

## Highlights of Paraguay

Wrap-up of 2004 and  
Perspectives for 2005\*



# 1 Moderate growth in spite of the severe drought

After five years of stagnation, the Paraguayan economy is taking off with a moderate growth of 2.9% in year 2004. For the second consecutive year the economic growth rate is higher than the 2.2% vegetative population growth, which leads to a slight improvement in per capita income, further enhanced by the 7.4% average appreciation of the local currency in relation to the US dollar.

During 2004, all the sectors in the economy showed positive results, for the first time in the past 9 years. The agricultural sector, accounting for 28.5% of GDP, grew at 3.9% driven by production increases in cotton, rice, sugar cane, sunflower, corn, manioc and wheat, while soybean, tobacco, beans and peanuts showed decreases. The non-agricultural sectors also showed growth at 2.6% due to the good performance of cattle-raising, trading & finance business, manufacturing, and basic utilities, showing growth at 8%, 2%, 2% and 3.4%, respectively, and accounting for 52% of the overall growth achieved in 2004.

The internal factors sustaining growth during 2004 were: a comfortable price stability reflected in a low internal inflation rate of 2.8%; fiscal discipline resulting in a superavit of 0.6% of GDP; and finally, recovery of public confidence in the banking sector restoring credit and lending to economic agents, a factor which had limited growth in year 2003. Further, the external factors in 2004 were: greater stability and growth in the region, higher prices for export commodities during the initial 5 month period, and the decrease in the exchange rate for US currency favored by a stable US dollar in the region. There were further limiting factors in the external sector, such as the decrease in the export price of certain commodities after June 2004, the oil price hike up to unprecedented levels, plus the unilateral policy of implementing taxes on imports applied by the Brazilian Government which affected mainly the soybean exports from other countries in the region.

While historically Paraguay has been a country of open economy, the level of economic aperture increased from 32% in 1999 to 61% in 2004. This greater opening-up brought higher current account deficits in spite of having attained record exports in the last two consecutive years. The traditional performance indicators of the external sector showed disparate results in year 2004: while the ratio of debt to exports fell from 2.9 in 1999 to 1.5 in 2004, indicating improvement with the consequent growth in international reserves, the ratio of such reserves to average monthly imports during that period fell from 6.9 to 5.5 showing a clear impairment during the period together with a 2.8 % decrease in the real rate of exchange - an indication of slight loss in external competitiveness.

An important achievement of the government during year 2004 was the approval of several reviews to the Standby Agreement signed with the IMF in December 2003, which was possible mainly due to the good macroeconomic performance, apart from certain non-compliance instances with structural commitments. In order to address the pending issues Paraguay requested extending the Agreement up until September 2005, rescheduling the agenda of structural reforms. While not all the issues in the Agreement were complied with, there was progress in several items on the Agenda of reforms, such as enacting Law 2421 of Administrative Rearrangement and Fiscal Adaptation with reforms to the tax legislation, and promulgation of Law 2422 which implements the new Customs Code and creates the National Customs Bureau (DNA).

The law regulating contracts of public works has been extended to reach all levels of the Administration, thus providing transparency to the purchasing system of the Public Administration.

In spite of the good macroeconomic results, after one year and 4 months of President Nicanor Duarte's term in office, there was a decrease in the level of public approval to his administration, while still maintaining substantial public support. This situation may be attributed to the growing sense of insecurity both from the physical and legal points of view, pursuant to increase in the frequency of private property violations and kidnapping incidents.

## 2 Fiscal Reform and Restructuring of Customs

### Fiscal Reform

In July 2004 Law 2421/04 of "Administrative Rearrangement and Fiscal Adaptation" was enacted and partially enforced through issuance of detailed rulings. The following paragraphs summarize the more relevant changes introduced to tax regulations.

#### Business Income Tax on commercial, manufacturing and service activities

- The changes in this tax are pending enforcement which is expected to materialize by January 2006.
- The jurisdictional sphere of this tax is extended to reach income from financial investments placed abroad.
- Tax rates:

Comparison of tax rates	Current	Law 2421/04
General tax rate on profits or related dividends	30%	20% 1 <sup>st</sup> year 10% 2 <sup>nd</sup> year
To Head Office or foreign shareholders	5%	15%
Additional rate for profit distributions		5%
Foreign taxpayers - international income	35%	30%

- Certain expense deductions are amplified and certain exemptions are revoked.
- The taxable base of interest on external funding received is reduced.
- No tax loss carryforwards, for offset against future tax profits are provided for.

#### Income Tax on Farming Activities

- Tax enforced as from January 1, 2005.
- The prior tax regime on an imputed basis, is replaced by a tax levy on actual income derived by large rural property owners and a new imputed tax regime for medium rural property owners.
- Tax rate : 10% for large property owners and 2.5% for medium property owners.

