INTERNATIONAL MONETARY FUND

IMF Country Report No. 12/211

Paraguay

2012 ARTICLE IV CONSULTATION

August 2012

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 Article IV consultation with Paraguay, the following documents have been released and are included in this package:

- **Staff Report** for the Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 11, 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 June 8. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

PARAGUAY

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

June 8, 2012

KEY ISSUES

Context. GDP is projected to contract by 1½ percent in 2012, owing to a severe drought that impacted agriculture in Q1. Non-agricultural activity is, however, expected to grow at slightly below potential, supported by stimulative fiscal and monetary policies. With the drought now over, robust domestic demand, and strong confidence, a rapid turn-around in activity is expected over the coming months. Next year, GDP would expand by 8½ percent as weather conditions normalize and agriculture recovers. Inflation would remain in line with the central bank target (5 percent) in 2012-13.

Near-term policies. The current policy mix is appropriately supportive of activity and broadly consistent with meeting the inflation target in 2012. Fiscal and monetary policy can do little to mitigate the direct effect of the drought on agriculture, and should react only to the extent that there are spillovers to the rest of the economy and inflation remains under control. It is important to avoid relaxing these policies further, while allowing the exchange rate to help mitigate the supply shock. Inflationary pressures might resurface as 2013 approaches and the economy rebounds, and the authorities would need to be ready to tighten policies in a timely fashion. Protecting financial stability calls for keeping credit growth under control, continuing bolstering regulation and supervision, and strengthening the sector's buffers. It is also important to close information gaps in the financial sector.

Tax reform. The tax system needs to be improved to increase revenues. Higher revenues are needed to support upgrading basic infrastructure, improving social indicators and human capital, and reducing poverty. It is important to implement promptly the personal income tax, and improve agricultural taxation by limiting generous deductions and closing loopholes. There is also scope to raise the tax contribution of the financial sector, including by broadening the tax base and raising the currently-low VAT rate on financial services.

Approved By
David Vegara and Dhaneshwar Ghura

Discussions took place in Asuncion, during May 2–11. The staff team comprised Messrs. L. Abrego (Head), N. Magud, J. Podpiera, K. Ross, Resident Representative (all WHD), and V. Tulin (MCM). Mr. J. Maciel (OED) attended the meetings.

CONTENTS

TABLES

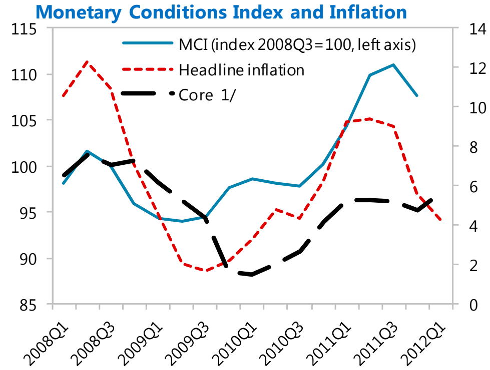
ANNEXES

BACKGROUND

1. ***GDP growth slowed down markedly in 2011 and turned negative in 2012Q1 (Figure 1).*** After a strong rebound in 2010 led by agriculture, growth slowed down to 3.8 percent in 2011, reflecting both monetary tightening and country-specific supply shocks. Against the backdrop of inflationary pressures, the central bank continued increasing interest rates through the third quarter of 2011. At the same time, cement shortages and an outbreak of foot-and-mouth disease followed by a beef export ban, impacted strongly the non–agricultural sector, which expanded by less than 3 percent in the year. The non-agricultural output gap (a more appropriate measure of demand pressures in Paraguay) turned negative in the third quarter of 2011 reaching about -1 percent in the last quarter. Unemployment declined slightly to about 5½ percent in 2011, while underemployment remained high, at above 20 percent. A severe drought hit the country in late 2011-early 2012 and is estimated to have caused significant losses in the agricultural sector, especially for key export products (e.g., soybeans). High frequency indicators suggest that GDP contracted by over 3 percent (y/y) in 2012Q1 as a result of the drought, but non-agricultural activity grew at close to 4½ percent.

2. ***Inflation has declined below the central bank target, but core inflation has remained relatively high (Figure 1).*** After peaking at over 10 percent (y/y) in early 2011, inflation began easing in mid-year, reaching 5 percent (the central bank target) at year-end and falling further to 3¼ percent in April 2012. This decline reflects mainly lower food inflation, derived partly from a large reduction in meat prices following the export ban. Tighter monetary conditions and a substantial appreciation of the guaraní (see chart) also played a role in reducing inflation pressures in 2011.[1] However, despite a negative output gap, core inflation (6¼ percent in April 2012) has

Monetary Conditions Index and Inflation

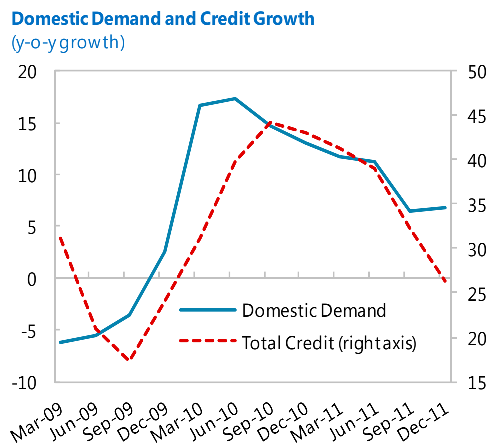


1/ Excludes food and fuels

[1] The monetary conditions index shown in the text chart is a weighted average of the real interest rate and the real exchange rate, with the relative weights determined by the degree of openness of the Paraguayan economy.

remained somewhat above the official target for headline inflation, reflecting mainly still strong domestic demand growth and one-off factors.[2]

3. *Credit growth has moderated, helping reduce domestic demand pressures and financial sector risks (Figure 2).* From mid-2010 to August 2011 the central bank (BCP) raised the policy rate by 800 bps (to 8½ percent). This contributed to a deceleration in credit growth from 43 percent at end-2010 to 19 percent in April 2012.[3] Growth of credit in U.S. dollars has experienced an even stronger deceleration, though from a higher base, reflecting mainly the problems in the primary sector and reduced FX earnings. Against this background, domestic demand growth has moderated, although it remains above potential output growth.



4. *Against a backdrop of easing inflation and external uncertainty, the BCP began cutting interest rates in late 2011.* The BCP reduced the policy rate by 200 bps between November 2011 and February, and by an additional 25 bps in May (to 6¼ percent). In easing monetary policy, the BCP cited initially the softening of inflation and risks from an uncertain global economic outlook and, more recently, weakening domestic demand growth. While the real policy rate remains positive (at around 1¼ percent), it is below its neutral level (Box 1). This seems broadly consistent with the current negative output gap.

5. *The current account deficit improved and international reserves continued to grow in 2011 (Figure 3).* Despite the negative shock to beef exports and the appreciation of the guaraní (by 14 percent in real effective terms during 2011), the external current account deficit declined to 1¼ percent of GDP in 2011 (from 3½ percent of GDP in 2010). The improvement reflected better terms of trade, a stronger services account (mainly related to electricity royalty payments by Brazil and Argentina), and higher worker remittances. Capital inflows, notably

---

[2] The main one-off factor in early 2012 was related to higher education costs, owing to a new law that introduced obligatory social security contributions for private schools. This has contributed about ½ percentage points to the increase in core inflation since December 2011, with the rest of the uptick attributed to domestic demand factors and exchange-rate pass-through.

[3] External financial developments might have also played a role in lowering credit growth. See Selected Issues Paper, Chapter II.

foreign direct investment, remained strong, allowing the BCP to increase net international reserves by 1½ percent of GDP in 2011, to about 24 percent of GDP. The central bank continued to intervene on both sides of the market during 2011, aiming at limiting excessive exchange rate volatility. More recently, in 2012Q1, the BCP sold a sizeable amount of FX to (i) withdraw an unexpected large liquidity injection by the government (which used BCP deposits to, *inter alia*, pay-off outstanding accounts payable), and (ii) stem strong depreciation pressures following the drought. These operations prevented the exchange rate from depreciating in response to the drought-induced supply shock. FX intervention in 2011–12 appears to have limited exchange rate flexibility (Box 2).

6. ***Fiscal policy was slightly expansionary in 2011 (Figure 4).*** The overall fiscal surplus declined by ½ percentage points, to 1 percent of GDP, driven by a large increase in primary spending (especially capital expenditures). This implied a fiscal impulse (measured by the change in the structural primary balance) of about ¾ percent of GDP. Revenue growth decelerated but remained strong, supported by continued improvements in tax administration. Public debt continued on a declining trend, with general government debt falling below 14 percent of GDP, one of the lowest in the region.

7. ***The banking sector has remained sound, but NPLs have risen.*** Profitability is high and capital adequacy ratios remain strong. NPLs are low (2 percent in March), but have risen over the last year.[4] More stringent provisioning measures and higher capital requirements became effective in January 2012, helping strengthen financial institutions' buffers. A program to bolster the prudential and regulatory framework of the cooperative sector is being implemented.

Paraguay: Selected Financial Soundness Indicators for the Banking Sector
(In percent, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011	Mar-12
Asset Quality							
Regulatory capital to risk-weighted assets	20.1	16.9	16.3	16.3	15.4	14.9	17.3
Nonperforming loans to gross loans	3.3	1.3	1.1	1.6	1.3	1.7	2.0
Provisions to nonperforming loans	59.1	78.4	77.7	78.8	74.4	69.1	66.9
Return on assets (before tax)	3.5	3.5	3.9	2.9	2.8	2.7	2.8
Return on equity (before tax)	29.7	30.0	35.6	27.1	27.6	25.5	26.5
Liquid assets to total assets	44.0	44.8	36.8	41.0	33.6	32.5	33.5
Customer deposits to total (noninterbank) loans	183.5	173.2	150.8	160.3	131.0	119.0	120.9

Source: Central Bank of Paraguay and IMF staff calculations.

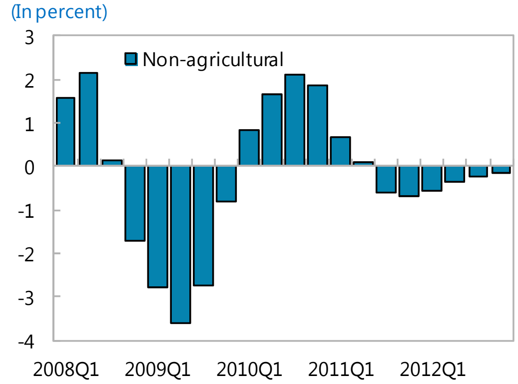
[4] Provisions have also declined. However, this reflects changes in the composition of NPLs, with the share of recently overdue loans (which carry a lower provision) increasing. Regulations on provisioning have actually been tightened by the central bank.

Congress recently approved legislation to shift public sector deposits from commercial banks to a state-owned bank. These deposits amount to about 6 percent of GDP and its abrupt shifting and concentration could strongly impact the liquidity distribution within the banking system. The initiative is on hold as the BCP has filed a suit with the Supreme Court challenging the legislation on constitutional grounds.

MACROECONOMIC OUTLOOK AND RISKS

8. ***The economy is projected to contract in 2012 as a result of the recent drought.*** Staff projects real GDP to fall by 1½ percent, driven by a decline in agricultural activity of about 25 percent. While spillovers from agriculture to the rest of the economy seem modest,[5] the agricultural contraction would have a notable effect on the non-agricultural sector, given the size of the shock. However, following the 2012Q1 contraction, a rapid recovery is expected. Growth is likely to turn positive already in 2012Q2, supported in the non-agricultural sector by high confidence, a strong fiscal impulse, stimulative monetary conditions, and the partial reversion of negative supply shocks that hit the sector in 2011. Staff projects the non-agricultural sector to expand by 4¼ percent in 2012 (compared to potential growth of 4½ percent), with a slightly negative output gap in 2012. Normalization of weather conditions will positively impact the agricultural sector next year and GDP would expand by 8½ percent, before stabilizing around potential over the medium term.

Output Gap
(In percent)



9. ***Inflation is expected to remain at about 5 percent in 2012.*** Upward pressure on inflation should be relatively muted in 2012 given: (i) a slightly negative output gap; (ii) subdued global commodity prices; and (iii) local food price increases limited by the existing beef export ban. Inflationary pressures, however, may arise toward next year once the export ban is lifted and economic activity rebounds strongly. These pressures and their impact on expectations can be contained as long as the BCP appropriately tightens monetary policy in a timely fashion and

[5] Staff estimates indicate that a 10 percent decline in agriculture reduces non-agricultural activity by 0.8-1.0 percent.

allows the exchange rate to appreciate (as during 2011). Over the medium term, inflation could decline below 5 percent, provided that the BCP completes the transition to an inflation-targeting regime and sets a lower inflation target.

Paraguay: Medium-Term Outlook

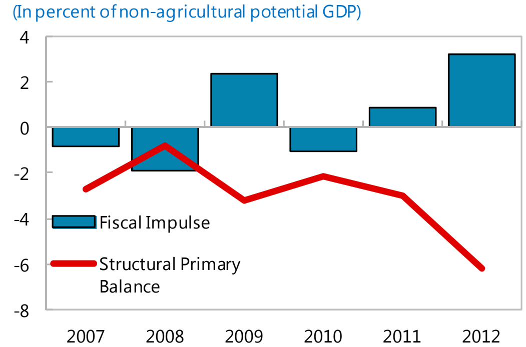
				Prel.	Proj.					
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
	(Annual percentage change, unless otherwise indicated)									
Production and prices										
Real GDP	5.8	-3.8	15.0	3.8	-1.5	8.5	4.6	4.7	4.7	4.7
Consumer prices (end of period)	7.5	1.9	7.2	4.9	5.0	5.0	5.0	4.6	4.3	4.0
	(In percent of GDP, unless otherwise indicated)									
Public finances										
Central government primary balance	3.1	0.7	1.8	1.2	-2.2	-1.7	-0.4	0.2	0.5	0.8
Central government overall balance	2.5	0.6	1.5	0.9	-2.5	-2.0	-0.8	-0.1	0.2	0.6
Central government structural primary balance 1/	-0.8	-3.2	-2.2	-3.0	-6.2	-5.5	-3.8	-2.9	-2.3	-1.7
General government overall balance	2.9	2.0	1.5	1.0	-1.0	-0.2	0.9	1.5	1.8	1.0
General government debt (in percent of GDP)	18.9	17.9	15.0	13.6	14.2	13.4	13.2	11.7	11.2	10.9
External sector										
Terms of trade 2/	38.9	-19.1	6.7	3.8	-0.8	-0.3	-1.1	-0.2	-0.5	0.0
Current account	-1.9	0.5	-3.4	-1.2	-3.1	-1.3	-1.6	-1.4	-1.1	-1.3
Foreign direct investment	1.6	1.4	1.8	2.3	1.9	2.1	2.1	2.2	2.3	2.2
Net international reserves	16.9	27.1	22.0	23.5	22.1	19.8	18.7	18.5	18.2	17.8

Sources: Central Bank of Paraguay; Ministry of Finance; and Fund staff estimates and projections.
1/ Excludes electricity royalties and grants. See 2011 Art. IV Staff Report.
2/ Annual percentage change.

10. *The external current account would temporarily weaken in 2012, owing to the supply shocks.* Agricultural exports are projected to contract sharply as a result of the drought, while beef exports would remain essentially stagnant due to the current ban. While the decline in overall exports is expected to be partially offset by lower imports, the current account deficit is projected to rise above 3 percent of GDP. This deterioration would be reversed in 2013, with the recovery of agriculture and the expected lifting of the export ban in late 2012, with the current account deficit stabilizing at around 1¼ percent of GDP over the medium.

11. *Fiscal policy would provide significant stimulus to economic activity in 2012.* As reflected in the government's Financial Plan, the 2012 budget envisages a sizeable loosening of fiscal policy. The mission projects headline and structural balances to weaken by 3¼ percent of non-agricultural GDP (2 percent of total GDP). While this will help cushion the impact of the drought on the non-agricultural sector, the budget includes a large increase in current expenditure (particularly wages, which are growing by about 30

Structural Primary Balance and Fiscal Impulse 1/
(In percent of non-agricultural potential GDP)



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

percent, with an impact on pensions through the existing indexing mechanism), mostly determined by congress.[6] Staff projects real revenue to grow by 3½ percent in 2012, supported by increased electricity royalty payments from Brazil (following the new agreement on Itaipú) and a still relatively robust domestic demand.[7] The 2012 stimulus is projected to be withdrawn only slowly, with the government accounts remaining in deficit through 2014. However, in line with recent historical experience in Paraguay, it is expected that deficits would remain modest. Against this background, while general government debt would rise to over 14 percent of GDP in 2012, it would resume its declining trend in 2013, aided by the strong rebound in economic growth.

12. ***Main risks to the short-term outlook are as follows (Annex 1)***:

- *Growth and inflation.* While weaker-than-expected global growth would hurt activity in Paraguay, the main risk to domestic growth in 2012 comes from the drought's spillovers to domestic demand, which could be stronger than currently estimated.[8] In such a scenario, real GDP would contract more than envisaged in the baseline, with possible effects on the financial sector and the fiscal accounts. For 2013, risks to growth and inflation are overall tilted to the upside: the agricultural rebound could be even stronger than currently envisaged, and non-agricultural activity could also expand more rapidly on the back of strong domestic demand growth—leading to higher inflationary pressures—although this could be dampened by lower global growth.

