



# PARAGUAY

## 2013 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE

February 2014

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2013 Article IV consultation with Paraguay, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 14, 2014, following discussions that ended on December 12, 2014, with the officials of Paraguay on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 30, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its February 14, 2014 consideration of the staff report that concluded the Article IV consultation with Paraguay.

The following document has been or will be separately released.

Selected Issues Paper

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

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# PARAGUAY

## STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

January 30, 2014

### KEY ISSUES

**Context:** Paraguay has strong economic fundamentals—low debt, sizeable official reserves, and small fiscal and external imbalances. The main challenge ahead is to improve social and economic development, while strengthening the macroeconomic policy framework to cement strong fundamentals. To address these challenges, the government that assumed office in August 2013 with a strong mandate, has proposed important reforms and made a solid start by enacting key pieces of legislation—new taxes, and private-public partnerships (PPPs) and fiscal responsibility laws.

**Prospects:** Paraguay's outlook for 2014–18 is favorable with broadly balanced risks, despite less buoyant external conditions. The economy would continue to be one of the most dynamic in the region, with growth returning to potential of about 4.5 percent a year by 2016, inflation in line with the central bank's target rate and small fiscal and current account deficits. Consistent with this outlook, a tightening in the policy stance should take place in the near term, with policies guided by the fiscal responsibility and incipient inflation targeting frameworks over the medium term.

**Cementing sound economic fundamentals:** The fiscal responsibility law provides a sound anchor to underpin fiscal sustainability but stronger budget institutions are needed to improve the quality of spending along with strengthened tax and customs administration and capacity to deal with potential risks from PPPs. Civil service and pension reforms are also needed to further strengthen the fiscal framework. The central bank has made important advances in implementing an inflation-targeting (IT) regime along with greater exchange rate flexibility. The focus should remain on steps to achieve a full-fledged IT regime and on strengthening risk-based bank supervision in line with international best practices.

**Inclusive growth:** Success in reducing poverty will depend on ensuring the long-term sustainability of initiatives underway and on increasing labor market flexibility to reduce informality as well as improved public enterprises management to bolster access to basic public services at reasonable cost.

Approved By  
**Charles Kramer**  
**(WHD) and Vikram**  
**Haksar (SPR)**

Discussions took place in Asunción during December 2–12, 2013. The staff team comprised Messrs. U. Fasano (Head), C. Pérez Marulanda, J. Rodríguez Delgado, J. Yépez Albornoz, K. Ross, Resident Representative (all WHD), and G. Horman (FAD). They were assisted at Headquarters by X. Jordan, E. Moreno and E. Tawfik (all WHD) and in the Field by V. Garay and R. Amat y León (Resident Representative office). Staff met with Minister Rojas (Finance); Minister Jiménez (Public Works and Communications); Minister Leite (Industry and Commerce); Minister Molina (Planning); Central Bank President Fernández; other government officials; and representatives from congress, the financial sector, business, donors, and think-tanks. Mr. J. Corvalán (OED) attended some of the policy discussions.

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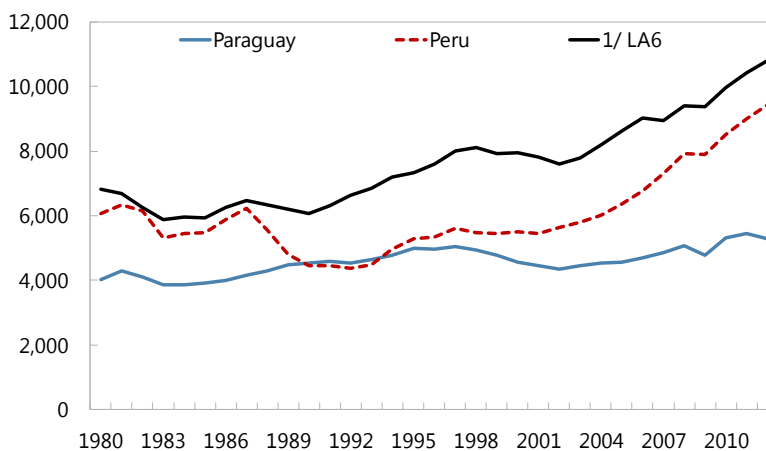
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## CONTEXT

**1. Paraguay's social and economic development has lagged behind the region.** In the late 1980s, per capita GDP peaked at 75 percent of the region's average in part due the construction of the two hydroelectrical dams, but declined to about 50 percent over the following two decades amid institutional weaknesses and large deficiencies in basic infrastructure (ports, river transportation, utilities and roads). In the 1990s, a deep financial crisis wiped out about half of the banks and per capita GDP stagnated. This situation was reversed during much of the 2000s, when the export commodity boom and macroeconomic stability brought about higher productivity and economic growth. However, limited implementation capacity and fiscal resources—reflecting a small tax base, low tax rates, and weak tax and customs administration—have continued to constrain investment and the fight against poverty and (rising) income inequality. On the positive side, the past two decades have seen the expansion of agricultural and livestock output and processed food industries—Paraguay has become the 4<sup>th</sup> and the 8<sup>th</sup> largest exporter of soya bean and meat in the world, respectively. More recently, export processing zones have attracted a rising number of companies, mainly to serve the Brazilian market.

**GDP per capita (PPP constant 2005 US dollars) 1980-2012**



Source: *World Development Indicators*; World Bank.

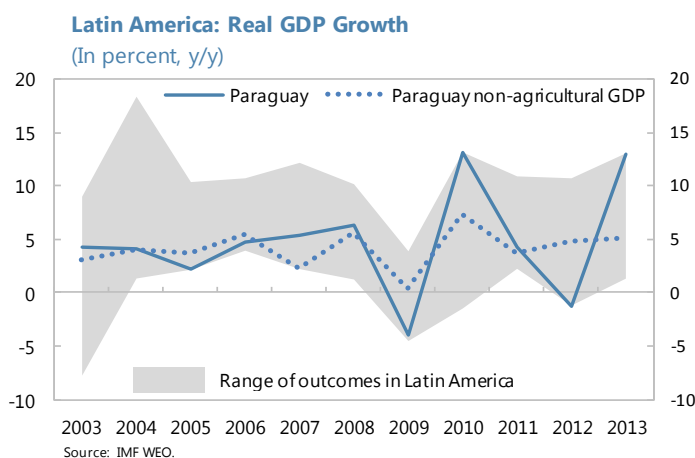
1/ Includes Argentina, Brazil, Bolivia, Chile, Peru, and Uruguay.

**2. The government's reform strategy would buttress growth and reduce poverty.** This strategy rightfully focuses on fostering investment in infrastructure and human capital, improving the business climate, and modernizing the public sector, including by curbing corruption and tax evasion while improving transparency and accountability of public resources. The private sector and foreign companies are expected to play a key role in closing the large infrastructure gap in the country. In support, the authorities will maintain fiscal discipline and stable low inflation while further strengthening bank supervision in line with international best practices.

## RECENT DEVELOPMENTS

### A. Strong Recovery along with Low Inflation in 2013

3. **In 2013, the economy recovered sharply from the previous year's severe drought.** After contracting by 1.2 percent in 2012, real GDP grew by 14.5 percent (y/y) in the first three quarters of 2013, as a result of a strong rebound in the primary sector (about 30 percent of GDP), mainly owing to higher soy output. While consumption might have slowed somewhat in the last quarter of 2013 (in part a reflection of rising smuggling from Argentina),<sup>1</sup> staff still expects 2013 GDP growth to remain fairly strong at 13 percent—the highest in the region, though the most volatile owing to weather-related shocks—with the non-agricultural sector growing around potential.



4. **Macroeconomic policies broadly supported the recovery amid low inflation.** The fiscal stimulus implemented in 2012 to counterbalance the effect of the exogenous shock in agriculture reverted to neutral in 2013 (see table on medium-term fiscal outlook). This reflected lower execution of public investment in part due to the political cycle and stricter spending controls. Last year, tax revenue increased by only 6 percent in nominal terms despite continued strong non-agricultural output growth, and the central government fiscal balance posted a deficit of about 2 percent of GDP. The deficit was financed by local bonds, though at times during the year, the government had to request short-term financing from the central bank due to limited cash availability. Public debt remained the lowest in the region at about 14 percent of GDP.<sup>2</sup> Monetary policy was on hold until December 2013, when, in view of rising inflationary pressures, the central bank raised the policy rate by 50 basis points to 6 percent—the first increase since August 2012—followed by another hike in January 2014, bringing the policy rate to 6.5 percent and monetary policy closer to neutral settings.<sup>3</sup>

<sup>1</sup> The large differential between the official and parallel exchange rates of the Argentinean peso combined with subsidies on food items in the neighboring country has led to a sharp increase in smuggling, in turn, affecting formal imports, tax collection and local food sales.

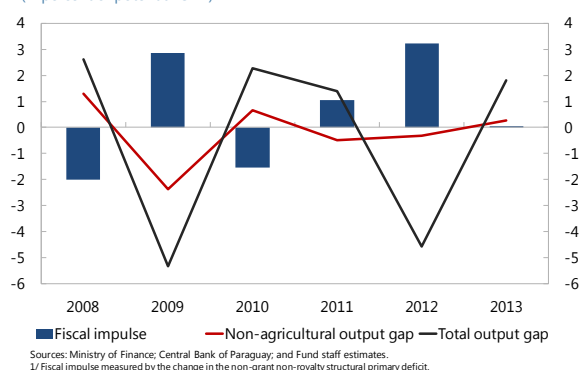
<sup>2</sup> The low public debt reflects eight consecutive years (2003–11) of fiscal surpluses averaging 1 percent of GDP a year.

<sup>3</sup> As a result of this hike, the ex post real policy interest rate reached about 2.5 percent, within the staff's estimate of a neutral real interest rate of between 3 percent and 2.2 percent (the latter estimate based on: "To Cut or Not to Cut?"

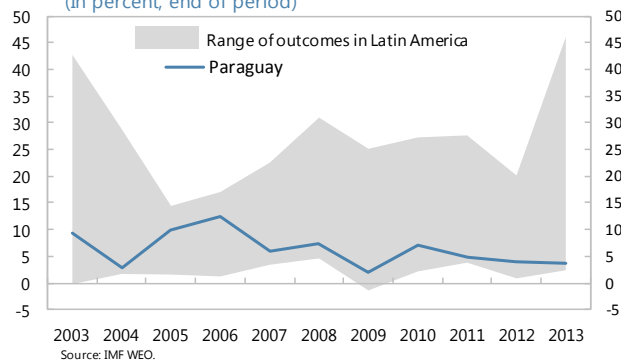
(continued)

Paraguay's inflation picked up pace during 2013 on higher food prices, but end-year inflation finished lower than expected at 3.7 percent—also below the central bank's target rate of 5 percent for the third consecutive year—in part due to a decline in beef prices and a significant increase in price competition from smuggling food and other products from Argentina favored by the weaker peso and porous border.

**Fiscal impulse and output gap 1/**  
(in percent of potential GDP)



**Latin America: Annual Inflation**  
(In percent, end of period)



**5. The current account balance switched to a surplus in 2013 owing to buoyant agricultural and meat export volumes.** The current account balance reached a surplus of almost 1 percent of GDP despite rising imports and a deterioration in Paraguay's terms of trade. As a result and despite lower net capital inflows, net international reserves (NIR) increased by almost US\$900 million to US\$5.9 billion by end-2013, exceeding a range of reserve coverage indicators. However, over half of this increase was accounted for by a US\$500 million international bond—the country's first international sovereign bond—issued in January 2013 to finance infrastructure and energy projects, along with delays in the implementation of projects to be financed by the bond. External debt has remained low at about 20 percent of GDP.

**6. The banking sector continued to show adequate profitability, liquidity and capitalization in 2013.** The total assets of the banking system have grown significantly since 2007–08 fueled by rapid credit growth, that has slowed down to about 17 percent a year in nominal terms since end-2012. Loans have remained concentrated on the agriculture and livestock sectors, which transact mainly in U.S. dollars, but loans for consumption have also grown considerably, albeit from a small base, now accounting for about 15 percent of total banks' loan portfolio. Despite the rapid increase in credit, the loans to deposits ratio has stayed below one and NPL ratios declined to 2.2 percent of total loans in November (Annex I). However, concentration ratios have continued to

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*That is the (Central Bank's) Question: In Search of the Neutral Interest Rate in Latin America* by N. Magud and E. Tsounta, IMF Working Paper WP/12/243).

increase with the four top banks accounting for 61 percent of total assets by end-2012 from 52 percent in the mid-2000s and lending rates and spreads have remained high.<sup>4</sup>

**7. Congress has supported the government's reform strategy by approving key laws.** To broaden the tax base, on top of the new personal income tax, Congress approved in October 2013 a revamped tax on agricultural income and a generalized VAT to include unprocessed agricultural products. It also recently approved a Fiscal Responsibility law (FRL) which will be applied to the 2015 budget, and Public-Private Partnerships (PPPs) and joint-venture laws to foster private sector investment in infrastructure as well as the State Financial Administration Modernization law to improve the government's cash management. Laws are being drafted to update financial sector legislation and perk up the business climate (Table 1).

**8. The authorities have broadly agreed with policy recommendations in previous Article IV consultations.** In August 2012, the personal income tax became effective, though the minimum taxable income will be gradually decreased every year through 2019 to expand the taxable base, and in 2013, the fiscal stimulus was withdrawn. The government that took office in August is implementing macroeconomic policies and long-term reforms broadly in line with Fund recommendations. Paraguay has also heavily used Fund technical assistance (TA) across all areas. Moreover, the authorities have embraced transparency in the discussions by publishing the concluding statement immediately at the end of WHD missions, including staff's views and policy recommendations, which usually receive broad press coverage.

## OUTLOOK AND RISKS

**9. The staff and authorities broadly agreed with the economic outlook and risks.** Reforms underway together with sustained macroeconomic stability will most likely lead to higher private investment. That said, it is too early to determine precise amounts, as existing institutional and structural weaknesses—difficult to overcome in the short run—constitute the main constraints to faster growth in the near term. The authorities expect that the PPPs and other initiatives will attract a large participation of the private sector and foreign companies in the government's ambitious infrastructure investment plan.<sup>5</sup> They also consider that Paraguay's cost advantage over Brazil (lower electricity rates, wages and payroll and other taxes) and access to the European market through the General System of Preferences plus Scheme (GSP+) will continue to draw export-oriented industrial investment projects into the country.

**10. Growth is expected to be in line with medium term potential output, accompanied by low inflation.** Real GDP would grow by 4.8 percent in 2014, supported by continuing dynamism in

<sup>4</sup> See Chapter 1 in the accompanying Selected Issues Paper.

<sup>5</sup> The government estimates that Paraguay needs some US\$1.2 billion (about 4.0 percent of GDP) in investment per year over the next decade to modernize infrastructure, including transportation and water and energy sectors. The Ministry of Public Works plans to tender in infrastructure projects US\$500 million in 2014, and US\$1 billion in 2015, up significantly from an annual execution level of about US\$200 million in the past years.



the agricultural and livestock sector, and an increase in overall investment (of 0.5 percent of GDP). Rising food prices and public services tariffs will most likely push inflation to the central bank's target rate of 5 percent toward end-2014.<sup>6</sup> As for the medium term, expected higher investment in export-oriented industries and infrastructure would support real GDP growth of about 4.5 percent a year in the period 2015–18, while inflation would remain in line with the central bank's target. In this scenario, the current positive output gap would gradually close, as potential output growth would moderate slightly from about 5 percent in 2011–13 to 4.7 percent by 2018 (Annex II). The authorities viewed these growth projections as reasonable for a baseline scenario amid a less benign external environment characterized by lower external demand, higher global interest rates, and a deterioration in the terms of trade.

### Paraguay Medium-Term Outlook

	Est.		Proj.				
	2012	2013	2014	2015	2016	2017	2018
(In percent of GDP, unless otherwise indicated)							
<b>National accounts and prices</b>							
Real GDP Growth (in percent)	-1.2	13.0	4.8	4.5	4.5	4.5	4.5
Net private savings	1.0	3.3	1.9	1.0	1.2	0.9	0.8
Net public savings	-2.0	-2.4	-2.8	-1.8	-1.8	-1.7	-1.8
Gross domestic investment	15.4	15.9	16.4	17.2	18.0	18.8	19.5
Consumer prices (end of period; in percent)	4.0	3.7	5.0	5.0	5.0	5.0	5.0
Output gap (in percent of potential GDP)	-4.8	2.0	1.7	1.1	0.7	0.3	0.1
<b>Public finances</b>							
Central government primary balance	-1.6	-1.7	-1.4	-0.6	-0.6	-0.5	-0.5
Central government overall balance	-1.8	-2.0	-1.8	-1.0	-1.0	-1.0	-1.0
Consolidated public debt <sup>1/</sup>	12.6	15.1	14.6	14.5	14.3	14.4	14.4
<b>External sector</b>							
Current account	-1.0	0.9	-0.9	-0.8	-0.6	-0.8	-1.0
Foreign direct investment	1.9	1.3	1.7	1.9	2.2	2.6	2.9
<u>Net international reserves</u>	<u>20.0</u>	<u>20.8</u>	<u>19.4</u>	<u>18.5</u>	<u>17.7</u>	<u>16.9</u>	<u>15.8</u>

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

<sup>1/</sup> Excludes Letras de Regulacion Monetaria (Central Bank Paper).

**11. The external current account will likely post small deficits.** In 2014, the current account balance will likely swing to a deficit of about 0.9 percent of GDP, owing to a softening in international soybean prices even as volumes of other exports (e.g. soy derivatives) are likely to expand further. Over the medium term, along with some moderate deterioration in Paraguay's terms of trade, expected stable private sector net savings would contribute to maintaining the current account deficit low at about 1.0 percent of GDP. In this baseline scenario, foreign direct investment

<sup>6</sup> The subsidy on public transportation has been eliminated as of January 2014 which will result in a 20 percent increase in tariffs and about US\$20 million in savings to the budget (slightly less than 0.1 percent of GDP). Increases in water and electricity tariffs are under consideration.

(FDI) would rise to 2.9 percent of GDP by 2018, compared with close to 2.0 percent in recent years, attracted by rising investment opportunities. This, in turn, would allow the central bank to keep the reserve coverage ratio within the recommended levels identified in the IMF's reserve adequacy metric.

**12. Paraguay's external position appears broadly consistent with medium-term fundamentals, though some model based estimates suggest a degree of real exchange rate overvaluation.** The staff's assessment that the guaraní is, on average, about 8 percent above its equilibrium level reflects largely the results from CGER's fundamental equilibrium exchange rate model for Paraguay, complemented by other indicators, such as relative prices and market share analysis (Annex III). However, after a small depreciation in 2012, the average real effective exchange rate (REER) appreciation of some 7 percent in 2013 mainly reflected the sharp bilateral nominal appreciation of the guaraní against the currencies of Argentina and Brazil, since it depreciated against the U.S. dollar and the Euro following the trend of other currencies in the region. The authorities believe that the loss of competitiveness with respect to Argentina from recent peso depreciation would be most likely temporary, as rising inflation has usually eroded these gains in the past in that country. Moreover, Paraguay maintains an important cost advantage vis-à-vis Brazil. Also, tighter fiscal settings should facilitate some rebalancing in the medium term and lower pressure on the real exchange rate. As such, the current account deficit, while widening some, is projected to remain small over the medium term, amid sizeable foreign reserves, and improvements underway in infrastructure, which should support the country's external competitiveness going forward.

**13. The risks to the outlook are broadly balanced.** On the downside, lower growth in key regional partners, specially Brazil (Box 1), hard landing in China and/or disorderly withdrawal of monetary stimulus in the United States could affect Paraguay through lower external demand and commodity prices and higher sovereign borrowing costs, while weak PPP management and/or execution of public investment could also reduce growth prospects in light of the sizeable projected pick-up in the medium-term baseline projection.<sup>7</sup> On the upside, more employment in the formal sector through improved labor market flexibility, and faster reduction of institutional weaknesses could increase growth potential. Supply constraints coupled with possible additional increases in food and administrated prices pose an upside risk to inflation. Weather-related shocks remain a looming risk in Paraguay. However, low debt, sizeable official reserves, greater exchange rate flexibility, a sound financial system, and a stronger policy framework provide the government with better buffers than in the past to cope with these shocks.

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<sup>7</sup> Although Paraguay has no capital restrictions, short term portfolio flows are practically nil, reflecting its thin domestic capital markets.

Paraguay: Risk Assessment Matrix <sup>1/</sup>

Shock	Direction	Relative Likelihood	Impact	Policy Response 2/
Sustained decline in commodity prices (triggered by deceleration of global demand).	↓	Low	High	Use exchange rate as a shock absorber; reserves could be used to avoid excessive volatility; flexible fiscal stimulus should be treated as last resort.
Protracted global financial volatility (triggered by prospective exit from unconventional monetary policy).	↓	Medium	Low	Use exchange rate as a shock absorber; reserves could be used to avoid excessive volatility. Ease of monetary and macro-prudential policies to ensure the stability of the domestic financial market.
Regional shock, including sharp slowdowns in key partners.	↓	Low/Medium	Medium/High	Use exchange rate as a shock absorber; reserves could be used to avoid excessive volatility; accelerate measures to improve productivity and business climate to reduce investment cost; ease monetary and macro-prudential policies to ensure the stability of the domestic financial market; a temporary and flexible fiscal stimulus should be treated as last resort.
Weather-related shock impact agricultural exports.	↓	Low	High	Use exchange rate as a shock absorber; reserves could be used to avoid excessive volatility.
Strong domestic demand could lead to overheating.	↑	Low	High	Accelerate structural measures to reduce supply constraints; tighten monetary policy, including through macro-prudential measures, if inflationary pressures were to arise. A fiscal withdrawal could be also considered if positive output-gap rises rapidly.
Weak PPP management and/or execution of public investment.	↓	Medium	Medium	Strengthen public investment monitoring and selectivity.

<sup>1/</sup> The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities in December 2013. Non-mutually exclusive risks may interact and materialize jointly.

<sup>2/</sup> Policy response recommended by staff. Starting in 2015, fiscal response guided by the Fiscal Responsibility law (FRL).

## POLICY DISCUSSIONS

**14. Discussions focused on policies and reforms to cement strong economic fundamentals and promote inclusive growth over the medium term.** The authorities broadly agreed with the policy recommendations and pointed out that the Fund continued support through TA will remain critical to implement the reform agenda.

**15. A policy mix rebalance should take place in the near term.** Fiscal policy is expected to be tightened in 2014 and 2015 to reflect the transition toward a more rigorous fiscal stance under the FRL. While the 2014 budget recently approved by Congress envisages a deficit of 2.8 percent of GDP—higher than the 2.2 percent of GDP submitted by the government—staff estimates a lower deficit (1.8 percent of GDP) as a result of expected lower capital expenditure execution in line with past experience (60 percent of the budgeted amount), and a further reduction in the deficit (to 1 percent of GDP) in 2015, as the FRL takes effect. Thus, a fiscal withdrawal of close to 1 percent of GDP would take place in 2014 and 2015, which will also support some external rebalancing. Monetary policy settings have recently tightened, moving closer to neutral levels. The central bank stressed that it will continue to adjust the policy rate as necessary to keep inflation near the target rate of 5 percent.

### A. Stronger Fiscal Framework

**16. Staff welcomed significant improvements in the fiscal framework.** The fiscal responsibility law provides an effective fiscal anchor, limiting current spending and making fiscal policy more predictable, though the regulation to implement the law could include more explicit guidelines for compliance, accountability, and escape clauses (Box 2). In addition, new taxes will add much needed revenues and contribute to making the tax system more progressive. The implementation of a Treasury Single Account and the issuance of short-term debt beginning in 2014 under the recently approved State Financial Administration Modernization law, will help use limited public resources more efficiently, with the Treasury moving from the present system of cash rationing to a modern cash management system. This, in turn, should eliminate the need for short-term loans from the central bank as was the case in 2013.

**17. Fiscal settings will be guided by the FRL over the medium term.** Thus, staff projects the central government deficit to be, on average, about 1.0 percent of GDP a year in the period 2016–18, on account of additional increases in tax collection—though less rapidly than envisaged by the government given weaknesses in tax and customs administration that will take time to overcome—and restrained growth in current primary spending, in particular the wage bill.<sup>8</sup> As a result, the

<sup>8</sup> The government estimates the new taxes will likely increase tax collection by 2 percent of GDP over the medium term, while staff estimate is about half that amount.

fiscal policy stance is expected to become broadly neutral in the period 2016–18, as the economy grows around potential (see table below). Financing of these deficits should be manageable through domestic and/or foreign sources. Solid GDP growth would keep the debt to GDP ratio below 15 percent of GDP (Annex IV).

#### Medium-Term Fiscal Outlook 1/

(p.p. of non-agricultural potential GDP; unless otherwise indicated)

	2012	Est. 2013	Projections		
			2014	2015	2016-18 (avg)
<b>Fiscal impulse (- = withdrawal)</b>	<b>3.2</b>	<b>0.1</b>	<b>-0.8</b>	<b>-0.9</b>	<b>0.0</b>
Non-royalty non-grant structural revenue (- = more revenue)	-0.6	0.5	-0.4	-0.9	-0.2
<i>of which: tax revenue 2/</i>	-0.2	0.2	-0.4	-0.9	-0.2
Primary expenditure (- = less spending)	4.0	-0.5	-0.5	0.0	0.1
<i>of which:</i>					
wages and salaries 3/	2.2	0.4	-0.9	0.3	-0.4
capital expenditure	0.9	-0.5	-0.1	0.1	0.2
<b>Memo items:</b>					
Public capital expenditure (in percent of GDP)	4.8	4.0	4.0	4.1	4.3
Consolidated public debt (in percent of GDP)	12.6	15.1	14.6	14.5	14.4
Overall balance (in percent of GDP)	-1.8	-2.0	-1.8	-1.0	-1.0
Primary current expenditure real growth (in percent)	20.7	4.9	2.9	4.0	4.0

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

1/ Central Government, unless otherwise indicated.

2/ For 2015, includes full year impact of recent tax measures.

3/ Public wages are adjusted in line with the FRL whenever accumulated inflation reaches 10 percent.

**18. Staff observed that additional efforts are required to strengthen the fiscal policy framework.** Stronger budget institutions (design, control and monitoring) are needed to enhance the credibility of fiscal policy and improve the quality of spending. Ongoing efforts to implement results-based budget monitoring are welcome. Despite some progress over the past decade, tax collection remains relatively low (estimated at about 51 percent of its potential vis-à-vis a regional average of 71 percent) as a result of limited human and information system resources.<sup>9</sup> The tax agency is not fully prepared to rapidly absorb an increase in taxpayers by about 15 to 20 percent in the short-run due to the new taxes, hindering the mobilization of additional revenue. Consequently, it might be necessary to revise some current low tax rates. In this context, the authorities clarified they are considering raising the VAT on financial services from its current 5 percent to the 10 percent general rate, on top of the recent increase in rural and urban property taxes. Staff suggested the authorities be cautious on revenue projections and, in line with Fund TA advice, strengthen tax and customs administration by giving priority to new information and risk management systems, improving the quality of taxpayer's registry and controls via database crosschecks, and enhancing audit and arrears collections systems and procedures.

