April 16, 2020
Approval: 4/23/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/29-1

10:00 a.m., April 24, 2019

1. Paraguay—2019 Article IV Consultation

Documents: SM/19/64 and Correction 1; and Supplement 1; SM/19/67; and Correction 1

Staff: Bakker, WHD; Haksar, SPR

Length: 57 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	A. Tivane (AE), Temporary
	H. Razafindramanana (AF)
	J. Corvalan (AG), Temporary
N. Ray (AP)	
	B. Saraiva (BR)
	Y. Zhao (CC), Temporary
	A. Guerra (CE)
L. Levonian (CO)	
R. Kaya (EC)	
	A. Castets (FF)
S. Meyer (GR)	
S. Gokarn (IN)	
	M. Psalidopoulos (IT)
	Y. Naruse (JA), Temporary
	M. Daïri (MD)
	P. Al-Riffai (MI), Temporary
	R. Doornbosch (NE)
	I. Skrivere (NO), Temporary
A. Mozhin (RU)	
	R. Alkhareif (SA)
	Z. Abenoja (ST), Temporary
P. Inderbinen (SZ)	
	O. Haydon (UK), Temporary
	M. Svenstrup (US), Temporary

S. Bhatia, Acting Secretary
H. Malothra, Summing Up Officer
V. Sola, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present

Legal Department: K. Kwak. Secretary's Department: E. Michaels, K. Sanchez Alcaraz. Strategy, Policy, and Review Department: E. Gemayel, V. Haksar. World Bank Group: M. Sabella. Western Hemisphere Department: B. Bakker, X. Che, M. Ghazanchyan, T. Roy. Executive Director: G. Lopetegui (AG), L. Villar (CE). Alternate Executive Director: L. Palei (RU), P. Trabinski (SZ). Senior Advisors to Executive Directors: N. Jost (NE),

R. Morales (AG), E. Rojas Ulo (AG), A. Tolstikov (RU), G. Vasishtha (CO). Advisors to Executive Directors: M. Albert (FF), A. Arevalo Arroyo (CE), O. Bayar (EC), S. Buetzer (GR), L. Cerami (IT), M. Coronel (BR), G. Kim (AP), R. Lopes Varela (AF), C. Moreno (AG), E. Ondo Bile (AF), D. Vogel (AG).

1. PARAGUAY—2019 ARTICLE IV CONSULTATION

Mr. Lopetegui and Mr. Corvalan Mendoza submitted the following statement:

On behalf of the Paraguayan authorities, we would like to thank the mission chief Bas Bakker and his team for the constructive dialogue during the 2019 Article IV Consultation discussions. We would also like to thank the supportive team here at headquarters for their close engagement with the country.

For the past 15 years, governments from different political orientations have embraced the idea of laying the foundations to reduce poverty and inequality in a sustainable manner. During this period, with the help and advice of regional and international organizations and development partners, social indicators in Paraguay, as well as key macroeconomic variables, have experienced continuous improvement. The challenge now is to maintain the same course in the years to come.

Risks are mounting for the country within a complex and evolving regional and international scenario. Supportive tail winds from the past like high agricultural commodity prices and easy financial conditions are vanishing. In addition, climate change is perceived as more extreme than in previous decades.

To tackle these challenges, substantial efforts are being made to accelerate an ambitious investment plan in road infrastructure, education, hospitals, and social housing, using available financial options by engaging with the private sector through PPP's.

Regarding education, it is worth mentioning that scholarship programs launched a few years ago are gaining steam. More than 500 students have been trained for their Master's and PhD degrees in the top 300 universities around the world. Scholarships are obtained through a simple and transparent process by which Paraguayan citizens must comply with three basic rules: being under the age of 40, having a letter of acceptance from one of the 300 top universities in the world, and being willing to return to Paraguay for at least double the time spent abroad. The main objective is to have well-trained citizens who could serve the private and public sectors, as well as creating a critical mass of knowledge and expertise for the country.

Real Sector

Economic activity showed significant dynamism in the first months of 2018, with substantial growth in the services, manufacturing, and agricultural sectors. The pace of expansion, however, moderated significantly in the second half of the year, largely because of the more complex regional environment, as well as some domestic factors on the supply side. The depreciation of the currencies of neighboring countries resulted in an appreciation of the bilateral real exchange rate, which led to an important reduction of border trade with Argentina and Brazil, also affecting the performance of businesses linked to tourism. At the same time, other sectors were negatively affected by supply shocks, particularly those related to livestock production, construction, and the generation of electricity. Despite this moderation, real GDP growth is estimated at 3.6 percent in 2018.

A growth rate of 4 percent is foreseen for 2019, mainly because of strong activity in the tertiary sector (commerce and other services) and the secondary sector (manufacturing, construction, and electricity); the primary sector would grow at a slower rate. On the expenditure side, the main contributors to growth are expected to be private consumption and investment. Net external demand would also have a positive contribution, although minimal, with similar rates of growth for both exports and imports. Adverse weather conditions affected the performance of the agricultural sector in 2019, especially the production of soybeans, and the growth projection could be revised downwards at the end of April.

Monetary Sector

Annualized inflation was 2.8 percent in March 2019, falling within the target range of 4 +/-2 percent. This result was explained mainly by price pressures in the transport sector and, to a lesser extent, in the other categories, except for food items and beverages, which registered a decline in prices during the year. Inflation trend measures closed the year at levels consistent with the target range.

Towards the end of last year and the beginning of 2019, headline inflation, as well as the measures of underlying inflation, have shown a downward trajectory. Taking into account both the recent and expected evolution of prices, together with the latest indicators of economic activity and domestic demand, the Central Bank of Paraguay considered it timely to ease the monetary policy stance by reducing the monetary policy rate by 25 bps in both February and March 2019, to 4.75 percent.

The exchange rate has remained in line with the dynamics observed at global and regional levels. During 2018, the Guarani depreciated by around 7 percent vis-à-vis the U.S. dollar, with Central Bank participation in the foreign exchange market being limited to attenuating abrupt exchange rate volatility without altering the trend determined by market fundamentals. Net International Reserves as of today are slightly over USD 8.2 billion (20 percent of GDP), a level that gives a comfortable margin of liquidity to face eventual sudden fluctuations of the exchange rate.

Fiscal Sector

With regards to the public finances, the fiscal deficit is estimated at 1.3 percent of GDP in 2018, below the limit established in the Fiscal Responsibility Law. For 2019, the deficit is also expected to remain below the ceiling established in the fiscal responsibility law (1.5 percent of GDP).

Tax revenue stands at 10 percent of GDP, maintaining the upward trend exhibited in recent years. In mid-2018, in the middle of the political transition to a new administration, the Ministry of Finance established a Technical and Economic Commission for Taxation as well as a Commission to optimize public expenditures. The purpose of these two commissions that interact directly with civil society is to analyze the current tax system and reach an agreement with stakeholders to modernize and simplify the collection of taxes and streamline expenditures. Initial projections show that without increasing the level of tax rates, reducing deductible expenses in the personal income tax, eliminating exemptions, and equalizing VAT rates would allow revenues to increase gradually by 1 percentage point of GDP in the coming years. At the same time, potential savings on the expenditure side would add another percentage point of GDP, according to projections.

The interaction between the government and society in the context of these commissions is not easy but understandings have been reached, and a bill is expected to be sent to Congress during the first half of 2019.

The composition of expenditures is also moving in the right direction, with more fiscal resources being directed to capital and social expenditures while keeping current expenditures in check. It is well understood that additional resources are needed to tackle infrastructure gaps, especially for a landlocked country like Paraguay, as well as to increase investment in human capital.

Financial Sector

The financial system remains stable, with solvency indicators that are in line with the Basel minimum capital requirements. Moreover, liquidity, non-performing loans and profitability indicators continue to stand at adequate levels. Stress testing reveals that the system is resilient to face extreme shocks. At the same time, the process of financial regulation reform continues, with the main challenges involving the development of regulatory frameworks to adapt to the digital environment, as well as to improve market transparency and discipline. Some draft laws that are currently being studied include the creation of a Credit Bureau, Crowdfunding, Transparency of the Total Cost of Credit, Foreign Exchange Brokers, and modifications to the Cooperatives Law and the Charter of the National Institute of Cooperativism (INCOOP), among others.

Final Remarks

Important efforts are being deployed to improve the quality of institutions in Paraguay. In previous years a law was passed by Congress to offer free access to public information, which proved very useful to upgrade the level of transparency of state institutions and reinforce the engagement of civil society with the public sector.

On April 17, Congress approved a financial operation to speed up a digital agenda for the public sector. This action aims to improve the competitiveness of the economy and the quality of public services provided to citizens and corporations.

More recently, three new laws were submitted to Congress to tackle issues that hampered the ease of doing business, namely a new bankruptcy law, a law dealing with company formation simplification, and legislation allowing companies to use moveable assets as collaterals.

In addition, twelve new laws are now being discussed in Congress which are related to the creation of a financial intelligence secretariat to mitigate AML/CFT risks. Other legislations include court sentencing, criminal appeal (all specialized in Money Laundering, drug trafficking, anti-kidnapping, financing terrorism, corruption, and organized crime), along with the creation of punishable acts of transnational bribery.

The agenda is ambitious, but our experience in the past 15 years is that structural reforms bring benefits to all sooner rather than later. The country still has plenty of space to improve its institutions and close the income gap relative to well-performing economies. To enhance the level of productivity and connectivity going forward, society is demanding good governance and stronger institutions.

Mr. Tombini, Mr. Saraiva and Mr. Antunes submitted the following statement:

We thank staff for the reports and Mr. Lopetegui and Mr. Corvalan for their thorough statement. Despite regional economic difficulties in the past few years, Paraguay kept an impressive performance, with real GDP growth rates averaging above 4.5 percent in the past decade. Moreover, social indicators have improved at a robust pace, with important strides being made to reduce poverty and enhance access to basic services. Key to the good results were the prudent fiscal and monetary policies. In 2018, growth slowed down to an estimated 3.6 percent, still substantially above the regional average. The challenge ahead is to consolidate the trend in economic and social gains, translating them into a sustained and inclusive long-term growth trajectory. In order to do so, it will be necessary to accelerate investments in infrastructure and education, as well as further diversify the economy.

Paraguay’s fiscal position is solid, displaying low debt and deficit levels. Deficit has been kept below the Fiscal Responsibility Law ceiling of 1.5 percent and the baseline projection in the DSA points to the debt stabilizing at very low levels starting in 2020. External debt is expected to decline over the upcoming years as the Itaipu binational hydroelectric company debt will be fully amortized by 2023. However, Paraguay can improve resource mobilization, creating fiscal space to boost public investments, while keeping fiscal discipline. We concur with staff’s advice that the authorities should look into reducing exemptions and improving tax compliance with a view to increase tax revenues.

