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# Macroeconomic trends in *Paraguay from 1989 to 1997:* consumption bubble *and financial crisis*

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This article looks at macroeconomic trends in Paraguay since 1989: a critical date, because it marks the return to democracy and a move towards liberalization of the economy. The stabilization process embarked upon at that time resulted in favourable evolution of the monetary variables, but not of investment or of growth of the product. The combination of heavy inflows of capital and an excessive increase in aggregate demand gave rise to a growing external imbalance reflected in a domestic consumption bubble. Trade transactions which are not officially registered – a special feature of the Paraguayan economy – have affected the evolution of the macroeconomic situation and appear to have contributed to the worsening of the trends in question, since there was also a deficit on this type of trade up to 1994. In the financial sector, the liberalization process was not accompanied by the strengthening of banking supervision. In this permissive context, the financial sector has contributed to the consumption bubble of the 1990s, through the proliferation of high-risk activities, loans to enterprises linked with the lenders themselves, and the rapid growth of an informal or “black” financial sector. The resulting increasingly fragile situation of many financial establishments explains why a combination of domestic and external upsets led in 1995 to a financial crisis which had recessionary effects on the whole economy. Failure to take care of elements of such fundamental importance as the monitoring of excess spending and the modernization of banking supervision, and the mistaken option for a model based on imports and informal trade, facilitated the procurement of quasi-privilege rents by certain interest groups and the formation of consumption bubbles which contributed to the crisis. What is needed, then, is a sustainable macroeconomic policy aimed at promoting growth on the basis of a process of genuine innovation.

# I

## Introduction

The economic evolution of Paraguay since the return to democracy in 1989 has displayed favourable features. Throughout the 1990s, the country maintained a satisfactory fiscal balance; inflation was gradually brought down, reaching a single digit in 1996; the level of the international reserves rose; and the external public debt went down until in 1996 it only represented around 14% of GDP: the lowest relative level in Latin America. On the other hand, however, the product grew only slightly and per capita GDP did not increase at all.

At the same time, various problems were arising, as in other countries of the region. At the macroeconomic level, the lower inflation was achieved through a policy of control of the money supply and an exchange rate anchor, accompanied by a fiscal austerity strategy, but not enough attention was paid to such fundamental aspects as aggregate demand, which registered high growth rates during the period. This situation gave rise to growing external imbalances, with an average annual growth rate of imports which was much higher than that of exports. Moreover, the imports were increasingly made up of consumer goods.

As a corollary to this, there was a growing inflow of volatile capital in the first part of the decade. In these circumstances, in which domestic demand was rising but domestic saving was falling and being progressively replaced by external saving, gross fixed capital formation stagnated and it became impossible to keep up the level of absorption reached.

Section II of this article analyses this evolution and the behaviour of the main macroeconomic variables and shows how the elements in question helped to form a consumption bubble which made future contraction inevitable, as occurred in 1995.

Section III looks at the theory according to which the excess of imported goods and the apparent difference between domestic expenditure and GDP is really the result of Paraguay's traditional re-export trade, in which the goods imported for subsequent sale abroad are registered but not the actual re-exports. It is shown that the various available estimates largely disprove this explanation and that there may even have been a deficit on this unregistered trade too,

because part of the unregistered imports remained in the country instead of being re-exported, thus feeding the domestic consumption bubble.

Section IV examines the state of the financial system after the liberalization begun in the early 1990s. This liberalization was carried out in a context of feeble prudential regulation rules and ineffective supervision of their application, with a Central Bank which had little *de facto* autonomy. In this context, fraudulent practices and administrative mismanagement abounded because of the lack of supervision by the responsible authorities. At the same time, the dichotomous situation of the financial system, in which sound and efficient establishments operated side-by-side with others whose practices were not in keeping with the rules of good management, was reflected in the persistence of high interest rates throughout the period and the rationing of credit to the detriment of part of the production sector, namely, small and medium-sized enterprises which were not linked with some banking group.

The consumption bubble was reflected in the financial sphere in a credit boom (without pretending to identify the direction of the causality between the two phenomena) which extended to the whole financial system, although most markedly to the domestically owned banking sector. The situation was made worse by big capital inflows attracted by the high prevailing interest rates. Because of the weakness of supervision, these flows fed the boom in loans for consumption, speculative and short-term financial activities, operations in the informal sector, and real-estate speculation, etc., which led to an excessive concentration of economic activity in high-risk sectors generating little value added. This accumulation of high-risk portfolios, facilitated by the implicit State guarantee on deposits and the scale attained by malpractices, seems to have been responsible for many of the banking failures which took place from 1995 onwards.

To the extent that the net worth of firms was weakened by numerous risky unregistered operations—generally carried out at very high interest rates—, by loans made to their own associates, etc., they were

the first to be affected by a series of events in 1995 which included the decline in international soybean prices, the partial reversal of capital flows, and a domestic financial scandal. The financial crisis which began in 1995 is seen as a process of correction in which an external shock subjected the banking system to excessive tensions and led to the breakage of its weakest links: in this case, the high-risk and/or illegal activities. Through its impact on the informal credit system, this financial crisis had repercussions on the whole economy and gave rise to a major recessive adjustment.

