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PARAGUAY'S PUBLIC ENTERPRISES: DESTROYING ECONOMIC GROWTH

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Summary

Paraguay's large and inefficient state-owned enterprises, which expanded rapidly in the wake of the economic boom of the 1970s, have emerged as the country's most significant economic burden and as a powerful magnet for massive corruption opportunities. Far from acknowledging growing criticism from domestic groups and international financial officials calling for dramatic spending cuts and the privatization of state firms, government officials are instead using the state entities to enhance their political control and increase their personal wealth. Despite some emerging pressure from the business sector, we see little prospect for reforms. We believe that the regime's continued pursuit of statist economic policies and its pervasive corruption will boost Paraguay's foreign debt, encourage capital flight, and nurture the country's growing role as a regional smuggling and narcotics center. Over the longer term, these factors will likely contribute to political instability after President Stroessner's death.

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This typescript was requested by Mr. Robert Gelbard, Deputy Assistant Secretary of State for South American Affairs. It was prepared by [redacted] South America Division, Office of African and Latin American Analysis. Comments and queries are welcome and may be directed to the Chief, South America Division, ALA [redacted]

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### The Economic Backdrop Before the Parastatals

Favorable external circumstances throughout the last decade fueled unusually rapid economic development in Paraguay, where annual growth rates averaged 8 percent in the 1970s. The Brazilian-financed binational Itaipu dam, the world's largest hydroelectric project, stimulated domestic demand--providing direct or indirect employment for more than a fifth of the population--and generated foreign exchange inflows that, at times, exceeded Paraguay's export revenues, according to press reports. Simultaneously, increasing world demand and favorable international prices for agricultural goods--Paraguay's main exports--hastened development of modern cotton and soybean farms. [redacted]

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The Stroessner regime, however, took advantage of the booming economic conditions to postpone structural adjustments and overvalue its currency, which discouraged export development and eroded the country's trade-based tax revenues. These policies, in our view, left Paraguay vulnerable to the economic strains caused by the sharp reversal of external trends that began early this decade. The near completion of Itaipu has removed the primary engine of growth: the financial press reports that revenues from the dam dropped from 13 percent of GDP in 1981 to less than 2 percent this year. The collapse of world prices for agricultural goods--combined with flood and drought disasters--reduced registered export revenues from \$753 million in 1981 to less than \$250 million last year. [redacted]

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### The Rise of the Parastatals

With the fall-off of Itaipu revenues, the regime turned to state-owned companies such as steel and cement firms to provide further economic growth. Massive investment into these state enterprises increased markedly beginning in the late 1970s, boosting, in turn, the public sector role in the economy. For example, the state now consumes 40 percent of registered imports and employs a fifth of the workforce--including thousands of phantom workers in the state firms--and the public sector's budgeted expenses now equal a quarter of GDP--as opposed to roughly 12 percent in 1980. The press reports that public sector spending expanded by an average of 17 percent annually in the 1980s, while revenues increased by only 3 percent per year, creating a huge fiscal deficit. [redacted]

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While Paraguay has relatively few parastatals, two white elephants alone, the national steel (ACEPAR) and cement (INC) companies--which Asuncion recently spent over half a billion dollars to modernize--are key factors in the country's financial crisis and economic decline. For example, the charcoal-fueled steel mill--run by the military--has yet to sell any steel commercially but has an installed capacity that is almost six times as much as the domestic market needs. Independent economists estimate that even if ACEPAR produced as much steel as Paraguay uses, its output would cost 16 times as much as a comparable product from Brazil or Argentina. Similarly, Paraguay's cement is two to three times more expensive than cement produced in neighboring countries. While the repayment terms of the two enterprises are tightly held, press reports estimate that their obligations amount to 23 percent of Paraguay's total foreign debt. [redacted]

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In addition to the financial pressures these two large state-owned firms put on Paraguay's limited economic resources, Asuncion is helping a group of smaller state enterprises against private producers in other industries by legislating competitive advantages. For example, the state merchant fleet has first rights to all export cargo and some private alcoholic beverage producers must purchase all their raw materials from the state alcohol administration. Moreover, parastatals enjoy easy access to long term credit, while the state development bank cannot make loans to private firms for more than a year, severely limiting their fixed capital investments. We concur with United Nations Industrial Development Organization reports that blame these distortions for the country's shrinking industrial base. Moreover, while these policies are bankrupting private Paraguayan businesses, press reports indicate ~~that they have~~ not helped the parastatals stop foreign companies from increasing their share of the local market. [redacted]

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### The Impact of Public Sector Growth