The expansionary monetary policy stance is warranted, giving the low and declining inflation. At 3.6 percent in average during 2018, inflation is under control and has recently fallen to an annualized rate of 2.8 percent. Inflation significantly below the center of the target provides support for the central bank’s decision to promote the two rate cuts this year so far, from 5.25 to 4.75 percent.

Paraguay’s agriculture is heavily mechanized and yields of major crops are close to the technological frontier, increasing the payoff for diversifying the economy. Moreover, the country’s economic performance is heavily dependent on international prices of agriculture commodities, particularly soybeans, making it vulnerable to cyclical and structural changes in relative prices. For that reason, we commend the authorities’ efforts to develop the manufacturing sector, aiming at the larger Mercosur market. We second staff's assessment that future growth in Paraguay will increasingly depend on the expansion of the non-agriculture/non-energy sector, which will be ever more critical for job creation. At the same time, the perspective of reforms in the South American trade bloc may significantly impact the Paraguayan economic diversification strategy. Staff's comments would be welcome.

Per capita GDP growth has resulted in an impressive record of poverty reduction, while there remains significant room to improve social indicators. With a Human Development Index score of 0.702, Paraguay ranks considerably below most of the countries in the region. We welcome the administration's substantial effort to accelerate an ambitious investment plan in infrastructure, education, health and social housing, as highlighted by Mr. Lopetegui and Mr. Corvalan. Such a bold approach should increase life expectancy, improve the quality of education and enhance labor productivity. Indeed, there can be important synergies between implementing the Sustainable Development Goals (SDGs) in Paraguay and consolidating the country's economic performance over the long run. Furthermore, giving Paraguay's intensive agriculture model, promoting the sustainable use of environmental resources, particularly water, is of paramount importance. Could staff comment on Paraguay's progress towards achieving SDGs? Relatedly, is there an assessment of environmental risks that may impact growth perspectives in the long run?

Paraguay is on the right track. We agree with staff's assessment that the current policy mix is appropriate, and that Paraguay's external position is strong. Nevertheless, considering regional and international uncertainties, Paraguayan authorities should keep prudent fiscal and monetary policies, while intensifying efforts towards poverty alleviation, social inclusion and economic diversification. We commend the authorities for their continuing commitment to sound policies, which have yielded remarkable results and wish all the success in their future endeavors.

Mr. Meyer and Mr. Buetzer submitted the following statement:

We thank staff for the insightful set of reports and Mr. Lopetegui and Mr. Corvalan Mendoza for their helpful buff statement. Sound macroeconomic management and favourable external conditions have spurred economic performance over the last decade. Solid growth has continued more recently in spite of recent regional headwinds and the agricultural sector being confronted with inclement weather conditions. The overarching challenges faced by the Paraguayan authorities at this stage are maintaining the convergence path by sustaining recent gains in growth and managing the transformation of the economy towards a more diversified and competitive structure. To this end, prudent macro policies should be upheld and structural impediments for the development of competitive and export-oriented private sector activity removed.

A cautious approach in both fiscal and monetary policy has backed macroeconomic stability that served the Paraguayan economy well. A functioning inflation targeting regime has contributed to overall stable monetary conditions, mutually reinforced by a floating exchange rate regime with interventions duly limited to spikes in volatility not driven by fundamentals and mindful of the development stage of domestic capital markets. Particularly laudable is the observed downward path of public debt that was achieved by prudent counter-cyclical fiscal policies.

Notwithstanding the overall commendable low debt levels, the high share of public debt issued in foreign currency makes the country susceptible to reversals in international risk sentiment and exchange rate volatility, thus warranting a continued vigilant fiscal strategy looking ahead. Within these constraints, productive capital spending should be prioritized to keep pace with the development needs and to enable further convergence. In view of that, we agree with staff that the comparatively low level of public revenues needs to be increased. In this context, we would like to ask if staff could provide further insights on the blue print for tax reform that was envisaged for March 2019 (cf. para 54).

Regarding staff's advice to rely more on public-private partnerships to significantly expand public investments, we are more cautious than staff and would underline the need to strengthen administrative capacities and institutional frameworks in order to operate and monitor such projects and related fiscal risks adequately.

We welcome the overall robust state of the banking sector and commend the authorities for the progress in the implementation of the 2017 FSSR recommendations. We encourage making further progress on the regulatory agenda and developing the appropriate supervisory capacities for effective enforcement, including with regards to the AML/CFT framework. Furthermore, staff makes a case for the need to close some regulatory blind spots in the non-bank financial sector, e.g. microfinance and pension funds, that call for a commensurate response to safeguard stability and allow for a more complete and inclusive delivery of financial services.

High priority should be given to reducing widespread institutional and structural weaknesses that impede sustainable long-term growth. A weak rule of law and corruption still loom large in the country, constituting major impediments to private sector growth. In this context, public governance should be further improved through continuing the commendable progress in recent years in improving transparency towards international best-practises, cutting red tape, and combatting corruption. Implementing an ambitious structural reform strategy in combination with more targeted efforts in catering itself to the internal business community would help to attract FDI, develop more productive higher-value supply chains, and unleash entrepreneurial forces.

We note with interest the way how staff gauges the priorities of different reform areas. While we do indeed see great merits in identifying priority areas for reform, we caution somewhat against applying such a method too rigidly when it comes to guidance for sequencing policies. Even supposedly less urgent reforms could well be key components of a comprehensive reform agenda due to interrelations between different policies. For example, albeit being positioned in the quadrant of lowest significance, raising government effectiveness could be an important catalyst for reforms in other policy areas such as the rule of law or the quality of education.

Given the reference to more elevated climate change related risks in the buff of Mr. Lopetegui and Mr. Corvalan Mendoza, we were wondering if staff could briefly comment on how the country is exposed to such risks and if staff considers discussing such risks in greater detail in the future.

Mr. Agung and Mr. Abenoja submitted the following statement:

We thank staff for their comprehensive report and Mr. Lopetegui and Mr. Corvalan Mendoza for their insightful buff statement.

The Paraguay economy continues to grow near potential driven by significant contributions from household consumption and private investment. Inflation is declining and is on target while the fiscal deficit is below the ceiling set under the Fiscal Responsibility Law (FRL). However, downside risks could emanate from a weak performance of neighboring countries, volatility in commodity prices, and possible delays in the implementation of public investments. Over the medium term, challenges remain to broaden the sources of growth, raise productivity, widen the tax base to support government expenditures and strengthen financial sector supervision. In this vein, we view favorably authorities’ continued focus on sound economic policies to avoid boom-busts cycles and commitment to pursue structural and administrative reforms. We share the general thrust of the staff's assessment and offer the following comments for emphasis.

Tax reforms to improve revenue effort and support priority government expenditures are crucial in accelerating growth and helping further reduce poverty. Fiscal policy in 2018 was neutral and the deficit was contained within FRL limits. However, the revenue effort ratio remains modest while government capital expenditures has recently declined. Thus, we agree with staff that the tax base needs to be widened to provide fiscal space for increasing government expenditure levels which are already at low levels. We welcome authorities' effort to focus on low-hanging fruits in the near term to raise revenues including through simplifying the tax system and improving compliance. However, the importance of pursuing the fundamental follow-through reforms cannot be overemphasized. The creation of the Technical and Economic Commission for Taxation and a Commission to optimize public expenditures are important steps in generating support from the stakeholders in modernizing the tax system and prioritizing expenditures. We support the work of these commissions in analyzing proposals to reduce deductions to income taxes and rationalize exemptions and reduced rates for VAT. At the same time, we view favorably the initiatives of authorities to raise the efficiency of public investments and shift more fiscal resources to capital and social expenditures to support broad-based economic growth. These efforts should be complemented by measures to improve the efficacy of health and education expenditures as well as to integrate the social protection system. Can staff provide updates on the details of the tax reform blueprint as well as the progress of the review of public expenditure?

The accommodative stance of monetary policy and the adoption of a flexible exchange rate policy, with central bank participation limited to addressing abrupt exchange rate volatility, are appropriate to support inflation objectives. The downtrend in inflation and softening of domestic demand support the reduction in monetary policy rates in early 2019. We agree with staff assessment that continued vigilance is needed and market action may be called for in case downside risks from neighboring countries exert pressure on the foreign exchange rate and affect inflation expectations. Private sector credit to GDP increased rapidly from 13 percent in 2003 to 40 percent in 2017. Can staff clarify if financial stability issues remain since the previous credit boom episode and if authorities have adequate tools to manage any vulnerabilities?

The continued reform efforts in financial and pension sectors are important in further strengthening the financial system stability. We positively note the advances made across a broad front in implementing the FSSR recommendations including those pertaining to interagency coordination protocols, establishment of a financial stability council, surveillance data collection on interconnectedness and enhancements of the framework on crisis prevention and resolution. However, there is room for improving financial supervision, particularly over the non-bank financial sector. Can staff provide more information on the importance of the intermediation activities of casas de credito and casas commerciales and the general thrust of the BCP study in regulating these entities? Reform in the pension sector is also needed to provide oversight to the sector and facilitate the development of domestic capital market. In this vein, we welcome authorities' commitment to establish pension fund supervision.

In the real sector, the continued diversification of the economy beyond agriculture and increase in productivity would be pivotal in sustaining growth over the long term. An expansion of the non-tradeable sector, particularly the manufacturing where labor productivity is higher, would raise overall productivity and output growth. We commend the staff for their efforts to identify the prioritization of the needed structural reforms to boost investments in other sectors, by taking into account not only the impact of reforms on growth but also the extent of social support for these initiatives. We are encouraged that there is broad agreement between staff and authorities on the priority reforms, specifically the investments in transport infrastructure, enhancement of the business environment, improvements in human capital and the promotion of rule of law. We recognize the progress being made by authorities in improving the business climate through laws that address bottlenecks to ease of doing business including a new bankruptcy law, simplification of procedures for company formation and allowing the use of moveable assets as collateral by firms. At the same time, we appreciate the point of the authorities on the usefulness of programs to further promote Paraguay as an investment destination. Can staff provide information on initiatives of authorities to promote the country to foreign investors, including for example the establishment of an investor relations office? We also welcome the various efforts of authorities to promote public governance transparency, mitigate AMF/CFT risks and fight corruption and organized crime.

With these comments, we wish the authorities continued success in their future endeavors.