#### Selective Consumers Tax on sales

- The changes introduced are in force since January 2005.
- There are general increases in the maximum rates for tobacco and alcoholic beverages and rate decreases for non-alcoholic beverages.
- The taxable base is expanded to include perfumes, cosmetics, certain electric appliances, jewelry, hardware, mobile phones, watches, arms and ammunition, toys and sport articles, all subject to a tax rate of 1%.

### **Value Added Tax (VAT)**

- While the enforcement date has not yet been defined for the changes to this tax, the enforcement date is expected to be January 2006.
- The tax base is expanded to reach all individuals providing services of a personal nature on an independent basis, and to all enterprises.
- Fuel, rentals and financing activities are also included.
- The general tax rate is 10% but there are rates of 5% or less fixed for certain cases such as sale of real estate property, products of the basic consumers basket, of pharmaceutical products and loans.

### **Tax on Acts and Documents**

- Effective January 1, 2005 the tax rate has been reduced for fund transfers, and the taxable base has been changed.
- Repealing this tax on bank loans is foreseen.
- Effective February 28, 2005, this tax is being revoked for exports of goods.

### **New taxes established by the Fiscal Adaptation Law**

#### **Personal income tax**

- To be enforced as from January 1, 2006.
- Levied on income of Paraguayan source derived from activities generating personal income.
- The tax rate is 10%.

#### **Small taxpayers' Income Tax**

- Date of enforcement not defined as yet, but expected for January 2006.
- Levied on actual income derived by small businesses in general, to the extent it does not exceed (the equivalent of) US\$ 16,000 per year.
- The tax rate is also 10%.

#### **Extraordinary Fiscal License for Vehicles**

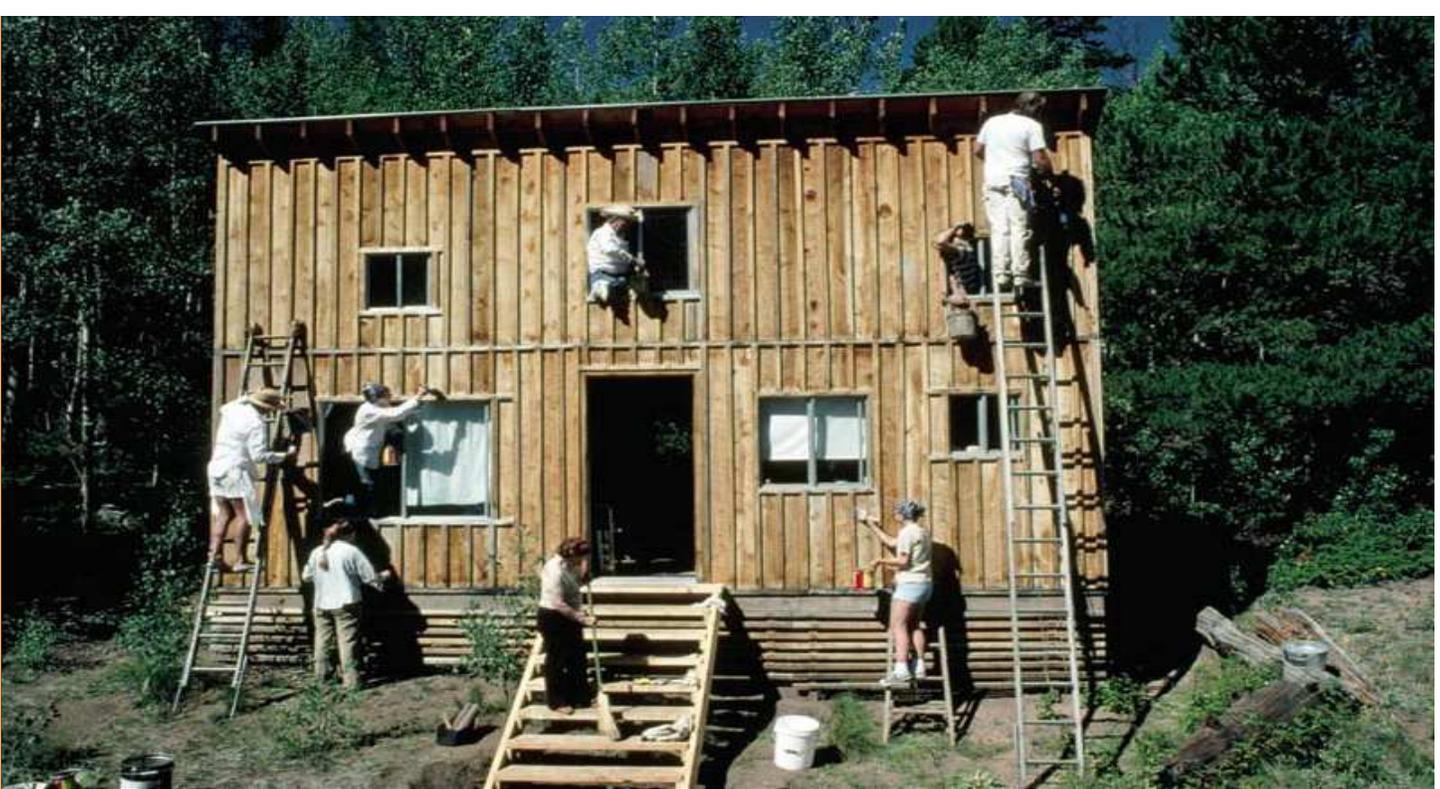
- In force as from January 2005.
- Levies the possession of vehicles with a tax assessed value exceeding (the equivalent of) US\$ 30,000.
- The tax rate is 2% per annum.
- There is a tax exemption for vehicles of official diplomatic representations and of the government, police, firemen and public transportation.

