

**IMMEDIATE
ATTENTION**

SM/11/188

July 15, 2011

To: Members of the Executive Board

From: The Secretary

Subject: **Paraguay—Staff Report for the 2011 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2011 Article IV consultation with Paraguay, which meets the criteria for consideration on a lapse of time basis.

In the absence of a request by an Executive Director by **noon on Wednesday, July 27, 2011**, that this matter be brought to the agenda of the Executive Board, the consultation will be deemed approved on Friday, July 29, 2011, by the Executive Board and the following decision will be recorded in the minutes of the next meeting thereafter:

The Executive Board endorses the thrust of the staff appraisal in the report for the 2011 Article IV Consultation with Paraguay (SM/11/188, 7/15/11).

It is expected that the next Article IV consultation with Paraguay will take place on the standard 12-month cycle.

If an Executive Director requests that the matter be taken up at a Board meeting, the item will be tentatively scheduled for discussion on Friday, July 29, 2011.

At the time of circulation of this paper to the Board, the authorities of Paraguay have indicated that they need more time to consider whether they will consent to the Fund's publication of this paper. Publication will only proceed upon the receipt by the Fund of the member's explicit consent. Any requests for modifications for publication are expected to be received two days before the Board concludes its consideration.

If there is no request for a Board discussion, the Executive Board Assessment section of the Public Information Notice will be based on the staff appraisal.

Questions may be referred to Mr. Abrego (ext. 38754) and Mr. Magud (ext. 38497) in WHD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Monday, July 25, 2011; and to the European Commission, the European Investment Bank, and the Inter-American Development Bank, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (<http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm>) for the issuance date shown above.

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PARAGUAY

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

July 15, 2011

KEY ISSUES

Context. The economy is projected to continue growing above potential in 2011, at a time when overheating pressures have already emerged. Supportive macroeconomic conditions will contribute to inflation of close to 10 percent this year and a widening external current account deficit. While the banking system remains sound, risks are increasing, mainly as a result of very rapid credit growth (40 percent), particularly credit in foreign currency (58 percent). Economic policies need to be geared toward reducing overheating pressures and protecting financial sector stability.

Monetary policy. Given current stimulative monetary conditions, tightening needs to continue. The menu of options should include higher reserves requirements, especially to address the very rapid expansion of credit in foreign currency. Continued exchange rate flexibility would also help reduce inflationary pressures.

Fiscal policy. Fiscal policy is adding stimulus to activity and should become at least neutral. It is important to contain current expenditure growth and save any revenue overperformance. Pressures to further loosen fiscal policy ahead of the 2013 elections also need to be resisted.

Macro-prudential and financial sector policies. Macro-prudential measures would help address financial sector risks while contributing to reducing credit growth. Higher specific provisions and stricter limits on loan-to-income ratios would help deal with very high consumer credit growth and currency mismatches. It is also important to continue moving forward with efforts to strengthen regulation and supervision of cooperatives, and address legal constraints that limit a more effective risk-based supervision for banks.

Monetary policy framework. The recapitalization of the central bank (BCP) is crucial to increase monetary policy's room for maneuver. The recent decision to adopt inflation targeting calls for increased efforts to clarify the BCP's operational framework, including by limiting FX intervention and thus sending a clearer signal that inflation is its main objective.

Approved By
David Vegara and
Dominique Desruelle

Discussions took place in Asuncion during June 1–14. The staff team comprised L. Abrego (head), N. Magud, H. Zavarce, T. Roy, Resident Representative (all WHD), and V. Tulin (MCM). Mr. Maciel (OED) attended the meetings.

CONTENTS

I. BACKGROUND	4
II. MACROECONOMIC OUTLOOK AND RISKS	6
III. POLICY DISCUSSIONS	8
A. Near-term Macroeconomic and Financial Sector Policies	7
B. Monetary Policy Framework and Exchange Rate	10
C. Structural Financial Sector Issues	11
D. Structural Fiscal Issues	12
E. Employment and Poverty	14
IV. STAFF APPRAISAL	15

BOXES

1. Measuring the Fiscal Stance in Paraguay	17
2. Paraguay: Use of Macro-prudential Tools	18
3. Paraguay: Recapitalization of the Central Bank	19
4. Exchange Rate Assessment	20
5. Financial Sector Assessment Program: Main Recommendations	21

FIGURES

1. Real Sector Developments	22
2. Balance of Payments Developments	23
3. Monetary Developments	24
4. Fiscal Developments	25
5. Banking System Indicators in International Perspective	26
A.1 Public Debt Sustainability: Bound Tests	35
A.2 External Debt Sustainability: Bound Tests	37

TABLES

1. Selected Economic Indicators	27
2. Central Government Operations	28
3. Operations of the Consolidated Public Sector	29

4. Summary Accounts of the Central Bank	30
5. Summary Accounts of the Banking System	31
6. Balance of Payments	32
7. Indicators of External Vulnerability	33
8. Financial Soundness Indicators for the Banking Sector 2006-10	34
A.1 Public Sector Debt Sustainability Framework 2003-2016	36
A.2 External Debt Sustainability Framework 2004-2016	38

ANNEX

Draft Public Information Notice	39
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I. BACKGROUND

1. ***Paraguay weathered the global economic crisis well, supported by an appropriate policy response.*** The authorities responded to the crisis through countercyclical fiscal and monetary policies while bolstering financial sector supervision. Output contracted by 3¾ percent in 2009, though this reflected mainly the effects of a severe drought that hit the agricultural sector. The country's relatively low public debt ratio was broadly unchanged, as the fiscal accounts still recorded a small surplus; the external adjustment was smooth, aided by a flexible exchange rate regime; and the financial system remained sound, with adequate capital levels and low non-performing loans.

2. ***Economic growth rebounded strongly in 2010, and the economy has started showing signs of overheating*** (Figure 1). Real GDP grew by 15 percent, driven by a record crop, strong monetary stimulus and credit growth, and a favorable external environment. The non-agricultural sector expanded by 8½ percent, while domestic demand grew by 17 percent. The output gap for the nonagricultural sector is estimated to have closed in mid-2010 and stood at 1¾ percent at end-year. Inflation has picked up from 2 percent in 2009 to 8¾ percent in June 2011, reflecting strong domestic demand growth and rising commodity prices. Core inflation as measured by the authorities (i.e., excluding the most

volatile food items) has experienced a similar increase and stood at 9½ percent in June.

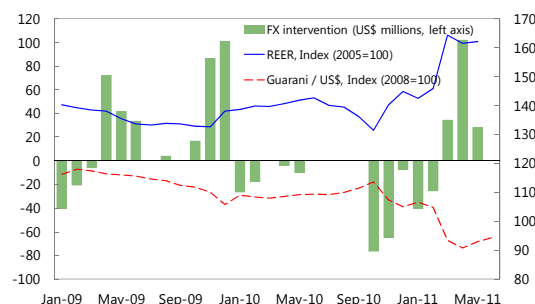
3. ***Despite very favorable terms of trade, the external current account weakened in 2010, driven mainly by rapid domestic demand growth*** (Figure 2). The current account deficit rose to 2¾ percent of GDP (from near balance in 2009), reflecting very rapid import growth and a drop in remittances. However, with strong private capital inflows (notably foreign direct investment, FDI), the Central Bank (BCP) continued accumulating international reserves, which rose to US\$4.2 billion (23 percent of GDP) at end-2010. The real effective exchange rate appreciated slightly during the year, driven by the strengthening of the guarani against the U.S. dollar.

4. ***Against the backdrop of rising inflation and rapid credit growth, the BCP started to tighten monetary policy in mid-2010*** (Figure 3). The central bank has raised policy interest rates by 775 basis points since mid-2010 (375 basis points this year), starting from a level close to zero. Real policy rates, however, have remained in negative territory, and given weaknesses in the monetary transmission channel, deposit and lending rates have increased only modestly in real terms. In this context, credit growth has remained very high (40 percent y/y in May), especially credit in foreign currency (58 percent). The latter reflects its relatively

low cost, abundant dollar liquidity from export proceeds, and strong capital inflows (notably FDI). In an effort to curb credit growth faster, the BCP raised reserve requirements (RR) effective May (by 3 and 4 percentage points for domestic and foreign-currency deposits, respectively), bringing them back to their pre-crisis levels.

5. ***The BCP has allowed the guarani to appreciate substantially in recent months, while intervening in the FX market.*** As of end-May, the guarani had risen by about 10 percent vis-à-vis the U.S. dollar (13 percent in real effective terms) compared to end-2010. The appreciation reflects mainly improved terms of trade, seasonal liquidation of export proceeds and increased private capital inflows, especially FDI. The BCP started to purchase FX (without full sterilization) in March, and stepped up its presence in the market in April, trying to contain appreciation pressures. As the guarani stabilized, the BCP reduced its intervention in May and did not intervene in June.

Exchange Rate and Foreign Exchange Intervention 1/



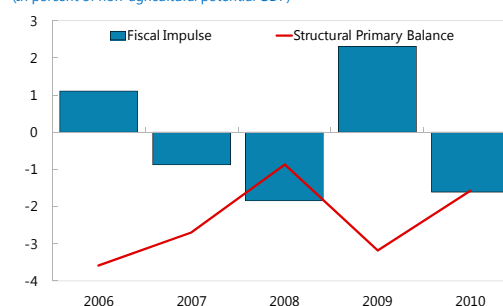
1/ ER decreasing implies appreciation. REER decreasing implies depreciation.

6. ***Fiscal policy remained countercyclical in 2010, while public debt***

continued on a declining path (Figure 4).

Real growth of primary spending fell sharply to around 8 percent, while tax revenue growth accelerated to 19 percent on the back of strong activity and import growth, as well as improvements in administration. In cyclically-adjusted terms, the primary balance (excluding electricity royalties and grants) strengthened by 1½ percent of non-agricultural GDP, implying withdrawal of most of the stimulus provided in 2009 (Box 1). Public debt declined by over 4 percentage points to 19 percent of GDP.

Structural Primary Balance and Fiscal Impulse 1/ (In percent of non-agricultural potential GDP)



1/ Excludes electricity royalties, and grants.

7. ***The banking sector remains generally sound*** (Figure 5). The overall capital adequacy ratio for banks remains above the regulatory level (10 percent), although it is somewhat lower (by about 3 percentage points) when Basel I definitions are used. The nonperforming loan (NLP) ratio is low, but the level of NPLs is growing fast (17 percent y/y in May),¹ and overall provisions are low.

¹ NPLs for guarani operations are higher than for foreign-currency loans (2.3 percent vs. 0.4 percent), and growing faster (21 percent vs. 8 percent, y/y).

Profitability has remained very high. In late 2010, the Bank Superintendency (SBP) approved measures to strengthen financial

system buffers, including higher general provisions and minimum capital, which will become effective in January 2012.

II. MACROECONOMIC OUTLOOK AND RISKS

8. ***Economic growth is projected to decelerate in 2011, but would remain above potential.*** GDP growth is projected at 6¾ percent, reflecting solid agricultural growth, stimulative macroeconomic conditions, and strong confidence. Domestic demand is projected to grow at 9 percent, reflecting continued high credit growth and fiscal stimulus (paragraph 11). With

nonagricultural potential growth estimated at 4–4¼ percent (see Chapter 1 of the Selected Issues Paper), the output gap would average 2¾ percent. Risks to growth in 2011 are slanted to the upside, mainly because agricultural growth could turn out higher. Growth is expected to decelerate over the medium term and return to its potential level in 2013–14.

Paraguay: Medium-Term Outlook

	Paraguay: Medium-Term Outlook								
	Proj.								
	2008	2009	2010	2011	2012	2013	2014	2015	2016
	(Annual percentage change, unless otherwise indicated)								
Production and prices									
Real GDP	5.8	-3.8	15.0	6.7	5.5	4.5	4.0	4.0	4.0
Consumer prices (end of period)	7.5	1.9	7.2	10.3	7.5	6.0	5.0	4.0	4.0
	(In percent of GDP, unless otherwise indicated)								
Public finances									
Central government primary balance	3.1	0.7	1.8	1.1	0.0	0.2	0.5	0.4	0.4
Central government overall balance	2.5	0.6	1.4	0.6	-0.4	-0.2	0.1	0.0	0.0
Central government structural primary balance 1/	-0.9	-3.2	-1.6	-2.8	-3.8	-3.3	-2.9	-2.9	-2.6
General government overall balance	2.9	2.0	1.7	1.2	0.0	0.2	0.4	0.3	0.3
Consolidated public debt	23.2	23.0	19.1	17.8	15.7	14.4	13.3	12.5	11.8
External sector									
Terms of trade (change, in percent)	38.9	-19.1	5.8	4.5	-3.0	-1.9	-1.8	-1.7	-1.4
Current account	-1.9	-0.1	-2.8	-3.8	-4.0	-3.9	-3.5	-3.2	-3.1
Foreign direct investment	1.6	1.4	2.1	3.1	2.5	2.6	2.8	2.9	3.0
Net international reserves	16.9	27.2	22.6	22.1	19.2	18.4	18.5	18.5	18.3

Sources: Central Bank of Paraguay; Ministry of Finance; and Fund staff estimates and projections.

1/ Excludes electricity royalties and grants. In percent of nominal non-agricultural potential GDP.

9. ***Inflation is projected to remain well above the BCP's target range this year, and remain relatively high over the next couple of years.*** While inflation has declined somewhat in recent months, it is projected at close to 10 percent for end-

2011, given a positive output gap, continued high commodity prices, and cost-push factors (e. g., the minimum wage was raised by 10 percent in April). Risks are tilted to the upside in line with those to domestic growth, and as commodity prices could turn out

higher than currently projected. Going forward, and assuming that tighter monetary conditions continue and commodity prices ease, inflation would subside but remain above the BCP's target through 2013.

10. ***The external current account deficit would continue widening in 2011, before easing over the medium term.***

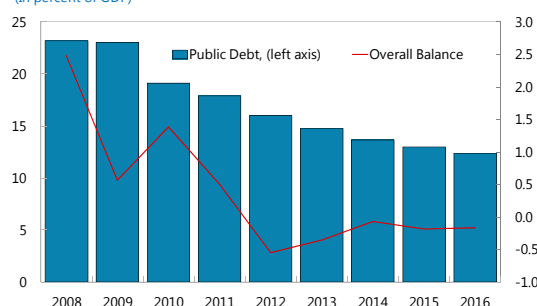
Despite improving terms of trade, the current account deficit is projected to rise to 3¾ percent of GDP this year, led by continued strong import growth, a less favorable services account, and lower remittances. Staff expects the deficit to gradually decline and stabilize at around 3 percent of GDP over the medium term. This is predicated on a significant moderation of import growth, as domestic growth and global commodity price inflation ease, and solid (though lower than in 2010-11) growth of agricultural exports.

11. ***The fiscal stance would turn expansionary in 2011.*** Driven by large increases in current and capital spending, the overall balance is projected to weaken by 1 percent of GDP, to ½ percent of GDP.² This would imply a fiscal impulse of about 1¼ percent of non-agricultural GDP (Box 1). Fiscal balances will likely continue deteriorating in 2012 as pressures to increase spending rise ahead of the 2013 presidential

²This includes additional revenue from Itaipú equivalent to about ½ percent of GDP this year (paragraph 28).

and congressional elections. However, with output growing at around potential and provided that overall deficits remain moderate, public debt would continue to decline and would fall to 15 percent by 2013.

