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

June 15, 2007

The following item is a Letter of Intent of the government of Paraguay, which describes the policies that Paraguay intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Paraguay, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

Asunción, Paraguay
June 15, 2007

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

Dear Mr. de Rato:

1. This letter and the attached memorandum of economic and financial policies (MEFP) update and supplement our letters of May 8, and September 12, 2006; describe performance under our economic program for 2006 and early 2007; and propose our economic program for the rest of 2007. The attached MEFP articulates, in some detail, the economic policies that the government intends to carry out during 2007 as well as the key targets of the program. The government's objectives continue to be the consolidation of our stabilization efforts while establishing policies to foster private investment, enhance employment, remove impediments to growth and reduce poverty on a sustainable basis.
2. Performance under our economic program, supported by a 27-month Stand-By Arrangement (SBA), has been quite strong. All quantitative and structural performance criteria through end-March 2007 were observed. With three exceptions (explained by the changes at the Central Bank leadership), all structural benchmarks were also met. Economic growth remains strong and inflation under control. The public finances are on a strong footing and international reserves are at a record high level.
3. To continue supporting our efforts, the Government of Paraguay hereby requests:
(i) complete the second and third reviews under the SBA supported program; (ii) reschedule the missed structural benchmarks on designing the strategy to strengthen the financial position of the Central Bank to end-June 2007; (iii) modify the missed structural benchmark on implementing regulatory measures outlined in the banking strategy and sending to Congress amendments to the banking law to three new structural benchmark on: (a) the design of an ambitious action plan to strengthen financial sector reform and aiming at increasing the coverage of Basel Core Principles of banking supervision to around 80 percent by end-June 2007; (b) approval of a modified resolution 8/03 by end-September 2007 with a view to become effective on January 1, 2008; and (c) implementation of prudential regulations in line with the Central Bank's operational plan by end-December 2007; (iv) introduce an adjustor to the target on the Central Government balance for the cost of strengthening the financial position of the Central Bank; (v) move the fourth and fifth

program reviews to mid-September and mid-December 2007 respectively, and switch to semi-annual program reviews (while retaining quarterly performance criteria) after the fifth SBA review; and (vi) rephase purchases according to the changes in reviews described before. We intend to continue treating the arrangement as precautionary.

4. The government of Paraguay will maintain the continuous and fruitful dialogue with the Fund, the government believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of its program, but we will take any further measures that may become appropriate for this purpose. In the spirit of cooperation, Paraguay will consult with the Fund on the adoption of these measures, 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.

5. As part of our information policy, we intend to publish this letter and the attached MEFP on the websites of the Ministry of Finance and Central Bank to keep the public informed. We also authorize the Fund to publish these documents to facilitate a wider dissemination of our policies among the international community.

Sincerely yours,

_____/s/_____
Germán Rojas
President
Central Bank of Paraguay

_____/s/_____
Ernst Bergen
Minister of Finance

**MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES OF THE GOVERNMENT OF
PARAGUAY (MEFP)**

I. BACKGROUND

1. **Following the successful stabilization of the period 2003–05, the government adopted an ambitious economic program for 2006–08 to promote growth and reduce poverty while entrenching macroeconomic stability.** Right after taking office, the administration of President Duarte-Frutos designed a program to stabilize the economy, address deep-rooted macroeconomic imbalances and lessen remaining regional contagion. The program was supported by a Stand-By Arrangement from the IMF and quickly began to bear fruit. During the stabilization period of 2003–05 we achieved some of the best macroeconomic results in a decade. The economy began to grow; the public finances were adjusted in an orderly manner; the financial system was strengthened; and the Central Bank tightened its control on inflation while managing to increase international reserves to record highs. These stabilizing efforts were underscored by the successful completion of the SBA in November 2005. Subsequently, we embarked upon designing a program for the period 2006–08 with the objective of removing impediments to growth, and alleviating poverty, while cementing economic stability. The program contains an ambitious structural reform agenda and a strong macroeconomic component. The medium-term objectives of the program are to keep the growth rate of the economy to 4–5 percent; to tend to reduce inflation to industrial country levels; keep the consolidated public debt burden below 30 percent of GDP; and maintain a comfortable international reserve position.