In the light of the foregoing, by way of conclusion, the concluding section sets forth some guide-

lines for a sustainable macroeconomic policy programme for Paraguay aimed not only at stabilization but also at growth. Finally, it is noted as a basis for future analysis that the bubble phenomenon observed may be ascribed to the exploitation of what Nochteff (1996) calls "quasi privilege rents": a system in which dominant interest groups take advantage of their influence on institutions to perpetuate those rents at different levels (importation and re-export of smuggled goods, financial and real-estate speculation). In many cases this phenomenon impeded the pursuit of quasi-technological rents which would have propelled development based on innovation and the generation of genuine competitive advantages.

## II

### The macroeconomic scene in the 1990s

The evolution of the macroeconomic indicators in Paraguay between 1989 and 1997 shows the results of the stabilization policy undertaken in the new context of liberalization and sound management which accompanied the return to democracy. In particular, during this period fiscal management was satisfactory (the central government deficit never exceeded 0.8% of GDP, while the non-financial public sector maintained a surplus throughout the period) and inflation was brought down steadily from the peak level reached in 1990 (table 1).

Various sectors of the economy were liberalized. The exchange rate, which had previously had multiple rates and was subject to political manipulation, was replaced by a single floating exchange rate. Interest rates were freed and foreign currency operations were authorized. Monetary policy management was placed on a sounder basis, and after 1990 the automatic rediscounting granted to certain sectors<sup>1</sup> (especially cotton) and the possibility of monetary financing of the public sector were eliminated. During the period, there was an increase in the international reserves, which amounted to US\$ 1062 million

at the end of 1996 (equivalent to 2.4 months of imports of goods and services) and the weight of the external public debt was reduced, so that in 1997 it came to only 14% of GDP: a very low figure by the standards of the region (table 1). In spite of these favourable indicators, however, the real growth of the economy was insufficient: it averaged 3.1%, which was barely higher than population growth (estimated at between 2.7% and 3%), so that per capita GDP remained unchanged.

The monetary policy applied as from 1991 could be described as a "dual anchor" policy based on both the money supply and the exchange rate. The Central Bank's scheme aimed –without very much success– at maintaining moderate growth of the monetary aggregates (table 2), together with an exchange rate managed through a dirty float. This policy ended up by placing greater emphasis on the second element, since it was hard for the monetary authorities to control the money supply in a partially dollarized economy with enormous unregistered financial operations, and without any real possibilities of controlling foreign exchange movements inside and outside the country. Consequently, the partial anchoring of the exchange rate resulted in a substantial difference between the variations in prices of tradeable and non-tradeable goods and in considerable appreciation of the currency (table 3).

<sup>1</sup> The rediscounting was not completely eliminated, however, since as explained in section IV, up to 1994 there was a system of indirect rediscounting through the reduction of the compulsory reserve requirements connected with the financing of cotton.

TABLE 1

**Paraguay: General indicators, 1989-1996**  
(Millions of dollars at current prices, unless otherwise indicated)

	1989	1990	1991	1992	1993	1994	1995	1996	1997
GDP	4 115	5 285	6 254	6 447	6 841	7 857	8 970	9 686	10 029
GDP (millions of 1982 dollars)	6 614	6 818	6 987	7 113	7 407	7 636	7 996	8 097	8 311
Per capita GDP (1982 dollars)	1 618	1 616	1 612	1 597	1 619	1 625	1 656	1 634	1 634
GDP growth (%)	5.8	3.1	2.5	1.8	4.1	3.1	4.7	1.3	2.6
Central government fiscal surplus (+) or deficit (-)	100	158	-19	-18	-48	75	-25	-76	-0.8
As a percentage of GDP	2.4	3.0	-0.3	-0.3	0.7	1.0	-0.3	-0.8	-0.8
Non-financial public sector fiscal surplus (+) or deficit (-)	79	276	98	60	83	191	228	167	...
As a percentage of GDP	1.9	5.2	1.6	0.9	1.2	2.4	2.5	1.7	...
Monetary reserves	427	675	975	611	698	1 044	1 107	1 062	800
External debt	2 076	1 670	1 637	1 249	1 217	1 240	1 328	1 336	1 413
Debt/exports of goods and services (%)	148	89	81	66	44	36	30	32	37
Inflation (%)	28.5	44.1	11.8	17.8	20.4	18.3	10.5	8.2	6.2

Source: Prepared by the author on the basis of official figures of the Central Bank and the Ministry of Finance of Paraguay.

TABLE 2

**Paraguay: Evolution of monetary aggregates and inflation, 1989-1996**  
(December-December variation, %)

	1989	1990	1991	1992	1993	1994	1995	1996
Monetary base	27.2	21.4	25.7	31.2	16.8	27.4	23.0	3.2
M1	46.1	27.6	27.4	28.5	19.3	32.8	20.3	2.0
M2	41.5	28.1	35.4	28.4	15.3	38.5	34.8	13.3
M3	75.6	36.0	41.1	39.8	28.7	28.7	22.9	21.9
Inflation	28.5	44.1	11.8	17.8	20.4	18.3	10.5	8.2

Source: Prepared by the author on the basis of figures from the Central Bank of Paraguay.

TABLE 3

**Paraguay: Evolution of relative prices, 1990-1996**  
(Tradeable/non-tradeable goods; 1990=100)

1990	100
1991	95.2
1992	93.8
1993	91.1
1994	88.6
1995	87.4
1996	80.0

Source: Prepared by the author on the basis of data from the Central Bank of Paraguay.