Central Government Balance and Public Debt
(In percent of GDP)



12. ***Risks to the medium-term outlook are as follows:***

- ***Balanced risks to growth and upside risks to inflation.*** Domestic demand growth could decelerate more slowly than envisaged in the baseline, resulting in higher growth. At the same time, global growth could turn out lower than currently projected, hurting domestic growth. The possibility of higher global commodity prices and more stimulative macroeconomic policies than envisaged in the baseline pose upside risks to inflation.
- ***Downside fiscal risks.*** The government lacks a majority in Congress, which has strong powers and tends to favor expansionary fiscal policies. This could complicate government efforts to increase tax revenues and to contain expenditure pressures originating in the Legislature. Spending pressures could rise particularly ahead of the 2013 elections.

III. POLICY DISCUSSIONS

13. **Focus of the consultation.** The 2011 consultation focused on the macroeconomic and financial sector policies needed to reduce the risks of a hard landing from the current high economic and credit growth. The

authorities need to moderate domestic demand pressures and return to a more balanced growth path while protecting financial stability.

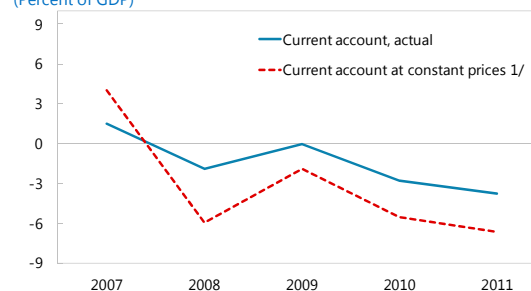
A. Near-term Macroeconomic and Financial Sector Policies

14. **Rapid credit growth and excess demand pressures pose significant risks to macroeconomic and financial stability.**

Economic policies should be geared toward containing domestic demand growth in order to lower inflation faster and moderate the external current account deficit, while preserving financial soundness. Capital inflows are expected to remain strong enough to finance the projected current account deficits. However, the relatively large size of these deficits poses an important risk as an abrupt reversal of private flows or the terms of trade could cause serious macroeconomic disruptions.³ In the financial sector, while bank financial soundness indicators have held up well so far, the authorities would need to preempt a deterioration of bank portfolios (the level of NPLs is growing rapidly at a time of high economic growth) and excessive risk-taking by financial institutions, while strengthening cushions to increase resilience

to a reversal of favorable macroeconomic conditions.

Current Account Balance at Current and Constant 2005 Prices
(Percent of GDP)



1/ Current account assuming terms of trade are unchanged since 2005.

15. **The mission advised to continue tightening monetary policy.** Staff recommended resuming interest rate increases while giving consideration to further raising RR. The mission emphasized the need for higher RR on U.S. dollar deposits to deal with the very rapid growth of credit in this currency. It also called for extending RR to term deposits, which are currently exempt. These measures should be adopted without delay, given the still high pace of overall credit growth and the extremely rapid expansion of loans in foreign currency. While indicating that

³ Staff estimates show that had commodity prices remained at 2005 levels, the current account deficit would have been about 3 percent of GDP higher in 2010 (text figure).

additional monetary tightening might be needed, the authorities were of the opinion that they should wait for new data and the effects of recent measures before resuming monetary tightening. They may also consider the proposal to raise RR on foreign currency deposits. Staff noted that increasing RR on guarani deposits would have a faster impact on liquidity conditions while helping avoid creating excessive incentives for carry trade. At the same time, it would still be necessary to increase the RR differential across currencies, with higher RR on foreign currency, to lower incentives to borrow in foreign currency.

16. *Staff recommended targeting at least a neutral fiscal stance in 2011–12.*

The stance of fiscal policy needs to become at least neutral, but preferably countercyclical, to contain domestic demand pressures and ease the burden on monetary policy. A neutral stance would require tightening by 1¼ percent of non-agriculture GDP in 2011 relative to current projections. To achieve this, the mission recommended saving any revenue over-performance—including from the potential adoption of revenue measures currently in congress and higher Itaipú royalties—while reducing the growth rate of primary expenditures, notably of current outlays, and avoiding supplementary budget appropriations. The authorities agreed with the need for a non-

expansionary fiscal stance but thought that this was extremely difficult to achieve this year in light of existing political constraints, notably the government's lack of a majority in congress. They shared the mission's concern regarding the risk of a continued loose fiscal stance next year. In light of the growth and inflation outlook for 2012, staff stressed the importance of avoiding an expansionary fiscal policy next year.

17. *Staff highlighted the importance of continued exchange rate flexibility to lower inflationary pressures.*

Given Paraguay's highly-open economy and a significant exchange rate pass-through, a strong guarani would help contain inflationary pressures, as evidenced by the behavior of tradable goods inflation in recent months. The mission suggested intervening only if there is a need to correct a markedly overvalued exchange rate or excessive volatility, and to fully sterilize any intervention. It stressed that FX intervention is costly and casts doubts on the BCP's commitment to lowering inflation, while potentially encouraging one-sided bets.

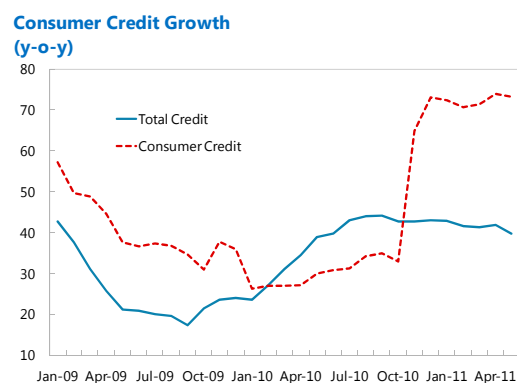
18. *There was agreement that broadening the use of macro-prudential (MaP) measures would help protect financial stability.*

In addition to RR, the toolkit could include tighter limits on loan-to-value and debt-to-income ratios, higher

capital requirements and increased provisions, including through the adoption of dynamic provisioning (Box 2). The authorities noted that this approach underlay the measures approved in late 2010 (paragraph 7) and that they were considering adopting additional similar measures from 2012, including the introduction of dynamic provisioning. Staff stressed the need to adopt MaP measures without further delay this year, and encouraged the authorities to bring forward the implementation of the measures approved in late 2010. Given weaknesses in the monetary transmission channel, these measures would also help to contain credit growth.

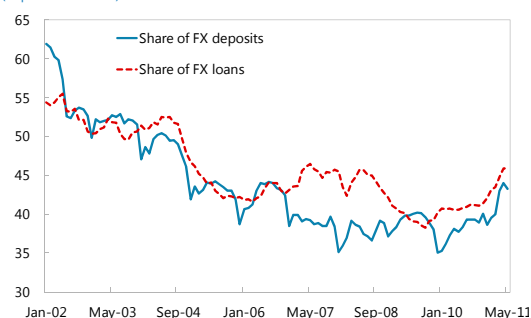
19. ***The mission recommended the introduction of measures targeting consumer credit, and to enhance monitoring of other key credit and asset markets.*** Credit has been growing particularly strongly in the consumer segment (73 percent in May), where the share of NPLs is the highest. Staff noted that the pace of growth in this sector poses a significant risk to financial stability going forward. With strong bank competition and high credit demand, real interest rates for consumer credit have increased significantly less than the average during the current tightening cycle. The mission recommended using stricter debt-to-income ratios and increasing specific

provisions to reduce consumer credit growth faster and bolster financial institutions' buffers. The authorities agreed that these measures were needed and will consider putting them in place. Staff also suggested stepping up monitoring of developments in construction and mortgage lending, as well as in real estate markets, including by improving the compilation of statistics. While hard data is lacking, anecdotal evidence suggests that in some regions real estate prices have been growing very rapidly, both in the residential and commercial segments. Although available information points to an expansion of construction that is mostly self-financed, with limited bank exposure, close monitoring of market developments and bank exposure is warranted.



20. ***Measures are needed to deal with currency mismatches.*** Financial dollarization in Paraguay remains high, with the share of deposits and loans in foreign currency at over 40 percent and growing. Addressing currency mismatches would help

Bank Credit and Deposit Dollarization
(In percent of total)



limit the balance-sheet effects of a sudden reversal of capital flows and an ensuing depreciation. Staff noted that there was some

evidence of currency mismatches in borrower's balance sheets and recommended imposing additional specific provisions for such lending. The authorities agreed with this proposal and indicated they were considering increasing provisions for consumer loans involving currency mismatches, more likely from 2012.

B. Monetary Policy Framework and Exchange Rate

21. ***The mission welcomed the recent announcement to move to an inflation-targeting (IT) regime and encouraged further improvements in the monetary framework.*** The authorities expect the move to an IT regime to take two years and indicated that they are taking the necessary steps to support the transition. Banks' chronic excess reserves are an important factor behind the weak monetary transmission channel and limit the effectiveness of monetary policy (see Chapter 2 of the Selected Issues Paper). Staff supported existing initiatives to address this problem by allowing compliance with RR on an average basis. It also encouraged the BCP and the Finance Ministry to step up efforts to exchange forward-looking information on budget execution and revenues and other sources of liquidity changes. The mission also stressed the need for the BCP to strengthen and clarify its operational framework,

including by (i) limiting (and sterilizing) interventions in the FX market and thus sending a clearer signal that inflation is its main objective; and (ii) focusing its policy actions on a short-term interest rate, leaving the yield curve to be determined by the market. The authorities agreed with these recommendations, and noted that the BCP has started to move away from fixing interest rates for longer maturities, allowing them to become market-determined.

22. ***The recapitalization of the BCP is crucial to improve the effectiveness of monetary policy and enhance further the credibility of the BCP*** (Box 3). The BCP's negative capital position has been an important factor in the slow response of monetary policy to rising inflation during the current cycle, as the central bank incurred in additional losses when rising interest rates. The mission welcomed the authorities' plans to accelerate the implementation of the

recapitalization law approved in April 2010. The recapitalization will also be crucial to support the move to an IT regime. The mission also encouraged the authorities to carry out the recapitalization following sound international practices. These would include, *inter alia*, issuance of tradable bonds at market rates and appropriate maturities, and ensuring that the BCP gets a regular cash flow in the form of interest.

23. ***The exchange rate seems broadly consistent with its equilibrium level*** (Box 4). Paraguay has a relatively flexible exchange

rate regime. While FX intervention has been frequent in recent months, the BCP has allowed the guarani to move within a relatively wide range. Staff estimates suggest that the exchange rate was aligned with its medium-term fundamentals as of end-2010, with a slight (1-2 percent) overvaluation. Given the appreciation of the guarani in the last five months, the extent of currency overvaluation might have increased, although probably not significantly since some fundamentals (e.g., terms of trade and prospects for continued solid agricultural growth) have also strengthened.

C. Structural Financial Sector Issues

24. ***The mission welcomed the development of a program to strengthen regulation and supervision standards for cooperatives, in line with FSAP recommendations*** (Box 5). A program supported by the Inter-American Development Bank (IADB) has been developed and is being implemented to strengthen regulation and supervision for cooperatives, with the aim of eventually converging to the standards applied to banks. The program also includes setting up a financial safety net for the sector. The mission encouraged further work to address shortcomings of the sector's regulator (the INCOOP), notably the lack of sufficient resources and enforcement powers, and a governance structure that generates conflict of interests. Staff noted that while

cooperatives are losing ground to banks, they remain important players in the financial system (accounting for 20–25 percent of deposit and credit) and could still pose significant financial and fiscal risks.

25. ***Bank regulation and supervision have improved significantly in recently years, but there is scope for further progress.*** As noted in the FSSA, several important prudential norms have been strengthened and supervision has become more risk-based. The mission encouraged the authorities to work toward implementing FSAP recommendations to address legal constraints (e.g., the banking law) that have limited updating prudential standards required for more effective risk-based supervision. These include bringing the definition of capital and loan classification

fully in line with international standards, and enhancing the monitoring of large exposures, as well as amending existing banking legislation to focus it on establishing principles while giving the BCP more powers to specify concrete requirements and technical details. The mission also encouraged the authorities to implement other FSAP recommendations, including strengthening the resolution regime for systemic crises and emergency liquidity assistance and bolstering contingent funding for the deposit insurance scheme, given its large coverage.

26. ***Coordination and information sharing among all agencies responsible for financial sector stability and oversight needs to be improved.*** As recommended in the FSSA, the authorities should consider setting up a high-level committee comprising all regulators (including the INCOOP) to regularly discuss financial stability issues and ensure harmonization of prudential standards. This committee should also play a role in guiding the implementation of the IADB-supported program for the cooperative sector.

D. Structural Fiscal Issues

27. ***Higher tax revenues are key to addressing basic shortcoming in infrastructure and expanding social programs.*** The authorities are strongly committed to increasing Paraguay's tax ratio, which (at 13½ percent) is one of the lowest in the region. Staff noted that cyclical considerations impart more urgency to the need to advance on this front. Proposals for the implementation of the personal income tax (which congress has postponed several times since its approval in 2004) and introducing exports taxes on selected agricultural products (sponsored by individual parliamentarians) are currently in congress. The mission supported the goal of raising tax revenues and the government's efforts to implement the personal income tax without further delay while expressing its preference

for a broad-based tax (at a low rate) on agricultural sales, rather than an export tax.

28. ***It is essential to ensure sound management of increased revenues from Itaipú.*** Revenue from electricity sales to Brazil will treble in U.S. dollars, following the recent approval by the Brazilian congress of the 2009 agreement.⁴ The mission supported the authorities' proposal to safeguard the additional revenues by placing them in a special fund, which would finance high-return infrastructure projects and human capital and

⁴ The parameter governing the compensation that Paraguay receives for the sale of excess electricity to Brazil was renegotiated through an agreement signed in July 2009 and ratified by the Brazilian congress in May 2011. As a result, the annual compensation would rise from about US\$120 million to about US\$360 million (1.6 percent of 2011 GDP).

build a countercyclical reserve.⁵ Nonetheless, it recommended that a significant part of these revenues is used to build up the countercyclical reserve.

29. ***The development of a forward-looking framework for public-private partnerships (PPPs) would reduce contingent fiscal liabilities.*** Staff welcomed the authorities' plans to expand the role of PPPs in the provision of infrastructure services, particularly in airports and the transportation network. For the near term, the mission suggested amending and enforcing the concessions and public sector financial administration laws to provide a binding framework for specific legislation. It also recommended developing a more comprehensive PPP legal framework over the medium term. On the institutional side, there is a need to strengthen the role of the Ministry of Finance in assessing and approving PPPs, with a view to achieving value for money and managing fiscal risks.