2. **The program remains on track as policy implementation was strengthened.** Performance under the program has been quite strong. Following strict adherence to all targets for end-June 2006, all quantitative performance criteria for end-September and end-December 2006 were observed.¹ On the structural front, the two structural performance criteria and all but three benchmarks were observed through end-April 2007.² With the aim

¹ The variables subject to quarterly quantitative performance criteria under the program include: (i) overall balance of the Central Administration; (ii) wage bill of the Central Administration; (iii) overall balance of the consolidated public sector; (iv) net international reserves of the Central Bank; (v) net domestic assets of the Central Bank; (vi) contracting or guaranteeing of nonconcessional external debt by the nonfinancial public sector; (vii) contracting or guaranteeing of short-term external debt by the nonfinancial public sector on a continuous basis; and (viii) non-accumulation of external debt arrears on a continuous basis.

² The list of structural measures observed through April 2007 include: (i) improve the capital-risk-weighted-asset ratio of the National Development Bank (BNF) to 5 percent by end-June 2006 and 10 percent by end-December 2006 according to an audited and inspected balance sheet (performance criterion); (ii) design a plan to improve the business climate by end-September 2006; (iii) preparation of the tax code by end December 2006 (performance criterion); (iv) implement result-oriented management contracts for ANDE, COPACO, ESSAP, INC and PETROPAR by end-December 2006; (v) creation of a conditional cash transfer system for 7,000 families living under conditions of extreme poverty based on contracts with beneficiaries by end-December 2006. The missing benchmarks were: (i) implementation of the regulatory measures outlined in the

(continued)

of strengthening program implementation, the Government issued decree 7712 in June 2006 by which the execution of specific measures under the program is delegated to individual Ministries within the Government. The same decree also provides adequate control and monitoring mechanisms to ensure a successful program implementation.

3. **Economic conditions continued to improve in 2006.** Real GDP is estimated to have grown by 4 percent, exceeding the program objective of 3½ percent for 2006, driven by a combination of a strong external demand (buoyant exports, especially for beef) and a dynamic domestic demand (higher private investment, especially in mobile telecommunications). Headline inflation exceeded the program objective of 7 percent for 2006, mostly on account of a surge in beef prices in the regional and international markets; however core inflation (excluding the beef price shock) was in line with the program objective. The public finances remained with a small surplus in 2006, against a program objective of fiscal balance, mainly due to strong tax collections and strict control on expenditures. The Central Bank managed to accumulate a record level of reserves in 2006, while maintaining control of monetary aggregates and allowing the *guaraní* to strengthen against major international currencies, as the external position continued to be positive.

4. **Economic performance in the first quarter of 2007 was also strong, and macroeconomic stability was further enhanced.** Following the unwinding of the supply shock observed at end-2006, the price level fell by 1½ percent, bringing down the 12-month rate of headline inflation to about 6 percent by end-April. We have maintained strong fiscal discipline, and the central government budget recorded a significant surplus in the first quarter on account of continued strong revenue performance and expenditure restraint. The export sector enjoyed robust growth as a result of continued productivity increases, especially in soy and beef production, as well as from favorable external conditions. As a result, we strengthened our reserve position by over US\$300 million in the first four months of 2007 to reach yet another historic record. In view of the positive external position, large level of reserves, progress in implementing the program, and in recognition of the revolving nature of the Fund resources, we request—in the context of the next program review—a reduction in access under the Stand-By Arrangement (which would also reduce the commitment fee).