Fiscal policy was used mainly as a support for the monetary strategy, with compulsory surpluses frozen in the Central Bank, thus explaining the good budgetary results. However, this was achieved at the cost of systematic cuts in infrastructural investments, which became the adjustment variable of fiscal expenditure. As the country had not adopted a decisive policy of privatization of public works or their trans-

fer to the private sector, the lag in terms of infrastructure became still greater, which probably helps to explain the slow growth observed so far in the 1990s.<sup>2</sup> At the same time, the process of renewed access to external financing observed throughout the region extended to Paraguay too (Ffrench-Davis, 1996; Aninat and Larrain, 1996) and from 1990 onwards there were substantial inflows of capital, mostly short-term (table 4, line 9). There was a simultaneous marked reduction in domestic saving (especially by households), with heavy growth of consumption expenditure, marked by a high imported component.

Part of this inflow of capital helped to increase the reserves. The rate of investment stagnated around its initial level of 23% of GDP throughout the period, and moreover its composition—in which there was an excessive preponderance of construction activities—

<sup>2</sup> For an analysis of the infrastructural situation in the continent, see World Bank, 1996.

TABLE 4

## Paraguay: Macroeconomic Indicators, 1989-1996

	A. In millions of 1982 Guaraníes							
	1989	1990	1991	1992	1993	1994	1995	1996
1. Gross domestic product	899 500	927 317	950 208	967 312	1 007 377	1 038 547	1 087 409	1 101 158
2. Gross national income	865 321	899 381	913 048	925 581	967 657	1 001 577	1 044 539	1 066 832
3. Consumption (4+5)	669 245	753 036	780 600	836 997	881 575	999 299	1 034 007	1 059 270
4. Public consumption	64 639	66 707	80 047	86 288	90 847	94 382	105 772	116 349
5. Private consumption	604 606	686 329	700 553	750 709	790 728	904 917	928 235	942 921
6. Investment	200 747	219 175	238 030	222 482	227 557	237 699	254 588	254 311
7. Excess of expenditure over GDP (3+6-1)	-29 508	44 894	68 422	92 167	101 755	198 451	201 186	212 423
8. Excess of expenditure over GNI (3+6-2)=11	4 671	72 830	105 582	133 898	141 475	235 421	244 056	246 749
9. Net inflow of capital	36 437	111 342	151 037	81 823	154 169	278 748	238 549	241 671
10. Variation in reserves	31 766	38 512	45 455	-52 075	12 694	43 327	5 782	-5 078
11. External saving (9-10)=8	4 671	72 830	105 582	133 898	141 475	235 421	244 056	246 749

  

	B. As a percentage of GDP							
	1989	1990	1991	1992	1993	1994	1995	1996
1. Gross domestic product	158	100	100	100	100	100	100	100
2. Gross national income	96.2	97.0	96.1	95.7	96.1	96.4	96.1	96.9
3. Consumption (4+5)	74.4	81.2	82.2	86.5	87.5	96.2	95.1	96.2
4. Public consumption	7.2	7.2	8.4	8.9	9.0	9.1	9.7	10.6
5. Private consumption	67.2	74.0	73.7	77.6	78.5	87.1	85.4	85.6
6. Investment	22.3	23.6	25.1	23.0	22.6	22.9	23.4	23.1
7. Excess of expenditure over GDP (3+6-1)	-3.3	4.8	7.2	9.5	10.1	19.1	18.5	19.3
8. Excess of expenditure over GNI (3+6-2)=11	0.5	7.9	11.1	13.8	14.0	22.7	22.4	22.4
9. Net inflow of capital	4.1	12.0	15.9	8.5	15.3	26.8	21.9	21.9
10. Variation in reserves	3.5	4.2	4.8	-5.4	1.3	4.2	0.5	-0.5
11. External saving (9-10)=8	0.5	7.9	11.1	13.8	14.0	22.7	22.4	22.4

Source: Prepared by the author from national accounts and balance of payments figures.

meant that the efficiency of gross fixed capital formation was low, as shown by the high incremental capital/product ratio of 9.5 for the period 1990-1996 (or 6.9 if the two years of lowest growth are excluded) (Moon, 1997), which is almost the same as that of developed countries.<sup>3</sup> It may be noted that the big institutional investors (the Social Security Institute and the other pension funds) have traditionally placed most of their funds in real-estate enterprises, thus helping to limit the resources available for productive investments.

It is highly probable that the stabilization policy and the bias against the local production of tradeable

goods resulting from the tendency to over-valuation of the exchange rate not only hindered fixed capital formation but also led to serious under-utilization of the existing production capacity, partly explaining the mediocre growth rates of the secondary sector during the period.

Another characteristic feature of the stabilization process was the failure to monitor the evolution of aggregate demand and, hence, of the expenditure-product gap in recent years. This latter indicator displayed big fluctuations in relation to GDP and also in relation to gross national income, which is a variable representing the total amount of money available to the agents in a country for spending in a given period.

The rapid increase in the expenditure-product gap in the 1990s indicates that insufficient attention was paid to the evolution of domestic expenditure and its compatibility with the economic policy of the country. Thus, between 1990 and 1995 domestic con-

<sup>3</sup> A high incremental capital/product ratio means that greater gross capital formation is needed in order to raise GDP growth by a given amount. The value observed in the case of Paraguay is higher than that of other countries with a similar level of income.

