The strategy contains two plans: (i) a legal plan that includes measures that require changes in legislation and (ii) an operational plan that includes measures that can be implemented by the Central Bank. The legal plan identifies six issues that need to be modified in the current legislation, namely: (i) deficiencies in the process of sanctioning financial institutions; (ii) elimination of the sanctions when appealed; (iii) creation of fit and proper criteria for issuing banking licenses; (iv) modification of minimum capital requirements; (v) coordination with foreign supervisory bodies when issuing licenses to foreign banks; and (vi) strengthening monitoring of presumed connected lending. The operational plan include modifications related to: (i) design, structure and publication of the banking ranking (CADEF); (ii) provisioning for credit risk; (iii) foreign exchange position limits; (iv) streamlining sanctions' procedures; (v) capital requirements; and (vi) any change that is needed after the banking law amendments are approved. We expect to implement the operational plan and to submit amendments to the banking law to Congress according to the legal plan by end-September 2006 (structural benchmark). We have requested technical assistance from the IMF for this purpose.

23. **We will strengthen the financial position of the Central Bank to improve its effectiveness**. Weaknesses in the balance sheet of the Central Bank have been hampering the conduct of monetary policy. To address this problem, the Central Bank will design, in coordination with the Ministry of Finance, a plan and a timetable to strengthen its financial position. We will announce the agreed plan by end-December 2006 (structural benchmark). The government will send a bill to Congress by April 15, 2007 reflecting the legal and budgetary implications of the agreed plan to strengthen the financial position of the Central

Bank (structural benchmark). We have requested technical assistance from the IMF for this purpose.

C. Pro-Growth Agenda

24. **We will adopt a comprehensive strategy seeking to improve the efficiency of public enterprises and the quality and coverage of public services.** Building on the comprehensive management audits that are being conducted (a performance criterion under the previous SBA); we will design and announce "Result-Oriented Management Contracts" (ROMC) for the National Electricity Company (ANDE), the Petroleum Company (PETROPAR), the Cement Industry (INC), the Telephone Company (COPACO), and the Water and Sewage Company (ESSAP) by end-September 2006. We will implement these ROMCs by end-December 2006 (structural benchmark). Each individual contract will comprise of relevant financial and managerial performance indicators. These indicators will be reviewed quarterly by the Planning Ministry (STP). The STP will publish the reviews, along with specific recommendations to monitor the performance of each public enterprise. Similar contracts will be adopted for the National Aerospace Authority (DINAC) and the National Port Authority (ANNP) during 2007. At the same time, we will also look for the possibility of private sector participation in the management of some public enterprises. This would be implemented through different modalities such as granting the management of the selected public enterprise to the private sector in exchange of a "success fee", private-public partnership schemes (PPP), or the outsourcing of specific business units. We will work closely with the World Bank and the Inter-American Development Bank in implementing these measures.

25. **We intend to design a master plan to improve the investment climate in the economy and facilitate higher sustainable growth**. A significant improvement in the investment climate has repeatedly been identified as a key factor to unlock the growth potential of the economy. The plan is expected to help promote the development of small and medium enterprises and direct investment by: (i) simplifying procedures to start and close business; (ii) implementing a plan for the modernization of properties registration; (iii) establishing a one-stop shop for exporters; (iv) strengthening of institutions involved in regulating firms and certifying product quality; and (v) improving mechanisms for VAT refunds. We expect to finalize the design of a master plan by end-September 2006 (structural benchmark). We will work closely with the World Bank and the Inter-American Development Bank in formulating this plan.

26. **The Development Financial Agency (AFD) is expected to mobilize long-term resources to provide adequate financing for private investment projects with long gestation periods**. One of the main impediments to growth has been the low level of private investment due to the lack of adequate long-term financing. The AFD is expected to eliminate that bottleneck. The AFD will channel resources from international financial institutions to the local financial system, which will intermediate the funds on competitive terms to private investors (and assume the credit risk). Eligible domestic financial institutions

include commercial banks, *"financieras"* and cooperatives. The AFD is expected to begin operations in May 2006.

D. Social Safety Net

27. **We will implement a cash transfer system aimed at alleviating extreme poverty**. To mitigate possible adverse social effects of reforms, the government will improve on the quality of social spending. We intend to create a system of targeted cash transfers that will be conditioned by contracts with beneficiaries. We expect that some 7,000 families will benefit from this scheme by end-December 2006 (structural benchmark). Within the envelope of the allocated public investment program and additional transfers, the government intends to intensify implementation of several projects aimed at reducing the economic burden among the most vulnerable groups in the population. We will also introduce a centralized system that identifies the most vulnerable groups and those living under conditions of extreme poverty. We will work closely with the donor community for this purpose.