30. ***There have been advances in developing a medium-term fiscal framework (MTFF), but there is scope for further progress.*** The Ministry of Finance (MoF) has started to prepare a fiscal policy report containing, *inter alia*, three-year macroeconomic and fiscal projections. The first such report was published jointly with the 2011 budget bill last year. The MoF is in the process of creating a macro-fiscal unit, charged with preparing macro-fiscal projections, identifying contingent risks, and preparing reports on the macro-fiscal outlook. There is scope for further improvement to the MTFF, including by integrating it to the budget, identifying and assessing fiscal risks and reporting them in budget documents, and by setting up a medium-term expenditure framework. The mission encouraged the authorities to consider adoption of a fiscal rule targeting the structural primary balance (excluding revenue from electricity royalties and grants). This could serve as an anchor for the MTFF and facilitate its integration to the budget.

⁵ The current proposal allocates the extra revenue as follows: health and education infrastructure and water sanitation, 40 percent; transportation infrastructure, 40 percent; human capital formation, 10 percent; and counter-cyclical stabilization fund, 10 percent.

E. Employment and Poverty

31. **Poverty has declined in recent years but remains high.** Higher economic growth and employment levels have contributed to a significant reduction in the poverty rate, although this is still high (35 percent in 2009). While unemployment seems low (6 percent at end-2010), underemployment affects a large proportion (23 percent) of the working population. Some progress has been made in the last few years in addressing basic social needs, including a considerable expansion of the conditional cash-transfer program (*Tekopora*) and improvements in access to public-health services (e.g., free services for mothers and children). There is scope, however, for further improvements in the

targeting of *Tekopora*. Increasing the low tax ratio and improving the quality of public spending are key to boosting the government's ability and effectiveness to address Paraguay's social needs. Maintaining a stable macroeconomic framework, including low inflation, would also be important to continue reducing poverty.

Paraguay: Growth, Employment and Poverty
(In percent)

	Real per capita GDP growth	Employment 1/	Underemploye nt 2/	Unemployment 2/	Poverty
2002	-2.0	66.8	25.1	10.8	49.7
2003	1.9	69.2	24.1	8.1	44.0
2004	2.8	69.9	24.2	7.3	41.3
2005	1.1	71.4	25.1	5.7	38.6
2006	2.3	71.1	23.5	6.5	43.7
2007	4.7	72.3	26.6	5.5	41.2
2008	3.8	73.4	26.5	5.7	37.9
2009	-5.7	71.7	25.1	6.4	35.1
2010	12.8	71.9	22.9	6.1	...

1/ Percent of working age population (15 to 64 years).

2/ Percent of labor force.

IV. STAFF APPRAISAL

32. **An appropriate policy response helped Paraguay weather the global crisis.** Countercyclical macroeconomic policy cushioned the effects of lower external demand. While GDP still contracted in 2009, this owed mainly to a severe drought and the nonagricultural sector still experience modest growth. Despite significant stimulus, public debt remained broadly unchanged, given the strong initial position of the fiscal accounts, while a flexible exchange rate regime helped a smooth external adjustment. The financial system was unscathed, with adequate capitalization and low NPLs.

33. **The strong rebound of economic growth in 2010 has given rise to overheating pressures.** GDP grew by 15 percent in 2010, reflecting a record harvest, strong credit growth, and favorable external conditions. Driven by excess demand pressures and higher commodity prices, inflation has risen sharply over the last year, while the external current account has deteriorated substantially, despite term-of-trade improvements. Fiscal policy was appropriately countercyclical in 2010, withdrawing most of the stimulus provided in 2009. Monetary policy remained accommodative, however, with real policy

rates well in negative territory and abundant liquidity.

34. ***Macroeconomic policies are currently expansionary.*** Despite a large increase since mid-2010, real policy rates remain negative, while real deposit and lending rates have increased only modestly and credit growth is still very high. Reflecting strong expenditure growth, fiscal policy is being expansionary, with the structural primary balance projected to weaken by 1¼ percent of nonagricultural GDP in 2011. There is also the risk that the fiscal stance remains loose in 2012 as pressures to increase spending rise ahead of the 2013 general elections.

35. ***Policies need to adjust further to ensure a soft landing of the economy.*** Policies should be geared toward moderating domestic demand pressures and returning to a more balanced growth path, in order to reduce inflation, contain the external current account deficit, and preserve financial stability. Monetary policy tightening should continue without delay, with the menu of options including further increases in RR, particularly on foreign currency deposits. The fiscal stance should become at least neutral, but preferably countercyclical. To this end, constraining current expenditures and saving any revenue over-performance, including from the potential approval of revenue measures currently in congress, will be critical. It would also be important to avoid loosening the fiscal

stance in 2012, given a positive output gap and an inflation rate above the BCP's target. Broadening the use of MaP measures would help protect financial stability going forward while contributing to a faster reduction of credit growth.

36. ***The banking system remains sound, but there is a need to guard it against emerging risks.*** Bank financial soundness indicators are generally strong, including very high profitability. However, provisions are low overall and the level of NPLs is growing rapidly. Very high credit growth, particularly in foreign currency, and currency mismatches pose considerable risks that should be dealt with immediately. Macro-prudential measures, such as higher specific provisions and stricter limits on debt-to-income ratios, would help contain such risks and strengthen buffers. Developments in construction and mortgage lending, as well as in real estate markets, warrant close monitoring, including by improving the compilation of statistics. Staff welcomes the existing program to strengthen regulation and supervision and to set up a financial safety net in the cooperative sector. It encourages the authorities to also move forward with changes to legislation required for a more effective risk-based supervision for banks.

37. ***The monetary policy framework should be strengthened further to support the move to an IT regime.*** Many necessary components for this step are already in place,

thanks to long-lasting and continued reforms and institutional strengthening at the BCP. Swift implementation of the recapitalization of the BCP and better liquidity management are also needed to further enhance the credibility of the central bank and increase the effectiveness of monetary policy. It would also be important for the BCP to strengthen and clarify its operational framework, including by limiting (and sterilizing) interventions in the FX market and thus sending a clearer signal that inflation is its main objective.

38. ***Higher tax revenues are needed to address important deficiencies in infrastructure and basic social services.*** Staff supports government efforts to implement the personal income tax without further delay and continue improving tax administration. It will also be essential to ensure sound management of increased revenues from Itaipú energy sales. Staff supports the authorities' proposal to safeguard the additional revenues by placing them in a special fund, and suggests allocating a

significant part of these revenues to build up a countercyclical reserve.

39. ***There is scope to strengthen the fiscal framework.*** Plans to expand the role of PPPs in the provision of infrastructure services are welcome. It would be important to strengthen the legal framework governing concessions and develop a more comprehensive PPP framework, while increasing the MoF's role in assessing and approving PPPs to achieve value for money and manage fiscal risks. There is also room to strengthen the MTFF, including by integrating it to the budget, adopting a systematic reporting and assessment of fiscal risks, and setting up a medium-term expenditure framework. A fiscal rule targeting the structural primary balance (excluding revenue from electricity royalties and grants) could serve as an anchor for the MTFF and facilitate its integration to the budget.

40. It is recommended that the next Article IV consultation takes place on the standard 12-month cycle.

Box 1. Measuring the Fiscal Stance in Paraguay

Different measures can be used to gauge the effects of fiscal policy on domestic demand. The fiscal impulse, defined as the change in a cyclically-adjusted balance, is commonly used to assess the impact of fiscal policy on domestic demand. Several alternative measures of adjusted balances can be used for Paraguay: (i) the structural primary balance (SPB), which adjusts revenues by the output gap;¹ (ii) the SPB excluding electricity royalties and foreign grants; and (iii) the SPB corrected for the cyclical deviations of domestic absorption from its trend. These structural balances can be used as complementary measures of the fiscal stance. An additional indicator is given by comparing growth of real primary spending with potential output growth.

The SPB excluding electricity royalties and grants could provide an appropriate measure of the fiscal stance for Paraguay. It is

better measure than the traditional SPB. In addition to correcting for the output gap, it abstracts from revenues unrelated to domestic economic activity and that may be subject to large fluctuations due to exchange rate movements often unrelated to domestic policies. It is also important to appropriately scale and adjust this balance. In this respect, given the features of agriculture in Paraguay (developments in the sector are driven largely by external and weathered-related factors and the sector's linkages to the rest of the economy are weak), non-agricultural GDP seems a

Table 1: Alternative Measures of Fiscal Policy Stance

	2008	2009	2010	2011	2012
1. Structural primary balance					
(In percent of nominal potential GDP)					
Structural revenues	17.4	19.4	19.3	20.4	20.2
<i>of which</i> royalties & grants	3.8	4.2	3.6	3.9	3.7
Primary expenditure	14.6	17.5	17.7	19.9	21.0
Primary balance	2.8	2.0	1.6	0.5	-0.8
Fiscal impulse	-1.2	0.9	0.4	1.1	1.3
2. Non-royalties non-grants structural primary balance (NRSPB)					
(In percent of nominal non agricultural potential GDP)					
Structural revenues	16.3	17.2	14.0	14.6	14.5
Primary expenditure	17.2	20.4	15.5	17.5	18.3
Primary balance	-0.9	-3.2	-1.6	-2.9	-3.9
Fiscal impulse	-1.8	2.3	-1.6	1.3	1.0
3. NRSPB adjusted for structural absorption					
(in percent of nominal non agricultural potential GDP)					
Structural revenues	16.8	17.9	13.7	14.3	14.1
Primary expenditure	17.2	20.4	15.5	17.5	18.3
Primary balance	-0.4	-2.5	-1.8	-3.2	-4.2
Fiscal impulse	-2.1	2.1	-0.7	1.4	0.9
4. Expenditure Growth					
Real primary spending growth	-2.8	21.7	7.6	16.0	8.7
Long-term real potential GDP growth	4.4	4.4	4.4	4.4	4.4

superior normalization option, and the output gap for the non-agricultural economy is more appropriate to correct for the cycle. Estimates based on this measure show that in 2010 fiscal policy withdrew stimulus by 1½ percentage points of non-agricultural GDP. This measure points to a positive stimulus of 1¼ and 1 percent of non-agricultural GDP for 2011 and 2012, respectively.

The SPB could also be corrected for temporary deviations of domestic absorption from its trend.² This is particularly relevant for the current cycle in Paraguay, given the strong domestic demand growth, including from imports, which provide a significant share of tax revenue. This measure shows similar results to the previous one, except for 2010, where the withdrawal of stimulus is now significantly lower, reflecting the large expansion of imports that took place that year.

¹ $R^S = R * \left(\frac{Y^*}{Y}\right)^\epsilon$, where R^S stands for structural revenues, R for revenues, Y^* for potential GDP, Y for actual GDP, and ϵ for the elasticity of potential GDP with respect to actual GDP.

² The procedure is similar to the footnote 1 above, controlling for the ratio of observed absorption to long-run absorption

$(R^S = R * \left(\frac{Y^*}{a}\right)^\beta$, where a^* stands for long-run absorption and a for observed absorption; β is its elasticity).

Box 2. Paraguay: Use of Macro-prudential Tools

Macro-prudential (MaP) policy instruments have been widely used across emerging markets in recent years. They should be used to address financial stability concerns and can, under certain conditions, complement traditional macroeconomic policies. International experience has shown that periods of high favorable terms of trade and strong capital inflows can mask underlying macroeconomic imbalances and financial sector vulnerabilities. Current account deficits and exchange rate volatility can exacerbate these vulnerabilities if capital inflows suddenly reverse or the terms of trade decline, potentially causing boom-bust cycles.

With credit expanding at 42 percent, substantial capital inflows, and favorable terms of trade, MaP policies could be used in Paraguay to help deal with risks to macroeconomic and financial stability. Combined with further monetary tightening, a less stimulative fiscal stance, and continued exchange rate flexibility, MaP measures could help lower financial stability risks and bolster financial sector cushions. They would also contribute to achieving a faster deceleration of credit growth and reducing overheating pressures. MaP measures could play a particularly important role in complementing monetary policy in Paraguay, given a weak monetary transmission channel, with a slow and limited pass-through from policy rates to market rates. Furthermore, they could contribute to limiting incentives to carry-trade oriented capital inflows that can further complicate macroeconomic management.

Paraguay has made some use of MaP measures in recent times. Measures already in place include reserve requirements (RR) on bank deposit liabilities, with different rates being applied to deposits in local and foreign currencies. In April, these were raised to pre-crisis levels from 15 to 18 percent for domestic-currency deposits and from 21 percent to 25 percent for foreign-currency deposits. The BCP has also set limits on banks' net open foreign exchange positions, which were tightened in August 2010. From January 2012, the central bank is also raising general provisions and minimum capital, as well as tightening the definition of overdue loans.

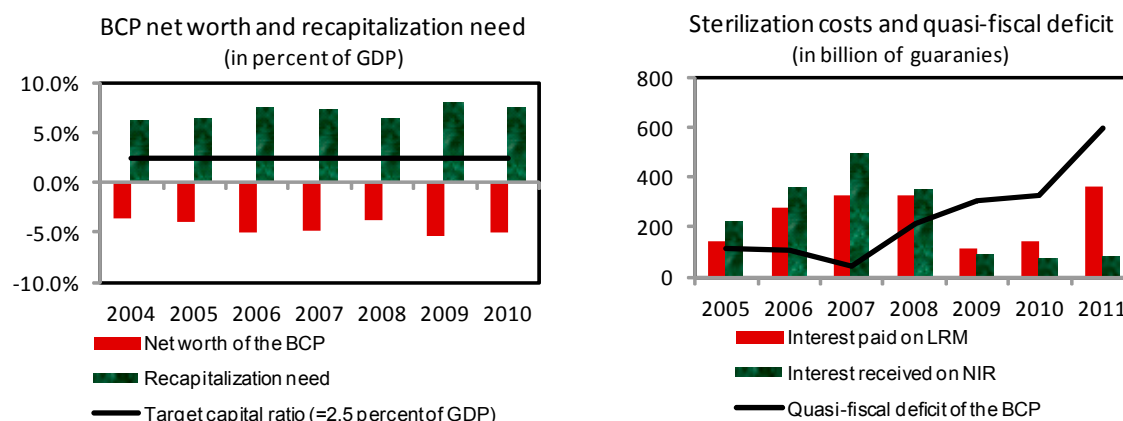
However, there is scope for greater use of MaP instruments. An expanded toolkit could include: (i) tighter loan-to-value and debt service-to-income ratios to make access to credit for durable goods and housing more stringent; (ii) RR on external credit lines to banks; (iii) higher RR on foreign-currency deposits, given the very high growth in credit in US dollars; (iv) higher capital requirements and increased provisions to lower the pace of consumer credit growth and currency mismatches; and (v) introduction of dynamic provisioning. Currently, RR on local currency deposits are applied to sight deposits only, and are broadly in line with regional levels (see chapter 2 of the Selected Issues Paper). Nevertheless, with credit in guaranies still expanding at close to 30 percent, there is a case for raising them further. Unlike other countries in the region, term deposits in local currency are exempt from RR. While they constitute a relatively small share of total deposits (around 30 percent), there is also a case for subjecting them to RR.

Box 3. Paraguay: Recapitalization of the Central Bank

International experience suggests that financially weak central banks suffer from higher inflation rates. Concerns about the impact of interest rate decisions on central bank balance sheets undermine central bank credibility and effectiveness and increase the costs of inflation stabilization in terms of output losses.¹ A credible path toward central bank recapitalization is needed to stabilize inflation expectations and to support the implementation of an effective monetary policy strategy.

