

Concluding Statement by an IMF Article IV Staff Mission to Paraguay

December 12, 2013

An International Monetary Fund (IMF) mission visited Paraguay during December 2-12 for discussions with government officials, the private sector, the donor community and other stakeholders, as part of the IMF's annual Article IV consultations with its member countries. At the conclusion of the visit, mission chief Ugo Fasano issued the following statement:

Paraguay has strong economic fundamentals—low debt, sizeable official reserves, and a manageable fiscal deficit. The main challenge ahead is to improve social and economic development, which has lagged behind the region amid widespread structural weaknesses. The authorities have crafted a good economic plan and have made a solid start by enacting important pieces of legislation. Implementation of the legislative and economic reform agenda, particularly in the context of a less favorable external environment and longstanding institutional weaknesses, will be critical.

The government's economic plan would help buttress Paraguay's growth potential and reduce poverty over the medium term. This plan rightfully focuses on fostering investment in infrastructure, improving the business climate, modernizing the public sector, and maintaining fiscal prudence. In support, the central bank will remain focused on maintaining stable, low inflation within an inflation-targeting (IT) regime, while further strengthening financial supervision in line with international best practices. If fully implemented, these reforms together with sustained macroeconomic stability could lead to higher investment though, at this stage, it is debatable by how much and how fast it can be executed, given a softer external environment and weaknesses in institutional capacity. So far, indications of interest by local and foreign investors have been encouraging.

A brisk economic expansion is expected to continue over the medium term, amid low inflation and fiscal and external deficits (Tables 1 and 2):

- **Growth.** After contracting by 1.2 percent in 2012, activity grew by 14.9 percent (y/y) in the first three quarters of 2013, as agricultural output recovered from last year's drought. While economic activity might have slowed somewhat recently (in part a reflection of rising smuggling from Argentina), the mission still expects overall 2013 growth to remain robust at 12.7 percent, with non-agricultural output growing by 5.2 percent, slightly above potential. Real GDP is projected to expand on average by about 4.5 percent in the period 2014-18 given robust agriculture and livestock sectors and expected higher investment in export-oriented industries and infrastructure (overall investment would increase by about 4.0 percentage points of GDP over the period).
- **Inflation.** Higher food prices, notably meat, have been pushing inflation up during much of 2013, with accumulated headline inflation reaching 3.7 percent in the period January-November. End-2013 inflation should be slightly above 4.0 percent, and hover at about the central bank's target rate of 5.0 percent next year and over the medium term.
- **The central government deficit.** The mission expects the fiscal deficit to stay low over the medium term in line with the ceilings imposed by the fiscal responsibility law, keeping the

current low debt, broadly stable in percent of GDP. Given past under-execution of capital spending, we estimate a deficit of 1.8 percent of GDP in 2014—just 0.1 percentage points above the 2013 estimated outcome. The deficit will likely decline over the medium-term to about 1.0 percent of GDP, as a result of rising tax collection—though less rapidly than envisaged by the government given tax and customs administration resource constraints—and restrained growth in current primary spending, in particular the wage bill. This would imply a broadly neutral fiscal stance in the coming years. Deficit financing will be provided by foreign sources (multilaterals) and in a lesser extent through domestic debt issuances.

- **The external current account balance.** Despite continued real effective appreciation of the guaraní, buoyant agricultural and meat exports would cause the current account surplus to widen to close to 1.0 percent of GDP by the end of 2013. However in 2014, the current account will likely swing to a deficit of about 0.8 percent of GDP, owing to some softening in soybean and beef prices even as volumes expand further. Over the medium term, private sector net savings would contribute to maintaining the current account deficit low at about 1.0 percent of GDP, despite negative public sector net savings and some projected deterioration in Paraguay's terms of trade. The expected increase in foreign direct investment (FDI) in response to the development strategy would keep official reserves at a relatively high level through 2018 (equivalent to over four months of imports).

Overall, the risks to the outlook are balanced. The main downside risks stem from possible lower regional growth, negative price shocks to Paraguay's main commodity exports, tighter global financial conditions, and/or internal disruptions related to weather and labor and other supply bottlenecks. Upside risks include faster than expected progress on the implementation of the government's reform agenda. Supply constraints, coupled with possible increases in food and administrated prices, pose an upside risk to inflation.

Against this background, the mission discussed with the authorities policies to: (a) manage shocks and maintain macroeconomic stability; (b) cement stability via strengthened fiscal, monetary and financial policy frameworks; and (c) promote strong, sustainable and inclusive growth.