**19. Staff recommended that a civil service and pension reform be part of a medium-term strategy to further strengthening the fiscal framework.** A civil service reform must seek to attract

<sup>9</sup> See Fenochietto, R. and Pessino, C. *Understanding Countries' Tax Effort*, IMF Working Paper 13/244.

and maintain qualified personnel at a competitive salary, while at the same time opening the fiscal space to increase essential social spending. Staff welcomed work under way in the domestic tax and customs agencies with Fund TA to overhaul human resource policies, including through the creation of a professional career system. Although the aggregate pension system still generates a small cash surplus (equivalent to 0.2 percent of GDP in 2013), several pension regimes run deficits of about 0.3 percent of GDP that are covered by the central government. A pension reform is required to reduce potentially large fiscal liabilities but also to improve national savings and foster development of domestic capital markets. With the assistance of other multilateral agencies, the authorities are working on drafting new legislation and establishing a pension regulator.

**20. While PPPs offer potential efficiency gains, they can also pose significant fiscal risks.**

Although the PPP law seems to provide a sound legal framework to reduce these risks, staff advised the authorities to first of all focus on strengthening public investment management, planning and regulatory capacity before engaging in any large PPP project (Box 3). Moreover, staff recommended including PPP projects in the national public investment system (SNIP) and publishing data on all contingent liabilities along with the budget documentation to increase transparency and accountability. Prioritization of PPP infrastructure projects that are likely to have high economic rates of return, such as roads and energy, will be key to preserving strong growth momentum. The authorities agreed with these recommendations and pointed out that the regulatory decree under discussion that will guide the implementation of the PPP law, will clarify many of these issues.

**21. Several initiatives are being put in place to speed up investment.** A ministerial group was formed to ease the decision-making process on priority investments while an inter-ministerial group would remove bureaucratic obstacles and enhance monitoring, particularly of PPP projects. The authorities are considering outsourcing management of public investment projects in certain cases, following closely the experience of other countries with this type of initiative. All PPP projects will be done through international open bids. They also expect that the diverse legal framework in place—PPPs, joint ventures, leasing, concessions—will facilitate the private sector's response to new investment opportunities in infrastructure. Ongoing efforts to improve the business climate by strengthening the legal protection of investment and drastically reducing red tape will likely further encourage private and foreign investment.<sup>10</sup>

## **B. Monetary and Exchange Rate Policy at the Forefront to Manage Risks**

**22. The central bank has made significant advances in implementing an inflation-targeting (IT) regime since 2011, and further steps are in train.** In line with Fund TA, recent implemented measures include publishing a bi-annual inflation report and the minutes of the monetary policy committee as well as refining liquidity management and monetary policy instruments—daily

<sup>10</sup> The Ministry of Industry and Commerce already reduced red tape for all transactions linked to activities in the export processing zones (EPZ) from weeks to just a few days and additional reductions are envisaged in 2014. For instance, approval time to establish a new company in an EPZ went down from 50 days to 20 days and a further reduction to 5 days is expected in 2014.

liquidity forecasts are now being prepared and actively used as the basis for decisions on liquidity management operations (Annex V). The central bank has recently introduced an overnight standing lending and deposit facility, establishing a corridor of  $\pm 100$  basis points around the policy rate, to ensure that the overnight interbank rates remain within a predefined corridor and to increase the flexibility of the commercial banks' internal liquidity management. The central bank is also moving reserve requirements (RR) towards an average system (from a fixed amount) within a reserve maintenance period, which was facilitated by the launching in November of the Real Time Gross Settlements (RTGS) payments system. This average RR will likely contribute to reducing the need for banks to maintain excess reserves. In addition, beginning in 2014, the central bank narrowed the band around the target inflation rate of 5 percent from  $\pm 2.5$  to  $\pm 2.0$  percent.

**23. The central bank reaffirmed its commitment to complete the transition towards a full-fledged IT regime in the near term.** This regime has been successful in reducing inflation along with a decline in the exchange rate pass-through (the latter, an important development in a highly dollarized economy).<sup>11</sup> To complete this transition, priority will be given to developing an active interbank money market by increasing the predictability of central bank operations and available instruments, further improving communication with market participants and eliminating legal impediments to secondary markets trading. Reversing the perception of high credit risk among banks by strengthening bank risk supervision will be also needed to reduce the intermediary role of the central bank in all interbank transactions. Staff reiterated previous Fund recommendations to fully recapitalize the central bank with marketable and fungible securities, further strengthening the recapitalization process initiated in 2012 when the Ministry of Finance offered the central bank nonmarketable bonds (paying only 0.25 percent a year).

**24. Staff endorsed recent steps taken by the central bank to establish a foreign exchange (FX) policy that is more transparent, better communicated and more consistent with a full-fledged IT regime.** The central bank indicated that since mid-2013, they have followed Fund TA advice, implementing a more disciplined FX framework by pre-announcing an auction system for the sale of government dollar proceeds from revenue of the two binational hydroelectrical companies, including the nature, frequency and size of these sales. This framework has contributed to improving the predictability about the central bank's role and participation in the market. FX interventions outside the pre-announced sales have been limited to offsetting excessive volatility as the exchange rate is subject to strong seasonal pressures. The authorities confirmed that they adhere to a flexible exchange rate policy and do not target the level of the exchange rate. Staff indicated that maintaining exchange rate flexibility will create incentives for the deepening of the incipient forwards market in Paraguay as the private sector learns to internalize exchange rate risks and this, in turn, could also contribute to reducing dollarization.

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<sup>11</sup> According to staff estimates, the exchange rate pass-through declined to 21.5 percent in the period 2000–2013 from 26.7 percent in 2000–2010 (period excluding IT which started in 2011).

**25. Further entrenching the de-dollarization process would strengthen the effectiveness of the monetary policy framework.** After declining during much of the 2000s, dollarization ratios started to increase in the past few years—at 40 percent for both loans and deposits, they still remain one of the highest in the region. While cementing macroeconomic stability should instill confidence in the guaraní, the use of carefully designed macro-prudential tools could also create incentives to internalize the risks of dollarization, tilt against foreign currency loans and deposits, and enhance the transmission mechanism. Key steps could include increasing provisioning requirements for foreign currency loans and the spread in required reserve ratios between foreign and domestic deposits.<sup>12</sup> The authorities agreed that reversing certain macroprudential measures taken at the time of the global financial crisis, such as the reduction in banks' reserve requirements for foreign currency deposits, could help sustain a gradual de-dollarization process. However, they pointed out that for the foreseeable future, dollarization would remain a key feature given Paraguay's openness and the prominence of the agricultural sector, which trades exclusively in dollars.

### C. Stronger Supervisory-Regulatory Framework

**26. The supervisory-regulatory framework of the financial system has undergone major improvements in recent years in line with FSAP recommendations.** Staff welcomed ongoing efforts to align bank and central bank legislation with international best practices in risk-based supervision and prudential norms, as well as steps to migrate to international accounting standards (i.e. IFRS) for bank and supervisory reporting (Annex VI). The supervisory approach and soundness of cooperatives (which account for 20 percent of financial system assets) will be strengthened over a period of two years beginning in 2014, as a result of new legal requirements (e.g., increased capital adequacy, provisioning and liquidity requirements and better information reporting). This, in turn, would facilitate introduction of a liquidity assistance facility and a deposit insurance scheme for cooperatives in line with FSAP recommendations. Recommended changes to strengthening cooperatives governance are still pending.

**27. Although credit growth has stabilized since end-2012, closer monitoring is warranted if it accelerates further.** The authorities indicated that although banks usually request solid collateral from their clients (real estate, land, agricultural output which are usually valued below market prices to reduce risk) or direct salary deductions in the case of consumer loans, a significant improvement in credit information would take place in the near term by providing up-to-date data on corporate and household balance sheets to credit registry agencies. Staff indicated that additional efforts are also needed to strengthen the bank supervisor's loan classification system by requiring institutions to properly identify transactions' terms and credit quality, and to increase competition in the banking sector to reduce large interest rate spreads.

<sup>12</sup> Staff estimates show that by reducing dollarization ratios in loans by 10 percentage points from currently 40 percent, the long-run pass-through from the policy rate to retail interest rates could increase by 14 percentage points (the current pass-through is 36 percent, well below the regional average of 50 percent). See Chapter 2 in the accompanying Selected Issues Papers.



**28. Paraguay's anti-money laundering plan (AML/CFT) launched in June 2013 is being activated.** The authorities' recent agreement with the Central Bank of Brazil on measures to control cross-border cash flows is an important step. However, additional efforts are needed to address legal and operational shortcomings that remain in controlling the cross border physical transportation of cash and bearer negotiable instruments while corruption continues to be a serious obstacle for effective actions.

#### D. Promoting Inclusive Growth

**29. Staff commended the government's focus on reducing poverty.** Poverty and inequality in Paraguay are among the highest the region. Staff endorsed the government's holistic approach to tackle key dimensions of poverty supported by sustained strong economic growth (Box 4). These dimensions include: *vulnerability* through social safety nets, such as conditional cash transfer programs; *social exclusion* through increased access to basic services, such as schooling, health care, electricity and safe water and sewerage; and *economic exclusion* through opportunities to increase earnings via programs to improve rural infrastructure and enhance small-scale farmers' earnings, including through a reforestation program. Assuring the long-term sustainability of all these initiatives will be crucial to succeed in the fight against poverty.

**30. Labor market inefficiencies must 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.

**31. A public enterprises (PEs) reform is needed to improve both efficiency and access to basic public services.** PEs play an important role in key sectors, and increasing their efficiency can help ease their capacity constraints that limit investment.<sup>13</sup> Public enterprises combined operating surplus declined from 1.4 percent of GDP in 2011 to about 0.4 percent of GDP in 2013, with their investment level representing below 10 percent of total expenses. Staff welcomed important steps taken to strengthen PE monitoring and performance as well as increased transparency in PEs accounts and audits. While staff agreed with the authorities that it would be ideal to achieve improvements in cost efficiency before increasing tariff rates to support investment plans, water and electricity rates will likely need to be raised in the near future, after been fixed for about 11 years. Staff also advised eliminating the general diesel fuel subsidy, which benefits the agriculture sector the most. However, any increase in tariffs must be accompanied by targeted safety net measures to ensure that the most vulnerable are protected. In addition, it would be crucial to establish a long-

<sup>13</sup> There are currently ten public enterprises covering electricity distribution, oil distribution (diesel), airports, ports management, cement, steel blades, railroad, sugar cane production, telecommunications and water and sewage.

term development plan to make sure that PEs can accommodate the robust growth outlook, particularly in the energy sector, to avoid bottlenecks.<sup>14</sup>

## STAFF APPRAISAL

**32. Staff commends the government's ambitious agenda of growth-enhancing reforms and poverty reduction.** Paraguay's per capita income remains significantly below the region average and income distribution has deteriorated. The reform strategy targets key areas, in particular closing the large infrastructure gap, to sustain robust economic and productivity growth in support of Paraguay's aims to transition to a dynamic emerging market economy over the next decade. The country's medium-term look is positive with balanced risks. Critical legislation has been already enacted, which signals Paraguay's commitment to address institutional and structural weaknesses. However, the regulation to implement these laws will need to be executed carefully.

**33. A steady implementation of the FRL will be critical to buttress fiscal discipline and supportive of near term macro management needs.** Implementation of the FRL will support a desirable near term policy mix of tighter fiscal settings and monetary policy settings close to neutral. Congress and the executive should take advantage of the new fiscal framework to work closer to ensure that the budget becomes a true macroeconomic planning instrument. As experience is gained with the implementation of the new framework, some features of the law might need to be revised to provide more flexibility across economic cycles and to make escape clause more effective and clear.

**34. Additional efforts are needed to cement a stronger fiscal policy framework.** Strengthening budget design, control and monitoring, with a stronger emphasis on results, and a medium-term expenditure framework should be priorities as much as mobilizing additional resources. Moreover, strengthening public investment management, planning and the regulatory capacity will reduce potential fiscal risks associated with PPP projects and ensure that these and all public projects provide high-quality infrastructure services efficiently. A civil service and pension reform must be also part of a medium-term strategy to further strengthen the fiscal framework and, in turn, to open fiscal space to increase essential social spending and reduce potentially large fiscal liabilities. To bring Paraguay's tax collections to par with other countries in the region, high level of informality, tax evasion and exemptions will need to be drastically reduced. To this end, Fund TA recommendations provide an appropriate reform guide.

**35. The central bank's track record in keeping inflation on target amid greater exchange rate flexibility is fortifying the credibility of the IT framework.** To complete the transition to a full-fledged IT regime and further enhance the monetary policy transmission mechanism, priority should be given to developing an active money market while strengthening bank supervision in

<sup>14</sup> The lack of infrastructure in electricity distribution and constant outages represent today a constraint to economic development.

order to reduce the perception of high credit risk among banks. Macroprudential measures, such as reversing the decline in banks' reserve requirements for foreign currency deposits, could help sustain the de-dollarization process over time. Although credit growth has recently slowed down, closer monitoring is warranted if it accelerates further, in part through improved credit information of companies and households. Given uncertainties as the regime transitions, it will be important for the central bank to remain vigilant to respond to incipient price pressures.

**36. Maintaining exchange rate flexibility remains instrumental in cushioning the economy against potential shocks and supporting the IT regime.** While limited foreign exchange intervention could be necessary to reduce volatility and to contain excessive risks to the balance sheets in a highly dollarized economy, the exchange rate ought to continue to be driven by fundamentals. Moreover, maintaining exchange rate flexibility will create incentives for the deepening of the incipient forwards market in Paraguay as the private sector learns to internalize exchange rate risks.

**37. To succeed in the fight against poverty, it will be crucial to assure the long-term sustainability of all initiatives underway to address social and economic exclusion.** In addition, labor market inefficiencies together with efforts to increase female labor force participation, will need to be addressed to reduce informality and lower poverty. Improved public enterprises management and long-term investment plans will facilitate access to basic public services at reasonable cost—though increases in certain rates might be unavoidable in the near term despite ongoing efforts to reduce operating cost.

**38. It is recommended that the next Article IV consultation takes place on the standard 12-month cycle.**

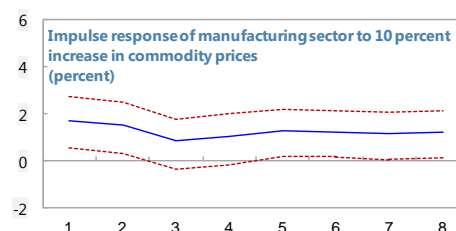
### Box 1. Impact of External and Domestic Shocks on Paraguay's Non-Agricultural Sector

Paraguay is a landlocked, small open economy highly dependent on agribusiness (20 percent of GDP), and featuring strong regional economic and financial ties. Ties are particular strong with Brazil, which absorbs close to one-third of the country's exports; also, a Brazilian bank, Itau, is the second largest in Paraguay, and Brazilian branches and subsidiaries account for 20 percent of total bank credit to the non-financial private sector. While external shocks are mainly transmitted to the economy primarily through the agricultural sector, staff analysis suggests modest spillovers onto non-agricultural sectors (industry, construction and services).

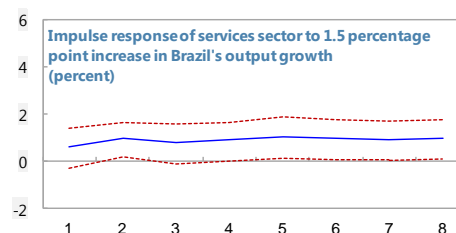
**Commodity prices shock:** The industrial sector is the only non-primary sector directly affected by the impact of a commodity price shock, given that its production is geared towards processing agricultural products and livestock. A 10 percentage point change in commodity prices increases industrial production by about 1.2 percent over a year. This translates into a 0.2 percentage point increase in overall GDP growth. (By comparison, the agricultural sector expands by 3.5 percent in response to the same shock, increasing GDP growth by 0.7 percentage points).

**Regional shocks:** Services (60 percent of non-agricultural GDP) is the non-agricultural sector with the largest response to a shock stemming from Brazil (with an implied elasticity of 0.9 percent). A 1.5 percentage point increase in Brazil's output increases non-agricultural output by a 0.6 percentage points over a year, raising overall GDP growth by 0.5 percent (by comparison, the agricultural sector expands by 5.2 percent in response to the same shock, contributing roughly 1.0 percentage point to overall GDP growth). Also, and as discussed in a previous the previous Article IV report, cross-border lending by foreign banks is a main transmission channel of foreign shocks into the Paraguayan economy. The report finds that the external financial channel accounts on average for about two-thirds of total variations in non-agricultural GDP growth. Financial services are an important segment of the tertiary sector.

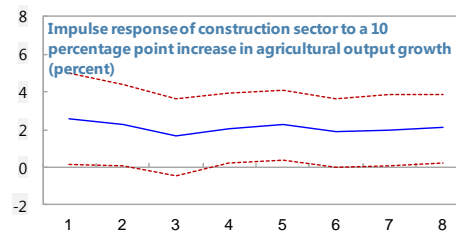
**Agricultural output shock:** Spillovers from the agricultural sector are mainly transmitted to the construction and services sectors. A 10 percent increase in agricultural production raises construction output by just about 2 percent during a one year window. The same shock leads to a 0.7 percent increase in output from the services sector, which can be driven by the historical large exposure of banks to the agricultural sector (35 percent of loans are directed towards agriculture). The total response of the non-agricultural sector is roughly 0.5 percent. This small impact is not surprising: as discussed in IMF 2011, the small effects of the agricultural sector in the rest of the economy stem from the fact the sector relies heavily on imports of intermediate and capital goods, it is a land and capital intensive sector, and pays little taxes.



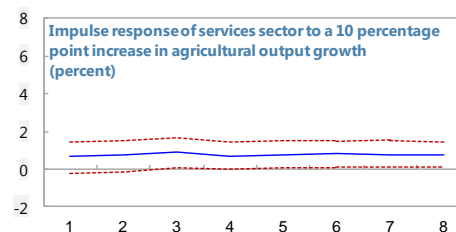
Source: Fund staff estimates.



Source: Fund staff estimates.



Source: Fund staff estimates.



Source: Fund staff estimates.

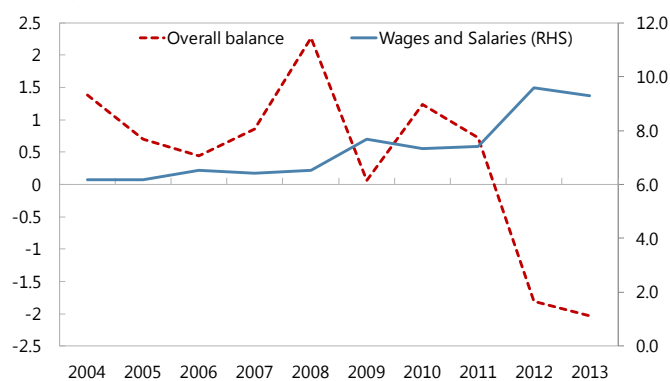
Note: X axis measured in quarters

## Box 2. Paraguay: The Fiscal Responsibility Law

The Fiscal Responsibility Law (FRL) stands to contribute to cementing fiscal discipline and support the authorities' investment-led growth strategy. However, while it imposes rigorous controls on current primary expenditure, its success will require both improved spending management and efficiency and higher tax revenue.

**After eight consecutive years of fiscal surpluses, Paraguay's central government fiscal position has switched to a deficit since 2012.** This was the result of a sharp rise in the wage bill due to both salaries and hiring, in turn reducing budget flexibility—at its peak in 2012, the wage bill accounted for 60 percent of current spending, absorbed 75 percent of tax revenue and reached almost 10 percent of GDP.

**Recent shift in the fiscal stance**  
(in percent of GDP)



Sources: National authorities and Fund staff estimates

**The FRL aims to restore fiscal discipline, setting stringent conditions.** It was enacted in October 2013 with effect in 2015. The authorities are working on the regulatory aspects of the law and plan to use it as guiding benchmark during the *execution* of the 2014 budget. The law sets the following limits/ceilings:

1. The real growth of current primary spending of the *consolidated* public sector (excluding municipalities) should not exceed 4 percent a year; a relatively tight limit since it is below estimates of potential GDP growth. As a result, current primary expenditure would decline as a ratio of GDP over time, which in turn would create fiscal space for higher investment while satisfying the fiscal deficit ceiling.
2. The overall deficit of the central government, *including transfers to the rest of the public sector*, should not exceed 1.5 percent of GDP (3 percent in periods of crisis). Further, the FRL sets a medium-term (3 years) average deficit ceiling of 1 percent of GDP a year—the annual budget is required to include a medium-term framework. However, given the current deficit (2 percent of GDP in 2013), complying with this rule would depend on successful revenue mobilization from the recently implemented tax measures and/or more stringent growth limits on current (or overall) spending.
3. Public sector wages will increase in line with the increase in the minimum wage (which is adjusted when accumulated annual inflation reaches 10 percent).

**Going forward, the approved framework could be strengthened in some areas.** The current coverage of the law is quite broad as it includes central government's transfers to the rest of the public sector, except municipalities, which are autonomous entities under Paraguay's Constitution. However, since the latter can issue debt, it would be appropriate to also encourage them to apply similar rules. The regulations to implement the law could include more explicit guidelines for compliance, accountability and escape clauses. While the expenditure ceiling limits the potential procyclicality of using a headline balance rule, the demand-management role of fiscal policy could be further strengthened by setting the deficit ceiling in terms of a structural/cyclically-adjusted balance.

### Box 3. Paraguay: The Public-Private Partnerships (PPPs) Law

**Paraguay has an ambitious investment plan in infrastructure for the upcoming years.** The recently approved PPPs law is expected to play a key role in encouraging and facilitating private sector participation in this plan. The government has identified three possible projects to be awarded through PPPs: the modernization and operation of the Asuncion airport (US\$100 million), the concession of the Asuncion-Ciudad del Este-Encarnacion roads (US\$900 million) and the Paraguay River dredging (US\$100 million).

**The PPPs law is comprehensive and covers essentially all relevant issues for managing fiscal risks.** It also includes many components of international best practices, such as:

- **A clear definition of PPPs and a broad institutional scope.** The Ministry of Public Works will be responsible for developing, selecting, awarding and executing transportation projects. The PPP unit under the Secretaría Técnica de Planificación (STP) will promote, communicate and coordinate the initiatives in other sectors.
- **A limit to the government's exposure to PPP operations.** The law states that contingent and actual liabilities are not to exceed 2 percent of GDP in net present value and not to be higher than 0.4 percent of GDP in a given year. A Fiduciary Guarantee and Liquidity Fund will be set to meet contractual obligations derived from PPP projects. The Ministry of Finance will participate as a gatekeeper throughout project implementation to limit the financial exposure of the government from PPP operations.

**Some aspects of the law could be strengthened and clarified in the upcoming regulatory decree:**

- **Risk allocation.** While allocating risks in each contract allows for some flexibility, it could make contract renegotiations more difficult given the weak institutional capacity in the contracting entities at the public sector. Accordingly, regulations of the law should provide clear guidelines about typical risks (construction, demand and availability). At the same time, the legal framework should provide guidelines for renegotiating and terminating PPP contracts.
- **Fiscal risks.** The methodology for accounting and reporting contingent liabilities in the fiscal accounts and in the budget needs to be better specified in line with international standards.

#### Box 4. Paraguay: The Government's Strategy to Reduce Extreme Poverty

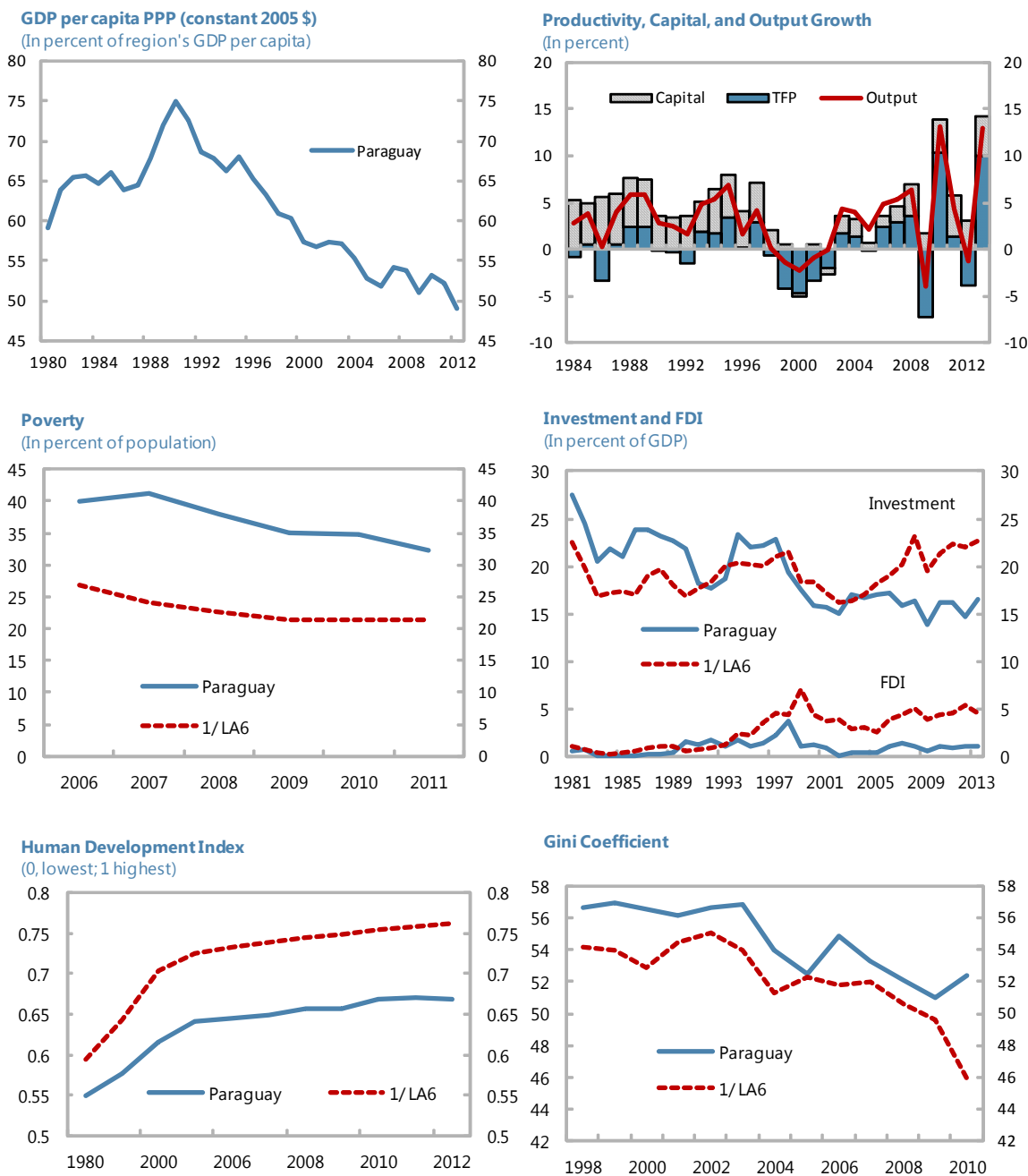
**Despite a decline over the past decade, poverty in Paraguay still remains among the highest in the region.** Amid the economic and financial crisis, overall poverty in Paraguay worsened significantly in the second half of the 1990s and early 2000s reaching a peak of 49.7 percent by 2002. Since then, it has gradually declined, reaching 32.4 percent in 2011, just slightly below the level achieved in the mid-1990s (36.1 percent). In contrast, practically no improvement in extreme poverty has taken place, still affecting in 2011, 18 percent of the population (or 220,000 families, of which 67 percent live in rural areas) compared with 18.8 percent in the mid-1990s. At the same time, income inequality has continued to deteriorate over the past decade, in contrast with the trend in the region.