5. **The program for 2007 envisages further consolidation of the stabilization gains and further deepening of the reform agenda to achieve higher growth.** The structure of the 2007 program will be similar to that of 2006. The program will continue to be based on five policy pillars, a strong macroeconomic program anchored by four structural reform

Central Bank's banking strategy and the amendments to the banking law according to the same strategy by end-September 2006; (ii) design of a strategy to strengthen the financial position of the Central Bank by end-December 2006; and (iii) send to Congress a bill with the legal and budgetary implication of the abovementioned strategy by mid-April 2007.

areas: (i) public sector reform; (ii) financial sector reform; (iii) pro-growth agenda; and (iv) a social safety net to alleviate poverty. Performance criteria and structural benchmarks for 2007 related to these policies are specified in Tables 1 and 2 and further defined in the attached technical memorandum of understanding. Policies for 2008 will be articulated at the time of the fifth program review, expected for late 2007.

II. MACROECONOMIC PROGRAM FOR 2007

6. **The macroeconomic framework for the 2007 program aims at raising growth and reducing inflation.** An important program objective will be to raise economic growth to the 4-5 percent range in 2007. This objective seems realistic as agriculture is expected to rebound and the supply effects of the structural reforms begin to have an impact on the economy. Another key objective for the 2007 program is to tend to reduce the core inflation rate to 5 percent (within a range of +/- 2½ percent), as the impact of supply shocks is absorbed, and the Central Bank continues with an adequate control of monetary aggregates.

A. Fiscal Policy

7. **The program aims at maintaining fiscal discipline while targeting higher capital spending.** The 2007 budget submitted to Congress envisaged a small deficit of 0.8 percent of GDP. Given financing constraints and the objective to reduce the debt-to-GDP ratio, we have designed a financial plan to limit spending and achieve a balanced fiscal position. The program's objective is to contain non-social current expenditures of the Central Administration while allowing for a higher level of capital and social expenditure to support growth and poverty alleviation efforts. In particular, the program aims at increasing capital I expenditure to 4½ percent of GDP and to further increase social spending.

8. **An adjustor will be introduced to facilitate the implementation of the structural reform agenda.** The fiscal targets will be adjusted to accommodate the cost of structural reforms. In particular, the fiscal target for the Central Administration will be adjusted to take into account the interest cost or additional transfers resulting from the government's intention to strengthen the financial position of the Central Bank. In the case of issuance of bonds, the interest costs will be recorded as part of the expenditure of the Central Administration. This adjustor will apply to the Central Administration, but not to the Consolidated Public Sector.

9. **As in the past, the program will endorse higher than targeted levels of public investment and poverty alleviation programs, provided appropriate safeguards are in place.** The 2007 program will allow for a level of capital and targeted social expenditures beyond program objectives provided that macroeconomic conditions allow the absorption of these expenditures and there is revenue over-performance or else financing on appropriate terms directed to high quality projects. This issue will be addressed in the context of program reviews.

10. **The program seeks to achieve fiscal balance at the consolidated public sector level.** The rest of the public sector is expected to maintain its surplus position by restraining current expenditures. This will help in covering the expected losses of the Central Bank or the Central Administration once the Central Bank's position is being strengthened.

B. Monetary Policy

11. **The key monetary policy objective of the 2007 program will be to maintain core inflation at around 5 percent.** While this may appear as an ambitious target given the end-2006 headline inflation of 12½ percent, the core inflation was about 7 percent at the end of the same period. Moreover, with a deflation of about 1½ percent in the first four months, the 12-month rate of inflation already fell to about 6 percent in April 2007. However, given the variability of inflation and the vulnerability to external shocks, the Central Bank believes it is prudent to adopt a range of plus/minus two and a half percentage points, making the core inflation range 2½ to 7½ percent in 2007.

12. **To achieve the inflation objective, the Central Bank will maintain to reasonable levels the growth of monetary aggregates.** The Central Bank will follow a monetary policy that is consistent with an economy growing at 4-5 percent, a core inflation objective of 5 percent (within a range of +/- 2½ percent), and a moderate strengthening in real money demand. The Central Bank made large purchases of foreign exchange in the first quarter of 2007 to prevent the exchange rate from appreciating beyond fundamentals and reduced interest rates to stop attracting foreign exchange inflows. For the rest of the year, the Central Bank will focus its policy on controlling the pace of currency expansion through additional placements of "*Letras de Regulación Monetaria*." With a record level of international reserves beyond US\$2 billion at end-May 2007, the Central Bank does not have a need to accumulate further reserves and might use part of the foreign exchange purchased earlier in the year in case there is a reversal of the flows. In any case, the Central Bank level of international reserves will not be below US\$1.92 billion by end-2007.