A. Managing shocks and maintaining stability.

While macroeconomic policies have been broadly appropriate in 2013, it would be prudent to move to a neutral monetary stance in the short-term. In light of inflationary pressures, brisk credit growth, and expected robust economic activity, the mission welcomed the recent policy rate increase bringing it closer to the estimated neutral real interest rate of about 2 percent. As this may increase the central bank's quasi-fiscal deficit, which has already reached about 0.6 percent of GDP in 2012 from 0.3 percent in 2010, we would recommend increasing the remuneration rate on the recapitalization bonds, which currently pay only 0.25 percent per year. Fiscal policy is expected to remain broadly neutral anchored on the rules established in the fiscal responsibility law.

Exchange rate flexibility and monetary policy remain the first line of defense against potential external shocks. Despite low public debt, active fiscal policy should be a last resort in the face of potential shocks and designed such that it does not reduce future budget flexibility (as was the case in 2012 with the large increase in the wage bill). Strong fundamentals and greater exchange rate flexibility provide the government with better buffers to cope with these temporary external shocks than in the past.

Although the banking sector remains sound, closer monitoring is warranted if credit growth increases further.. The banking sector has continued to show adequate profitability, liquidity and capitalization in 2013. After increasing since 2008, non-performing loans (NPLs) have remained relatively stable over the past year at about 2.3 percent as of September, which is below regional levels. However, in a relatively short period of time, credit to the private sector, including consumer loans, has doubled in percent of GDP since 2007-08, reaching 34 percent in 2013, rising faster than in other countries in the region.

B. Cementing sound fundamentals.

Fiscal framework

The mission welcomed recent significant improvements in the fiscal framework. The fiscal responsibility law should reduce fiscal policy uncertainty. In addition, efforts to broaden the tax base—through a revised tax on agricultural profits and generalized VAT along with a new personal income tax—will add much needed revenues to maintain fiscal sustainability over the medium-term in light of rising social expenditures. The laws on public-private partnerships (PPPs) and joint ventures may improve the quality of investment, ease financial constraints, and foster private sector participation in infrastructure projects.

Nonetheless, the mission encourages the authorities to continue their efforts in further strengthening:

- *The fiscal rule:* As the government gains experience with the fiscal responsibility law, it would seem appropriate to expand the coverage of the deficit rule beyond the central government; making the triggers to invoke escape clauses more specific; and improving the reporting requirements to encourage public accountability and transparency. The mission expects that the issuance of the regulations of the law will clarify some of these issues.
- *Public financial management:* Strong budget institutions are needed to further enhance the credibility of fiscal policy and improve the quality of spending. To this end, strengthening budget design, control and monitoring, with a stronger emphasis on results, and adopting a medium-term expenditure framework should be a priority, as much as mobilizing additional resources. It is also important to efficiently use limited public resources, with the Treasury moving from the present system of cash rationing to a modern cash management system. The mission welcomed the recently enacted state financial administration modernization law that establishes a Treasury Single Account and opens the possibility to issue short-term government debt.
- *Public investment management, planning and regulatory capacity* needs to be strengthened to increase the execution rate of projects and ensure that PPPs provide high-quality infrastructure services efficiently. PPP projects should be included in the national public investment system (SNIP), and the regulation of the law must provide clear guidelines for the specification, renegotiation and termination of contracts in line with international best practices. The mission conveys with the authorities that initial emphasis of PPPs should be on sound projects that address clear bottlenecks in transportation and power infrastructure, as they are likely to have high economic rates of return. In addition, it would be important to aim at transparent fiscal

accounting and comprehensive disclosure of all fiscal contingencies related to the ongoing initiatives to encourage private sector participation in infrastructure and other public projects.

- *Tax policy and revenue administration:* Despite some progress over the past decade, tax collection efforts remain relatively low (estimated at about 51 percent of its potential vis-à-vis a regional average of 71 percent). Thus, implementation of new information systems, improved taxpayer controls via database crosschecks and the use of risk management systems are urgently required to improve revenue administration. The mission encourages the authorities to raise the VAT on financial services from its current 5 percent to the 10 percent general rate, and complete as soon as possible the assessment of property values to further increase revenue. Fund technical assistance (TA) recommendations in these areas provide an adequate reform guide.
- *Pension reform* could reduce potentially large fiscal liabilities, improve national savings, and foster the development of domestic capital markets. The mission welcomed efforts underway to draft new framework legislation and establish a pension regulator.