VI. Other

28. **We will continue negotiating disputed claims in good faith**. There are a number of existing claims in dispute, which we hope to resolve during the program. We will do the same for any new disputed claims that may arise.

Table 1. Paraguay: Proposed Quantitative Targets for 2006

	2006		
	end-Jun	end-Sep	end-Dec
Fiscal targets			
1. Overall balance of the central administration (floor, in billions of guaranies) 1/	250	325	0
2. Wage bill of the central administration (ceiling, in billions of guaranies) 2/	1,795	2,695	3,880
3. Overall balance of the public sector (floor, in billions of guaranies) 1/	350	440	0
Monetary targets			
4. Net international reserves (floor, in millions of U.S. dollars) 2/	1,297	1,307	1,317
5. Net domestic assets (ceiling, in billions of guaranies) 2/	-5,711	-5,751	-5,098
Public debt and arrears targets			
6. Contracting or guaranteeing of nonconcessional external debt by the NFPS (ceiling, in millions of US$) 1/	500	500	500
Continuous PCs			
7. Contracted or guaranteed short-term external debt by the NFPS 3/	0	0	0
8. Non-accumulation of external debt arrears 3/	0	0	0

1/ Cumulative flows from the beginning of the calendar year.

2/ NIR is adjusted upward (downward) for any increase (decrease) in reserve requirement for foreign currency deposits (above pre-specified amounts) and upward by the amount of any program disbursements. Similarly, the NDA target will be adjusted downward (upward) following the adjustment in the NIR.

3/ Continuous performance criteria.

Table 2. Paraguay: Proposed Structural Conditionality Under the Program for 2006/07

Measure	Conditionality [1/]	Timing
Public Sector Reform		
A. Preparation of a tax code in consultation with the Fund	PC	end-Dec 2006
B. Design of an action plan to develop an effective commitment control system for the public sector and rationalize the Treasury account system	SB	end-Jun 2006
Financial Sector Reform		
C. Audited and inspected CAR (fully provisioned) of 5 percent for BNF at end-June 2006	SB	end-Sep 2006
D. Audited and inspected CAR (fully provisioned) of 10 percent for BNF at end-December 2006	PC	end-Mar 2007
E. Implement regulatory measures outlined in the banking strategy and put together draft legislation	SB	end-Sep 2006
F. Announce a strategy to strengthen the financial position of the Central bank and a timetable for its implementation	SB	end-Dec 2006
G. Send a bill to Congress that reflects the legal and budgetary implications of the agreed plan to strenghten the financial position of the Central Bank	SB	mid-Apr 2007
Pro-Growth Reform		
H. Design a plan to improve business climate	SB	end-Sep 2006
I. Implement result-oriented management contract for ANDE, COPACO, ESSAP, INC, and PETROPAR	SB	end-Dec 2006
Social Safety Net		
J. Create a conditional cash transfer mechanism for 7,000 families living under extreme povery based on contracts with beneficiaries	SB	end-Dec 2006

1/ SB = structural benchmarks; PC = performance criteria

PARAGUAY—TECHNICAL MEMORANDUM OF UNDERSTANDING

This Technical Memorandum of Understanding (TMU) defines the variables subject to quantitative targets (performance criteria and indicative targets), specified in the Memorandum of Economic and Financial Policies (MEFP). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets.

A. Fiscal Targets

1. Targets on the Overall Balance of the Central Administration

Cumulative balance (from December 31, 2005)	Floor (In billions of *guaraníes*)
End-April 2006 (program projection)	213
End-May 2006 (program projection)	277
End-June 2006 (performance criterion)	250
End-July 2006 (program projection)	285
End-August 2006 (program projection)	309
End-September 2006 (performance criterion)	325
End-October 2006 (program projection)	320
End-November 2006 (program projection)	322
End-December 2006 (performance criterion)	0

For the purposes of the program, the central administration (CA) includes the executive, judicial and legislative branches. The overall balance of the CA will be measured and monitored from the financing side, as equal to *minus* the net financing of the CA. The net financing of the CA is defined as the sum of: (i) net external financing to the central government; (ii) the change in net credit to the central government from the financial system, excluding government bonds; (iii) the net issuance of government bonds; (iv) net financing from all other sources to the government (consisting of any form of financing other than government bonds) including by the private sector; (v) asset sales; (vi) the net change in domestic floating debt (*deuda flotante*), as defined below; and (vii) the net change in external arrears. Items denominated in foreign currency will be converted into *guaraníes* at the average exchange rate for each month.