TABLE 5

**Paraguay: Composition of imports, by type of goods, 1990-1996**  
(As percentages of the total)

	1990	1991	1992	1993	1994	1995	1996
Consumer goods	26.4	32.1	42.5	42.5	43.4	46.8	44.6
Non-durable	20.6	25.1	29.2	29.5	30.9	34.3	36.4
Durable	5.8	7.0	13.3	13.0	12.5	12.5	8.3
Intermediate goods	26.0	24.8	24.9	23.0	21.3	18.1	23.0
Capital goods	47.6	43.1	32.6	34.5	35.3	35.0	32.3

Source: Prepared by the author on the basis of figures from the Central Bank of Paraguay.

sumption increased by 37.3% (a figure resulting from weighting the growth in private consumption (35.2%) and public consumption (58.6%)), whereas the GDP grew by only 17.3%.<sup>4</sup>

As a consequence of exchange rate appreciation and the big increase in demand, there was a growing deficit on registered trade. Over the period 1989-1995, imports grew by an average of 23% per year, whereas exports registered a trend decline of 2%. This phenomenon is similar to that observed in Latin America in general, since much of the recovery in demand in the region in the 1990s was satisfied with bigger imports. Indeed, the countries which did not make the timely corrections needed, such as Argentina and Mexico, subsequently suffered traumatic recessive adjustments (Ffrench-Davis, 1996).

### III

#### The external deficit and unregistered trade: an appraisal

Paraguay's external trade has been marked in recent decades by the substantial share of unregistered trade. The appearance of this type of trade is explained not only by the country's special landlocked geographical situation but also by other factors: for example, its close relations with Brazil, high tariff levels which are not accompanied by an import substitution policy, multiple exchange rates, and political

Even more interesting is what happened with regard to the composition of imports. This composition changed substantially as from 1990, with the share of imports of capital goods going down from 47.6% in that year to 32.3% in 1996, while the share of imports of consumer goods rose from 26.4% to 44.6% over the same period (table 5).

The special features of Paraguay's external trade, however, which included a growing proportion of unregistered trade in the 1990s, caused many observers to underestimate the effects of this situation on the macroeconomic performance of the country. There was a general belief that the excessive expenditure observed or, what amounts to the same thing, the trade and current account deficits,<sup>5</sup> were only apparent and were actually offset by a surplus on unregistered trade.

authorities which, under the dictatorship, were very indulgent to certain interest groups (Masi, 1995). Unregistered trade, which consisted mainly of imports smuggled in from Brazil in the 1970s and 1980s, expanded towards the middle of the latter decade with the appearance of the so-called re-export trade based on the high protective tariffs applied in Brazil and Argentina to imports of finished goods such as

<sup>4</sup> In this case, we have taken the sub-period 1989-1995, because the financial crisis which took place in May 1995 changed consumption and investment tendencies and led to a drop in overall growth in 1996.

<sup>5</sup> The accounting identities in the national accounts show that the trade deficit is equal to the excess of expenditure with respect to GDP, whereas the current account deficit corresponds to the excess of expenditure with respect to gross national income.



TABLE 6

## Paraguay: Registered and unregistered trade

	A. In millions of current dollars								
	1989	1990	1991	1992	1993	1994	1995	1996	1997
1. Registered exports	1 009.4	958.7	737.1	656.6	725.2	816.8	919.3	1 043.4	1 088.6
2. Registered imports	660.8	1 193.4	1 275.4	1 237.1	1 477.5	2 140.4	2 782.2	2 850.5	2 957.1
3. Unregistered exports	170.6	407.5	372.4	397.6	1 103.4	1 464.9	2 111.1	1 723.3	1 554.8
4. Unregistered imports	355.1	442.4	592.2	688.2	1 240.3	1 411.3	1 689.0	1 345.1	1 080.0
5. Deficit on unregistered trade (3-4)	-184.5	-349.9	-219.8	-290.6	-136.9	53.6	422.1	378.2	474.8

  

	B. As a percentage of GDP								
	1989	1990	1991	1992	1993	1994	1995	1996	1997
1. Registered exports	24.5	18.1	11.8	10.2	10.6	10.4	10.2	10.8	10.9
2. Registered imports	16.1	22.6	20.4	19.2	21.6	27.2	31.0	29.4	29.5
3. Unregistered exports	4.1	7.7	6.0	6.2	15.5	17.8	23.3	17.8	15.5
4. Unregistered imports	8.6	8.4	9.5	10.7	18.0	17.9	19.2	13.9	10.8
5. Deficit on unregistered trade (3-4)	-4.5	-0.7	-3.5	-4.5	-2.5	-	4.2	3.9	4.7

Source: Central Bank of Paraguay, on the basis of IMF, "Directions of Trade".

liquors, cigarettes, electronic items, perfumes, sports footwear, etc. This led to a new triangular trade flow of products from the Asian countries and, to a lesser extent, from the United States, which are re-exported to neighbouring countries. Likewise, because of the high taxes imposed within Brazil, goods such as cigarettes or clothing are brought into Paraguay from Brazil for subsequent re-export by *sacoleiros* to that same country.<sup>6</sup>

In 1989, the informal "re-export" model was given official recognition by establishing tariff reductions for the so-called "tourist goods", and in 1991, as part of the tax reform, such goods were granted preferential VAT treatment (VAT of 2% instead of the uniform regular 10% rate). Finally, in 1995 a large number of these "tourist goods" were included in the lists of goods excepted from the MERCOSUR common tariff, which, in the case of Paraguay, consist of 399 products on which the tariffs are to converge towards the 10% common external tariff within a period of 5 to 10 years.