Monetary framework

The mission congratulated the authorities on the significant advances made in implementing an inflation-targeting (IT) regime. The BCP has taken several important steps, including the publishing a bi-annual inflation report, implementing a new Real Time Gross Settlements (RTGS) payments system, as well as refining its liquidity management and forecasting framework, and monetary policy instruments. Additional advances would help achieve the BCP's goal of moving to a full-fledged IT regime, including developing an active money market by increasing the predictability of its operations and available instruments. Continuing with a market based process of financial de-dollarization would further enhance Paraguay's monetary policy framework. In particular, well designed macro-prudential rules could be used to reduce foreign exchange risk and further entrench a de-dollarization process.

The mission welcomed recent steps taken by the central bank to establish a foreign exchange (FX) intervention policy that is more transparent, better communicated and more consistent with a full-fledged IT regime. The BCP has intervened in the market since last July only through its pre-announced "sales program" and indicated that it would only adjust this program to offset excessive FX volatility. As a result, the central bank has only accumulated \$16 million in international reserves since July 2013. However, to avoid affecting market expectations on the exchange rate, the mission recommends that the central bank disclose, well in advance, the size of its sale program (in addition to the nature and frequency as it currently does). This will require improved coordination and communication between the Ministry of Finance and the BCP on government's financial transactions.

Financial sector framework

The supervisory-regulatory framework of the banking system has undergone major improvements in recent years. The mission welcomes ongoing efforts to align bank and BCP legislation with international best practices in risk-based supervision and prudential norms. Moreover, efforts are also needed to improve the availability of credit information on borrowers, and to strengthen the bank supervisor's loan classification system. The mission welcomed efforts underway with Fund TA

to migrate to international accounting standards (i.e. IFRS) for banks and in supervisory reporting. The supervisory approach and soundness of cooperatives are expected to strengthen as a result of new legal requirements (e.g., increased capital adequacy and provisioning) to be enacted early next year. This, in turn, would make possible setting up a liquidity assistance facility and a deposit insurance scheme for cooperatives, in line with the 2010 FSAP update recommendations.

The authorities' anti-money laundering plan (AML/CFT) launched in June 2013 needs to be activated as soon as possible. There are legal and operational shortcomings in controlling the cross border physical transportation of cash and bearer negotiable instruments while corruption continues to be a serious obstacle for effective actions. In this context, the authorities' agreement with the Central Bank of Brazil on measures to control cross-border cash flows is a welcomed advancement. Additional Fund TA is available to support the authorities as they continue to implement the plan.

C. Achieving development goals.

Paraguay faces widespread structural weaknesses that have hindered productivity and growth potential. These include poor quality of infrastructure, education and the legal system. In fact, the country ranks relatively low in the *World Economic Forum's Global Competitiveness Index* (119/148) and the *World Bank's Doing Business Indicators* (109/185). The authorities' reform agenda rightly targets key areas to lift productivity, a key driver of long-term growth prospects and sustainable improvements in living standards. Growth prospects could improve further if structural reforms deepen and/or expand to other areas.

Labor market inefficiencies, in particular, will have to be addressed to support the development strategy. The large informal sector in Paraguay has hindered productivity and overall economic growth. To some extent, this informality has flourished given labor market institutions that are weak by international standards, with structural rigidities linked to hiring and firing practices and redundancy costs. Efforts to increase female labor force participation—a large part of the informal sector—and to improve the quality of training would also help raise productivity and lower poverty.

Civil service and public enterprise (PE) reforms are needed to improve efficiency and cost effectiveness. The civil service should seek to attract and maintain qualified personnel at a competitive salary while at the same time opening the fiscal space to increase essential social and infrastructure spending. PEs play an important role in key sectors, and increasing their efficiency can help ease constraints their capacity to invest. Thus, the government should continue improving public enterprise monitoring and performance and consider increasing water and electricity rates and eliminating the general diesel fuel subsidy—while including targeted safety net measures to ensure that the most vulnerable are protected. In addition, it would be crucial to establish a long-term development plan to make sure that PEs can accompany the robust growth outlook, particularly in the energy sector, to avoid bottlenecks.

The mission commended the government's focus on reducing poverty. While sustained strong economic growth is no doubt an essential condition for reducing poverty, the mission welcomed the holistic approach that the government is implementing to tackle several key dimensions of poverty: *vulnerability* (social safety nets through conditional cash transfer programs and targeted

subsidies), *social exclusion* (increase access to basic services such as schooling, health, safe water and sewerage, and electricity) and *economic exclusion* (expand opportunities to increase earnings, such as by improving rural roads and enhancing small-scale farmers' earnings). To succeed, assuring the long-term sustainability of all these initiative will be crucial.

