



# DIÁLOGO A FONDO

El blog del FMI sobre temas económicos de América Latina

## Why 2018 Is a Pivotal Year for Paraguay

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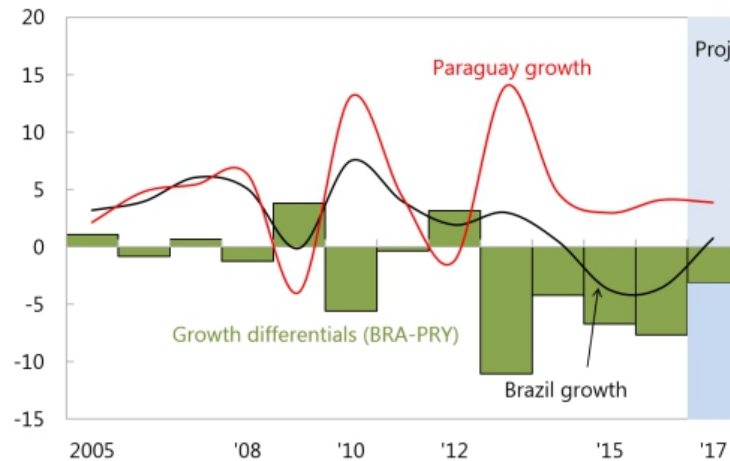
*View of Asunción city, Paraguay (photo: JTB PhotoUIG Universal Images Group/Newscom).*

Paraguay's economy continues to perform remarkably well. We recently visited Asunción to discuss economic developments, and found a small open economy that is vibrant despite large external shocks. After its two largest regional trading partners—Argentina and Brazil—fell into recession and commodity prices declined, Paraguay's growth [remained resilient](#) in 2015 and 2016. Interestingly, the Paraguayan economy did not move in line with its largest neighbor, given supportive policies, a more diversified economic base and favorable supply shocks.

## Growing apart

The Paraguayan economy is no longer moving in the same direction as the Brazilian economy.

(real GDP growth, in percent).



Source: IMF, *World Economic Outlook*.



Now, with a budding recovery underway in the region, Paraguay is poised to do even better. Our growth forecasts are likely to be revised up (by about  $\frac{1}{4}$  of a point) to slightly above 4 percent in both 2017 and 2018, led by stronger-than-expected domestic demand. This provides a window of opportunity to tackle many of Paraguay's deeper structural challenges that impede faster income catch-up with its regional peers.

The year ahead will also be important given the upcoming national elections in April 2018. A central challenge for the new administration next year will be to pursue key policy priorities that preserve the economy's enviable economic stability and further address structural barriers—such as infrastructure and education—to achieve greater prosperity and equity.

What would such a roadmap look like and what are those key priorities? This blog takes a closer look at these challenges.

### Twin anchors

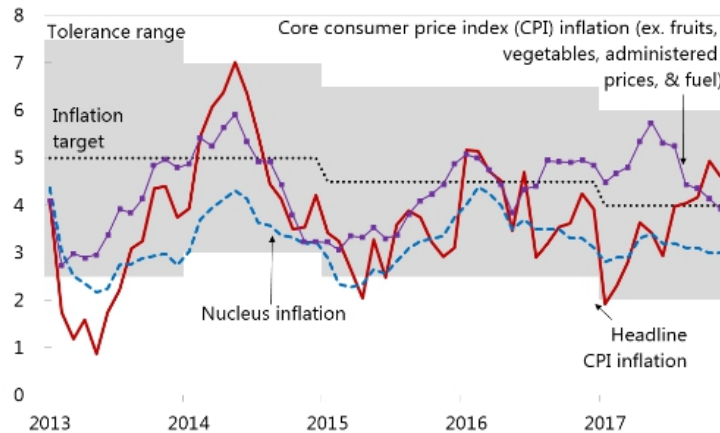
At the heart of Paraguay's success story has been a strong track record of economic stability—supported by two main policy anchors. First, *inflation targeting* has been successful in guiding monetary policy and containing inflation since it was introduced in 2011. In fact, the Central Bank of Paraguay recently lowered its inflation target to 4 percent and market expectations adjusted quickly to remain around the central bank's objective. This credibility enabled the central bank to provide needed support to growth by lowering interest rates since April 2015 in the wake of the large external

shocks—including lower soy prices and weak growth in major trade partners. With the expansion now broadening, credit recovering, and higher headline inflation, monetary accommodation should gradually be removed to safeguard the central bank’s credibility.

### Well anchored

Headline inflation in Paraguay is currently higher, but measures of underlying inflation (nucleus and core) are in line with the target.

(inflation, in percent, year-on-year)



Sources: Central Bank of Paraguay; and IMF staff calculations.

Note: Nucleus inflation is the Central Bank of Paraguay’s preferred measure of underlying (or trend) inflation.