With regard to the macroeconomic impact of this situation, an estimate of the trade flows represented by unregistered trade may be attempted by taking the

estimated figures prepared by the Central Bank of Paraguay on the basis of figures from the International Monetary Fund's "Directions of Trade" statistics (table 6). When the unregistered trade balance is isolated in the official source it may be seen that, contrary to what is usually believed, this item registered deficits between 1989 and 1993 and only registered a clear surplus from 1995 on.

This is a controversial conclusion, since the prevailing belief is that unregistered trade has traditionally shown a surplus. In addition to the estimates in question, however, there are two other facts which support the idea that unregistered trade showed a deficit up to 1994 which was only reversed as from 1995. Firstly, 1995 marked the beginning of the recessive cycle in Paraguay (i.e., the moment when domestic demand went down and, with it, the demand for imports) and of the application of the Plano Real in Brazil, which gave rise to a consumption boom (including consumption of imported goods) through the stabilization of prices and appreciation of the local currency. Secondly, it is a well-known fact that much of the unregistered imports from Brazil consist of "smuggled" foodstuffs, toilet articles, construction inputs, etc. for domestic consumption, and that this trade prospered mainly up to 1994 because of the favourable exchange-rate conditions but went down appreciably after the adjustment of the Brazilian currency under the Plano Real (see annex).

<sup>6</sup> The name *sacoleiros* is applied to the persons who cross the Puente de la Amistad between Ciudad del Este (Paraguay) and Foz de Iguacu (Brazil) carrying goods in big bags. The incessant to and fro movement of the *sacoleiros* accounts for a large part of the "re-exports" to Brazil.

If it is true that part of the unregistered imports were consumed within Paraguay instead of being re-exported, this would be in keeping with the theory of a consumption boom arising from the analysis of other macroeconomic data. Thus, if unregistered trade showed a deficit throughout the first part of the 1990s, then the economic authorities' decision to endorse the import model (with its additional re-export component), especially through tariff and fiscal advantages but also through over-valuation of the national currency, helped to aggravate the macroeconomic imbalances generated by the growth in consumption and excessive domestic absorption. Furthermore, the over-emphasis on exploiting the competitive disadvantages of neighbouring countries (protectionism, high domestic taxes) by particular interest groups took place at the expense of the exploitation of Paraguay's own comparative advantages, thereby contributing to the sluggish performance of local production units.

The exhaustion of the import-based model as from 1995 with the entry into force of MERCOSUR and the process of tariff convergence, as well as the

progressive blockage of cross-border trade by the Brazilian and Argentine authorities, has faced the country with the challenge of radically changing its economic policy lines towards a scheme compatible with the promotion of an export-oriented strategy.<sup>7</sup> This process must be actively promoted by the main economic agents, because it will not be automatic. It seems inevitable that the tariff convergence process begun in 1995 will lead to the disappearance of unregistered re-export trade, by reducing the differences in the tariffs levied on finished goods in the various MERCOSUR countries. Nevertheless, Herken Krauer (1995) argues that in view of the relatively erratic characteristics of the integration process (such as the continued existence of non-tariff barriers and special modifications in the common external tariff) the factors responsible for such trade will continue to be the real exchange rate, non-tariff barriers and the financial and monetary instability of the member countries, so that Paraguay's re-export trade is likely to continue to have a firm basis, even though its profit margins may go down.

## IV

### Macroeconomic evolution and the financial system

Between 1988 and 1992, a financial reform programme was carried out in Paraguay which was aimed at liberalizing the system but which involved only some of the measures applied in other reform processes in Latin America (table 7).

Two aspects are particularly noteworthy in this respect. Firstly, out of the eight measures listed in table 7, the only ones applied were the liberalization of interest rates and the reduction of compulsory reserve requirements. Secondly, the sequencing of the measures was clearly unsuitable:<sup>8</sup> whereas these fi-

nancial variables were liberalized (together with the exchange rate and the possibility of effecting operations in foreign currency), no progress was made in the correction and supervision of a financial system hitherto marked by serious structural distortions, including the custom of operating without the slightest risk, thanks to the automatic rediscounts granted by the Central Bank, and the formation of big cross-linked portfolios in the main financial-industrial-commercial groups (Duarte-Giménez, 1997). This context of rapid liberalization without the concomitant strengthening of prudential supervision sowed the seeds of the future financial crisis of 1995.<sup>9</sup>

The weak supervision exerted by the Office of the Superintendent of Banks in the period in question

<sup>7</sup> The integration commitments undertaken by the country obviously include the obligation to apply policies aimed at checking illicit activities, since continuing to favour a model based on informal trade would give rise to the opposition of Paraguay's partners in MERCOSUR and make it impossible to develop such an export-oriented model.

<sup>8</sup> For an analysis of financial reform processes in Latin America since 1988 and an assessment of the proper sequence of such reforms, see IDB, 1996.