- *Financial sector.* The contraction of agriculture in 2012 and related spillovers might lead to higher NPLs, although this risk looks limited as farmers have large buffers from very high profits in recent years. Banks have relatively strong capital and loss-related reserve buffers, and should be able to deal with a moderate rise in NPLs. Credit to the private sector expanded rapidly in the last few years, but risks to financial stability from a credit bubble have declined lately, given the recent marked

[6] Through its Financial Plan (FP), the government has some ability to alter spending plans approved by congress, but cannot change wages. For 2012 the FP cut spending by over 1 percent of GDP relative to the approved budget. The public sector wage increase is not expected to influence wage growth in the private sector, which tends to follow the minimum wage. The latter is adjusted in line with 12-month inflation when inflation is 10 percent or higher; otherwise it is set discretionally by the government. With inflation running well below 10 percent, minimum wage and overall private sector wage growth are expected to be modest in 2012.

[7] The agricultural contraction will have a very limited direct impact on revenues, given that the sector's contribution to tax collections is negligible.

[8] See Selected Issues Paper, Chapter II.

deceleration in credit growth and the strengthening of buffers in the banking sector. The possibility that public sector deposits at commercial banks might be shifted to a state-owned bank constitutes a risk to financial stability, as it would abruptly affect private banks' funding sources and the liquidity distribution within the financial system.

- *Fiscal accounts*. With general elections in 2013 and ongoing pressures for higher spending, downside risks dominate in the near term, especially given the ability of the Paraguayan congress to independently increase expenditures. A weaker fiscal stance could lead to a higher external current account deficit and inflation, and to a more depreciated exchange rate, which could fuel second-round inflationary pressures.

13. ***Medium-term risks stem mainly from the external environment (Annex 1).*** These include a large decline in commodity prices and a substantially weaker external demand.[9] At present, staff considers these risks to be low to medium. However, were they to materialize, they would have a significant impact on Paraguay's highly-open and commodity-dependent economy. In such a scenario, the external current account would weaken, and the guaraní could be put under significant pressure. This would tend to push inflation up, although weaker economic activity would partially offset such pressures. Economic activity would be broadly affected, putting strong pressure on the financial system given that the non-agricultural sector has weaker buffers. These risks highlight the importance of continuing bolstering financial sector cushions while improving bank regulation and supervision. Fiscal risks are also tilted to the downside, given the powers of congress and its tendency to produce expansionary budgets.

POLICY DISCUSSIONS

14. ***Focus of the consultation.*** The 2012 consultation focused on (i) macroeconomic and financial policies needed to maintain stability against the backdrop of supply shocks; (ii) improving the tax system to raise the revenue ratio to help fund higher spending on basic social and infrastructure needs; and (iii) increasing long-term growth and other structural issues.

15. ***Implementation of past Fund policy advice.*** The previous Article IV consultation (IMF Country Report 11/238) highlighted the need to gear short-run policies toward moderating

[9] See Selected Issues Paper, Chapter II.

domestic demand pressures and returning to a more balanced growth path, in order to reduce inflation, contain the external current account deficit, and preserve financial stability. It also stressed the need to advance on the implementation of structural reforms in the monetary, fiscal, and financial sectors. There has been progress in several of these areas, but implementation has lagged in some others. In particular, monetary tightening has helped moderate domestic demand growth and lower inflation, against the backdrop of a substantial deceleration in credit growth (paragraphs 2-3) There have also been advances in financial sector reforms (paragraph 7 and Box 5) and in strengthening the monetary framework (Box 6), but further steps should be taken. Progress has been slower on fiscal reforms (e. g., fiscal framework and tax reform), which in the case of tax policy reflects largely the government's lack of a majority in congress.

A. Near-Term Macroeconomic and Financial Sector Policies

16. ***Policies need to focus on keeping inflation in line with the official target and the external current account deficit under control, while protecting financial stability.*** The current policy mix is supportive of economic activity and broadly consistent with achieving the BCP inflation target in 2012. Given the nature of the shock buffeting the Paraguayan economy this year, there are limits to how much macroeconomic policies can do to cushion its effects on activity. The authorities concurred that policies cannot do much to mitigate the direct impact of the drought on agriculture, and should react only to the extent that there are spillovers to the rest of the economy, provided that the inflation dynamics allow it. Limiting risks to financial stability calls for maintaining close monitoring of credit growth, continuing bolstering regulation and supervision, and strengthening financial sector's buffers.

17. ***The mission recommended to avoid easing monetary policy further and to stand ready to tighten if the recent inflation dynamics reverse.*** The current policy rate is below its neutral level. This appears to be broadly consistent with a negative output gap in the non-agricultural sector and meeting the BCP inflation target in 2012, given that food inflation would remain subdued. Interest rates could be eased further only if there were clear signs of weaker-than-anticipated non-agricultural growth or external demand were set to decline significantly, and the dynamics of core inflation showed clear signs of softening. Staff also noted that inflationary pressures will likely increase as 2013 approaches, once the beef export ban is lifted and economic activity recovers. The BCP should be ready to tighten monetary policy accordingly to keep inflation in line with the target. The authorities agreed with this assessment. Consistent with this, in its last policy communiqué, the BCP appropriately suggested that the policy rate had reached a minimum in the current easing cycle and signaled an increase in rates towards 2012Q4.

18. ***There is room for greater exchange rate flexibility.*** Staff stressed that FX intervention should be limited to dealing with excessive volatility and to prevent potential disorderly movements in the FX market.[10] The mission noted that, at the current juncture, some depreciation of the exchange rate would help cushion the impact of the drought on economic activity and the external sector. With a strong rebound of agriculture in 2013, pressures for the guaraní to strengthen might arise. While considering that some FX intervention could be appropriate in that context to smooth out sharp movements in the exchange rate, staff stressed the importance of not resisting the trend and letting the exchange rate play its role in containing any inflationary pressures.

19. ***Staff emphasized the importance of improving liquidity management.*** Excess liquidity is a structural problem in Paraguay, complicating the implementation of monetary policy and limiting its effectiveness. This is especially relevant in a context in which the BCP is moving towards an inflation targeting regime. The BCP has been trying to address this problem by fostering the interbank market. In this regard, staff encouraged the authorities to move to average reserves requirements as soon as feasible. The BCP indicated that it will implement this change later this year once a new payments system is in place (see paragraph 29). Staff also indicated that the BCP should consider issuing long-term paper to absorb liquidity if unexpected spikes reappear, given that relying on FX operations can have unintended consequences on the exchange rate (see paragraph 5). In this context, staff also encouraged the authorities to improve communication and coordination between the BCP and the Ministry of Finance to avoid large, unexpected changes in public deposits at the central bank.

20. ***There was agreement on the need to avoid further relaxation of fiscal policy in 2012 and start withdrawing fiscal stimulus next year.*** Fiscal policy is already providing a strong stimulus to the economy this year. The authorities concurred that adding more stimulus could undermine the ability of the central bank to meet the inflation target while further widening the external current account deficit. They shared the mission's view on the need to start withdrawing the stimulus next year, while noting that this could be challenging given that 2013 is an election

[10] Chapter I of the Selected Issues Paper provides international evidence on other potential benefits of exchange rate flexibility in emerging economies.

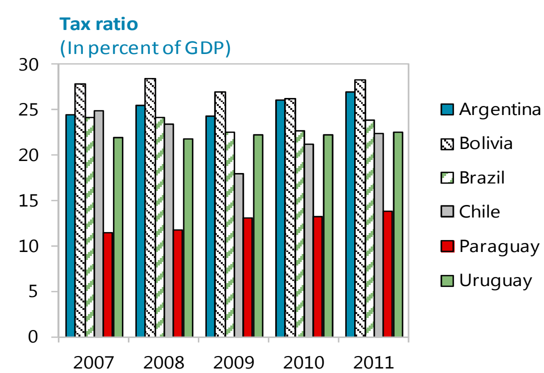
year. The team also pointed to the importance of protecting fiscal buffers built during recent years, and indicated that were activity to turn out significantly weaker than anticipated, the first line of defense should be monetary policy. Staff stressed that the permanent large increase in public sector wages this year would crowd out needed capital spending, thus hindering a better allocation of scarce budgetary resources.

21. ***There is room to improve financial sector monitoring and for greater use of macro-prudential tools.*** There are currently important information gaps regarding the extent of currency mismatches by borrowers, adequate loan classification by sector and maturity, and developments in real estate markets. Staff welcomed plans to address some of these weaknesses (e.g., credit classification) while noting that it is essential to take steps to fill such gaps as soon as feasible. At the same time, while imperfect, available information in some of these areas should be used to limit financial institutions' risks and further strengthening buffers. The mission recommended moving forward with plans to adopt higher provisioning for foreign-currency loans, and encouraged the authorities to evaluate the use of other similar measures such as higher capital requirements for such lending. The mission also supported authorities' plans for introducing dynamic provisioning.

22. ***The exchange rate does not seem to be fundamentally misaligned*** *(Box 3)*. The mission's estimates based on CGER and measures of external competitiveness suggest that the guaraní was overvalued by less than 10 percent at end-2011. All the methodologies used point consistently to an overvaluation of around that magnitude.

B. Improving the Tax System

23. ***Paraguay needs to raise its tax ratio to support upgrading basic infrastructure, improving social indicators, and reducing poverty.*** While tax revenues have been growing at a solid pace in recent years, the tax ratio remains one of the lowest in Latin America, and is well below that in neighboring countries. Insufficient public resources are a major factor behind important shortcomings in basic infrastructure, which, in turn, hinder raising long-run growth. At the same



time, modest social spending contributes to a relatively low level of human development and high poverty incidence.[11] Higher social and education-related spending could help progress in these areas while also being beneficial to long-run economic growth. Against this backdrop, and building on recent TA advice, the mission supported existing tax reform plans and made recommendations to increase the revenue effort while improving tax equity.

24. ***Staff supported the authorities' efforts to implement the personal income tax (PIT).*** The PIT was originally approved in 2004 but its implementation has been postponed several times by congress. Implementation prospects in the short run have greatly improved after congress's lower house approved the tax's enactment in early May. The senate is expected to consider the bill soon, and a favorable outcome is anticipated. There was agreement that, while the current PIT law has several shortcomings, it is important to implement it as soon as possible. A PIT will not only increase revenues and tax equity—although marginally in the short-run—but will also contribute to reducing informality. The authorities also agreed that, going forward, it would be important to work on enhancing the PIT to bolster its income-tax features by limiting overly generous deductions.

25. ***Staff also supported improving agricultural taxation.*** Despite accounting for over 20 percent of GDP, the agricultural sector's share of tax revenues is negligible. The mission supported recent changes to agricultural taxation, including limiting VAT credits against the agricultural income tax (IMAGRO) liabilities and broadening the IMAGRO base. Staff welcomed legislation plans to, *inter alia,* bring cooperatives under the IMAGRO and limit overly generous deductions. Staff highlighted that there is scope for further trimming of deductions, closing loopholes, and unifying the various taxation regimes in place in the sector. It cautioned against the introduction of export taxes (a bill sponsored by individual lawmakers is currently in congress, with slim chances of approval); instead, it recommended adopting a sales tax on agricultural products to be levied at the first stage in the transaction chain and at a low rate.

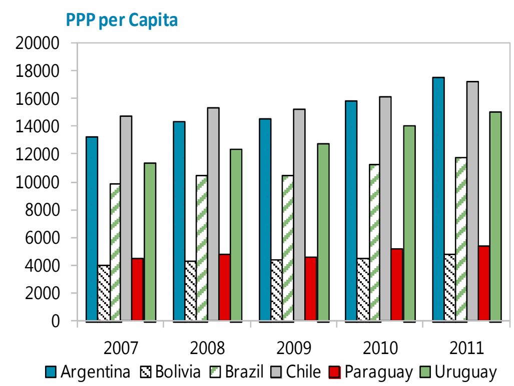
26. ***There is scope to increase financial sector taxation.*** The financial sector is considered to be under-taxed, owing to exemptions and a low VAT rate (5 percent, compared to the 10 percent general rate). Building on recent TA advice, the mission recommended progressively raising (one percentage point per year) the VAT on financial transactions to the general rate level.

[11] Paraguay ranked 107 out of 197 in the UN's 2011 Human Development Index. Poverty affected 35 percent of the population in 2010.

It also suggested bringing the cooperative sector under the corporate income tax, and eliminating exemptions on interest and capital gains on stocks and public debt holdings. The authorities agreed with these recommendations.

C. Long-Term Growth and Other Structural Issues

27. ***There is room to raise long-term growth.*** Paraguay's potential growth is estimated at about 4½ percent, which is broadly in line with regional levels. However, Paraguay's per capita income is considerably lower than that of its neighbors, which suggests scope for higher potential growth rates. This would require raising the investment ratio (on the low side by regional levels) and increasing competitiveness and productivity. The mission identified some key constraints to growth in the country related to infrastructure shortcomings, relatively low levels of human capital, a weak business climate, and labor market inefficiencies (Box 4). Staff encouraged the authorities to work on a strategy for easing these constraints. It also supported ongoing efforts to improve public enterprise monitoring and performance (including through the enactment of appropriate legislation); if sustained, they should increase overall efficiency and help ease constraints to long-run growth.[12]



28. ***The authorities are planning pension system reforms.*** The current public pension system comprises a variety of pay-as-you-go, defined-benefit schemes, each governed by a separate law and with some intended for specific occupations. They cover less than 20 percent of the working-age population. Although the aggregate system generates a small cash surplus, due to parametric differences, several pension regimes have sizable cash flow deficits that have to be covered by the central government. Reliable data on the system's liabilities and assets lacks comprehensiveness, partly due to weak reporting requirements. The mission stressed the need for a proper actuarial assessment of the existent pension schemes. It also welcomed plans to address other shortcomings, including through homogenizing and strengthening the system's regulation and supervision, for which the authorities plan to create a superintendency of

[12] There are 9 state-owned enterprises in Paraguay, including in water services, telecommunications, cement, oil distribution, ports, and airports. Financial performance for most of them has been improving in recent years, reflecting closer monitoring and improved management. Information on their performance is also now publicly available.

pensions with World Bank support. The authorities' plans also include a broader reform to pursue a modern and encompassing pensions system based on sustainability and portability principles. The project also aims at reducing contingent liabilities.

29. ***Financial sector reform is advancing in some areas in line with recent FSAP recommendations*** (Box 5)**.** Staff supported advances on the program to strengthen regulation and supervision of cooperatives, and to create a financial safety net for the sector. Little progress has been made in other areas in the sector, however, notably on governance reform. The mission welcomed plans for implementing a new payments system later this year. It also supported ongoing discussions to set up a high-level committee to strengthen cooperation and coordination among regulators. The authorities explained that plans to reform bank and BCP legislation will likely move more slowly as they require strong support in congress, where the current administration lacks a majority. These reforms would facilitate updating bank prudential requirements and support a more effective risk-based supervision, including by bringing the definition of capital and loan classification fully in line with international standards.

30. ***The BCP continues moving forward with the process of adopting an inflation-targeting (IT) regime*** (Box 6). In 2011 the authorities announced their intention to adopt IT, envisaging that the process would be completed before end-2013. The mission welcomed steps taken by the BCP to support this process, including adopting a 14-day rate as the policy rate, producing a bi-annual inflation report, and improving communications. The mission encouraged the BCP to continue moving forward with the implementation of recommendations made by a recent MCM technical assistance missions in the areas of monetary framework and operations, liquidity management and forecasting, and FX operations. The team also reiterated its recommendation to recapitalize the central bank by implementing the 2010 recapitalization law.[13]

STAFF APPRAISAL

31. ***A severe drought will lead to a contraction in 2012, but the economy is expected to rebound strongly next year.*** GDP is projected to fall by 1½ percent this year, driven by the agricultural sector. Although domestic demand growth has receded from high levels in 2011, it

[13] Concerns about the financial cost to the Treasury appear to have been a key factor in the delay of the recapitalization of the BCP.

should remain robust, in line with strong confidence. With the drought now over and supportive policies in place, growth will likely resume in the second quarter and accelerate in the second half of the year. The non-agricultural sector should grow at close to potential, although the output gap would remain negative. As weather conditions normalize and agriculture recovers, GDP would expand by 8½ percent in 2013.

32. ***The current policy mix seems broadly appropriate for 2012.*** The monetary policy stance is stimulative, with a policy rate below its neutral level underpinning robust credit growth. Fiscal policy is providing strong stimulus to activity, with an impulse of over 3 percent of non-agricultural GDP. This policy mix is broadly consistent with meeting the BCP inflation target (5 percent) in 2012 and will help offset the impact of the drought on the non-agricultural sector. However, staff considers that this year's permanent large increase in public wages precludes a better allocation of scarce budgetary resources as it would crowd out needed public sector investment. Regarding exchange rate policy, heavy FX intervention in 2012Q1 appears to have prevented the guaraní from depreciating, which would have also helped cushion the effects of the drought.

33. ***It is important not to relax policies further, and stand ready to tighten if inflationary pressures resurface.*** With non-agricultural GDP close to its potential, further monetary and fiscal stimuli will likely fuel inflationary pressures and widen the external current account deficit. At the same time, were clear signs of weaker-than-anticipated non-agricultural growth to appear, monetary policy should be the first line of defense. Going forward, with the expected reversal of the recent decline in meat prices once the export ban is lifted, and given the strong recovery anticipated, inflationary pressures are likely to rise as 2013 approaches. The BCP should stand ready to tighten monetary policy in a timely manner while allowing for sufficient exchange rate flexibility. Fiscal policy would also need to play a role by starting to withdraw the significant stimulus provided in 2012.

