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| Project Name | Republic of Paraguay-Financial Sector... Adjustment Loan |
| Region | Latin America and the Caribbean Region |
| Sector | Financial Sector |
| Project ID | PYPE39994 |
| Borrower | Republic of Paraguay |
| Implementing Agency | Ministry of Finance and Central Bank of Paraguay |
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1. Country and Sector Background. Paraguay is considered to be a middle income country and has a GDP per capita of $1,360. The economic base depends in large part on the agricultural sector and hydroelectric power generation, although much economic power is concentrated in the cattle ranching business, various trade activities and the State itself. There is a small domestic consumer goods manufacturing sector but the agricultural sector provides nearly 40% of employment, and constitutes 75% of Paraguay's merchandise exports, primarily from the soybean business as well as cotton. Of a total population of 5.6 million, 1.9 million are economically active, of which between 15%-20% are unemployed. Economic activity is distributed in concentrated geographical pockets, since the Chaco region, which constitutes about three fifths of the country's land, hardly contributes 3% of total GDP. To date, economic activity has been concentrated around Asunción as well as Ciudad del Este.

2. Paraguay's economic growth in the past 4-5 years has been dismal with real GDP growth being negative or close to zero. During the late 1970s and early 1980s the economy had a brief spurt of very high growth which was mostly due to the returns generated from the Itaipú hydroelectric project. The rest of the 1980s had uneven though still positive growth, and in the early to mid 1990s high crop production due to weather conditions resulted in 4%-5% growth which then fell after 1995. Given Paraguay's dependence on agricultural products which are affected both by international prices and weather conditions, as well as a lack of a solid industrial base, coupled with a spate of partial banking crises in the mid to late 1990s, future prospects for reasonable growth are unlikely unless a major industrial/economic restructuring effort takes place coupled with a completion of ongoing privatization efforts. Nevertheless, despite such conditions, risks have been temporarily mitigated due to the significant economic activity in the informal and contraband economy as well as the results from the power sector supported by the Yacyretá hydroelectric project and demand from the Itaipú generator.

3. Program Context. The central bank has been able to keep inflation in check by issuing central bank bills for open market operations in order to absorb the liquidity in the banking system. Inflation has been steadily declining from almost 40% in the early 1990s to just under 8% for 2001. However, the low economic growth also has contributed to reduce inflation. The large devaluation of the Brazilian currency in early 1999, however, put pressure on the competitiveness of Paraguayan manufacturing and agricultural exports given that Brazil is Paraguay's largest trading partner. The Brazilian devaluation resulted in an influx of cheap Brazilian products, of which some began competing with Paraguayan producers. However, during mid-1999, the central bank began allowing the guaranÚ to depreciate to gain competitive parity, although after mid 2001, the Brazilian real again depreciated causing a similar situation, and the central bank following some deliberation allowed the guaranÚ to depreciate again. However, it has still not matched the cumulative depreciation of the Brazilian currency in the last 3 years.

4. The revealed problems in crisis management and the lack of cost effective results from the first banking crisis in 1995, and in particular the revelation that there existed a large sector of unregistered 'black' deposits, prompted reforms to the banking and central bank laws and the eventual halting of central bank lending to commercial banks. To avoid further direct involvement in the banking system as well as to increase transparency, deposits of public sector entities were transferred to the private banking system. However, this policy which is still in effect, generates risks to the local banks whose dependence on public sector deposits can cause liquidity problems if the public agencies decide they need to withdraw substantial funds on short notice. Another area that the Paraguayan authorities have become increasingly involved in, along with U.S. cooperation, is the development and strengthening of anti-money laundering techniques which are currently supported by financial sector and criminal legislation in Paraguay - this is particularly important to address the heavy contraband business and crime in Ciudad del Este where there have been detections of alleged terrorist activity as well.

