



# Paraguay: Political and Economic Conditions and U.S. Relations

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## Summary

Paraguay, a landlocked nation in the center of South America, has friendly relations with the United States and has been a traditional ally. Paraguay's turbulent political history and tradition of political authoritarianism have resulted in international isolation that the country is seeking to overcome. The population of 6.9 million people is one of the most homogenous mestizo populations in the hemisphere. Paraguay's largely agrarian economy has grown well in recent years on the strength of global commodity prices. However, in 2009, a severe drought and the impact of the global economic recession sharply reduced growth, but a recovery is anticipated in 2010.

The April 2008 election of Fernando Lugo, a former Roman Catholic bishop and leader of the Patriotic Alliance for Change, as President ended 61 years of one-party rule by the still-dominant Colorado Party. The United States has encouraged the strengthening of democracy in Paraguay, and hailed the peaceful transition of power. Known as the "bishop of the poor" after a decade of work in an impoverished rural diocese, Lugo pledged to introduce land and agrarian reform, improve education and health services to better serve Paraguay's poor majority, and combat widespread corruption. Yet, as he entered his second year in office, there were more frequent calls for his impeachment. His loose electoral alliance had splintered, and he faced broad opposition in the opposition-dominated Paraguayan Congress that had stymied his center-left agenda at nearly every turn. At the end of 2009, polls indicated that Lugo had one of the lowest popularity ratings of any leader in the region.

The United States and Paraguay cooperate in a number of areas but especially in the fight against corruption, and on anti-drug, counterterrorism and anti-smuggling initiatives. In 2006 and 2009, the United States and Paraguay signed two Millennium Challenge Corporation threshold agreements totaling more than \$60 million dollars to combat corruption and strengthen the rule of law. Paraguay is a major transit country for cocaine and produces the largest crop of marijuana in South America. The United States remains concerned about illegal activities in the loosely controlled tri-border region with neighboring Brazil and Argentina, such as money-laundering, drugs and arms trafficking, and trade in counterfeit and contraband goods.

The 111<sup>th</sup> Congress has expressed growing interest in Paraguay. In April 2009, two bills were introduced entitled the "U.S.-Paraguay Partnership Act of 2009" (H.R. 1837 and S. 780). On September 14, 2009, the ATPDEA Expansion and Extension Act of 2009 (S. 1665) was introduced in the Senate. Each of these bills would amend the Andean Trade Promotion and Drug Eradication Act (Title XXXI of the Trade Act of 2002, P.L. 107-210) to extend unilateral trade preferences to Paraguay. Indicating additional interest in Paraguay, the House Democratic Partnership (formerly the House Democratic Assistance Commission) made a study trip to Paraguay in August 2009. Members of the eight-member delegation had discussions with the bicameral Congress and the executive about the need to work together to support democracy in Paraguay.

This report examines recent political and economic developments in Paraguay and issues in U.S.-Paraguayan relations.

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## Introduction

On April 20, 2008, a former Roman Catholic bishop, Fernando Lugo, was elected President of Paraguay, a land-locked South American nation critically wedged between Brazil, Argentina, and Bolivia. The Lugo victory was hailed as a step toward strengthening Paraguay's fragile democracy, ending six decades of one-party rule. In many ways, the election of President Lugo raised hopes for a historic break with Paraguay's past and its tradition of authoritarian leadership, political isolation, and widespread corruption.

## Political Background<sup>1</sup>

The current political environment in Paraguay has been shaped by the country's turbulent political history. Paraguay was defeated in the War of the Triple Alliance (1864-1870) against Argentina, Brazil and Uruguay and lost 25% of its territory and over half of its population. This defeat led to an extensive period of political instability, with three civil wars in the first half of the 20<sup>th</sup> century. In the late 19<sup>th</sup> century, a two-party political system emerged with the formation of the Colorado Party and the Liberal Party, but the Colorado Party soon became the dominant political force, ruling between 1887 and 1904. The Liberal Party captured control of the government and ruled from 1904 until 1940. A war with neighboring Bolivia between 1932-1935, the Chaco War, further weakened political institutions and hindered economic development until the military assumed control in 1940 and governed through a succession of authoritarian leaders.

The Colorado Party returned to power in 1946, consolidating its control through the military, dominant economic groups, and the state bureaucracy. In the late 1940s, the party assumed greater control over state institutions to the point where party membership was a prerequisite for civil service positions and promotion in the military. General Alfredo Stroessner, a member of the Colorado party, staged a coup in 1954, and consolidated power in a repressive military dictatorship. Stroessner, who engineered his "election" to complete the unexpired term of his predecessor, was subsequently re-elected seven times, ruling almost continuously under the state of siege provision of the constitution, with support from the military and Colorado Party.<sup>2</sup> Nominally governed by a constitution approved in 1967, Stroessner's rule increased the isolation of Paraguay from the world community. During Stroessner's 35-year rule, (known as the Stronato), political opponents were systematically harassed and persecuted, accused of communist sympathies or posing a threat to state security.<sup>3</sup>

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<sup>1</sup> This report draws from archived CRS Report RL34180, *Paraguay: Background and U.S. Relations*, by Mark P. Sullivan.