Finally, the IMF mission would like to thank the authorities, private sector representatives, the donor community and other stakeholders for their cooperation and a very open and fruitful dialogue.

Table 1. Paraguay: Selected Economic and Social Indicators

I. Social and Demographic Indicators							
Population 2012 (millions)	6.6			Gini index (2011)		52.0	
Unemployment rate (2012)	4.9			Life expectancy at birth (2010)		72.3	
Percentage of population below the poverty line (2011)	32.4			Adult illiteracy rate (2011)		4.7	
Rank in UNDP development index (2012)	111 of 186			GDP per capita (US\$, 2012)		3,730.2	
II. Economic Indicators							
	2008	2009	2010	2011	2012	Est. 2013	Proj. 2014
(Annual percentage change, unless otherwise indicated)							
Income and prices							
Real GDP	6.4	-4.0	13.1	4.3	-1.2	12.7	4.8
Nominal GDP	16.3	-2.0	20.0	14.6	0.0	15.6	9.3
Consumer prices (end of period)	7.5	1.9	7.2	4.9	4.0	4.2	5.0
Nominal exchange rate (Guarani per U.S. dollar, eop)	4,945.0	4,610.0	4,573.8	4,439.9	4,288.8	4,430.3	...
Monetary sector							
Currency issue	15.0	11.3	18.5	11.6	17.5	19.4	10.1
Credit to private sector	62.0	21.4	37.3	25.8	15.8	16.4	12.6
Liabilities to private sector	42.4	24.9	19.2	19.4	14.1	20.2	14.1
External sector							
Exports (fob)	29.7	-20.3	35.1	20.7	-7.8	16.0	5.9
Imports (cif)	44.7	-23.6	44.7	22.9	-5.8	10.1	9.5
Terms of trade	3.3	-3.0	8.2	14.3	-10.2	-7.0	-9.1
Real effective exchange rate 1/	16.3	-7.4	2.8	13.4	-0.3	4.8	...
(In percent of GDP, unless otherwise indicated)							
Current account	1.0	3.0	-0.3	0.5	-1.0	0.9	-0.8
Trade balance	5.7	7.1	4.3	3.5	2.2	4.5	3.0
Exports	52.5	48.7	50.6	52.3	46.7	46.8	46.7
Registered	24.1	19.9	21.9	22.8	20.3	24.6	24.7
Energy	10.5	12.0	9.5	9.4	8.9	7.6	7.4
Unregistered	17.9	16.9	19.2	20.2	17.5	14.6	14.6
Imports	-46.8	-41.7	-46.4	-48.8	-44.5	-42.3	-43.6
o/w Oil imports	-7.0	-5.7	-5.2	-6.2	-6.6	-6.2	-5.9
Other (export and import of services, income, current transfers)	-4.7	-4.0	-4.5	-3.1	-3.2	-3.6	-3.9
o/w Remittances	2.2	3.3	2.7	3.0	3.0	2.5	2.2
Capital account and financial account	0.9	-0.3	1.1	2.0	1.9	1.2	0.4
General government	-0.5	0.1	0.3	-0.2	-0.1	1.8	0.4
Private Sector	1.4	-0.4	0.8	2.3	2.0	-0.6	-0.1
o/w Direct investment	1.1	0.6	1.0	2.3	1.9	1.3	1.6
Errors and omissions	-0.2	2.3	0.9	0.9	-0.9	0.7	0.0
Net international reserves (in millions of U.S. dollars)	2,876	3,817	4,165	4,971	4,983	5,801	5,664
(Stock in months of next year imports of goods and services)	4.8	4.4	3.9	5.0	4.5	4.8	4.5
(Stock over total external short term debt)	1.4	1.8	2.6	2.3	2.4	2.7	3.5
Gross domestic investment	16.4	13.8	16.2	16.2	15.4	15.3	16.0
Private sector	13.5	9.1	11.8	11.6	9.8	11.1	11.7
Public sector	3.0	4.7	4.5	4.7	5.6	4.1	4.2
Gross national saving	17.4	16.8	16.0	16.7	14.4	16.2	15.1
Private sector	11.7	13.1	11.0	10.6	10.8	14.0	13.3
Public sector	5.7	3.7	4.9	6.0	3.6	2.2	1.8
External saving (+) disavings (-)	1.0	3.0	-0.3	0.5	-1.0	0.9	-0.8
Central government revenues	15.8	17.5	17.1	17.4	18.9	17.4	17.5
o/w Tax revenues	10.7	11.6	12.0	12.1	12.7	12.1	12.4
Central government expenditures	13.5	17.5	15.9	16.7	20.8	19.1	19.3
o/w Wages and salaries	6.5	7.7	7.3	7.4	9.6	9.1	8.5
Transfers	3.1	3.7	3.4	3.6	4.4	5.2	5.5
Capital expenditure	2.4	4.1	3.4	3.9	4.8	3.3	3.4
Central government primary balance	2.8	0.6	1.6	1.0	-1.6	-1.4	-1.3
Central government overall balance	2.3	0.1	1.2	0.7	-1.8	-1.7	-1.8
Consolidated public debt (in percent of GDP)	22.8	22.5	18.6	16.2	15.9	18.7	17.4
o/w external	17.0	15.6	13.3	11.1	10.7	11.4	11.1
domestic	2.0	2.4	2.0	1.3	1.9	2.9	2.7
LRM 2/	3.8	4.5	3.3	3.8	3.3	4.5	3.6
Memorandum items:							
GDP (in billion of Guaranies)	80,735	79,117	94,934	108,795	108,832	125,771	137,504
GDP (US\$billions)	18.5	15.9	20.7	24.1	24.9	28.8	30.7