III. STRUCTURAL REFORMS FOR 2007

13. **The structural reform agenda for 2007 will continue to build on the accomplishments of the past year with the ultimate objective of removing impediments to growth.** Plans designed in 2006 will be implemented in 2007. Measures already agreed for 2007 will be executed during the year. Reforms that began last year will be finalized in 2007/08. In designing the reform agenda, we have minimized the use of legislative change. However, in those cases where it has been impossible to make progress without some form of legislative action, we will work closely with the National Congress to initiate the dialogue and explain the rationale for the proposed legislation, increasing ownership of the reform process and facilitating the approval of the proposed legislation.

A. Public Sector Reform

14. **The institutional framework for tax collection will continue to be strengthened.** The increases in tax collections of the last few years need to be locked in through the adoption of a tax procedures code to ensure macroeconomic stability over the medium-term. Following the design of a draft tax procedures code in December 2006, the Ministry of Finance will prepare the implementing regulations for such tax procedures code by end-September 2007 (structural benchmark). We will continue requesting technical assistance from the IMF for this purpose.

15. **A coherent public expenditure policy will be designed to improve the efficiency of government spending.** The current system is quite rigid and lacks adequate control systems. Reforms are needed to ensure that expenditures are carried out in the areas with higher social return.

- ***Controls on current expenditures will be firmed up to better achieve agreed limits and avoid undue fluctuations in spending patterns.*** Following the design of an action plan to develop effective commitment control systems for the public sector in June 2006, the Ministry of Finance will establish an expenditure control system at the commitment level for the Executive Branch by end-December 2007 (structural benchmark). This will require regulations and changes in the financial management information system needed to record all budget execution stages. We will continue requesting technical assistance from the IMF for this purpose.
- ***Selection of investment projects will be strengthened to increase the efficiency of capital expenditures.*** Given the shortfalls in project implementation and the lack of a comprehensive system to establish priorities in public investment over the medium-term, the Ministry of Finance will design a public sector investment system to improve prioritization, efficiency, maximize investment return, and ensure that programs reflect the government priorities by end-December 2007 (structural benchmark). We will request technical assistance from the Inter-American Development Bank for this purpose.
- ***A comprehensive approach is needed to solve the common problems of the different pension systems.*** This will complement the piecemeal approach adopted in the past to solve the financial problems of specific pension systems. To this end, the Ministry of Finance will develop an action plan for a pension reform aimed at ensuring its long-term solvency, appropriately endorsed by the Economic Cabinet by end-September 2007 (structural benchmark).

B. Financial Sector Reform

16. **Reforms are needed in a number of areas to enhance the functioning of the financial system.** Significant progress has been made in strengthening the architecture of the

domestic financial system since the emergence of the 2002 financial crisis (including by upgrading the banking resolution framework, introducing deposit insurance, and improving the financial situation of BNF) but additional steps are needed to consolidate those gains.