<sup>2</sup> U.S. Department of State, "Background Note: Paraguay," August 2009.

<sup>3</sup> *Ibid.*

Figure I. Map of Paraguay



Source: CRS Graphics.

The demise of the Stroessner military dictatorship in 1989 initiated a challenging political transition over the next 20 years. Due in large part to the country's authoritarian past, Paraguay's state institutions had remained weak while corruption continued to undercut democratic consolidation and economic development. In 1992, a new constitution was adopted, and in 1993, Paraguay elected its first civilian president in almost 40 years. For the next 15 years, however,

Paraguay's democracy alternated between periods of greater and lesser instability, including an attempted military coup, the assassination of a Vice President, and the resignation of a President.

Observers maintain that corruption is a major impediment to consolidating democratic institutions. President Nicanor Duarte Frutos (2003-2008) took important measures to combat corruption that included increased penalties for tax evasion, other measures to increase tax revenue, greater oversight of government spending, and a crackdown on the trade in contraband and counterfeit goods. He removed members of the Supreme Court after corruption allegations surfaced against them. These measures were partially successful, as suggested by Transparency International's 2006 corruption perceptions index in which Paraguay moved up to 111 out of 163 countries<sup>4</sup> after Paraguay was ranked among the six most corrupt countries in the world in 2004. In both the 2007 and 2008 index, however, Paraguay dropped to 138 out of 180 countries,<sup>5</sup> and in the 2009 index Paraguay ranked 154—ahead of only Venezuela and Haiti in the hemisphere.<sup>6</sup>

In April 2008, Paraguay took another historic step with the election of former bishop Fernando Lugo to the presidency. For some observers, Lugo's victory is seen as a chance for Paraguay to strengthen its democratic transition. One of President Lugo's central challenges is to establish presidential control over the entrenched government bureaucracy that is still essentially controlled by the Colorado Party.

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<sup>4</sup> Transparency International, *Corruption Perceptions Index 2006*.

<sup>5</sup> "Chile and Uruguay the Least Corrupt in Latin America," *LatinNews Daily*, September 27, 2007; Transparency International, *Corruption Perception Index 2007 and 2008*.

<sup>6</sup> Transparency International, *Corruption Perceptions Index 2009*.

## Lugo's 2008 Election

There were three major candidates in the presidential election of April 20, 2008. They were the former minister of education Blanca Ovelar of the long-ruling Colorado Party; Fernando Lugo, then known in Paraguay as the “bishop of the poor,” backed by the Patriotic Alliance for Change; and former military commander Lino Oviedo, the leader of a failed 1996 coup who was released from prison in early September 2007, running as a candidate of the party that he founded, the National Union of Ethical Citizens (UNACE).

In the campaign, Lugo emphasized empowering the poor, agrarian reform, health reform, and ending endemic corruption, which he viewed as the legacy of decades of Colorado Party dominance. Lugo said that he was open to private capital and a consensus-based development model.<sup>7</sup> As a cornerstone of his candidacy, he pushed for renegotiating the Itaipú and Yacyretá hydroelectric power supply treaties with Brazil and Argentina and sought to raise the price of Paraguay's supply of hydro-energy to these countries.

### From Bishop to Presidential Candidate

Fernando Lugo served as a bishop in an impoverished rural diocese from 1995 to 2005. Lugo emerged in 2006 as a powerful spokesman against the previous government. He aligned with political opposition parties and civic organizations that protested against then-President Duarte's failure to combat social exclusion and rising crime, and his efforts to revise the constitution to allow for consecutive presidential re-election. Lugo led a center-left coalition to power called the Patriotic Alliance for Change (Alianza Patriótica para el Cambio, APC). This broad coalition included the Authentic Radical Liberal Party (Partido Liberal Radical Auténtico, PLRA—an offshoot of the traditional Liberal Party), the Country in Solidarity party (País Solidario), the Tekojoja Popular Movement (Movimiento Popular Tekojoja), the Progressive Democratic Party (Partido Democrático Progresista), and other smaller parties.

Lugo's coalition of opposition parties—the Patriotic Alliance for Change (APC—see text box for the coalition's various parties) won the election with 40.8% of the vote according to the National Election Tribunal, followed by Colorado's Blanca Ovelar with 30.6% and UNACE's Oviedo with 21.9% of the vote.<sup>8</sup> International observation teams from the Organization of American States (OAS) and the U.S.-based International Foundation for Electoral Systems (IFES) praised the successful conduct of the elections. Both groups characterized the election as historic, with the OAS maintaining that “in spite of differences, political parties and movements achieved a fundamental consensus on the rules of the game, which as in the rest of Latin America, constitutes the essential minimum for the construction of democracy.”<sup>9</sup>

## Prospects for the Lugo Administration

Lugo took office on August 15, 2008, for a five-year term. He declared his top priorities as fighting widespread corruption and reducing economic inequality.