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

1/ Average annual change; a positive change indicates an appreciation. For 2013, end-September.

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

Table 2. Medium-Term Outlook

	2008	2009	2010	2011	2012	Est.		Proj.			
						2013	2014	2015	2016	2017	2018
(In percent of GDP, unless otherwise indicated)											
National accounts and prices											
Real GDP Growth (in percent)	6.4	-4.0	13.1	4.3	-1.2	12.7	4.8	4.5	4.5	4.5	4.5
Real Non-Agricultural GDP Growth (in percent)	5.5	0.5	7.2	3.7	5.0	5.2	4.8	4.8	4.8	4.5	4.5
Net private savings	-1.8	4.0	-0.7	-0.9	1.0	2.9	1.6	0.6	0.9	0.6	0.6
Gross private savings	11.7	13.1	11.0	10.6	10.8	14.0	13.3	12.9	13.9	14.2	14.7
Gross private investment	13.5	9.1	11.8	11.6	9.8	11.1	11.7	12.4	13.0	13.6	14.1
Net public savings	2.8	-1.0	0.4	1.4	-2.0	-2.0	-2.4	-1.5	-1.5	-1.4	-1.5
Gross public savings	5.7	3.7	4.9	6.0	3.6	2.2	1.8	2.9	3.1	3.4	3.6
Gross public investment	3.0	4.7	4.5	4.7	5.6	4.1	4.2	4.4	4.6	4.8	5.1
Consumer prices (end of period; in percent)	7.5	1.9	7.2	4.9	4.0	4.2	5.0	5.0	5.0	5.0	5.0
Public finances											
Central government primary balance	2.8	0.6	1.6	1.0	-1.6	-1.4	-1.3	-0.6	-0.6	-0.6	-0.5
Central government overall balance	2.3	0.1	1.2	0.7	-1.8	-1.7	-1.8	-1.0	-1.0	-1.0	-1.0
Public sector overall balance 1/	2.8	-0.8	0.5	1.4	-1.8	-1.9	-2.4	-1.4	-1.4	-1.3	-1.4
Consolidated public debt	19.0	18.0	15.3	12.4	12.6	14.3	13.8	13.8	13.7	13.8	13.7
External sector											
Terms of trade (annual percentage change)	3.3	-3.0	8.2	14.3	-10.2	-7.0	-9.1	-2.1	1.2	-0.6	-0.8
Current account	1.0	3.0	-0.3	0.5	-1.0	0.9	-0.8	-0.9	-0.6	-0.8	-0.9
Foreign direct investment	1.1	0.6	1.0	2.3	1.9	1.3	1.6	1.8	2.2	2.5	2.8
Net international reserves (US\$ billion)	2.9	3.8	4.2	5.0	5.0	5.8	5.7	5.8	6.0	6.2	6.3
Net international reserves	15.5	24.0	20.1	20.6	20.0	20.1	18.5	17.7	16.8	16.1	14.8

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

1/ Includes NFPS and the Central Bank.