Supporting the burgeoning public sector enterprises has inhibited the regime's ability to manage the rest of the economy. While the Central Bank reports that the public sector deficit is 4 percent of GDP, independent financial assessments conclude that if public sector imports and debt service payments were recorded at the free market exchange rate, the fiscal deficit would exceed 7 percent of GDP, making it the highest in the region. In addition to limiting the funds available for private sector investment in the country, we believe that this deficit is spurring inflation, now running at more than 60 percent annually. Furthermore, according to the US Embassy, public enterprise savings and time deposits--which account for more than 40 percent of deposits in commercial banks-- increased the money supply at a record clip this year, further aggravating inflationary pressures until the Central Bank limited their holdings in June. [redacted]

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In addition to encroaching on Paraguay's productive capacity, the parastatals, in our view, are accelerating foreign debt accumulation at an unsustainable pace, thereby draining the country's hard currency reserves. According to Central Bank data, the public sector holds virtually all of Paraguay's foreign debt, which has almost doubled since 1981 to more than \$2 billion. The collective external obligations of the state enterprises represent nearly two thirds of the country's foreign debt and an even higher portion of its estimated \$260 million annual debt service bill. The government's practices of allowing featherbedding and corruption within the state firms and granting subsidies in the form of preferential exchange rates for parastatal debt payments and import charges have contributed to this trend. [redacted]


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Business Concern

Paraguay's long quiescent business community, which has gradually become alarmed by deteriorating economic and financial conditions over the last two years, has recently focused its attention on Asuncion's support of the state enterprises. Some businessmen have begun to hint publicly at problem areas by pointing out that the INC's budget exceeds that of the Ministry of Agriculture and that the state airline's annual expenditures could fully fund the national university for 20 years. Speakers at a recent business forum went so far as to demand that the government channel credit from inefficient parastatals to productive private firms, even calling for the privatization of some state entities--an unparalleled example of discontent from a sector previously noted for its deference to the regime. 

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Business leaders as well as some political opponents of the regime have also begun to take aim at the corruption factor, blaming rake-offs from the state-owned operations by powerful government officials for much of the sector's inefficiency. Private entrepreneurs have complained that the public sector's expansion over the past six years has been almost exclusively in response to the political and personal financial appetites of government officials. For example, they have noted that the national telephone company may devote one fifth of its payroll to phantom workers. [redacted]

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#### Poor Prospects for Reform

We judge the probability of public sector--or any economic--reform in Paraguay over the next year to be remote. In our view, the failure of the economic reactivation plan of last September underscored the depth of the regime's commitment to maintaining the parastatals, regardless of the long-term costs to the economy. Paraguayan officials emphasized during consultations with the IMF last August that, short of closing down the large state enterprises--which they deemed politically unacceptable--they could not limit the firms' deficits. [redacted]

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[redacted]

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Moreover, far from considering reforms that would require constricting the public sector, the government has signaled that it plans to encourage and even expand the range and finances of the parastatals. Stroessner recently praised the sector's growing role in the economy in his State of the Nation address, specifically lauding several of the most deficit-ridden operations. Minister Ugarte announced in June that Asuncion plans to construct a state textile mill and fertilizer plant, claiming--disingenuously in our view--that the needed investment outlays were beyond the financial capacity of the private sector. [redacted]

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Finally, many officials, indifferent to the economic crisis and hoping to dip into public enterprises' revenues until the next "Itaipu" comes along, will almost certainly resist any changes that might cut off their illegal income from these firms. Indeed, we suspect that the growing anxiety in Asuncion regarding the composition of any post-Stroessner government will induce the regime's officials to feather their beds with even greater determination to guard against any sudden reversal of political fortune. [redacted]

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#### Outlook

We believe that the regime's continued commitment to corruption-ridden, statist-oriented policies will only deepen the economic malaise begun by the lack of attention to structural problems during the 1970s boom. Projected at their current pace, debt service payments bills for the public sector entities would climb to an overwhelming \$1 billion in the next 10 years. The overvalued exchange rate will discourage production for foreign sales, further undermine domestic confidence in the guarani, spur ever-increasing dollar withdrawals from banks, and

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[redacted]

accelerate capital flight. These developments, in our view, will only strengthen the growing smuggling and narcotics trafficking sectors, which according to some press estimates already generate one and one-half times the revenues of legal trade. [redacted]

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Despite rising disgruntlement with the state-owned enterprises, we do not believe their corrosive impact on the economy can be tapped to generate sufficient political discontent to threaten the Stroessner regime's grip on power. Over the longer term, however, Asuncion's [redacted] inept economic policies are likely to put considerable stress on Paraguay's political system--possibly during the potentially delicate post-Stroessner transition period when the country may be least be able to cope with it. In particular, economic ~~mismangement~~ will almost certainly aggravate the growing stress fractures between the Stroessner loyalists and moderate factions in the ruling Colorado party, and may make the military leadership [redacted] increasingly restive. [redacted]

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