Lugo's election greatly raised expectations among Paraguay's poor majority. The APC coalition that brought Lugo to office, however, fractured in late June 2009 following the congressional

<sup>7</sup> “Paraguayan Former Bishop Aims to End 60 Year One-Party Rule,” *Agence France-Presse*, September 18, 2007.

<sup>8</sup> “Background Note: Paraguay,” January 2009.

<sup>9</sup> OAS, “El Secretario General de la OEA Felicita Masiva y Tranquila Participación de Paraguayos en Las Elecciones Generales,” April 21, 2008; IFES, “IFES Congratulates Paraguayan on Historic and Genuine Democratic Elections,” Press Release, April 21, 2008.

leadership elections. The APC lost the support of the influential PLRA (a wing of the Liberal Party and the second-largest party in Congress) when a faction of the PLRA chose to leave the coalition.<sup>10</sup> In July 2009, the entire PLRA split from the electoral alliance and joined the opposition in criticizing Lugo. This defection included his Vice President, Frederico Franco, who accused the President of treason for his inability to make good on electoral promises in a December 2009 news article.<sup>11</sup> In response to political challenges and conflict, President Lugo has reportedly retreated from leadership and has left the problems facing his reform agenda in the hands of his ministers.<sup>12</sup> His inability to manage the growing opposition in Congress has raised questions about his capacity to effectively influence policy, and even the possibility of impeachment.

Adding to his perceived weakness, a scandal erupted in April 2009 when the President was accused of fathering children during his years as a priest with three different women. (He has admitted to fathering one boy.) This scandal has further undermined his credibility in some quarters;<sup>13</sup> however, others have argued that the political fallout from the paternity claims may not be so great in a culture where virility is highly valued.<sup>14</sup> In late November 2009, Lugo held a press conference to accuse his detractors of being part of an “orchestrated campaign” led by the country’s “powerful mafia groups.”<sup>15</sup> In December, however, he took steps to address the controversy by agreeing to a DNA test in response to the third paternity suit.<sup>16</sup>

In his first year in office, President Lugo had very limited success in working with an opposition congress. Lugo’s reform agenda is stymied by a number of challenges: his electoral coalition has splintered; he is a political novice and has not acquired the political skills to build bridges with a constitutionally mandated strong Congress; and he faces a political and administrative culture reportedly riddled with corruption, clientelism, and a sympathy for and habituation to authoritarianism.<sup>17</sup>

Lugo’s popular support has dwindled. A December 2009 poll showed less than 18% of respondents thought he was doing a “good” or “very good” job, down from 38% at the end of 2008.<sup>18</sup> As Lugo entered his second year in office, calls for impeachment became more frequent. Impeachment is allowed by the Paraguayan Constitution and has been used recently (in 1999 and an almost successful attempt in 2003). Although factions within various parties support impeachment and in early December a Colorado Party Congress of 600 delegates voted to

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<sup>10</sup> Economist Intelligence Unit, *Country Report: Paraguay*, July 2009. The PLRA left the coalition when their attempt to split the Senate leadership with UNACE failed. After the Colorado Party made a deal with some small leftist parties it turned out that the presidency of the Senate went to the Beloved Fatherland Party (PPQ), the Colorado Party got the first vice-presidency, and the Tekojoja Popular Movement won the second vice-presidency.

<sup>11</sup> Economist Intelligence Unit, *Country Report: Paraguay*, January 2010.

<sup>12</sup> Ibid.

<sup>13</sup> Economist Intelligence Unit, *Country Report: Paraguay*, December 2009.

<sup>14</sup> Matt Potter, “Paraguay,” *Hemispheric Highlights*, vol. VIII, no. 4 (April 2009).

<sup>15</sup> Economist Intelligence Unit, *Country Report: Paraguay*, December 2009.

<sup>16</sup> Economist Intelligence Unit, *Country Report: Paraguay*, January 2010.

<sup>17</sup> USAID/Paraguay, *Paraguay Democracy and Governance Assessment*, USAID Contract Number DFD-1-00-04-00227-00, October 2009.