**The government's program "Sembrando Oportunidades" aims to halve extreme poverty to about 9 percent by 2015.** Under this program, the poverty reduction would be mainly achieved by providing opportunities to increase income:

- **Support small-scale farmers with technical, financial and managerial assistance to improve their access to markets and the development of value chains.** This will be done in part by expanding the Paraguay Sustainable Agriculture and Rural Development Project (PRODERS), with an additional financing of US\$100 million from the World Bank. The idea is to scale up the existing project to some of regions in the country with the highest incidence of rural poverty. The government plans to increase the number of beneficiary families from 50,000 in 2013 to 120,000 in 2014. In addition, it plans to expand income opportunities for families through work in reforestation activities.
- **Investment in infrastructure.** To generate an alternative source of income for families not involved in agricultural activities, the government plans to hire rural labor to work in building and maintaining infrastructure, such as roads, schools, health centers, and water and sewage.
- **Expansion of conditional cash transfers (CCT) programs.** Increase the number of beneficiary families under the *Tekopora* program from currently 83,000 to 100,000 to expand access to education, health care and food security for up to six years.
- **Increase training and labor opportunities in urban areas.** Coordinate with the private sector to match technical careers and training courses with demand requirements.

**Figure 1. Paraguay: Long-Term Growth and Poverty**

*Paraguay's economic and social development has lagged behind the region*



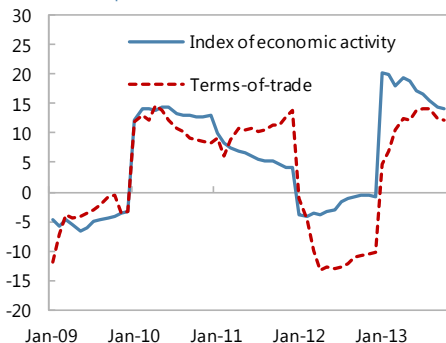
Sources: Fund staff estimates, World Bank; *World Development Indicators*, and UNDP.  
 1/ Includes Argentina, Bolivia, Brazil, Chile, Peru, and Uruguay.



**Figure 2. Paraguay: Real Sector Developments, 2009-2013**

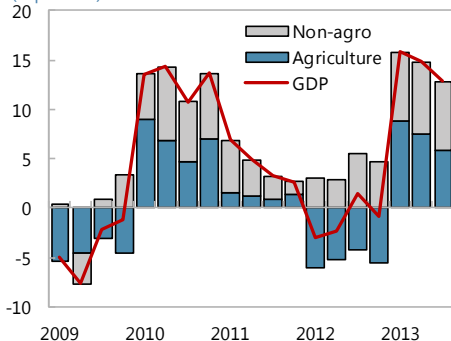
*Paraguay's economic activity continues to be very susceptible to terms-of-trade dynamics...*

**Index of Economic Activity**  
(Cumulative, percent)



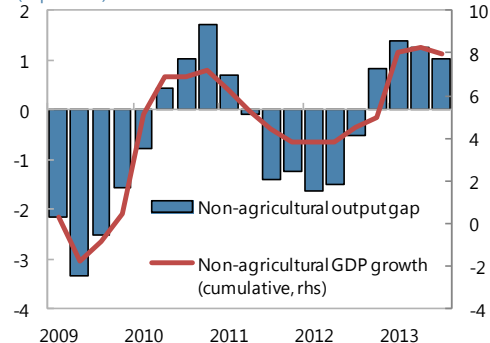
*Growth picked up in 2013, driven by the recovery of the agribusiness sector...*

**Sector Contribution to GDP Growth**  
(In percent)



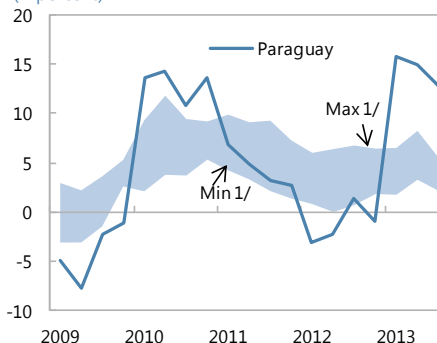
*The non-agricultural output gap has narrowed somewhat...*

**Non-Agricultural GDP Growth and Output Gap**  
(In percent)



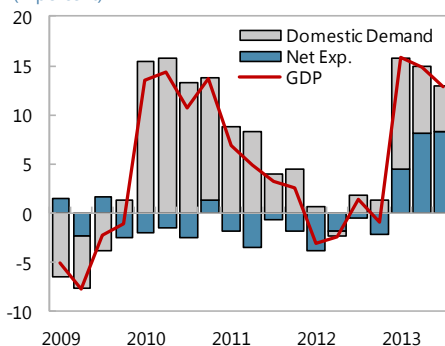
*...making GDP growth very volatile (as compared with the region).*

**Real GDP Growth**  
(In percent)



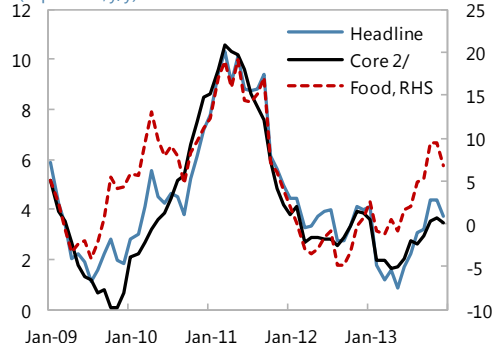
*...and robust external demand.*

**Demand Side Contribution to GDP Growth**  
(In percent)



*...and inflation remains low.*

**Inflation**  
(In percent, y/y)



Sources: Central Bank of Paraguay and Fund staff estimates.

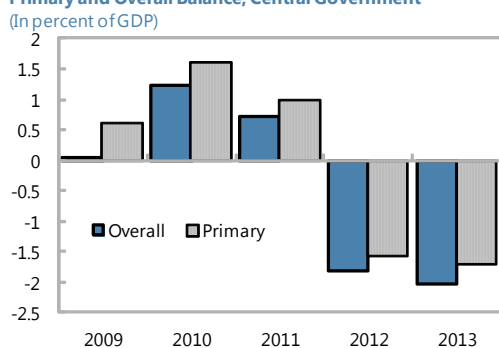
1/ Includes Argentina, Bolivia, Brazil, Chile, Peru, and Uruguay.

2/ Excludes fruits and vegetables.

**Figure 3. Paraguay: Fiscal Developments, 2009–2013**

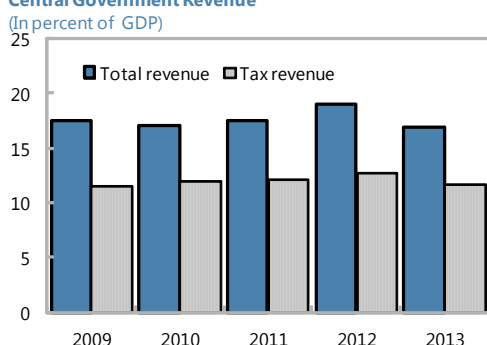
The overall fiscal balance swung into a deficit in 2012, and will remain broadly unchanged in 2013...

**Primary and Overall Balance, Central Government**



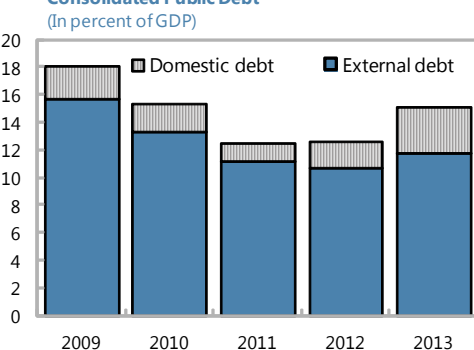
Revenue mobilization has been weak in recent years...

**Central Government Revenue**



Public debt is relatively low and mostly composed of external debt...

**Consolidated Public Debt**



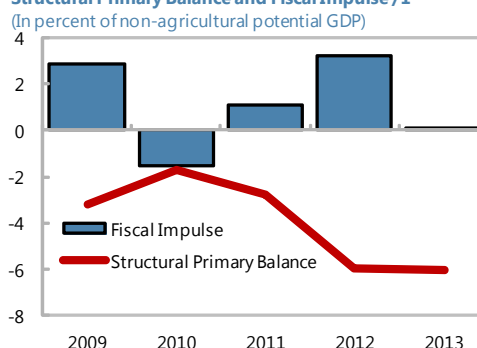
Sources: Central Bank of Paraguay, Ministry of Finance and Fund staff calculations.

1/ Excludes electricity royalties and grants. See 2011 Art. IV Staff Report.

2/ Debt service in 2012 includes debt exchange with the central bank.

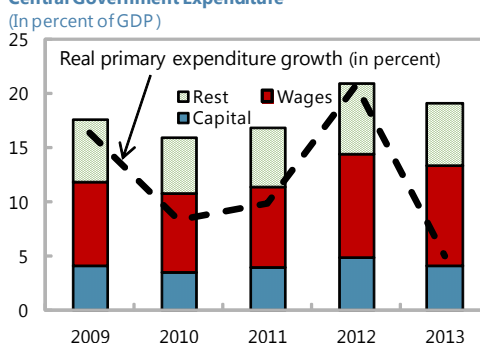
... leading to a neutral stance in 2013, after two years of injecting stimuli.

**Structural Primary Balance and Fiscal Impulse /1**



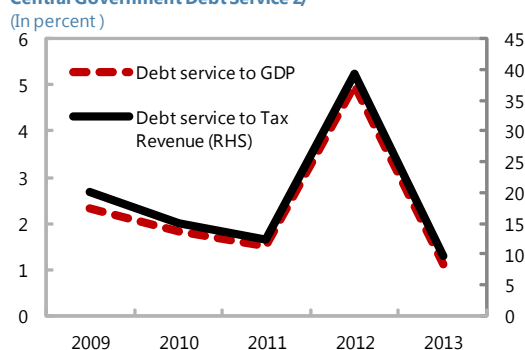
... while expenditure has increased driven by wage outlays, and capital expenditure has remained about constant.

**Central Government Expenditure**



... and debt service indicators remain relatively low...

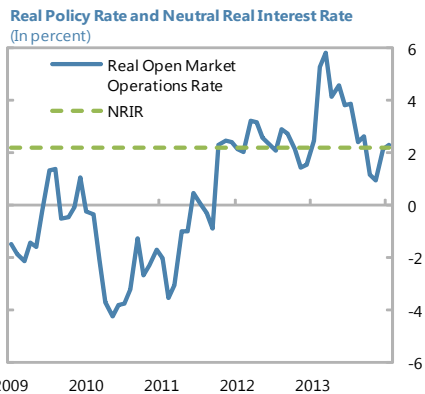
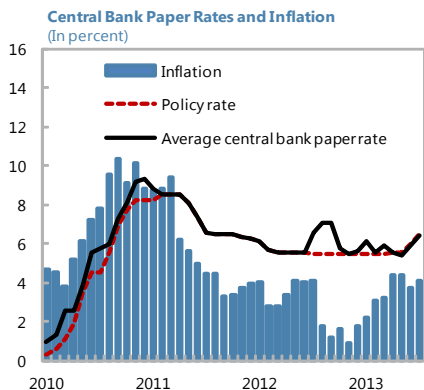
**Central Government Debt Service 2/**



### Figure 4. Paraguay: Monetary Developments, 2009–2014

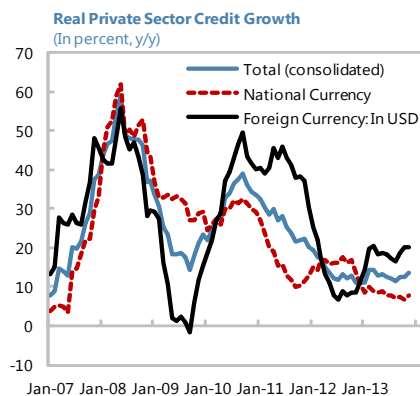
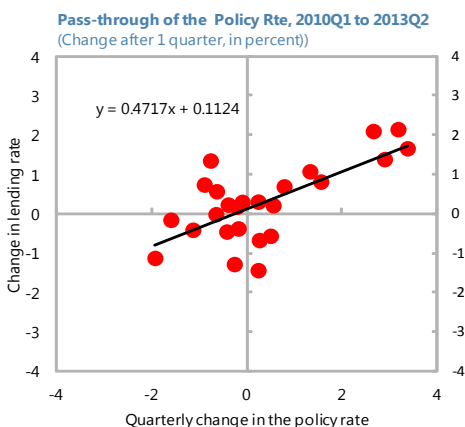
After a prolonged pause, the central bank increased its policy rate by a combined 100 bps in December 2013 and January 2014.

bringing the real policy rate close to neutral.



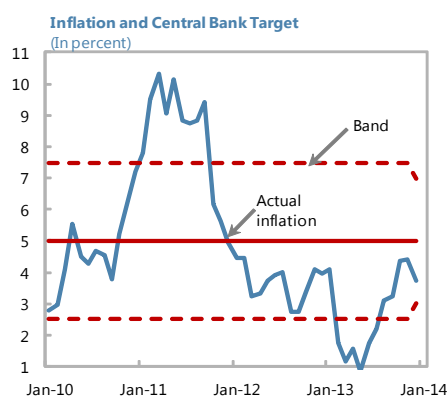
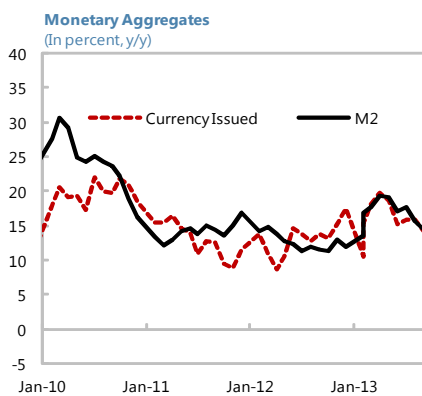
The pass-through from policy to lending rates remains low.

Real credit growth has moderated recently but remains brisk at about 13 percent (y-o-y).



Growth of monetary aggregates has slowed down

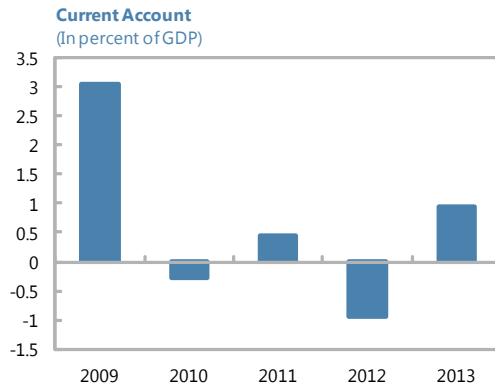
...and inflation is below the central bank target



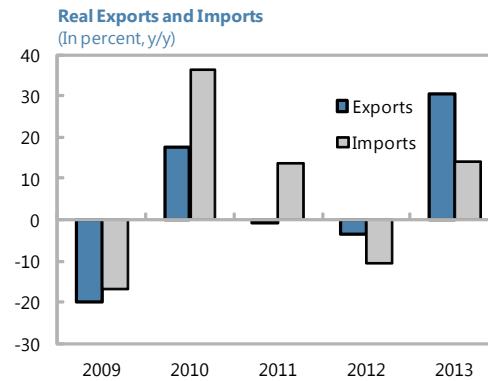
Sources: Central Bank of Paraguay and Fund staff calculations.

**Figure 5. Paraguay: Balance of Payments Developments, 2009–2013**

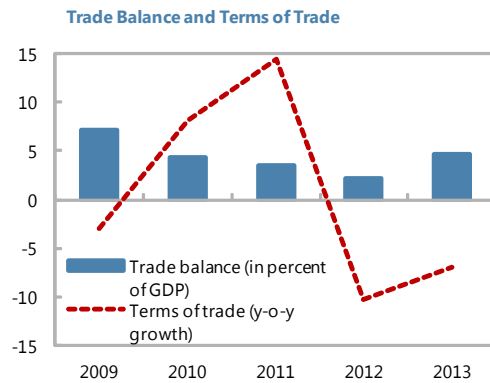
*The current account switched to surplus in 2013...*



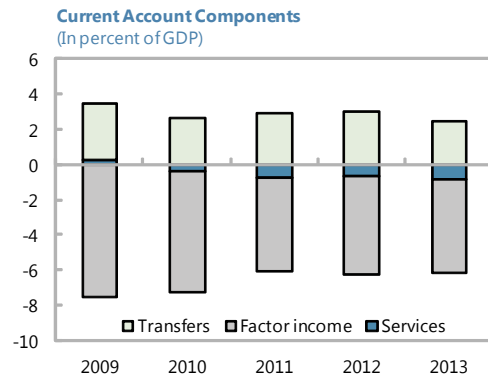
*... driven by a revamp in soy and meat exports,*



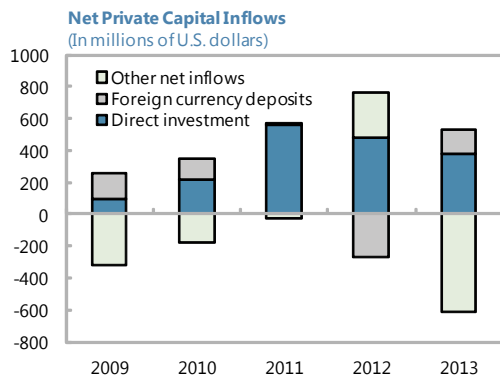
*even under a deterioration of the terms of trade.*



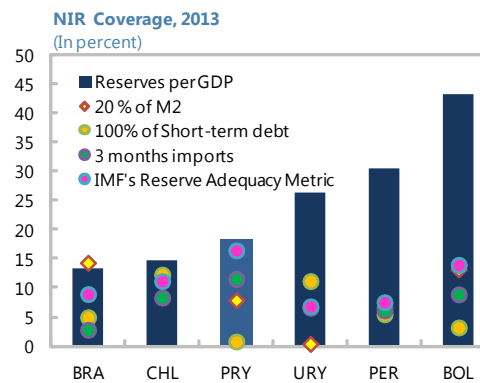
*The trade surplus compensated for lower transfers.*



*Private sector inflows were smaller...*



*... but reserves remained sizeable.*

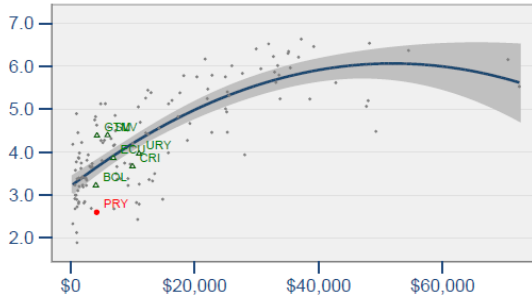


Sources: Central Bank of Paraguay and Fund staff calculations.

**Figure 6. Paraguay: Structural Indicators <sup>1/</sup>**

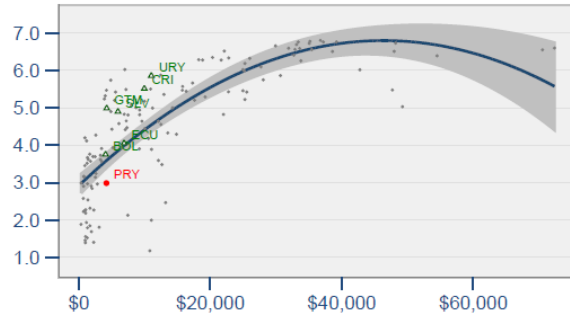
*Several indicators confirm Paraguay's widespread structural weakness*

**Quality of Overall Infrastructure**  
(Score, 1=worst 7=best)



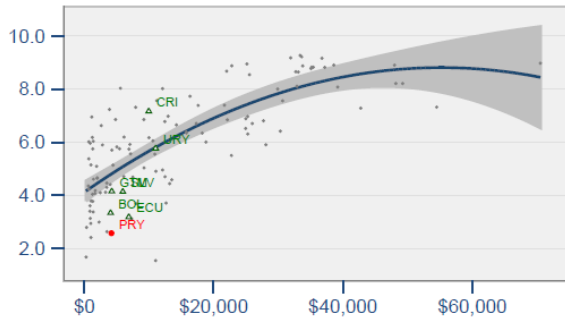
Note: 2012 data used for quality of overall infrastructure scores.

**Quality of Electricity Supply**  
(Score, 1=worst 7=best)



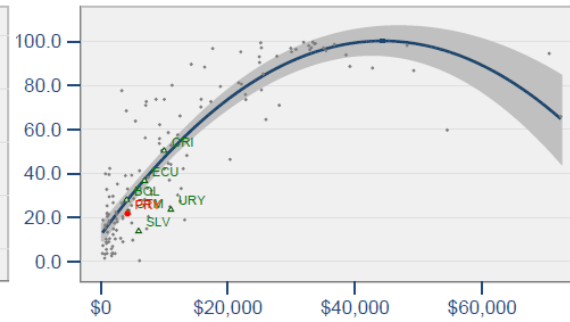
Note: 2012 data used for quality of electricity supply scores.

**Legal System and Property Rights**  
(Rating)



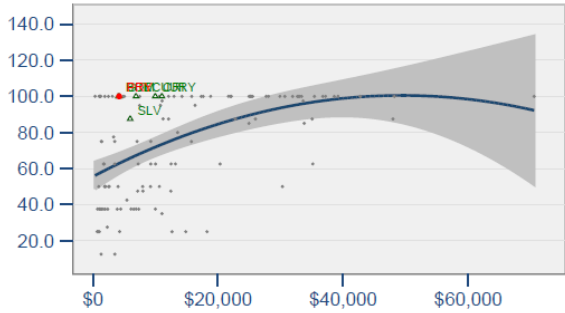
Note: Average of 2006-2012 data used for Legal System & Property Rights ratings.

**Adults with Account at Formal Financial Institution**  
(In percent of total adult population)



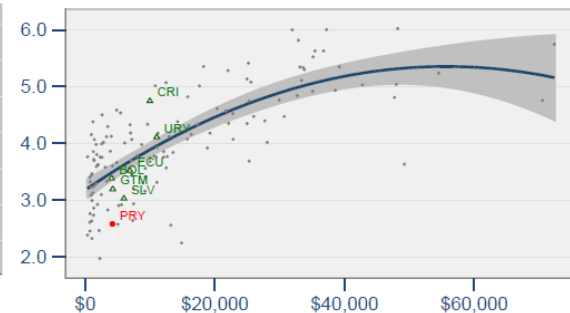
Note: 2010 data used for percentage of adults with an account at formal fin. inst.

**Lack of Financial Restrictions on Capital Account Transactions**  
(Quinn, 0-100 sca)



Note: Average of 2007-2011 data used for Lack of financial restrictions on Capital account transactions scale.

**Quality of Education**  
(Score, 1=worst 7=best)



Note: 2012 data used for quality of education scores.

Source: World Bank.

<sup>1/</sup> Countries for comparison include Bolivia, Costa Rica, Ecuador, El Salvador, Guatemala, and Uruguay.

**Table 1. Paraguay: Legislated Policy Reforms, 2012–13**

<b>Fiscal Laws</b>	<b>Status</b>	<b>Description</b>
1) Fiscal Responsibility Law	Enacted in late October 2013. The government is working on the regulation of the law. It will apply as of 2015.	Introduces a ceiling on: central government deficit of 1.5% of GDP (or 1% average in a 3-year period), current primary expenditures' growth of 4% in real terms and wage increases in the public sector in line with changes in the minimum wage.
2) Public Private Partnership (PPPs) Law	Enacted in early November 2013. The government is working on the regulation of the law.	Regulates public-private participation in infrastructure and service projects. Introduces a trust fund for guarantees and liquidity of PPP contracts.
3) Joint Ventures Law	Enacted in October 2013. The government is working on the regulation of the law.	Expands the scope of the PPP law to include more areas for joint venture projects. Establishes that the local component has to be at least 25%.
<b>Tax Revenue</b>		
4) New Personal Income Tax	Enacted in July 2012; applies as of August 2012.	Income taxed up to 10%. Some incomes are exempted, such as pensions; numerous deductions, including personal expenses and
5) VAT Generalization	Enacted in early October 2013; applies as of Jan. 2014.	Extends VAT of 5% (half of the general rate) to primary production.
6) New Agricultural Income Tax	Enacted in early October 2013; applies as of Jan. 2014.	Introduces up to a 10% annual tax on agricultural income (IRAGRO) in substitution of the IMAGRO which taxed the size of the landholding. Annual tax paid in March of the following year.
<b>Public Financial Management</b>		
7) Financial Modernization of the State	Enacted in October 2013. Regulations approved; applies as of Jan. 2014.	Improves liquidity management by introducing a Treasury Single Account (TSA) and short-term local debt titles.
8) Superintendence of Pensions	Draft Law under study at the Ministry of Finance.	Improves management, control, and financial sustainability of the pension system.
<b>Central Bank</b>		
7) Modification of the Central Bank Law	Draft law under study at the Central Bank.	Updates the law on the main functions, objectives and structure of the central bank.
<b>Financial Sector</b>		
9) Modification of the Securities Market Law	Under discussion in the Senate.	Update the law on financial markets innovation and practices. Corrects for overlappings and introduces security
10) Modification of the Banking Law	Draft law under study at the Central Bank.	Updates the law to strengthen risk-based supervision in line with best international standards.
11) Deposit Guarantee Fund Law	Project under study at the Central Bank.	Updates the law to strengthen control mechanisms.
<b>Business Climate</b>		
12) National Land Directory Law	Draft law.	Regularizes property ownership of rural and urban land.
13) Legal Security for Investments Law	Draft law under study at Ministry of Industry.	Promotes legal security for investors.

Source: National authorities.