Mr. Ray, Mr. Saito, Mr. Kim and Mr. Naruse submitted the following joint statement:

We thank staff for their report and Mr. Lopetegui and Mr. Corvalan for their informative buff statement. Paraguay's economy is performing extremely well, with strong growth, low unemployment, and subdued inflation, to the extent that the staff report focuses mainly on how to sustain rapid growth of real income. But we agree with staff that Paraguay continues to face vulnerabilities from volatile agricultural commodity prices, slow growth of trading partners, and lopsided economic structure.

Countercyclical and prudent fiscal policy should continue. We concur that tax revenue should be raised to create space for public investment and structural reforms. We also acknowledge that strong commitment to the Fiscal Responsibility Law (FRL) has contributed to reducing government debt. In this vein, it will be imperative to search for alternative financing sources including through PPPs, given the limited fiscal space and large infrastructure investment needs. We agree with staff that preemptive parametric adjustment in pension age, benefits, and contribution rates will be helpful to contain the potential fiscal vulnerabilities which may be posed by the pension fund. Political dialogue should resume to establish appropriate pension fund supervision and to allow the pension fund to purchase in government bonds. In addition, it is noteworthy that improving tax compliance will be essential to increase tax revenue, given that informal employment is estimated at about 65 percent of total employment.

As a small open economy, Paraguay's monetary policy should remain expansionary to offset insufficient external demand. We note that credit boom and bust is susceptible to the external environment, particularly the growth of major trading partners and agricultural prices as noted in staff's SIP. We also note that dollar- and guaraní-denominated credit could move in a different direction in the face of different shocks. In this sense, we would like to ask staff's assessment of the authorities' efforts toward de-dollarization. We agree with staff that the non-banking sector should be monitored carefully, particularly its interconnectedness with the banking sector.

The flexible exchange rate should be the primary shock absorber and interventions should be limited to address disorderly market conditions. We note that exports heavily depend on agricultural commodities and related products. Furthermore, declining commodities prices would lead to reduce domestic demand through a decline in income. Have staff considered the impact of the US-China trade negotiation on Paraguay in terms of export substitution of soybean?

We support staff's call for further structural reforms, with a focus on developing new industries and faster growth of the non-agriculture, non-energy tradeable sector. Furthermore, noting the staff's assessment that banks have excess liquidity, we encourage the authorities to improve the efficiency of credit allocation so that productive sectors can receive the necessary financing. In this respect, we would like to hear staff's views on banks' ability to assess the creditworthiness of firms and the efficiency of overall credit allocation. We commend staff's analysis identifying the priority structural reforms considering the potential growth impact and the capacity of the private sector. We agree with staff that improving the rule of law including in customs and trade regulation is a priority in the short term. In the long run, Paraguay should exploit its comparative advantage in abundant hydro power resources and high labor productivity in the manufacturing sector in order to attract private investment and FDI.

Mr. Geadah and Ms. Al-Riffai submitted the following statement:

We thank staff for their reports and Messrs. Lopetegui and Mendoza for their buff statement. Prudent macroeconomic policies have contributed to growth—making Paraguay one of the fastest growing economies in South America over the past one and half decades—lowered inflation, and significantly reduced external debt, public debt, and poverty. We commend the authorities on this performance.

The neutral fiscal stance is appropriate from a cyclical perspective and in line with the Fiscal Responsibility Law. However, with spending needs—including for infrastructure—exceeding revenues, we concur with staff on the need for greater resource mobilization. The authorities' focus on simplifying the tax system and improving compliance in the immediate future is welcome.

The banking sector is well capitalized and profitable. NPLs are low, the return on equity is above the regional average. The authorities have been making progress in implementing the 2017 FSSR recommendations. However, the non-bank financial sector—which is the main provider of uncollateralized consumer loans and installment credit to lower and middle income brackets—is unsupervised. We thus welcome the authorities' attention to this sector and encourage them to apply the supervision standards for casas de credito and casas comerciales as for other credit institutions.

Maintaining the rapid growth of per capita incomes could benefit from efforts to further diversify the economy. To that end, we welcome the authorities' priority focus on improving the business environment, as evident in improvements in public transparency, as well as reforms to increase the ease of doing business and promote competition in key industries. These efforts would also benefit from addressing the current infrastructure gaps and improving human capital. We welcome the authorities' plan to strengthen primary healthcare, and look forward to the education reform roadmap that is expected to be completed by the end of this year. We also positively note the government's proposed legislation to simplify company formation and registration.

We wish the authorities continued success in their management of the economy.

Mr. de Villeroché, Mr. Castets and Ms. Albert submitted the following statement:

We thank staff for the informative set of reports, as well as Mr. Lopetegui and Mr. Corvalan for their helpful buff statement. A prudent policy-mix contributed to support economic growth despite a deteriorating and volatile environment over the past year. However, as the ongoing bounce back might not last, we encourage the authorities to pursue their efforts to adapt Paraguay's development model, relying mostly on the agribusiness sector, towards a more diversified and inclusive model, in order to further reduce poverty and income inequality. Enhanced and progressive domestic resource mobilization efforts would create fiscal space to increase investment in infrastructures and education. Fighting corruption and improving governance also appear as key priorities. We agree with the thrust of the staff appraisal and would underscore several points:

Structural reforms

Ensuring sustained and inclusive growth might prove challenging going forward as the effect of the ongoing bounce back dissipates and as the external environment becomes less supportive. Growth has been supported by the bounce back after years of subdued performance, as well illustrated in the dedicated selected issues paper, and partly based on agribusiness fueled by conversion of natural ecosystem. As pointed by staff enhanced public and private investment are warranted, notably in the transportation sector as Paraguay is landlocked and the country lags behind regional peers in this regard. To boost private investment creating a more business-friendly environment and tackling corruption are key priorities.

Fighting poverty and reducing informality to decrease income inequality also remains a challenge, and we would have appreciated more developments in the report about these dimensions. Improving education, to take advantage of the demographic dividend, and boosting TFP, especially the agricultural productivity, are also major levers to ensure a strong and sustainable long-term growth.

We note that the report mentions in footnote p.35 that historical GDP series were revised in 2018, including a 30 percent upward revision in nominal GDP for 2017. Could staff indicate if this revision corresponds to a modification in the sectoral structure of the economy?

Fiscal policy

Public debt is low due to prudent fiscal management and enhanced tax revenues would create additional fiscal space to finance the much-needed public investment while tackling income inequality. Paraguay seems to have significant fiscal space as public debt level is low at 21.6 percent of GDP in 2018. In this respect and as “spending needs are large” as pointed out by staff, the Fiscal Responsibility Law appears quite restrictive. Indeed, on the expenditures side, boosting investments is crucial, as the report highlights the significant infrastructures (20 percent of GDP over the next five years in infrastructures) and education needs. Against this background, and considering the overall sound macroeconomic framework, did staff assess the potential impact of a flexibilization of the FRL ceiling? On the revenue side, tax revenues are especially low for an upper middle-income economy, below 10 percent of GDP. Moreover, staff indicates that the current tax system is regressive. We therefore would encourage the authorities to consider a tax reform to create additional fiscal space to accommodate the investment needs. Moreover, we note on the report that “Paraguay has a history of overly optimistic nontax revenue projections”. Could staff elaborate on the reasons of this overestimation?

Monetary, exchange rate and financial policies

The monetary policy stance appears appropriate as inflation remains within the central bank target range. On the foreign exchange market, we note the intervention of the central bank last year to avoid disorderly volatility and pressures not in accordance with the fundamentals. The intervention was justified by exceptional pressures and the level of reserves is close to two times the level considered adequate under the Fund’s metric. Nonetheless, the flexibility of the exchange rate should remain the first tool to absorb external shocks and we concur with staff about the necessity of limiting interventions in exceptional circumstances of disorderly market conditions.

We welcome the progress made to reinforce the banking sector supervision. Tackling organized crime, informality and corruption has been identified as the main priority by the last AML/CFT assessment. We encourage the authorities those vulnerabilities and look forward to the upcoming GAFILAT evaluation in 2020.

Mr. Doornbosch and Mr. Jost submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Lopetegui and Mr. Corvalan Mendoza for their informative buff statement. We welcome the sound economic developments in Paraguay, despite the volatile economic environment in the region. We commend the authorities for their success in reducing income inequality and poverty rates. As the Risk Assessment Matrix (RAM) outlines, the majority of risks the country is facing, according to staff, are external. In that sense policies should continue to remain prudent, including on the fiscal side.

While we welcome the authorities' commitment to sound fiscal policy, we support their plans to re-direct more fiscal resources towards human capital and infrastructure investment. The examples provided by Mr. Lopetegui and Mr. Corvalan Mendoza regarding the scholarship program and the recently decided financial support for the digital agenda for the public sector are good examples of efficient allocation of capital. At the same time, and in order to address the large spending needs, the authorities should consider increasing revenues, including by improving compliance. Staff mentions that a commission was to propose a blueprint for tax reform by March 2019. What were the main findings in this context?

We welcome staff's useful assessment of the quantitative impact of a set of possible structural reforms on GDP convergence. In addition to the importance of investment in human capital and infrastructure, we agree with staff on the importance of building an effective public investment framework. We encourage the authorities to tackle challenges regarding the informal sector and continue to improve the business climate, including by addressing governance-related shortcomings, which could contribute to attracting more private investment into the country and foster entrepreneurship. In this context, we were wondering if staff has discussed ways to actively address informal economic activity?

In their statement, Mr. Lopetegui and Mr. Corvalan Mendoza mention that climate change is perceived as more extreme than in previous decades. In the RAM, staff links weather-related shocks (as one of the two only internal risks) to financial stability, fiscal performance and monetary policy of the country. For instance, staff's recommended response to weather-related shocks is that budget execution should remain compliant with the Fiscal Responsibility Law. In this sense, does staff consider climate-related events to be macro-critical in the case of Paraguay? Is compliance with the Fiscal Responsibility Law realistic given the expected impact of a possible weather-related shock?

Mr. Inderbinen and Mr. Imashov submitted the following statement:

We commend the authorities for the favorable economic outcome. Paraguay's growth rate of over last decade is remarkable, also in the regional context, as is the significant reduction in poverty. The achievements are in no small part due to stable and reliable macro-economic policy. External vulnerabilities have declined, and the reduction of public debt in particular is noteworthy. This puts Paraguay in a favorable position to mitigate the current downside risks to the economic outlook.

The current policy mix appears appropriate. We agree that the expansionary monetary stance should mitigate the slowdown and reduce downside risks. However, as staff note, a gradual tightening of monetary conditions will likely be warranted over the medium term. We welcome the authorities' continued commitment to price stability and two-way exchange rate flexibility.