<sup>18</sup> “Paraguayan Church urges Lugo to become paternal role model,” *Latin American Weekly Report*, December 10, 2009.



consider impeachment, the opposition in Congress does not appear to have the two-thirds majority needed to impeach Lugo.<sup>19</sup>

In November 2009, President Lugo shuffled the military leadership for the fourth time since he took office. Although he complained about pro-coup sentiment in the military when he made the announcement, he later released a statement that denied a coup plot had been discovered.<sup>20</sup> The President had been under pressure to improve security since the October 2009 kidnapping of wealthy businessman Fidel Zavala by the Army of the Paraguayan People, (EPP), a small guerrilla group with reported links to some of Paraguay's peasant organizations. In January 2010, his Vice President, Frederico Franco, now in opposition to President Lugo, called for increased security measures in the north of the country, where the kidnapping occurred, and more aggressive action against the EPP. Fortunately for Lugo, Zavala was released unharmed on January 17, 2010, after more than three months of captivity following the reported payment of a ransom by his family. Lugo has pledged to bring the kidnapers to justice and increase security in the area where the EPP operates.<sup>21</sup>

Despite congressional gridlock and vocal opposition, President Lugo has had some political successes. His focus on increasing social and health expenditures to reduce inequality has resulted in modest reforms of education and healthcare.<sup>22</sup> Progress to reduce poverty included an expansion of the conditional cash transfer program. He enacted policies to provide more poor families with conditional benefits (about \$40 per month while their children remain in school) from 50,000 to 70,000 families.<sup>23</sup>

In a meeting with the President of Brazil on July 25, 2009, President Lugo obtained an agreement to sharply increase the payments received from Brazil for hydro-electric power from the Itaipú Dam, one of his campaign promises. The dam, constructed on the Parana River jointly by the Brazilian and Paraguayan governments, is the second-largest hydropower producer in the world. Sale of the power is regulated by a treaty that gives each country the right to 50% of the 14 gigawatts of electricity generated by the dam.<sup>24</sup> Paraguay now uses only about 5% of the power from the project. Until 2023, when the treaty expires, the unused electricity generated for Paraguay must be sold to Brazil's state-owned power utility Electrobras at a fixed price. In the July 2009 accord, Brazil agreed to triple the price it paid Paraguay for the energy, and included financing for high-capacity transmission lines to be constructed from the dam to the Paraguayan capital, Asunción. Some analysts see the new agreement as an effort by Brazilian President Lula da Silva to offer President Lugo a hand as his electoral coalition was fracturing. Lugo had pledged during the campaign to use the power sale proceeds to finance poverty relief, health care, school nutrition programs, and ultimately, far-reaching land reform.<sup>25</sup> The Paraguayan Congress

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<sup>19</sup> "Paraguay: Another Honduras?," *Economist Intelligence Unit - Business Latin America*, July 27, 2009; Economist Intelligence Unit, *Country Report: Paraguay*, January 2010.

<sup>20</sup> "Loose-lipped Lugo," *Economist*, December 12, 2009.

<sup>21</sup> Ireena Renuncio Mateos, "Paraguay Strengthens Security After Liberation of Kidnapped Businessman," *HIS Global Insight Daily Analysis*, January 19, 2010.

<sup>22</sup> "Loose-lipped Lugo," *Economist*, December 12, 2009."

<sup>23</sup> Hugh O'Shaughnessy, *The Priest of Paraguay: Fernando Lugo and the Making of a Nation* (London/New York: Zed Books, 2009).

<sup>24</sup> "Lula, Lugo reach historic accord on Itaipú and bilateral integration," *EFE News Service*, July 25, 2009.

<sup>25</sup> Alexei Barrionuevo, "Energy Deal with Brazil Gives Boost to Paraguay," *New York Times*, July 27, 2009, (late edition).

quickly approved the new agreement, but it has moved slowly through the Brazilian Congress, where it must also be ratified. The new agreement would boost Paraguay's income from the dam to \$360 million and is expected to be approved by the Brazilian Congress in the first half of 2010.<sup>26</sup>

## Foreign Policy

In terms of foreign policy, Lugo has resisted ideological labels. During the electoral campaign, Lugo refrained from criticizing the United States, and also was careful not to criticize or praise Venezuelan President Hugo Chávez. Lugo has declared his intention to maintain good bilateral relations with the United States. When Lugo visited the White House on October 27, 2008, President George W. Bush said he “stood with” Lugo in pursuing a “social justice agenda” and supported his efforts to fight corruption.<sup>27</sup> Following the 2008 visit, Paraguay received a one-time increase in health and economic growth assistance from the United States of \$10 million.<sup>28</sup> The United States has supported anti-corruption and democratization programs in Paraguay including providing more than \$60 million in funding from the Millennium Challenge Corporation (see “U.S. Assistance”). The two countries collaborate extensively on anti-narcotics and anti-smuggling efforts.

Some of Lugo's opponents accuse him of maintaining close ties to President Chávez, a charge that Lugo denies. He has maintained friendly relations with President Chávez but has not shown an inclination to join the Bolivarian Alternative for the Americas (ALBA), the leftist political alliance organized by Venezuela's President, which includes Cuba, Bolivia, Ecuador, and Nicaragua.<sup>29</sup> Paraguay is a member of the Common Market of the South (Mercosur)<sup>30</sup> along with Brazil, Argentina and Uruguay, and has been aligned with the trade group despite being Mercosur's poorest member. In August 2009, Lugo was forced to withdraw his support of legislation allowing Venezuela's membership in Mercosur because he lacked a majority in his Congress.<sup>31</sup> As a full voting member of Mercosur, Paraguay has opposed the elevation of Venezuela to full membership in the customs union because of strong animosity toward Chávez in the Paraguayan Congress.

