

**FOR
INFORMATION**

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To: Members of the Executive Board

From: The Secretary

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PARAGUAY—ASSESSMENT LETTER FOR THE WORLD BANK

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1. The last Article IV consultation was concluded in April 2019. A staff visit took place in November 2019. The next Article IV mission is scheduled for late April 2020. A FSSR was conducted in 2017.

2. Paraguay has grown rapidly in the past decade and a half, the result of a bounce-back from a crisis in the late 1990s, good macro-policies, and a boom in agricultural commodity prices, which spilled over to the non-tradable sector. Economic growth averaged 4½ percent from 2004–18, and the poverty rate fell from 58 percent of the population (2002) to 24 percent (2018), though income inequality is still among the highest in the region. The key question going forward is whether the pace of real income growth can be sustained, as the factors that propelled Paraguay’s economy in the past are likely to provide less support in the future. Since the end of the commodity price boom, growth prospects for agriculture have moderated, and future growth will increasingly need to come from the non-energy/non-agriculture sector. This will require further diversification and productivity growth through investment in infrastructure, education reform, and improvements in governance and the rule of law.

3. In 2019, Paraguay’s economy was impacted by several shocks. Agricultural output was first hit by a drought and then by flooding. Hydro-electricity production was hurt by low water levels. Exports suffered from economic weakness in Argentina and Brazil and the sharp depreciation of the Argentinean peso. All these shocks spilled over to the rest of the economy, and growth in 2019 is estimated at close to zero. The Central Bank reacted by lowering its policy rate in five steps from 5¼ to 4 percent. Slowing economic activity and a real appreciation of the domestic currency following the Argentinean peso depreciation put a lid on inflationary pressures, and CPI inflation decreased to 2.8 percent in end-2019 while remaining within the Central Bank’s target range of 2-6 percent.

4. The downturn resulted in a shortfall in revenue, and a widening of the deficit to 2.5–2.8 percent of GDP, above the 1½-percent ceiling under the Fiscal Responsibility Law (FRL). The deficit increase was further exacerbated by a recovery in public investment, after an (election-related) shortfall in 2018. The deficit overrun did not violate the FRL, as the government invoked the FRL’s emergency escape clause, which temporarily allows a deficit of up to 3 percent of GDP in case of a “decline in economic activity”; this exception was approved by Congress in late 2019.

5. In 2020, real GDP growth should rebound to 4 percent, assuming normal weather and a gradual economic recovery in Brazil. The 2020 central government budget appropriately targets a return of the fiscal deficit below the FRL ceiling, but this will require keeping spending growth in check, including from the wage bill, which has been growing

rapidly in recent years. While the recently approved tax reform becomes effective in 2020, its impact on tax revenue will be marginal for the time being, underscoring the need to improve the quality of current expenditure in particular.

6. Paraguay's macroeconomic fundamentals remain strong. Thanks to prudent fiscal and monetary policies in the past, public debt is low and sustainable at about 25 percent of GDP. However, Paraguay has gradually shifted to external sovereign bond issuance since 2013, and more than 85 percent of public debt is now denominated in foreign currency, which has increased vulnerability to exchange rate and other external shocks. It would be desirable to increase the share of government debt that is financed domestically. Improved pension system oversight, while allowing pension funds to invest in government bonds, would give a boost to the domestic capital market and more effectively channel domestic savings toward the financing of public investment. Paraguay's external position remains robust. The external current account has a slight surplus, external debt is low, and international reserves exceed 7 months of imports.

7. Structural reforms are needed to maintain fiscal sustainability and increase competitiveness. Pension reform through modest parametric changes are needed — sooner rather than later— to prevent that large deficits in the system will emerge over the next decade. Unfortunately, the long-term pressures from demographic trends have been exacerbated by recent increases in retirement benefits for selected groups that were approved by Congress. The efficacy of health and education spending also needs to be improved, and the social safety net needs to be strengthened by eliminating the current fragmentation of the social protection programs, building an integrated social protection system.

8. The financial system is sound and well-capitalized. The banking system appears to have weathered well the impact of the shock on the agricultural sector; profitability is high, and the ratio of nonperforming loans remains moderate at 3.2 percent. The Central Bank should continue to modernize its banking supervision by moving toward a risk-based supervision system. However, parts of the non-bank financial sector such as credit houses and exchange bureaus need to be better understood and supervised.

9. To achieve income convergence with advanced economies, Paraguay needs to accelerate improvements in governance and strengthen its anti-corruption frameworks. Common governance indicators on control of corruption, property rights, and rule of law all point in the same direction: Over the past 15 years, Paraguay has improved in its indicators, driven by notable progress in some areas such as fiscal transparency. But its ratings are still poor, and the speed of improvement is short of those achieved by other high-growth economies. Money and asset laundering are serious problems. A new FATF (GAFILAT) review with tighter standards is now underway. While Paraguay achieved significant progress in amending its AML/CFT legal framework in 2019, effective implementation will require deeper reforms to the judicial system. The 2020 Article IV Consultation will focus on issues related to governance and corruption.