The Fiscal Responsibility Law continues to ensure a prudent fiscal policy stance. This said, there is certainly potential to increase tax revenues and improve spending efficiency, and we take good note of the outreach of the two independent Commissions to this end. We note that, while the fiscal framework has enabled a counter-cyclical stance, deficits have recently increased to levels close to the mandated ceiling. Has staff engaged with the authorities on a possible strengthening of their fiscal rule?

We welcome the progress in implementing the 2017 FSSR recommendations. We commend the authorities on the well capitalized and profitable banking sector. We note the achievements on risk-based supervision, macro-prudential instruments, and crisis management. This progress notwithstanding, we join staff in calling on the authorities to strengthen supervision of the non-bank sector, including by improving the coordination with INCOOP and strengthening data collection. The update of the AML/CFT risk assessment is welcome. This said, we note staff's finding that the effectiveness of the AML/CFT framework will depend on increased efforts to fight corruption. Could staff inform on work underway to this effect?

Efforts are required to improve the business environment and strengthen governance. In this regard, we welcome the authorities' ambition to increase the ease of doing business, including the legislation in train to simplify company formation and strengthen bankruptcy procedures. We also take good note of the efforts to increase the transparency of the public sector and the legislation currently before Congress to strengthen the criminal justice system. Efforts to increase governance and transparency will be essential to attract FDI as well as funding for PPP projects.

Further structural adjustment is needed over the medium term. We note staff's finding that Paraguay lags countries that have successfully converged to higher income status in terms of industrial capacity, diversification of exports, and reliance on agriculture. Against this background, the authorities' efforts to address bottlenecks to diversification and growth, including the improvement of infrastructure and education, are certainly warranted. Diversification should also help reduce deforestation, lessen the vulnerability to climate events, and reduce the volatility of GDP growth.

Mr. Guerra and Ms. Arevalo Arroyo submitted the following statement:

We thank staff for the informative set of reports and Mr. Lopetegui and Mr. Corvalan Mendoza for their helpful buff statement. Over a decade ago, the Paraguayan authorities started a process to improve the macroeconomic policy framework and opening the economy. These policy efforts, supported by a series of IMF programs, have been reflected in a period of sustained and resilient growth, a reduction in debt levels and, more importantly, a considerable decrease in the poverty rate. Going forward, as acknowledged in the buff statement, the challenge will be to continue convergence at a faster pace that could help reduce poverty levels, which are still among the highest in the region.

While the structure of the economy has changed in the past years, diversification of economic activity and improving the business climate will be required to maintain rapid growth. Risks to growth are increasing as external conditions deteriorate. Lower economic activity in Asia can have an impact in commodity prices and financial conditions could tighten further than currently expected. Although external vulnerabilities have declined as foreign debt has decreased, and international reserves have increased, the economy is still heavily dependent on the agricultural sector. In this regard, we believe the authorities should take the opportunity to put in place an effective and comprehensive structural reform agenda. We commend staff for the excellent analytical work on the drivers of growth and reform priorities. We notice that several of the structural reforms highlighted in the staff's analysis are already part of the authorities' program, including transport infrastructure, health and education. In staff's, view which additional elements should be also given prominence in the authorities' reform agenda?

We concur with the staff assessment that the current monetary policy stance appears appropriate to meet the inflation objective. Going forward, the authorities should continue using the exchange rate as an important shock absorber. Moreover, we note that the BCP has intervened in the foreign exchange market to prevent unwarranted movements in disorderly market conditions.

Regarding financial supervision, we commend the authorities for their continued efforts to strengthening risk-based banking supervision such as the establishment of a financial stability council. We notice that in general the financial soundness indicators show a resilient banking sector. Nevertheless, as reported by staff, it is important to adopt supervisory standards to Casas de Crédito and Casas Comerciales and upgrade the supervisory activities of financial cooperatives. Regarding the financial soundness indicators, can staff comment on the reasons behind the increase in the FX position/equity from 9.6 in 2017 to 17.3 in 2018?

Finally, resilience shown by the Paraguayan economy to regional shocks has been supported by the prudent fiscal policies pursued by the authorities for more than a decade, but important challenges should be addressed. To secure the needed resources for infrastructure and social expenditure, it is necessary to improve tax compliance and thus effective tax rates. Also, it will be instrumental to restore the long-term sustainability of the pension system in a gradual manner by adjusting in a timely manner the pension age, benefits and contributions rates. These measures should be complemented by establishing a pension fund supervisor to allow for a wider range of assets to invest, which should boost development of the domestic capital market. Moreover, allowing pension funds to invest in government bonds could contribute to reduce the amount of public sector debt denominated in a foreign currency and reduce exposure to the banking sector.

Ms. Levonian, Ms. McKiernan and Ms. Vasishtha submitted the following statement:

We thank staff for a comprehensive report and Mr. Lopetegui and and Mr. Mendoza for an informative buff statement.

Paraguay has experienced rapid economic growth over the past 15 years reflecting sound macroeconomic policies, a boom in agricultural commodity prices, and a relatively benign external environment. Poverty has fallen over this period, although poverty rates have stagnated recently. Going forward, the key challenge will be to sustain this rapid growth under likely less beneficial external conditions. We concur with the staff's overall assessment that developing the non-agriculture, non-energy tradable sector and boosting productivity growth will be key to sustained growth and convergence over the long run. We commend the authorities for their commitment to sound policies and encourage them to further strengthen efforts towards poverty reduction.

Future growth will need to increasingly come from the non-agriculture sector.

Given that Paraguay's exports remain heavily reliant on the agricultural sector, which is facing constraints on expansion, diversification and increased productivity growth will be essential for sustainable long-run growth. This, in turn, will be facilitated by a better business climate and improved governance. Reform efforts should focus on improving transport infrastructure, the rule of law, and the quality of education, which would boost private sector investment and help attract FDI. In this context, we welcome the authorities' efforts to improve the ease of doing business, the quality of institutions, as well as enhance public governance transparency.

The fiscal policy stance remains prudent, anchored by the Fiscal Responsibility Law (FRL). Yet, revenue and expenditure levels are low while spending needs are large, with reforms to transport infrastructure and education requiring substantial resources. Tax reforms that broaden the tax base will help raise revenues to support public investment and structural reforms. The pension system is also in need of gradual reform through adjustments to benefits, contribution rates, and pension age.

The banking sector appears to be well capitalized and profitable, but supervisory weaknesses in the non-bank sector pose important risks. While we take note of the progress in implementing the 2017 FSSR recommendations, we concur with staff that supervision of financial cooperatives and the casas de credito and casas comerciales should be improved. Likewise, establishing a pension fund supervisor is critical to mitigate risks, allow pensions funds to invest in a wider range of assets, and facilitate the development of the domestic capital market.

Strengthening the AML/CFT framework and its implementation is also important for financial stability. We urge the authorities to continue making efforts to address the main money laundering risks identified in the 2018 national risk assessment, including organized crime and the presence of a large informal sector. Tackling structural corruption issues will also be crucial in this regard.

Finally, we acknowledge the authorities' significant reform agenda, as outlined in the buff statement, to improve the quality of institutions, enhance competitiveness, improve the ease of doing business, and mitigate AML/CFT risks. Effective implementation of this ambitious reform agenda will be equally important in demonstrating commitment to good governance and stronger institutions and removing bottlenecks to long-term growth.

Mr. Alkhareif and Mr. Rawah submitted the following statement:

We thank staff for the well-focused set of reports and Mr. Lopetegui and Mr. Corvalan Mendoza for their helpful buff statement. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

We encourage Paraguay to continue prioritizing structural reforms to boost growth and achieve higher economic diversification. We note that Paraguay has experienced a growth acceleration over the past decade, supported by good macroeconomic policies and a boom in agricultural commodity prices. This has led to sharp GDP per capita increase and significant poverty reduction. Nonetheless, poverty continues to be one of the highest in Latin America while investment level is low and export diversification is limited. In this context, it is important to focus on structural reforms to enhance the business environment to attract investment, including FDI. Efforts should also focus on facilitating diversification through greater emphasis on supporting the growth of the non-energy/non-agricultural export sector and the development of new industries. Reforms should continue to address business constraints and lift productivity including through improving transport infrastructure, rule of law, quality of education, as rightly noted by staff.

We see merit in staff's call to improve revenue mobilization and better streamline spending. We take positive note of the authorities' prudent policies to reduce debt over the past fifteen years. In this context, we note staff mention to adopt a policy mix of revenue mobilization through tax reforms and spending rationalization, particularly with regard to the public wage bill. Here, we appreciate staff views on how rigid is the Fiscal Responsibility Law, especially given the large spending needs for public investment to boost growth and satisfy social spending priorities, particularly in health and education.

Finally, we acknowledge the important progress made in the implementation of the 2017 FSSR and strengthening AML/CFT framework and call for sustained efforts in this regard. It is encouraging to note that the financial sector remains stable and that banks are well-capitalized, profitable, and broadly resilient to shocks. Moreover, we take positive note of the authorities' strides to improve risk-based supervision and further develop macroprudential tools and echo staff call on the need to expeditiously adopt supervision standards for the non-bank financial sector. On AML/CFT, we look forward to addressing remaining priorities and agree that further strengthening the country's anticorruption efforts are warranted. Also, the authorities' commitment to establish pension fund supervision is welcome.

With these remarks, we wish the authorities further success.

Mr. Kaya and Mr. Bayar submitted the following statement:

We thank staff for the comprehensive set of reports, and Messrs. Lopetegui and Corvalan Mendoza for their helpful buff statement. Paraguay has established a track record of sound macroeconomic policies which – together with a broadly favorable external backdrop - contributed to strong and stable growth, a sharp fall in poverty rates, and reduced imbalances. Nevertheless, challenges remain as the factors that supported the expansion of the economic activity in the past decade started to wane, calling for renewed efforts to address the bottlenecks to faster income convergence, including through further diversification of the economy as well as reigniting productivity growth. We agree with the thrust of the staff's assessments, and policy advice and would like to highlight several points for emphasis.

Paraguay's strong fiscal position helped the economy withstand the headwinds impacting the region. The authorities have done a commendable job in persevering with a prudent fiscal policy, which significantly reduced debt-related vulnerabilities, while avoiding a procyclical stance. While recognizing the relatively confined role of the state in Paraguay's economy, the spending needs stemming from the country's infrastructure gaps as well as the priority structural reform areas call for mobilizing more tax revenues without undermining the social contract. We welcome, in this regard, the establishment of a technical commission to render broad stakeholder support for the much-needed tax reforms. Given Paraguay's rather volatile debt trajectory since the 90's, we believe that the rules-based fiscal framework has served the Paraguayan economy well. Nevertheless, we tend to concur with staff in that the legal ceiling on the fiscal deficit (i.e. at 1.5 percent of the GDP) could unduly limit the authorities' room to buttress growth, as needed, and therefore, wonder whether there was a discussion with the authorities to introduce counter-cyclical elements to the fiscal rule.