## Economic Situation

Paraguay, approximately the size of California, has a population of about 6.9 million people who are concentrated in and around the capital city of Asunción. The majority of the population is of

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<sup>26</sup> Pedro Servin, “Energy treaty that would transform Paraguay stuck in committee in Brazil's congress,” *The Associated Press*, December 16, 2009.

<sup>27</sup> See “Remarks Following a Meeting With President Fernando Armino Lugo Mendez of Paraguay,” by President George W. Bush, *Weekly Compilation of Presidential Documents*, Volume 44; Issue 43; November 3, 2008.

<sup>28</sup> Communication from an official in the U.S. Embassy in Paraguay, January 15, 2010.

<sup>29</sup> Economist Intelligence Unit, *Country Report: Paraguay*, July 2009.

<sup>30</sup> Mercosur is a common market composed of Brazil, Argentina, Uruguay and Paraguay that was established in 1991 to promote economic integration and political cooperation.

<sup>31</sup> Following the Brazilian Senate's mid-December 2009 approval of Venezuela's membership, there were reports that the Brazilians will use the approval of the Itaipú agreement to leverage Paraguay's support of Venezuela's membership in Mercosur. Paraguay is the only country yet to ratify Venezuela's membership, and all members are required to ratify new membership. See: Economist Intelligence Unit, *Country Report: Paraguay*, January 2010.

mixed Spanish and Guaraní Indian descent. Both Spanish and Guaraní are the official languages, with over 90% of the population fluent in Guaraní.<sup>32</sup> In 2008, Paraguay's gross national income (GNI) was \$16.3 billion, with a per capita GNI of \$2,180, up from \$1,670 in 2007.<sup>33</sup>

Paraguay's small, primarily agricultural economy grew by a robust 6.8% in 2007. It is one of the poorest countries in Latin America, however, and has suffered significantly from a recent drought and the global economic downturn. The Paraguayan economy is particularly dependent on its two larger neighbors, Brazil and Argentina, for its export markets. While GDP growth slowed to an estimated 5.8% in 2008, it has contracted sharply in 2009. Economic growth is estimated to have contracted by 3.8% in 2009, with a projected return to growth of 4.2% in 2010.<sup>34</sup>

Paraguay experienced an economic recession for several years in the aftermath of a series of bank failures from 1996-1998 that wiped out half of Paraguay's locally owned banks. When inaugurated in 2003, former President Duarte inherited a government that had defaulted on \$138 million in debt, primarily as a result of low tax revenue.<sup>35</sup> Under President Duarte, the economy rebounded, due in part to the implementation of reforms that included anti-corruption initiatives, which increased revenue, strengthened institutions, and created a more favorable environment for foreign investment.

The Paraguayan economy remains heavily dependent on its traditional agricultural exports of soybeans, cotton and meat. Approximately 20% of GDP is derived from agriculture, and agricultural activities employ approximately one-quarter of the country's workforce.<sup>36</sup> Other agricultural products include wheat, corn, sugarcane, sesame and other fruits and vegetables. Paraguay's industrial sector is still largely underdeveloped, with much of the population still employed in subsistence agriculture. Economic growth tends to be limited by Paraguay's dependence on imports of manufactured goods, as well as capital goods that are necessary to supply the industrial and investment requirements of the economy.<sup>37</sup>

The small manufacturing sector includes agricultural goods, leather, textile, automatic data processing (ADP) machine parts, and tobacco products. The service sector is dominated by communications, which has benefitted from strong foreign direct investment (FDI) and electricity production from the Itaipú hydropower plant co-owned with Brazil and the Yacyretá plant co-owned with Argentina.

Paraguay's informal sector is very large and may be twice the size of the formal sector.<sup>38</sup> Consequently, while the official unemployment rate is relatively low (5.4% estimated for 2008), the actual unemployment and underemployment rates are estimated to be much higher.<sup>39</sup> Poverty

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<sup>32</sup> U.S. Department of State, "Background Note: Paraguay," August 2009.

<sup>33</sup> World Bank, *World Development Report 2010*, October 2009; World Bank, "Paraguay Country Brief: World Bank Indicators," at [http://ddp-ext.worldbank.org/ext/ddpreports/ViewSharedReport?&CF=&REPORT\\_ID=13609&REQUEST\\_TYPE=VIEWADVA NCED&HF=N&DIMENSIONS=28](http://ddp-ext.worldbank.org/ext/ddpreports/ViewSharedReport?&CF=&REPORT_ID=13609&REQUEST_TYPE=VIEWADVA NCED&HF=N&DIMENSIONS=28), accessed January 29, 2010.

<sup>34</sup> Economist Intelligence Unit, *Country Report: Paraguay*, January 2010.