**Table 2. 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	2014	2015	Proj. 2016	2017	2018
(Annual percentage change, unless otherwise indicated)											
<b>Income and prices</b>											
Real GDP	6.4	-4.0	13.1	4.3	-1.2	13.0	4.8	4.5	4.5	4.5	4.5
Nominal GDP	16.3	-2.0	20.0	14.6	0.0	15.6	9.7	9.7	9.8	10.1	10.6
Consumer prices (end of period)	7.5	1.9	7.2	4.9	4.0	3.7	5.0	5.0	5.0	5.0	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	4,585.0	...	...	...	...	...
<b>Monetary sector</b>											
Currency issue	15.0	11.3	18.5	11.6	17.5	13.9	10.1	18.1	11.5	11.5	12.1
Credit to private sector	62.0	21.4	37.3	25.8	15.8	17.5	11.9	16.7	9.8	8.0	16.1
Liabilities to private sector	42.4	24.9	19.2	19.4	14.1	20.6	10.6	9.2	-1.2	-10.9	-25.7
<b>External sector</b>											
Exports (fob)	29.7	-20.3	35.1	20.7	-7.8	16.0	5.3	5.1	6.3	5.7	5.7
Imports (cif)	44.7	-23.6	44.7	22.9	-5.8	10.1	9.0	4.3	6.0	6.6	6.9
Terms of trade	3.3	-3.0	8.2	14.3	-10.2	-7.0	-9.1	-2.1	1.2	-0.6	-0.8
Real effective exchange rate 1/	16.3	-7.4	2.8	13.4	-0.3	6.8	...	...	...	...	...
(In percent of GDP, unless otherwise indicated)											
<b>Current account</b>	<b>1.0</b>	<b>3.0</b>	<b>-0.3</b>	<b>0.5</b>	<b>-1.0</b>	<b>0.9</b>	<b>-0.9</b>	<b>-0.8</b>	<b>-0.6</b>	<b>-0.8</b>	<b>-1.0</b>
Trade balance	5.7	7.1	4.3	3.5	2.2	4.6	3.1	3.3	3.4	2.9	2.4
Exports	52.6	48.6	50.6	52.3	46.7	47.6	47.8	46.6	45.7	44.7	43.9
Registered	24.1	19.9	21.9	22.8	20.3	25.1	25.1	24.3	23.7	23.0	22.4
Energy	10.5	11.9	9.5	9.4	9.3	8.2	8.1	8.0	7.8	7.7	7.7
Unregistered	17.9	16.8	19.2	20.2	17.2	14.4	14.6	14.4	14.2	14.0	13.9
Imports	-46.9	-41.6	-46.4	-48.8	-44.5	-43.0	-44.7	-43.3	-42.3	-41.8	-41.5
o/w Oil imports	-7.0	-5.7	-5.2	-6.2	-6.6	-6.3	-6.1	-5.6	-5.2	-4.9	-4.7
Other (export and import of services, income, current trans)	-4.7	-4.0	-4.5	-3.1	-3.2	-3.6	-4.0	-4.1	-4.0	-3.7	-3.4
o/w Remittances	2.2	3.3	2.7	3.0	3.0	2.5	2.3	2.2	2.1	2.0	1.9
<b>Capital account and financial account</b>	<b>0.9</b>	<b>-0.3</b>	<b>1.1</b>	<b>2.0</b>	<b>1.9</b>	<b>1.6</b>	<b>0.5</b>	<b>1.4</b>	<b>1.2</b>	<b>1.4</b>	<b>1.1</b>
General government	-0.5	0.1	0.3	-0.2	-0.1	1.7	0.5	1.0	1.0	1.0	1.0
Private sector	1.4	-0.4	0.8	2.3	2.0	-0.1	0.0	0.3	0.1	0.3	0.1
o/w Direct investment	1.1	0.6	1.0	2.3	1.9	1.3	1.7	1.9	2.2	2.6	2.9
Errors and omissions	-0.2	2.3	0.9	0.9	-0.9	0.7	0.0	0.0	0.0	0.0	0.0
<b>Net international reserves (in millions of U.S. dollars)</b>	<b>2,876</b>	<b>3,817</b>	<b>4,165</b>	<b>4,971</b>	<b>4,983</b>	<b>5,889</b>	<b>5,763</b>	<b>5,943</b>	<b>6,143.0</b>	<b>6,356</b>	<b>6,403</b>
(Stock in months of next year imports of goods and service)	4.8	4.4	3.9	5.0	4.5	4.9	4.6	4.4	4.3	4.2	4.2
(Stock over total external short term debt)	1.4	1.8	2.0	2.3	2.4	2.8	2.7	2.7	2.7	2.7	2.7
<b>Gross domestic investment</b>	<b>16.4</b>	<b>13.8</b>	<b>16.2</b>	<b>16.2</b>	<b>15.4</b>	<b>15.9</b>	<b>16.4</b>	<b>17.2</b>	<b>18.0</b>	<b>18.8</b>	<b>19.5</b>
Private sector	13.5	9.1	11.8	11.6	9.8	11.1	11.6	12.3	12.9	13.5	14.0
Public sector	3.0	4.7	4.5	4.7	5.6	4.8	4.8	4.9	5.1	5.3	5.6
<b>Gross national saving</b>	<b>17.4</b>	<b>16.8</b>	<b>16.0</b>	<b>16.7</b>	<b>14.4</b>	<b>16.8</b>	<b>15.5</b>	<b>16.4</b>	<b>17.4</b>	<b>18.0</b>	<b>18.5</b>
Private sector	11.7	13.1	11.0	10.6	10.8	14.4	13.5	13.2	14.1	14.3	14.8
Public sector	5.7	3.7	4.9	6.0	3.6	2.5	2.0	3.2	3.4	3.6	3.8
<b>External saving (+) disavings (-)</b>	<b>1.0</b>	<b>3.0</b>	<b>-0.3</b>	<b>0.5</b>	<b>-1.0</b>	<b>0.9</b>	<b>-0.9</b>	<b>-0.8</b>	<b>-0.6</b>	<b>-0.8</b>	<b>-1.0</b>
<b>Central government revenues</b>	<b>15.8</b>	<b>17.5</b>	<b>17.1</b>	<b>17.4</b>	<b>18.9</b>	<b>17.0</b>	<b>17.0</b>	<b>17.8</b>	<b>17.8</b>	<b>17.8</b>	<b>17.9</b>
o/w Tax revenues	10.7	11.6	12.0	12.1	12.7	11.7	12.0	12.8	13.0	13.1	13.2
<b>Central government expenditures</b>	<b>13.5</b>	<b>17.5</b>	<b>15.9</b>	<b>16.7</b>	<b>20.8</b>	<b>19.0</b>	<b>18.9</b>	<b>18.9</b>	<b>18.9</b>	<b>18.9</b>	<b>18.9</b>
o/w Wages and salaries	6.5	7.7	7.3	7.4	9.6	9.3	8.5	8.8	8.2	8.4	7.8
Transfers	3.1	3.7	3.4	3.6	4.4	4.2	4.5	4.1	4.5	4.1	4.4
Capital expenditure	2.4	4.1	3.4	3.9	4.8	4.0	4.0	4.1	4.2	4.3	4.5
<b>Central government primary balance</b>	<b>2.8</b>	<b>0.6</b>	<b>1.6</b>	<b>1.0</b>	<b>-1.6</b>	<b>-1.7</b>	<b>-1.4</b>	<b>-0.6</b>	<b>-0.6</b>	<b>-0.5</b>	<b>-0.5</b>
<b>Central government overall balance</b>	<b>2.3</b>	<b>0.1</b>	<b>1.2</b>	<b>0.7</b>	<b>-1.8</b>	<b>-2.0</b>	<b>-1.8</b>	<b>-1.0</b>	<b>-1.0</b>	<b>-1.0</b>	<b>-1.0</b>
<b>Consolidated public debt (in percent of GDP)</b>	<b>22.8</b>	<b>22.5</b>	<b>18.6</b>	<b>16.2</b>	<b>15.9</b>	<b>20.9</b>	<b>19.1</b>	<b>17.6</b>	<b>17.2</b>	<b>18.3</b>	<b>17.1</b>
o/w external	17.0	15.6	13.3	11.1	10.7	11.7	11.4	11.6	11.7	11.9	12.1
domestic	2.0	2.4	2.0	1.3	1.9	3.3	3.1	2.9	2.7	2.5	2.3
LRM 2/	3.8	4.5	3.3	3.8	3.3	5.8	4.5	3.1	3	3.8	2.7
<b>Memorandum items:</b>											
GDP (in billions of Guaranies)	80,735	79,117	94,934	108,795	108,832	125,856	138,079	151,487	166,274	183,119	202,484
GDP (US\$billions)	18.5	15.9	20.7	24.1	24.9	28.4	29.7	32.0	34.8	37.6	40.4

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 3a. Paraguay: Central Government Operations

	2008	2009	2010	2011	2012	Est. 2013	Proj. 2014	2015
(in percent of GDP; unless otherwise indicated)								
<b>Total revenues</b>	<b>15.8</b>	<b>17.5</b>	<b>17.1</b>	<b>17.4</b>	<b>19.0</b>	<b>17.0</b>	<b>17.0</b>	<b>17.8</b>
Tax revenues:	10.7	11.6	12.0	12.1	12.7	11.7	12.0	12.8
Value added tax	5.6	5.6	6.2	6.2	6.5	5.7	5.8	6.1
Nontax revenues 1/	5.0	5.9	5.1	5.3	6.2	5.3	5.0	5.0
Capital revenues	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Current expenditures</b>	<b>11.1</b>	<b>13.4</b>	<b>12.5</b>	<b>12.8</b>	<b>16.0</b>	<b>15.0</b>	<b>14.9</b>	<b>14.8</b>
Wages and salaries	6.5	7.7	7.3	7.4	9.6	9.3	8.5	8.8
Goods and services	0.9	1.3	1.4	1.5	1.6	1.2	1.3	1.4
Interest payments	0.6	0.6	0.4	0.3	0.2	0.3	0.5	0.5
Transfers	3.1	3.7	3.4	3.6	4.4	4.2	4.5	4.1
<b>Capital expenditures and net lending</b>	<b>2.4</b>	<b>4.1</b>	<b>3.4</b>	<b>3.9</b>	<b>4.8</b>	<b>4.0</b>	<b>4.0</b>	<b>4.1</b>
Statistical discrepancy 2/	0.4	0.0	0.1	0.1	0.0	0.0	0.0	0.0
<b>Overall balance</b>	<b>2.3</b>	<b>0.1</b>	<b>1.2</b>	<b>0.7</b>	<b>-1.8</b>	<b>-2.0</b>	<b>-1.8</b>	<b>-1.0</b>
<b>Financing</b>	<b>-2.3</b>	<b>-0.1</b>	<b>-1.2</b>	<b>-0.7</b>	<b>1.8</b>	<b>2.0</b>	<b>1.8</b>	<b>1.0</b>
External debt (increase +)	-0.4	0.1	0.3	-0.2	-0.1	1.9	0.5	1.0
Disbursements	0.6	1.5	1.3	0.5	0.8	2.6	1.1	1.5
Amortizations	1.1	1.4	1.0	0.8	0.9	0.6	0.5	0.5
Domestic bonds (increase +)	0.0	0.5	0.0	-0.4	0.7	1.6	0.0	0.0
Net credit from the banking system	-1.7	-1.3	-1.7	-0.3	0.9	-1.5	1.3	0.0
Other	-0.5	0.6	0.1	0.3	0.2	0.0	0.0	0.0
<b>Memorandum Items:</b>								
Current primary expenditure	10.5	12.8	12.1	12.6	15.7	14.7	14.4	14.3
Primary balance	2.8	0.6	1.6	1.0	-1.6	-1.7	-1.4	-0.6
Current primary expenditure real growth (in percer)	3.7	16.4	8.3	9.8	20.7	4.4	3.0	4.2
Structural primary balance 3/	-0.4	-3.2	-1.7	-2.8	-6.0	-6.0	-5.2	-4.3
Fiscal impulse	-2.0	2.9	-1.5	1.1	3.2	0.1	-0.8	-0.9

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

1/ Includes receipts from the binational hydroelectric plants Itaipu and Yacyreta, and grants.

2/ Measurement error to reconcile above-the-line estimate with measure of the fiscal balance from the financing side.

3/ Excludes royalties and grants; in percent of non-agricultural potential GDP



Table 3b. Paraguay: Central Government Operations (2001 GFSM)

	2008	2009	2010	2011	2012	Est. 2013	Proj. 2014	2015
	(in percent of GDP; unless otherwise indicated)							
<b>Revenue</b>	<b>15.8</b>	<b>17.5</b>	<b>17.1</b>	<b>17.4</b>	<b>18.9</b>	<b>17.0</b>	<b>17.0</b>	<b>17.8</b>
Taxes	10.7	11.6	12.0	12.1	12.7	11.7	12.0	12.8
Income taxes	1.9	2.8	2.2	2.4	2.7	2.7	2.7	3.1
Excises	1.7	1.9	1.9	1.8	1.9	2.0	2.1	2.1
Value added tax	5.6	5.6	6.2	6.2	6.5	5.7	5.8	6.1
Import duties	1.3	1.2	1.6	1.6	1.5	1.2	1.3	1.4
Other	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social contributions	1.1	1.3	1.2	1.2	1.6	1.3	1.3	1.3
Other revenue	3.9	4.6	3.9	4.1	4.7	4.0	3.7	3.7
Itaipu-Yacyreta	2.3	2.9	2.1	2.1	2.8	2.5	2.2	2.2
Other nontax revenue	1.6	1.8	1.8	1.9	1.9	1.5	1.5	1.5
Capital revenue 1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Expenditure</b>	<b>13.5</b>	<b>17.4</b>	<b>15.8</b>	<b>16.5</b>	<b>20.6</b>	<b>18.7</b>	<b>18.6</b>	<b>18.6</b>
<b>Expense</b>	<b>12.0</b>	<b>14.8</b>	<b>13.4</b>	<b>14.2</b>	<b>18.0</b>	<b>16.4</b>	<b>16.2</b>	<b>16.1</b>
Compensation of employees	6.5	7.7	7.3	7.4	9.6	9.3	8.5	8.8
Purchases of goods and services	0.9	1.3	1.4	1.5	1.6	1.2	1.3	1.4
Interest	0.6	0.6	0.4	0.3	0.2	0.3	0.5	0.5
Grants 2/	0.9	1.4	0.9	1.4	2.0	1.4	1.3	1.3
Social benefits 3/	1.7	1.9	1.6	1.5	1.9	1.9	1.9	1.9
Other expense	1.4	2.0	1.9	2.1	2.6	2.2	2.6	2.2
Transfers 4/	1.4	1.9	1.8	2.0	2.5	2.2	2.5	2.2
Other	0.0	0.1	0.1	0.1	0.1	0.0	0.0	0.0
<b>Net acquisition of nonfinancial assets</b>	<b>1.5</b>	<b>2.6</b>	<b>2.4</b>	<b>2.2</b>	<b>2.6</b>	<b>2.3</b>	<b>2.4</b>	<b>2.4</b>
<b>Gross operating balance</b>	<b>3.7</b>	<b>2.7</b>	<b>3.7</b>	<b>3.2</b>	<b>0.9</b>	<b>0.5</b>	<b>0.8</b>	<b>1.7</b>
<b>Net lending/borrowing (overall balance)</b>	<b>2.6</b>	<b>0.1</b>	<b>1.4</b>	<b>1.0</b>	<b>-1.6</b>	<b>-1.8</b>	<b>-1.6</b>	<b>-0.8</b>
<b>Net financial transactions</b>	<b>2.6</b>	<b>0.1</b>	<b>1.5</b>	<b>0.9</b>	<b>-1.6</b>	<b>-2.9</b>	<b>-2.2</b>	<b>-1.6</b>
<b>Net acquisition of financial assets</b>	<b>0.0</b>	<b>0.1</b>	<b>0.1</b>	<b>0.2</b>	<b>0.1</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>
Loans 5/	0.0	0.1	0.1	0.2	0.1	0.3	0.3	0.3
<b>Net incurrence of liabilities</b>	<b>-2.7</b>	<b>-0.1</b>	<b>-1.4</b>	<b>-0.7</b>	<b>1.8</b>	<b>3.1</b>	<b>2.5</b>	<b>1.8</b>
Domestic	-2.2	-0.1	-1.6	-0.4	1.8	0.1	1.3	0.0
Foreign	-0.4	0.1	0.3	-0.2	-0.1	1.9	0.5	1.0

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

1/ Includes capital transfers as well as some sale of assets.

2/ Grants cover capital transfers and other which are mostly paid to municipalities.

3/ Pensions and benefits are included in social benefits.

4/ Some grants are included here, but pensions and benefits are recorded under social benefits.

5/ Includes net lending which is a financial item from the 2001 GFSM

**Table 4. Paraguay: Operations of the Consolidated Public Sector <sup>1/</sup>**

	2008	2009	2010	2011	2012	Est. 2013	Proj. 2014	2015
	(In percentage of GDP)							
<b>Revenue</b>	<b>20.1</b>	<b>21.0</b>	<b>20.9</b>	<b>22.6</b>	<b>23.9</b>	<b>21.5</b>	<b>21.1</b>	<b>22.1</b>
Taxes	10.8	11.7	12.1	12.1	12.8	11.8	12.1	12.9
Other revenue	9.4	9.4	8.8	10.4	11.1	9.8	9.1	9.2
Nontax revenue and grants 2/	8.7	9.4	8.5	9.0	10.4	9.2	8.7	8.6
Capital revenue	0.1	0.2	0.1	0.1	0.2	0.0	0.0	0.0
Public enterprises' operating surplus	0.6	-0.2	0.2	1.4	0.5	0.5	0.4	0.6
<b>Expenditure</b>	<b>17.3</b>	<b>21.8</b>	<b>20.4</b>	<b>21.1</b>	<b>25.7</b>	<b>23.9</b>	<b>23.9</b>	<b>23.8</b>
<b>Expense</b>	<b>14.3</b>	<b>17.1</b>	<b>15.9</b>	<b>16.5</b>	<b>20.1</b>	<b>19.1</b>	<b>19.1</b>	<b>18.9</b>
Compensation of employees	8.1	9.5	9.1	9.2	12.1	11.6	10.8	11.1
Purchases of goods and services	1.7	2.4	2.2	2.6	2.7	2.5	2.6	2.6
Interest	1.0	0.7	0.8	0.7	0.6	0.6	0.9	0.8
Other expense	3.5	4.4	3.8	4.0	4.6	4.4	4.7	4.4
Transfers 3/	3.5	4.3	3.7	3.9	4.5	4.3	4.6	4.3
Other	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
<b>Net acquisition of nonfinancial assets 4/</b>	<b>3.0</b>	<b>4.7</b>	<b>4.5</b>	<b>4.7</b>	<b>5.6</b>	<b>4.8</b>	<b>4.8</b>	<b>4.9</b>
<b>Gross operating balance</b>	<b>5.8</b>	<b>3.9</b>	<b>5.0</b>	<b>6.1</b>	<b>3.8</b>	<b>2.5</b>	<b>2.1</b>	<b>3.2</b>
<b>Net lending / borrowing (overall balance)</b>	<b>2.8</b>	<b>-0.8</b>	<b>0.5</b>	<b>1.4</b>	<b>-1.8</b>	<b>-2.3</b>	<b>-2.7</b>	<b>-1.7</b>
<b>Net financial transactions</b>	<b>2.9</b>	<b>-0.8</b>	<b>0.4</b>	<b>1.4</b>	<b>-1.8</b>	<b>-2.3</b>	<b>-2.7</b>	<b>-2.3</b>
<b>Net incurrence of liabilities</b>	<b>-2.9</b>	<b>0.8</b>	<b>-0.4</b>	<b>-1.4</b>	<b>1.8</b>	<b>2.3</b>	<b>2.7</b>	<b>2.3</b>
Domestic	-2.3	0.7	-0.5	-2.0	1.9	0.5	2.4	0.8
Debt securities	0.0	0.5	0.0	-0.4	0.7	1.6	0.0	0.0
Loans	-2.0	-0.8	-0.9	-1.3	0.8	-1.5	1.8	0.3
Net credit from the banking system	-2.0	-0.8	-0.9	-1.3	0.8	-1.5	1.8	0.3
From commercial banks	-0.3	0.5	0.8	-1.0	-0.1	0.0	0.4	0.3
From central banks	-1.7	-1.3	-1.7	-0.3	0.9	-1.5	1.3	0.0
Other accounts payable	-0.3	1.0	0.4	0.9	0.5	0.5	0.6	0.5
Quasifiscal deficit financing	0.3	0.4	0.3	0.6	0.2	0.5	0.6	0.5
Other	-0.5	0.6	0.1	0.3	0.2	0.0	0.0	0.0
Foreign	-0.6	0.1	0.0	0.5	-0.2	1.8	0.4	1.5
Loans	-0.6	0.1	0.0	0.5	-0.2	1.8	0.4	1.5
Disbursements	0.6	1.5	1.3	0.5	0.8	2.6	1.1	1.5
Amortizations	1.2	1.4	1.2	0.9	1.0	0.8	0.7	0.6
<b>Memorandum items:</b>								
Primary balance	3.9	0.0	1.3	2.1	-1.1	-1.7	-1.8	-0.9
Public debt (excl. LRMs)	19.0	18.0	15.3	12.4	12.6	15.1	14.6	14.5
Domestic public debt	2.0	2.4	2.0	1.3	1.9	3.3	3.1	2.9
Foreign public debt	17.0	15.6	13.3	11.1	10.7	11.7	11.4	11.6

Sources: Ministry of Finance and Fund staff estimates.

1/ Public sector comprises only the nonfinancial public sector and the Central Bank.

2/ Includes also social contributions and grants.

3/ Includes also social benefits and grants.

4/ Includes as well capital transfers.

**Table 5. Paraguay: Summary Accounts of the Central Bank**

	2008	2009	2010	2011	2012	Est. 2013	Proj. 2014
(In billions of Guaranies; end-of-period; valued at constant exchange rate)							
<b>Currency issue</b>	<b>4,974</b>	<b>5,538</b>	<b>6,564</b>	<b>7,324</b>	<b>8,606</b>	<b>9,804</b>	<b>10,789</b>
Growth	15.0	11.3	18.5	11.6	17.5	13.9	10.1
<b>Net international reserves</b>	<b>14,664</b>	<b>19,467</b>	<b>20,825</b>	<b>24,854</b>	<b>24,914</b>	<b>29,443</b>	<b>28,811</b>
(In millions of U.S. dollars)	2,875	3,817	4,165	4,971	4,983	5,889	5,762
<b>Net domestic assets</b>	<b>-9,690</b>	<b>-13,929</b>	<b>-14,262</b>	<b>-17,529</b>	<b>-16,308</b>	<b>-19,639</b>	<b>-18,022</b>
Net nonfinancial public sector	-823	-1,515	-3,045	-3,202	-1,448	-2,044	-1,544
Net credit to the central government	-1,318	-1,965	-3,534	-3,708	-1,435	-2,046	-1,546
Net credit to the rest of NFPS	494	450	489	507	-13	1	1
Net credit to the banking system	-6,601	-9,296	-8,586	-11,730	-12,126	-15,207	-14,963
Reserve requirements	-3,476	-4,278	-4,927	-6,388	-6,828	-8,262	-9,183
Free reserves	-1,476	-3,332	-2,143	-2,657	-2,735	-735	-735
Monetary control instruments 1/	-3,019	-3,054	-2,881	-4,111	-3,665	-7,488	-6,324
Other	1,370	1,368	1,365	1,426	1,102	1,278	1,278
Other assets and liabilities (net)	-2,265	-3,119	-2,630	-2,598	-2,734	-2,387	-1,514
Capital and reserves	-39	396	681	1,244	1,503	2,147	2,998
Other assets net 2/	-2,226	-3,515	-3,311	-3,842	-4,238	-4,534	-4,512
<b>Memorandum Items:</b>							
Total stock of IRMs outstanding 1/	3,282	3,412	3,137	4,155	3,601	7,488	6,324
Quasifiscal balance 3/	-216	-306	-324	-601	-644	-641	-868
In percent of GDP	-0.3	-0.4	-0.3	-0.6	-0.6	-0.5	-0.6
Costs of monetary policy operations	375	140	142	433	400	374	575
In percent of GDP	0.5	0.2	0.2	0.4	0.4	0.3	0.4

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

1/Include an overnight-deposit facility and central bank bills (LRM). A fraction of LRM is held by non-bank institutions.

2/ Includes LRM held by the non-banking sector.

3/ Cumulative since beginning of year.

**Table 6. Paraguay: Summary Accounts of the Financial System**

	2008	2009	2010	2011	2012	Est. 2013	Proj. 2014
(In billions of Guaranies; end-of-period; valued at constant exchange rate)							
I. Central Bank							
<b>Net international reserves</b>	<b>14,664</b>	<b>19,467</b>	<b>20,825</b>	<b>24,854</b>	<b>24,914</b>	<b>29,443</b>	<b>28,811</b>
(In millions of U.S. dollars)	2,875	3,817	4,165	4,971	4,983	5,889	5,762
<b>Net domestic assets</b>	<b>-9,690</b>	<b>-13,929</b>	<b>-14,262</b>	<b>-17,529</b>	<b>-16,308</b>	<b>-19,639</b>	<b>-18,022</b>
Credit to public sector, net	-823	-1,515	-3,045	-3,202	-1,448	-2,044	-1,544
Credit to banking system, net 1/ Credit	-3,582	-6,242	-5,705	-7,619	-8,460	-7,719	-8,640
Deposits	1,370	1,368	1,365	1,426	1,102	1,278	1,278
Central bank securities	4,952	7,610	7,070	9,045	9,562	8,997	9,918
Other	3,282	3,412	3,137	4,155	3,601	7,488	6,324
	-2,002	-2,760	-2,374	-2,554	-2,799	-2,387	-1,514
<b>Currency issue</b>	<b>4,974</b>	<b>5,538</b>	<b>6,564</b>	<b>7,324</b>	<b>8,606</b>	<b>9,804</b>	<b>10,789</b>
II. Monetary Survey							
<b>Net foreign assets</b>	<b>16,462</b>	<b>20,927</b>	<b>21,658</b>	<b>24,394</b>	<b>24,342</b>	<b>27,072</b>	<b>23,666</b>
(In millions of U.S. dollars)	3,228	4,103	4,332	4,879	4,868	5,414	4,733
<b>Net domestic assets</b>	<b>12,036</b>	<b>14,124</b>	<b>19,977</b>	<b>24,606</b>	<b>31,371</b>	<b>39,864</b>	<b>50,921</b>
Credit to the public sector	-1,791	-2,676	-4,722	-6,558	-4,996	-5,797	-5,567
Credit to the private sector	20,277	24,615	33,786	42,517	49,249	57,867	64,746
Other	-6,450	-7,815	-9,088	-11,354	-12,881	-12,206	-8,258
<b>Broad liquidity (M4)</b>	<b>28,498</b>	<b>35,050</b>	<b>41,635</b>	<b>49,000</b>	<b>55,713</b>	<b>66,936</b>	<b>74,587</b>
Bonds and issued securities	0	0	0	0	0	0	0
Other monetary liabilities	1,159	1,475	1,704	2,602	2,896	3,493	4,805
Central bank securities with private sector	263	358	255	44	0	0	0
<b>Broad liquidity (M3)</b>	<b>27,077</b>	<b>33,217</b>	<b>39,675</b>	<b>46,353</b>	<b>52,817</b>	<b>63,443</b>	<b>69,783</b>
Foreign currency deposits	8,631	10,483	13,249	15,486	18,246	22,078	26,493
<b>Money and quasi-money (M2)</b>	<b>18,445</b>	<b>22,734</b>	<b>26,426</b>	<b>30,867</b>	<b>34,571</b>	<b>41,365</b>	<b>43,289</b>
Quasi-money	8,344	9,778	11,638	14,729	16,813	20,253	20,511
Money (M1)	10,101	12,956	14,788	16,138	17,758	21,112	22,778
(Annual Percentage Change)							
M0 (Currency issued)	15.0	11.3	18.5	11.6	17.5	13.9	10.1
Credit to the private sector	62.0	21.4	37.3	25.8	15.8	17.5	11.9
M1	8.6	28.3	14.1	9.1	10.0	18.9	7.9
M2	37.7	23.3	16.2	16.8	12.0	19.7	4.7
M3	35.4	22.7	19.4	16.8	13.9	20.1	10.0
Of which: Foreign currency deposits	30.8	21.5	26.4	16.9	17.8	21.0	20.0
<b>Memorandum items:</b>							
Ratio of foreign currency deposits to M3 (percent)	31.9	31.6	38.7	38.4	38.5	40.9	44.1
Ratio of foreign currency deposits to private sector deposits (percent)	42.9	44.0	45.3	43.8	44.0	47.5	51.2

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

1/Excludes LRM held by the banking sector.