The monetary policy appropriately keeps the inflation dynamics in check, while mitigating downside risks to growth and financial stability. In view of the weakening inflationary pressures emanating from both the supply and demand side, we see the recent accommodative policy actions by the central bank timely and warranted. While preserving the exchange rate flexibility as a first line of defense against external shocks, it is also critical for the authorities to closely monitor the impact of the exchange rate pass-through on inflation expectations within their inflation targeting framework. The authorities should continue to strictly limit their interventions to the exchange rate market to attenuate excessive volatility.

The banking sector appears stable, well-capitalized, and profitable. We welcome the improved asset quality in the system as epitomized by low and declining NPLs, strong liquidity positions, as well as resilience against various stress scenarios. Nevertheless, there are gaps in the regulatory coverage, notably of the non-bank financial sector and the uncollateralized credit activity. We are, therefore, encouraged by the authorities' comprehensive legal agenda pertaining to the regulatory field and look forward to a timely conclusion of these steps. Further, allowing pension funds to invest in a wider range of assets would not only help deepen the capital markets, but also could diversify the funding base of the government. We take note of the staff recommendation to introduce a pension fund supervisor, which has not received sufficient support from the Parliament. We would appreciate further elaboration by staff on the reasons for the political divergence on this matter.

Faster convergence of the Paraguayan economy to high-income status hinges critically on improving the governance and educational outcomes as well as the success of the diversification efforts. We appreciate the wealth of analyses staff has put forward, including through the Selected Issues Paper on Paraguay's reform priorities, to provide actionable guidance to the policy makers. In this respect, we are encouraged by the authorities' awareness of and determination to resolve the impediments to stronger and more sustainable growth, such as heavy reliance on the primary sector, dominance of unregistered economy, tepid productivity growth, and challenges pertaining to the business climate.

Finally, in view of the upcoming evaluation by the regional AML/CFT standard setter, we encourage the authorities to expedite their efforts to strengthen their legal framework, institutional capacity, and transparency in line with the findings of the 2018 AML/CFT national risk assessment.

Mr. Psalidopoulos and Ms. Cerami submitted the following statement:

We thank staff for their comprehensive set of reports and Mr. Lopetegui and Mr. Corvalán Mendoza for their informative buff statement. We concur with staff’s assessment and policy recommendations and provide the following comments for emphasis.

We agree with staff that investing in infrastructure and human capital and promoting the diversification of the economy will be necessary to sustain growth and continue improving living standards. Prudent macroeconomic policies and favorable external developments have laid the groundwork for a long period of robust growth and remarkable economic convergence. Nonetheless, poverty remains high while the outlook for the still dominant agricultural sector has become less favorable and cannot sustain real income growth going forward.

Fiscal discipline has been strong, but tax revenue needs to be raised to create space for public investment and structural reforms. We commend the authorities for adhering to the fiscal target and spending rules in line with the fiscal responsibility law. However, as non-tax revenue projections tend to be optimistic and tax rates are relatively low, we encourage the authorities to implement measures to expand tax revenue thereby avoiding underspending on capital expenditure. In this regard, we welcome the first follow-up actions, as reported in the buff, to broaden the tax base and optimize public spending in line with the recommendations by the ad-hoc commissions established by government. We also encourage the authorities to consider staff’s recommendation to increase the share of government debt issued domestically. In addition to reducing external vulnerabilities, a larger domestic government securities market would help developing the capital market and raise funding for much needed public and private investments.

Financial regulation and supervision of the non-banking sector should be reformed and strengthened. The banking sector is adequately capitalized and relatively profitable, but lack of data on other financial intermediaries prevent assessing their soundness despite their growing share of the consumer credit market. The regulatory and supervision framework should be swiftly broadened to include non-bank credit providers as well as strengthened in line with the 2017 Financial Sector Stability Review recommendations. Moreover, we fully support staff’s recommendation to establish a supervisor for pension funds and lift limits on their investments in order to facilitate the development of the domestic capital market. In this regard, we regret that a legislative initiative along these lines has recently been rejected.

Properly designed structural reforms can greatly contribute to developing a more diversified economy and boosting productivity growth. As well documented in one of the Selected Issue Papers, Paraguay significantly lags its peers in key structural indicators. Closing the gaps could spur sustained growth and allow the country to fully reap the benefits of macro stability and low electricity costs. Staff’s analysis identifies some structural reforms that would be most effective and acceptable to the private sector. We found this analysis very helpful and encourage the authorities to consider its conclusions and prioritize transport infrastructure, the quality of education, the rule of law, and customs and trade regulations.

Ms. Pollard and Ms. Svenstrup submitted the following statement:

Paraguay has experienced rapid growth and a sharp reduction in poverty over the last 15 years due to sound economic policies and favorable commodity prices. Despite recent regional and weather-related shocks, macroeconomic fundamentals and the near-term outlook remain sound. Yet, with poverty still high, the authorities face the challenge of sustaining growth momentum in the context of less supportive conditions. To do so, the authorities must free up significant resources for infrastructure and development priorities and support economic diversification—all while retaining policy space to respond to potential external shocks. We welcome the authorities’ recognition of these challenges, as noted in Mr. Lopetegui and Mr. Corvalan Mendoza’s helpful buff Statement. While the staff report touches on key policy areas, we think that it would have benefitted from more specific policy recommendations.

Paraguay’s infrastructure and social spending needs are sizable—3-8 percent of GDP per year per the OECD. Staff highlight growth-friendly tax reform and a shift the composition of expenditures to create fiscal space, but regrettably did not delve into specific areas of emphasis (e.g., customs administration, tax evasion, etc.). What is staff's assessment of proposals included in the blueprint for tax reform due end-March 2019? What is the timing and fiscal/growth impact of the most promising proposed measures?

The ability to meaningfully increase investment spending is ultimately constrained by the binding nature of the Fiscal Responsibility Law (FRL), which caps the deficit at 1.5 percent of GDP even in the context of growth shocks. The 2017 staff report notes that the authorities were considering reforms to the FRL, including looking at the structural balance, and it would have been helpful to hear how those discussions evolved. What is staff's view on the appropriateness of the FRL given Paraguay's significant development needs and low level of public debt? Do staff see scope to allow for more spending or borrowing to fund needed investments? Although the overall level of public debt is manageable, we agree with staff that it would be sensible to increase the share of domestically-financed debt, including by allowing pension funds to invest in government bonds. Further, as the authorities explore scaling up public sector and PPP investments, we caution that robust and transparent public and corporate governance standards will be needed to safeguard fiscal sustainability, including with regards to debt, public procurement, and public investment management.

We agree that the current monetary policy stance is appropriate given low inflation. Exchange rate flexibility will continue to be a key shock absorber, and we urge the authorities to continue to limit intervention to mitigate disorderly conditions. The Informational Annex classifies the exchange rate as "crawl like" since June 2018, depreciating within a 2 percent band against the dollar. Could staff confirm whether there was an operational or policy change in the country's exchange rate management?

Structural reforms are needed to support economic diversification, develop the formal sector, and improve productivity. We welcome staff's methodology for initially prioritizing the focus of structural reform policies based on potential growth impact and domestic political support. However, the three areas selected—transport infrastructure, quality of education, and rule of law – are each multifaceted and progress may be hindered by fiscal space constraints discussed above. In this context, it would have been helpful for staff to articulate the key actionable, near-term structural policy priorities in each of these areas. Like Mr. Meyer and Mr. Buetzer, we also urge staff to consider the enabling impact of structural reforms in such prioritization exercises. For example, reforms in areas such as government effectiveness or administrative capacity may have limited direct impact, but may be necessary to facilitate broader reform implementation.

Finally, given the macro-critical significance of corruption and governance challenges, we expected a more robust discussion and concrete policy recommendations on this topic and urge staff to take this up in the next annual surveillance report.

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

We thank staff for the informative reports and Mr. Lopetegui and Mr. Corvalan Mendoza for their helpful buff statement. Paraguay’s economic progress over the past 15 years has been impressive. Driven initially by a commodity boom, growth spilled over to the non-tradeable sector, leading to a broad increase in economic activity. Underpinned by the authorities’ prudent macro-economic policies, the economy has avoided boom-bust cycles, while the public debt and the external debt have been reduced dramatically. Inflation targeting regime keeps inflation stable and low, while international reserves are maintained at a comfortable level.

Notwithstanding the impressive progress made, substantial challenges remain. The poverty rate has fallen sharply, but still is one of the highest in Latin America. Moreover, economic growth on the basis of booming agriculture cannot last long, as food prices are softening, and expansion of sowing areas is reaching its limits. While macroeconomic stability is largely achieved, the new sources of growth are needed. Therefore, we agree with staff that the authorities should focus on the diversification of the economy on the basis of increased investments in infrastructure, improved business environment, and enhanced human capital.

We commend the authorities for their prudent fiscal policies. The public debt has been reduced from 52 percent of GDP in 2002 to just 20 percent of GDP and fiscal deficit is maintained below the 1.5 percent of GDP limit established by the Fiscal Responsibility Law. At the same time, the revenue level remains low, which constrains public investment and priority social spending. We, therefore, underscore the need to boost fiscal revenue through improved tax compliance, simplification of the tax system, and reduction of exemptions. Reducing very high informality of the economy can substantially improve revenue collection. On the expenditure side, the authorities are well advised to realign spending composition to create room for infrastructure investment, education, healthcare and social safety spending while reducing other current expenditure.

We agree that a moderately expansionary monetary policy stance remains appropriate, given declining inflation, real exchange rate appreciation, tightening monetary conditions and weakening domestic demand. The inflation targeting regime should be supported by the exchange rate flexibility with limited foreign exchange interventions to mitigate excessive market fluctuations.

While the overall financial system is stable and resilient, some pockets of vulnerability still exist in some parts of the non-bank financial sector, where monitoring and supervision should be strengthened. We also agree that it is important to establish a pension funds supervisor and relax their rigid investment rules. Increasing flexibility of the pension funds' investment portfolio while strengthening their oversight would improve efficiency and facilitate the development of a domestic capital market.

In order to diversify from dependence on energy and agriculture Paraguay needs to attract investment and FDI to other sectors. The country's macroeconomic stability and low energy costs create favorable preconditions for attracting investors. It is important to improve the business climate and quality of governance, which are still considered to be relatively weak. We note ambitious legislative agenda prepared by the authorities in this area and look forward for its adoption and implementation.

With these remarks, we wish the authorities further success.

The Acting Chair (Mr. Zhang) made the following statement:

The Board will visit Paraguay sometime next month, so this discussion is quite timely, and Directors will see what is happening on the ground as a test of today's discussion.