<sup>35</sup> Michael Thomas Derham, "Against All Odds," *LatinFinance*, March 1, 2005.

<sup>36</sup> U.S. State Department, "Background Note: Paraguay," August 2009.

<sup>37</sup> Luis Carlos Nino, "Inflation Increases Slightly as Paraguay's Trade Deficit Widens," *Global Insight Analysis*, June 4, 2007.

<sup>38</sup> U.S. State Department, "Background Note: Paraguay," August 2009.

<sup>39</sup> For example, USAID reports that the national underemployment rate is 24%.

rates have dropped slightly from 61% of the population in 2001 to 58.2% in 2008.<sup>40</sup> Remittances from Paraguayans living abroad have significantly contributed to economic growth, increasing from approximately \$200 million in 2000 to \$800 million in 2008.<sup>41</sup>

A significant but declining part of the country's commercial sector consists of importing goods from the United States and Asia for re-export into neighboring countries. Most of these imported goods are not declared at customs, preventing the government from obtaining substantial tax revenue. Counterfeit trade and smuggling are prevalent in the country's border regions. Increased government enforcement of taxes and custom laws is having an impact on the underground economy as a whole, although much remains to be done.

Overriding a presidential veto, Paraguay's Congress voted to delay implementation of a personal income tax for a third successive time in June 2009. This was a blow to the Lugo Administration's plans to raise social expenditures and implement a land reform program.<sup>42</sup> The Colorado/UNACE majority in Congress also increased the fiscal deficit by raising the state pension for low income earners and other public sector wages. Members of Lugo's inner circle accused the Congress of sabotaging the President's land and fiscal reform policies. The personal income tax was again due to take effect in early 2010, but opposition in Congress has continued to prevent implementation.<sup>43</sup>

While promising to address income inequality and land reform, President Lugo has continued the orthodox macroeconomic policies adopted by the predecessor Duarte Administration in 2003. Those policies contributed to a slow and steady economic recovery after a period of recessions and weak recoveries and led to the achievement of positive economic growth. Lugo's appointment of Dionisio Borda as finance minister, and of other centrist politicians to his cabinet, are seen by many observers as an indication of his intent to consolidate macroeconomic stability. Borda is an independent economist, known for implementing fiscal reform. Stricter fiscal controls begun under the prior administration, which Borda also served, continue to increase the number of registered taxpayers and the amount of revenue generated by the business income tax.

## **Relations with the United States**

Paraguay and the United States have good relations, cooperating extensively on counternarcotics and counterterrorism efforts. The United States strongly supports the consolidation of Paraguay's democracy and continued economic reforms. Following the April 2008 election, then-U.S. Ambassador to Paraguay James Cason congratulated Lugo and the APC on their victory and expressed a commitment to work with them to strengthen bilateral relations. U.S. imports from Paraguay totaled \$78.4 million in 2008 while the value of U.S. exports to Paraguay was over \$1.6 billion.<sup>44</sup> Machinery and electrical machinery account for the lion's share of U.S. exports to Paraguay.

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<sup>40</sup> U.N. Economic Commission for Latin America and the Caribbean, *Social Panorama of Latin America 2009*. Briefing Paper. November 2009. The official figures are 37.9% in 2008, with extreme poverty at 19%. Rural areas are the most poor, with poverty levels at 48.8% in 2008. See: "Regional Statistics," *LatinNews Daily*, November 24, 2009.

<sup>41</sup> U.S. Agency for International Development, "USAID/Paraguay: Country Profile," June 2009.

<sup>42</sup> Economist Intelligence Unit, *Country Report: Paraguay*, July 2009.

<sup>43</sup> Communication from an official at the U.S. Embassy in Paraguay on January 14, 2010.

<sup>44</sup> U.S. Department of Commerce data, as presented by *Global Trade Atlas*, January 2010.

The protection of intellectual property rights (IPR, e.g., fighting piracy, counterfeiting, and contraband) has been a U.S. concern. The Duarte government made significant efforts to improve IPR protection, but the United States Trade Representative maintains that the country continues to have problems due to its porous border and ineffective prosecutions. In 2003, U.S. and Paraguayan officials signed a Memorandum of Understanding (MOU) to strengthen legal protection and enforcement of intellectual property rights in Paraguay. In December 2007, the MOU was revised and extended through 2009, and in November 2009 the agreement was extended again through 2011.<sup>45</sup>

## **U.S. Assistance**

The United States provided about \$13.1 million in foreign assistance to Paraguay in FY2008 and an estimated \$26.1 million in FY2009.<sup>46</sup> The increase in FY2009 was due to a one-time addition of \$10 million for health and economic growth assistance resulting from the October 2008 meeting between President Lugo and former President Bush. Under the Obama Administration's FY2010 request, Paraguay would receive \$13.9 million in assistance, with \$2.1 million to support Global Health and Child Survival, \$5.8 million in Development Assistance, \$425,000 in International Military Education and Training, \$750,000 for Foreign Military Financing, \$500,000 in International Narcotics Control and Law Enforcement assistance, and \$4.3 million for the continuation of a Peace Corps program in the country, with approximately 200 volunteers.