Table 7. Paraguay: Balance of Payments

	2008	2009	2010	2011	2012	Est. 2013	2014	2015	Proj. 2016	2017	2018
(In millions of U.S. dollars; unless otherwise indicated)											
<b>Current account</b>	<b>184</b>	<b>482</b>	<b>-57</b>	<b>110</b>	<b>-238</b>	<b>269</b>	<b>-263</b>	<b>-255</b>	<b>-206</b>	<b>-296</b>	<b>-391</b>
Trade balance	1,051	1,124	882	855	556	1,302	919	1,071	1,180	1,107	983
Exports	9,726	7,751	10,469	12,634	11,649	13,510	14,224	14,947	15,891	16,792	17,747
Registered	4,463	3,167	4,534	5,509	5,052	7,106	7,480	7,776	8,248	8,635	9,040
Energy	1,948	1,901	1,967	2,257	2,310	2,314	2,399	2,551	2,720	2,903	3,099
Unregistered	3,315	2,683	3,969	4,867	4,287	4,090	4,345	4,620	4,923	5,254	5,607
Imports	-8,675	-6,627	-9,587	-11,779	-11,093	-12,209	-13,305	-13,876	-14,711	-15,685	-16,763
Registered	-8,506	-6,497	-9,400	-11,549	-10,756	-11,574	-12,914	-13,465	-14,271	-15,213	-16,256
Of which: Fuel products	-1,302	-909	-1,073	-1,507	-1,647	-1,786	-1,816	-1,793	-1,802	-1,836	-1,887
Unregistered	-169	-129	-187	-230	-337	-635	-391	-411	-440	-472	-507
Services (net)	-155	40	-84	-181	-171	-247	-284	-189	-225	-210	-195
Transport	-169	-152	-250	-309	-297	-291	-312	-334	-370	-375	-378
Travel	-18	74	72	67	58	16	2	1	3	13	21
Other	33	118	93	62	68	28	25	144	142	152	162
Factor income	-1,126	-1,201	-1,412	-1,278	-1,381	-1,494	-1,584	-1,847	-1,896	-1,950	-1,960
Transfers	414	519	557	714	759	708	686	710	735	757	781
<b>Capital and financial account</b>	<b>164</b>	<b>-54</b>	<b>223</b>	<b>490</b>	<b>478</b>	<b>444</b>	<b>137</b>	<b>435</b>	<b>406</b>	<b>509</b>	<b>438</b>
General government	-99	11	54	-55	-14	488	144	326	360	378	417
Disbursements	113	231	260	129	198	193	316	495	530	548	600
Amortization	-212	-220	-206	-184	-212	-205	-172	-169	-169	-169	-184
Other	0	0	0	0	0	500	0	0	0	0	0
Private sector 1/	263	-64	169	545	491	-44	-7	109	46	131	21
Direct investment	209	95	216	557	480	382	497	606	778	969	1,184
Foreign currency deposits	77	164	128	17	-268	151	-207	-70	-2	426	693
Other	-23	-323	-175	-29	280	-578	-297	-427	-729	-1,264	-1,856
<b>Errors and omissions</b>	<b>-40</b>	<b>371</b>	<b>182</b>	<b>206</b>	<b>-228</b>	<b>193</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Overall balance</b>	<b>308</b>	<b>800</b>	<b>348</b>	<b>806</b>	<b>12</b>	<b>906</b>	<b>-126</b>	<b>180</b>	<b>200</b>	<b>213</b>	<b>47</b>
Net international reserves (increase -)	-389	-942	-348	-806	-12	-906	126	-180	-200	-213	-47
Gross reserves	-389	-942	-348	-806	-12	-906	126	-180	-200	-213	-47
Reserve liabilities	0	0	0	0	0	0	0	0	0	0	0
Exceptional financing	81	142	0	0	0	0	0	0	0	0	0
Arrears deferral (+)/clearance (-)	81	142	0	0	0	0	0	0	0	0	0
<b>Memorandum items:</b>											
Current account in percent of GDP	1.0	3.0	-0.3	0.5	-1.0	0.9	-0.9	-0.8	-0.6	-0.8	-1.0
Gross reserves (in millions of U.S. dollars)	2,876	3,817	4,165	4,971	4,983	5,889	5,763	5,943	6,143	6,356	6,403
In months of imports of GNFS	4.8	4.4	3.9	5.0	4.5	4.9	4.6	4.4	4.3	4.2	4.2
External public debt in percent of GDP 1/	17.6	15.7	13.4	11.2	10.7	11.8	11.5	11.6	11.7	11.9	12.1
Debt service in percent of exports GNFS	13.0	17.4	12.6	10.1	11.0	9.1	9.0	8.6	8.1	7.7	7.5
Export volume (percentage change)	5.6	-19.8	17.8	-0.7	-3.7	30.6	7.6	6.1	5.2	5.3	5.3
Import volume (percentage change)	21.7	-17.1	36.5	13.5	-10.4	14.1	6.3	5.7	6.6	6.6	6.5
Terms of trade (percentage change)	3.3	-3.0	8.2	14.3	-10.2	-7.0	-9.1	-2.1	1.2	-0.6	-0.8

Sources: Central Bank of Paraguay and Fund staff estimates.

1/ Based on average exchange rate valuation of GDP.

**Table 8. Paraguay: Indicators of External Vulnerability**

	2008	2009	2010	2011	2012	2013
	(In percent of GDP, unless otherwise indicated)					
<b>Monetary and financial indicators</b>						
Broad money (M3), percentage change 1/	35.4	22.7	19.4	16.8	13.9	20.1
Credit to the private sector, real (percentage change) 1/	50.7	19.2	28.1	19.9	11.4	13.3
Share of nonperforming loans in total loans (percent) 2/	1.1	1.6	1.3	1.7	2.1	2.2
Average domestic lending rate, real	17.6	23.0	21.5	6.0	11.0	12.0
Central Bank bill yield, real	-5.0	0.3	0.8	-0.8	1.8	3.2
International reserves (millions of U.S. dollars)	2,875	3,817	4,165	4,971	4,983	5,889
Central bank foreign short-term liabilities (millions of U.S. dollars)	0.0	1.2	0.0	0.0	0.0	0.0
<b>External indicators</b>						
Merchandise exports (percentage change)	29.7	-20.3	35.1	20.7	-7.8	16.0
Merchandise imports (percentage change)	44.7	-23.6	44.7	22.9	-5.8	10.1
Merchandise terms of trade (percentage change)	3.7	-3.3	8.3	24.8	1.3	-7.0
Real effective exchange rate (percentage change)	16.3	-7.4	2.8	13.4	-0.3	5.8
Current account balance (percent of GDP)	1.0	3.0	-0.3	0.5	-1.0	0.9
Capital and financial account (percent of GDP)	0.9	-0.3	1.1	2.0	1.9	1.6
Net foreign direct investment (percent of GDP)	1.1	0.6	1.0	2.3	1.9	1.3
Other net investment (percent of GDP)	-0.4	-1.2	-0.2	-0.9	-2.2	-1.8
External public debt (percent of GDP) 2/	17.6	15.7	13.4	11.2	10.7	11.8
Debt service (in percent of exports GNFS)	13.0	17.4	12.6	10.1	11.0	9.1
Net reserves (in U.S. dollars)	2,876	3,817	4,165	4,971	4,983	5,889
In months of imports of GNFS	4.8	4.4	3.9	5.0	4.5	4.9
Over short-term external debt 3/	1.4	1.8	2.0	2.3	2.4	2.8
Over foreign currency deposits in domestic banks	2.1	2.6	2.3	3.0	2.8	3.3

Sources: Central Bank of Paraguay and Fund staff calculations.

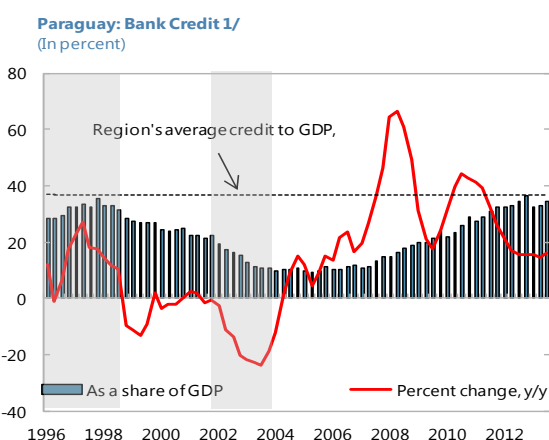
1/ Foreign currency components are valued at the accounting exchange rate.

2/ Based on end-of-period exchange rate conversion of U.S. dollar-denominated debt.

3/ Private and public external debt with a residual maturity of one year or less. Excludes foreign currency deposits in banking system.

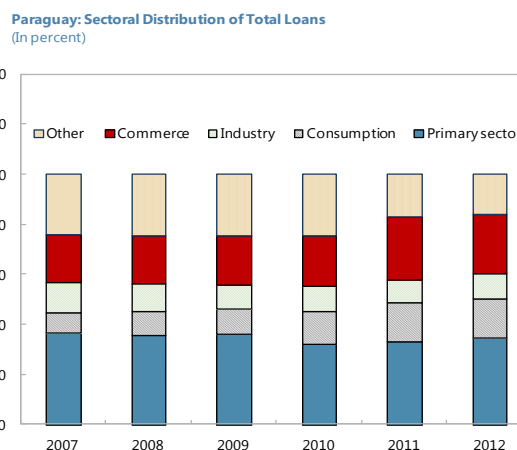
## Annex I. Paraguay: Banking Credit Developments<sup>1</sup>

**1. Total assets of the banking system have grown significantly in recent years fueled by rapid credit growth.**<sup>2</sup> Following a sharp decline in the mid-1990s and early 2000s during the banking crises, credit to the private sector has started to recover and grew briskly since 2007. As a result, credit reached about 36 percent of GDP in 2013—an increase of almost 20 percentage points of GDP in six years, catching up to the region’s current average and Paraguay’s credit level prior to the banking crises. All bank credit categories have experienced strong growth rates but especially consumer loans, which now represent 15 percent of total credit (compared to 8 percent in 2007).<sup>3</sup> Bank loans continue to be mainly concentrated in the large agriculture and livestock sectors, which account for 1/3 of the banking system’s total loan portfolio.<sup>4</sup> Economic stability, a strengthening of labor markets and a marked reduction in poverty, have been important factors in increasing the demand for credit by businesses and households since the mid-2000s.



Sources: Paraguayan Authorities; World Bank's World Development Indicators; and Fund staff estimates.

1/ Shaded region denotes banking crisis period.



Sources: Paraguayan Authorities; World Bank's World Development Indicators; and Fund staff estimates.

<sup>1</sup> Prepared by J. Yopez.

<sup>2</sup> The banking system hold assets equivalent to 77 percent of total system assets, with foreign asset ownership representing about 45 percent of total bank assets. There are 15 commercial banks, of which three are foreign-owned and five are majority foreign-owned. The financial system also consists of 12 finance companies, 372 cooperatives, 32 insurance companies, and 5 pension funds, with the rest of financial services entities being financial warehouses, exchange houses, and second-tier banks.

<sup>3</sup> Consumer loans are mainly linked to direct salary deposits.

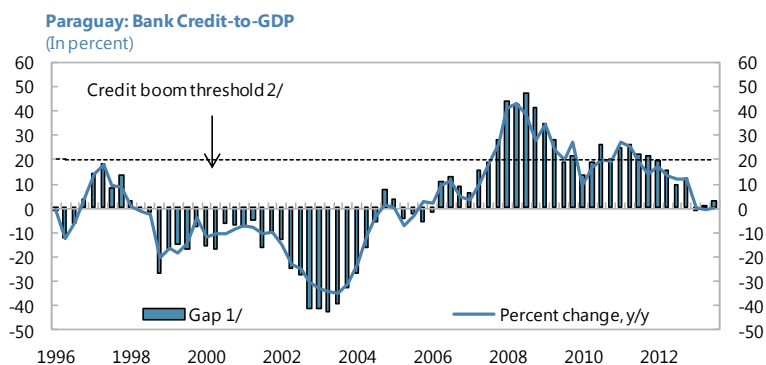
<sup>4</sup> Despite the large exposure to the primary sector, recent supply shocks to the sector did not spillover to the financial system. Risks have been limited by farmers' large buffers and high profits in recent years and by banks' strong capital and loss related buffers. Due to the high volatility of growth (agriculture accounts for 20 percent of the GDP), banks are subject to periodic stress tests.

## 2. High credit growth, if continued, could pose risks to the stability of the financial system.

International experience shows that periods of rapid credit expansion have often been associated with increased macro-financial vulnerabilities. Dell’Ariccia et al. (2012) find that about one in three booms have been followed by a period of sub-par growth or a banking crisis.<sup>5</sup>

These authors classify credit expansion episodes as credit boom when the annual growth rate of the credit-to-GDP ratio exceeds 20 percent. According to this definition, Paraguay experienced a credit boom from the last quarter of 2007 up to the first quarter of 2011.

However, the growth of credit relative to GDP in Paraguay has moderated during the past couple of years, shrinking the credit-to-GDP gap that had emerged during 2006–11.



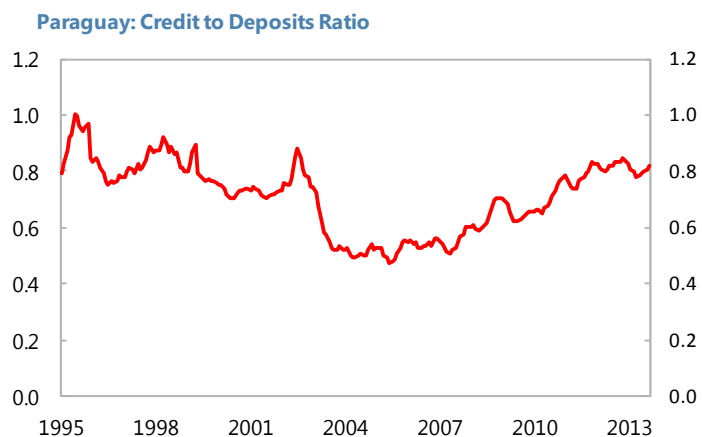
Sources: Paraguayan Authorities and Fund staff estimates.

1/ The credit-to-GDP GAP is defined as the difference between nominal growth rates of credit and GDP.

2/ Dell’Ariccia et al. (2012) define a credit boom episode as a period when the annual growth rate of credit-to-GDP exceeds 20 percent.

## 3. Despite the rapid increase in credit, the loans to deposits ratio has remained significantly below the 1.5 benchmark ratio for potential banking crises.

Banks in Paraguay rely almost entirely on deposits. On average, deposits constitute about 85 percent of total liabilities, most of them in checking and savings accounts (60 percent of total deposits). In recent years, the share of non-deposit funding to total liabilities has hovered around 13 percent. After a prolonged period of gradual process of financial de-dollarization, the process has stalled. As in the case of deposits, the ratio of foreign currency denominated credit to total credit currently stands at about 40 percent (compared to 70 percent in 2000).<sup>6</sup>



Source: Central Bank of Paraguay

<sup>5</sup> Dell’Ariccia, G., D. Igan, L. Laeven, and H. Tong. April 2012. “Policies for Macrofinancial Stability: How to Deal with Credit Booms” IMF Staff Discussion Note.

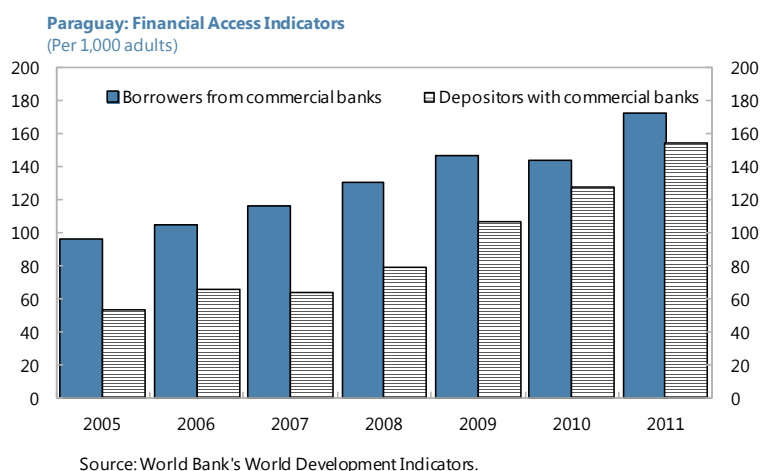
<sup>6</sup> Owing to limits defined by prudential regulations, banks net open foreign positions are low (there is a net open position limit of 50 percent of bank capital). Most of foreign currencies denominated loans are directed towards the agriculture sector, a sector that trades exclusively in dollars.



#### 4. Paraguay's banking sector risks appear well contained.

Banks account for 77 percent of the assets of the financial system. With capital to risk-weighted asset ratios (CAR) of 16.8 percent (above the minimum requirement of 12 percent), non-performing loans (NPL) of 2.3 percent at end-2013, and return-on-equity (ROE) of 26.8 at end-2013, the banking system remains well-capitalized, sound and profitable (Table 1 and Figure 1).<sup>7</sup> In

addition, according to the 2011 FSAP update, most banks appear resilient to shocks, although the exposure to large borrowers is high and some small banks are exposed to significant liquidity risk.



#### 5. Regulation and supervision of the banking system has undergone major progress in recent years, in particular, becoming more risk-based.

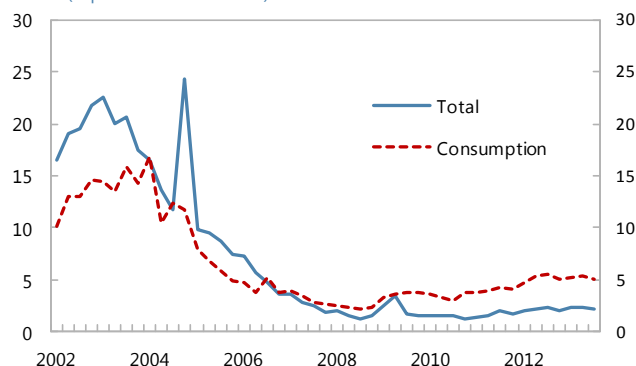
With regards to bank capital, the central bank approved a capital adequacy adjustment with regard to risk weighted assets and liabilities, in line with the definition of the Basel Accord (Basel I). More stringent provisioning measures and higher capital requirements became effective in January 2012, helping strengthen financial institutions' buffers. However, central bank's work on modernizing banking supervision has been constrained by an outdated legal framework. The current banking and central bank laws are unusually detailed and prescriptive, and determine quantitative limits, risk weights, and even the amount of fines, with very limited delegated capacity to the central bank. New central bank and banking laws are being drafted to establish principles and general requirements, while given the central bank the responsibility for establishing specific requirements and technical details. Additional efforts are also needed to improve the availability of credit information on borrowers and to strengthen the bank supervisor's loan classification system.

<sup>7</sup> However, this reflects changes in the composition of NPLs, with the share of recently overdue loans (which carry a lower provision) increasing. Regulations on provisioning have actually been tightened by the Central Bank.

## 6. Financial deepening has been accompanied by some financial inclusion.

Mobile money platforms have been an important tool for spearheading a financial inclusion process to accompany rapid financial deepening in Paraguay. At the same time, the Central Bank of Paraguay with the collaboration of the World Bank has recently introduced several programs aimed at expanding access to financial services and improving consumer's financial education. Long-term financial deepening would be crucial for Paraguay meeting its large infrastructure and other developmental needs. Preserving the sustainability of this process will require monitoring the current credit expansion closely, maintaining banking sector buffers, and continue strengthening financial supervision.

Paraguay: Non-Performing Loans  
(In percent of total loans)



Source: Central Bank of Paraguay

### Paraguay: Selected Financial Soundness Indicators for the Banking Sector

(In percent, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013 <sup>1/</sup>
<b>Capital adequacy and asset quality</b>							
Regulatory capital to risk-weighted assets	16.9	16.3	16.3	15.4	14.9	16.2	16.8
Nonperforming loans (NPL) to gross loans	1.3	1.1	1.6	1.3	1.7	2.1	2.4
Provisions to nonperforming loans 2/	78.4	77.7	78.8	74.4	69.1	72.4	69.9
<b>Earnings and Profitability</b>							
Return on assets (before tax)	3.5	3.9	2.9	2.8	2.7	2.3	2.8
Return on equity (before tax)	30.0	35.6	27.1	27.6	25.7	26.0	26.8
<b>Liquidity</b>							
Liquid assets to total assets	44.8	36.8	41.0	33.6	32.5	40.5	42.7
Customer deposits to total (noninterbank) loans	173.2	150.8	160.3	131.0	119.0	116.9	122.9
<b>Agricultural distribution of loans to total loans 1/</b>							
Agriculture and livestock	36.6	35.7	35.9	32.4	33.0	34.8	34.6
Manufacturing	12.0	11.2	9.3	9.7	9.1	10.0	10.8
Trade	17.4	19.3	19.6	21.1	25.6	23.8	22.9
Services	11.6	10.8	11.5	13.0	8.3	8.7	7.8
Consumer credit	8.4	9.4	10.4	13.1	15.4	15.4	15.9
Financial sector	14.0	13.5	13.1	10.6	8.3	7.0	7.8
<b>Other indicators</b>							
Foreign-currency-denominated loans to total loans	44.6	42.9	38.5	40.6	43.6	42.3	45.6
Foreign-currency-denominated deposits to total deposits	43.0	44.4	40.3	42.2	39.1	38.8	41.1
<b>Memo items</b>							
NPL financieras 3/	...	...	...	...	4.3	4.5	5.3
NPL cooperativas 3/	...	...	...	...	4.2	4.3	4.9
<b>Return on equity 3/</b>							
Financieras	...	...	...	...	17.4	11.9	9.9
Cooperativas	...	...	...	...	11.8	12.8	10.9

Sources: Central Bank of Paraguay, IMF FSI database and Fund staff calculations.

1/ For 2013, end-June.

2/ Exclude generic provisions.

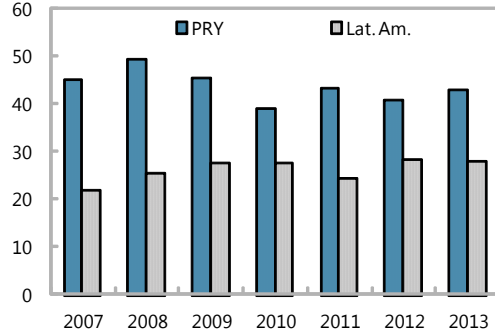
3/ For 2013, end-September data.

**Figure A1.1. Paraguay: Banking System Indicators <sup>1/</sup>**

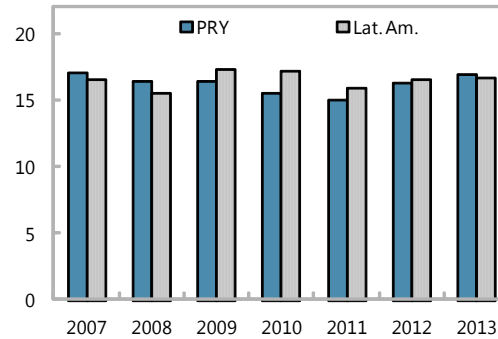
*Banks in Paraguay remain liquid and well capitalized.*

*Capital adequacy remains above the regulatory requirement, and in line with regional levels.*

**Liquid Assets to Total Assets**  
(In percent)

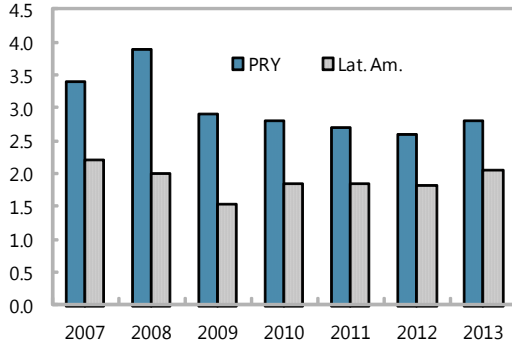


**Regulatory Capital to Risk-Weighted Assets**  
(In percent)

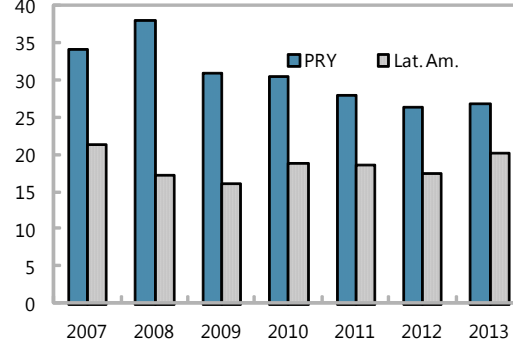


*Bank profitability has declined as compared to previous year, but still is among the highest in the region.*

**Return on Assets**  
(In percent)



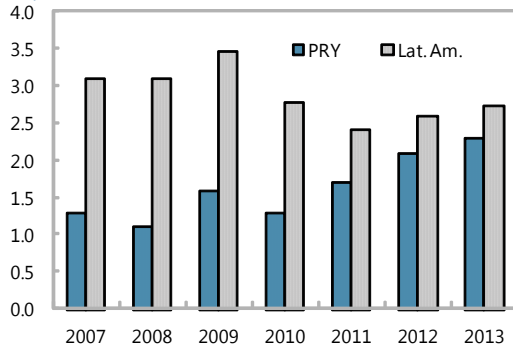
**Return on Equity**  
(In percent)



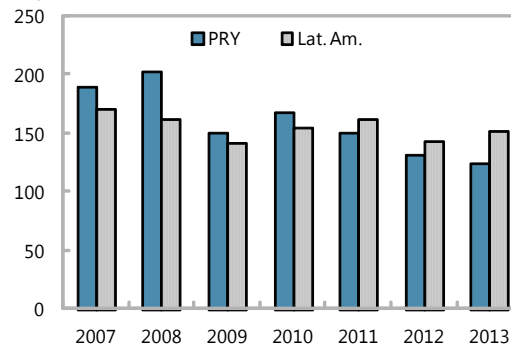
*After increasing in 2008, NPLs have remained relatively stable...*

*...and provisions are declining despite a tightening in their regulation..*

**Nonperforming Loans to Total Loans**  
(In percent)



**Provisions to Nonperforming Loans**  
(In percent)



Sources: Paraguayan Authorities; IMF Financial Indicators; and Fund staff estimates.