But as Directors' gray statements noted, Paraguay has been one of the fastest-growing economies in South America, thanks to the authorities' prudent macroeconomic policies. However, to sustain this economic performance, it will be important to diversify the economy away from the agricultural sector. As widely observed in Directors' gray statements, some policies and structural reforms, including enhancing the business climate and improving governance, will be key going forward.

Mr. Daïri made the following statement:

We commend the authorities for their excellent performance over a long period, which has helped strengthen the macroeconomic and financial position and deliver stronger growth and a decline in poverty. This was largely a reflection of the sound policies followed by the authorities, but also, they had some favorable developments, particularly favorable commodity price developments. Overall, the environment now is probably less supportive both at the international and at the regional level, which requires stronger attention from the authorities to stand ready to face potential shocks. Here, the exchange rate is the first shock absorber, and the authorities are following the right track in limiting the interventions to smoothing excessive fluctuations.

I have an issue with the fiscal space assessment. The staff seems to indicate that fiscal space is low, referring in particular to the fiscal rule, and like other Directors, I wonder whether there is not some room for interpreting the fiscal rule more flexibly, or amending it if necessary, because the country has significant needs in terms of infrastructure and social spending. Revenue is low, and even the tax reform that they are expecting is not projected to increase revenues significantly. To add one year, over several years of revenue, when the revenue-to-GDP is very low already, there is probably something to do there as well. As indicated by Mr. Lopetegui and Mr. Corvalan Mendoza, the authorities are doing some good work in trying to reprioritize the spending, but it is not enough. I look forward to the staff's response to the issues raised by several Directors.

We agree with much of the staff appraisal and the suggestions, and we agree on the need to strengthen supervision of non-bank financial institutions and also the oversight of the pension system, and we encourage the authorities to do more to improve the business climate.

Mr. Saraiva made the following statement:

We issued a gray statement, so I will discuss some issues regarding the Paraguayan economy, which shows very strong fundamentals.

The fiscal situation is robust with low levels of debt. Inflation has been kept around the target, and the external sector is solid, with the current account well balanced and an adequate level of international reserves. Moreover, the Paraguayan economy has shown resilience to exogenous shocks, so it is not as if it only took advantage of favorable tailwinds. But even in the current situation, where its main trading partners are facing difficulties and not providing an impulse to the Paraguayan economy, it has performed well. This is a good aspect of the situation in Paraguay, which points to the structural challenges that the country faces. Those are probably the most important issues that need to be faced now, and I call attention to the space to raise tax revenues in order to increase investment, especially in infrastructure, but also for education, and to keep social spending at the proper level so that the country can continue to make progress in terms of reducing poverty and improving the social indicators and also increase potential growth, especially by diversifying the economy. If one looks at the risks to the Paraguayan economy, one of the most important risks is related to environmental issues. Drought, which happens maybe every three years has an important toll on Paraguayan activity, which enhances the payoff for diversifying the economy away from agriculture, which also requires improving the business climate and continuing to make progress in governance and anti-corruption. Having said that, we wish the Paraguayan authorities continued success in their endeavors.

Mr. Guerra made the following statement:

We also thank the staff for the analysis and especially the selected issues papers about the factors behind the growth in Paraguay and the different structural reforms that should be done, and I believe that this is an analysis that we should see more often. We also thank Mr. Lopetegui and Mr. Corvalan Mendoza for the buff statement.

The Paraguayan economy has been resilient because the authorities have been engaging in a fiscally prudent policy during the past two decades, and that has allowed Paraguay to grow in a steady manner above the median of the Latin American region, and also to be resilient.

I will touch on the issue of the fiscal rule. It is very important to have fiscal resilience in Paraguay as a signal to foreign investment in order to have the re-convergence of the economy into the non-agricultural sector. In this regard, we believe that if we are going to discuss the issue of the fiscal ceiling, we should be discussing the broader issue of the fiscal rule. Let me put it in a simple way.

In the paper, it is stated that there could be around 1 percent of additional income from tax revenues, and also there could be an additional 1 percent of room on the expenditure side by enhancing the way the public expenditure is done. We are talking about, give or take, 2 percent of GDP if those reforms are implemented in the following years.

The second issue that I believe we should be careful about is that this fiscal ceiling is a very good signal, and we know from the strain in our countries in Latin America that sometimes we tend to overstate income in order to have more expenditure. Increasing the ceiling at this moment could give a signal that may not be timely.

Last but not least, we should let the authorities decide how they want to handle the situation and be careful with the signal that we send in our communications regarding the fiscal rule.

The staff representative from the Western Hemisphere Department (Mr. Bakker), in response to questions and comments from Executive Directors, made the following statement:[1]

I will now respond to a number of fiscal questions that have been asked by Directors. Most of these questions focus on whether the fiscal responsibility law is too rigid and whether it should be changed. Paraguay has not gone through the fiscal boom and bust that some of its neighboring countries have experienced, and this is the result of a decade and a half of prudent fiscal policies, which began around 2004. The fiscal responsibility law was the coronation of this strategy. At the same time, however, Paraguay likely needs higher spending. For one, investment needs are large. To give one example, there is only one bridge connecting Paraguay and Brazil. Spending on education and health care likely also needs to be increased. This raises the question of should the deficit target be relaxed to allow a higher level of spending, and can we relax the deficit target without running into fiscal problems down the road? These are not easy questions.

For starters, it should be noted that general government spending has increased rapidly in the past decade from about 13 percent of GDP in 2008 to about 20 percent of GDP currently. The annual growth rate of nominal spending was about 13 percent, which is rapid. About a quarter of this increase in spending was a result of an increase in government wages by 22 percent in 2012, and 16 percent in 2015. Spending has increased rapidly, and further increases in spending will be helpful only if well managed, and this applies particularly to investment.

It should also be noted that about half of the increase in spending in the past decade has been financed by a deterioration of the government balance. This has come from a surplus of 2 percent to a deficit of about 1.5

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

percent. The deficit target has now become binding, but this is only after a significant deterioration in the past decade. If one were to adjust the deficit target, what would this mean for debt sustainability? In the long run, the debt-to-GDP ratio converges to the ratio of the deficit-to-GDP ratio and nominal GDP growth. For example, if the deficit is 3 percent of GDP, and nominal GDP growth is 5 percent, then the debt ratio will converge to 3 over 5, or 60 percent of GDP. This is precisely where the Maastricht criteria come from in this combination of a 3 percent deficit target and 60 percent debt ratio. If we apply this to Paraguay, as long as nominal GDP growth is around 8 percent, 4 percent real and 4 percent inflation, then a deficit of 1.5 percent of GDP is consistent with a debt ratio of around 20 percent of GDP. Raising the deficit target by 1 percentage point would result in a long-term debt ratio of 30 percent of GDP. If at the same time, growth would fall to 6 percent, for example, 3 percent real and 3 percent inflation, debt would converge to 42 percent of GDP, and that would no longer be low for a country at Paraguay's development stage. We see that a combination of a small increase in the deficit target and a moderate reduction in growth results in a debt ratio that is much higher.

Moreover, if we look at the current debt ratio, it is low only when measured as a percent of GDP. It is not low when measured as a percent of revenue. Revenue is not high. In fact, the current ratio of debt-to-revenue is about 120 percent. This is a level similar to that of Argentina in 2014. Moreover, the bulk of government debt is foreign-currency denominated, which increases its riskiness.

To keep debt low, the deficit ceiling cannot be raised much, too little to boost spending in a meaningful way. The main constraint on a further increase in spending is revenue. Revenue is low. Tax revenue is low not only because tax rates are low, but also because the tax base is eroded by deductions and exemptions. For example, the personal income tax yields only 0.1 percent of GDP.

Another question is, should the deficit ceiling be cyclically adjusted? In theory, yes, but there are some practical considerations.

First, the impact of the cycle on the deficit is lower than in other countries. Tax revenue is 10 percent of GDP, so 1 percent lower growth leads to an increase of the deficit by 0.1 percent of GDP only.

Second, we have had a boom of 15 years. We hope it continues, but if the economy slows down—and we noted in the report that factors that have boosted growth in the past decade are likely to provide less support going forward—it will be hard initially to distinguish a cyclical slowdown from a slowdown in potential growth. If there is a cyclical fiscal rule with an overly optimistic potential output growth estimate, one may quickly destroy fiscal buffers. In other words, having a cyclically adjusted deficit is better in theory but also increases risks that deficits will increase.

In short, fiscal rules are not perfect, but they are easily understandable, and they set a clear benchmark. They can be adjusted, but the best time to relax them may not be when they are binding. The real issue is not the deficit target. The real issue is raising revenue.

Finally, the Paraguayan authorities have indicated that there are significant risks if a revised fiscal rule is discussed and voted on by Congress. There is a chance that a draft revised law would be weakened so much that it may be better to keep the current law as it is.

Mr. Daïri remarked that he was under the impression that the approach to assessing the impact of the deficit on the debt was static. There was no mention or reference to the impact of the additional spending on growth. He remarked that the view should be updated to take account of the impact.

Mr. Meyer made the following statement:

I wanted to thank the mission chief for the elaborations. It was extremely helpful. It was broad. While not pretending that this is an easy topic, it had the dynamic element in it, because thinking about being prudent, that we sometimes overstate revenues, as the Brazilian chair has indicated. It was a good answer. It does not mean that we all agree on this way or that way forward, but it was a very good presentation.

Certainly the Board does not have a consensus view on how we look at the dynamic on the growth aspect. This chair certainly always comes across as erring on the side of caution in this regard. Others certainly come to look more at the growth side—take that risk and see more revenues.

Mr. Daïri made the following statement:

I notice the selected issues paper comparing countries in terms of convergence, and I am a bit surprised that we made a list of countries as at high or low levels of converging, not in absolute terms, but in reference to a peer group, which means that the reader would immediately see that one country is rapidly converging and another one is slow in converging. It is not based on a standard of what convergence should be for this peer group in particular, so I object very strongly to the list of countries being shown. The staff can argue that they have analyzed a group of countries that are considered rapidly converging, and this is where the countries stand, but we should not show a table where countries are classified as converging or not converging according to a very subjective and ad hoc approach to what convergence should be.