The monetary policy operations of the BCP have been severely hampered by its negative capital position. The BCP's negative capital is a legacy of the past, reflecting non-performing claims related to loans to the public and to the financial sector that were largely incurred before the BCP's 1995 charter prohibited such practices. Carrying costs on NIR (the interest differential between BCP sterilization papers and NIR yields) have also contributed to BCP losses, though to a lesser degree. As a consequence, monetary policy steps have at times lagged the underlying economic cycle.

Differences in the speed of economic recovery with respect to advanced economies pose particular challenges for the BCP, as diverging policy rates exacerbate pressures on its balance sheet. In line with regional trends and responding to inflationary pressures, the BCP has appropriately embarked on a monetary tightening cycle, raising policy rates on its sterilization instruments (LRM) from close to zero to between 8.0 and 9.0 percent during the past 12 months. Given that interest rates of reserve currencies remain subdued, the BCP's carrying costs on NIR and non-yielding domestic assets are projected to rise substantially during 2011 and possibly beyond. Resolving the pending balance-sheet issues of the BCP is vital for sustaining monetary policy credibility and increasing its effectiveness.



A BCP recapitalization law was approved in April 2010, and the Ministry of Finance and the BCP are working on its implementation. The law authorizes the Ministry of Finance (MoF) to issue and transfer to the BCP securities in the amount of up to 6.25 percent of 2009 GDP (4,419 billion guaraníes, equivalent to about US\$1 billion). In return, the BCP's non-performing claims against public entities will be extinguished, and any remaining legal claims on guaranties by third parties to the BCP will be conveyed to the MoF. Interest rates and maturities on the bonds to be transferred will be defined between BCP and MoF. Both institutions are currently working on defining the financial conditions of the transfer.

Besides the need for prompt and effective implementation of the law, to guarantee the success of the operation the recapitalization bonds should possess certain properties:

- The securities should be marketable and defined in line with the terms of existing treasury securities that are traded in the market, with a maximum maturity of five years. This is necessary so the BCP can use these securities as collateral for reverse repo operations within the financial system.
- Willingness to roll-over expiring securities should be guaranteed by the BCP. Rollover dates should be set according to discrete time intervals, to avoid bunching of the rollover at one particular date.
- The transfer could be phased in according to a strict and credible time schedule, to facilitate the inclusion of interest payments on the securities in the central government budget.

¹ Klüh, Ulrich, and Peter Stella (2008), "Central Bank Financial Strength and Policy Performance: An Econometric Evaluation," IMF Working Paper 08/176.

Box 4. Exchange Rate Assessment

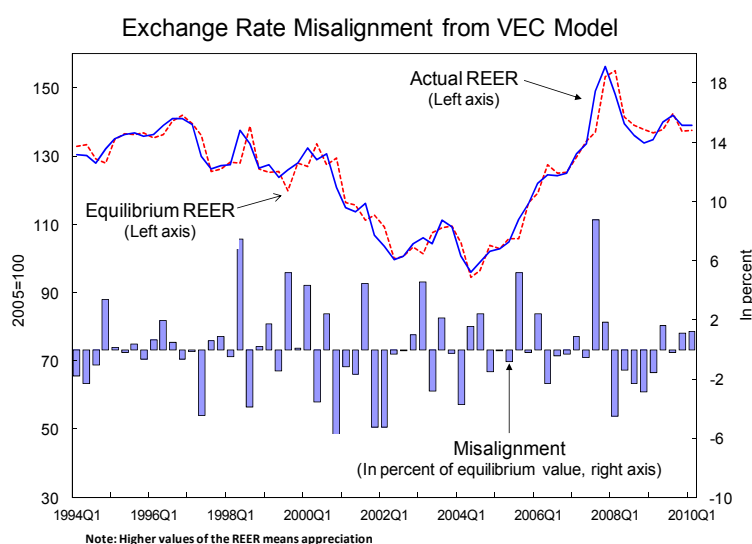
CGER methodologies. As of December 2010, the real effective exchange rate (REER) remained broadly in line with fundamentals according to standard CGER approaches. The average of the three methodologies suggests a slight overvaluation, in contrast with the assessment at the time of the 2010 Article IV consultation, which found a small undervaluation.

REER Deviation from Equilibrium (In percent)		
	2010 Art IV	2011 Art IV
I. Macroeconomic Balance approach	-5.5	-1.8
II. External Sustainability approach	-1.9	3.2
III. Equilibrium Real Exchange Rate approach 1/	2.9	1.4
IV. Vector Error Correction Model approach		1.2
Overall CGER misalignment (average I-III)	-1.5	0.9
Overall REER misalignment (average I-IV)		1.0

Source: IMF staff calculations.

1/ Considers the REER as a historical average 2004-2010.

Country-specific VEC model. Staff also estimated a vector error correction (VEC) model for Paraguay, using quarterly data for 1994Q1–2010Q4. The model specification includes relative productivity growth, trade openness, the terms of trade, net foreign assets (NFA), an interest rate differential, and government consumption. The analysis finds one cointegrating relation between the REER, relative productivity growth and NFA. Results from the model are very similar to those from the CGER's equilibrium exchange rate approach, and suggest a small overvaluation as of end-2010. The model indicates that the rapid increase in the equilibrium real exchange rate that Paraguay experienced during 2004-08 reflected mainly a stronger net international position and positive productivity developments. The subsequent decline in the equilibrium rate in the context of the global crisis seems to be associated with a weakening of the terms of trade and a negative shock to productivity.



Box 5. Financial Sector Assessment Program: Main Recommendations

This Box summarizes the key recommendations of the FSAP Update.¹

Financial Institutions Soundness and Vulnerabilities

- Adopt a capital ratio definition following Basel Accords (Basel I).
- Proceed with the planned introduction of forward-looking provisioning.
- Enhance the regulatory approach to renewed, refinanced and restructured operations.

Monetary Policy and Systemic Liquidity Management

- Proceed with the planned recapitalization of the BCP to ensure its financial and operational independence and strengthen its lender-of-last-resort capacity.
- Enhance the BCP capacity for systemic liquidity management.

Payment and Security Settlement Systems

- Approve the draft payment system law to provide legal support to the new payment system.
- Complete implementation of the new payment system, including real-time gross settlements, a security repository, and automated clearing house.

Financial Sector Oversight

- Amend the legal framework to empower the BCP to issue and develop prudential regulations, and to apply due discretion.
- Review the legal framework to avoid suspension of INCOOP's corrective actions by ongoing judiciary appeal process and strengthen INCOOP's enforcement capacity.
- Align cooperatives' prudential framework with banking sector standards, particularly regarding capital adequacy and provisioning requirements of large cooperatives.
- Strengthen INCOOP's governance by instituting appointment of its Board by the President of the country in accordance with fit and proper qualification criteria.
- Set up a committee of all regulators at the highest level with a clear mandate, technical capacity and deliverables to strengthen the coordination between regulators and enhance financial stability analysis.

Financial Safety Net and Crisis Resolution Framework

- Strengthen the Deposit Guarantee Fund's contingency funding to ensure sufficient capacity to resolve a medium to large scale bank.
- Set up a liquidity assistance facility for cooperatives to ensure effective and timely emergency liquidity assistance.
- Setup a deposit insurance scheme for cooperatives to increase public confidence in the sector.

¹ The FSAP Update mission took place in November 2010, and the FSSA (SM/11/93) was considered by the Board as a stand-alone report and on a LOT basis in May 2011.

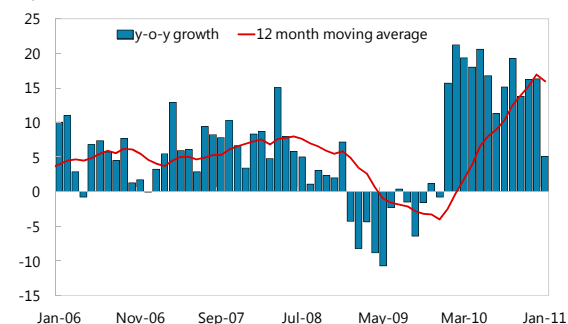
Figure 1 Paraguay: Real Sector Developments

After contracting in 2009, the economy rebounded strongly in 2010, growing at 15 percent. The recovery was driven by a record harvest, an improved external environment, and continued monetary stimulus. Excess demand pressures and rising commodity prices have led to a significant increase in inflation.

The economy recovered swiftly in 2010 after the 2009 recession.

Index of Economic Activity

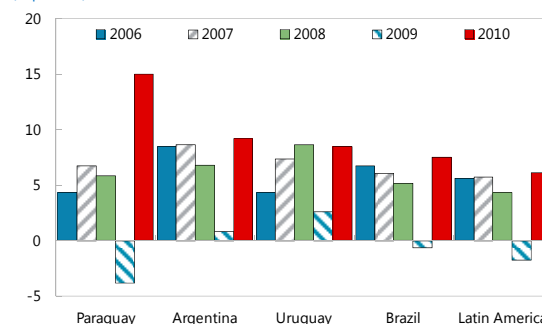
(In percent)



Paraguay's growth rebound was much stronger than that of the rest of the region...

Real GDP Growth

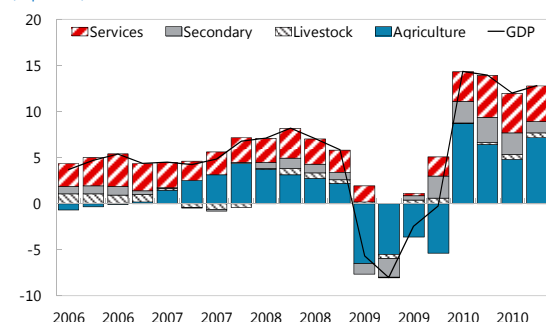
(In percent)



...reflecting a strong expansion of agriculture and services...

Sector Contribution to GDP Growth

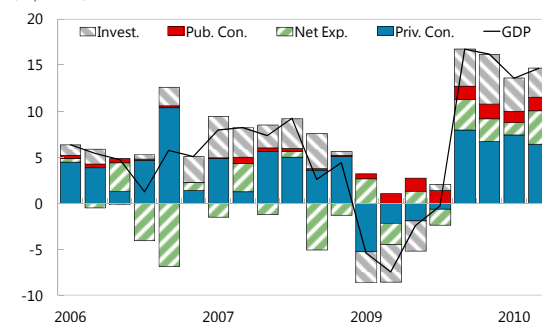
(In percent)



...and very rapid domestic demand growth.

Breakdown of GDP Growth from the Demand Side

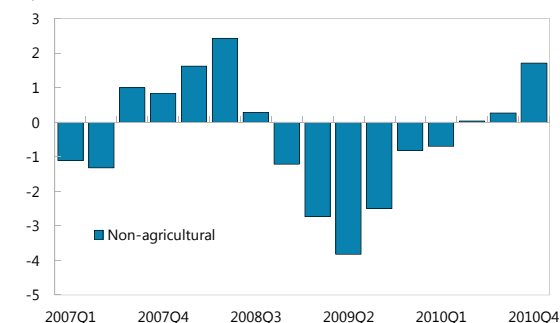
(In percent)



The output gap closed in mid-2010...

Output Gap

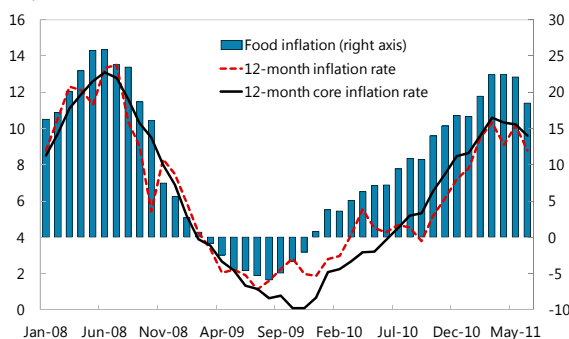
(In percent)



...which, coupled with rapidly rising food prices, has contributed to a substantial increase in inflation

Inflation

(In percent)



Sources: Paraguayan Authorities and Fund staff estimates.

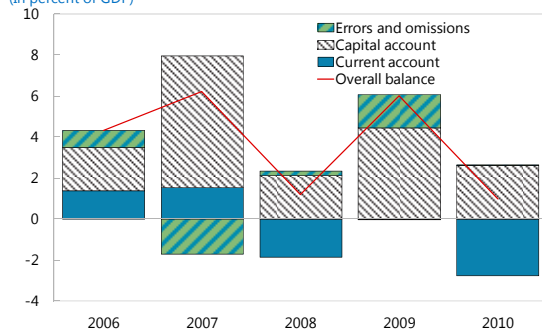
Figure 2 Paraguay: Balance of Payments Developments

Driven by rapid domestic demand growth, imports recovered strongly in 2010, offsetting a large export rebound and leading to a weakening of the current account. However, high private capital inflows allowed the central bank to continue accumulating reserves.

The current account deficit widened in 2010....

Balance of Payments

(In percent of GDP)



Imports grew strongly on the back of robust domestic demand, especially investment.

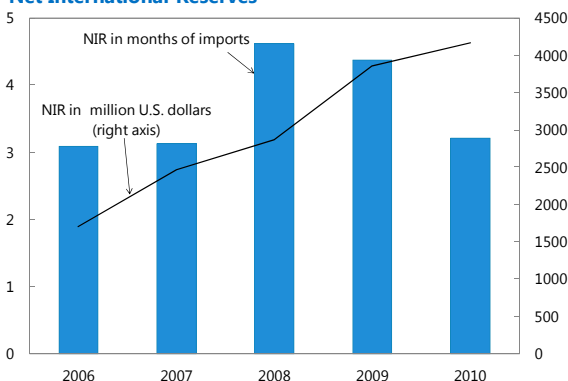
Imports

(y-o-y growth rate)



...allowing further accumulation of reserves, although import coverage still declined.

Net International Reserves

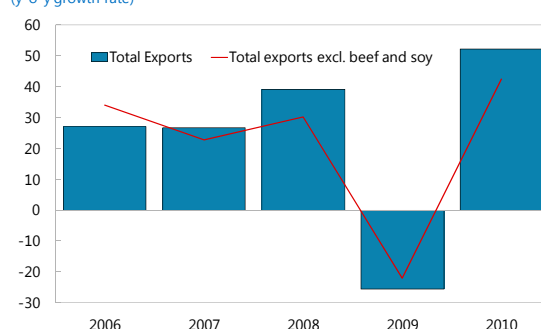


Sources: Paraguayan Authorities and Fund staff estimates.

...despite a strong rebound in exports.

Exports

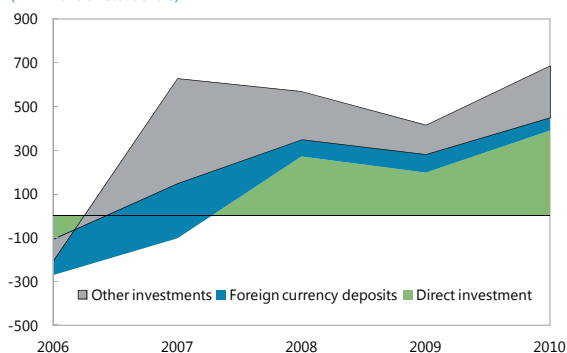
(y-o-y growth rate)



FDI and other private capital inflows experienced a substantial increase....