For the purposes of the program, any government bonds issued to (i) capitalize the central bank, (ii) capitalize the Banco Nacional de Fomento (BNF), or (iii) finance the deposit guarantee will not be included in the definition of fiscal deficit.

Net external financing is defined as central government's foreign borrowing, including bonds issued abroad, less amortization payments (including debt prepayments) of foreign debt. Net credit from the financial system is defined as the change in net credit to government, as reported in the monetary accounts of the BCP, excluding government bonds. Net change in domestic floating debt is defined as the difference between accrued expenditure (*gastos obligados*) and payments transferred (*gastos transferidos*). Net change in external arrears is defined as the difference in the stock of arrears to external creditors during a period of reference, as reported by the Ministry of Finance's SIGADE system. Data will be provided to the Fund by the Ministry of Finance with a lag of not more than three weeks past the test date.

2. Targets on the Central Administration Wage Bill

Cumulative flows (from December 31, 2005)	Ceiling (In billions of *guaraníes*)
End-April 2006 (program projection)	1,185
End-May 2006 (program projection)	1,487
End-June 2006 (performance criterion)	1,795
End-July 2006 (program projection)	2,090
End-August 2006 (program projection)	2,389
End-September 2006 (performance criterion)	2,695
End-October 2006 (program projection)	2,999
End-November 2006 (program projection)	3,309
End-December 2006 (performance criterion)	3,880

The wage bill of the CA is defined as the accrued remuneration to all central administration employees *(servicios personales)*, including overtime and effective social contributions (budget line items 100–199)[1], as reported in by the Ministry of Finance's monthly *Situación Financiera de la Administración Central*. Data will be provided to the Fund by the Ministry of Finance with a lag of not more than three weeks past the test date.

1 It will exclude any Treasury transfers to the Caja Fiscal registered as wages for new employment positions authorized in the budget but not yet appointed.

3. Targets on the Overall Balance of the Consolidated Public Sector

Cumulative flows (from December 31, 2005)	Floor (In billions of *guaraníes*)
End-April 2006 (program projection)	289
End-May 2006 (program projection)	361
End-June 2006 (performance criterion)	350
End-July 2006 (program projection)	395
End-August 2006 (program projection)	426
End-September 2006 (performance criterion)	440
End-October 2006 (program projection)	441
End-November 2006 (program projection)	448
End-December 2006 (performance criterion)	0

For the purposes of the program, the consolidated public sector comprises: (i) the non-financial public sector (NFPS) and (ii) the Central Bank of Paraguay (BCP).

The NFPS includes the CA as defined above, the social security institutes, the provincial governments, autonomous decentralized agencies, and the nonfinancial public enterprises.[2]

Under the program, the consolidated public sector's overall balance will be measured and monitored as equal to *minus* the net financing of the NFPS, *plus* the operating balance of the BCP. The net financing of the NFPS is defined as the sum of: (i) net external financing; (ii) the change in net domestic credit to public sector from the financial system, excluding government bonds; (iii) the net issuance of government bonds; and (v) other net financing of the nonfinancial public sector by the private sector, including net increase in the stock of domestic floating debt, external arrears, and asset sales. Items denominated in foreign currency will be converted into *guaraníes* at the average exchange rate for each month.

Net external financing of the NFPS is defined as all external disbursements less amortization paid by the NFPS as defined above. The change in net credit is defined as the net flow of gross domestic credit (excluding treasury bonds) plus use of deposits by the NFPS in the

[2] Altogether they include: Pension funds (Instituto de Previsión Social (IPS), Caja Bancaria, Caja Ande, Caja Ferroviaria, Caja de Empleados Municipales), the public universities (UNA, UNE, UNP, UNI), 17 provinces (*gobiernos departamentales*), 17 autonomous regulatory and development agencies, the public enterprises (PETROPAR, ANDE, ANNP, DINAC, and INC) and incorporated enterprises owned by the state (ESSAP and COPACO).

domestic financial system. Domestic floating debt of the NFPS is defined as the difference between accrued expenditure (*gastos obligados*) and payments transferred (*gastos transferidos*) vis-à-vis the private sector. It will be measured as the central government floating debt net of debts with the rest of the NFPS as defined herein. External arrears are defined as the sum of (i) any principal and interest accrued by the NFPS and not paid by the due date as reported by the Ministry of Finance's SIGADE; (ii) the net change in arrears to foreign suppliers of the NFPS. The operating balance of the BCP is measured as all administrative and financial revenues minus costs (including costs of monetary policy and interest on BCP external debt). Data will be provided to the Fund by the Ministry of Finance and the central bank with a lag of not more than three weeks past the test date.