34. ***Staff encourages closing important information gaps in the financial sector.*** Improving information on currency mismatches, loan classification, and real estate prices is essential to enhance financial sector monitoring. At the same time, while imperfect, available information should be used to limit financial sector risk. In this regard, staff encourages the authorities to implement plans to adopt higher provisioning for foreign-currency loans. Staff considers congress's initiative to abruptly move public sector deposits from commercial banks to a state-owned bank to pose a risk to financial stability; appropriate alternatives should be considered.

35. *A higher tax ratio would help address significant deficiencies in infrastructure and social indicators.* Paraguay has one of the lowest tax ratios in the region. Higher tax revenues would help improve basic infrastructure, finance higher levels of social spending and improve human capital, and support poverty reduction. Staff welcomes the authorities' efforts to implement the PIT as soon as possible. Going forward, it would be important to strengthen the tax by limiting overly generous deductions. Staff also supports improving income taxation in agriculture, where generous deductions and significant loopholes are major factors behind very low revenue collections. There is scope to increase the tax contribution of the financial sector, including by broadening the base and raising the VAT rate on financial transactions, which is only half the general rate.

36. *Key constraints to long-run growth need to be addressed.* Staff considers that, given Paraguay's income level, there is room for achieving higher long-run growth. Growth is being constrained, in particular, by large infrastructure gaps, relatively low levels of human capital, and a weak business climate. Sectors where public enterprises have a strong presence could also improve their efficiency. In this regard, staff supports the authorities' efforts to improve monitoring and performance of public enterprises, and encourages the authorities to consolidate recent advances, including by enacting appropriate legislation.

37. *Staff welcomes progress on structural financial sector reforms and encourages the authorities to move forward with the reform agenda.* The program to bolster regulation and supervision, and to set up a safety net for cooperatives is advancing. Its full implementation will strengthen the sector and the overall financial system. Staff supports the forthcoming implementation of a new payments system, and encourages the authorities to set up promptly a high-level committee of regulators. It is important that reforms to banking and BCP legislation are implemented as soon as feasible to support a more effective risked-based supervision and bring prudential regulations fully in line with international standards. Finally, staff supports plans to reform the pension system, including by strengthening its regulation and supervision.

38. *The authorities' efforts to support IT implementation are welcome but further work would be needed to transition to a full-fledged regime.* The BCP has recently taken several important steps to support this process, including the establishment of a single monetary policy rate and the publication of bi-annual monetary policy reports. Further advances in several areas, including the monetary framework, and monetary and FX operations, would also be required for the BCP to transition to full-fledged IT. Moving to average reserve requirements would help reduce excess liquidity and foster the interbank market, improving the monetary transmission mechanism. Implementing the BCP recapitalization would also be important to further strengthen monetary policy. Improved communication and coordination between the BCP and the Ministry of Finance would also facilitate liquidity management and forecasting.

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

Box 1. The Natural Real Interest Rate in Paraguay

The natural real interest rate (NRIR) can be used as a benchmark to evaluate the stance of monetary policy. The assessment involves a comparison with the real policy rate. If the economy is in full-employment and absent any financial friction, the NRIR should equal the growth rate of potential output and clear the savings-investment equilibrium. In practice, being a latent variable, the NRIR has to be estimated through various methods and might differ from potential growth. This Box presents two alternative measures of the NRIR for Paraguay based on economic theory: one derived from a consumption-smoothing model with a risk-free real rate, and a second one based on the uncovered interest rate parity (UIP) condition.

A parameterized consumption model with a risk-free rate suggests a NRIR for Paraguay of around 3¾ percent. In this model, which in the version considered incorporates habit persistence, the NRIR is a linear function of the expected long-run growth rate of output, its volatility, and some measure of risk aversion.[1] As is standard in the literature, discount factors between 0.97 and 0.99 and coefficients of relative risk aversion in the 1.0–2.0 range are used. Under these assumptions, the NRIR for Paraguay would be between 2.2 and 5.4, with an average value of 3.8—below the 4½ estimated potential output growth.

Paraguay: NRIR w/ habit consumption

Disc. Factor	Coef. of relative risk aversion		
	1.0	1.5	2.0
0.970	4.23	4.82	5.41
0.975	3.72	4.31	4.90
0.980	3.20	3.80	4.39
0.985	2.69	3.29	3.88
0.990	2.19	2.78	3.37

Estimates based on the UIP condition suggest a NRIR around 3 percent. The interest parity condition states that the domestic interest rate should equal the international interest rate plus/minus the expected rate of depreciation/appreciation of the domestic currency and any country and/or exchange rate risk.[2] The exercise estimates Paraguay's NRIR for different expected rates of appreciation. This is based on the consideration that a country like Paraguay should normally experience productivity growth and become richer. It is assumed that productivity in the tradable sector relative to the non-tradable sector grows at a similar pace in Paraguay compared to the rest of the word. Based on this, a long-run real appreciation between zero and one percent per annum is considered. For this range of values, the NRIR is estimated to lie between 2.5 and 3.5 percent, with an average of 3.0 percent.

---

[1] Specifically, $ln\, R_t = r_t = -ln\beta + \gamma ln\Delta y_{t+1} - \left(\frac{\gamma^2}{2}\right) Var(\Delta ln y_{t+1})$, where *r* stands for the NRIR, β for the discount rate, γ represents risk aversion and *y* is output. Adding habit consumption, it modifies to $ln\, R_t = r_t = -ln\beta + \gamma g - \frac{1}{2}\gamma(1-\varphi)$, where g is the long-run growth rate and φ is the weight of past consumption in habit formation.

[2] Specifically, $i = i^* + e + \rho$, where i is the interest rate (an asterisk denotes international), e is the expected rate of depreciation, and ρ the risk/currency premium. The experiment considers a U.S. long-run inflation of 2 percent, Paraguay's inflation target of 5 percent, a country risk premium of 3½ percent, an exchange rate premium of 2 percent, and 2 percent NRIR for the U.S.

Box 2. Exchange Rate Flexibility in Paraguay

FX flows exert pressures on the exchange rate. Policymakers may choose to let the exchange rate move freely with FX flows, or may decide to resist such pressures by intervening in the FX market and changing the level of net international reserves. The extent to which these pressures are resisted determines the degree of flexibility of an exchange rate regime. In a purely flexible regime, the exchange rate carries the entire burden of the adjustment, with no intervention by the authorities and no change in reserves. In a purely fixed exchange rate regime, on the contrary, the exchange does not change, as reserve accumulation absorbs FX flows. In practice, however, most exchange rate arrangements are somewhat between these two extremes. Exchange rate flexibility can enhance monetary policy transmission and help the economy absorb shocks.

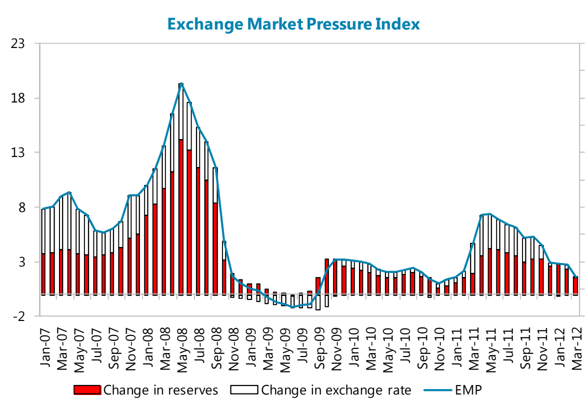
To gauge systematically exchange rate pressures and the degree of resistance to them by the BCP, two indicators are built: (i) an index of exchange market pressures (EMP), and (ii) a resistance index (RI). The latter is an indicator of exchange rate flexibility. The EMP index is a combination of changes in the exchange rate and changes in net international reserves, normalized by each variable's standard deviation:

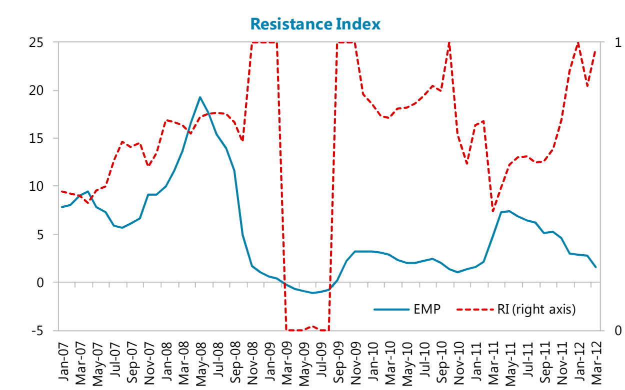
$$\Delta er_t = \frac{e_t - e_{t-12}}{e_{t-12}} \quad , \quad \Delta res_t = \frac{NFA_t - NFA_{t-12}}{MB_{t-12}} \quad , \text{ and } EMP_t = \frac{1}{\sigma_{\Delta er_t}}\Delta er_t + \frac{1}{\sigma_{\Delta res_t}}\Delta res_t$$

where e_t stands for the exchange rate in month t, measured in U.S. dollars per guaraní; NFA_t the stock of net foreign assets at the BCP at the end of month *t;* and MB_t the stock of monetary base in month t. $\sigma_{\Delta er_t}$ ($\sigma_{\Delta res_t}$) is the 12-month standard deviation of the percentage change in the exchange rate (in reserves) ending in period *t*. The RI is normalized to the 0-1 range (zero for pure flex, one for pegs) and represents the share of the EMP that the central bank does not allow to be passed-through to the exchange rate:

$$RI_t = 1 - \left[\left(\frac{\Delta er_t}{\sigma_{\Delta er_t}}\right)/EMP_t\right] = \left[\left(\frac{\Delta res_t}{\sigma_{\Delta res_t}}\right)/EMP_t\right]$$

The BCP has tended to resist exchange market pressures in recent years. This resistance grew during most of 2007–08 in the face of strong and rising appreciation pressures. Somewhat lower resistance during late-2010 and part of 2011, a period of appreciation as well, appear to have helped contain inflation. Resistance then started to increase again in 2012Q1 as appreciation pressure rose. Especially since late 2011, the BCP has resisted almost entirely exchange market pressures against a backdrop of negative supply shocks (drought and foot-and-mouth disease) that might have required a weakening of the guaraní. Overall, measured by the RI, exchange rate flexibility decreased in Paraguay over the last year, reversing a trend that had started in late 2009.



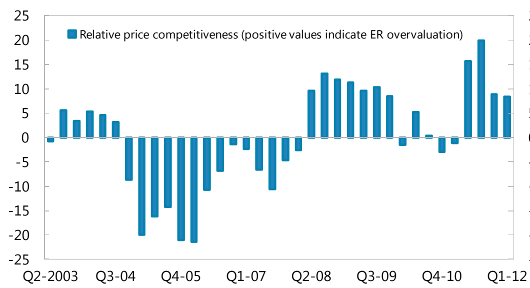


Box 3. Exchange Rate Assessment in Paraguay

According to CGER estimates, the guaraní was overvalued by about 9 percent at end-2011. The guaraní appreciated by 14 percent in real effective terms during 2011, reflecting both a moderate nominal strengthening and an inflation rate exceeding that of Paraguay's trading partners. This was only partially offset by improvements in medium-term fundamentals, notably the current account deficit, the net foreign asset position, and the terms of trade.

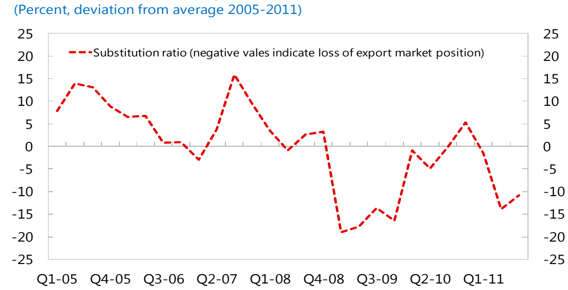
Other methods suggest a similar degree of overvaluation. Staff also assessed the level of the guaraní using two additional indicators of external competitiveness, namely relative prices and market shares for Paraguay's primary products in major export markets.[1] Changes in market shares are measured through the evolution of the substitution ratio of Paraguayan vs. domestic products sold in export markets. These indicators are compared with their respective medium-term levels. The methodology indicates that the guaraní was overvalued by over 9 percent at end-2011. The correlation between these two measures of external competitiveness considered was found to be high (-77 percent). This makes sense, given that Paraguay's exports are easily-substitutable commodities, with a high sensitivity of demand to changes in relative prices.

External Price Competitiveness
(Percent, deviation from average 2003-2012)



Sources: Haver, BCP, and IMF staff calculations

External Volume Competitiveness
(Percent, deviation from average 2005-2011)



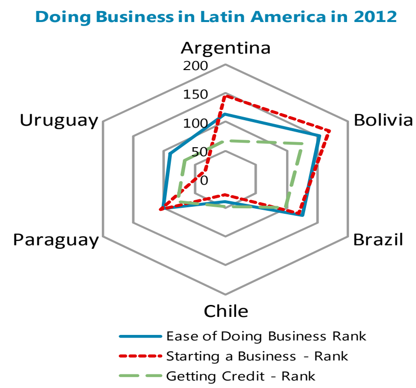
Sources: Haver, BCP, and IMF staff calculations

[1] These markets are Brazil, Argentina, Uruguay, Chile, Russia, Germany, and Switzerland, and they account for 72 percent of Paraguayan exports. The primary products considered represent 85 percent of Paraguay's registered exports.

Box 4. Constraints to Long-Term Growth

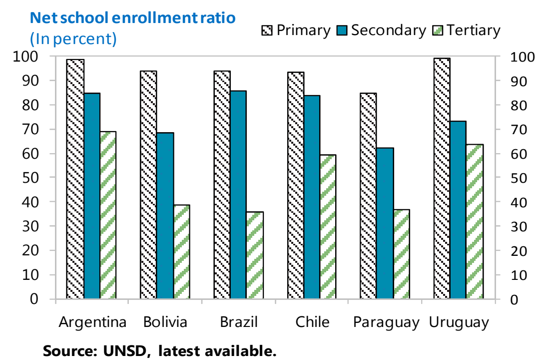
Long-rung growth prospects in Paraguay would improve by easing constraints in some key areas:

- *Investment and basic infrastructure.* Investment is low by regional standards (below 19 percent of GDP). In particular, there are large deficiencies in basic infrastructure (e.g., ports, river transport, utilities, roads), which increase production costs and constitute a drag on growth. Public-private partnerships could be used as a vehicle to support infrastructure improvements, while carefully assessing the fiscal contingencies related to them. At the same time, moving forward with reforms to improve efficiency, transparency, and accountability at key state-owned enterprises (cement, utilities) would help ease infrastructure bottlenecks while reducing contingent fiscal liabilities.



- *Competitiveness and ease of doing business.* Paraguay ranks 102 of 183 in the World Bank's *Ease of Doing Business*. A weak business environment results in higher costs and likely deters private investment, especially from abroad.

- *Human capital development.* Studies show that the marginal return to education in Paraguay is among the highest in Latin America.[1] This reflects largely the relative scarcity of human capital in the country. Indicators of schooling are low compared with its neighbors. In addition to helping raise productivity, improving human capital by raising schooling could help attract higher volumes of (and higher value-added) FDI flows while reducing inequality and poverty.



- *Labor markets.* Paraguay ranks low by international standards in its labor market institutions, which increases production costs and hurts competitiveness. Based on World Bank data, labor market features that account for Paraguay's low international ranking include: (i) a high ratio of minimum wage to the average value added per worker, (ii) significant barriers to hiring and firing employees, and (iii) substantial rigidity of hours. To put these issues in perspective, the minimum wage in Paraguay is about ½ of average value added, versus a Latin American average of 32 percent. Days of paid annual leave—30 after 10 years of service—are about one third higher than the regional norm. Moreover, notice periods on redundancy dismissal (some 7½ salary weeks) are more than twice the regional average.

[1] See IADB (2008), *"Growing Pains. Binding constraints to Productive Investment in Latin America,"* Washington, D.C.