<sup>9</sup> The second financial crisis, in 1997, is viewed here as a continuation of that which occurred in 1995, because timely corrective measures were not taken.

TABLE 7

## Paraguay: Financial reform measures, 1988-1995

Liberalization of interest rates		Changes in compulsory reserve requirements <sup>a</sup>		Percentage of managed credit	Privatization of loan market (State banks)
Deposits	Loans	Local currency	Foreign currency		
Yes	Yes	Reduced	Unchanged	Maintained in part	No
Greater independence of Central Bank		Improved regulation of capital market		Improved regulation of banks	Improved supervision of banks
No <sup>b</sup>		Yes <sup>c</sup>		No <sup>d</sup>	No <sup>e</sup>

<sup>a</sup> Compulsory reserve requirement in national currency was gradually reduced from 42% in 1989 to 25% in 1994 (18% for banks which undertook to use the differential to provide credits for the cotton sector). This level was maintained until 1996.

<sup>b</sup> The Central Bank does not currently have legal or technical independence.

<sup>c</sup> It should be noted that although legislation does exist and some 60 firms are currently quoted on the stock market, the activities of this market essentially involve money market instruments.

<sup>d</sup> The new banking law was only adopted in 1996, after the 1995 financial crisis.

<sup>e</sup> According to the assessment made by the IDB (IDB, 1996), banking supervision requires a major overhaul. This assessment still holds good today.

permitted a big rise in the level of risk of the portfolios of most banking institutions, as reflected in the rapid growth in the number of entities and in the total amount of private sector credit. Between 1989 and 1994, 13 new banks and 38 finance companies were opened, attracted by the high profits promised by free interest rates.<sup>10</sup> In the first years of this period, there was an excessive concentration of risks in the soybean and cotton export sector, which led to a serious deterioration in loan portfolios when there were three consecutive years of poor harvests and depressed international prices, further complicated by the growing over-valuation of the local currency with respect to the dollar. The necessary reorientation of credit activities towards other sectors was retarded by a perverse practice of the Central Bank, which, although it had officially done away with *ad hoc* rediscounts, introduced a system of reduced compulsory reserve requirements on cotton sector financing, thus perpetuating the former system.

<sup>10</sup> The excessive growth of the financial system is even more evident when it is considered that in 1994 there was one financial institution (bank or finance company) for every 47,000 inhabitants. At that time (i.e., before the financial crisis) there were 34 banks and 65 finance companies, as well as various savings and loan cooperatives, savings and loan companies for housing loans, etc.

The banks which did reorient their loan portfolios did so by concentrating on activities that were at once more lucrative and more risky: consumer credit and credit cards, thus contributing to the consumption bubble of the 1990s. The "black" financial system also grew apace, thanks to the scant control exerted by the banking supervisory body and the tax authorities. An increasingly large proportion of the deposits received went to high-yield illicit activities such as smuggling, or to loans made at usurious interest rates to firms operating in illicit ("black") activities. As a result, there were big rises in interest rates on both deposits and loans because of the need to procure more and more deposits to finance those high-risk activities. The implicit State guarantee on deposits further encouraged this.

This behaviour was observed in the case of the majority of domestically-owned banks and finance companies. Their bad management practices (including both mere inefficiency and operations outside the law) led them to seek clients—of an increasingly risky nature—at higher and higher interest rates, thus reducing the quality of their loan portfolios. Furthermore, part of the resources was lent to persons or firms directly linked with the owners of the banks concerned, without applying proper project evaluation criteria, so that many of these financial institutions ran up heavy losses.

The banking system was marked, however, by a clear situation of duality, since on the other hand there were institutions –mostly branches of foreign-owned banks –which were able to adapt to the circumstances thanks to better management and in any case had traditionally restricted their supply of credit to top-level clients (big firms, external trade operations with their home countries). This fact, together with the concentration of the local banks on speculative activities or consumer loans, meant that a large segment of the productive sector –small and medium-sized enterprises, and especially those which were not linked with some financial group– had little access to bank credit during this period.

Economic theory on the functioning of financial markets analyses the reasons why the money market is a complex market in which prices (interest rates) do not always adjust to balance supply and demand and in which balances may be produced through rationing (Stiglitz and Weiss, 1981). They are subject to effects of “adverse selection” and “incitements” which mean that interest rates channel information relating not only to levels of supply and demand but also to the quality of clients. The result is that yields grow in line with interest rates (although more slowly) up to a certain level, after which the expected yield decreases. In keeping with this phenomenon of the “adverse selection” effect –the fact that the clients willing to pay higher rates are also those with the highest risks– rational financial institutions limit their supply of credit even though there is still unsatisfied demand.

Moreover, because of the situation of tacit oligopoly existing in the Paraguayan financial market, the foreign-owned banks did not appreciably reduce their rates but merely set them a little below those of the most inefficient or daring financial intermediaries, thereby obtaining high rates of return. Thus, average annual interest rates remained very high during the period: negative rates on deposits, and rates on loans which fluctuated between 10% and 20%, with differences of between 15% and 20%.