<sup>1/</sup> End of period data. Data for 2013 corresponds to latest available observation. Regional aggregates correspond to median values of Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, and Peru.

## Annex II. Assessing Paraguay's Potential Growth over the Medium Term<sup>1</sup>

1. The assessment of Paraguay's long-run potential output growth builds on a standard growth accounting exercise.<sup>2</sup> Specifically, the following Cobb-Douglas production function is estimated:

$$Y_t = A_t K_t^\alpha L_t^{1-\alpha}$$

where  $Y_t$  is total output,  $A_t$  is a technology parameter or TFP,  $K_t$  and  $L_t$  denote the capital stock and labor inputs, respectively, and  $\alpha$  is the share of capital income in total output (assumed to be 0.3).

2. In this setting, the capital stock evolves according to the following law of motion:

$$K_{t+1} = I_t + (1 - \delta)K_t$$

where  $I_t$  is total investment and  $\delta$  is the depreciation rate of the capital stock. This methodology requires the estimation of Paraguay's capital stock.

3. To estimate the capital stock an initial condition is required, which is obtained from the following steady state relation,

$$K_{ss} = I_{ss}/(\delta + g)$$

where  $g$  is the long-run growth rate of the capital stock. The capital stock of the year 1962,  $K_{1962}$ , is set as the initial condition for the model. Specifically, this is obtained from Eq. (3) using investment figures for the year 1962,  $I_{1962}$ , and setting  $\delta=0.08$ —a capital depreciation rate of 8 percent per year—and  $g$  is set to 4.2 percent—the average GDP growth rate over the last 60 years, equal to 4.06 percent.<sup>3</sup> Over the long run (in the steady state), the growth rate of the capital stock and GDP should coincide. The capital stock later evolves according to Eq. (2).

4. Results show that over the medium term, maintaining the growth rates in potential GDP of about 5 percent observed in the last five years will require:

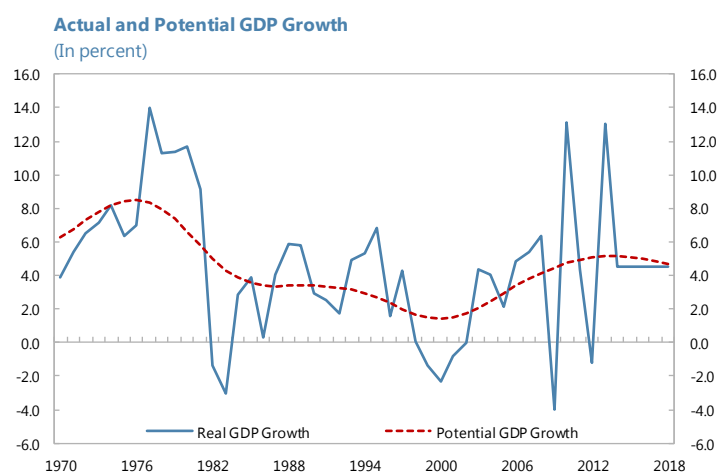
- Growth of physical capital is expected to accelerate somewhat, reflecting a pickup in investment of around 3.6 percentage points of GDP between 2013 and 2018—driven primarily by higher foreign and private domestic investment.
- The young labor force is envisaged to continue growing at around 3 percent, with labor continue to be the main driver for economic growth.

<sup>1</sup> Prepared by J. Yopez

<sup>2</sup> Based on Acosta-Ormaechea, S. *Paraguay—Potential Output Growth and Spillovers from Agriculture*, Selected Issues Paper, Chapter I, 2011, IMF Country Report No. 11/239.

<sup>3</sup> The depreciation rate for the capital stock was taken from Fernández Valdovinos, C. and Monge Naranjo, A. *Economic Growth in Paraguay*, Economic and Social Study Series, Inter-American Development Bank (May 2004).

- Our baseline projections also entail a slowdown in TFP growth for Paraguay, consistent with the normalization in the business cycle. TFP performance is typically procyclical, and—as the output gap close and growth moderate to medium term potential—TFP would grow at rates closer to its 2008–12 average.
- Under less favorable external conditions —softening in terms-of-trade, downside risks for economic growth in main trading partners, and a normalization of the easy external financing conditions—economic growth will likely remain slightly below potential growth rate of 4.9 percent, with the positive output gap narrowing over time. However, growth prospects could improve if structural reforms increase TFP growth, public investment management is strengthened and domestic and foreign investors respond more rapidly to the PPPs framework.



Sources: Central Bank of Paraguay and Fund staff calculations.

**Paraguay: Decomposition of Potential GDP Growth, 1971-2018**  
(In percent)

	1/				2008	2009	2010	2011	2012	Est. 2013	Baseline projection					2014-18 1/
	1971-80	1981-91	1992-2002	2003-2007							2014	2015	2016	2017	2018	
K growth	11.3	6.3	2.3	1.6	2.4	2.8	3.2	3.5	3.8	4.2	4.4	4.5	4.5	4.4	4.3	4.4
L growth	2.6	2.8	2.5	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	2.9	3.0
TFP growth	2.5	0.1	-0.2	0.4	1.2	1.4	1.6	1.7	1.8	1.7	1.7	1.6	1.5	1.4	1.4	1.5
Potential GDP growth	7.7	3.9	2.2	2.9	4.1	4.4	4.7	4.9	5.1	5.2	5.1	5.1	5.0	4.8	4.7	4.9
<b>Contribution</b>																
K growth	3.3	1.8	0.7	0.5	0.7	0.8	0.9	1.0	1.1	1.2	1.3	1.3	1.3	1.3	1.2	1.2
L growth	1.9	2.0	1.8	2.1	2.1	2.1	2.1	2.1	2.1	2.2	2.2	2.2	2.1	2.1	2.0	2.1
TFP growth	2.6	0.1	-0.2	0.4	1.3	1.5	1.7	1.8	1.8	1.8	1.7	1.6	1.5	1.5	1.4	1.6
Potential GDP growth	7.7	3.9	2.2	2.9	4.1	4.4	4.7	4.9	5.1	5.2	5.1	5.1	5.0	4.8	4.7	4.9
<b>Memorandum items</b>																
GDP growth rate	8.9	3.0	1.8	4.1	6.4	-4.0	13.1	4.3	-1.2	13.0	4.8	4.5	4.5	4.5	4.5	4.5
Investment/GDP	22.6	24.0	19.4	16.7	16.4	13.8	16.2	16.2	15.4	15.9	16.4	17.2	18.0	18.8	19.5	18.0
o/w private	...	...	13.0	12.6	13.5	9.1	11.8	11.6	9.8	11.1	11.6	12.3	12.9	13.5	14.0	12.8
Total output gap	-1.7	-0.1	1.0	-0.9	2.6	-5.7	1.9	1.3	-4.8	2.3	1.7	1.1	0.7	0.3	0.1	0.8

Sources: Country authorities and Fund staff estimates and projections.

1/ Average over the period.

## Annex III. Paraguay: Balance of Payments Stability Assessment<sup>1</sup>

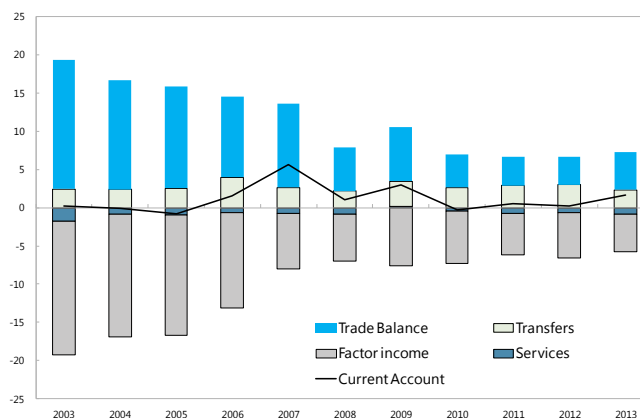
Paraguay's external position appears broadly consistent with medium-term fundamentals though some model based estimates point at a degree of real exchange rate overvaluation. Exchange rate strength reflects in part continued appreciation vis-à-vis the Argentinean peso and the Brazilian real. However, the country's external position would remain sound over the foreseeable future, amid sizeable foreign reserves, and expected improvements in infrastructure.

### A. Current Account

#### 1. Despite a sharp appreciation of the real exchange rate during the past decade, Paraguay's current account posted on average a surplus of about 1 percent of GDP over the past decade.

This mainly reflected an increase in the volume of primary exports and improved terms of trade, even though imports have been growing steadily over the period. Regarding the other components of the current account, Paraguay has been a net recipient of transfers, mainly worker's remittances, while net services and income components has been negative owing to the repatriation of utilities by FDI companies and the financial costs of foreign debt. The current account surpluses also reflected the fact that both the private and public sectors have been net savers—the public sector until 2011—amid booming commodity prices and low investment.

Current Account Components  
(in percent of GDP)

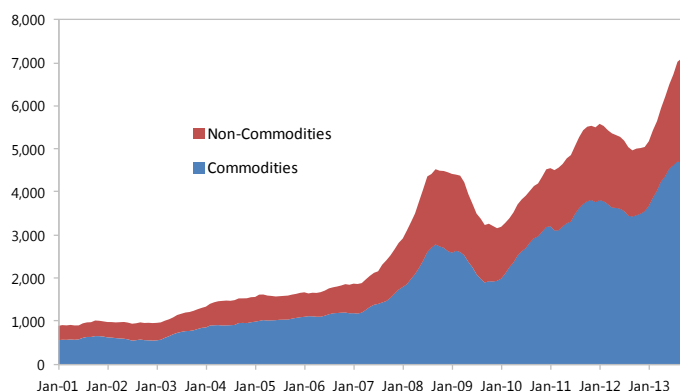


Sources: Central Bank of Paraguay and Fund staff calculations.

#### 2. The composition of Paraguay's exports has changed in the 2000s.

While commercial agriculture still weighs heavily on total exports, the rising industrialization of agricultural products is slowly showing into exports. In addition, exports of textiles, leather, and auto parts produced in the export processing zones have also gained importance. As a result, non-commodity exports

Exports by category  
(Mil. USD, 12 month sum)



Sources: Haver, Inc., Central Bank of Paraguay, dxdata, Datastream and IMF; *International Financial Statistics*.  
Note: Commodities include: Soybean seeds, cereals, meat, cotton fibers and wood. Non-commodities include vegetable oils, flour, and other products.

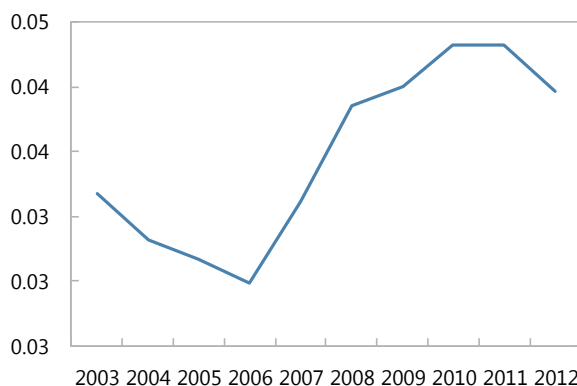
<sup>1</sup> Prepared by C. Perez Marulanda.

increased from 7.7 percent to 12 percent of non agro GDP between 2003 and 2013. Mercosur countries, in particular Brazil, remain Paraguay’s main trading partners, but their share in total exports has declined in the past years, while other regions, such as the European Union, the United States and Russia, have gained importance. Finally, Paraguay has also increased its share in global exports markets during the past decade.

**3. The current account balance is expected to switch to a deficit of about 1 percent of GDP over the medium term under the baseline scenario and the current level of the real exchange rate.** This weakening is mainly attributed to a slight deterioration in the terms of trade and rising import volumes. The latter is associated with an expected increase

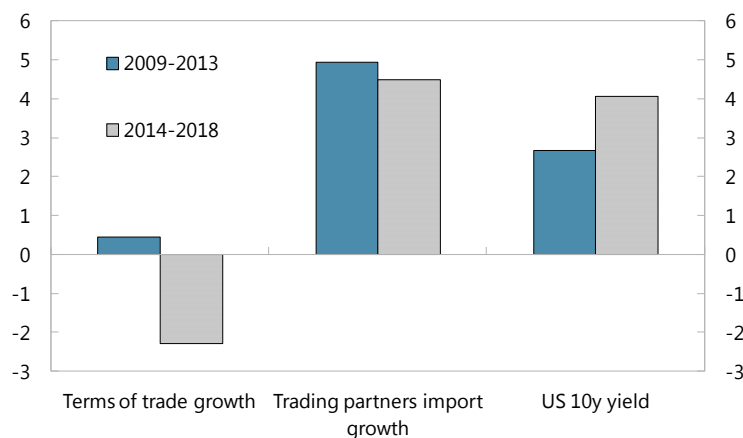
in FDI inflows, mainly into the agricultural and export oriented manufacturing sectors, to take advantage of recent government reforms and relatively lower cost than other countries in the region. The current account balance also reflects the fact that the private sector’s net saver position would narrow due to rising investment through 2018, though this is in part offset by increased public sector savings as fiscal settings are tightened in the near term consistent with the requirements of the new fiscal responsibility law. In addition, external gross financing needs are expected to remain within reasonable levels in the medium term and covered to a great extent by FDI.

**Share of World exports**  
(In percent of World exports)



Sources: International Financial Statistics and Fund staff calculations.

**Paraguay: External Headwinds**  
(in percent; period average)



Sources: WEO, National authorities and Fund staff estimates.

**Paraguay: Medium Term External Gross Financing Needs**  
(in percent of GDP)

	Proj.				
	2014	2015	2016	2017	2018
Gross Financing Needs	3.3	3.0	2.7	2.7	2.8
Non interest current account deficit	0.5	0.5	0.3	0.4	0.6
Amortizations	2.4	2.2	2.1	1.9	1.8
Interest payments 1/	0.3	0.3	0.3	0.3	0.4
<i>Memo Item</i>					
FDI	1.7	1.9	2.2	2.6	2.9

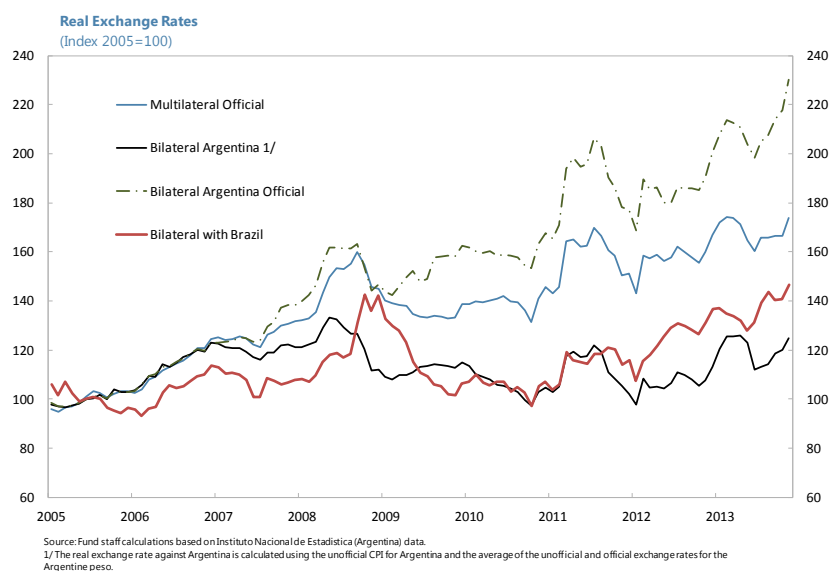
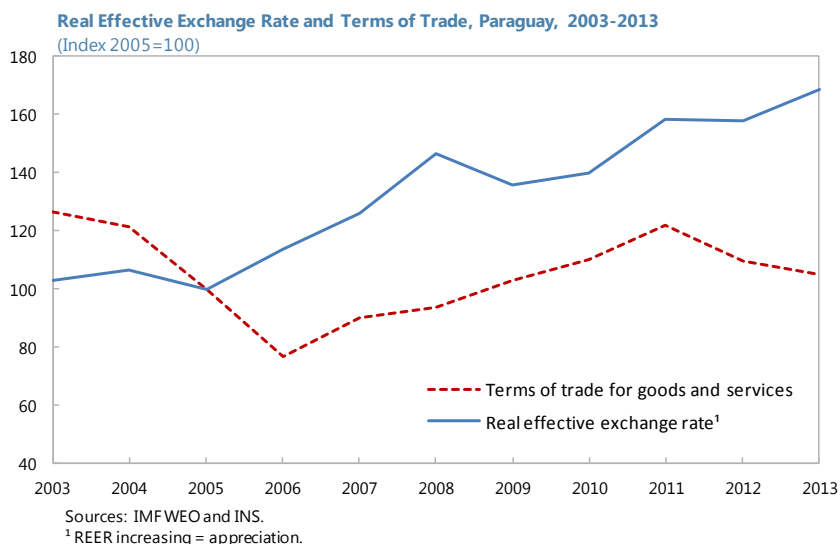
Source: Fund staff estimates.

1/Excludes interest payments of binational companies

## B. Exchange Rate

### 4. Paraguay's real exchange rate has appreciated by about 60 percent since 2005, against a backdrop of substantial reserve accumulation.

The appreciation of the guaraní has been higher than in other countries of the region, and explained in part by favorable terms of trade and stronger economic fundamentals, including eight consecutive years of fiscal surpluses (2003–11). The real appreciation has been driven primarily by nominal appreciations. In 2013, the real effective exchange rate appreciated by about 7 percent, mainly as a result of the nominal appreciation against the Argentinean peso (18 percent y/y) and the Brazilian real (6 percent y/y), with the real appreciation being slightly lower when adjusted by private estimates of inflation and the parallel exchange rate in Argentina. In contrast, in line with the movement of other currencies in the region, the guaraní depreciated in nominal terms vis-à-vis de U.S. dollar (8.5 percent y/y) and the euro (13.5 percent y/y).



## C. Competitiveness

5. **Although Paraguay's exchange rate appears to be slightly over its equilibrium level, a broader assessment yields no competitiveness concerns.** However, the results vary substantially among the different methods.



**CGER Assessment**

**6. Under the CGER methodologies, the guaraní appears to be slightly above equilibrium on average by about 8 percent**, mostly due to the results under the equilibrium real exchange rate methodology :

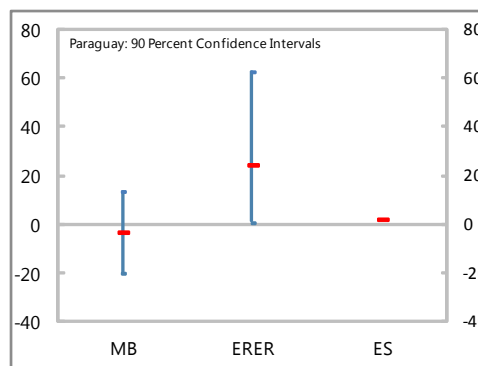
- The macroeconomic balance approach (MB) suggests that the current account deficit norm is -1.8 percent of GDP, while the projected underlying current account balance is -0.4 percent of GDP. The implied result is that the real exchange rate is slightly undervalued by just 3 percent. However, this result is not statistically significant.
- The external sustainability approach (ES) points that the net foreign asset (NFA) position, as measured by the net international investment position, would stabilize with a current account deficit norm of 0.2 percent. This suggests that the REER is slightly above equilibrium by only about 2 percent.
- Under the equilibrium real exchange rate methodology (ERER), estimated as a function of medium-term fundamentals (terms of trade, NFA, public expenditure, FDI and productivity), the guaraní appears to be significantly above equilibrium by 25 percent. However, the estimated deviation from equilibrium has a high degree of uncertainty given the wide range of the confidence interval.

**Paraguay Exchange Rate Assessment \***

CGER Methodology (October WEO data)

	CA/GDP Norm	
Macrobalance approach	-1.8	-3.0
External sustainability approach		2.3
Equilibrium REER		24.6

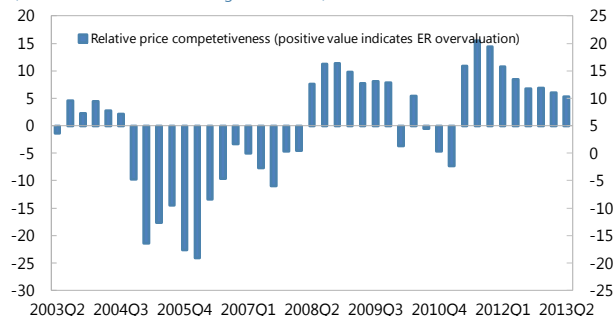
\* A positive sign indicates an overvaluation



Sources: IMF, and Fund staff estimates.

**External Price Competitiveness**

(Percent, deviation from average 2003-2013)



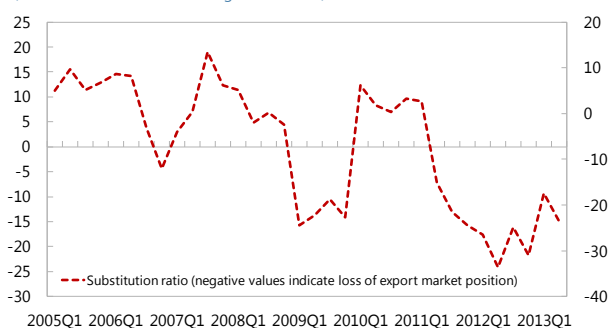
Sources: Haver Analytics, Central Bank of Paraguay, and Fund staff calculations.

**Other Assessments**

**7. Relative prices and market shares indicators were also used to assess Paraguay's competitiveness.** Changes in market shares for the country's primary products in major export markets are measured through the evolution of the substitution ratio of Paraguayan vs. domestic products sold in export markets. Changes in relative prices are measured with respect to local producer prices in export markets. These indicators are compared with their respective

**External Volume Competitiveness**

(Percent, deviation from average 2005-2013)

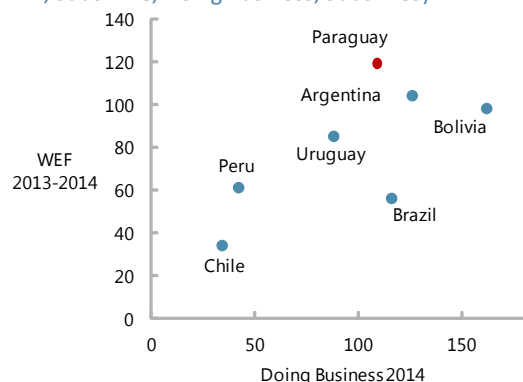


Sources: Haver Analytics, Central Bank of Paraguay, and Fund staff calculations.

medium-term levels. The results for these two indicators also show that the guaraní was above equilibrium by on average about 11 percent in 2013.

**8. Business Environment.** Paraguay has widespread structural and institutional weaknesses that affect its capacity to attract private investment and diversify its production base. The country’s overall ranking in the World Bank’s Doing Business Index in 2014 went down to 113 from 110 in the previous year. Although it improved substantially in the easiness of paying taxes, it declined on the other components of the index, such as dealing with construction permits, getting credit and resolving insolvency. Paraguay’s relative position vis-à-vis other countries in the region (such as Argentina, Brazil and Bolivia) remains in a better ranking. In the World Economic Forum’s Global Competitiveness Index (WEF), Paraguay also went down to 119 in 2013–14 from 116 in the previous survey. The results show that the most problematic areas for doing business in the country are: an inadequate educated workforce and supply of infrastructure, corruption and inefficient government bureaucracy. On the institutional front, the latest International Transparency Indices show that Paraguay is performing worse than the regional average on perception of institutional corruption (Congress and political parties), and paying bribes.

**World Economic Forum and Doing Business Indicators**  
(WEF, out of 148; Doing Business, out of 185)

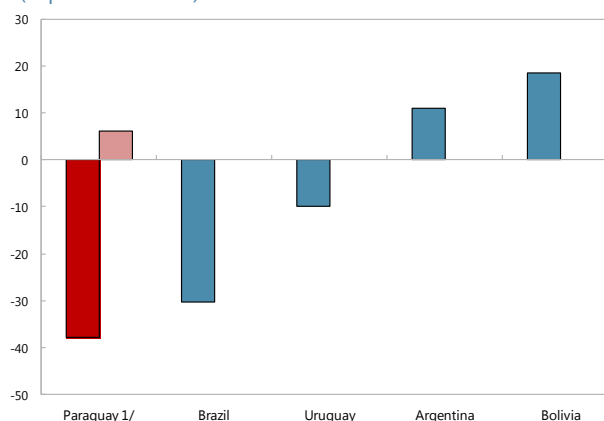


Sources: Doing Business and World Economic Forum.

#### D. Capital and Financial Account and International Investment Position

**9. The capital and financial account has been on surplus since 2008.** Given that portfolio inflows in Paraguay are very small, the main components of the capital account are FDI and private and public sector borrowing. FDI has hovered around 1.4 percent of GDP in the past five years, below the regional average, even though according to the annual report of the Economic Commission for Latin America (ECLAC), the profitability of FDI in Paraguay is the 2nd highest in the region and the country offers substantial incentives to (foreign) investors, particularly in the export processing zones. However, FDI is expected to increase over the medium term in response to recent government reforms and relatively higher

**Net IIP, latest observation**  
(In percent of GDP)



Source: Fund staff calculations.

1/ The second bar excludes the debt of binational entities.

production cost in other countries in the region. Among the sectors that are attracting FDI are: agricultural, metallurgic, and maquila or export processing zones (clothing, shoes and auto parts).

**10. The net international investment position (IIP) has been improving in the past years.**

As of 2012, the net position of the IIP was negative equivalent to 37 percent of GDP, compared to a negative position of 153 percent of GDP in 2005. It is important to highlight that the main cause of the negative position is the debt of the two binational electricity companies that was included as a net liability after a change in the national accounts methodology. The stock of this debt is estimated at US\$9 billion (35% of GDP) for 2013. The debt has been declining mainly because Itaipu's debt has been repaid by the Paraguayan government with the procedures of the energy sold to Brazil and is expected to be expire by 2023.

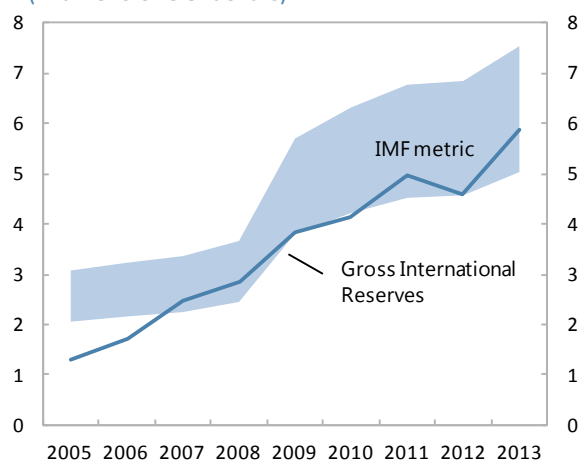
## E. Reserve Adequacy

**11. Paraguay's reserve position is within the suggested adequacy rate.**

Net international reserves reached US\$5.9 billion at the end- December 2013, an increase of \$0.8 billion from end-2012. Using the composite reserve adequacy metric (100–150 percent), the actual level of reserves is above the recommended range. For the medium term, the projection indicates that reserves will cover around 4 months of imports.