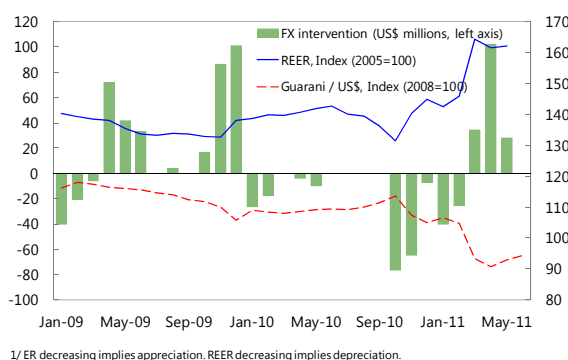
Net Private Capital Inflows

(In millions of U.S. dollars)



The guarani strengthened significantly over the last year.

Exchange Rate and Foreign Exchange Intervention 1/



1/ ER decreasing implies appreciation. REER decreasing implies depreciation.

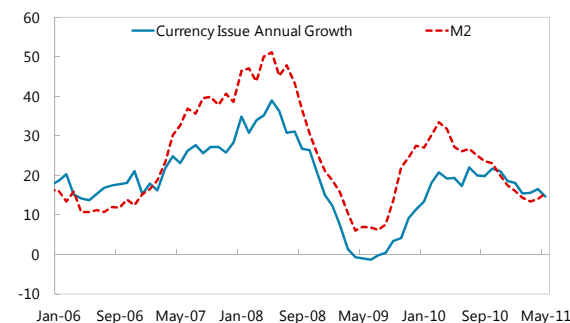
Figure 3 Monetary Developments

The authorities started withdrawing the monetary stimulus provided during the global crisis very slowly, which led to monetary policy turning procyclical in 2010. Credit growth accelerated sharply, contributing to excess demand pressures and a large increase in inflation, which is now well outside the BCP's target range.

Growth of monetary aggregates is moderating but remains relatively high.

Monetary Aggregates

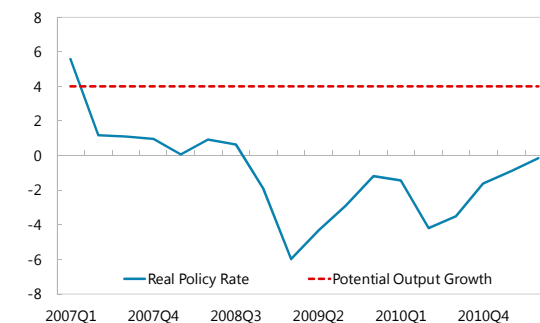
(y-o-y growth)



The policy rate has been raised substantially, but is still negative in real terms.

Real Policy Rate and Output Gap

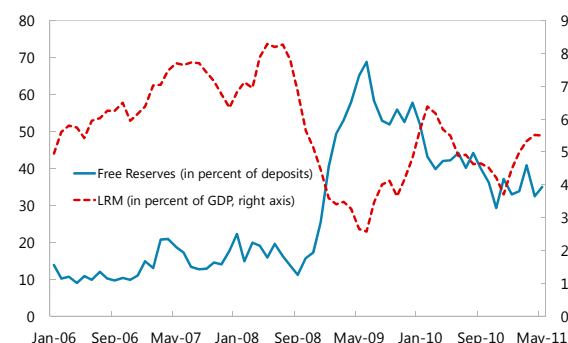
(In percent)



With higher policy rates, the BCP has been able to withdraw liquidity in recent months...

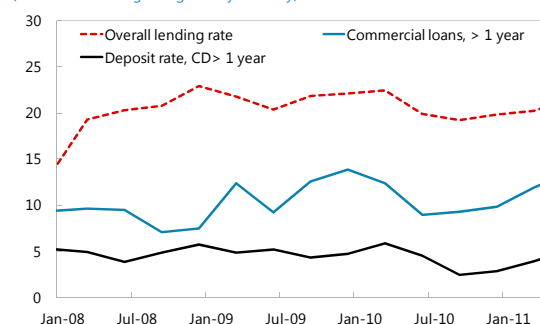
...but market interest rates have risen only modestly...

Central Bank Paper and Free Reserves at the BCP



Local Real Currency Interest Rates

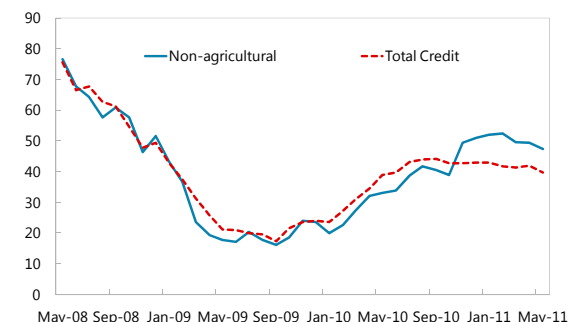
(All rates are average weighted by maturity)



... and credit growth remains very high.

Credit Growth

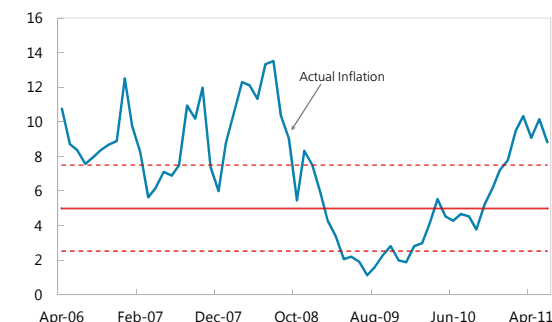
(y-o-y)



In this context, inflation has increased markedly, moving outside the BCP's range.

Inflation

(In percent)



Sources: Paraguayan Authorities and Fund staff estimates.

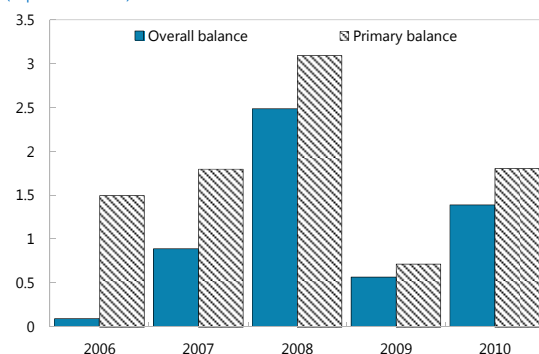
Figure 4 Paraguay: Fiscal Developments

Fiscal policy exhibited a countercyclical tone in 2010. Growth of real primary spending declined sharply, while revenue growth accelerated, driven by a buoyant domestic demand and improvements in tax administration. With the fiscal accounts in surplus, public debt continued its declining trend.

Fiscal balances strengthened substantially in 2010...

Primary and Overall Balance, Central Government

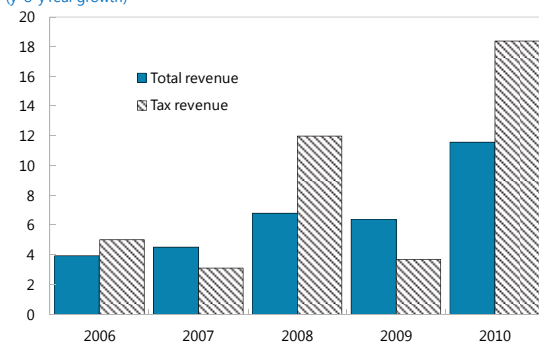
(In percent of GDP)



Revenues increased sharply, especially tax revenue...

Real Revenue Growth

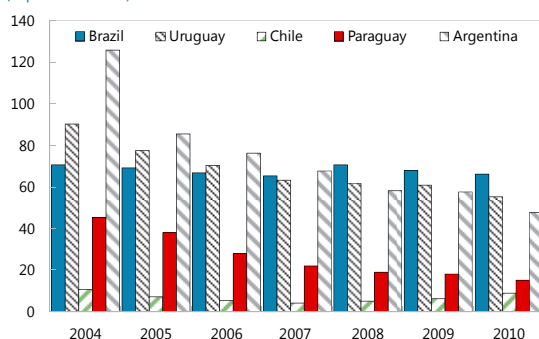
(y-o-y real growth)



Public debt continued to decline in 2010 and remains low by regional standards.

Public Debt

(In percent of GDP)

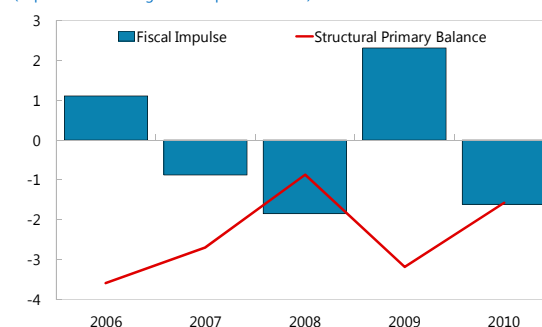


Sources: Paraguayan Authorities and Fund staff estimates.

... resulting in the withdrawal of a large portion of the stimulus provided in 2009.

Structural Primary Balance and Fiscal Impulse 1/

(In percent of non-agricultural potential GDP)

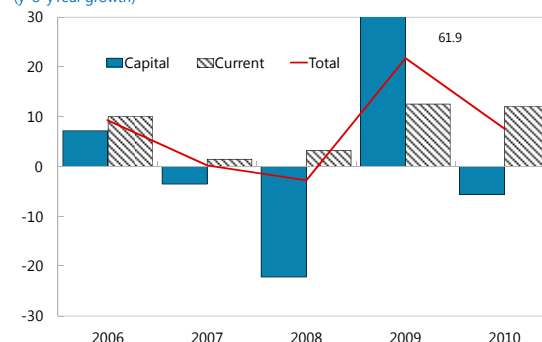


1/ Excludes electricity royalties, and grants.

... while real primary spending decelerated, reflecting lower capital expenditure.

Real Primary Expenditure Growth

(y-o-y real growth)



Public debt in Paraguay is denominated overwhelmingly in foreign currency.

Public Debt Composition

(In percent of total debt)

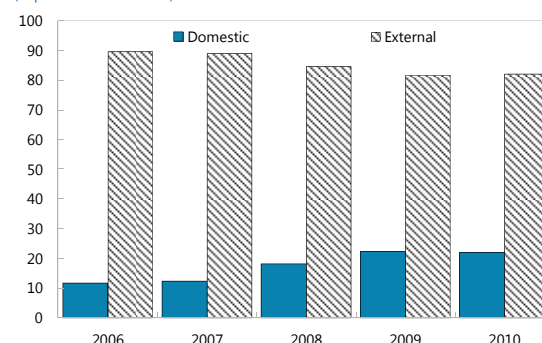
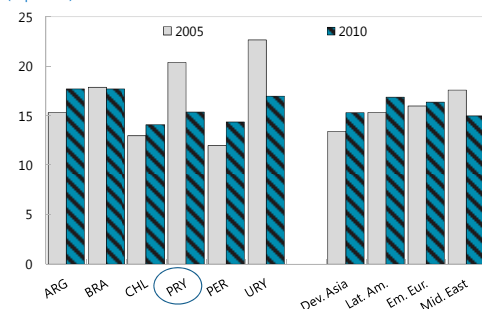


Figure 5 Paraguay: Banking System Indicators in International Perspective 1/

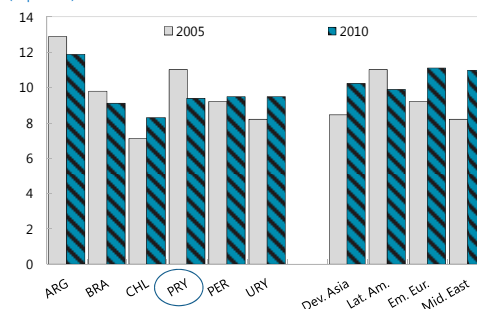
Capital levels are strong overall, and broadly in line with regional levels

Regulatory Capital to Risk-weighted Assets

(In percent)


Bank Capital to Assets

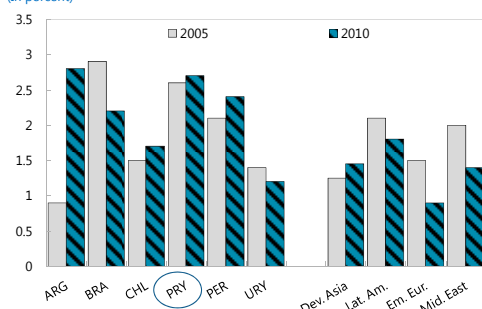
(In percent)



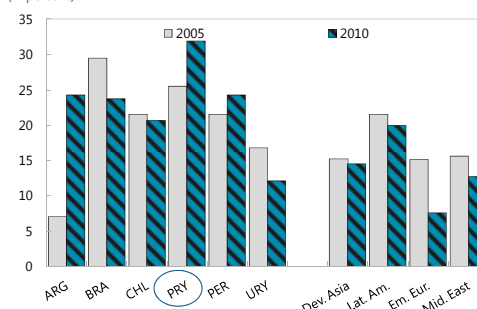
Profits are among the highest in the region

Return on Assets

(In percent)


Return on Equity

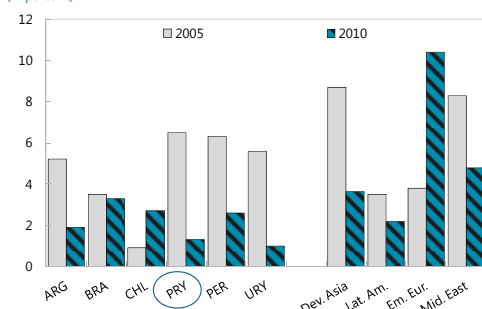
(In percent)



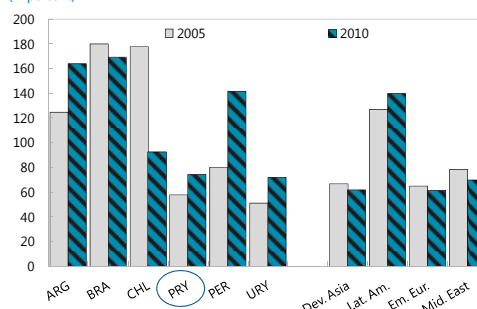
The NPL ratio is low but the NPL level has been growing fast; provisions are among the lowest in region

Nonperforming Loans to Total Loans

(In percent)


Provisions to Nonperforming Loans

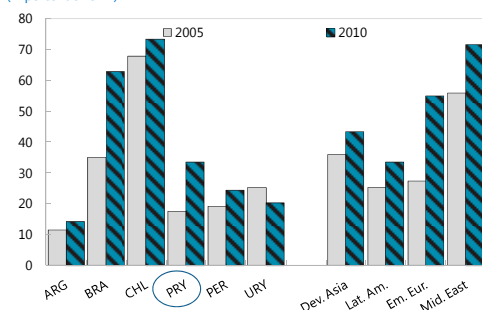
(In percent)



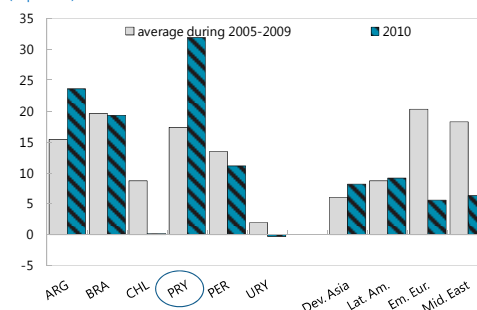
Private sector credit has now reached regional levels and has continued to grow strongly

Claims on Non-financial Private Sector

(In percent of GDP)


Real Credit Growth, to Non-financial Private Sector

(In percent)



Sources: Paraguayan Authorities and Fund staff estimates.