The staff representative from the Western Hemisphere Department (Mr. Bakker), in response to further questions and comments from Executive Directors, made the following additional statement:

I will start with the impact of additional government spending on growth. We fully agree that some forms of government expenditure are more conducive to longer-term growth than others. Increasing investment is definitely better than raising the wage bill. If we look at the spending composition of Paraguay, the wage bill is relatively high. The wage bill is similar to that in other countries even though the overall size of the government is much lower. Having more government spending will likely boost growth. To the extent that it boosts growth, it also yields more tax revenue. It creates further room for spending. Even if the deficit target is not changed, shifting spending from current expenditure to capital expenditure is good and may boost growth. The question is should one boost a deficit target because one thinks that extra investment will boost growth? Once again, there are tradeoffs between how cautious one wants to be. There are many examples of countries that have big investment increases, where the growth impact may take a while. If in the meantime one raises deficit targets, then one may end up with higher deficit. There is no disagreement that more investment may boost growth. This also may help the public finances, but it still may mean that it may be good to be cautious and not to count chickens before they hatch.

On the convergence question, let me explain the background. Paraguay has been growing rapidly in the past 15 years, but it has been after a period in which it was not growing so rapidly. For all countries, we would like to see their income levels converge rapidly with rich countries, and we have been noticing that there are some regions in the world where we have seen rapid convergence and other regions where there is not. Europe is a good example of rapid convergence. If one makes a chart of GDP per capita and growth between 1995 and now, there is a very steep line, so poorer countries have grown much faster and there are relatively few outliers. Europe is a great example of convergence. If we made a similar chart for the countries in the

Western Hemisphere, the slope is much weaker, and there are far more outliers. In Latin America, convergence has been very weak.

This raises the question of why have some countries converged rapidly and others have not. In this background paper, we tried to look at this issue, and in the longer-term, clearly institutions play a role. This may be one of the reasons why Europe, in particular Eastern Europe, has converged too rapidly after the abolition of communism—institutions were upgraded, particularly for countries that became EU members, and one can see the payoff in terms of convergence.

What we hope to see is the elements that are important for longer-term convergence. The paper identified a number of issues that seemed to matter for longer-term convergence, and based on that, we have made our list of recommendations.

The purpose of the paper is not at all to single out particular countries. It is to get a feel of the factors that make a distinction between why some countries converge and others do not.

Mr. Daïri made the following statement:

I heard from the staff that they consider that the Western Hemisphere countries are low converging countries, but in the list we see only Venezuela and Jamaica from the Western Hemisphere. It is a very subjective table or classification, and I object very strongly to publication of this table because it gives the wrong impression of what we are talking about.

On the point raised on the impact of investment on growth, it is disappointing that we are saying exactly the opposite of what we say in public, which is that investment in infrastructure and social spending when there is fiscal space is very good for growth. If other Directors do not agree, that is their right to say so, but it is absolutely what Mr. Meyer has said and what the staff has said here, and that is absolutely the opposite from what we say in public. We have to be transparent about how we look at the issue and not tell stories outside this Board.

Mr. Doornbosch made the following statement:

I have very high regard for Mr. Daïri, and normally he always makes very good points. In this case, I am not so sure. I highly appreciated the analysis on the real convergence. It was extremely helpful to see what factors

> had contributed in countries that had seen rapid convergence to sustainable growth, and because a list of countries is not subjective in this case, because it is just GDP per capita and in that sense quite factual, I do not see the reason why this would be problematic in this situation. I thought it was a very helpful analysis and would like to support the staff on this point.

The staff representative from the Western Hemisphere Department (Mr. Bakker), in response to further questions and comments from Executive Directors, made the following additional statement:

> This list was not subjective at all. The countries were selected according to a methodology that was specified in the paper. We looked at countries that were at a similar income level as Paraguay now and then looked at how much they have grown in the following period. then the high-converging peers are defined as the country-year combinations where the speed of the country's GDP convergence to the U.S. level in the subsequent 10-year period is higher than 75 percent of the countries in the peer group. In addition, being included in the high-converging country group requires that there has not been any relapse in the convergence if the country's convergence level at the end of the data sample is still higher than in the beginning of its high-converging period. The low-converging peers consist of the countries in the peer group that have had a 10-year convergence rate slower than 75 percent of the countries in the peer group. This is a purely mechanical exercise. There is not any judgment. We looked at countries that started at a similar income level as Paraguay to make it as relevant for Paraguay as possible.

The Acting Chair (Mr. Zhang) remarked that Mr. Daïri's concerns were not about the methodology, but rather the grouping of countries and the fact that countries were named. He remarked that management and the staff would consider whether that information should be made public.

Mr. Corvalan made the following concluding statement:

> I would like to thank the members of the Board for their insightful comments on Paraguay. I will convey the valuable information on the country's economic policies to my authorities.
>
> I also thank the mission chief and his team for their dedication and well-organized set of documents, as well as the supportive team at headquarters for their continued close engagement with the country.

The tailwinds that helped us in the past 15 years are vanishing, and the quest to sustain inclusive growth will require deeper structural reforms. Several issues rightly pointed out by Directors today—like the need to address productivity, governance, rule of law, education, health care, infrastructure, doing business, tax compliance, and more diversification of the economy—will be taken on board by the authorities. The executive branch is already working with legislators to deploy an ambitious reform agenda aimed at removing important bottlenecks that impede faster and more inclusive growth for the coming years.

Presently, conversations are underway between the government, civil society, and other stakeholders, specifically on taxation. To put this issue in context, it is worth mentioning that current tax levels in Paraguay are low, with equal rates of 10 percent for personal income tax, the corporate tax, and the VAT. These rates will most probably remain the same for a while, but reducing deductibles expenses in the personal income tax, eliminating exemptions, and equalizing VAT across sectors would allow revenues to increase.

In mid-2018, in the midst of the political transition to a new administration, the Ministry of Finance established two technical commissions with private sector participation, one on taxation and the second one on public spending. The idea was to reach a reasonable agreement on how to modernize and simplify tax collection and enhance expenditure efficiency with the purpose of proposing a new law to congress. As was recently indicated by my authorities, a good level of understanding has already been reached, and if the proposal receives positive reception in congress, we believe that the revenue intake might increase by 1 percentage point of GDP in the coming years, while savings on the expenditure side could add another percentage point of GDP.

Challenges are enormous to deploy the structural reforms necessary to enhance productivity in the county. However, the Paraguayan society embarked on this journey more than a decade ago, and with technical support from the Fund, other international and regional organizations, and development partners, good progress has been made in this area.

As is customary, reports prepared in the context of staff visits and Article IV consultations are made public. Moreover, press releases and direct contact with the media have been the norm at the end of each mission to Paraguay. Therefore, my authorities have agreed to make this report public as well.

Finally, my authorities reaffirm their dedication to improving the implementation of the inflation-targeting regime in the context of flexible exchange rate. They also reiterate their commitment to solidify fiscal discipline, which will provide space to support their investment-led growth strategy with an emphasis on human capital and infrastructure.

Paraguay is an Article VIII member and no decision is proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the Paraguayan authorities for their prudent macroeconomic policies which have contributed to rapid growth and sharp reduction in poverty. Directors considered that policy priorities ahead should focus on consolidating macroeconomic gains, reducing dependence on the agriculture sector by diversifying the economy, and enhancing productivity to attain sustainable and strong growth as well as further reduce poverty.

Directors commended the authorities' prudent fiscal policies which have reduced the public debt. However, they noted that with the deficit close to the ceiling under the Fiscal Responsibility Law it is important to take action to create further fiscal space for priority reforms and investment. Directors recommended increasing revenues, particularly by reducing exemptions and deductions, and improving tax compliance. They also encouraged the authorities to reprioritize expenditure within the existing envelope, away from current spending and toward investment in infrastructure, capital, and social spending, including in health and education.

Directors considered that the current accommodative monetary policy stance is appropriate and consistent with inflation objectives. They noted that exchange rate flexibility should continue to be a key shock absorber and that interventions should be limited to mitigate disorderly market conditions.

Directors welcomed that the banking system is well-capitalized and profitable. They encouraged continued strengthening of supervision of financial cooperatives and adopting supervision standards for the *casas de credito* and *casas comerciales*. Directors commended the progress made towards implementing the 2017 Financial Sector Stability Review recommendations and encouraged steps to further strengthen the institutional framework for interagency coordination. They underscored that further strengthening the AML/CFT framework would support financial stability

Directors encouraged the authorities to reform the pension system to ensure its long-term sustainability, seizing the opportunity that demographic trends are still favorable. They noted that resuming the effort to establish a pension fund supervisor would be an important step in this regard.

Directors noted that economic diversification and productivity growth are needed to maintain rapid growth. They considered that priority should be given to tackling corruption and strengthening the rule of law, enhancing the business climate, as well as improving transport infrastructure and quality of education.

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

APPROVAL: April 23, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Economic Outlook and Risks

1. ***We note that the report mentions in footnote p.35 that historical GDP series were revised in 2018, including a 30 percent upward revision in nominal GDP for 2017. Could staff indicate if this revision corresponds to a modification in the sectoral structure of the economy?***

- The GDP revision increased the share of the industrial sector from 12 to 19 percent and the service sector from 48 to 55 (partly due to the improved measurement of financial sector and real estate sector activities), while the share of the agricultural sector fell from 27 to 12 percent. However, the agriculture sector remains a significant driver of the economy, as much of the industrial and service sector production is linked to agriculture.

Fiscal Policy

2. ***In this context, we would like to ask if staff could provide further insights on the blue print for tax reform that was envisaged for March 2019 (cf. para 54).***

3. ***Can staff provide updates on the details of the tax reform blueprint as well as the progress of the review of public expenditure?***

4. ***Staff mentions that a commission was to propose a blueprint for tax reform by March 2019. What were the main findings in this context?***

5. ***What is staff's assessment of proposals included in the blueprint for tax reform due end-March 2019? What is the timing and fiscal/growth impact of the most promising proposed measures?***

- The submission of the **tax reform** proposals to parliament was delayed by a few weeks at the request of the private sector, which needed more time to study the proposals in detail. The current proposals include a simplification of the corporate income tax, by merging it with the agricultural income tax. Personal income tax rates will be maintained at their current levels, but tax deductions for personal expenditures will be curtailed. However, there is not yet a consensus in the Committee about the extent to which deductions will be curtailed. Increases of taxes on alcohol, tobacco, and high-end luxury items are still being negotiated. To sort out remaining differences and reach consensus, a final meeting between the Committee and the President is scheduled for this week.

- Regarding the **expenditure review**, the time line to prepare a proposal is end-June 2019. One of the most promising areas for efficiency gains is a reform of the system of purchases of goods and services. Studies estimate that the scope for efficiency gains is about 1 percent of GDP.