Box 5. Status of Implementation of Main Recommendations from the 2010 FSAP

Financial Institutions Soundness and Vulnerabilities

• Adopt capital ratio definition following Basel Accords (Basel I).	Partially completed
• Proceed with planned introduction of forward looking provisioning.	Pending
• Enhance the regulatory approach to renewed, refinanced, and restructured operations.	In progress

Payment and Security Settlement Systems

• 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.	Near completion

Financial Sector Oversight

• 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.	Pending
• Review the legal framework to avoid suspension of INCOOP's corrective actions by ongoing judiciary appeal process to strengthen INCOOP's enforcement capacity.	Pending
• 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

Financial Safety Net and Crisis Resolution Framework

• 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.	In progress
• Setup deposit insurance scheme for cooperatives to increase public confidence in the sector.	In progress

Box 6: Migration to IT Regime—Status of Implementation of MCM Recommendations

A. Monetary Policy Framework

Focus Monetary Policy Committee (MPC) meetings only on monetary policy discussions, using developments in other areas only as inputs for such discussions.	In progress
Align the schedules for MPC meetings and the release of the CPI information.	Completed
Establish a dedicated task force to lead the implementation of IT by the targeted timeline.	Pending
Focus MPC statements on movements in the BCP reference interest rates. Deal with statements on FX interventions separately.	Completed
Improve communication through regular contact with journalists, economists, and other stakeholders.	In progress
Produce a forward-looking Inflation Report to improve policy communication.	Completed
Develop a formal projection framework that includes, *inter alia*, exploring the implications of risks and uncertainties. Integrate projections in a framework with two types of cycles: a complete cycle associated with the release of the national accounts, and a short cycle for the other months.	Completed
Set up independent units for the cycle of projections, including: monitoring data; short-term projections; medium/long term projections; and reporting.	In progress

B. Monetary Operations, and Liquidity Management and Forecasting

Allow averaging of reserve requirements.	Pending
Allow the constitution of required reserves only in dollars for foreign currency deposits.	Completed
Recapitalize the BCP with marketable securities to, *inter alia*, facilitate the use of repo transactions to manage short term liquidity.	Pending
Focus policy actions on a short-term interest rate by using the 14-day rate as the policy rate to simplify the operational framework and eventually move to an overnight rate.	Completed
Improve price discovery in auctions for IRMs of over 14-day terms and create market benchmarks to develop a yield curve and extend the term structure of liquidity absorption.	In progress
Use fine tuning repo and deposit operations.	Pending
Consolidate FLIR as a standing facility to complement short term liquidity management and the use of average reserves; phase out the interbank liquidity management window.	Pending
Regularly exchange forward-looking information with the Ministry of Finance; Minimize same-day transactions by the government or the BCP to reduce volatility on daily liquidity projections.	In progress
Elaborate long-term liquidity projections based on available information and the monetary program to control systemic liquidity over the long run.	Pending

C. Foreign Exchange Operations

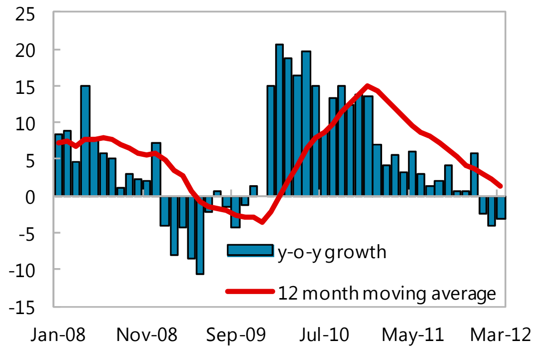
Limit FX intervention to situations of extreme volatility or strong market distortions. Reduce the frequency of FX interventions gradually (for a proper learning period).	In progress
Further strengthen communication on FX policy; start the calculation of a daily interbank fixing for the exchange rate.	In progress
Use daily transaction reports to build intraday and daily reports.	Completed

Figure 1 Paraguay: Real Sector Developments

Following a record-high level in 2010, growth decelerated strongly in 2011, on the back of monetary tightening and domestic supply shocks. Domestic demand remained robust, but also decelerated. Declining food prices and lower demand growth reduced inflation.

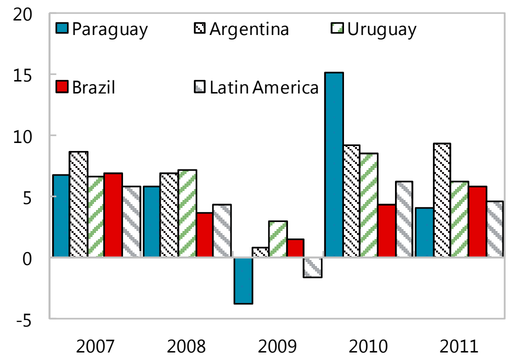
Growth slowed down markedly in 2011...

Index of Economic Activity
(In percent)



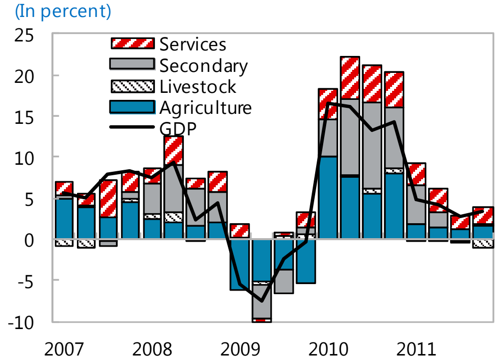
...falling well below average growth in the region.

Real GDP Growth
(In percent)



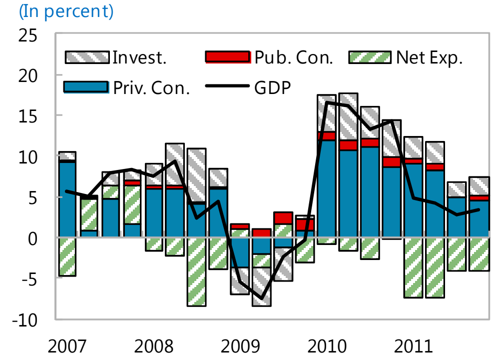
The deceleration was mainly driven by the primary and construction sectors, which were hit by supply shocks.

Sector Contribution to GDP Growth
(In percent)



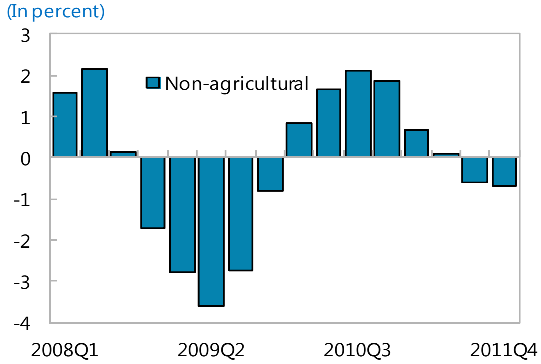
Domestic demand remained relatively strong, but also experienced an important deceleration.

Demand Side Contribution to GDP Growth
(In percent)



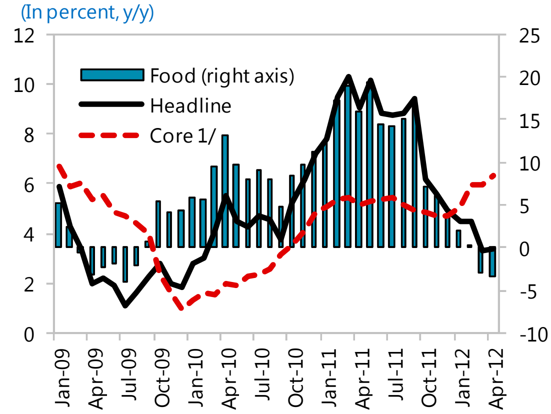
The output gap turned negative in the second half of 2011.

Output Gap
(In percent)



Headline inflation has declined below the official target, driven mainly by food prices.

Inflation
(In percent, y/y)



1/ Excludes food and fuels

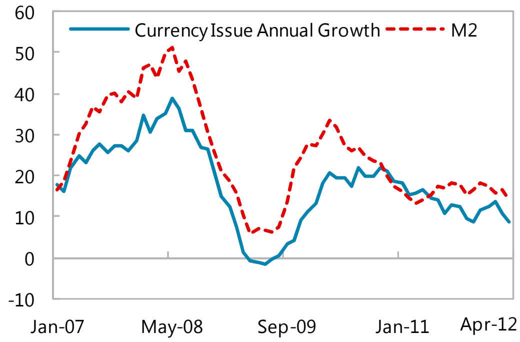
Sources: Paraguayan Authorities and Fund staff estimates.

Figure 2 Paraguay: Monetary Developments

The authorities withdrew monetary stimulus during most of 2011. Credit growth decelerated, contributing to lowering domestic demand growth. Monetary tightening helped pushed inflation within the BCP's target band.

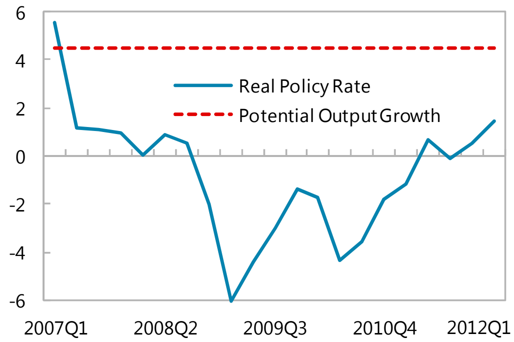
Growth of monetary aggregates has moderated.

Monetary Aggregates
(y-o-y growth)



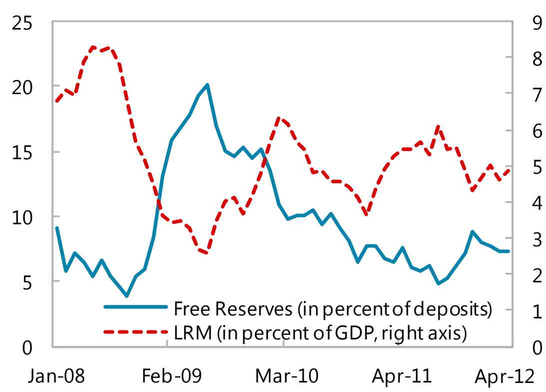
After a prolonged tightening cycle, the real policy rate turned positive in the second half of-2011...

Real Policy Rate and Output Gap
(In percent)



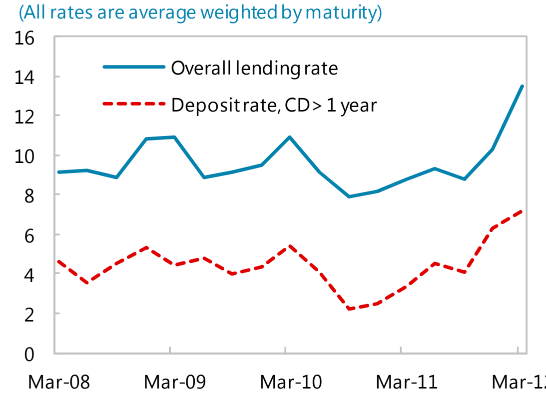
...helping the BCP withdraw liquidity, although bank reserves have remained high.

Central Bank Paper and Free Reserves at the BCP



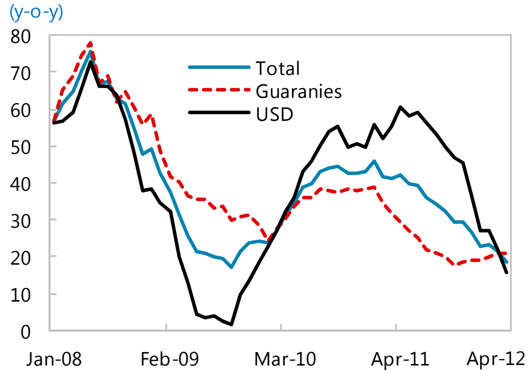
Higher policy rates were partially passed-through to market interest rates during 2011

Local Real Currency Interest Rates
(All rates are average weighted by maturity)



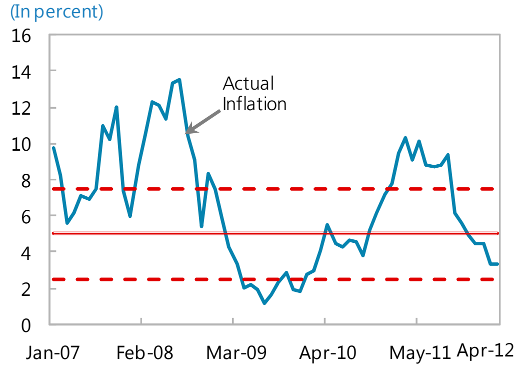
Credit growth has decelerated markedly both in guaranies and U.S. dollars, ...

Credit Growth
(y-o-y)



...contributing to the softening of inflation, which is now below the BCP's target.

Inflation
(In percent)

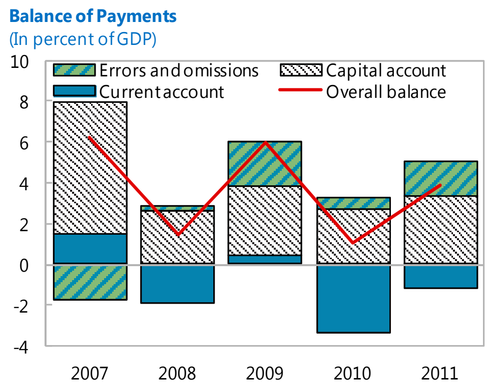


Sources: Paraguayan Authorities and Fund staff estimates.

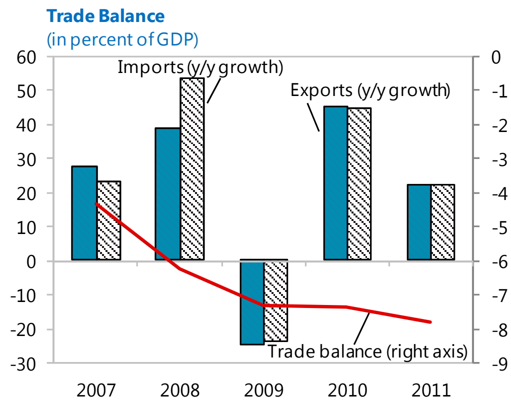
Figure 3 Paraguay: Balance of Payments Developments

The external current account deficit decreased in 2011, driven by a stronger services account and higher remittances. High private capital inflows allowed the central bank to continue accumulating reserves.

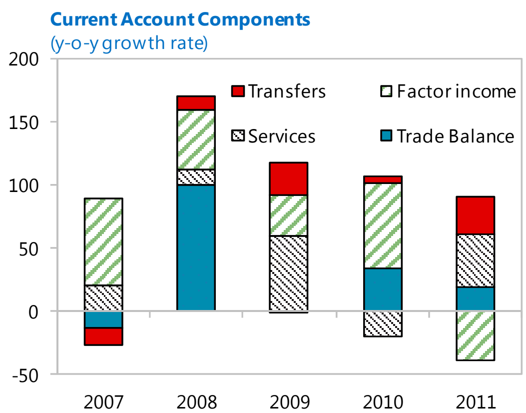
The current account balance improved markedly in 2011....



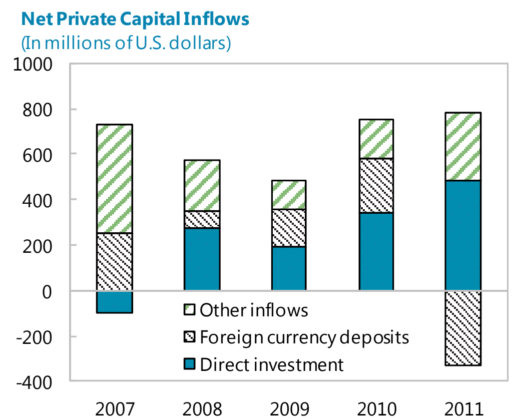
...despite a small deterioration in the trade balance.



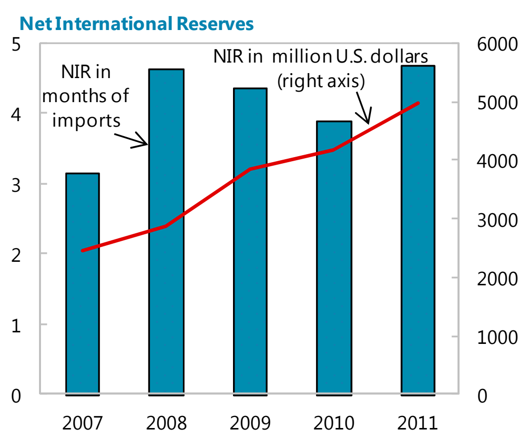
The services account and transfers from worker remittances recorded strong improvements.



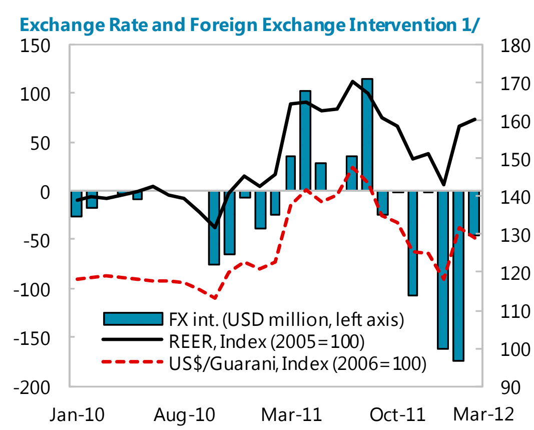
Private capital inflows remained strong....



... allowing substantial accumulation of reserves by BCP.



The guaraní appreciated in real terms, despite large FX purchases by the central bank..



1/ An increase in exchange rates implies appreciation.

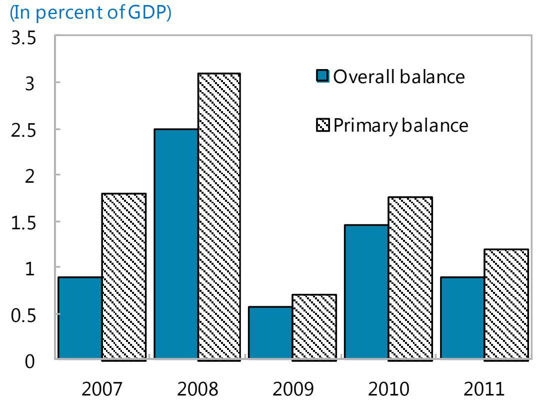
Sources: Paraguayan Authorities and Fund staff estimates.

Figure 4 Paraguay: Fiscal Developments

Fiscal policy exhibited an expansionary tone in 2011. Growth of real primary spending increased sharply, while revenue growth decelerated, as the economy slowed down. With the fiscal accounts in surplus, however, public debt continued its declining trend.