B. Monetary Targets

4. Targets on Net International Reserves of the Central Bank of Paraguay (BCP)

Outstanding stock as of:	Floor (In millions of U.S. dollars)
End-April 2006 (program projection)	1,254
End-May 2006 (program projection)	1,273
End-June 2006 (performance criterion)	1,297
End-July 2006 (program projection)	1,303
End-August 2006 (program projection)	1,306
End-September 2006 (performance criterion)	1,307
End-October 2006 (program projection)	1,311
End-November 2006 (program projection)	1,314
End-December 2006 (performance criterion)	1,317

For monitoring purposes, net international reserves (NIR) of the BCP are defined as the U.S. dollar value of gross foreign assets in foreign currencies minus gross liabilities in foreign currencies with original maturity of less than one year. Data will be provided by the BCP to the Fund with a lag of not more than five days past the test date.

Gross foreign assets are defined consistent with SDDS and include all liquid foreign currency-denominated claims of BCP, including monetary gold, holdings of SDRs, the reserve position in the IMF, and foreign currency in the form of cash, deposits abroad, and Paraguay's net cash balance within the Latin America Trade Clearing System (ALADI). Excluded from gross foreign assets are participations in international financial institutions (including *Corporación Andina de Fomento* (CAF), IDB, IBRD, *Asociación Internacional de Fomento*, and *Banco de Desarrollo del Caribe*), the holdings of nonconvertible currencies, and holdings of precious metals other than gold. Gross foreign liabilities are all foreign currency denominated BCP liabilities of contracted maturity up to and including one year plus the use of Fund credit. Non-U.S. dollar denominated foreign assets and liabilities will be converted into U.S. dollars at the market exchange rates of the respective currencies as of December 31, 2005.

NIR targets will be adjusted *upward (downward)* for any *increase (decrease)* in reserve requirement deposits (*encaje)* associated with foreign currency deposits in commercial banks, compared to the following levels: June 30, 2006: US$263 million; September 30, 2006: US$267 million; and December 31, 2006: US$265 million.

NIR targets will also be adjusted upward (downward) by the surplus (shortfall) in program disbursements relative to the baseline projection. Program disbursements are defined as uncommitted external disbursements that are usable for the financing of the overall central government budget.

External Program Disbursements (Baseline Projection)

Cumulative flows (from December 31, 2005)	(In millions of *U.S. dollars*)
End-April 2006 (program projection)	0
End-May 2006 (program projection)	0
End-June 2006 (program projection)	0
End-July 2006 (program projection)	0
End-August 2006 (program projection)	30
End-September 2006 (program projection)	45
End-October 2006 (program projection)	45
End-November 2006 (program projection)	45
End-December 2006 (program projection)	45

5. Targets on Net Domestic Assets

Net domestic assets (NDA) of the BCP are defined as the difference between currency issue (provided by the BCP) and the net international reserves (NIR) of the BCP, both measured based on end-of-period data. Data will be provided to the Fund by the BCP with a lag of not more than five days past the test date.

Outstanding stock as of:	Ceiling (In billions of *guaraníes*)
End-April 2006 (program projection)	-5,372
End-May 2006 (program projection)	-5,540
End-June 2006 (performance criterion)	-5,711
End-July 2006 (program projection)	-5,740
End-August 2006 (program projection)	-5,742
End-September 2006 (performance criterion)	-5,751
End-October 2006 (program projection)	-5,768
End-November 2006 (program projection)	-5,728
End-December 2006 (performance criterion)	-5,098

For the purpose of NDA calculation, NIR will be converted into *guaraníes* at an accounting exchange rate of G 6,280/US$. The ceiling on NDA will be adjusted *upward* (*downward*) by the equivalent in *guaraníes* of the *downward* (*upward*) adjustments made to the floor on the NIR of the BCP as described above.

C. Financial Sector Targets

6. Targets on Banco Nacional de Fomento (BNF)

For the purposes of the program, the capital adequacy ratio (CAR) of the Banco Nacional de Fomento (BNF) will be measured as the ratio of the summation of risk-weighted assets, excluding risk-free assets as Cash and Government Bonds (Disponibilidades and Valores Publicos), divided by total net equity, as of end-June 2006 (structural benchmark) and end-December 2006 (performance criterion). For the calculation of risk-weighted assets and net equity, the bank's loans portfolio (inclusive of both performing and non-performing loans, to the financial and the non-financial sectors) will be fully classified, provisioned for, risk-weighted and accrued for interests in accordance with the rules set by the Central Bank in the Resolution No. 8/2003.