1/ Regional aggregates correspond to median values.

Table 1 Selected Economic Indicators

I. Social and Demographic Indicators						
Population 2010 (millions)	6.5			Gini index (2009/2010)		53.2
Unemployment rate (2010)	6.1			Life expectancy at birth (2010)		72.3
Percentage of population below the poverty line (2009)	35.1			Adult illiteracy rate (2008)		5.4
Rank in UNDP development index (2010)	96 of 169			GDP per capita (US\$, 2010)		2,875.1
II. Economic Indicators						
	2007	2008	2009	2010	2011	2012
	Proj.					
	(Annual percentage change, unless otherwise indicated)					
Income and prices						
Real GDP	6.8	5.8	-3.8	15.0	6.7	5.5
Nominal GDP	17.7	19.7	-4.0	19.5	14.2	12.3
Real per-capita income growth	4.7	3.8	-5.7	12.8	4.6	3.4
Consumer prices (end of period)	5.9	7.5	1.9	7.2	9.8	7.3
Monetary sector						
Currency issue	28.3	15.0	11.3	18.5	13.5	15.0
Credit to private sector	46.2	49.3	24.1	42.9	33.6	27.9
Liabilities to private sector	33.3	30.8	26.7	26.1	24.0	22.1
External sector						
Exports (fob)	27.7	38.8	-25.3	43.2	19.4	4.9
Imports (cif)	22.5	44.0	-22.0	43.1	21.5	6.9
Terms of trade	13.6	38.9	-19.1	6.7	4.5	-3.0
Real effective exchange rate 1/	11.0	16.3	-7.4	2.8	...	...
	(In percent of GDP, unless otherwise indicated)					
Current account	1.5	-1.9	-0.1	-2.8	-3.8	-4.0
Trade balance	-4.4	-6.3	-7.6	-8.4	-9.2	-9.0
Exports	46.0	46.1	40.9	45.3	44.7	39.0
Registered	23.0	26.4	22.3	24.6	25.7	22.4
Unregistered	22.9	19.7	18.7	20.6	19.0	16.6
Imports	50.3	52.4	48.6	53.7	54.0	48.0
o/w Oil Imports	5.9	7.7	6.5	5.8	6.9	6.0
Other (export and import of services, income, current transfers)	5.9	4.4	7.6	5.7	5.0	4.2
o/w Remittances	3.1	2.5	3.7	2.9	2.6	2.3
Capital account and financial account	6.5	3.4	4.5	4.4	7.4	5.0
General Government	-1.1	0.1	1.5	0.7	0.3	-0.1
Private Sector	7.6	3.4	2.9	3.7	7.1	5.1
o/w Direct Investment	1.6	1.6	1.4	2.1	3.1	2.5
Errors and Omissions	-1.7	0.4	1.6	0.0	0.0	0.0
Net international reserves (in millions of U.S. dollars)	2,462	2,864	3,861	4,168	4,968	5,218
(Stock in months of next year imports of goods and services)	3.1	4.6	4.4	3.2	4.5	4.4
(Stock over total external short term debt)	4.4	2.9	3.5	3.4	3.9	4.1
Gross domestic investment	18.0	18.1	15.5	16.9	18.2	19.0
Private sector	13.4	14.3	10.0	12.2	12.7	13.2
Public sector	4.6	3.7	5.5	4.7	5.5	5.8
Gross national saving	19.6	16.2	15.5	14.1	14.4	15.0
Private sector	13.5	9.7	9.6	8.1	8.5	10.0
Public sector	6.1	6.4	5.8	6.0	5.9	5.0
External saving (+) Disavings (-)	1.5	-1.9	-0.1	-2.8	-3.8	-4.0
Central Government revenues	17.6	17.3	19.7	19.2	20.3	20.2
Of which: Tax revenues	11.4	11.8	13.0	13.5	14.2	14.2
Central Government expenditures	16.7	14.8	19.1	17.8	19.8	20.7
Of which: Wages and salaries	7.1	7.1	8.6	8.2	8.3	8.8
Transfers	3.8	3.5	4.2	3.8	4.4	4.5
Capital Expenditure	3.7	2.7	4.6	3.8	4.7	5.0
Central Government primary balance	1.8	3.1	0.7	1.8	1.0	-0.1
Central Government overall balance	0.9	2.5	0.6	1.4	0.5	-0.5
Consolidatd public debt (in percent of GDP)	28.2	23.2	23.0	19.1	18.0	16.1
Of which: external	19.9	16.8	15.3	13.2	10.6	8.9
domestic	1.9	2.2	2.7	2.2	2.2	2.3
LRM3 2/	6.4	4.2	5.0	3.7	5.2	4.9
Memorandum items:						
GDP (in billion of Guaranies)	61,512	73,622	70,705	84,523	96,498	108,389
GDP (US\$ millions)	12,222	16,905	14,216	18,407	22,251	26,763

Sources: Central Bank of Paraguay; Ministry of Finance; and Fund staff estimates and projections.

1/ Average annual change; a positive change indicates an appreciation.

2/ Letras de Regulación Monetaria (Central Bank paper).

Table 2 Paraguay: Central Government Operations

	2007	2008	2009	Prel. 2010	Projections 2011	2012
(In billions of Guaranies)						
Total revenues	10,837	12,748	13,915	16,247	19,636	21,850
Tax revenues	7,019	8,656	9,208	11,406	13,672	15,359
Income taxes	1,229	1,381	2,140	2,096	2,441	2,744
Excises	1,310	1,555	1,398	1,778	2,063	2,427
Value added tax	3,318	4,313	4,128	5,908	7,153	8,195
Import Duties	853	1,055	977	1,526	1,752	1,766
Other	309	351	565	99	263	227
Nontax revenues 1/	3,794	4,064	4,705	4,837	5,959	6,486
Of which: Public pension contributions	752	907	1,014	1,141	1,206	1,368
Itaipu-Yacyreta	2,042	1,872	2,267	1,952	2,411	2,633
Capital revenues	25	28	2	5	5	5
Current expenditures:	7,964	8,963	10,608	11,869	14,625	16,958
Wages and salaries	4,360	5,216	6,079	6,951	8,034	9,542
Goods and services	704	713	1,055	1,285	1,854	2,022
Interest payments	515	449	443	353	461	435
Transfers	2,366	2,557	2,966	3,220	4,205	4,905
Of which: Pensions and benefits	1,264	1,370	1,475	1,503	2,051	2,287
Other	19	28	65	61	70	54
Capital expenditures and net lending	2,280.3	1,954	3,246	3,204	4,521	5,469
Capital formation	1,514	1,237	2,080	2,265	2,990	3,260
Of which: Net lending	-33	-14	50	77	177	141
Capital transfers and other	799	732	1,116	862	1,355	2,068
Statistical discrepancy 2/	-46	1	0	0	0	0
Overall balance	547	1,831	399	1,174	490	-578
Financing	-547	-1,830	-399	-1,417	-490	578
External debt (increase +)	-207	-334	42	247	262	-98
Disbursements	724	495	1,136	1,193	0	652
Amortizations	932	829	1,094	946	1,070	750
Domestic bonds (increase +)	186	23	396	7	607	405
Net credit from the banking system	-832	-1,478	-980	-1,833	0	271
Other	307	-93	142	162	-25	0
(In percent of GDP)						
Total revenues	17.6	17.3	19.7	19.2	20.3	20.2
Tax revenues:	11.4	11.8	13.0	13.5	14.2	14.2
Income taxes	2.0	1.9	3.0	2.5	2.5	2.5
Excises	2.1	2.1	2.0	2.1	2.1	2.2
Value added tax	5.4	5.9	5.8	7.0	7.4	7.6
Import duties	1.4	1.4	1.4	1.8	1.8	1.6
Other	0.5	0.5	0.8	0.1	0.3	0.2
Nontax revenues 1/	6.2	5.5	6.7	5.7	6.2	6.0
Of which: Public pension contributions	1.2	1.2	1.4	1.3	1.2	1.3
Itaipu-Yacyreta	3.3	2.5	3.2	2.3	2.5	2.4
Capital revenues	0.0	0.0	0.0	0.0	0.0	0.0
Current expenditures	12.9	12.2	15.0	14.0	15.2	15.6
Wages and salaries	7.1	7.1	8.6	8.2	8.3	8.8
Goods and services	1.1	1.0	1.5	1.5	1.9	1.9
Interest payments	0.8	0.6	0.6	0.4	0.5	0.4
Transfers	3.8	3.5	4.2	3.8	4.4	4.5
Of which: Public pensions and benefits	2.1	1.9	2.1	1.8	2.1	2.1
Other	0.0	0.0	0.1	0.1	0.1	0.1
Capital expenditures and net lending	3.7	2.7	4.6	3.8	4.7	5.0
Of which: Capital formation	2.5	1.7	2.9	2.7	3.1	3.0
Net lending	-0.1	0.0	0.1	0.1	0.2	0.0
Other	1.3	1.0	1.6	1.0	1.4	0.1
Statistical discrepancy 2/	-0.1	0.1	0.0	0.0	1.8	0.0
Overall balance	0.9	2.5	0.6	1.4	0.5	-0.5
Financing	-0.9	-2.5	-0.6	-1.7	-0.5	0.5
External debt (increase +)	-0.3	-0.5	0.1	0.3	0.3	-0.1
Domestic bonds (increase +)	0.3	0.0	0.6	0.0	0.7	0.7
Net credit from the banking system	-1.4	-2.0	-1.4	-2.2	0.0	0.4
Other	0.5	0.0	0.2	0.1	0.0	0.2
Memorandum Items:						
Primary balance	1.8	3.1	0.7	1.8	1.0	-0.1
GDP (In billions of Guaranies)	61,512	73,622	70,705	84,523	96,498	108,389
Structural primary balance 3/	-2.7	-0.9	-3.2	-1.6	-2.9	-3.9

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes receipts from the binational hydroelectric plants Itaipu and Yacyreta, and grants.

2/ Measurement error to reconcile above-the-line estimate with measure of the fiscal balance from the financing side.

3/ Excludes electricity royalties and grants.

Table 3 Paraguay: Operations of the Consolidated Public Sector 1/

	2007	2008		Prel.	Projections	
			2009	2010	2011	2012
(In billion of Guaranies)						
Revenue	13,508	15,879	16,950	19,646	22,959	25,663
Tax revenue	7,044	8,696	9,245	11,452	13,643	15,401
Nontax revenue and grants	6,432	7,137	7,547	8,137	9,292	10,245
Capital revenue	32	46	158	57	24	17
Current expenditure	10,191	11,522	13,415	14,910	17,715	20,848
Wages and salaries	5,357	6,407	7,455	8,607	9,594	11,453
Goods and services	1,194	1,314	1,896	2,130	2,450	2,896
Interest payments	910	829	585	527	751	851
Transfers	2,692	2,896	3,372	3,542	4,830	5,541
Other	38	75	108	104	90	107
Capital expenditure and net lending	2,832	2,757	3,913	4,233	5,416	6,279
<i>Of which:</i> capital expenditure	3,085	3,059	4,479	4,689	5,857	6,776
Primary balance	2,109	2,848	999	1,718	1,737	42
Public enterprises' operating surplus	715	689	792	689	1,158	656
Statistical discrepancy 2/	-268	-30	0	0	0	0
Overall balance	931	2,460	414	1,192	986	-809
Financing	-931	-2,460	-414	-1,192	-986	809
External financing net	-384	-346	22	39	-58	-898
Disbursements	724	593	22	39	-58	-898
Amortizations	1,109	939	1,114	1,154	1,251	898
Domestic financing net	-547	-2,022	-578	-1,301	8,564	1,707
Bond financing	186	23	396	7	-192	405
Net credit from the banking system	-777	-2,261	-1,281	-1,632	8,651	669
<i>Of which:</i> Net credit from commercial banks	56	-840	-496	222	-751	398
Net credit from Central Bank	-832	-1,421	-784	-1,854	9,402	271
Quasifiscal deficit financing	44	216	306	324	596	633
Other	0	-93	142	70	-9,492	0
(In percent of GDP)						
Revenue	22.0	21.6	23.3	23.2	23.8	23.7
Tax revenue	11.5	11.8	12.7	13.5	14.1	14.2
Nontax revenue and grants	10.5	9.7	10.4	9.6	9.6	9.5
Capital revenue	0.1	0.1	0.2	0.1	0.0	0.0
Current expenditure	16.6	15.6	18.5	17.6	18.4	19.2
Wages and salaries	8.7	8.7	10.3	10.2	9.9	10.6
Goods and services	1.9	1.8	2.6	2.5	2.5	2.7
Interest payments	1.5	1.1	0.8	0.6	0.8	0.8
Transfers	4.4	3.9	4.6	4.2	5.0	5.1
Other	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure and net lending	4.6	3.7	5.4	5.0	5.6	5.8
<i>Of which:</i> Capital expenditure	4.6	3.7	5.4	5.0	5.6	5.8
Public enterprises' operating surplus	1.2	0.6	1.1	0.8	0.7	0.6
Statistical discrepancy 2/	-0.4	0.0	0.0	0.0	0.0	0.0
Overall balance	1.5	2.7	0.6	1.3	0.4	-0.7
Financing	-1.5	-2.7	-0.6	-1.3	-0.4	0.7
External financing net	-0.6	-0.6	0.0	0.0	0.1	-0.2
Disbursements	1.2	0.8	1.6	1.4	1.4	0.6
Amortizations	1.8	1.3	0.0	1.4	1.3	0.8
Domestic financing net	-0.9	-2.2	-0.8	-1.4	-0.5	1.0
<i>Of which:</i> Quasifiscal deficit financing	0.1	0.3	0.4	0.4	0.6	0.6
Other	0.0	-0.1	0.2	0.0	0.0	0.0
Memorandum Item:						
Primary balance	3.0	3.8	1.4	2.0	1.3	0.0

Sources: Ministry of Finance and Fund staff estimates.

1/ Public sector comprises only the nonfinancial public sector and the Central Bank.

2/ Measurement error to reconcile above the line estimate with estimates of the fiscal balance from the financing side.

