

Asunción, 5 November 2015

MH No. 1116

Mr. LUIS ALBERTO MORENO
PRESIDENT
INTER-AMERICAN DEVELOPMENT BANK (IDB)
WASHINGTON D.C., USA

Dear Mr. Moreno,

I am pleased to have this opportunity to write to you about the measures and actions that are being adopted by President Horacio Cartes's administration, through this State portfolio in particular, to successfully address the major challenge that the execution of the projected development plans represents. It is in this context that the "Public investment Management Program" with the Inter-American Development Bank has been under way. This program includes commitments to make profound transformations to strengthen our public investment system. The main objective of the reforms promoted by this program is to make public investment financing and management more efficient.

This represents a broad effort to improve and consolidate our incipient public investment system by adopting a series of policy measures aimed at: (i) strengthening the strategic, legal, and institutional framework of the National Public Investment System; (ii) improving the management of public investment projects and programs; and (iii) promoting the use of innovative approaches to financing public investment.

Public investment plays a central role in the Government Plan, in that public investment programs and projects are the key means by which the national government addresses the country's main development challenges. However, the efficiency of public investment in Paraguay and its consequent social and economic impact are limited. This, among other factors, is because of the State's incipient and still weak institutional capacity to manage public investment projects with the desired efficiency. This shortcoming, apparent from project cost overruns, delays, and low budget execution, is an urgent and important challenge that demands profound reforms to overcome it.

In recent years, the State has made major efforts to improve the management of public investment. It is in this context that the general guidelines for the design and coordination of policies, standards, and procedures for the operation of the National Public Investment System (SNIP) were established in 2010. In 2011 the Public Investment System Division (DSIP) was set up within the Ministry of Finance as the lead agency responsible for SNIP administration. The SNIP's procedures and processes were established in 2012, along with the institutional roles of the Technical Planning Secretariat (STP) and the Ministry of Finance in the system. A Preinvestment Fund was created that same year in order to finance preinvestment studies. However, despite this significant progress, the SNIP still faces a series of challenges that have not yet been sufficiently addressed. These include: (i) the SNIP's weak strategic, legal, and institutional framework; (ii) limited public investment project management capacity; and (iii) the absence of a regulatory framework allowing alternative measures to be used to finance and manage large-scale projects. The relevance of the topic for the country's economic and social

development justifies the definition of an ambitious program of reforms such as that proposed.

In recent years the country has managed to achieve a broad consensus as to the urgent and pressing need to significantly improve efficiency and transparency in the use of public resources, particularly those earmarked to finance investment projects. This consensus makes it possible to promote the design and execution of this reform program in a way that guarantees its sustainability over time. The strategy of reforms proposed by this program, which the IDB has supported from the design stage, aims to address the problems referred to above, and rests on the following three fundamental pillars:

- Strengthening of the SNIP's strategic, legal, and institutional framework, in order to provide tools for the system's institutional coordination and consolidation, by: (i) developing a strategic and regulatory framework for the SNIP; (ii) strengthening the tools and processes of the DSIP, as the SNIP's lead agency; and (iii) strengthening the capacities of the SNIP's technical staff;
- Enhancement of capabilities for the management of public investment programs, in order to support the SNIP entities in their efforts to improve their capacity to manage investment programs, by: (i) strengthening the preinvestment stage; and (ii) improving budget programming processes and fiduciary management; and
- Development of innovative measures for the financing and management of public investment. The use of innovative measures to improve the financing and management of large-scale public investment projects will be promoted in this pillar.

In terms of macroeconomic conditions, the country has one of the region's fastest growing economies and a sound macroeconomic situation. Over the past decade (2005-2014), the country underwent rapid economic expansion, with an average rate of GDP growth of 5%, higher than in previous decades, with per capita GDP of US\$4,447 in 2014. Meanwhile, total poverty fell from 41.2% (2007) to 22.6% (2014). This period of growth has been characterized by increased macroeconomic stability, stable inflation at an annual average of 6.2%, and sound fiscal accounts, with consecutive surpluses up until 2011 and moderate deficits since 2012. To curb possible deficit growth, the Fiscal Responsibility Act was passed in 2013, establishing a fiscal deficit ceiling of 1.5% of GDP in the formulation of the National General Budget. In 2014 the fiscal deficit was 1.1% of GDP. Paraguay maintains a solid external position with a level of international reserves of around 22% of GDP. This is equivalent to 180% of external debt, ensuring that the country can manage its obligations in a financially stable manner.

The Paraguayan economy is expected to continue to outpace regional average growth over the next few years. Nonetheless, the outlook for 2015 and 2016 suggests more moderate growth rates (3.7% and 4%, respectively), given the less favorable regional context. This growth will take place in a context of price stability, with an estimated inflation rate of 3.7% in 2015—below the Central Bank of Paraguay's annual inflation target of 4.5%. The inflation rate is projected to reach 4.3% by the end of 2016. As to the fiscal outlook, the Ministry of Finance projects a fiscal deficit of around 0.5% of GDP for 2018.

Despite the growth described, the sound position of the fiscal accounts, and responsible macroeconomic management, Paraguay still faces significant challenges in order to sustain economic growth and social development more effectively. In a less favorable medium-term international and regional context than in previous years,

there is an even more pressing need to adopt measures to overcome the shortcomings that limit the efficiency of public investment management so as to shore up economic growth and speed up execution of the public works needed to stimulate productivity and improve access to, and quality of, basic social services, with particular emphasis on the most vulnerable sectors of the population. In particular, it is essential to promote the measures contained in the program aimed at strengthening the national investment system and training technical staff responsible for the formulation, execution, and evaluation of public investment projects.

For these reasons, the Government of Paraguay considers it necessary and relevant to have the support of the Inter-American Development Bank, in the form of a policy-based loan of up to two hundred million U.S. dollars (US\$200,000,000), to be disbursed in two tranches of one hundred million U.S. dollars (US\$100,000,000) each, once compliance with the conditions agreed upon with the Bank has been confirmed.

With this Policy Letter, the Government of Paraguay undertakes to implement the actions described in the Policy Matrix agreed upon with the Bank, in the following areas: (i) maintaining a stable macroeconomic context; (ii) strengthening the SNIP's strategic, legal, and institutional framework; (iii) improving public investment program management capacity; and (iii) developing innovative measures to fund and manage public investment.

Sincerely,

[Signature]

SANTIAGO PEÑA PALACIOS
MINISTER OF FINANCE
GOVERNOR FOR PARAGUAY

[Seal of Ministry of Finance]

[IDB receipt stamp dated 6 November 2015]