Targets on the Capital Adequacy Ratio for BNF

CAR of BNF:	(In percent)
End-June 2006 (indicative target)	5.0
End-December 2006 (performance criterion)	10.0

D. Public Debt and Arrears Targets

7. Targets on Contracting or Guaranteeing of New Nonconcessional External Debt by the Public Sector

Cumulative flows (from December 31, 2005):	Ceiling (In millions of U.S. dollars)
End-April 2006 (program projection)	500
End-May 2006 (program projection)	500
End-June 2006 (performance criterion)	500
End-July 2006 (program projection)	500
End-August 2006 (program projection)	500
End-September 2006 (performance criterion)	500
End-October 2006 (program projection)	500
End-November 2006 (program projection)	500
End-December 2006 (performance criterion)	500

The limit applies to the contracting or guaranteeing by the public sector within the calendar year of new nonconcessional external debt with an original maturity of more than one year, including commitments contracted or guaranteed.[3] For program purposes, a debt is concessional if it includes a grant element of at least 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates (CIRR).[4] Excluded from the limits are credits extended by the IMF and balance of payments support loans extended by multilateral and bilateral creditors. The Ministry of Finance will provide data to the Fund with a lag of not more than 30 days from the test date.

[3] The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with respect to Foreign Debt adopted on August 24, 2000 (Board Decision No. 12274-(00/85).

[4] The grant element is calculated as the difference between the net present value (NPV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt (i.e., Grant = (Nominal Value – NPV) / Nominal Value). The NPV of debt is calculated by discounting the future stream of payments of debt service due on this debt. For debt with a maturity of at least 15 years, the ten-year average CIRR will be used to calculate the NPV of debt. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. For the purposes of the program, the CIRRs published by the OECD in February 2006 will be used.

The concessionality of loans in currency baskets will be assessed on the basis of U.S. dollar interest rate tables. For loans with interest rates based on the internal policy of the creditors, the relevant interest rate to define concessionality will be the interest rate for each creditor at the time of the commitment. Loans or portions of loans extended in the context of a debt rescheduling or a debt reduction operation will be excluded from the ceiling.

8. Performance Criterion on Short-Term External Debt of the Nonfinancial Public Sector

As a continuous performance criterion, the NFPS will neither contract nor guarantee any short-term external debt during the program period. Short-term debt is defined as debt with a contractual maturity of one year or less. Excluded are normal import-related credits, forward contracts, swaps, and other futures market contracts. The public enterprises will provide the necessary information to the Ministry of Finance, which will provide the data to the Fund, with a lag of not more than 30 days from the test date.

9. Performance Criteria on External Payments Arrears of the Public Sector

The Public Sector, excluding PETROPAR, will accumulate no new external arrears during the program period. The stock of external arrears of the PS will be calculated based on the schedule of external payments obligations reported by SIGADE. Data on external arrears will be reconciled with the relevant creditors, and any necessary adjustments will be incorporated in these targets as they occur. For the purposes of this performance criterion, an arrear will be defined as a payment, which has not been made within 30 days after falling due. In addition, the public enterprises will report to the Ministry of Finance and the BCP arrears on any external debt that is not recorded under SIGADE. The same 30-day grace period will be applied to all external payments of public enterprises, except where explicit agreements exist with creditors on an extended grace period. The Ministry of Finance will provide the final data on the stock of public sector external arrears to the Fund, with a lag of not more than 30 days from the test date.

In addition, the government is engaged in good faith efforts to resolve overdue claims in dispute, and will attempt to negotiate and resolve these as soon as possible.

E. Reporting

Monitoring the program requires accurate and timely data. All information on performance criteria, indicative targets, and balance of payments support loans will be reported to Fund staff within the timeframes prescribed above. Debt stocks and associated flows broken down by both creditor and debtor types and maturity will be provided on a quarterly basis.

The Ministry of Finance will be responsible for gathering data on a monthly basis from all the institutions that comprise the consolidated public sector, including the incorporated enterprises (*Sociedades Anónimas*) COPACO and ESSAP. It will compile this information according to the standard format of the Ministry of Finance's monthly financial situation report *(Situación Financiera).* The data will be supplied to the Fund and published on the Ministry of Finance's external website within 30 days of each test date.