Because of this dichotomy of the financial system and the specialization of banking institutions, credit to certain sectors was rationed, while there was a big increase in credit to other higher-yield activities such as commerce, finance and various kinds of in-

TABLE 8

Paraguay: Ratio of growth rate of credit to growth rate of GDP, 1989-1995

Locally-owned banks	10.4
Foreign-owned banks	4.6
Public-sector banks	4.7
<b>Total banking system</b>	<b>6.2</b>

Source: Prepared by the author on the basis of data from the Central Bank of Paraguay.

formal activities. Between 1989 and 1995 there was thus a rapid but not exaggerated increase in total credit, from 10.8% to 19.7% of GDP. The sustainability of this growth may be better appreciated when it is compared with the degree of penetration of financial activity. In real terms, the ratio of the growth rate of credit to the growth rate of GDP during the period was 6.2 (table 8): a somewhat higher ratio than those registered in other countries with a similar degree of penetration, such as Argentina and Colombia (*The Economist*, 1997, p. 19).

As already noted, however, the growth in credit was more pronounced in the case of the locally-owned private banks than in that of the foreign-owned banks and the public banking system, the respective average annual growth rates being 32.2%, 14.4% and 14.7% in real terms. Taking only the locally-owned private banks, the ratio was 10.4: comparable to that of Mexico in the same period, and much higher than the level considered to be sustainable.

At the same time, the very big inflows of capital registered in the period were only partially sterilized and fed the boom in short-term credit to high-yield activities, as well as providing a steady flow of resources to the real estate sector.<sup>11</sup> A number of poorly-timed economic policy decisions, especially the decision to free the funds belonging to public bodies which had previously been deposited in the Central Bank, without properly regulating the use to be made of them, helped to aggravate the situation still further, since these resources simply went to the activities offering the highest interest rates.

<sup>11</sup> For an analysis of the relation between capital flows and the financial sector, see Folkerts-Lindau and others, 1995.

## V

## Conclusion: Consumption bubble and financial crisis

In 1995, a combination of events subjected the financial bodies with the highest exposure to excessive tensions, including the unfavourable evolution of international soybean prices, which caused heavy losses in some firms over-involved in the financing of the harvest, and the decline in capital inflows after the Mexican crisis. Another event which helped to set off the crisis, at the domestic level, was the discovery of a serious case of embezzlement of funds from the vaults of the Central Bank through the diversion of funds corresponding to the compulsory reserves of the commercial banks, with the complicity of representatives of those private bodies.

Banks which had run up losses exceeding their net worth (in some cases by several times that figure) as a result of unregistered operations, speculative activities and loans to related enterprises found themselves in a state of illiquidity and had to face runs on their deposits. The fact that the situation reached this level was due largely to shortcomings in supervision, since the annual balances of some banks which then had to be officially intervened had not been approved for several years, without anyone doing anything about this.

Gavin and Hausmann (1995) see the financial crises of many Latin American countries as the result of a macroeconomic upset coinciding with conditions of weakness of the financial system, so that the "chain" (the system) breaks at its weakest "link" (the affected banks). In the case of Paraguay, the weakness in question was due mainly to high-risk or illicit ("black") activities and loans to enterprises linked with the banks themselves. In the light of what was set forth earlier in this article, however, the 1995 financial crisis may be said rather to be a symptom of the bursting of a consumption bubble largely connected with the growth of the informal sector and illicit financial activities and fed by big capital inflows.

The breakage of the chain of payments and credits which followed the financial problems of 1995 was due essentially to the sudden blockage of the use

of post-dated cheques as instruments of commercial transactions and informal credit. Post-dated cheques, which were illegal at the time, had become the main instrument of alternative credit, because of the means of enforcement imparted to them by the fact that the issue of cheques without funds was punishable by imprisonment. At the same time, the financial institutions had developed a black market for rediscounting these instruments through their associated finance companies. The collapse of several banks which were active in this business and public mistrust in the banking system were then reflected in the abrupt termination of these operations, which further aggravated the recessionary impact of the crisis.

With regard to the prevailing macroeconomic context, it would appear that bad policies, in the sense of permitting an exaggerated increase in spending on the one hand and neglecting proper supervision of the banks in a context of financial liberalization on the other, prepared the ground for the crisis. Finally, the ill-advised option for an import-based model and three-way trading, with a permissive attitude to unregistered trade, helped to worsen the imbalances in question, resulting in the need for a severe recessionary adjustment after the 1995 financial crisis. The economic policy flaws shown up by the behaviour of the variables between 1989 and 1995 points to the need for a sustainable and growth-oriented macroeconomic strategy (ECLAC, 1995).

As well as placing the financial system on a sound basis and strengthening banking supervision—prior requisites for any sustainable macroeconomic strategy—it is also necessary to watch domestic spending more closely and impose suitable regulation of capital flows. The economic statistics (specifically those on the external sector) also need to be improved: an unavoidable condition closely linked with the adoption of a different economic model.

With regard to the bubble phenomenon analysed here, a more detailed analysis of its organizational-institutional aspect is called for (see Nochteff, 1996), for in each of the markets in question this phenome-

non is linked to the exploitation of quasi privilege rents by groups enjoying various kinds of protection. Thus, the persistence of an import-based model with important smuggling and re-export components—in contradiction with the declared liberalization and export-oriented strategy—was due to the preservation of the benefits of some particular agents, at the expense of greater use of the country's own compara-

tive advantages (Herken Krauer, 1995). Likewise, for a number of years numerous inappropriate practices were tolerated in the financial sphere although their existence was well known, thus giving rise to fat profits for certain economic groups and the excessive growth of loan portfolios connected with unsustainable activities, all of which finally culminated in the 1995 financial crisis.