- ***The supervisory and regulatory framework for banks needs to be strengthened.*** The Central Bank will continue in their efforts to strengthen the financial system and will take the following measures:
 - ***The Central Bank will design an ambitious plan and timetable to reshape the banking sector reform.*** The plan will address weaknesses in the regulatory and supervisory frameworks of the banking system and will be finalized by end-June 2007 (structural benchmark). The plan will aim at increasing compliance with the Basel Core Principles of Banking Supervision to the highest in the region (about 80 percent). We will continue requesting technical assistance from the IMF for this purpose.
 - ***A modified resolution 8/03 will be reinstated.*** The Central Bank will enter in a process of consultation with the banking community with a view to reach consensus on a modified resolution 8/03 to upgrade credit requirements, loan classification and provisioning. The Central Bank Board will approve a modified resolution 8/03 by end-September 2007 (structural benchmark), which will become effective on January 1, 2008.
 - ***Prudential regulations will be bolstered.*** The Central Bank Board will implement a number of prudential regulations included in the Central Bank's operational plan (approved in November 2005) with the aim of strengthening criteria for calculating capital requirements, improving rules for provisioning, streamlining administrative sanctions proceedings, rationalizing rules on open net foreign exchange positions and the public reporting on banks' financial position by end-December 2007 (structural benchmark). We will continue requesting technical assistance from the IMF for this purpose.
- ***A regulatory framework for cooperatives will be designed.*** To reduce regulatory and supervisory differences between financial institutions, and reduce vulnerabilities to the financial system, INCOOP will develop an effective supervisory and regulatory framework for financial cooperatives by end-September 2007 (structural benchmark). These efforts will aim at leveling the regulatory and supervisory playing field for financial institutions in the country. INCOOP will also strengthen the monitoring framework to compile monetary statistics for the main cooperatives, and their incorporation in the Central Bank's monetary statistics.
- ***Measures will be taken to improve the payment system.*** As part of the modernization efforts of the financial system to enhance liquidity management, facilitate

transactions and mobilize financial resources as well as improving the conduct of monetary policy, the Central Bank will implement the regulatory framework addressing weaknesses in the payment system, and in consultation with the government, will prepare a draft payments system law approved by the economic cabinet by end-September 2007 (structural benchmark). We aim at establishing a real-time gross settlements system (RTGS) by 2008. We will request technical assistance from the IMF for this purpose.

17. While significant progress has been made in strengthening the National Development Bank, further efforts are needed to reduce the vulnerability of the system.

The program includes two main objectives on BNF

- ***Further strengthening the bank's financial position is still needed.*** A milestone of the program has been to turn around BNF's capital from negative (technically bankrupt) to positive through improvements in its administration, which allowed for profit increases and bad debt recoveries. The independent audit confirmed that our objective to increase BNF's capital adequacy ratio to 10 percent by December 2006 was achieved. We will continue strengthening BNF's management to ensure that the bank remains viable over the medium-term.
- ***Additional efforts will be required to restructure the bank.*** To consolidate BNF's financial position, and strengthen its lending policies, BNF will develop a strategy for reducing its operating costs, increasing its asset recovery, improving its credit and risk management practices, and enhancing its internal controls by end-June 2007 (structural benchmark).

18. It is imperative to continue with the efforts to strengthen the financial position of the Central Bank to enhance the effectiveness of monetary policy. We intend to announce a strategy to strengthen the Central Bank's balance sheet and a timetable for its implementation by June 2007 (structural benchmark), the Ministry of Finance will prepare and send legislation to Congress that reflects the budgetary implications of such strategy by September 2007 (structural benchmark). We will continue requesting technical advice from the IMF for this purpose.

19. The development of capital markets will be necessary to foster domestic savings and improve its allocation into productive investment projects. Capital markets are at an early stage of development and serious efforts are needed for these markets to emerge. It will require a number of legal changes as well as institutional development. The Ministry of Finance, in coordination with the Central Bank, will design a strategy for the development of capital markets by end-December 2007 (structural benchmark). The strategy will identify all public obligations; aim to convert all non-marketable public obligations into marketable securities; formulate a plan for improving the profile of domestic public debt; and revamp the

legal framework for government debt management and the development of the government securities market. We will request technical assistance from the IMF for this purpose.

C. Pro-Growth Agenda

20. **Higher levels of foreign and domestic investment will require improvements in the investment climate in the country.** A better investment climate will lead to higher investment and higher growth. Following the design of a master plan to help promote the investment climate in September 2006, the Ministry of Industry will implement such plan by end-September 2007 (structural benchmark).