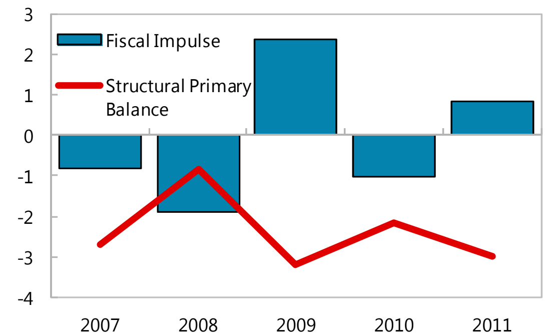
Fiscal balances, though still in surplus, worsen in 2011...

Primary and Overall Balance, Central Government
(In percent of GDP)



...implying some modest stimulus to the economy.

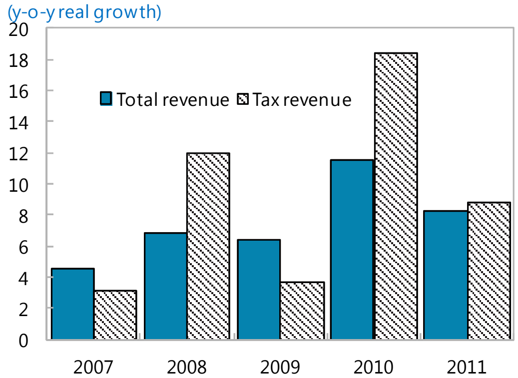
Structural Primary Balance and Fiscal Impulse 1/
(In percent of non-agricultural potential GDP)



1/ Excludes electricity royalties, and grants. See Paraguay's 2011 Staff Report.

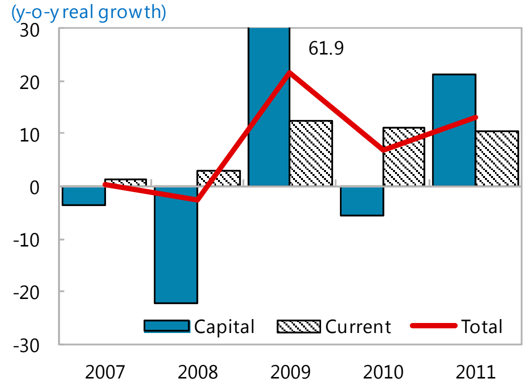
Revenues growth decelerated sharply but remained strong...

Real Revenue Growth
(y-o-y real growth)



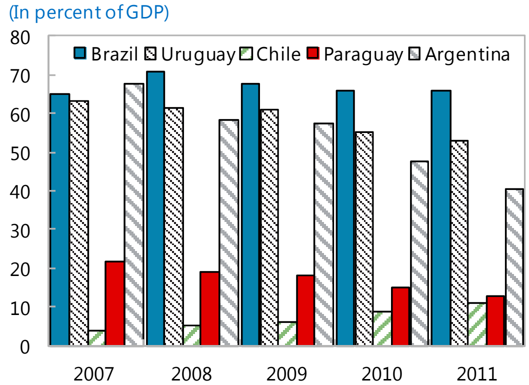
... while growth of real primary spending accelerated, driven by capital outlays.

Real Primary Expenditure Growth
(y-o-y real growth)



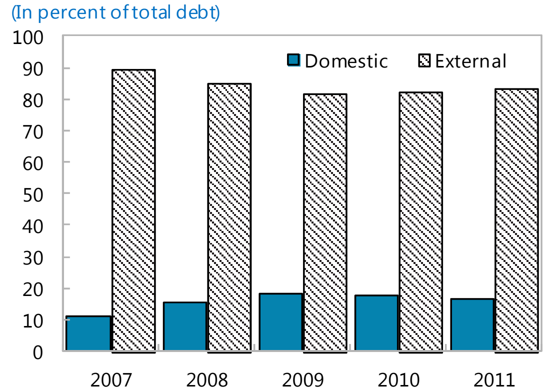
Public debt continued to decline in 2011, remaining one of the lowest in the region.

Public Debt
(In percent of GDP)



Public debt in Paraguay is denominated overwhelmingly in foreign currency.

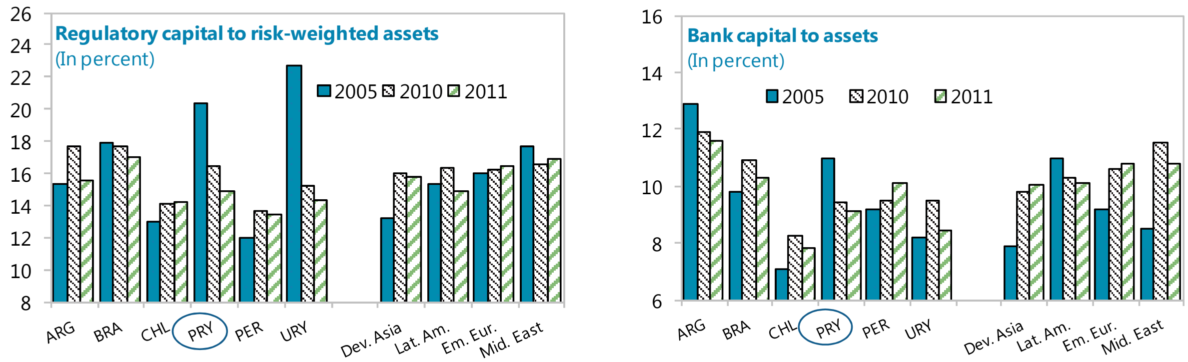
Public Debt Composition
(In percent of total debt)



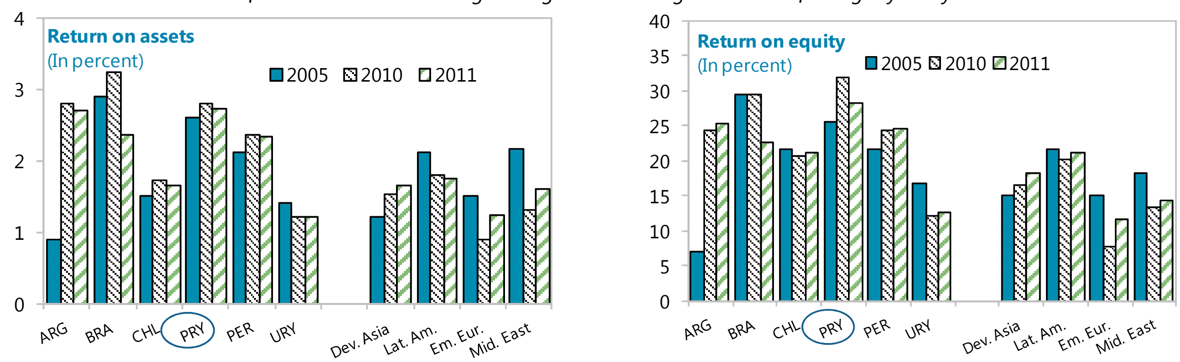
Sources: Paraguayan Authorities and Fund staff estimates.

Figure 5 Paraguay: Banking System Indicators in International Perspective 1/

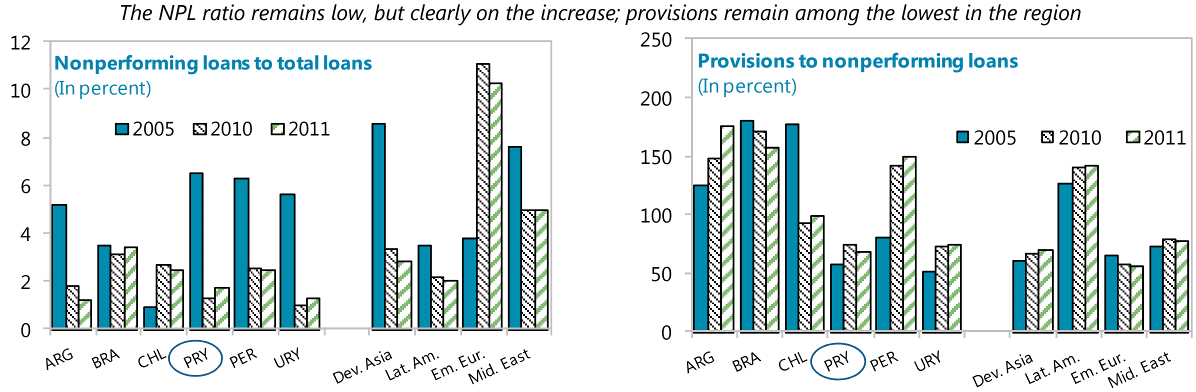
Capital ratios have remained in line with regional levels, but declined slightly in 2011



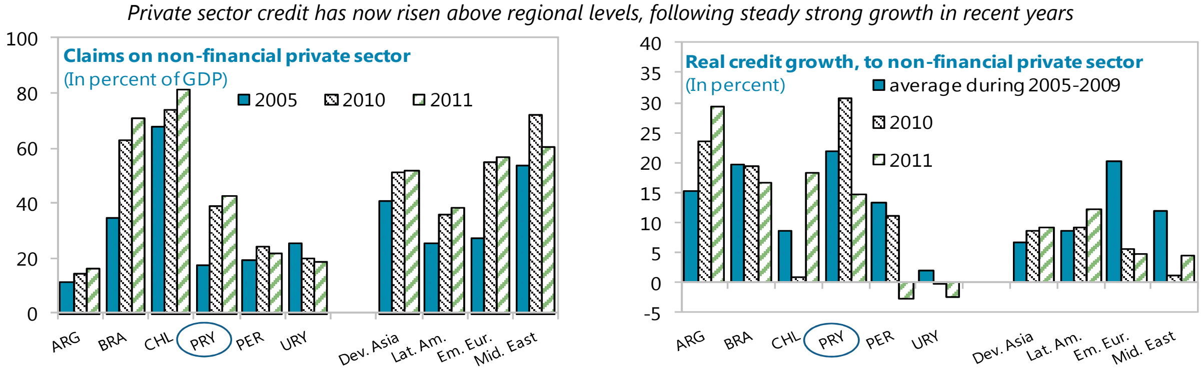
Profits continue to be among the highest in the region but also fell slightly last year



The NPL ratio remains low, but clearly on the increase; provisions remain among the lowest in the region



Private sector credit has now risen above regional levels, following steady strong growth in recent years



Sources: Paraguayan Authorities and Fund staff estimates.
1/ Regional aggregates correspond to median values.

Table 1. Paraguay: Selected Economic and Social Indicators

I. Social and Demographic Indicators

Population 2011 (millions)	6.6	Gini index (2010)	51.2
Unemployment rate (2011)	5.6	Life expectancy at birth (2010)	72.3
Percentage of population below the poverty line (2010)	34.7	Adult illiteracy rate (2010)	5.3
Rank in UNDP development index (2011)	107 of 187	GDP per capita (US$, 2011)	2,961.2

II. Economic Indicators

					Prel.	Proj.	
	2007	2008	2009	2010	2011	2012	2013
(Annual percentage change, unless otherwise indicated)							
Income and prices							
Real GDP	6.8	5.8	-3.8	15.0	3.8	-1.5	8.5
Nominal GDP	17.7	19.7	-4.0	22.8	10.5	7.4	13.4
Real per-capita income growth	4.7	3.8	-5.7	12.8	1.8	-3.4	6.4
Consumer prices (end of period)	5.9	7.5	1.9	7.2	4.9	5.0	5.0
Monetary sector							
Currency issue	28.3	15.0	11.3	18.5	11.6	10.9	14.5
Credit to private sector	46.2	49.3	24.1	42.9	26.3	18.2	24.2
Liabilities to private sector	33.3	30.8	26.7	26.1	20.6	17.9	21.2
External sector							
Exports (fob)	27.7	38.8	-24.8	45.3	22.0	-5.9	20.3
Imports (cif)	22.5	44.0	-22.0	43.6	21.5	-0.5	12.9
Terms of trade	13.6	38.9	-19.1	6.7	3.8	-0.8	-0.3
Real effective exchange rate 1/	12.2	16.0	-6.4	2.0	-0.5	...	...
(In percent of GDP, unless otherwise indicated)							
Current account	**1.5**	**-1.9**	**0.5**	**-3.4**	**-1.2**	**-3.1**	**-1.3**
Trade balance	-4.3	-6.3	-7.3	-7.4	-7.8	-9.4	-6.4
Exports	45.6	45.9	41.2	44.9	48.9	41.6	42.2
Registered	22.9	26.3	22.3	23.9	26.6	20.7	23.4
Unregistered	22.7	19.6	18.9	21.0	22.3	20.9	18.8
Imports	49.9	52.2	48.5	52.3	56.7	51.1	48.5
o/w Oil imports	5.9	7.7	6.5	5.7	7.1	7.0	6.1
Other (export and import of services, income, current tran:	5.8	4.4	7.8	4.0	6.2	5.8	4.6
o/w Remittances	3.0	2.4	3.6	2.9	3.3	3.1	2.7
Capital account and financial account	6.4	3.4	3.4	4.1	3.3	4.0	2.5
General government	-1.1	0.1	0.0	0.2	1.2	1.6	1.2
Private Sector	7.5	3.3	3.4	4.0	2.1	2.4	1.3
o/w Direct investment	1.6	1.6	1.4	1.8	2.3	1.9	2.1
Errors and omissions	-1.7	0.4	2.2	0.9	1.7	0.0	0.0
Net international reserves (in millions of U.S. dollars)	**2,462**	**2,864**	**3,861**	**4,168**	**4,984**	**5,184**	**5,515**
(Stock in months of next year imports of goods and servic	3.1	4.6	4.3	3.9	4.7	4.3	4.4
(Stock over total external short term debt)	4.4	2.9	3.5	3.4	3.9	4.1	4.3
Gross domestic investment	**18.0**	**18.1**	**15.5**	**17.7**	**19.3**	**19.1**	**18.5**
Private sector	13.4	14.3	10.0	13.2	14.0	13.8	13.8
Public sector	4.6	3.7	5.5	4.6	5.2	5.3	4.7
Gross national saving	**19.5**	**16.2**	**16.0**	**14.4**	**18.1**	**16.0**	**17.2**
Private sector	13.5	9.8	10.2	8.5	12.2	13.5	14.9
Public sector	6.1	6.4	5.8	5.8	5.9	2.5	2.3
External saving (+) disavings (-)	1.5	-1.9	0.5	-3.4	-1.2	-3.1	-1.3
Central government revenues	**17.6**	**17.3**	**19.7**	**18.7**	**19.8**	**20.1**	**20.0**
o/w Tax revenues	11.4	11.8	13.0	13.1	13.8	13.6	13.8
Central government expenditures	**16.7**	**14.8**	**19.1**	**17.3**	**19.0**	**22.6**	**21.9**
o/w Wages and salaries	7.1	7.1	8.6	8.0	8.4	10.3	10.3
Transfers	3.8	3.5	4.2	3.7	4.0	5.1	5.1
Capital expenditure	3.7	2.7	4.6	3.7	3.8	4.5	3.9
Central government primary balance	**1.8**	**3.1**	**0.7**	**1.8**	**1.2**	**-2.2**	**-1.6**
Central government overall balance	0.9	2.5	0.6	1.5	0.9	-2.5	-2.0
Consolidatd public debt (in percent of GDP)	**28.1**	**23.1**	**23.0**	**18.6**	**18.0**	**19.6**	**19.0**
o/w external	19.8	16.7	15.3	12.8	11.8	11.9	11.0
domestic	1.9	2.2	2.7	2.2	1.8	2.3	2.4
LRM 2/	6.4	4.2	5.0	3.6	4.3	5.4	5.6
Memorandum items:							
GDP (in billion of Guaranies)	61,512	73,622	70,705	86,808	95,942	103,072	116,924
GDP (US$millions)	12,323	16,981	14,232	18,958	21,236	23,465	27,879

Sources: Central Bank of Paraguay; Ministry of Finance; and Fund staff estimates and projections.
1/ Average annual change; a positive change indicates an appreciation.
2/ Letras de Regulacion Monetaria (Central Bank paper).