5. Project Objectives. The project aims to modernize the banking regulatory framework and to establish market friendly exit mechanisms for insolvent banks as well as to rationalize state owned banking institutions to prevent future losses and focus primarily on small rural lending. The rationalization of the public banking component is primarily geared towards improving access of credit by the micro and small rural and agricultural businesses, by inter alia, limiting first tier public lending to these sectors and excluding large corporate borrowers from preferential lending. For the banking system as a whole, the implementation of bank resolution and deposit insurance schemes will, as a priority, protect the smallest depositors with the least economic assets, and assure prompt repayment of their deposits in the event of bank failures.

6. Project Components:
(a) Banking, Legal and Regulatory Framework: This component will focus on the implementation of modifications to the Banking Law, to upgrade prudential limits for capital, loan classification as well as strengthening of supervision practices, in line with international standards and best practices.

(b) Bank Resolution Framework: This component addresses modifications to the Banking Law to incorporate mechanisms for the non traumatic and market friendly resolution of bank through transfer/sale of assets liabilities to the financial system.
(c) Deposit Insurance and Lender of Last Resort: This component entails modification to the Banking Law and Central Bank regulations to set up a pre-funded deposit insurance scheme with banking restructuring powers so as to minimize cash outlays during the banking resolution and bank exit process, and to provide proper incentives for access of the central bank's lender of last resort credit facilities.
(d) Institutional Framework: This component aims to strengthen the autonomy and independence of the financial regulatory and supervisory institutions via the modification to the central bank charter and implementation of directives to provide increased operational and political autonomy.
(e) Reform of the State Owned Banks: This component involves the restructuring and consolidation of the state owned banking institutions so as to achieve rationalization and downsizing of the state banks, and creation of one limited first tier rural bank and one second tier development fund financed from bilateral and multilateral external sources.

7. Benefits. The proposed project would have benefits in a number of areas of the financial system. The new legal framework would significantly modernize and facilitate the management and regulation of the financial system. The modernization of bank supervisory practices would cover the early application of sanctions to prevent deterioration of financial institutions and reverse faulty management or operational decisions, as well as upgrading the Superintendency's risk management monitoring tools. It would increase the autonomy of the supervisory body, and upgrade prudential financial regulations to enhance banking sector surveillance and reduce the frequency and severity of bank failures.

8. Institutional and Implementation Arrangements. Macroeconomic targets will be monitored by the Bank in coordination with the IMF. The reform of the State banks component will be executed by the Ministry of Finance and jointly monitored by the Bank and IADB. The reform of the regulatory framework of the banking system will be executed by the Central Bank and monitored/verified by the World Bank. Technical assistance in the form of grants and T.A. operations are expected to be provided both by the World Bank and IADB to support implementation of the reforms.

9. Executing agencies: The executing agencies are the Ministry of Finance of Paraguay and the Central Bank. Within the Central Bank, the Superintendency of Banks will have a key role in implementing the new legal framework.

10. Project Sustainability. Sustainability is expected provided that the reforms are supported by adequate technical assistance and an a priori public information campaign is conducted to persuade all stakeholders (Congress, banks, farmers, private sector, others). The principal risks to the reform program are political and macroeconomic as well as the risk of potential for incomplete implementation of the reforms given weak institutional capacity. The restructuring of the state owned banking sector poses additional political challenges: the closure of operations which do not cater to the small entrepreneur or the small farmer could generate political issues from more influential larger agricultural enterprises which currently benefit from some of these programs.

11. Poverty Category and Environmental Aspects. The project, while financial in nature, has a number of social oriented objectives which focus on

the individual stakeholder and credit access for the small business owner. The rationalization of the public banking component is primarily geared towards improving access of credit by the micro and small rural and agricultural businesses. For the banking system as a whole, the implementation of bank resolution and deposit insurance schemes will, as a priority, protect the smallest depositors with the least economic assets, and assure prompt repayment of their deposits in the event of bank failures. The project will not have any environmental impacts and thus its rating is "C". Nevertheless, within the guidelines developed for lending criteria of banks in Paraguay, the issue of environmental liabilities will be listed as one factor in determining viability for lending to enterprises.

12. Program Objective Category. Economic Management (EM)

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