6. ***Has staff engaged with the authorities on a possible strengthening of their fiscal rule?***

7. ***Against this background, and considering the overall sound macroeconomic framework, did staff assess the potential impact of a flexibilization of the FRL ceiling?***

8. ***We appreciate staff views on how rigid is the Fiscal Responsibility Law, especially given the large spending needs for public investment to boost growth and satisfy social spending priorities, particularly in health and education.***

9. ***What is staff's view on the appropriateness of the FRL given Paraguay's significant development needs and low level of public debt? Do staff see scope to allow for more spending or borrowing to fund needed investments***

10. ***We tend to concur with staff in that the legal ceiling on the fiscal deficit (i.e. at 1.5 percent of the GDP) could unduly limit the authorities' room to buttress growth, as needed, and therefore, wonder whether there was a discussion with the authorities to introduce counter-cyclical elements to the fiscal rule.***

- Staff will respond to these questions during the Board meeting.

11. ***Moreover, we note on the report that "Paraguay has a history of overly optimistic nontax revenue projections". Could staff elaborate on the reasons of this overestimation?***

- Overly optimistic nontax revenue projections are a legacy issue. In the past, Congress tried to raise public expenditure by adding artificially high estimates for "nontax revenue" to the proposed budget. In the execution of the budget execution, the Ministry of Finance would then adopt a financial plan that curtails expenditure relative to the budget. With the adoption of the FRL, the budgetary process has improved and become more realistic, but there is still a legacy effect from the past.

External Sector

12. ***Have staff considered the impact of the US-China trade negotiation on Paraguay in terms of export substitution of soybean?***

- To the extent that China buys fewer soybeans from the United States, Chinese demand for soybeans from other countries will increase. This was clearly visible in early 2019, when Chinese soybean imports from Brazil increased sharply.

- Paraguay benefits from higher demand for non-US soybeans from China. Higher soybean exports from Brazil are met in part by higher soybean imports from Paraguay.

- It should be noted, however, that total Chinese imports of soybeans have been falling this year. Imports for the first three months of 2019 came to 16.75 million tons, down 14.4 percent from the same quarter last year. Demand for the oilseed is under pressure as an epidemic of incurable African swine fever spreads across China, killing pigs and stopping farmers from replenishing herds.

13. ***Could staff confirm whether there was an operational or policy change in the country's exchange rate management?***

- There has been no change in the country's exchange rate management. Paraguay's currency moves broadly in line with other commodity exporters in the region, and there has been significant exchange rate flexibility in both directions. During the 2000s when commodity prices increased, the guarani appreciated vis-à-vis the dollar; in recent years when commodity prices have been under pressure, there has been a depreciation.

Monetary Policy and Financial Sector

14. ***We would like to ask staff's assessment of the authorities' efforts toward de-dollarization.***

- As discussed in the 2017 AIV report, Paraguay experienced a gradual decline in dollarization in the 2000s as macroeconomic stability improved, inflation declined, and the guaraní appreciated vis-à-vis the dollar. In recent years, the share of dollar deposits and loans has remained stable, despite the depreciation of the guarani vis-à-vis the dollar.

- Much of dollarization is the result of dollar-denominated borrowing by the agricultural sector. This sector borrows in dollars because a) most of its export revenue is in dollars; and b) the machines it imports are paid in dollars) and c) dollar loans carry a lower interest rate than guarani loans.

- Further progress on dollarization will necessitate a narrowing of the spread between interest rates on dollar loans and guarani loans, and a realization by the agricultural sector that borrowing in dollars does not provide a hedge. The real risk for the agricultural sector is not what happens with the exchange rate but what happens with agricultural commodity prices.

15. ***Can staff clarify if financial stability issues remain since the previous credit boom episode and if authorities have adequate tools to manage any vulnerabilities?***

- Further strengthening of supervision of the banking system (including by making supervision risk-based) and introducing similar standards for the ***casas de crédito and casas comerciales*** would help mitigate incipient vulnerabilities.

- Credit growth has resumed but is not growing at the same rates as during the boom years. A larger risk would be a sharp decline in commodity prices, which would affect bank loans to agriculture.

- The spectrum of the macroprudential tools to manage financial vulnerabilities is still narrow. However, staff analysis suggest that higher policy rates would help reduce credit growth, if needed.

16. ***Can staff provide more information on the importance of the intermediation activities of casas de crédito and casas comerciales and the general thrust of the BCP study in regulating these entities?***

- The activities of the ***casas de crédito and casas comerciales*** are mainly centered on instalment credit and micro-finance. Based on information collected by the BCP, their current size is around US$570 million (3 percent of total banking sector assets).

- There is no systematic data collection, except for the recent attempt by the Financial Intelligence Unit (SEPRELAD) to register a handful of large borrowers from the sector and acquire the list of entities operating in this segment of the financial system.

- The BCP is very keen to start supervising this sector once the scoping work on collecting the data of transactions and interconnectedness of the sector is completed.

17. ***We would like to hear staff's views on banks' ability to assess the creditworthiness of firms and the efficiency of overall credit allocation.***

- The agriculture sector is the primary client for the banks in Paraguay. The banking sector has a long tradition of lending to agriculture and is experienced in assessing the creditor risks in that sector. The downside of the banks' close tie with the traditional sector is that banks have less incentive to explore new lending opportunities to emerging industries, which affects financial inclusion and the dynamism of credit allocation.

18. ***We note staff's finding that the effectiveness of the AML/CFT framework will depend on increased efforts to fight corruption. Could staff inform on work underway to this effect?***

- Reducing corruption and improving governance is very important. It will be the main topic of next year's Article IV consultation.

19. ***Regarding the financial soundness indicators, can staff comment on the reasons behind the increase in the FX position/equity from 9.6 in 2017 to 17.3 in 2018?***

- This was partly the result of a drop in FX deposits. The banking regulation has clear limits on the FX open position for banks (10 percent of capital for negative positions, and 20 percent of capital for positive positions). The current NOP level is within those limits.

Structural Reforms

20. ***In staff's view, which additional elements should be also given prominence in the authorities' reform agenda?***

- As discussed in the Selected Issues paper, the authorities should also focus on improving the rule of law, customs and trade regulation, and government efficiency in their reform agenda. These areas, as indicated by surveys of private firms, are the main constraints of doing business in Paraguay. Improving the rule of law, in particular, is shown to have one of the highest impacts on growth, in additional to the quality of infrastructure and education. Increasing the quality of rule of law to the average level of other high-growth peer countries is estimated to boost the rate of economic convergence for Paraguay by close to 2 percentage points a year.

21. ***The perspective of reforms in the South American trade bloc may significantly impact the Paraguayan economic diversification strategy. Staff's comments would be welcome.***

- Staff agree that developments in Mercosur policies can have an economic impact in Paraguay. So far, most of the exports from emerging industries go to neighboring countries. To the extent that trade openness in the region would be increased, Paraguay would become more attractive for investment from countries outside Mercosur.

22. ***Can staff provide information on initiatives of authorities to promote the country to foreign investors, including for example the establishment of an investor relations office?***

- Paraguay has worked hard in recent years to promote the country to foreign investors. For example, in an effort to put Paraguay on the map, the government started issuing sovereign bonds in 2013. In addition, the Ministry of Industry and Commerce has a unit that is responsible for investment promotion and investor relations.

23. ***Could staff comment on Paraguay's progress towards achieving SDGs? Relatedly, is there an assessment of environmental risks that may impact growth perspectives in the long run?***

- On SDG goals, Paraguay has achieved the SDG goal on poverty and is on track to meet the goals on clean energy and clean water. For the other goals, while progress is being made, challenges remain.

- To reach the goals of the 2030 Agenda for Sustainable Development, Paraguay formed a commission in 2016 to implement and monitor the country's progress with the SDGs (ODS Paraguay 2030 Commission). Paraguay has also developed, together with the Office of the United Nations High Commissioner for Human Rights, the Monitoring System for Recommendations (SIMORE), a public online platform that reports on the implementation of international recommendations on SDGs.

- To improve the institutional framework for achieving the SDGs, Paraguay has also created the Inter -institutional Coordination Commission for the implementation, follow-up and monitoring of the international commitments assumed by the country within the framework of SDGs. For more details on the progress on achieving SDGs, please refer to the progress report:

- The World Bank has done extensive analysis on the environment risks to agriculture in Paraguay.[2]

24. ***We were wondering if staff has discussed ways to actively address informal economic activity?***

- One of the main problems with informality is that many workers are not registered at the social providence institute (IPS). We have discussed the issue with IPS, and they are undertaking renewed efforts to improve compliance by small and medium enterprises to register their employees.

- The authorities have also implemented a new law to simplify the process for registering new businesses.

25. ***We take note of the staff recommendation to introduce a pension fund supervisor, which has not received sufficient support from the Parliament. We would appreciate further elaboration by staff on the reasons for the political divergence on this matter.***

- The authorities' attempt to establish a pension fund supervisor last year met resistance with the public based on historical experience in the 1990s when the public pension funds faced losses due to a lack of legal safeguards. A strict legal asset allocation rule was then introduced, but without any supervision and oversight. The fears of a repetition of this episode of the 1990s were revived as the pension supervision law was discussed last year in Congress. The authorities have explained to us that this is largely a communication issue, and that they intend to re-introduce a new bill with more explanation and preparation.

Climate Change

26. ***Given the reference to more elevated climate change related risks in the buff of Mr. Lopetegui and Mr. Corvalan Mendoza, we were wondering if staff could briefly***

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[2] http://documentos.bancomundial.org/curated/es/105821468332711721/An%C3%A1lisis-de-riesgo-del-sector-agropecuario-en-Paraguay-identificaci%C3%B3n-y-priorizaci%C3%B3n-de-los-riesgos-agropecuarios

comment on how the country is exposed to such risks and if staff considers discussing such risks in greater detail in the future.

27. ***Does staff consider climate-related events to be macro-critical in the case of Paraguay? Is compliance with the Fiscal Responsibility Law realistic given the expected impact of a possible weather-related shock?***

- Like many other countries, Paraguay is indeed vulnerable to the impact of climate change. The country has a subtropical to temperate climate with southern hemispheric seasons characterized by wet summers between December and January and dry winters from June through August. The mean annual temperature is 23.5°C with geographical variation between the warmer western regions and cooler eastern regions of the country.

- Weather-related shocks have an economic impact in Paraguay in that they affect the production of agriculture and electricity, the two main exporting sectors of the country. El Niño Southern Oscillation influences inter-annual weather patterns in the country. El Niño years are associated with anomalous precipitation in mid spring and autumn and humid summers that are particularly pronounced in the east and lower Chaco. Paraguay also experiences occasional heat waves in the summer, frosts in the winter, and flooding events associated with El Niño.

- As regards climate change, so far, the temperature of the coldest month has increased in recent years to 18.37°C in 1991-2016 from 18.13°C in 1901-1930. To the extent that climate change increases the frequency of negative weather events, economic performance would be affected.