21. **Improvements in the efficiency of public enterprises are necessary to provide better public services and increase productivity economy-wide.** Public enterprises cover a wide range of economic activities and improvements in their performance are necessary for the proper functioning of the economy. Following the design of result-oriented management contracts for ANDE, COPACO, ESSAP, INC, and PETROPAR in December 2006, the Public Enterprise Supervising Council will publish the assessment reports according to the schedules defined in the contracts. It will also ensure that these performance contracts are satisfactorily observed during the year with an assessment by end-December 2007 (structural benchmark).

D. Social Safety Net

22. **While the conditional cash transfer program was implemented, its coverage needs to be broadened to become an effective vehicle for poverty alleviation.** Following the successful introduction of this program to some 8,800 families living under extreme poverty in 2006 (well above the program objective of 7,000 families, the challenge for 2007 is to strengthen the monitoring mechanisms and the required provision of health and education services while at the same time increasing the number of families receiving these transfers. Notwithstanding these logistic and budgetary challenges, the Ministry of Social Action will aim at widening the coverage of this program to 15,000 families by end-December 2007 (structural benchmark). We will request technical assistance from the IDB for this purpose.

IV. OTHER

We will continue to seek resolution to the disputed claims, negotiating 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: Quantitative Program Targets

	2007		
	End-Jun	End-Sep	End-Dec
Fiscal targets			
1. Overall balance of the central administration (floor, in billions of guaranies) 1/ 2/	184	330	0
2. Wage bill of the central administration (ceiling, in billions of guaranies) 1/	2,055	3,086	4,443
3. Overall balance of the public sector (floor, in billions of guaranies) 1/	202	459	0
Monetary targets			
4. Net international reserves (floor, in millions of U.S. dollars) 3/	1,900	1,915	1,920
5. Net domestic assets (ceiling, in billions of guaranies) 3/	-6,645	-6,700	-6,016
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	0	0	0
8. Non-accumulation of external debt arrears	0	0	0

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

2/ For 2007 adjusted downward for any cash transfer or payment of interest costs on securities used to strengthen the financial position of the central bank

3/ NIR stock 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.

Table 2. Paraguay: Proposed Structural Conditionality Under the Program for 2007

Measure	Conditionality ^{1/}	Timing
Public Sector Reform		
A. Draft implementing regulations for the tax procedures code	SB	end-Sep 2007
B. Develop an action plan for a comprehensive pension reform	SB	end-Sep 2007
C. Design a public sector investment system	SB	end-Dec 2007
D. Establish a commitment control system	SB	end-Dec 2007
Financial Sector Reform		
E. Announce a strategy to strengthen the financial position of the Central Bank and the timetable for its implementation	SB	end-Jun 2007
F. Develop a medium-term business plan for BNF that includes a strategy to reduce costs, increase asset recovery, and improve credit and risk management	SB	end-Jun 2007
G. Develop legal and regulatory framework to revamp the payment system and preparing a draft payment system law	SB	end-Sep 2007
H. Design an action plan to strengthen financial sector reform and increase compliance with Basel Core Principles to at least 80 percent (in line with regional best practices)	SB	end-Jun 2007
I. Send a bill to Congress that reflects the legal and budgetary implications of the agreed plan to strengthen the financial position of the Central Bank	SB	end-Sep 2007
J. Design a strategy for the development of capital markets	SB	end-Dec 2007
K. Development of an effective supervisory and regulatory framework for the cooperative sector	SB	end-Sep 2007
L. Reinstate a modified Resolution 8/03 to become effective on January 1 2008	SB	end-Sep 2007
M. Implement prudential regulations in line with BCP operational plan	SB	end-Dec 2007
Pro-Growth Reform		
N. Implement the plan to improve the investment climate designed in September 2006.	SB	end-Sep 2007
O. Observance of targets under the result-oriented management contracts for ANDE, COPACO, ESSAP, INC, and PETROPAR	SB	end-Dec 2007
Social Safety Net		
P. Increase the coverage of the conditional cash transfer program to 15,000 families and establish mechanisms for the evaluation of results.	SB	end-Dec 2007

1/ SB = structural benchmarks.