Reserve Adequacy ARA Metric

(In billions of U.S. dollars)



## Annex IV. Debt Sustainability Analysis

**Table A4.1 Paraguay: Public Sector DSA - Baseline Scenario**

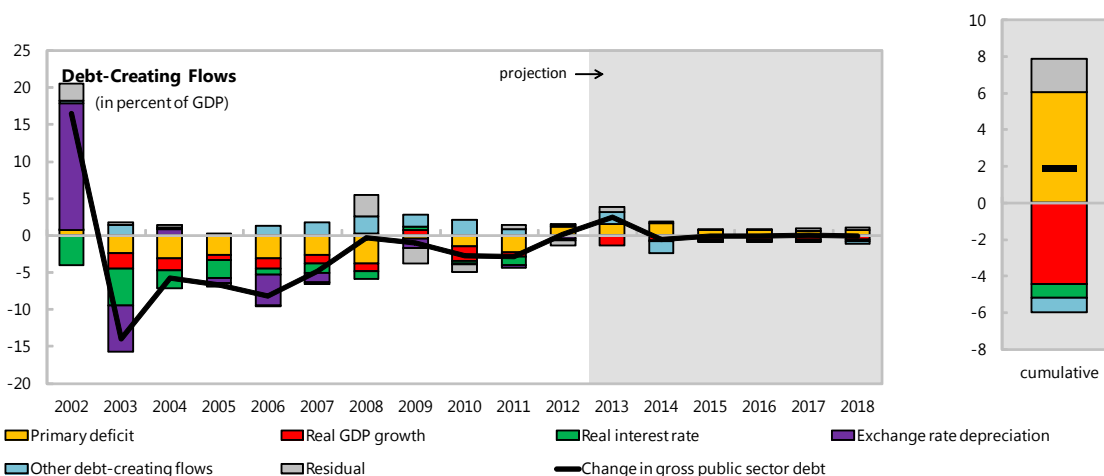
(in percent of GDP unless otherwise indicated)

### Debt, Economic and Market Indicators <sup>1/</sup>

	Actual			Est. Projections					As of January 16, 2014			
	2002-2010 <sup>2/</sup>	2011	2012	2013	2014	2015	2016	2017	2018			
Nominal gross public debt	30.0	12.4	12.6	15.0	14.5	14.5	14.4	14.5	14.5	Sovereign Spreads		
Public gross financing needs	3.3	0.6	7.7	4.0	4.1	3.1	4.2	2.8	2.8	EMBIG (bp) <sup>3/</sup> 238		
Real GDP growth (in percent)	4.0	4.3	-1.2	13.0	4.8	4.5	4.5	4.5	4.5	5Y CDS (bp) ...		
Inflation (GDP deflator, in percent)	8.8	9.8	1.3	2.3	4.7	5.0	5.0	5.4	5.8	Ratings	Foreign	Local
Nominal GDP growth (in percent)	13.2	14.6	0.0	15.6	9.7	9.7	9.8	10.1	10.6	Moody's	Ba3	Ba3
Effective interest rate (in percent) <sup>4/</sup>	3.7	2.2	2.2	3.1	4.1	4.2	4.2	4.2	4.3	S&Ps	BB-	BB-
										Fitch	BB-	BB-

### Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance <sup>9/</sup>
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018		
Change in gross public sector debt	-3.0	-2.9	0.2	2.5	-0.5	-0.1	-0.1	0.1	0.0	1.9	
Identified debt-creating flows	-3.2	-3.5	0.9	1.8	-0.8	-0.2	-0.2	-0.3	-0.3	0.1	
Primary deficit	-2.1	-2.3	1.2	1.5	1.6	0.7	0.8	0.7	0.8	6.0	-1.1
Primary (noninterest) revenue and grants	28.1	28.4	30.9	28.4	28.2	28.9	28.8	28.8	28.7	171.8	
Primary (noninterest) expenditure	26.0	26.1	32.1	29.9	29.8	29.6	29.5	29.5	29.5	177.9	
Automatic debt dynamics <sup>5/</sup>	-2.4	-2.0	-0.1	-1.4	-0.8	-0.7	-0.7	-0.8	-0.8	-5.2	
Interest rate/growth differential <sup>6/</sup>	-2.9	-1.6	0.3	-1.4	-0.8	-0.7	-0.7	-0.8	-0.8	-5.2	
Of which: real interest rate	-1.9	-1.1	0.1	0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.8	
Of which: real GDP growth	-1.0	-0.6	0.2	-1.4	-0.7	-0.6	-0.6	-0.6	-0.6	-4.4	
Exchange rate depreciation <sup>7/</sup>	0.5	-0.3	-0.4	...	...	...	...	...	...	...	
Other identified debt-creating flows	1.3	0.8	-0.3	1.6	-1.6	-0.1	-0.2	-0.2	-0.3	-0.8	
NFPS Assets withdraw (+ withdraw) (negative)	1.3	0.8	-0.3	1.6	-1.6	-0.1	-0.2	-0.2	-0.3	-0.8	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euroarea loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes <sup>8/</sup>	0.2	0.7	-0.7	0.7	0.3	0.1	0.1	0.3	0.3	1.8	



Source: Fund staff estimates and projections.

1/ Public sector is defined as non-financial public sector.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as  $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$  times previous period debt ratio, with  $r$  = interest rate;  $\pi$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;  $a$  = share of foreign-currency denominated debt; and  $e$  = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as  $r - \pi(1+g)$  and the real growth contribution as  $-g$ .

7/ The exchange rate contribution is derived from the numerator in footnote 5 as  $ae(1+r)$ .

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

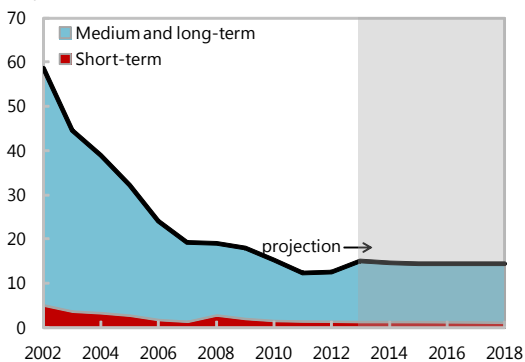
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

**Table A4.2 Paraguay: Public DSA - Composition of Public Debt and Alternative Scenarios**

**Composition of Public Debt**

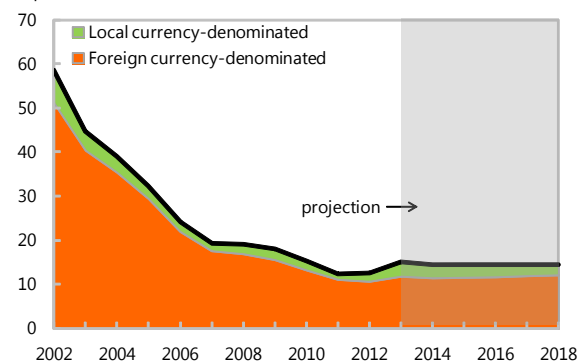
**By Maturity**

(in percent of GDP)



**By Currency**

(in percent of GDP)



**Alternative Scenarios**

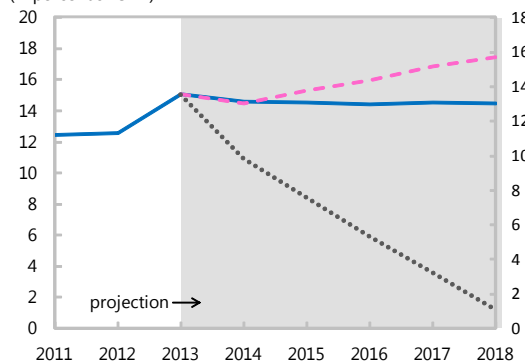
— Baseline

..... Historical

- - - Constant Primary Balance

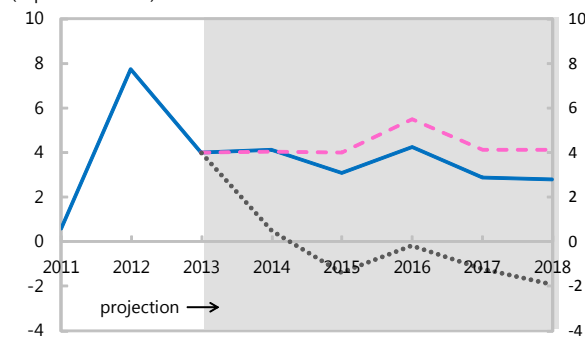
**Gross Nominal Public Debt**

(in percent of GDP)



**Public Gross Financing Needs**

(in percent of GDP)



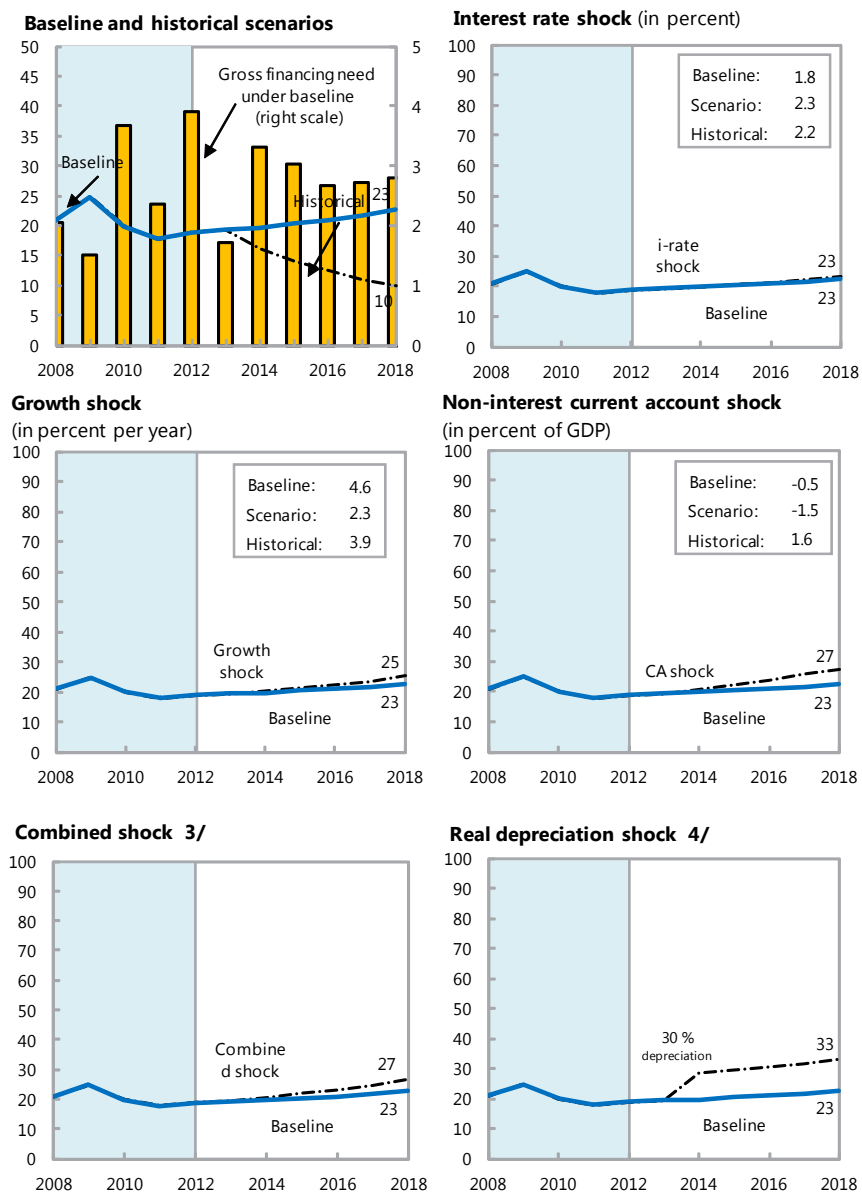
**Underlying Assumptions**

(in percent)

Scenario	2013						2014						2015						2016						2017						2018					
	Real GDP growth	Inflation	Primary Balance	Effective interest rate	Real GDP growth	Inflation	Primary Balance	Effective interest rate	Real GDP growth	Inflation	Primary Balance	Effective interest rate	Real GDP growth	Inflation	Primary Balance	Effective interest rate	Real GDP growth	Inflation	Primary Balance	Effective interest rate	Real GDP growth	Inflation	Primary Balance	Effective interest rate	Real GDP growth	Inflation	Primary Balance	Effective interest rate	Real GDP growth	Inflation	Primary Balance	Effective interest rate				
<b>Baseline Scenario</b>	13.0	2.3	-1.5	3.1	4.8	4.7	-1.6	4.1	4.5	5.0	-0.7	4.2	4.5	5.0	-0.8	4.2	4.5	5.4	-0.7	4.2	4.5	5.4	-0.7	4.2	4.5	5.4	-0.7	4.2	4.5	5.4	-0.7	4.2				
<b>Constant Primary Balance Scenario</b>	13.0	2.3	-1.5	3.1	4.8	4.7	-1.5	4.1	4.5	5.0	-1.5	4.2	4.5	5.0	-1.5	4.1	4.5	5.4	-1.5	4.2	4.5	5.4	-1.5	4.2	4.5	5.4	-1.5	4.2	4.5	5.4	-1.5	4.2				
<b>Historical Scenario</b>	13.0	2.3	-1.5	3.1	3.9	4.7	2.1	4.1	3.9	5.0	2.1	4.9	3.9	5.0	2.1	5.7	3.9	5.4	2.1	5.4	3.9	5.4	2.1	5.4	3.9	5.4	2.1	7.4	3.9	5.8	2.1	7.4				

Source: Fund staff estimates and projections.

**Figure A4.1. Paraguay: External Debt Sustainability: Bound Tests 1/ 2/**  
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff calculations.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2010.

**Table A4.3 Paraguay: External Debt Sustainability Framework, 2008-2018**  
(In percent of GDP, unless otherwise indicated)

	Actual						Projections						Debt-stabilizing non-interest current account 6/ -2.2
	2002	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
<b>1 Baseline: External debt</b>	51.5	20.9	24.9	19.9	17.7	18.8	<b>19.3</b>	<b>19.7</b>	<b>20.3</b>	<b>20.9</b>	<b>21.7</b>	<b>22.7</b>	
2 Change in external debt		-2.1	4.0	-4.9	-2.2	1.1	0.4	0.4	0.6	0.6	0.8	1.0	
3 Identified external debt-creating flows (4+8+9)		-7.9	0.8	-6.5	-4.1	-0.6	-3.7	-0.8	-0.9	-1.3	-1.3	-1.3	
4 Current account deficit, excluding interest payments		-1.5	-3.5	-0.1	-0.8	0.7	-1.2	0.5	0.5	0.3	0.4	0.6	
5 Deficit in balance of goods and services		-4.8	-7.3	-3.9	-2.8	-1.5	-3.7	-2.1	-2.4	-2.4	-2.1	-1.7	
6 Exports	54.2	55.0	52.3	53.8	55.3	49.7	50.5	50.8	49.6	48.5	47.5	46.7	
7 Imports		50.1	45.0	50.0	52.5	48.2	46.8	48.6	47.2	46.1	45.5	45.1	
8 Net non-debt creating capital inflows (negative)		-1.0	0.5	-1.1	-0.8	-1.0	-0.6	-0.8	-0.9	-1.1	-1.2	-1.4	
9 Automatic debt dynamics 1/		-5.4	3.9	-5.3	-2.5	-0.4	-1.9	-0.5	-0.5	-0.5	-0.5	-0.5	
10 Contribution from nominal interest rate		0.5	0.5	0.4	0.4	0.2	0.2	0.3	0.3	0.3	0.3	0.4	
11 Contribution from real GDP growth		-1.1	1.0	-2.5	-0.7	0.2	-2.2	-0.9	-0.8	-0.8	-0.9	-0.9	
12 Contribution from price and exchange rate changes 2/		-4.8	2.4	-3.2	-2.1	-0.8	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/		5.7	3.1	1.6	1.9	1.7	4.2	1.3	1.5	1.9	2.1	2.4	
External debt-to-exports ratio (in percent)	95.2	38.0	47.5	37.0	32.1	37.9	38.1	38.8	40.9	43.0	45.6	48.6	
<b>Gross external financing need (in billions of U.S. dollars) 4/</b>		<b>0.4</b>	<b>0.2</b>	<b>0.8</b>	<b>0.6</b>	<b>1.0</b>	<b>0.5</b>	<b>1.0</b>	<b>1.0</b>	<b>0.9</b>	<b>1.0</b>	<b>1.1</b>	
in percent of GDP		2.0	1.5	3.7	2.4	3.9	1.7	3.3	3.0	2.7	2.7	2.8	
<b>Scenario with key variables at their historical averages 5/</b>							<b>19.3</b>	<b>16.1</b>	<b>14.0</b>	<b>12.5</b>	<b>11.1</b>	<b>9.8</b>	<b>-1.2</b>
<b>Key Macroeconomic Assumptions Underlying Baseline</b>							Historical Average	Standard Deviation					
Real GDP growth (in percent)		6.4	-4.0	13.1	4.3	-1.2	3.9	4.5	13.0	4.8	4.5	4.5	4.5
GDP deflator in US dollars (change in percent)		26.1	-10.3	14.7	11.9	4.6	11.0	11.0	0.7	0.1	3.1	3.9	3.3
Nominal external interest rate (in percent)		2.9	2.1	2.1	2.1	1.3	2.2	0.9	1.4	1.9	1.8	1.8	1.8
Growth of exports (US dollar terms, in percent)		29.4	-18.1	33.6	20.0	-7.1	14.9	16.4	15.6	5.3	5.2	6.3	5.8
Growth of imports (US dollar terms, in percent)		43.6	-22.7	44.2	22.7	-5.2	19.6	20.5	10.5	8.9	4.5	6.1	6.4
Current account balance, excluding interest payments		1.5	3.5	0.1	0.8	-0.7	1.6	2.1	1.2	-0.5	-0.3	-0.4	-0.6
Net non-debt creating capital inflows		1.0	-0.5	1.1	0.8	1.0	0.5	0.6	0.6	0.8	0.9	1.1	1.2

1/ Derived as  $[r - g - r(1+g) + ea(1+r)] / (1+g+r+g)$  times previous period debt stock, with  $r$  = nominal effective interest rate on external debt;  $r$  = change in domestic GDP deflator in U.S. dollar terms,  $g$  = real GDP growth rate,  $e$  = nominal appreciation (increase in dollar value of domestic currency), and  $a$  = share of domestic-currency denominated debt in total external debt.  
2/ The contribution from price and exchange rate changes is defined as  $[-r(1+g) + ea(1+r)] / (1+g+r+g)$  times previous period debt stock.  $r$  increases with an appreciating domestic currency ( $e > 0$ ) and rising inflation based on GDP deflator.  
3/ For projection, line includes the impact of price and exchange rate changes.  
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period. Interest payments exclude binational companies.  
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.  
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of their last projection year.

## Annex V. Paraguay: Migration to Full-Fledged Inflation Targeting Regime—Status of Main Recommendations

Recommendations	Status
<b>Monetary Policy Framework</b>	
Communicate explicitly that the 5 percent inflation is the monetary policy target.	Completed
Commit to a medium-term target horizon for the inflation target.	Completed
Start publishing minutes of the Monetary Policy Committee (CEOMA) meetings within two weeks after the meetings.	Completed
Improve the content of the Monetary Policy Report (MPR) by addressing remaining weaknesses related to the horizon of the inflation projection, scarcity of other projections (e.g., on core inflation measures), and lack of risk balance analysis	In progress
Develop and discuss with the Board the new research projects that would include an estimation of (a) a monetary policy reaction function; (b) an exchange rate pass-through; (c) other channels of monetary policy transmission mechanisms; and (d) the long-term real exchange rate.	Completed
Include modeling as an integral part of the discussions between the members of the Board and BCP staff.	Completed
Revise the Credit Expectations Survey in order to incorporate a sectoral analysis with additional questions related to various types of credit.	Completed
Include exchange rate to the interest rate function in the inflation projection model.	Completed
Develop a better understanding of the monetary policy transmission mechanism at work with the purpose to enhance efficacy of the main channels, i.e., interest rate and the exchange rate pass-through.	Completed
Increase the human resources of the Economics Department in order to broaden the work on projection models.	In progress
Prepare and disseminate additional forward-looking surveys on macroeconomic variables and a business confidence index.	In progress
Continue efforts towards full recapitalization of the BCP	In progress



<b>Monetary Operations, Liquidity Management, and Forecasting</b>	
Separate the functions of liquidity forecasting and the back-office.	Completed
After moving to an averaging system of reserve requirements start forecasting the demand for reserves and extend the forecasting horizon to 1 month.	In progress
Strengthen efforts toward reducing excess liquidity in the system and increase the absorption of structural liquidity via the regular issuance of Monetary Regulation Instruments (IRMs) and open market operations.	In progress
Introduce the averaging system for the reserve requirements.	Near completion
Clearly distinguish the standing lending facility from the BCP's function as an LOLR; the separation of facilities should be based on institutional discretion for access, differences in maturities, and eligibility of collateral.	Completed
Institute a symmetric corridor system, initially with the width of 200 basis points (difference between the rates of the standing lending and deposit facilities) around the policy rate.	Completed
Take steps to establish a risk-free benchmark yield curve with maturities up to 1 year.	Completed
Strengthen the BCP's supervisory functions in order to ensure the soundness and stability of the banking sector and to reduce the existing perception of high counterparty credit risk.	In progress
Maintain the Interbank Liquidity Management (VLI) window, but limit its tenure to overnight transactions.	Completed
Take measures aimed at removing the legal impediments to horizontal repo agreements and broader secondary market trading.	Pending
<b>Foreign Exchange Operations</b>	
Clarify the duality of objectives between the sale of government proceeds and FX interventions, and make a distinction between the two mechanisms: the auction system for the sale of government revenues in dollars, and bilateral trades for FX intervention.	Completed
Pre-announce a monthly program for the sale of government proceeds and stick to the calendar and fixed amounts.	Completed
Limit FX intervention to exceptional circumstances in order to enhance the BCP's credibility in pursuing its policies and its commitment to having a unique nominal anchor—the inflation target.	Completed
Consider conducting bilateral transactions via telephone rather than Datatec in order to strengthen the message given to	Pending

market participants.	
Introduce a channel of communication for verbal intervention, so-called <i>open mouth operations</i> .	Pending
Encourage a market making agreement, but transact only with a limited number of participants, who are the BCP counterparties for FX interventions.	In Progress
Start publishing the reference exchange rate once a day at 1:00 p.m., based on interbank transactions.	Pending

## Annex VI. Paraguay: 2011 FSAP Status of Main Recommendations

Recommendations	Status
<b>Macroeconomic Risks: Financial Institutions Soundness and Vulnerabilities</b>	
Legislations should adopt a CAR definition consistent with the Basel Accords (Basel I).	Completed
Proceed with planned introduction of forward looking provisioning.	In progress
Enhance the regulatory approach to renewed, refinanced, and restructured operations.	Near completion
<b>Payment and Security Settlement Systems</b>	
Approve the draft payment system law to provide legal support to the new payment system.	Completed
Complete implementation of the new payment system, including real-time gross settlements, a security repository, and automated clearing house.	Completed
<b>Financial Sector Oversight</b>	
Amend the legal framework to empower the BCP to issue and develop prudential regulations and to apply due discretion, thus providing the BCP and the Superintendence with flexibility to exercise timely risk-based supervision and address evolving banking sector risks.	In progress
Review the legal framework to avoid suspension of INCOOP's corrective actions by ongoing judiciary appeal process to strengthen INCOOP's enforcement capacity.	In progress
Align cooperatives' prudential framework with banking sector standards, in particular the capital adequacy and provisioning requirements of large cooperatives.	In progress
Strengthen INCOOP's governance by instituting appointment of its Board by the President of the country in accordance with the fit and proper qualification criteria.	Pending
Set up a committee of all regulators at the highest level with a clear mandate, technical capacity, and deliverables to strengthen the coordination between regulators and enhance financial stability analysis.	In progress
<b>Financial Safety Net and Crisis Resolution Framework</b>	
Strengthen the FGD contingency funding to ensure sufficient capacity to resolve a medium to large scale bank.	Pending
Set up liquidity assistance facility for cooperatives to ensure effective and timely emergency liquidity assistance. Setup deposit insurance scheme for cooperatives.	In progress

<b>Financial Sector Development Agenda</b>	
The government should develop and implement a comprehensive agenda to foster financial inclusion in a sustainable manner.	Completed
MoF should prepare legislation establishing a dedicated pension supervisor and undertake actuarial assessments of the various pension regimes—adhering to international standards—to anchor their parametric reform.	In progress
<b>Money and Debt Markets and Systemic Liquidity Management</b>	
MoF should expedite the planned recapitalization of the central bank.	Partially Completed
The central bank should enhance its capacity for systemic liquidity management.	In progress
<b>Credit Information Systems and Creditor Rights Framework</b>	
The central bank should prepare legislation establishing a sound legal framework for the credit reporting industry.	In progress
Submit to parliament the law on organization and coordination of the registry general and the cadastre, and make electronic registries for immovable assets fully operational and available online.	In progress



# PARAGUAY

## STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 30, 2014

Prepared By

The Western Hemisphere Department

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## FUND RELATIONS

(As of December 31, 2013)

Article VIII

**Membership Status:** Joined: December 28, 1945

<b>General Resources Account:</b>	<b>SDR Million</b>	<b>% Quota</b>
Quota	99.90	100.00
Fund holdings of currency	78.43	78.51
Reserve Tranche Position	21.48	21.50

<b>SDR Department:</b>	<b>SDR Million</b>	<b>% Allocation</b>
Net cumulative allocation	95.19	100.00
Holdings	110.64	116.22

**Outstanding Purchases and Loans:** None

### Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	May 31, 2006	Aug 31, 2008	30.00	0.00
Stand-By	Dec 15, 2003	Nov 30, 2005	50.00	0.00

### Projected Payments to Fund<sup>1/</sup>

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest	0.00	0.00	0.00	0.00	0.00
<b>Total</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>

<sup>1/</sup>When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

**Exchange Rate Arrangement:** The currency of Paraguay is the Paraguayan guaraní. The exchange rate regime is classified de facto as other managed arrangement (the de jure regime is classified as floating). The exchange rate is determined in the interbank foreign exchange market but the central bank intervenes in the foreign exchange and monetary markets to smooth out excessive exchange rate fluctuations due to strong seasonal pressures. The U.S. dollar is the principal intervention currency. Paraguay has accepted the obligations of Article VIII, Sections 2(a), 3 and 4 of the Fund's Articles of Agreement. Its exchange system is free of restrictions on the making of payments and transfer for current international transactions.