In 2009, the Department of Defense also provided Paraguay one-time security and stabilization assistance authorized under Section 1207 of the National Defense Authorization Act (NDAA). In FY2009, Paraguay received a total of \$6.69 million in "Section 1207" funding divided between counternarcotics and development accounts to support democratic consolidation and reduce violence in eastern Paraguay during the country's transition from one-party rule to multi-party democracy.<sup>47</sup>

In addition to regular foreign assistance funding, Paraguay signed a \$34.65 million Threshold Program agreement with the Millennium Challenge Corporation (MCC) in May 2006. Those funds, which are administered by the U.S. Agency for International Development (USAID), are targeted to strengthen the rule of law and build a transparent business environment.<sup>48</sup> The program has been credited with reducing the time it takes to start a business in Paraguay by half, among other accomplishments. In May 2009, the USAID-administered program was renewed with the signing of a second two-year MCC Threshold program for \$30.3 million.<sup>49</sup> The program supports anti-corruption efforts by Paraguay's government in law enforcement, customs, health care, and judicial sectors. The MCC program also aims to increase public support for anti-

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<sup>45</sup> "US, Paraguay meet to boost trade ties," *Agence France Press*, November 21, 2009.

<sup>46</sup> These figures include the appropriations for Peace Corps, totaling approximately \$3.3 million each year. However, according to the U.S. Embassy in Paraguay, foreign assistance (not including funding from the U.S. Department of Defense) totaled \$24.4 million in FY 2009.

<sup>47</sup> For more information on "Section 1207" funding, see CRS Report RS22871, *Department of Defense "Section 1207" Security and Stabilization Assistance: Background and Congressional Concerns*, by Nina M. Serafino.

<sup>48</sup> For more background on the scope of this program, see CRS Report RL32427, *Millennium Challenge Corporation*, by Curt Tarnoff.

<sup>49</sup> The Embassy notes with the second MCC threshold program awarded in 2009, the total U.S. government assistance provided to Paraguay in FY2009 exceeded \$60 million. For further information, see "U.S. Embassy Asunción Country Briefing on Paraguay for John Doe," January 15, 2010.

corruption efforts.<sup>50</sup> Paraguay also signed an agreement with the United States in 2006 under the Tropical Forest Conservation Act that provided Paraguay with \$7.4 million in debt relief in exchange for the Paraguayan government's commitment to conserve and restore tropical forests in the southeastern region.

## **Counternarcotics Cooperation**

Paraguay is a major transit country for illegal drugs destined primarily for neighboring South American states and Europe. It produces over half of the marijuana grown in South America. The Chaco region in the northwestern part of the country adjacent to Bolivia is a major transshipment point for illegal drugs, along with the tri-border area (TBA) with neighboring Argentina and Brazil. A 1987 U.S.-Paraguay bilateral counternarcotics agreement was extended in 2006.

U.S. counternarcotics efforts in Paraguay have focused on providing training, equipment and technical assistance to strengthen the country's National Anti-Drug Secretariat (SENAD), and to combat money laundering and corruption. The United States assisted in the completion of a helicopter pad and support facilities for SENAD. According to the State Department's February 2009 *International Narcotics Control Strategy Report*, SENAD continued to make progress against illegal narcotics trafficking in 2008 with record seizures of marijuana, although cocaine seizures were markedly down. The report notes that President Lugo has said he wants to reverse Paraguay's status as a "major drug transit country." Currently, SENAD agents are civil servants and they are not issued weapons. The Paraguayan Senate rejected a bill that would have made the SENAD an autonomous institution with the power to regulate its agents as law enforcement agents who can carry and use weapons. The bill had passed the Chamber of Deputies. This defeat is considered by some to be a major setback. Finally, INCSR notes that SENAD's work is limited by budget constraints, weak laws and pervasive corruption. After President Evo Morales of Bolivia kicked out the U.S. Drug Enforcement Administration (DEA) in late 2008, 10 of the 56 agents working in that country were redeployed to Paraguay in early 2009.<sup>51</sup>

In April 2009, bills entitled the "U.S.-Paraguay Partnership Act of 2009" were introduced in the House (H.R. 1837) and Senate (S. 780). On September 14, 2009, the ATPDEA Expansion and Extension Act of 2009 (S. 1665) was introduced in the Senate.<sup>52</sup> Each of these bills would amend the Andean Trade Promotion and Drug Eradication Act (Title XXXI of the Trade Act of 2002, P.L. 107-210) to extend trade preferences to Paraguay. Currently, Colombia, Ecuador, and Peru benefit from the ATPDEA in exchange for cooperation under anti-narcotics agreements.<sup>53</sup> Bolivia lost its eligibility for the program in 2008 when the Bush Administration determined that Bolivia no longer met the anti-narcotics cooperation requirements.