Table 2a. Paraguay: Operating Statement of Budgetary Central Government

	2007	2008	2009	2010	2011	2012	2013
					Prel.	Projections	
	(In billions of Guaranies)						
Revenue	**10,837**	**12,748**	**13,915**	**16,247**	**19,037**	**20,674**	**23,302**
Taxes	7,019	8,656	9,208	11,406	13,211	14,008	16,089
Income taxes	1,229	1,381	2,140	2,096	2,611	2,600	3,021
Excises	1,310	1,555	1,398	1,778	1,995	2,112	2,555
Value added tax	3,318	4,313	4,128	5,908	6,786	7,210	8,258
Import duties	853	1,055	977	1,526	1,704	1,770	2,023
Other	309	351	565	99	115	317	233
Social contributions	752	907	1,014	1,141	1,326	1,727	2,089
Other revenue	3,066	3,186	3,693	3,701	4,501	4,939	5,124
Itaipu-Yacyreta	2,042	1,872	2,267	1,952	2,323	2,636	2,516
Other nontax revenue	999	1,285	1,424	1,744	2,109	2,299	2,603
Capital revenue 1/	25	28	2	5	68	5	5
Expenditure	**10,263**	**10,918**	**13,853**	**15,073**	**18,184**	**23,237**	**25,633**
Expense	**8,749**	**9,681**	**11,774**	**12,808**	**15,751**	**20,611**	**23,205**
Compensation of employees	4,360	5,216	6,079	6,951	8,047	10,649	12,091
Purchases of goods and services	704	713	1,055	1,285	1,661	2,277	2,583
Interest	515	449	443	353	289	307	396
Grants 2/	785	717	1,166	939	1,777	2,054	2,111
Social benefits 3/	1,264	1,370	1,475	1,503	1,673	2,802	3,177
Other expense	1,121	1,215	1,555	1,778	2,304	2,522	2,846
Transfers 4/	1,102	1,187	1,490	1,716	2,209	2,470	2,787
Other	19	28	65	61	95	52	59
Net acquisition of nonfinancial assets	**1,514**	**1,237**	**2,080**	**2,265**	**2,434**	**2,626**	**2,428**
Gross operating balance	**2,089**	**3,067**	**2,142**	**3,439**	**3,287**	**64**	**98**
Net lending/borrowing (overall balance)	**620**	**1,831**	**399**	**1,266**	**853**	**-2,563**	**-2,330**
Net financial transactions	**514**	**1,868**	**448**	**1,591**	**765**	**-2,428**	**-2,178**
Net acquisition of financial assets	**-33**	**-14**	**50**	**77**	**267**	**135**	**153**
Loans 5/	-33	-14	50	77	267	135	153
Net incurrence of liabilities	**-547**	**-1,882**	**-398**	**-1,513**	**-498**	**2,563**	**2,330**
Domestic	-340	-1,548	-440	-1,760	-249	926	936
Debt securities	186	23	396	7	-509	659	566
New TB issues	382	167	712	439	-509	835	734
Amortizations	196	144	316	432	0	176	168
Loans	-832	-1,478	-979	-1,837	-68	267	370
Net credit from the Central bank	-837	-1,421	-783	-1,859	-40	0	0
Net credit from the commercial bank	4	-57	-196	21	-28	267	370
Other accounts payable	307	-93	142	70	329	0	0
Foreign	-207	-334	42	247	-248	1,637	1,395
Loans	-207	-334	42	247	-248	1,637	1,395
Disbursements	724	495	1,136	1,193	583	2,531	2,185
Amortizations	932	829	1,094	946	831	894	791
Statistical Discrepancy 6/	*46*	*1*	*337*	*92*	*0*	*0*	*0*
Memorandum items:							
Primary balance	1,089	2,279	505	1,527	1,141	-2,256	-1,935

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 financial item.
6/ To reconcile with the financial accounts, errors in the revenue and expenditure accounts are corrected through statistical discrepancy.

Table 2b. Paraguay: Operating Statement of Budgetary Central Government

	2007	2008	2009	2010	2011	2012	2013
					Prel.	Projections	
	(In percentage of GDP)						
Revenue	**17.6**	**17.3**	**19.7**	**18.7**	**19.8**	**20.1**	**20.0**
Taxes	11.4	11.8	13.0	13.1	13.8	13.6	13.8
Income taxes	2.0	1.9	3.0	2.4	2.7	2.5	2.6
Excises	2.1	2.1	2.0	2.0	2.1	2.1	2.2
Value added tax	5.4	5.9	5.8	6.8	7.1	7.0	7.1
Import duties	1.4	1.4	1.4	1.8	1.8	1.7	1.7
Other	0.5	0.5	0.8	0.1	0.1	0.3	0.2
Social contributions	1.2	1.2	1.4	1.3	1.4	1.7	1.8
Other revenue	5.0	4.3	5.2	4.3	4.7	4.8	4.4
Itaipu-Yacyreta	3.3	2.5	3.2	2.2	2.4	2.6	2.2
Other nontax revenue	1.6	1.7	2.0	2.0	2.2	2.2	2.2
Capital revenue 1/	0.0	0.0	0.0	0.0	0.1	0.0	0.0
Expenditure	**16.7**	**14.8**	**19.6**	**17.4**	**18.9**	**22.6**	**22.0**
Expense	**14.2**	**13.1**	**16.7**	**14.8**	**16.4**	**20.0**	**19.9**
Compensation of employees	7.1	7.1	8.6	8.0	8.4	10.4	10.4
Purchases of goods and services	1.1	1.0	1.5	1.5	1.7	2.2	2.2
Interest	0.8	0.6	0.6	0.4	0.3	0.3	0.3
Grants 2/	1.3	1.0	1.6	1.1	1.9	2.0	1.8
Social benefits 3/	2.1	1.9	2.1	1.7	1.7	2.7	2.7
Other expense	1.8	1.7	2.2	2.0	2.4	2.5	2.4
Transfers 4/	1.8	1.6	2.1	2.0	2.3	2.4	2.4
Other	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Net acquisition of nonfinancial assets	**2.5**	**1.7**	**2.9**	**2.6**	**2.5**	**2.6**	**2.1**
Gross operating balance	**3.4**	**4.2**	**3.0**	**4.0**	**3.4**	**0.1**	**0.1**
Net lending/borrowing (overall balance)	**1.0**	**2.5**	**0.6**	**1.5**	**0.9**	**-2.5**	**-2.0**
Net financial transactions	**0.8**	**2.5**	**0.6**	**1.8**	**0.8**	**-2.4**	**-1.9**
Net acquisition of financial assets	**-0.1**	**0.0**	**0.1**	**0.1**	**0.3**	**0.1**	**0.1**
Loans 5/	-0.1	0.0	0.1	0.1	0.3	0.1	0.1
Net incurrence of liabilities	**-0.9**	**-2.6**	**-0.6**	**-1.7**	**-0.5**	**2.5**	**2.0**
Domestic	-0.6	-2.1	-0.6	-2.0	-0.3	0.9	0.8
Debt securities	0.3	0.0	0.6	0.0	-0.5	0.6	0.5
New TB issues	0.6	0.2	1.0	0.5	-0.5	0.8	0.6
Amortizations	0.3	0.2	0.4	0.5	0.0	0.2	0.1
Loans	-1.4	-2.0	-1.4	-2.1	-0.1	0.3	0.3
Net credit from the Central bank	-1.4	-1.9	-1.1	-2.1	0.0	0.0	0.0
Net credit from the commercial bank:	0.0	-0.1	-0.3	0.0	0.0	0.3	0.3
Other accounts payable	0.5	-0.1	0.2	0.1	0.3	0.0	0.0
Foreign	-0.3	-0.5	0.1	0.3	-0.3	1.6	1.2
Loans	-0.3	-0.5	0.1	0.3	-0.3	1.6	1.2
Disbursements	1.2	0.7	1.6	1.4	0.6	2.5	1.9
Amortizations	1.5	1.1	1.5	1.1	0.9	0.9	0.7
Statistical Discrepancy 6/	*0.1*	*0.0*	*0.5*	*0.1*	*0.0*	*0.0*	*0.0*
Memorandum items:							
Primary balance	1.8	3.1	0.7	1.8	1.2	-2.2	-1.7
Nominal GDP in billions of Guaranies	61,512	73,622	70,705	86,808	96,001	102,887	116,678

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 financial item.

6/ To reconcile with the financial accounts, errors in the revenue and expenditure accounts are corrected through statistical discrepancy.

Table 3a. Paraguay: Operations of the Consolidated Public Sector 1/

	2007	2008	2009	2010	2011	2012	2013
					Prel.	Projections	
			(In billion of Guaraníes)				
Revenue	**14,223**	**16,569**	**17,699**	**20,340**	**24,494**	**26,174**	**29,536**
Taxes	7,044	8,696	9,245	11,452	13,211	13,990	16,068
Other revenue	7,179	7,873	8,454	8,888	11,284	12,184	13,468
Nontax revenue and grants 2/	6,432	7,137	7,540	8,137	9,798	10,666	11,600
Capital revenue	32	46	158	57	180	55	62
Public enterprises´operating surplus	715	689	756	694	1,306	1,463	1,806
Expenditure	**13,024**	**14,279**	**17,337**	**19,144**	**22,795**	**27,836**	**30,644**
Expense	**10,191**	**11,522**	**13,415**	**14,910**	**17,842**	**22,382**	**25,252**
Compensation of employees	5,357	6,407	7,455	8,607	9,977	11,898	13,373
Purchases of goods and services	1,194	1,314	1,896	2,130	2,882	3,036	3,435
Interest	910	829	585	527	637	757	875
Other expense	2,730	2,971	3,480	3,647	4,345	6,691	7,568
Transfers 3/	2,692	2,896	3,372	3,542	4,204	6,586	7,454
Other	38	75	108	104	141	104	115
Net acquisition of nonfinancial assets 4/	**2,832**	**2,757**	**3,922**	**4,234**	**4,954**	**5,454**	**5,392**
Gross operating balance	**4,032**	**5,047**	**4,283**	**5,430**	**6,653**	**3,792**	**4,284**
Net lending / borrowing (overall balance)	**931**	**2,459**	**361**	**1,196**	**1,699**	**-1,663**	**-1,108**
Net financial transactions	**931**	**2,459**	**361**	**1,196**	**1,699**	**-1,663**	**-1,108**
Net acquisition of nonfinancial assets	**…**	**…**	**…**	**…**	**…**	**…**	**…**
Net incurrence of liabilities	**-931**	**-2,459**	**-361**	**-1,196**	**-1,699**	**1,663**	**1,108**
Domestic	**-556**	**-2,118**	**-383**	**-1,238**	**-1,237**	**-566**	**2,024**
Debt securities	186	23	396	7	-509	659	566
Loans	-786	-2,264	-1,229	-1,639	-1,162	-1,874	643
Net credit from the banking system	-786	-2,264	-1,229	-1,639	-1,162	-1,874	643
From commercial banks	47	-843	-445	220	1,030	-1,874	643
From central banks	-832	-1,421	-783	-1,859	-2,192	0	0
Other accounts payable	44	123	449	394	878	650	815
Quasifiscal deficit financing	44	216	306	324	550	650	815
Other	0	-93	142	70	329	0	0
Foreign	**-375**	**-341**	**22**	**42**	**-462**	**2,228**	**-916**
Loans	**-375**	**-341**	**22**	**42**	**-462**	**2,228**	**-916**
Disbursements	724	593	22	42	-462	2,228	-916
Amortizations	1,100	935	0	1,151	1,044	881	1,114
Statistical discrepancy 5/	*-268*	*169*	*0*	*0*	*0*	*0*	*0*
Memorandum items:							
Primary balance	1,841	3,288	946	1,723	2,336	-905	-233

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.

5/ Measurement error to reconcile the line estimate with estimates of the fiscal balance from the financing side.

Table 3b. Paraguay: Operations of the Consolidated Public Sector 1/

	2007	2008	2009	2010	2011 Prel.	2012 Projections	2013
	(In percentage of GDP)						
Revenue	**23.1**	**22.5**	**25.0**	**23.4**	**25.5**	**25.4**	**25.3**
Taxes	11.5	11.8	13.1	13.2	13.8	13.6	13.8
Other revenue	11.7	10.7	12.0	10.2	11.8	11.8	11.5
Nontax revenue and grants 2/	10.5	9.7	10.7	9.4	10.2	10.4	9.9
Capital revenue	0.1	0.1	0.2	0.1	0.2	0.1	0.1
Public enterprises´operating surplus	1.2	0.9	1.1	0.8	1.4	1.4	1.5
Expenditure	**21.2**	**19.4**	**24.5**	**22.1**	**23.7**	**27.1**	**26.3**
Expense	**16.6**	**15.6**	**19.0**	**17.2**	**18.6**	**21.8**	**21.6**
Compensation of employees	8.7	8.7	10.5	9.9	10.4	11.6	11.5
Purchases of goods and services	1.9	1.8	2.7	2.5	3.0	3.0	2.9
Interest	1.5	1.1	0.8	0.6	0.7	0.7	0.8
Other expense	4.4	4.0	4.9	4.2	4.5	6.5	6.5
Transfers 3/	4.4	3.9	4.8	4.1	4.4	6.4	6.4
Other	0.1	0.1	0.2	0.1	0.1	0.1	0.1
Net acquisition of nonfinancial assets 4/	**4.6**	**3.7**	**5.5**	**4.9**	**5.2**	**5.3**	**4.6**
Gross operating balance	**6.6**	**6.9**	**6.1**	**6.3**	**6.9**	**3.7**	**3.7**
Net lending / borrowing (overall balance)	**1.5**	**3.3**	**0.5**	**1.4**	**1.8**	**-1.6**	**-0.9**
Net financial transactions	**1.5**	**3.3**	**0.5**	**1.4**	**1.8**	**-1.6**	**-0.9**
Net acquisition of nonfinancial assets	**....**	**....**	**....**	**....**	**....**	**....**	**....**
Net incurrence of liabilities	**-1.5**	**-3.3**	**-0.5**	**-1.4**	**-1.8**	**1.6**	**0.9**
Domestic	-0.9	-2.9	-0.5	-1.4	-1.3	-0.5	1.7
Debt securities	0.3	0.0	0.6	0.0	-0.5	0.6	0.5
Loans	-1.3	-3.1	-1.7	-1.9	-1.2	-1.8	0.6
Net credit from the banking system	-1.3	-3.1	-1.7	-1.9	-1.2	-1.8	0.6
From commercial banks	0.1	-1.1	-0.6	0.3	1.1	-1.8	0.6
From central banks	-1.4	-1.9	-1.1	-2.1	-2.3	0.0	0.0
Other accounts payable	0.1	0.2	0.6	0.5	0.9	0.6	0.7
Quasifiscal deficit financing	0.1	0.3	0.4	0.4	0.6	0.6	0.7
Other	0.0	-0.1	0.2	0.1	0.3	0.0	0.0
Foreign	-0.6	-0.5	0.0	0.0	-0.5	2.2	-0.8
Loans	-0.6	-0.5	0.0	0.0	-0.5	2.2	-0.8
Disbursements	1.2	0.8	0.0	0.0	-0.5	2.2	-0.8
Amortizations	1.8	1.3	0.0	1.3	1.1	0.9	1.0
Statistical discrepancy 5/	*-0.4*	*0.2*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Memorandum items:							
Primary balance	3.0	4.5	1.3	2.0	2.4	-0.9	-0.2
Public debt (excl. LRMs)	21.7	18.9	17.9	15.0	13.6	14.2	13.4
Domestic public debt	1.9	2.2	2.7	2.2	1.8	2.3	2.4
Foreign public debt	19.8	16.7	15.3	12.8	11.8	11.9	11.0
Nominal GDP in billions of Guaranies	61,512	73,622	70,705	86,808	96,001	102,887	116,678

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.

5/ Measurement error to reconcile the line estimate with estimates of the fiscal balance from the financing side.

Table 4. Paraguay: Summary Accounts of the Central Bank

(In billions of Guaranies; end-of-period; valued at constant exchange rate)

	2007	2008	2009	2010	Prel. 2011	Proj. 2012
Currency issue	**4,326**	**4,974**	**5,538**	**6,564**	**7,324**	**8,120**
Growth	28.3	15.0	11.3	18.5	11.6	10.9
Net international reserves	**12,309**	**14,322**	**19,304**	**20,841**	**24,919**	**25,919**
(In millions of U.S. dollars)	2,462	2,864	3,861	4,168	4,984	5,184
Net domestic assets	**-7,983**	**-9,348**	**-13,766**	**-14,278**	**-17,594**	**-17,799**
Net nonfinancial public sector	91	-1,104	-1,794	-3,326	-3,496	-2,774
Net credit to the central government	-260	-1,513	-2,154	-3,721	-3,902	-3,448
Net credit to the rest of NFPS	351	408	360	396	406	674
Net credit to the banking system	-7,421	-7,540	-10,401	-9,724	-12,759	-13,965
Reserve requirements	-3,051	-3,338	-4,175	-4,854	-6,096	-6,840
Free reserves	-1,019	-1,460	-3,308	-2,131	-2,855	-2,305
Monetary control bills (LRM) 1/	-3,352	-2,742	-2,918	-2,740	-3,873	-4,886
Other	2	0	0	0	65	65
Other assets and liabilities (net)	-653	-703	-1,571	-1,228	-1,340	-1,060
Capital and reserves	163	-40	355	680	1,241	1,891
Other assets net 2/	-815	-663	-1,926	-1,908	-2,581	-2,950
Memorandum Items:						
Total stock of LRMs outstanding 1/	3,907	3,282	3,412	3,137	4,155	5,517
Quasifiscal balance 3/	-44	-216	-306	-324	-550	-649
In percent of GDP	-0.1	-0.3	-0.4	-0.4	-0.6	-0.6
Costs of monetary policy operations	386	375	140	142	342	443
In percent of GDP	0.6	0.5	0.2	0.2	0.4	0.4

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

1/ A fraction of LRM is held by non-bank institutions.
2/ Includes LRM held by the nonbanking sector.
3/ Cumulative since beginning of year.