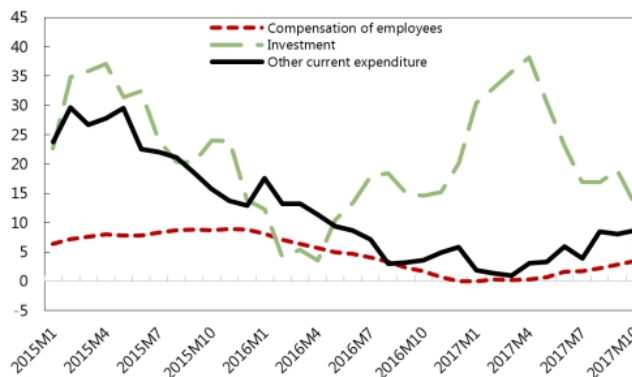


The second key policy guide has been Paraguay’s *fiscal responsibility law*—serving as an anchor for fiscal policy. In effect since 2015, the fiscal law imposes a budget deficit ceiling of 1.5 percent of GDP, which the government appears on track to meet again in 2017. At the same time, budgets have also restrained increases in current primary spending (spending excluding interest payments and investment) below the fiscal rule’s expenditure growth ceiling (4 percent in real terms). This has allowed the composition of public spending to shift desirably toward higher investment in recent years after many years of underspending in critical areas such as infrastructure. These investments should have [beneficial implications](#) for economic growth down the road.

## Under control

Paraguay is restraining current expenditure and shifting composition toward higher public investment.

(central government expenditure, annual growth of cumulative 12-month, in percent)



Source: IMF staff calculations based on authorities' data.



## Retaining fiscal discipline

Maintaining fiscal discipline under the fiscal law, however, has seen its share of challenges. As is typical, disagreements in government often arise around public spending priorities and increases in public debt. Shortcomings in the budget process, for example, were particularly evident last year, when tensions between branches of government culminated in a presidential veto of the 2017 budget.

This year, the electoral cycle and recent institutional changes on how the minimum wage is set have added to spending pressures in the 2018 budget negotiations. Proposals to significantly increase current spending (including the wage bill) risk breaching the fiscal rule's deficit ceiling and could undermine the needed shift toward higher public investment seen in recent years. Moreover, a higher deficit next year would imply unwanted fiscal stimulus during this economic upswing. Thus, adhering to the fiscal rule and preserving past budgetary trends would be instrumental in maintaining good macroeconomic performance.

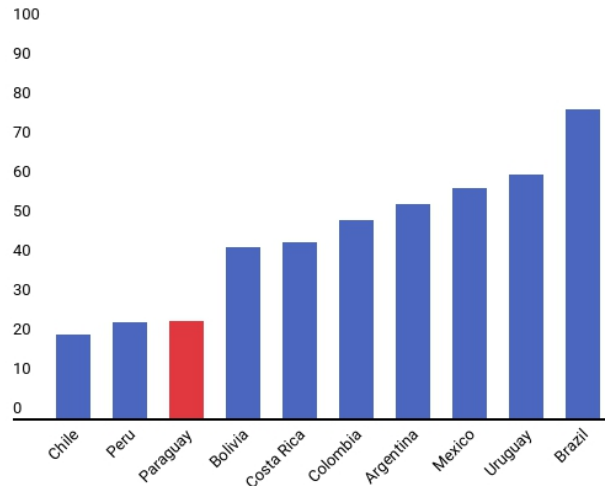
## Longer-term fiscal challenges

Looking beyond 2018, challenges include strengthening Paraguay's fiscal framework and institutions and further generating additional tax revenue. This includes efforts to improve [budget planning and control](#), as well as revisiting some aspects of the [fiscal rule's design](#). Although Paraguay has relatively low public debt compared with other countries in the region, another challenge remains convincing a wary public that the country can borrow safely and invest effectively. As discussed in previous [blogs](#), Paraguay ranks below its peers in public investment efficiency. Strengthening project selection and management, as well as public-private partnership processes, can help reap more infrastructure for each dollar spent.

### Low debt

Paraguay's debt is low compared with other countries in the region.

(debt-to-GDP ratio, in percent, 2016)



Source: IMF, *World Economic Outlook*.



On taxes, mobilizing additional revenue will be important to meet the country's priority spending needs while preserving fiscal soundness and low debt. Paraguay's tax system is characterized by low tax rates and heavy reliance on indirect taxes such as value-added taxes with low yields from personal income taxes. Value-added tax rates and personal and corporate income tax rates were set at 10 percent across the board in Paraguay's last major tax reform nearly 15 years ago. The time seems right to consider a tax reform that broadens the base, while maintaining competitive tax rates, including by reducing very generous income tax allowances and exemptions well above those of its regional peers. This would help with issues such as tax progressivity and income inequality.

### Boosting future growth

In terms of structural reforms, a central part of the policy roadmap is advancing the reform agenda outlined in the National Development Plan for 2014–30. Given the electoral cycle, efforts this year have focused on ongoing priorities—notably, infrastructure—not on new initiatives. When a new administration takes office next year, reviving the reform momentum will be crucial, including in areas such as health and education. With Paraguay recently joining the OECD's Program for International Student Assessment study, we should get a better idea of education challenges when the report's findings are released next year.

Finally, another critical area is pension reform—where a fragmented and underfunded system does not sufficiently channel national saving toward [productive investment](#). Legislative reforms on pensions would improve oversight but remain unfinished and could usefully be taken up by the next administration early in its tenure.

With an economic upswing and electoral cycle intersecting, 2018 is indeed shaping up to be a pivotal year for Paraguay.

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