**Article IV Consultation:** The Executive Board concluded the 2012 Article IV consultation on August 2012.

### Technical Assistance 2009–13

DPT	Purpose	Date of Delivery
STA	Monetary and Financial Statistics	March 2009
FAD	Performance Budgeting	February 2009
MCM	Banking Supervision	May 2009
MCM	Cooperatives	September 2009
MCM	Cooperatives	September 2009
FAD	Medium-Term Fiscal Framework	September 2009
FAD	Debt Management	February 2010
MCM	First Issuance Sovereign Bond	March 2010
STA	Monetary and Financial Statistics	April 2010
MCM	Banking Supervision	April 2010
STA	National Accounts	August 2010
MCM and WB	FSAP/FSSA	November 2010
FAD	Tax and Customs Administration	December 2010
FAD	Public-Private Partnerships	February 2011
STA	National Accounts Statistics	March–April 2011
FAD	Medium-Term Macro-Fiscal Framework and Public Investment Management	March–April 2011
MCM	Monetary Policy, Central Bank Operations, and Accounting	April 2011
FAD	Public Transport Subsidies	June–July 2011
MCM	Financial Soundness Indicators and Financial Oversight	November 2011
FAD	Improve Fiscal Projections and Financial Planning	December 2011
FAD	Modernization of the Customs Administration	December 2011
FAD	Debt and Cash Management	March 2012
FAD	Tax Policy	March 2012
MCM	Monetary Policy, Central Bank Operations, and Accounting	April 2012
FAD	Tax and Custom Administration	December 2012
FAD	Debt and Public Investment Management	May 2013
MCM/LEG	Launching of the AML/CFT	June 2013
MCM	Inflation Targeting and Central Bank Operations	August 2013
FAD	Revenue Administration	September 2013
FAD	Tax Administration	December 2013

**Safeguards Assessment:** Under the Fund's safeguards assessment policy, Central Bank of Paraguay (BCP) was subject to a full safeguard assessment in respect to the arrangement approved on May 31, 2006. A safeguards assessment of the BCP was completed in October 2006. The report stated that while the BCP has made some progress in strengthening the safeguards framework since

## PARAGUAY

the 2003 safeguards assessment, vulnerabilities remain in certain areas such as financial reporting and program data reporting to the Fund.

**Resident Representative:** Mr. Kevin Ross is the regional resident representative since July 2011. He is based in Lima, Peru.



## RELATIONS WITH THE WORLD BANK UNDER JMAP

**1. Meeting of teams.** The Fund and Bank Paraguay teams met in November 2013 to exchange views on economic developments in Paraguay, and discuss ongoing work and work plans for the year ahead. This Annex provides a summary of the discussions.

**2. The teams agreed that Paraguay's macroeconomic policies must be kept broadly neutral over the medium term.** In 2013, the economy recovered sharply from the previous year's severe drought. After contracting 1.2 percent in 2012, the economy rebounded to a 13 percent growth in 2013, as a result of a strong recovery in the primary sector, mainly attributed to higher soy output. Against this background, macroeconomic policies supported the recovery amid low inflation. The fiscal stimulus implemented in 2012 to counterbalance the effect of the exogenous shock in agriculture, reverted to a neutral position in 2013, and is expected to present a modest withdrawal in 2014-15—transition years to a more rigorous fiscal stance under the new Fiscal Responsibility law—and to remain broadly neutral through the end of projected period (2018). Real GDP would grow by 4.8 percent, supported by continuing dynamism in the agricultural and livestock sector and by higher overall investment. Although inflation at the end of 2013 was 3.7 percent, rising food prices and tariffs of public services will most likely push inflation to the central bank target (5 percent) by end-2014. Monetary policy was more accommodative during much of 2013, but the central bank raised the policy rate by a total 100 basis points in December 2013 and January 2014, bringing it up to 6.5 percent and monetary policy to a more neutral position.

**3. Over the medium term, policies need to cement economic fundamentals and promote social development.** The fiscal responsibility law provides an adequate anchor to maintain fiscal sustainability. The central government deficit will most likely decline on average to about 1 percent of GDP in the period 2015–18, becoming broadly neutral and supporting the gradual closing of the current positive output gap. Regarding monetary policy, after the recent policy rate hikes, the central bank stressed that it will continue to adjust it in the period ahead as necessary to keep inflation within the target. To promote social development and address structural and institutional weaknesses and rising inequality, the government proposed important reforms and the Congress approved key laws in 2013 that will be implemented starting in 2014. Going forward, stronger budget institutions are needed to improve the quality of spending along with strengthened tax and customs administration. A civil service and pension reforms must be part of a medium term strategy, along with improved public enterprises management to bolster access to public service.

**4. The following reform areas have been identified as critical:**

- *Tax policy and revenue administration reform.* Additional tax policy and reforms are needed to increase low revenues. These include increasing taxation on the financial sector and revenue collection efficiency while reducing exemptions.
- *Public financial management.* Better budget design, monitoring and control is needed along with a medium-term expenditure framework are needed to increase the quality of public spending and improve the allocation of resources.

- *Public-Private Partnerships.* The recently approved PPP law offers potential efficiency gains, but it can also increase fiscal risks. It is important to strengthen public investment management, planning and regulatory capacity. The regulation of the law should provide clear guidelines for risk allocation and accounting of contingent liabilities.
- *Financial system.* Continue reforms to banking and central bank legislation are needed to keep bolstering the banking system and strengthening regulation and supervision. There is also a need to strengthen regulation and supervision for cooperatives and establishing a safety net for the sector.
- *Monetary framework.* To complete the transition to a full-fledged inflation targeting regime, the central bank (BCP) would need to develop an active interbank monetary market, improving communication with market participants and eliminating legal impediments for secondary markets trading.

**5. The division of labor between the teams would be along the following lines:**

- *Tax and customs administration reform.* The Fund and the Bank will continue providing technical assistance (TA) to support authorities' efforts to reform the tax system and increasing revenue collection productivity.
- *Public financial management.* The Bank will provide TA on strengthening the corporate governance of public enterprises. The Fund will provide TA on strengthening the medium-term budget framework and cash management.
- *Monetary framework.* The Fund plans to provide TA on further strengthening monetary operations and transitioning to an inflation targeting regime.
- *Money Laundering.* The Fund will provide TA to implement the plan on money laundering and control of terrorism financing.
- *Medium-term debt management.* The Fund's will continue providing TA to develop a medium-term debt strategy so as to reduce domestic debt servicing costs and promote the development of a domestic government debt market.
- *Infrastructure and Logistics.* The Bank will provide TA on infrastructure and logistics required for the implementation of PPPs.
- *Poverty assessment and support.* The Bank will provide TA on equity assessment and poverty support. An approved loan of U\$100 million will be used to expand the coverage of the Paraguay Sustainable Agriculture and Rural Development Project.
- *Education and social programs.* The Bank will provide TA on education programs, social assistance, and rural and agricultural development.
- *Pensions.* The Bank will continue providing TA to improve the pension system supervision, including with best practices.
- *Growth volatility.* The Bank will provide TA on mechanisms to mitigate the impact of growth volatility.

**6. Work programs.** The table below lists the teams' work programs for the year ahead.

## Work Programs of the World Bank and IMF Teams

<b>Title</b>	<b>Products</b>	<b>Provisional Timing of Missions</b>	<b>Expected Delivery Date</b>
<i>Bank Work Program</i>			
	Country Partnership Strategy	Spring 2014	
	Public expenditure review	Spring 2014	November 2013. Pending dissemination.
	TA on volatility analysis	Spring 2014	March 2014
	TA on strengthening pension supervision	Spring 2014	Spring 2014
	TA on Equity Assessment and poverty support	Spring 2014	May 2014
	TA strengthening tax administration and SOE corporate governance	Spring 2014	July 2014
	TA on education programs	February 2014	December 2014
	EW Land Reform Report	Spring 2014	January 2014. Pending dissemination.
	TA on Infrastructure and Logistics PPP	Spring 2014	Fall 2014
<i>Fund Work Program</i>			
	Article IV Consultation	December 2013	February 2014
	TA medium-term budget framework	February 2014	April 2014
	TA to strengthen risk based AML/CFT supervision	April 2014	June 2014
	TA on IT implementation	March 2014	June 2014
	TA on revenue administration	March 2014	May 2014
	TA on STA issues (ROSC)	February 2014	April 2014

## RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(As of December 31, 2013)

The Inter-American Development Bank's Board of Executive Directors approved in 2009 the Country Strategy with Paraguay (2009–2013).<sup>1</sup> Sovereign-guaranteed lending under the program was expected to reach approximately US\$1 billion.

Under the Strategy, the national authorities and the Bank identified the following priority sectors in which the IDB Group would focus both its financial and non-financial products and services: (i) transport; (ii) energy; (iii) water, sanitation, and solid waste; (iv) agriculture and tourism; (v) climate change; (vi) health; (vii) education; (viii) institutional capacity; (ix) financial sector; and (x) urban development. Regarding the Bank's private sector operations, the Bank approved loans and technical assistance in the foreign trade and social responsibility sectors, which derived to an increase in approval of loans to companies: US\$28 million in 2010, US\$52 million in 2011, US\$9 million in 2012 and US\$132 million in 2013.

The strategic areas were selected taking into account the following objectives: (i) strengthen the governability and institutional capacity at the public sector to increase efficiency and transparency; (ii) create the basis for sustainable growth, increasing regional and global integration to promote private investment and improve competitiveness; and (iii) reduce poverty and improve the quality of life of the poor by developing human capital and giving access to basic services.

As of December 31, 2013, the Bank's portfolio in Paraguay included loans for the financing of 25 projects. The lending portfolio amounts to US\$866 million, of which US\$544 million are pending disbursement. Disbursements in 2014 are expected to total US\$74 million. The current portfolio includes lending to support the Government in the following sectors: infrastructure, social, public sector institutional strengthening, competitiveness, and regional integration. The portfolio also includes loans to the private sector for US\$203 million. In 2013, the Bank approved loans to the public sector in the areas of transport and investment promotion.

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<sup>1</sup> A new strategy covering the period 2014–18 is under discussion.

**Financial Relations with the Inter-American Development Bank<sup>1</sup>**  
(In millions of U.S. dollars)

				Loan Transactions					
	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>
Disbursement	67.2	67.8	85.6	91.3	240.3	91.4	102.8	142.4	73.4
Amortization	66.7	88.1	94.3	91.3	96.2	94.5	91	83.9	97.7
<b>Net Loan Flows</b>	<b>0.5</b>	<b>-20.3</b>	<b>-8.7</b>	<b>0</b>	<b>144.1</b>	<b>-3.1</b>	<b>11.8</b>	<b>58.5</b>	<b>-24.3</b>

Source: Inter-American Development Bank.

<sup>1/</sup> Only loans with sovereign guarantee are considered.

## STATISTICAL ISSUES

(As of December 2013)

### Assessment of Data Adequacy for Surveillance

**General: Data provision to the Fund has some shortcomings, but is broadly adequate for surveillance.** Following a data ROSC mission in January–February 2006, the authorities' response to the report and the mission's recommendations were published on the Fund's website on June 30, 2006. The country is a GDDS participant.

**1. National Accounts:** National accounts estimates, broadly consistent with the guidelines of the 1993 SNA, were released in 2005. However, no comprehensive regular program for data collection through economic surveys exists (an industrial survey was conducted in 2002). An economic census was undertaken in 2011. Source data for nonfinancial services, household consumption, and changes in inventories are insufficient. Major areas of concern include: (i) the 1994 reference year needs to be updated; (ii) excessive use is made of fixed coefficients for value added and household consumption; (iii) changes in inventories are obtained residually; (iv) informal activities are not monitored; and (v) supply and use tables have been compiled only until 1997. Annual GDP meets GDDS recommendations, and QNA meets DSSD timeliness requirements (90 days). Several STA missions on the compilation of quarterly national accounts (QNA) were fielded in August 2007, August 2008, November 2009 and March–April 2011. QNA series were published in December 2010. The STA mission of March–April 2011 assisted the authorities in outlining a work program for updating the national accounts' base year.

**2. Labor market:** Since the introduction of a regular household survey in 1998, the coverage and quality of employment and unemployment statistics have improved significantly. Since 2010, data are released on a quarterly basis, although the latter covers the Asunción area only. The last available observation for the quarterly series is the third quarter of 2013, whereas the annual data for 2012 has just been released in September 2013.

**3. Prices statistics:** Both the consumer (CPI) and producer price indices (PPI) are reported on a regular and timely basis. Since January 2008, the Central Bank of Paraguay (BCP) has been using a new CPI index based on the 2005–06 household budget survey (Dec. 2007=100). The geographic coverage of the CPI is limited to Greater Asunción (the capital and metropolitan area) and expenditure weights are representative of the consumption patterns of urban households. The PPI has a base weight period of June 2010 and its basket (185 items) is representative of current national output; electricity, water, and gas are not covered.

**4. The data ROSC mission found that the resources are insufficient for real sector statistics and constrain further development, particularly the full adoption of the 1993 SNA.** The authorities have been trying to address these resource shortcomings in the context of the recent compilation of a new CPI and the production of QNA series. A new ROSC mission has been scheduled for February 2014.

**5. Government finance statistics:** The Government finance statistics (GFS) used for internal purposes and for reporting to WHD is broadly consistent with the recommendations of the Manual on Government Finance Statistics 1986 (GFSM 1986). The authorities have not yet prepared a plan to migrate to the Government Finance Statistics Manual 2001 (GFSM 2001). Monthly data are available for the central administration (budgetary central government). The asset position of the social security system is available on a daily basis. Statistics on the central administration include data of the Postal Service Directorate (a nonfinancial public corporation) and the statistics of the nonfinancial public sector include data of financial public corporations—four employer social insurance schemes. These social insurance schemes are treated as financial corporations in the monetary and financial accounts. Data on medium and long-term external debt are reliable and available on a monthly basis. Domestic debt data are available on request, but need to be fully integrated with the external debt database. Deficiencies remain in recording short-term supplier and commercial credit of the public sector. Moreover, there is a discrepancy in the fiscal data reported by the monetary and fiscal authorities. Measures are being taken to make reporting more transparent.

Annual data covering general government for 2011 have been reported for publication in the 2012 edition of the GFS Yearbook. However, since 1994 no outstanding debt data and no breakdowns for expenditure by function have been provided for publication in the GFS Yearbook. Monthly and quarterly data are not reported for publication in IFS.

**6. Balance of payments:** The classification of the balance of payments and the international investment position (IIP) follows the recommendations of the Balance of Payments Manual, 5th edition. Quarterly data on balance of payments and the IIP are available from 2001 onwards, and are reported only once a year to STA for publication in the IFS. In May-2013, the CBP revised the BOP and IIP time series to exclude transactions and positions between residents and the bi-national hydroelectric energy enterprises, they are now considered 50% residents. Improvements have been made in the quality of the data on capital flows, especially in the coverage of foreign direct investment, and in the recording of external debt transactions. Special studies by the central bank have improved the estimation methods for remittances of Paraguayans abroad and unregistered trade transactions, but serious deficiencies remain.

Also, there are deficiencies in the area of private capital outflows, which are difficult to register due to Paraguay's open capital account. An STA mission on Balance of Payments Statistics assisted the BCP in November 2006 in implementing recommendations of the ROSC mission. In particular, the mission focused on: (1) assessing the surveys used to capture data on services, direct investment, nonfinancial private sector portfolio investment, and other investment; (2) reviewing and updating the statistical techniques used to calculate unrecorded trade; (3) reassessing the treatment of the binational hydroelectric energy enterprises in the external sector accounts; and (4) reviewing and preparing a preliminary template for reporting data on international reserves and foreign currency liquidity.

**7. Monetary and financial statistics:** Paraguay reports monetary data for the central bank and other depository corporations (ODCs) using the standardized report forms (SRFs). An integrated

monetary database meeting the data needs of the BCP, STA, and WHD is in operation Data on credit cooperatives, which account for around  $\frac{1}{4}$  of deposits and loans of the banking sector, are now included in the ODCs with data beginning in December 2008. The Superintendence of Banks reports 11 of the 12 core and 7 of the 13 encouraged financial soundness indicators for deposit takers to STA on a month basis.



## Paraguay: Table of Common Indicators Required for Surveillance

(As of January, 2014)

							Memo Items <sup>9</sup>	
	Date of Latest Observation	Date Received	Frequency of Data <sup>1</sup>	Frequency of Reporting <sup>1</sup>	Frequency of Publication <sup>1</sup>	Data Quality–Methodological Soundness <sup>10</sup>	Data Quality–Accuracy and Reliability <sup>11</sup>	
Exchange Rates	Daily	Daily	D	D	D			
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>2</sup>	Daily	Daily	D	D	D			
Reserve/Base Money	Dec. 2013	Dec. 2013	M	M	M	O, LNO, LO, O	O, O, O, LO, LO	
Broad Money	Dec. 2013	Dec. 2013	M	M	M			
Central Bank Balance Sheet	Dec. 2013	Dec. 2013	M	M	M			
Consolidated Balance Sheet of the Banking System	Dec. 2013	Dec. 2013	M	M	M			
Interest Rates <sup>3</sup>	Dec. 2013	Dec. 2013	W	W	M			
Consumer Price Index	Dec. 2013	Dec. 2013	M	M	M	O, LO, O, O	O, LO, LNO, O, LO	
Revenue, Expenditure, Balance and Composition of Financing <sup>4</sup> – General Government <sup>5</sup>	Dec. 2013	Dec. 2013	M	M	M	LO, LO, LO, LO	LO, LNO, O, LO, LO	
Stock of Central Government and Central Government-Guaranteed Debt <sup>6</sup>	Dec. 2013	Dec. 2013	M	M	M			
External Current Account Balance	Q3 2013	Nov. 2013	Q	Q	Q	O, LO, LO, LO	LO, O, LO, LO, LO	
Exports and Imports of Goods and Services <sup>7</sup>	Q3 2013	Nov. 2013	Q	Q	Q			
GDP/GNP	Q3 2013	Nov. 2013	Q	Q	Q	O, LO, LO, LO	LO, O, LNO, O, LO	
Gross External Debt	Q3 2013	Nov. 2013	M	M	M			
International Investment Position <sup>8</sup>	Q3 2013	Nov. 2013	Q	Q	Q			

<sup>1</sup> Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

<sup>2</sup> Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

<sup>3</sup> Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>4</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>5</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>6</sup> Guaranteed non-financial public sector debt. Including currency and maturity composition.

<sup>7</sup> Monthly frequencies for goods only.

<sup>8</sup> Includes external gross financial asset and liability positions vis-à-vis nonresidents.

<sup>9</sup> Reflects the assessment provided in the data ROSC (published on June 30, 2006, and based on the findings of the mission that took place during January–February, 2006) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

<sup>10</sup> Same as footnote 9, except referring to international standards concerning source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

<sup>11</sup> Same as footnote 9, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.



Press Release No. 14/61  
FOR IMMEDIATE RELEASE  
February 14, 2014

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

### **IMF Executive Board Concludes 2013 Article IV Consultation with Paraguay**

On February 14, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with Paraguay.<sup>1</sup>

Paraguay enjoyed robust economic growth in the past decade, on the heels of the export commodity boom, and supported by prudent macroeconomic policy implementation. Despite weather-related shocks hitting the key agribusiness sector, the economy has grown at an average rate of 4.7 percent a year since 2003 compared with about 2 percent the previous decade. Robust growth has been accompanied by declining inflation, particularly since 2011 when the central bank adopted inflation targeting. Despite the acceleration in growth in the 2000s, poverty and inequality in Paraguay remain among the highest in the region.

Activity rebounded to an estimated 13 percent in 2013 as the agricultural sector recovered sharply from the previous year's severe drought. Rising agricultural output led to higher exports and a surplus of close to 1 percent of GDP in the external current account, despite a deterioration in the terms of trade. Non-agricultural activity has been less volatile, growing at about potential in the past two years, underpinned by rising consumption. End-2013 inflation fell to 3.7 percent—below the central bank's inflation target rate of 5 percent—despite increasing food prices. Private sector credit growth has slowed to about 17 percent in nominal terms since end-2012, with loans concentrated on the agricultural sector; consumer credit has also grown rapidly, albeit from a low base. Paraguay's banking sector remains well capitalized and profitable, with low nonperforming loans.

Macroeconomic policies broadly supported the recovery. Fiscal spending under the stimulus implemented in 2012 decelerated in 2013 due to stricter spending controls, though the central

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in the summing up can be found here:

<http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

government deficit increased slightly to about 2 percent of GDP from 1.8 percent in 2012 as tax revenue remained modest. Monetary policy was on hold during much of 2013 until the central bank raised the policy rate by 100 basis points over December 2013 and January 2014, in light of incipient inflationary pressures.

The outlook for 2014 is positive. Growth should be strong at 4.8 percent, underpinned by continued dynamism in the agricultural sector and rising infrastructure investment. Annual inflation will likely increase to the central bank's target rate of 5 percent. The fiscal deficit should remain low, under the introduction of the recently approved Fiscal Responsibility Law. The external current balance would revert to a small deficit amid slightly deteriorating terms of trade and rising import volumes. Overall, the risks to this outlook are balanced. The main downside risks stem from regional growth and global borrowing conditions, while upside risks include faster-than-expected progress in reforms.

### **Executive Board Assessment<sup>2</sup>**

Executive Directors welcomed Paraguay's recent economic recovery and favorable outlook, underpinned by strong economic policies and fundamentals, with low debt, sizeable official reserves, and small fiscal and external imbalances. Directors noted that the key challenge ahead is to improve social and economic development, while strengthening the macroeconomic policy framework. They took positive note of the authorities' ambitious reform agenda and the critical legislation that has already been enacted to address institutional and structural weaknesses. Directors emphasized that resolute implementation of these laws and continued sound macroeconomic policies are necessary to reduce poverty and foster broad-based sustainable growth.

Directors welcomed the strengthening of the fiscal framework. The fiscal responsibility law provides a sound anchor to underpin fiscal sustainability. They encouraged the authorities to make the framework stronger, by further improving the quality of government spending, strengthening tax and customs administration, and enhancing the capacity to deal with potential risks from public-private partnerships. Civil service and pension reforms are also needed.

Directors welcomed the authorities' prudent monetary policy stance and the advances made in implementing an inflation-targeting regime. They encouraged additional steps to complete the transition towards a full-fledged inflation-targeting regime, including developing an active interbank money market, strengthening risk-based bank supervision, and updating financial sector legislation. Maintaining exchange rate flexibility and greater efforts to reduce dollarization will strengthen the monetary policy framework and help cushion the economy against potential shocks. Over the medium term, macroeconomic policies should be guided by the fiscal

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<sup>2</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

responsibility law and inflation-targeting frameworks. Directors called for steps to address the remaining deficiencies in the anti-money laundering regime.

Directors agreed that reducing poverty and inequality is a priority. They encouraged the authorities to sustain all the initiatives underway to promote social and economic inclusion while protecting vulnerable groups through social safety nets. Reform efforts should particularly focus on improving the business climate, addressing labor market inefficiencies, and increasing female labor participation as well as human capital investment. Improved public enterprises management will also facilitate access to basic public services at reasonable cost.

## 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)							
<b>Income and prices</b>							
Real GDP	6.4	-4.0	13.1	4.3	-1.2	13.0	4.8
Nominal GDP	16.3	-2.0	20.0	14.6	0.0	15.6	9.7
Consumer prices (end of period)	7.5	1.9	7.2	4.9	4.0	3.7	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	4,585.0	...
<b>Monetary sector</b>							
Currency issue	15.0	11.3	18.5	11.6	17.5	13.9	10.1
Credit to private sector	62.0	21.4	37.3	25.8	15.8	17.5	11.9
Liabilities to private sector	42.4	24.9	19.2	19.4	14.1	20.6	10.6
<b>External sector</b>							
Exports (fob)	29.7	-20.3	35.1	20.7	-7.8	16.0	5.3
Imports (cif)	44.7	-23.6	44.7	22.9	-5.8	10.1	9.0
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	6.8	...
(In percent of GDP, unless otherwise indicated)							
<b>Current account</b>	<b>1.0</b>	<b>3.0</b>	<b>-0.3</b>	<b>0.5</b>	<b>-1.0</b>	<b>0.9</b>	<b>-0.9</b>
Trade balance	5.7	7.1	4.3	3.5	2.2	4.6	3.1
Exports	52.6	48.6	50.6	52.3	46.7	47.6	47.8
Imports	-46.9	-41.6	-46.4	-48.8	-44.5	-43.0	-44.7
<b>Capital account and financial account</b>	<b>0.9</b>	<b>-0.3</b>	<b>1.1</b>	<b>2.0</b>	<b>1.9</b>	<b>1.6</b>	<b>0.5</b>
General government	-0.5	0.1	0.3	-0.2	-0.1	1.7	0.5
Private sector	1.4	-0.4	0.8	2.3	2.0	-0.1	0.0
o/w Direct investment	1.1	0.6	1.0	2.3	1.9	1.3	1.7
<b>Net international reserves (in millions of U.S. dollars)</b>	<b>2,876</b>	<b>3,817</b>	<b>4,165</b>	<b>4,971</b>	<b>4,983</b>	<b>5,889</b>	<b>5,763</b>
(Stock in months of next year imports of goods and services)	4.8	4.4	3.9	5.0	4.5	4.9	4.6
<b>Gross domestic investment</b>	<b>16.4</b>	<b>13.8</b>	<b>16.2</b>	<b>16.2</b>	<b>15.4</b>	<b>15.9</b>	<b>16.4</b>
Private sector	13.5	9.1	11.8	11.6	9.8	11.1	11.6
Public sector	3.0	4.7	4.5	4.7	5.6	4.8	4.8
<b>Gross national saving</b>	<b>17.4</b>	<b>16.8</b>	<b>16.0</b>	<b>16.7</b>	<b>14.4</b>	<b>16.8</b>	<b>15.5</b>
Private sector	11.7	13.1	11.0	10.6	10.8	14.4	13.5
Public sector	5.7	3.7	4.9	6.0	3.6	2.5	2.0
<b>Central government revenues</b>	<b>15.8</b>	<b>17.5</b>	<b>17.1</b>	<b>17.4</b>	<b>18.9</b>	<b>17.0</b>	<b>17.0</b>
o/w Tax revenues	10.7	11.6	12.0	12.1	12.7	11.7	12.0
<b>Central government expenditures</b>	<b>13.5</b>	<b>17.5</b>	<b>15.9</b>	<b>16.7</b>	<b>20.8</b>	<b>19.0</b>	<b>18.9</b>
o/w Wages and salaries	6.5	7.7	7.3	7.4	9.6	9.3	8.5
<b>Central government overall balance</b>	<b>2.3</b>	<b>0.1</b>	<b>1.2</b>	<b>0.7</b>	<b>-1.8</b>	<b>-2.0</b>	<b>-1.8</b>
<b>Consolidated public debt (in percent of GDP) 2/</b>	<b>22.8</b>	<b>22.5</b>	<b>18.6</b>	<b>16.2</b>	<b>15.9</b>	<b>20.9</b>	<b>19.1</b>
<b>Memorandum items:</b>							
GDP (in billions of Guaranies)	80,735	79,117	94,934	108,795	108,832	125,856	138,079
GDP (US\$billions)	18.5	15.9	20.7	24.1	24.9	28.4	29.7

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

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

2/ Includes letras de Regulacion Monetaria (Central Bank paper).