Table 4 Paraguay: Summary Accounts of the Central Bank

(In billions of Guaranies; end-of-period; valued at constant exchange rate)

	2007	2008	2009	Prel. 2010	Proj. 2011
Currency issue	4,326	4,974	5,538	6,564	7,450
Growth	28.3	15.0	11.3	18.5	13.5
Net international reserves	12,309	14,322	19,304	20,841	24,841
(In millions of U.S. dollars)	2,462	2,864	3,861	4,168	4,968
Net domestic assets	-7,983	-9,348	-13,766	-14,278	-17,391
Net nonfinancial public sector	91	-1,104	-1,794	-3,326	-4,684
Net credit to the central government	-260	-1,513	-2,154	-3,721	-5,080
Net credit to the rest of NFPS	351	408	360	396	396
Net credit to the banking system	-7,421	-7,540	-10,401	-9,724	-11,230
Reserve requirements	-3,051	-3,338	-4,175	-4,854	-5,686
Free reserves	-1,019	-1,460	-3,308	-2,131	-1,431
Monetary control bills (LRM) 1/	-3,352	-2,742	-2,918	-2,740	-4,113
Other	2	0	0	0	0
Other assets and liabilities (net)	-653	-703	-1,571	-1,228	-1,477
Capital and reserves	163	-40	355	680	1,276
Other assets net 2/	-815	-663	-1,926	-1,908	-2,753
Memorandum Items:					
Total stock of LRMs outstanding 1/	3,907	3,282	3,412	3,137	4,897
Quasifiscal balance 3/	-44	-216	-306	-324	-596
In percent of GDP	-0.1	-0.3	-0.4	-0.4	-0.6
Costs of monetary policy operations	386	375	140	308	391
In percent of GDP	0.6	0.5	0.2	0.4	0.4

Sources: Central Bank of Paraguay; and Fund staff estimates.

1/ A fraction of LRM is held by non-bank institutions.

2/ Includes LRM held by the nonbanking sector.

3/ Cumulative since beginning of year.

Table 5 Paraguay: Summary Accounts of the Banking System

(In billions of Guaranies; end-of-period; valued at constant exchange rate)

	2007	2008	2009	Prel. 2010	Proj. 2011
I. Central Bank					
Net international reserves	12,309	14,322	19,304	20,841	24,841
(In millions of U.S. dollars)	2,462	2,864	3,861	4,168	4,968
Net domestic assets	-7,983	-9,348	-13,766	-14,278	-17,391
Credit to public sector, net	91	-1,104	-1,794	-3,326	-4,684
Credit to banking system, net 1/	-4,069	-4,798	-7,483	-6,985	-7,117
Central bank securities	-3,907	-3,282	-3,412	-3,137	-4,897
Other	-98	-163	-1,077	-831	-693
Currency issue	4,326	4,974	5,538	6,564	7,450
II. Monetary Survey 2/					
Net foreign assets	13,240	15,861	20,844	21,829	26,062
(In millions of U.S. dollars)	2,648	3,172	4,169	4,366	5,212
Net domestic assets	4,485	6,186	6,286	11,855	15,488
Credit to the public sector	-1,675	-3,265	-5,143	-6,732	-7,950
Credit to the private sector	10,223	15,264	18,941	27,073	36,167
Other	-4,063	-5,813	-7,511	-8,486	-12,729
Broad Liquidity (M4)	17,725	22,047	27,130	33,684	41,550
Bonds and issued securities	0	110	174	362	399
Other monetary liabilities	82	55	121	159	207
Central bank securities with private sector	555	540	494	397	784
Broad liquidity (M3)	17,088	21,343	26,341	32,764	40,161
Foreign currency deposits	6,000	7,929	9,237	12,675	17,111
Money and quasi-money (M2)	11,088	13,413	17,104	20,090	23,050
Quasi-money	2,339	3,884	4,961	6,113	7,022
Money (M1)	8,749	9,529	12,144	13,976	16,028
(Annual percentage change)					
M0 (Currency issued)	28.3	15.0	11.3	18.5	13.5
Credit to the private sector	46.3	49.3	24.1	42.9	33.6
M1	38.2	8.9	27.4	15.1	14.7
M2	38.6	21.0	27.5	17.5	14.7
M3	31.4	24.9	23.4	24.4	22.6
Of which: Foreign currency deposits	20.0	32.1	16.5	37.2	35.0
Memorandum items:					
Ratio of foreign currency deposits to M3 (percent)	35.1	37.2	35.1	38.7	42.6
Ratio of foreign currency deposits to private sector deposits in banks (percent)	44.8	45.3	41.6	45.3	49.3

Sources: Central Bank of Paraguay; and Fund staff estimates.

1/ Exclude LRM held by the banking sector.

2/ In January 2008, a financiera representing about 5 percent of total banking asset was converted into a bank and thus added to the monetary survey.

Table 6 Paraguay: Balance of Payments

(In millions of U.S. dollars)

	2007	2008	2009	Prel. 2010	Projections 2011	2012
Current account	185	-318	-7	-510	-849	-1,083
Trade balance	-532	-1,063	-1,085	-1,551	-2,057	-2,399
Exports	5,616	7,793	5,819	8,330	9,947	10,439
Registered	2,817	4,463	3,167	4,534	5,722	5,993
Unregistered	2,799	3,330	2,652	3,796	4,225	4,446
Imports	-6,149	-8,856	-6,904	-9,881	-12,004	-12,838
Registered	-5,630	-8,506	-6,497	-9,400	-11,473	-12,269
Of which: Fuel products	-722	-1,308	-920	-1,073	-1,540	-1,608
Unregistered	-518	-350	-407	-481	-531	-569
Services (net)	499	558	868	868	1,001	1,153
Transport	-141	-169	-152	-220	-250	-272
Travel	-7	-12	76	65	88	126
Other	646	740	944	1,023	1,163	1,299
Factor income	-155	-227	-309	-369	-379	-443
Transfers	373	414	519	542	586	606
Capital and financial account	789	578	633	814	1,649	1,333
General government	-140	9	218	128	60	-24
Disbursements	153	142	231	260	307	161
Amortization	-184	-185	-220	-206	-247	-185
Other	-109	53	207	74	0	0
Private Sector 1/	929	568	415	686	1,589	1,357
Direct investment	199	272	198	390	700	680
Foreign currency deposits	251	77	84	60	-217	-187
Other	479	220	134	237	1,106	864
Errors and Omissions	-212	61	229	4	0	0
Overall Balance	762	321	855	308	800	250
Net International Reserves (increase -)	-759	-402	-996	-308	-800	-250
Exceptional Financing	-2	81	142	0	0	0
Arrears deferral (+)/clearance (-)	-2	81	142	0	0	0
Memorandum items:						
Current account in percent of GDP	1.5	-1.9	-0.1	-2.8	-3.8	-4.0
Gross reserves (in millions of U.S. dollars)	2,462	2,864	3,861	4,168	4,968	5,218
In months of imports of GNFS	3.1	4.6	4.4	3.2	4.5	4.4
External public debt in percent of GDP 2/	19.9	19.3	17.6	15.1	12.1	10.2
Debt service in percent of exports GNFS	5.2	2.9	5.0	3.3	2.9	2.6
Export Volume (percentage change)	5.9	-15.7	-12.1	26.0	6.8	5.9
Import Volume (percentage change)	15.4	21.5	-15.8	34.4	7.1	6.6
Terms of trade (percentage change)	13.6	38.9	-19.1	6.7	4.5	-3.0

Sources: Central Bank of Paraguay; and Fund staff estimates.

1/ Includes public enterprises and binationals.

2/ Based on average exchange rate valuation of GDP.

Table 7 Paraguay: Indicators of External Vulnerability

(In percent of GDP, unless otherwise indicated)

	2006	2007	2008	2009	2010
Monetary and financial indicators					
Broad money (M3), percentage change 1/	14.8	31.5	24.9	23.4	24.4
Credit to the private sector, real (percentage change) 1/	3.5	38.2	38.9	21.8	33.4
Share of nonperforming loans in total loans (percent) 2/	3.3	1.3	1.1	1.6	1.3
Average domestic lending rate, real	15.4	20.8	19.7	25.7	25.9
Central Bank bill yield, real	0.8	-2.3	-5.0	0.3	0.2
International reserves (millions of U.S. dollars)	1,703	2,462	2,864	3,861	4,168
Central bank foreign short-term liabilities (millions of U.S. dollars)	0.0	0.3	0.0	1.2	0.0
External indicators					
Merchandise exports (percentage change)	31.3	27.7	38.8	-25.3	43.2
Merchandise imports (percentage change)	31.7	22.5	44.0	-22.0	43.1
Merchandise terms of trade (percentage change)	-15.0	13.6	38.9	-19.1	6.7
Real effective exchange rate (percentage change)	13.6	11.0	16.3	-7.4	2.8
Current account balance (percent of GDP)	1.4	1.5	-1.9	-0.1	-2.8
Capital and financial account (percent of GDP)	2.1	6.5	3.4	4.5	4.4
Net foreign direct investment (percent of GDP)	1.8	1.6	1.6	1.4	2.1
Other net investment (percent of GDP)	0.0	4.6	1.6	2.7	2.1
External public debt (percent of GDP) 2/	25.4	19.9	19.3	17.6	15.1
Debt service (in percent of exports GNFS)	5.8	5.2	2.9	5.0	3.3
Gross reserves (in U.S. dollars)	1,703	2,462	2,864	3,861	4,168
In months of imports of GNFS	3.1	3.1	4.6	4.4	3.2
Over short-term external debt 3/	2.7	4.4	2.9	3.5	3.4
Over foreign currency deposits in domestic banks	1.5	1.9	2.1	2.7	2.3

Sources: Central Bank of Paraguay; and Fund staff estimates.

1/ Foreign currency components are valued at the accounting exchange rate.

2/ Based on end-of-period exchange rate conversion of U.S. dollar-denominated debt.

3/ Private and public external debt with a residual maturity of one year or less. Excludes foreign currency deposits in banking system.

Table 8 Paraguay: Financial Soundness Indicators for the Banking Sector 2006–10

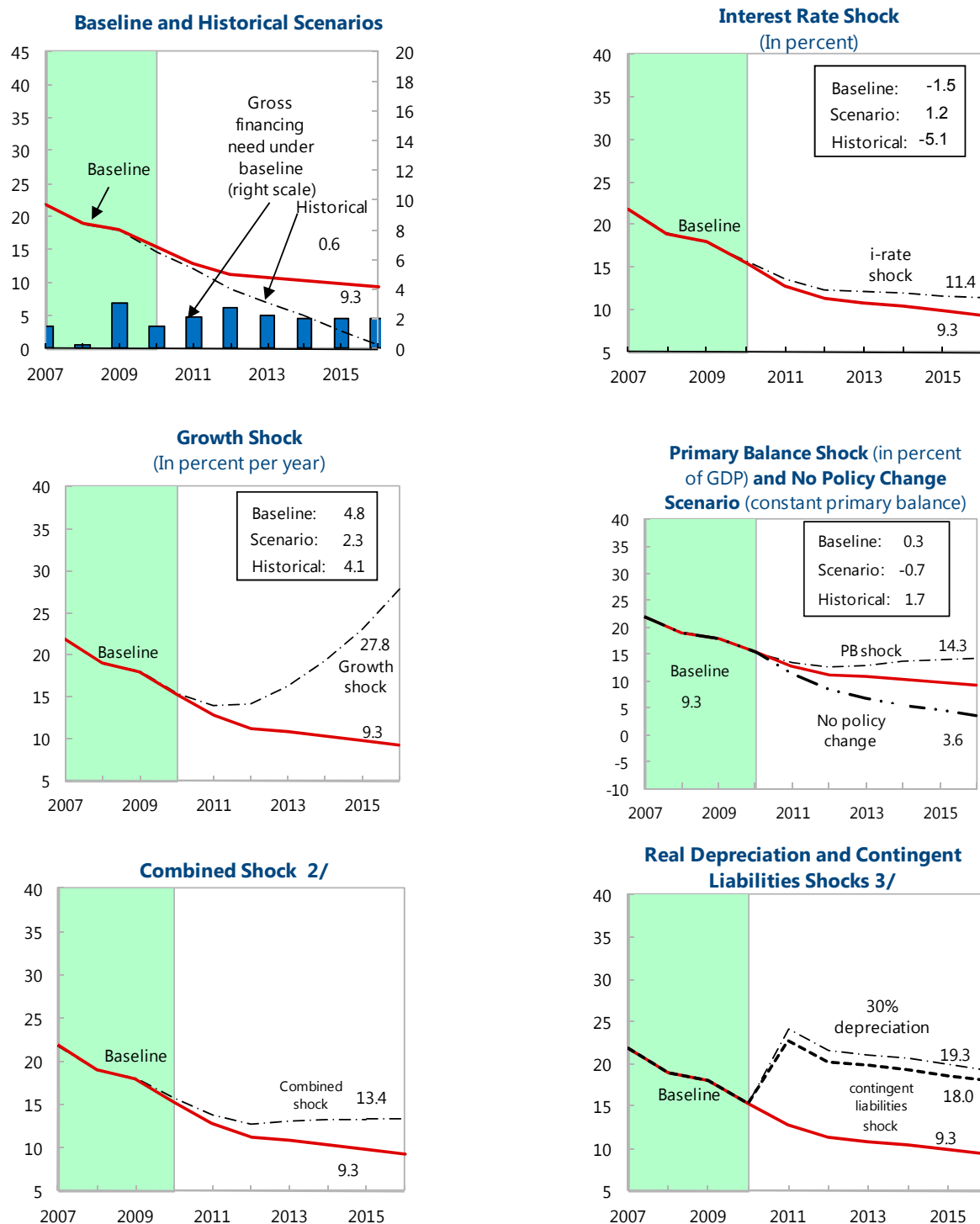
(In percent, unless otherwise indicated)

	2006	2007	2008	2009	2010	May-11
Capital Adequacy						
Regulatory capital to risk-weighted assets	20.1	16.9	16.3	16.3	15.4	18.3
Regulatory Tier 1 capital to risk-weighted assets	14.1	11.6	10.7	11.1	9.1	9.6
Asset Quality						
Nonperforming loans to gross loans	3.3	1.3	1.1	1.6	1.3	1.5
Provisions to nonperforming loans	59.1	78.4	77.7	78.8	74.4	71.9
Earnings and Profitability						
Return on assets (after tax)	3.0	2.8	3.2	2.4	2.4	2.7
Return on equity (after tax)	24.1	25.7	28.4	23.2	22.3	25.9
Liquidity						
Liquid assets to total assets	43.8	44.3	37.0	41.2	33.5	36.5
Liquid assets to short-term liabilities	73.0	73.8	70.4	74.0	64.6	72.5
Customer deposits to total (noninterbank) loans	183.5	173.2	150.8	160.3	131.0	133.1
Sensitivity to Market Risk						
Net FX exposure / capital	19.9	33.3	12.7	-1.2	4.7	11.2
Industry distribution of loans to total loans ^{1/}						
Agriculture and livestock	...	36.6	35.7	35.9	32.4	31.8
Industry	...	12.0	11.2	9.3	9.7	9.9
Trade	...	17.4	19.3	19.6	21.1	20.4
Services	...	11.6	10.8	11.5	13.0	12.1
Consumer credit	...	8.4	9.4	10.4	13.1	13.9
Financial sector	...	14.0	13.5	13.1	10.6	11.7
Other indicators						
Foreign banks assets in total banking assets	69.5	67.7	64.8	50.4	50.4	50.3
Foreign-currency-denominated loans to total loans	43.8	44.6	42.9	38.5	40.6	41.9
Foreign-currency-denominated deposits to total deposits	48.3	43.0	44.4	40.3	42.2	42.7

Sources: Central Bank of Paraguay and IMF staff calculations.