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, 2006	Floor (In billions of <i>guaraníes</i>)
End-June 2007 (performance criterion)	184
End-July 2007 (program projection)	251
End-August 2007 (program projection)	278
End-September 2007 (performance criterion)	330
End-October 2007 (program projection)	335
End-November 2007 (program projection)	351
End-December 2007 (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.

The floor on the Cumulative Central Administration Overall Balance for 2007 will be adjusted downward by the full amount of cumulative transfers and/or interest due on any bonds issued during 2007 as part of the program to strengthen the financial position of the Central Bank.

2. Targets on the Central Administration Wage Bill

Cumulative flows from December 31, 2006	Ceiling (In billions of <i>guaraníes</i>)
End-June 2007 (performance criterion)	2,055
End-July 2007 (program projection)	2,393
End-August 2007 (program projection)	2,736
End-September 2007 (performance criterion)	3,086
End-October 2007 (program projection)	3,434
End-November 2007 (program projection)	3,789
End-December 2007 (performance criterion)	4,443

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, 2006	Floor (In billions of <i>guaraníes</i>)
End-June 2007 (performance criterion)	202
End-July 2007 (program projection)	336
End-August 2007 (program projection)	429
End-September 2007 (performance criterion)	459
End-October 2007 (program projection)	449
End-November 2007 (program projection)	397
End-December 2007 (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 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

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).

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-December 2006	1,703
End-June 2007 (performance criterion)	1,900
End-July 2007 (program projection)	1,905
End-August 2007 (program projection)	1,910
End-September 2007 (performance criterion)	1,915
End-October 2007 (program projection)	1,920
End-November 2007 (program projection)	1,925
End-December 2007 (performance criterion)	1,920

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, 2006.

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, 2007: US\$292 million; September 30, 2007: US\$306 million; and December 31, 2007: US\$303 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, 2006	(In millions of <i>U.S. dollars</i>)
End-June 2007 (program projection)	0
End-July 2007 (program projection)	0
End-August 2007 (program projection)	0
End-September 2007 (program projection)	0
End-October 2007 (program projection)	0
End-November 2007 (program projection)	0
End-December 2007 (program projection)	0

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 <i>guaraníes</i>)
End-December 2006	-5,312
End-June 2007 (performance criterion)	-6,645
End-July 2007 (program projection)	-6,645
End-August 2007 (program projection)	-6,656
End-September 2007 (performance criterion)	-6,700
End-October 2007 (program projection)	-6,732
End-November 2007 (program projection)	-6,640
End-December 2007 (performance criterion)	-6,016

For the purpose of NDA calculation, NIR will be converted into *guaraníes* at an accounting exchange rate of G 5,100/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.

NDA targets will also be adjusted downward (upward) 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.

C. Public Debt and Arrears Targets³

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

Cumulative flows from December 31, 2006:	Ceiling (In millions of U.S. dollars)
End-June 2007 (performance criterion)	500
End-July 2007 (program projection)	500
End-August 2007 (program projection)	500
End-September 2007 (performance criterion)	500
End-October 2007 (program projection)	500
End-November 2007 (program projection)	500
End-December 2007 (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.⁴ 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).⁵

³ The stock of debt does not include disputed claims to the following parties: Belgium's Ex-Herstal, a South African supplier; French and Swiss import verification companies; the National Bank of Argentina, and a syndicate of European and American banks following a Swiss court ruling against Paraguay in May 2005. Any of these claims that would be considered as debt will be added to the stock figure.

⁴ 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). In line with Paraguayan law, debt will be deemed contracted only if it has received approval by Congress.

⁵ 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 Element = (Nominal Value –

(continued)

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.

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.

7. 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.

8. 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. Claims against

(NPV) / Nominal Value). The NPV of debt is calculated by discounting the future element 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 December 2006 will be used.

the state of Paraguay resulting from a judgment made by the Swiss Federal Supreme Court on May 31, 2005, will be considered claims in dispute.

D. 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.