Paraguay: Selected Economic and Social Indicators

I. Social and Demographic Indicators

Population 2018 (millions)	7.1	Gini index (2017)	48.8
Unemployment rate (2018)	4.7	Life expectancy at birth (2017)	74.0
Percentage of population below the poverty line (2017)	26.4	Adult literacy rate (2016)	94.7
Rank in UNDP development index (2018)	110 of 186	GDP per capita (US\$, 2018)	5,742

II. Economic Indicators

	2013	2014	2015	2016	2017	2018	Est. 2019	Proj. 2020
(Annual percent change, unless otherwise indicated)								
Income and prices								
Real GDP	8.4	4.9	3.1	4.3	5.0	3.7	0.2	4.0
Nominal GDP	13.2	7.8	4.7	8.6	7.2	5.9	3.1	10.9
Per capita GDP (U.S. dollars, thousands)	5.9	6.0	5.4	5.3	5.7	5.7	5.4	5.6
Consumption (contribution to real GDP growth)	3.1	4.6	3.2	1.9	3.4	3.1	0.2	2.5
Investment (contribution to real GDP growth)	2.2	2.1	-1.8	-0.2	2.7	2.7	0.2	1.0
Net Exports (contribution to real growth)	3.1	-1.9	1.7	2.6	-1.2	-2.1	-0.2	0.5
Consumer prices (end of period)	3.7	4.2	3.1	3.9	4.5	3.2	2.8	3.7
Nominal exchange rate (Guarani per U.S. dollar, eop)	4,524	4,626	5,807	5,767	5,590	5,961	6,453	...
Monetary sector								
Credit to private sector 1/	20.9	19.1	8.6	4.5	6.2	10.6	8.6	9.2
Monetary policy rate, year-end	6.0	6.8	5.8	5.5	5.3	5.3
External sector								
Exports (fob, values)	16.7	-3.7	-15.3	7.9	11.8	3.2	-5.0	9.6
Imports (cif, values)	7.8	1.1	-14.6	-5.1	17.8	12.1	-4.4	2.8
Terms of trade	5.1	3.8	-5.4	4.1	-1.9	-1.6	-0.3	4.7
Real effective exchange rate 2/	4.2	2.3	-2.3	-3.5	-0.8	3.3
(In percent of GDP, unless otherwise indicated)								
External current account	1.6	-0.1	-0.4	3.6	3.1	0.0	0.3	2.4
Trade balance	3.7	2.0	1.5	5.5	4.1	1.4	1.2	3.3
Exports	35.3	32.5	30.7	33.2	34.3	34.1	34.3	35.7
Of which: Electricity	5.8	5.3	5.6	5.9	5.4	5.2	4.8	4.6
Imports	-31.0	-30.0	-28.5	-27.1	-29.5	-31.9	-32.3	-31.5
Of which: Oil imports	-4.1	-4.2	-3.4	-2.7	-3.0	-4.0	-3.5	-3.4
Capital account and financial account	0.7	4.2	-1.7	0.2	1.1	1.9	2.0	-0.2
Of which: Direct investment	0.6	1.0	0.9	1.2	1.3	1.2	1.2	1.1
Gross international reserves (in millions of U.S. dollars)	5,871	6,891	6,200	7,144	8,146	8,004	8,404	8,809
In months of next-year imports of goods and services	5.3	7.2	6.8	6.7	6.9	7.0	7.2	7.2
Ratio to short-term external debt	1.9	2.2	1.9	2.3	2.6	2.2	2.3	2.4
Gross domestic investment	22.3	22.5	20.8	19.7	21.2	22.4	22.7	22.2
Gross domestic saving	23.9	22.4	20.4	23.3	24.3	22.5	23.0	24.6
Central government revenues	12.9	13.7	14.1	13.9	14.2	13.9	13.7	13.8
Of which: Tax revenues	8.9	9.7	9.6	9.5	9.9	9.9	9.7	9.8
Central government expenditures	14.1	14.6	15.5	15.0	15.3	15.3	16.2	15.3
Of which: Compensation of Employees	6.9	6.7	7.0	6.5	6.3	6.6	6.9	6.7
Of which: Net Acquisition of Non Financial Assets	1.8	1.8	2.0	2.2	2.4	2.0	2.5	2.1
Central government net lending/borrowing	-1.3	-0.9	-1.3	-1.1	-1.1	-1.4	-2.5	-1.5
Central government primary balance	-1.0	-0.6	-0.9	-0.5	-0.5	-0.7	-1.7	-0.6
Public sector debt (excl. central bank bills)	13.2	15.6	18.6	19.4	19.8	22.2	25.7	24.1
Of which: Foreign currency	9.2	11.2	14.1	15.4	15.8	18.0	21.8	20.5
Of which: Domestic currency	4.1	4.4	4.5	4.1	4.0	4.2	3.9	3.6
Memorandum items:								
GDP (billions of Guaranies) 3/	166,715	179,722	188,231	204,447	219,188	232,133	239,429	265,416
GDP (US\$ billions)	38.5	40.0	36.3	36.3	39.4	40.5

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

1/ Includes local currency credit and foreign currency credit valued at a constant exchange rate.

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

3/ Historical GDPs were revised in 2018, including a 30 percent upward revision in nominal GDP for 2017.