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<sup>50</sup> U.S. Agency for International Development, "USAID/Paraguay: Country Profile," June 2009.

<sup>51</sup> Briefing by State Department Desk Officer for Paraguay on July, 28, 2009.

<sup>52</sup> Under the bill, certain products from Paraguay and Uruguay would be eligible to receive duty-free or reduced tariff treatment until December 31, 2012.

<sup>53</sup> U.S. legislators designed the ATPDEA, first passed by Congress in 1991 as the Andean Trade Preferences Act, to discourage illegal drug production and to encourage the production of alternative export crops and products.

## Tri-Border Area and Terrorism

The United States is particularly concerned about illicit activities in the tri-border area (TBA) of Paraguay, Argentina, and Brazil, where money laundering, drug trafficking, arms smuggling, and trade in counterfeit and contraband goods are prevalent. The tri-border region is loosely controlled due to porous borders, a lack of surveillance, weak law enforcement and pervasive local corruption, especially in the Paraguayan border city of Ciudad del Este. The United States has worked closely with the governments of the TBA countries on counterterrorism issues through the “3+1” regional cooperation mechanism, which serves as a forum for discussions, and the United States has provided anti-terrorism and anti-money-laundering support to Paraguay.

U.S. Immigration and Customs Enforcement (ICE) sent a team of specialists to the tri-border region to investigate trade-based money laundering in 2006, and has assisted the Paraguayan government in developing a Trade Transparency Unit to examine discrepancies in trade data in order to detect customs fraud, trade-based money laundering or the financing of terrorism.<sup>54</sup> U.S. Treasury officials have held workshops in the region to encourage more banking sector involvement in efforts against money laundering. The U.S. embassy’s legal adviser in Asunción held training courses for local investigators and prosecutors to combat possible terrorism links.<sup>55</sup>

The United States has been concerned for a number of years that the radical Lebanon-based Hezbollah and the Sunni Muslim Palestinian group Hamas have used the TBA to raise funds from the region’s sizable Muslim communities by participating in illicit activities and soliciting donations. Nevertheless, according to the State Department’s annual terrorism report for 2008 (issued in April 2009), there is no corroborated information that these or other Islamic extremist groups have an operational presence in the TBA.

The State Department’s 2008 terrorism report stated although Paraguay was generally cooperative on counterterrorism efforts, its judicial system is weak and politicized, the police force is widely viewed as ineffective and corrupt, and the country lacks strong anti-money laundering and terrorist financing legislation. In June 2008, Paraguay’s Congress improved money laundering legislation as part of a major overhaul of the penal code. However, according to the terrorism report, a bill to enact important criminal procedure reform to prosecute money laundering and terrorism was delayed for a year by the Congress’s Legal Reform Commission. Effective terrorist financing legislation will be critical to keep Paraguay current with its international obligations.

The terrorism report also maintained that Paraguay did not exercise effective immigration or customs control on its borders. Efforts to address illicit activity in the TBA were uneven because of a lack of resources, and corruption within customs, police, and the judiciary. With U.S. support, the government’s Secretariat for the Prevention of Money Laundering reportedly made progress against money laundering, including December 2008 raids on illegal exchange houses. Under the MCC Threshold Program, the United States provided assistance with the training of judges, prosecutors and police in investigation techniques critical to money laundering and terrorist cases.

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<sup>54</sup> U.S. Department of State, *International Narcotics Control Strategy Reports: Volume II Money Laundering and Financial Crimes*, March 2007.

<sup>55</sup> Monte Reel, “South American Terror Pipeline?: U.S. is Helping to Crack Down on Money Laundering in a Region Where Three Nations Meet”, *Houston Chronicle*, August 6, 2006.

Paraguay made some progress on counterterrorism legislation in 2009. The Paraguayan Congress passed a measure in July 2009 that modifies the anti-money laundering law. The passed bill empowers the Secretariat for the Prevention of Money Laundering (SEPRELAD) in several ways. It elevates the agency to the level of a ministry that reports directly to the President, it broadens its capacity to require Suspicious Transaction Reports from a wider group of financial institutions, and it increases SEPRELAD's power to audit financial institutions to ensure their procedures are adequate to prevent money laundering. In addition, the Executive has initiated legislation that would criminalize the offences of terrorism, terrorist association and terrorist financing. Attempts to gain the approval of Congress on such legislation were made in 2007, November 2009, and December 2009. In December 2009, President Lugo withdrew the counterterrorism legislation that would modify some aspects of the criminal code over objections raised by human rights organizations who argued that the new legislation threatened the international protection of human rights and may undermine freedom of assembly and freedom of speech. Paraguayan authorities, however, remain optimistic that a modified initiative may pass later in 2010.<sup>56</sup>

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<sup>56</sup> Communication from the U.S. Embassy in Paraguay, February 1, 2010.