^{1/} Based on credit registry data.

Figure A.1 Paraguay: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2011, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A.1 Paraguay: Public Sector Debt Sustainability Framework 2003-2016

(In percent of GDP, unless otherwise indicated)

	2007	Actual			Projections					
		2008	2009	2010	2011	2012	2013	2014	2015	2016
Baseline: Public sector debt 1/	21.8	19.0	18.0	15.4	12.8	11.3	10.8	10.4	9.8	9.3
o/w foreign-currency denominated	21.6	19.0	18.0	15.4	12.8	11.2	10.8	10.4	9.8	9.3
Change in public sector debt	-5.9	-2.8	-1.0	-2.6	-2.6	-1.6	-0.4	-0.4	-0.6	-0.5
Identified debt-creating flows (4+7+12)	-7.2	-5.6	-0.6	-3.5	-2.4	-0.7	-0.6	-0.7	-0.4	-0.4
Primary deficit	-2.6	-3.0	-0.9	-1.1	-1.0	0.2	0.0	-0.2	0.0	0.0
Revenue and grants	32.0	30.7	32.9	31.1	33.5	32.2	32.0	32.3	32.2	32.2
Primary (noninterest) expenditure	29.5	27.7	31.9	30.1	32.5	32.4	32.1	32.1	32.2	32.2
Automatic debt dynamics 2/	-4.7	-2.6	0.3	-2.5	-1.4	-1.0	-0.6	-0.5	-0.5	-0.4
Contribution from interest rate/growth differential 3/	-3.2	-2.9	1.7	-2.5	-1.4	-1.0	-0.6	-0.5	-0.5	-0.4
Of which contribution from real interest rate	-1.6	-1.8	0.9	-0.2	-0.5	-0.3	-0.2	-0.1	-0.1	0.0
Of which contribution from real GDP growth	-1.6	-1.1	0.8	-2.3	-0.9	-0.6	-0.5	-0.4	-0.4	-0.4
Contribution from exchange rate depreciation 4/	-1.5	...	...	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3) 5/	1.4	2.8	-0.4	0.9	-0.2	-0.8	0.2	0.3	-0.1	-0.2
Public sector debt-to-revenue ratio 1/	68.2	61.8	54.7	49.4	38.3	35.0	33.8	32.2	30.5	28.9
Gross financing need 6/	1.5	0.2	3.1	1.5	2.1	2.7	2.3	2.0	2.1	2.0
in billions of U.S. dollars	0.2	0.0	0.4	0.3	0.5	0.7	0.7	0.6	0.7	0.7
Scenario with key variables at their historical averages 7/					12.2	9.0	6.9	5.0	2.7	0.6
Scenario with no policy change (constant primary balance) in 2008-2013					11.4	8.4	6.7	5.6	4.6	3.6
Key Macroeconomic and Fiscal Assumptions Underlying Baseline										
Real GDP growth (in percent)	6.8	5.8	-3.8	15.0	6.7	5.5	4.5	4.0	4.0	4.0
Average nominal interest rate on public debt (in percent) 8/	4.1	3.8	4.5	3.2	3.9	4.0	4.5	4.5	4.4	4.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-6.1	-9.3	4.6	-0.7	-3.1	-2.5	-1.3	-1.1	-0.6	-0.3
Nominal appreciation (increase in US dollar value of local currency, in percent)	6.5	-1.4	7.3	0.8	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	10.2	13.1	-0.1	3.9	7.0	6.5	5.8	5.6	5.0	4.9
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.6	-0.5	10.8	8.3	15.3	5.3	3.3	4.2	4.4	4.1
Primary deficit	-2.6	-3.0	-0.9	-1.1	-1.0	0.2	0.0	-0.2	0.0	0.0

1/ Nonfinancial public sector gross debt.

2/ Derived as $[(r - p(1+g) - g + ae(1+r))/(1+g+p+gp)]$ times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $ae(1+r)$.

5/ For projections, this line includes exchange rate changes.

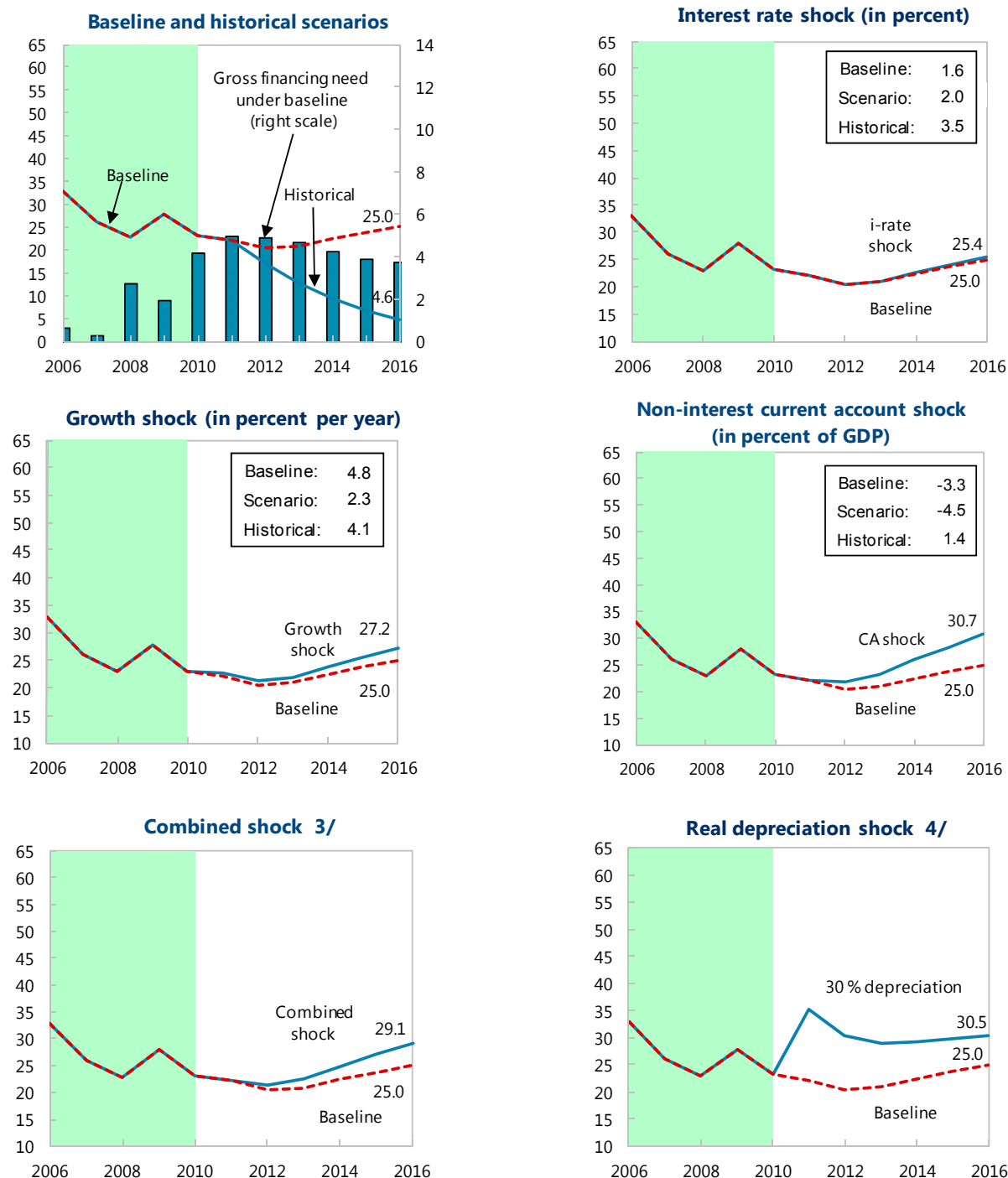
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

Figure A.2

Paraguay: External Debt Sustainability: Bound Tests 1/ (External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2011.

Table A.2 Paraguay: External Debt Sustainability Framework 2004–2016
(In percent of GDP, unless otherwise indicated)

	2007	Actual		2010	Projections					
		2008	2009		2011	2012	2013	2014	2015	2016
Baseline: External debt	26.0	22.9	27.9	23.1	22.2	20.4	20.9	22.4	23.7	25.0
Change in external debt	-6.9	-3.1	5.0	-4.8	-0.9	-1.7	0.5	1.5	1.3	1.3
Identified external debt-creating flows (4+8+9)	-10.7	-6.4	5.0	-5.5	2.1	2.7	2.7	2.4	2.0	1.9
Current account deficit, excluding interest payments	-2.6	1.2	-0.6	2.3	3.4	3.7	3.6	3.2	2.9	2.9
Deficit in balance of goods and services	0.3	3.0	1.5	3.7	5.2	5.4	5.2	4.8	4.8	4.8
Exports	53.8	52.9	50.8	53.9	52.4	45.8	44.2	44.2	43.9	43.5
Imports	54.1	55.9	52.4	57.6	57.6	51.2	49.4	49.0	48.7	48.3
Net non-debt creating capital inflows (negative)	-1.2	-1.1	0.6	-2.0	-0.4	-0.3	-0.3	-0.4	-0.4	-0.4
Automatic debt dynamics 1/	-6.9	-6.5	5.0	-5.9	-0.9	-0.6	-0.5	-0.5	-0.6	-0.6
Contribution from nominal interest rate	1.0	0.7	0.7	0.4	0.4	0.4	0.4	0.3	0.3	0.3
Contribution from real GDP growth	-1.7	-1.1	1.0	-3.2	-1.3	-1.0	-0.8	-0.8	-0.9	-0.9
Contribution from price and exchange rate changes 2/	-6.2	-6.1	3.3	-3.1	0.0	-2.7	-0.8	-0.1	-0.2	-0.4
Residual, incl. change in gross foreign assets (2-3) 3/	3.8	3.3	0.0	0.8	-3.1	-4.4	-2.3	-0.9	-0.7	-0.6
External debt-to-exports ratio (in percent)	48.3	43.2	54.8	42.9	42.3	44.6	47.3	50.6	53.9	57.4
Gross external financing need (in billions of US dollars) 4/	0.0	0.5	0.3	0.8	1.1	1.3	1.4	1.3	1.2	1.3
in percent of GDP	0.2	2.7	1.9	4.1	4.9	4.9	4.7	4.2	3.9	3.8
Scenario with key variables at their historical averages 5/					22.2	17.1	12.7	9.4	6.8	4.5
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (in percent)	6.8	5.8	-3.8	15.0	6.7	5.5	4.5	4.0	4.0	4.0
GDP deflator in US dollars (change in percent)	23.4	30.7	-12.5	12.5	13.3	14.0	4.1	0.5	1.1	1.7
Nominal external interest rate (in percent)	4.2	3.6	2.5	2.0	2.1	2.0	1.9	1.6	1.3	1.2
Growth of exports (US dollar terms, in percent)	26.6	36.0	-19.2	37.2	17.5	5.2	5.0	4.6	4.5	4.9
Growth of imports (US dollar terms, in percent)	22.4	42.9	-21.2	42.4	20.9	7.0	5.0	3.7	4.6	4.9
Current account balance, excluding interest payments	2.6	-1.2	0.6	-2.3	-3.4	-3.7	-3.6	-3.2	-2.9	-2.9
Net non-debt creating capital inflows	1.2	1.1	-0.6	2.0	0.4	0.3	0.3	0.4	0.4	0.4

1/ Derived as $[r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.



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Public Information Notice (PIN) No. 10/xx
FOR IMMEDIATE RELEASE
July, XX, 2011

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2011 Article IV Consultation with Paraguay

On [--], 2011 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Paraguay.¹

Background

Paraguay weathered the global crisis well, supported by an appropriate policy response. Countercyclical macroeconomic policy cushioned the effects of lower external demand. While GDP still contracted in 2009, this owed mainly to a severe drought. Growth rebounded strongly in 2010, with real GDP expanding at 15 percent, driven by a record crop, high credit growth, and favorable external conditions.

Reflecting the using up of slack capacity, overheating pressures have emerged. Inflation rose from 2 percent in 2009 to 8¾ percent in June 2011, driven by excess demand pressures and higher commodity prices. Despite very favorable terms of trade, the external current account weakened to 2¾ percent of GDP (from near balance in 2009) in 2010, reflecting very rapid import growth and a drop in remittances. With strong private capital inflows (notably foreign direct investment), however, the Central Bank (BCP) continued accumulating international reserves, which rose to US\$4.2 billion (23 percent of GDP) at end-2010.

Against a backdrop of rising inflation and rapid credit growth, the BCP started tightening monetary policy in mid-2010, raising interest rates by 775 basis points over the last year

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

(375 basis points this year), starting from a level close to zero. Real policy rates, however, remain negative, while deposit and lending rates have increased only modestly in real terms. Credit growth has remained very high (40 percent y/y in May), especially credit in foreign currency (58 percent). The BCP also raised reserve requirements effective May, bringing them back to their pre-crisis levels.

The BCP has allowed the guarani to appreciate substantially in recent months, while intervening in the FX market. As of end-May, the guarani had risen by over 10 percent vis-à-vis the U.S. dollar (13 percent in real effective terms) compared to end-2010. The appreciation reflects mainly improved terms of trade, higher private capital inflows, and seasonal liquidation of export proceeds. The BCP stepped up its purchases of FX in April, trying to contain appreciation pressures, but as the guarani stabilized, it reduced its intervention in May [and did not intervene in June].

Fiscal policy remained countercyclical in 2010, while public debt continued on a declining path. Real growth of primary spending decelerated significantly, while tax revenue increased sharply reflecting strong activity and import growth, and improvements in administration. In cyclically-adjusted terms, the primary balance (excluding electricity royalties and grants) strengthened by 1½ percent of non-agricultural GDP, implying withdrawal of most of the stimulus provided in 2009. Public debt declined by over 4 percentage points to 19 percent of GDP.

The banking sector remains generally sound. The overall capital adequacy ratio for banks remains above the regulatory level, although it is somewhat lower (by about 3 percentage points) when Basel I definitions are used. The nonperforming loan (NLP) ratio is low and declined slightly over the last year, but the level of NPLs is growing fast (17 percent y/y in May) and provisions are low. Profitability has remained very high. In late 2010, the Superintendency approved measures to strengthen financial system buffers, including higher generic provisions and minimum capital, which will become effective in January 2012.

In 2011, real GDP growth is projected at 6¾ percent, reflecting solid agricultural growth, stimulative macroeconomic conditions, and strong confidence. Inflation is projected to remain well above the BCP's target range, at close to 10 percent for year-end. The external current account deficit would widen to 3¾ percent of GDP, led by strong import growth, a less favorable services account, and lower remittances. The overall fiscal balance is projected to swing into a deficit of ½ percent of GDP, implying a fiscal impulse of 1¼ percent of non-agricultural GDP.

Executive Board Assessment

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Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.