Table 5. Paraguay: Summary Accounts of the Banking System
(In billions of Guaranies; end-of-period; valued at constant exchange rate)

	2007	2008	2009	2010	Prel. 2011	Proj. 2012
I. Central Bank						
Net international reserves	**12,309**	**14,322**	**19,304**	**20,841**	**24,919**	**25,919**
(In millions of U.S. dollars)	2,462	2,864	3,861	4,168	4,984	5,184
Net domestic assets	**-7,983**	**-9,348**	**-13,766**	**-14,278**	**-17,594**	**-17,799**
Credit to public sector, net	91	-1,104	-1,794	-3,326	-3,496	-2,774
Credit to banking system, net 1/	-4,069	-4,798	-7,483	-6,985	-8,885	-9,079
Central bank securites	-3,907	-3,282	-3,412	-3,137	-4,155	-5,517
Other	-98	-163	-1,077	-831	-1,058	-428
Currency issue	**4,326**	**4,974**	**5,538**	**6,564**	**7,324**	**8,120**
II. Monetary Survey 2/						
Net foreign assets	**13,240**	**15,861**	**20,844**	**21,829**	**24,571**	**25,573**
(In millions of U.S. dollars)	2,648	3,172	4,169	4,366	4,914	5,115
Net domestic assets	**4,485**	**6,186**	**6,286**	**11,855**	**15,361**	**21,471**
Credit to the public sector	-1,675	-3,265	-5,143	-6,732	-8,448	-10,351
Credit to the private sector	10,223	15,264	18,941	27,073	34,202	40,970
Other	-4,063	-5,813	-7,511	-8,486	-10,392	-9,148
Broad liquidity (M4)	**17,725**	**22,047**	**27,130**	**33,684**	**39,932**	**47,044**
Bonds and issued securities	0	110	174	362	980	1,054
Other monetary liabilities	82	55	121	159	162	193
Central bank securities with private sector	555	540	494	397	282	631
Broad liquidity (M3)	**17,088**	**21,343**	**26,341**	**32,764**	**38,508**	**45,166**
Foreign currency deposits	6,000	7,929	9,237	12,675	14,769	17,088
Money and quasi-money (M2)	**11,088**	**13,413**	**17,104**	**20,090**	**23,739**	**28,078**
Quasi-money	2,339	3,884	4,961	6,113	8,216	9,882
Money (M1)	8,749	9,529	12,144	13,976	15,524	18,196
(Annual Percentage Change)						
M0 (Currency issued)	28.3	15.0	11.3	18.5	11.6	10.9
Credit to the private sector	46.3	49.3	24.1	42.9	26.3	19.8
M1	38.2	8.9	27.4	15.1	11.1	17.2
M2	38.6	21.0	27.5	17.5	18.2	18.3
M3	31.4	24.9	23.4	24.4	17.5	17.3
Of which: Foreign currency deposits	20.0	32.1	16.5	37.2	16.5	15.7
Memorandum items:						
Ratio of foreign currency deposits to M3 (percent)	35.1	37.2	35.1	38.7	38.4	37.8
Ratio of foreign currency deposits to private sector deposits in banks (percent)	44.8	45.3	41.6	45.3	43.8	43.0

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

1/ Exclude LRM held by the banking sector.

2/ In January 2008, a financiera representing about 5 percent of total banking asset was coverted into a bank and thus added to the monetary survey.

Table 6. Paraguay: Balance of Payments

(In millions of U.S. dollars)

	2007	2008	2009	2010	Prel. 2011	Proj. 2012	Proj. 2013
Current account	**185**	**-318**	**67**	**-640**	**-260**	**-600**	**-207**
Trade balance	-532	-1,063	-1,042	-1,396	-1,669	-2,086	-1,629
Exports	5,616	7,793	5,862	8,515	10,388	9,773	11,761
Registered	2,817	4,463	3,167	4,534	5,642	4,858	6,526
Unregistered	2,799	3,330	2,695	3,981	4,746	4,915	5,236
Imports	-6,149	-8,856	-6,904	-9,910	-12,057	-11,859	-13,391
Registered	-5,630	-8,506	-6,497	-9,400	-11,546	-11,369	-12,851
Of which: Fuel products	-722	-1,308	-920	-1,073	-1,504	-1,633	-1,700
Unregistered	-518	-350	-407	-511	-511	-490	-540
Services (net)	499	558	891	714	1,015	1,118	1,146
Transport	-141	-169	-152	-250	-299	-295	-326
Travel	-7	-12	76	65	87	120	138
Other	646	740	966	900	1,226	1,292	1,334
Factor income	-155	-227	-300	-502	-307	-355	-470
Transfers	373	414	519	542	701	723	747
Capital and financial account	**789**	**578**	**480**	**785**	**716**	**800**	**539**
General government	-139	10	-4	32	252	373	333
Disbursements	154	142	231	261	296	576	521
Amortization	-184	-185	-220	-207	-209	-203	-189
Other	-109	53	-14	-22	166	0	0
Private sector 1/	928	568	484	753	464	428	206
Direct investment	199	272	194	337	483	448	584
Foreign currency deposits	251	77	164	242	-328	-82	-337
Other	478	219	126	174	309	62	-41
Errors and omissions	**-212**	**61**	**307**	**163**	**360**	**0**	**0**
Overall balance	**762**	**321**	**855**	**308**	**815**	**200**	**331**
Net international reserves (increase -)	-759	-402	-996	-308	-815	-200	-331
Gross reserves	-759	-402	-996	-308	-815	-200	-331
Reserve liabilities	0	0	0	0	0	0	0
Exceptional financing	-2	81	142	0	0	0	0
Arrears deferral (+)/clearance (-)	-2	81	142	0	0	0	0
Memorandum items:							
Current account in percent of GDP	1.5	-1.9	0.5	-3.4	-1.2	-2.6	-0.7
Gross reserves (in millions of U.S. dollars)	2,462	2,864	3,861	4,168	4,984	5,184	5,515
In months of imports of GNFS	3.1	4.6	4.3	3.9	4.7	4.3	4.4
Debt service in percent of exports GNFS	5.2	2.9	4.9	3.3	2.4	2.8	2.2
Export volume (percentage change)	5.9	-15.7	-11.5	27.8	9.6	-5.8	22.2
Import volume (percentage change)	15.4	21.5	-15.8	34.8	7.2	-3.7	14.4
Terms of trade (percentage change)	13.6	38.9	-19.1	6.7	3.8	-0.8	-0.3

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

1/ Includes public enterprises and binationals.

Table 7. Paraguay: Indicators of External Vulnerability

(In percent of GDP, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011
Monetary and financial indicators						
Broad money (M3), percentage change 1/	14.8	31.5	24.9	23.4	24.4	17.5
Credit to the private sector, real (percentage change) 1/	3.5	38.2	38.9	21.8	33.4	20.4
Share of nonperforming loans in total loans (percent) 2/	3.3	1.3	1.1	1.6	1.3	1.7
Average domestic lending rate, real	15.4	20.8	19.7	25.7	25.9	24.3
Central Bank bill yield, real	0.8	-2.3	-5.0	0.3	0.2	0.4
International reserves (millions of U.S. dollars)	1,703	2,462	2,864	3,861	4,168	4,984
Central bank foreign short-term liabilities (millions of U.S. dollars)	0.0	0.3	0.0	1.2	0.0	0.0
External indicators						
Merchandise exports (percentage change)	31.3	27.7	38.8	-24.8	45.3	22.0
Merchandise imports (percentage change)	31.7	22.5	44.0	-22.0	43.6	21.7
Merchandise terms of trade (percentage change)	-15.0	13.6	38.9	-19.1	6.7	3.8
Real effective exchange rate (percentage change)	12.3	12.2	16.0	-6.4	2.0	14.1
Current account balance (percent of GDP)	1.4	1.5	-1.9	0.5	-3.4	-1.2
Capital and financial account (percent of GDP)	2.1	6.4	3.4	3.4	4.1	3.4
Net foreign direct investment (percent of GDP)	1.8	1.6	1.6	1.4	1.8	2.3
Other net investment (percent of GDP)	0.0	4.6	1.6	1.7	2.2	0.9
External public debt (percent of GDP) 2/	25.2	19.8	16.7	15.3	12.8	11.8
Debt service (in percent of exports GNFS)	5.8	5.2	2.9	4.9	3.3	2.4
Net reserves (in U.S. dollars)	1,703	2,462	2,864	3,861	4,168	4,984
In months of imports of GNFS	3.1	3.1	4.6	4.3	3.9	4.7
Over short-term external debt 3/	2.7	4.4	2.9	3.5	3.4	3.9
Over foreign currency deposits in domestic banks	1.5	1.9	2.1	2.7	2.3	3.0

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

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.

Table 8. Paraguay: Financial Soundness Indicators for the Banking Sector 2006–2011

(In percent, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011
Capital Adequacy						
Regulatory capital to risk-weighted assets	20.1	16.9	16.3	16.3	15.4	14.9
Asset Quality						
Nonperforming loans to gross loans	3.3	1.3	1.1	1.6	1.3	1.7
Provisions to nonperforming loans	59.1	78.4	77.7	78.8	74.4	69.1
Earnings and Profitability						
Return on assets (after tax)	3.0	2.8	3.2	2.4	2.4	2.3
Return on equity (after tax)	24.1	25.7	28.4	23.2	22.3	22.4
Liquidity						
Liquid assets to total assets	43.8	44.3	37.0	41.2	33.5	32.6
Liquid assets to short-term liabilities	73.0	73.8	70.4	74.0	64.6	72.0
Customer deposits to total (noninterbank) loans	183.5	173.2	150.8	160.3	131.0	119.0
Sensitivity to Market Risk						
Net FX exposure / capital	19.9	33.3	12.7	-1.2	4.7	18.5
Industry Distribution of Loans to Total Loans 1/						
Agriculture and livestock	...	36.6	35.7	35.9	32.4	33.0
Industry	...	12.0	11.2	9.3	9.7	9.1
Trade	...	17.4	19.3	19.6	21.1	25.6
Services	...	11.6	10.8	11.5	13.0	8.3
Consumer credit	...	8.4	9.4	10.4	13.1	15.4
Financial sector	...	14.0	13.5	13.1	10.6	8.3
Other Indicators						
Foreign banks assets in total banking assets	69.5	67.7	64.8	50.4	50.4	47.7
Foreign-currency-denominated loans to total loans	43.8	44.6	42.9	38.5	40.6	43.6
Foreign-currency-denominated deposits to total deposits	48.3	43.0	44.4	40.3	42.2	39.1

Sources: Central Bank of Paraguay and Fund staff calculations.

1/ Based on credit registry data.

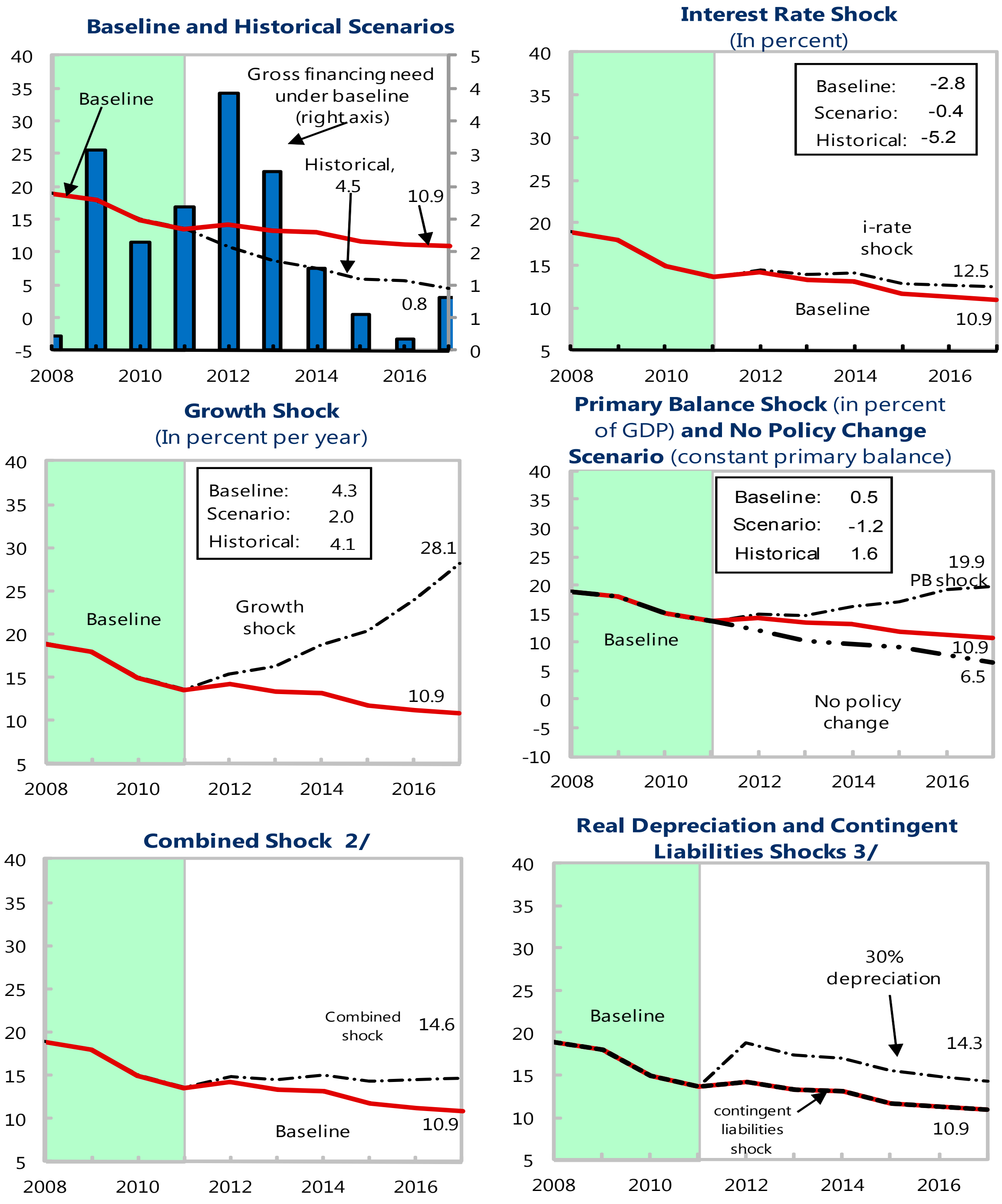
Annex 1. Paraguay: Risk Assessment Matrix[1]

<table>
<tr><th>Nature/Source of main threats</th><th>Relative Likelihood of realization in the next 1-3 years
(high, medium, or low)</th><th>Expected impact on economy if risk is realized
(high, medium, or low)</th></tr>
<tr><td colspan="3">External</td></tr>
<tr><td>Large decline in soy prices</td><td>Staff assessment: Low to medium
• A slow recovery of the global economy might adversely affect commodity prices.
• A large increase in U.S. interest rates or a strong deceleration in the Chinese economy could induce a moderation in demand-driven global price increases.</td><td>Staff assessment: Medium to large
• The external current account would worsen and strong pressures on the exchange rate could arise.
• If accompanied by a large decline in soy production (about 50 percent of agriculture), lower prices will drag down growth, including via spillovers to the non-agro economy.
• The financial sector might observe an increase in NPLs, which would be large only to the extent that the shock is sufficiently persistent.
• Fiscal and monetary policies could help sustain domestic demand.</td></tr>
<tr><td>Substantially weaker external demand</td><td>Staff assessment: Low to medium
• The probability of a much weaker external demand than currently envisaged seems to range from low to medium.</td><td>Staff assessment: Medium to large
• Effects similar to a collapse in the world price for soy (see above).
• A large and broad based decline in external demand would affect primarily the agricultural sector but would impact also the rest of the economy both directly and indirectly.</td></tr>
<tr><td colspan="3">Domestic</td></tr>
<tr><td>Spillovers from agriculture to rest of the economy stronger than currently estimated</td><td>Staff assessment: Low
• If spillovers to the non-agricultural sector are stronger than currently estimated, domestic demand would decelerate more strongly than currently anticipated. This would result in lower non-agricultural growth, which would impact the financial sector and the fiscal accounts more strongly.</td><td>Staff assessment: Low to medium
• Lower domestic demand and non-agricultural growth would hurt employment and incomes. Given weaker buffers in the non-agricultural sector, NPLs would be higher than in the baseline. Similarly, tax revenue growth would be negatively affected.</td></tr>
<tr><td>Persistent intense droughts (extended over two years)</td><td>Staff assessment: Low
• The probability of two consecutive intense droughts is low. However, were they to materialize, economic activity would experience a more prolonged decline, which would also amplify the shock.</td><td>Staff assessment: Medium to large
• A more prolonged economic contraction would impact the financial sector more strongly—including indirectly through spillovers to the rest of the economy—increasing NPLs.
• Lower export earnings could put the guarani under strong pressure and lead to a large depreciation, which could generate sizeable balance sheet effects and inflationary pressures.
• Strong buffers at various levels (by the BCP, farmers, and banks) would help deal with</td></tr>
</table>

Nature/Source of main threats	Relative Likelihood of realization in the next 1-3 years (high, medium, or low)	Expected impact on economy if risk is realized (high, medium, or low)
		depreciation pressures and potential financial sector stress from higher NPLs and balance sheet effects. However, some individual bank buffers might become strained.
Further fiscal relaxation	***Staff assessment: Medium*** • Congress tends to use its powers to increase spending without proper funding, and there are political pressures to make the current stance of fiscal policy more expansionary. • Going forward, congress could limit the ability of the Ministry of Finance to control spending through the Financial Plan.	***Staff assessment: Medium*** • While fiscal buffers are strong, a larger fiscal expansion would make it harder for the BCP to meet the inflation target. • It would widen further the current account deficit, and could put pressure on the guaraní. In addition to fueling inflation, this could produce balance sheet effects, with negative implications for the financial system. • A weakening of the fiscal framework could have long-lasting consequences for fiscal discipline and the public finances, rising debt and eroding current buffers. • It could also limit the space for implementing needed infrastructure expenditures to bolster potential growth.
Higher inflation	***Staff assessment: Medium*** • Pressures to relax macroeconomic policies could increase ahead of the elections. With relatively weakly anchored inflation expectations and a still developing inflation targeting regime, inflation could increase above the central bank's target. • A high openness to trade and strong pass-through implies a potentially significant price impact from exchange rate depreciation.	***Staff assessment: Low*** • While a setback, inflation will likely remain on the low side (single digits). • However, anchoring inflation expectations and establishing strong central bank inflation credentials would take longer than currently envisaged.