### **Innovations to the Paraguayan Customs Law**

Forming part of the legislative restructuring policy, a new Customs Code has been enacted (Law 2422/04), a legal instrument of essential importance in the frame of a process of modernizing and expediting the importation and exportation operations, and a crucial tool for combating irregularities that may take place.

This legal body enforced as from January 11, 2005, introduces E-government features such as the digital signature for identifying importers and exporters, electronic payments, the taxpayer's right to set forth consultations to the Authority and to receive a generally binding reply thereto. It further establishes a direct connection between the National Customs Bureau and the Unified Taxpayers' register carried by the Ministry of Finance for the purpose of a strict identification control of the parties ( individuals and legal entities) operating in foreign trade.

The Customs Code and the approval of the MERCOSUR Customs Code are the first step at the Common Market level, in the path of regional integration toward implementing the customs union of the block by year 2008.



## 3 2005, the year of reforms

The current economic expansion can be expected to continue during year 2005, at a higher pace, with growth at 3.1% for the base scenario, and ranging from 2.5% to 4% for the more pessimistic and optimistic scenarios, respectively. The favorable scenario will depend on climatic factors that may affect the soybean production expected to reach an all time record, among other factors. Another key for growth will be the implementation of financial plans by the Ministry of Finance aimed at curtailing the expenditure of the soaring and “unfunderable” General Budget of the Nation passed at Congress (with the compromise approval by the Executive Power as a sort of “price of peace”).

During the current year, the economy will again be driven by the export sector, expected to grow thanks to the exports of the primary sector, both in the areas of agriculture and cattle-raising, believed to continue in expansion, however at a slower pace. Inflationary pressures would not be of concern in year 2005, and price increases are expected to be in the range of 6% thanks to the application of restrictive monetary policies and to the stability in the exchange rate of the US dollar. In this connection the relative stability of the US currency throughout the year represents a possible appreciation of the dollar of 3% in the base scenario, with variations in the range of 3% downward and 6% upward, respectively for the optimistic and pessimistic scenarios. The Central Bank of Paraguay is expected to curtail its intervention in the exchange market during 2005, elaborating a plan for inflation targeting which would be applied substantially through the monetary policy.

During the second year in office of President Duarte, the Administration would concentrate efforts in passing the reform law of Government Banking intended to merge all the public credit institutions in one Bank with first floor and second floor characteristics. The Executive Power would likewise put weight on the law regulating the financial system, in the participation plan of private capital in Government enterprises and in a plan of reform of the public servants structure. The success of the reforms plan will necessarily depend on the lobbying and negotiation abilities of the Executive Power before Congress. Finally, there is also the expectation that the Executive will deploy a reform plan aimed at improving bureaucratic and administrative aspects without having to go through Congress approval, which would afford better chances of success in launching the long expected state reform.

# 4 Principal Economic Indicators

(Certain 2004 figures are estimates)

	2004	2003	2002	2001	2000
GDP growth (annual % change)	2.9	2.6	-2.3	2.7	-0.4
GDP USD per capita	1,271	1,138	1,080	1,347	1,555
Consumer Price Index (% per year)	2.8	9.3	14.6	8.4	8.6
Exchange Rate (buyers rate at year-end)	6,260	6,170	7,200	4,750	3,555
Average Exchange Rate (annual average bid-ask)	5,979	6,459	5,733	4,116	3,491
Exchange Rate (buyers rate % change)	1.5	-14.3	51.6	33.6	6.8
Average Exchange Rate (% change)	-7.4	12.7	39.3	17.9	11.9
Population (thousands)	5,397	5,279	5,163	5,069	4,958
Population Growth (annual % change)	2.2	2.2	2.2	2.2	2.2
Unemployment Rate (open & close)	13.2	13.7	16.4	15.3	15.3
Exports (% of GDP)	23.7	20.7	17.0	14.5	11.3
Imports (% of GDP)	37.3	31.0	27.1	29.1	26.6
Public Sector Surplus/ Deficit (+/-) (% of GDP)	0.6	-0.5	-3.0	-1.1	-4.3
Foreign Debt (% of GDP)	36.5	41.2	40.9	31.7	29.0

(Amounts in USD millions)

Gross Domestic Product	6,860	6,008	5,578	6,831	7,711
Public Sector Deficit (-)	43	-31	-165	-77	-329
Exports (FOB)	1,626	1,242	951	990	869
Imports (FOB)	2,562	1,862	1,510	1,989	2,050

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