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February 10, 2021

Statement by Mr. Merk and Mr. Fragin on Paraguay
(Preliminary)
Executive Board Meeting
February 12, 2021

We thank staff for its informative set of reports and Mr. Chodos and Mr. Corvalan Mendoza for their helpful Buff statement. We agree with the thrust of the staff appraisal. The pandemic hit Paraguay after more than two decades of high, albeit – due to the dependence on the agricultural sector and frequent weather shocks – volatile growth. Paraguay has also experienced a fast reduction in poverty rates. Low hospital capacity caused authorities to respond with an early lockdown, which included an almost year-long closing of schools. Due to its young population and the strict measures, Paraguay has experienced one of the lowest death tolls in the region. In the second half of 2020, restrictions were lifted and economic conditions indicators started to increase but so did the numbers of infections and deaths. An escalation of Covid-19 case numbers would put the recovery at risk.

Paraguay's past focus on macroeconomic stability allowed for a forceful reaction to the pandemic. The authorities responded by combining a 325-basis points reduction in the central bank policy rate with targeted social spending measures and increased public investment. Supported by a USD 274 million RFI and other external financing, the overall budget deficit rose to about 6.5% of GDP in 2020. Over the medium term, it will be crucial to find the right balance between fiscal consolidation – which may include higher tax revenues – and maintaining public investment to foster potential growth. We join staff in encouraging the authorities to return to the deficit ceiling of the (reformed) Fiscal Responsibility Law by 2024 while at the same time meeting the financing needs for education, infrastructure and poverty reduction. This will also require broader reforms, given that Paraguay's indicators on governance, the business climate as well as the development of human capital lag behind some other countries in the region, as noted by staff.

In order to lock in the broadly shared welfare gains of the past two decades and to reduce volatility, Paraguay would need to diversify its economic structure and reduce

its dependence on agriculture. We agree with staff that potential windfall gains from the end of debt service for the Itaipú hydroelectric plants and a newly negotiated agreement with Brazil about the plant's operation and revenue distribution should not be viewed as a shortcut towards higher living standards. We encourage the authorities to make full use of the economy's comparative advantages and ensure growth-friendly conditions for investments in new sectors. In this context, we note that staff [in the Selected Issues paper] suggests expanding varieties within agricultural products and primary materials, while also focussing on manufacturing of machinery and equipment to reduce reliance on electricity exports.

We take note of the significant share of FX-denominated public debt. Staff notes that the government has issued bonds in January 2020 worth USD 450 million succeeded by another USD 1 billion in April. For 2025, staff projects that about 86% of government debt will be in foreign currency, up slightly from about 80% in 2017. In this context, we recall that, in the 2019 report, staff recommended reforms in the financial sector to enable more domestic financing of government debt. *We kindly ask staff to elaborate on "the constraints on external borrowing put in place by congress" (para. 10) and to comment (i) on potential vulnerabilities of the government finances as well as (ii) on the potential need for reform to replace some of the FX-denominated debt through funds raised in domestic currency.*