### Annex

#### The problem of statistics in Paraguay, with special reference to the external sector

The unreliability of economic statistics in Paraguay is an obstacle to systematic analysis of the performance of the Paraguayan economy, since it makes it necessary—as in the present article—to use multiple sources, not all of them consistent with each other, and to fill some gaps with estimates.

Data are relatively abundant in the monetary sector. However, the high percentage of unregistered activities, which became evident after the 1995 financial crisis, leads one to believe that the monetary indicators only reflect a part of the real situation. It is known, for example, that many financial institutions were receiving three types of deposits: "white" (with an official receipt, and duly recorded in the accounts of the bank); "grey" (with an official receipt, but not recorded in the accounts), and "black" (without any official receipt or record in the accounts), which were likewise reflected in three types of accounts corresponding to each class of deposit (World Bank, 1996). It may be assumed that this situation has improved since 1995, due to the disappearance of various banks which were very active on the black market. The most reliable indicator is probably the consumer price index, whose base was renewed in 1995. The same cannot be said of the indicators on the monetary aggregates, because of the problems of registration in the financial system sources.

With regard to the real sector of the economy and the national accounts, there are systematic records, but they are very inaccurate because of approximations in their preparation. The unregistered activities of many economic agents, as described earlier in this article, partly explain their reluctance to provide data to the public authorities. Consequently, although the system of national accounts is governed

by the appropriate procedures—since 1997 the procedures used are those of the United Nations System of National Accounts, 1993, version 4—in many cases it lacks reliable inputs in the form of empirical data. It is estimated that the gross domestic product has traditionally been greatly underestimated by amounts varying—according to the sources used—from 30% to 60%.

The data which must be viewed with the greatest caution, however, are undoubtedly those of the external sector, because of the country's long tradition as a centre of unregistered trade in the Southern Cone of Latin America. The problems stem from both the non-registration and the under-registration of the true values of goods. The only sources available for trying to correct these shortcomings are the "Directions of Trade" estimates of the International Monetary Fund, published by the Central Bank of Paraguay (table 6). The methodology consists of cross-checking the official Paraguayan information (customs registers) with official data on exports to and imports from Paraguay by the country's main trading partners (Brazil, Argentina, the United States, Japan, Taiwan, etc.) in order to estimate possible omissions and under-estimates from the discrepancies observed. These data are used in the preparation of the national accounts. In the process, however, they undergo adjustments which mean, for example, that the external deficit (calculated with respect to both GDP and GNI) does not coincide with the corresponding balance of payments figures or those of the national accounts.

Table 4 presents a set of calculations by the author which seek to overcome these methodological difficulties. The lower part of the table has been adjusted by estimating the variation in the reserves in

constant-value guaraníes on the basis of their value in current dollars (at the current exchange rate and the implicit price index of the GDP) and then deducing the total capital inflow from that value and from the external saving given by the national accounts (upper part of the table). This is necessarily an approximation, since it is not feasible to use the preferred method, which would be to compute the two parts of the table separately in order to check their degree of coincidence.

With regard to the magnitude of unregistered trade, the first conclusion to be drawn from these estimates is that unregistered trade in Paraguay amounts to almost unbelievable levels: in 1994, for example, the estimated unregistered exports and imports represented 179% and 66% of registered exports and imports.

At the same time, according to the same estimates, unregistered trade showed a deficit between 1989 and 1993, broke even in 1994, and turned in surpluses as from 1995 (table 6). This result, which is of crucial importance for macroeconomic analysis, may be explained intuitively by a number of factors. Firstly, thanks to the prevailing exchange rate conditions, the "smuggling" of Brazilian products for domestic consumption in Paraguay (foodstuffs, toilet articles, construction inputs, etc.) reached its peak in the period up to 1994 (when the over-valuation of the guaraní with respect to the Brazilian currency came to an end with the introduction of the Plano Real in the latter country), which is in keeping with the fact that part of the unregistered imports remained in the country and were not re-exported. Secondly, 1995

was marked by substantial changes in the Paraguayan and Brazilian economies. In Paraguay, a markedly recessionary cycle began which reduced the country's capacity to absorb imports, while in Brazil the introduction of the Plano Real gave rise to a consumption boom and appreciation of the national currency, and the trade balance, which had been showing a surplus for years, began to register deficits. Obviously, part of Brazil's additional imports came from Paraguay and were not always officially registered. At the same time, however, the exchange-rate-based stabilization plan was accompanied as from 1995 with the scheduled convergence of tariff levels with MERCOSUR, so that the average Brazilian tariffs underwent sharp reductions, probably leading to a considerable increase in imports from outside the area. These factors back up the theory that the macroeconomic conditions prevailing between 1989 and 1994 strengthened the consumption-oriented tendencies of the Paraguayan economy and that there was indeed a deficit which was only reversed after 1994.

In the light of this analysis, both the available estimates and the evolution of the macroeconomic variables suggest that up to 1994 unregistered trade helped to aggravate the excessive domestic absorption described in the present article, backing up the theory that there was a domestic consumption bubble. Finally, it may be noted that after 1995 the surplus on unregistered trade represented only a small fraction of the deficit on registered trade, so that a substantial excess of absorption still persisted.

(Original: Spanish)

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