[1] The RAM shows relatively low probability events that could materially alter the baseline path, which is the scenario most likely to materialize in the view of the staff. Staff's subjective assessment of the relative likelihood among those low probability events as noted in the matrix (ranging from "low" to "high") is consistent across different country reports prepared in a given period.

Figure A.1. Paraguay: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and Fund staff estimates.

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

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2012, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A.1. Paraguay: Public Sector Debt Sustainability Framework, 2007-2016

(In percent of GDP, unless otherwise indicated)

					Prel.			Projections			
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Baseline: Public sector debt 1/	**21.7**	**18.9**	**17.9**	**15.0**	**13.6**	**14.2**	**13.4**	**13.1**	**11.7**	**11.2**	**10.9**
o/w foreign-currency denominated	21.5	18.9	17.9	14.9	12.4	12.7	11.8	11.6	10.2	9.9	9.7
Change in public sector debt	-5.9	-2.8	-1.0	-3.0	-1.4	0.6	-0.8	-0.2	-1.4	-0.5	-0.4
Identified debt-creating flows (4+7+12)	-7.2	-5.6	-0.6	-3.7	-1.9	0.6	-0.9	-1.6	-2.3	-2.4	-1.4
Primary deficit	-2.6	-3.0	-0.9	-0.8	-0.8	1.2	0.4	-0.9	-1.4	-1.7	-0.5
Revenue and grants	32.0	30.7	32.9	29.7	32.2	34.3	33.6	32.9	32.5	32.2	31.9
Primary (noninterest) expenditure	29.5	27.7	31.9	28.8	31.4	35.4	34.0	32.0	31.0	30.5	31.4
Automatic debt dynamics 2/	-4.7	-2.6	0.3	-2.9	-1.1	-0.6	-1.3	-0.8	-0.9	-0.8	-0.8
Contribution from interest rate/growth differential 3/	-3.2	-2.9	1.7	-2.9	-1.1	-0.6	-1.3	-0.8	-0.9	-0.8	-0.8
Of which contribution from real interest rate	-1.6	-1.8	0.9	-0.7	-0.6	-0.8	-0.2	-0.2	-0.3	-0.3	-0.3
Of which contribution from real GDP growth	-1.6	-1.1	0.8	-2.2	-0.5	0.2	-1.1	-0.6	-0.6	-0.5	-0.5
Contribution from exchange rate depreciation 4/	-1.5	...	...	...	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3) 5/	1.4	2.8	-0.4	0.7	0.5	0.0	0.1	1.4	0.8	2.0	1.0
Public sector debt-to-revenue ratio 1/	67.8	61.6	54.6	50.4	42.2	41.4	39.7	40.0	36.1	34.9	34.0
Gross financing need 6/	**1.5**	**0.2**	**3.1**	**1.7**	**2.2**	**3.9**	**2.7**	**1.3**	**0.5**	**0.2**	**0.8**
in billions of U.S. dollars	0.2	0.0	0.4	0.3	0.5	0.9	0.8	0.4	0.2	0.1	0.3
Scenario with key variables at their historical averages 7/					**13.6**	**10.9**	**8.7**	**7.5**	**6.0**	**5.7**	**4.5**
Scenario with no policy change (constant primary balance) in 2011-2017					**13.6**	**12.0**	**10.2**	**9.6**	**9.1**	**7.8**	**6.5**
Key macroeconomic and fiscal assumptions underlying baseline											
Real GDP growth (in percent)	6.8	5.8	-3.8	15.0	3.8	-1.5	8.5	4.6	4.7	4.7	4.7
Average nominal interest rate on public debt (in percent) 8/	4.1	3.8	4.5	3.2	2.6	2.7	3.0	3.4	3.2	3.2	3.1
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-6.1	-9.3	4.6	-3.5	-3.9	-6.3	-1.5	-1.4	-2.3	-2.4	-3.1
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	6.6	-1.6	7.2	0.9	1.8	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	10.2	13.1	-0.1	6.7	6.5	9.1	4.5	4.8	5.4	5.6	6.2
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.6	-0.4	10.7	3.9	13.2	11.0	4.2	-1.6	1.5	3.0	7.6
Primary deficit	-2.6	-3.0	-0.9	-0.8	-0.8	1.2	0.4	-0.9	-1.4	-1.7	-0.5

1/ Nonfinancial public sector gross debt.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = 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).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

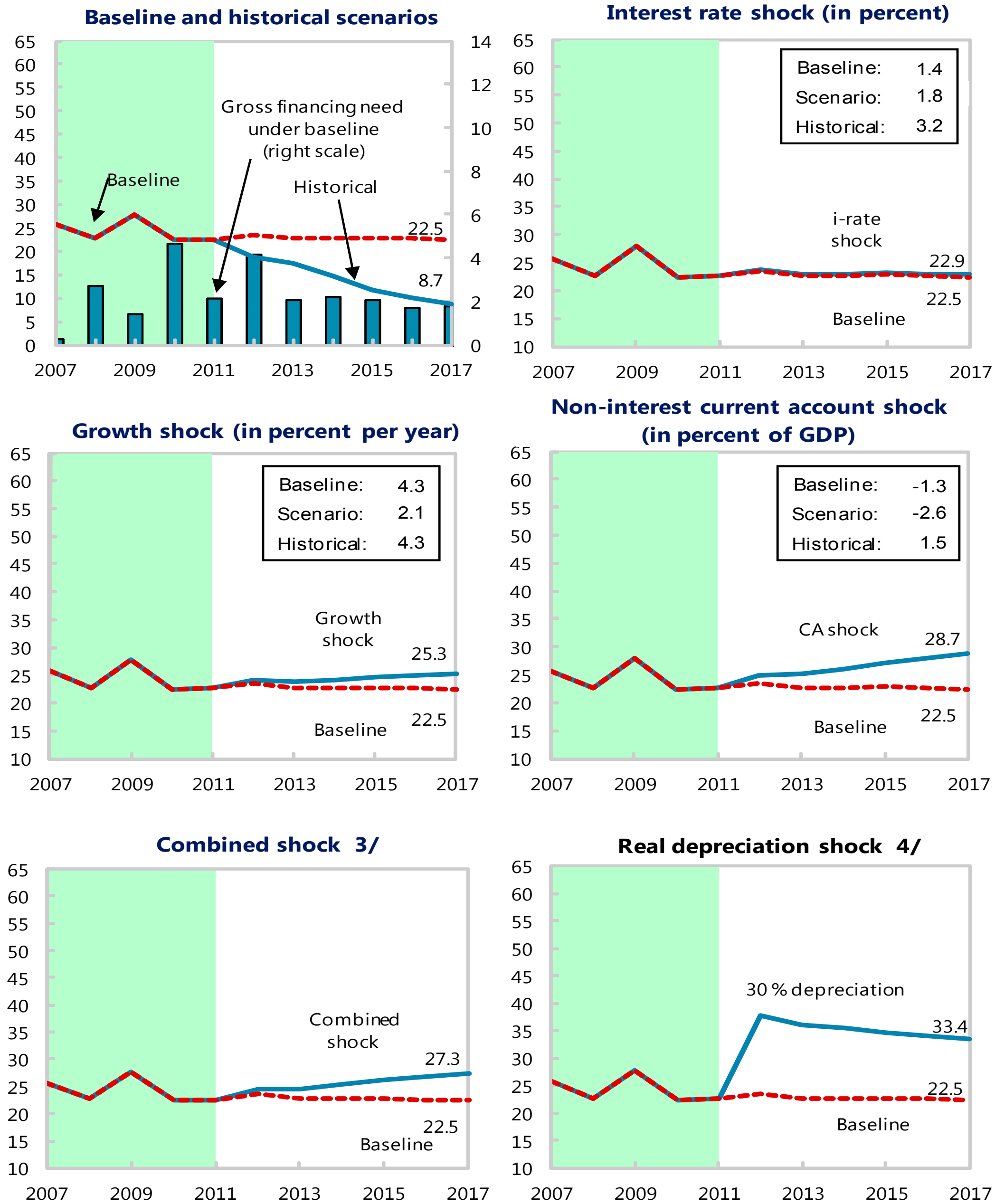
5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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



Sources: International Monetary Fund, Country desk data, and Fund staff estimates.
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 2012.

Table A.2. Paraguay: External Debt Sustainability Framework, 2007-2017

(In percent of GDP, unless otherwise indicated)

	Actual				Prel.	Projections					
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Baseline: External debt	**25.8**	**22.8**	**27.8**	**22.5**	**22.6**	**23.6**	**22.8**	**22.8**	**22.8**	**22.6**	**22.5**
Change in external debt	-6.9	-3.0	5.1	-5.3	0.1	1.0	-0.8	0.0	0.0	-0.1	-0.2
Identified external debt-creating flows (4+8+9)	-10.7	-6.3	4.5	-5.1	0.1	3.2	-0.7	0.3	0.1	-1.3	-1.1
Current account deficit, excluding interest payments	-2.5	1.2	-1.1	3.0	0.8	2.8	1.0	1.2	1.2	0.8	1.0
Deficit in balance of goods and services	0.3	3.0	1.1	3.6	3.5	5.2	2.7	2.6	2.4	2.4	2.5
Exports	53.4	52.7	51.2	52.7	57.3	49.5	49.3	46.7	46.1	45.2	44.0
Imports	53.7	55.6	52.3	56.3	60.7	54.7	52.0	49.3	48.5	47.6	46.5
Net non-debt creating capital inflows (negative)	-1.2	-1.1	0.6	-1.6	-0.3	-0.2	-0.3	-0.3	-0.3	-1.4	-1.3
Automatic debt dynamics 1/	-6.9	-6.4	5.1	-6.5	-0.4	0.7	-1.4	-0.6	-0.7	-0.7	-0.7
Contribution from nominal interest rate	1.0	0.7	0.7	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.2
Contribution from real GDP growth	-1.7	-1.1	1.0	-3.1	-0.8	0.3	-1.7	-0.9	-1.0	-1.0	-1.0
Contribution from price and exchange rate changes 2/	-6.3	-6.0	3.3	-3.8	0.0	-2.5	-2.0	-1.2	-0.3	-0.4	-0.7
Residual, incl. change in gross foreign assets (2-3) 3/	3.7	3.3	0.5	-0.2	0.0	-2.2	-0.1	-0.3	-0.1	1.2	0.9
External debt-to-exports ratio (in percent)	48.3	43.2	54.3	42.7	39.5	47.6	46.1	48.7	49.4	50.0	51.1
Gross external financing need (in billions of U.S. dollars) 4/	**0.0**	**0.5**	**0.2**	**0.9**	**0.5**	**1.0**	**0.6**	**0.7**	**0.7**	**0.6**	**0.7**
(in percent of GDP)	0.2	2.7	1.4	4.7	2.2	4.2	2.1	2.2	2.1	1.7	1.8
Scenario with key variables at their historical averages 5/					**22.6**	**18.9**	**17.3**	**14.7**	**11.7**	**10.2**	**8.7**
Key macroeconomic assumptions underlying baseline											
Real GDP growth (in percent)	6.8	5.8	-3.8	15.0	3.8	-1.5	8.5	4.6	4.7	4.7	4.7
GDP deflator in U.S. dollars (change in percent)	23.7	30.2	-12.8	15.8	7.9	12.2	9.5	5.4	1.2	2.0	3.0
Nominal external interest rate (in percent)	4.2	3.6	2.5	2.0	1.9	1.7	1.4	1.5	1.3	1.2	1.2
Growth of exports (U.S. dollar terms, in percent)	26.6	36.0	-18.5	36.9	21.8	-4.6	18.5	4.4	4.6	4.8	4.8
Growth of imports (U.S. dollar terms, in percent)	22.4	42.9	-21.2	43.3	20.9	-0.6	13.1	4.5	4.2	4.9	5.1
Current account balance, excluding interest payments	2.5	-1.2	1.1	-3.0	-0.8	-2.8	-1.0	-1.2	-1.2	-0.8	-1.0
Net non-debt creating capital inflows	1.2	1.1	-0.6	1.6	0.3	0.2	0.3	0.3	0.3	1.4	1.3

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US 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+gr) 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.

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.

INTERNATIONAL MONETARY FUND

PARAGUAY

June 8, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Western Hemisphere Department

CONTENTS

ANNEX 1. FUND RELATIONS

(As of April 30, 2012)

I. Membership Status: Joined December 28, 1945; Article VIII

II. General Resources Account:

	SDR Million	Percent of Quota
Quota	99.90	100.00
Fund holdings of currency	78.43	78.51
Reserve position in Fund	21.48	21.50

III. SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	95.19	100.00
Holdings	110.59	116.17

IV. Outstanding Purchases and Loans: None.

V. Financial Arrangements:

Type	Approval Date	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

VI. Projected Obligations to the Fund:

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

	Forthcoming				
	2010	**2011**	**2012**	**2013**	**2014**
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**

VII. 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 exchange rate fluctuations. The U.S. dollar is the principal intervention currency. On May 24, 2012, the average interbank rate for the U.S. dollar was ₲ 4,519 =US$1. 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.

VIII. Article IV Consultation: The Executive Board concluded the 2011 Article IV consultation on July 29, 2011.

IX. Technical Assistance:

Department	Purpose	Date of Delivery
FAD	Peripatetic Customs Advisor / Customs Administration	May, August, and December 2007
FAD	Tax Code Regulations	June 2007
MCM	Development of Local Capital Markets	June 2007
MCM	Banking Regulation and Supervision	June, August, and November 2007
STA	Quarterly National Accounts	August 2007
STA	Consumer Price Index	August 2007
STA	Monetary and Financial Statistics	November 2007
MCM	Bank regulation and supervision	February – March 2008, June 2008
FAD	Tax Administration Strategic Planning	April 2008
LEG	AML/CFT Standards Assessment	July 2008
FAD	Tax Policy	August 2008
STA	Quarterly National Accounts	August 2008
FAD	Tax and Customs Administration	September 2008
STA	Monetary and Financial Statistics	March 2009
FAD	Performance Budgeting	February 2009
MCM	Banking Supervision	May 2009
MCM	Cooperatives	September 2009

Department	Purpose	Date of Delivery
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

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

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

ANNEX 2. WORLD BANK-FUND COLLABORATION

1. **Meeting of teams**. The Fund and Bank Paraguay teams met in September 2011 and April 2012 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 main macroeconomic challenge will be responding appropriately to the supply shocks buffeting the economy**. Given the nature of these shocks (an outbread of foot and mouth disease and a drought), there are limits to what macroeconomic policies can do to cushion their effects on economic activity. Policies can do little to mitigate the direct effect of supply shocks on agriculture, and should react only to the extent that there are spillovers to the rest of the economy, and provided that the inflation remains under control. Against this background, the current policy mix seems appropriate to sustain activity in the non-agro sector, which would grow by over 4 percent in 2012. Domestic demand is projected to decelerate, but would remain robust, helped by a significant relaxation of fiscal policy and stimulative monetary conditions. However, given the severity of the recent drought and its strong impact on agricultural activity (projected to fall by 25 percent), the economy would contract by 1½ percent in 2012. Aided by subdued local food and global commodity prices, inflation is projected at around 5 percent (the authorities' target).

3. **Policies need to be geared toward maintaining macroeconomic and financial stability.** Policies need to focus on keeping inflation in line with the official target and the external current account deficit under control, while protecting financial stability. With the non-agricultural sector operating at close to capacity, there is virtually no space to relax macroeconomic policies further. Exchange rate flexibility to allow some depreciation of the guaraní should help to absorb the effects of the supply shocks. Risks to the financial sector from the contraction of agriculture look limited as farmers have large buffers from very high profits in recent years. Banks, in turn, have relatively strong capital and loss-related reserve cushions, and should be able to deal with a moderate rise in NPLs. At the same time, the recent moderation of credit growth has reduced the risk of a credit bubble. However, it would be important to keep credit growth under control while continuing to strengthen financial sector regulation and supervision.

4. The following reform areas have been identified as "macrocritical":

- *Tax reform.* Tax reforms are needed to increase low revenues. In particular, it is important to implement the personal income tax and reform agribusiness taxation, while there is also scope to raise taxation on the financial sector. Continuing with recent improvements in tax administration would also help raise revenues.
- *Fiscal framework.* Paraguay would benefit from further strengthening its fiscal framework, including through improved public financial management.
- *Financial system.* Further progress on reform to banking legislation would help strengthening regulation and supervision, as well as bringing prudential norms fully in line with international standards. It is also important to fully implement the program to strengthen regulation and supervision for cooperatives and establish a safety net for the sector.
- *Monetary framework*. To support the move to an inflation targeting regime, the central bank (BCP) would need to continue strengthening the monetary framework, as well as FX and monetary operations.

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

- *Tax reform.* The Fund would continue providing technical assistance (TA) to support authorities' efforts to improve the tax system.
- *Fiscal framework.* The Fund would continue providing TA to strengthen public financial management.
- *Monetary framework.* The Fund could continue providing TA to further strengthen the monetary framework and operations to support to BCP's efforts to transition to an inflation targeting regime.
- *Money Laundering.* The Fund will provide TA on the development of a national strategy concerning anti-money laundering and combating the financing of terrorism (AML/CFT).
- *Medium-term debt management.* The Bank, with the Fund's support (MCM), will continue providing technical assistance 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
- *Transfers.* The Bank will study the effects of royalty transfers on municipalities.

- *Poverty measurement.* The Bank will continue providing TA on improving the measurement of poverty and income inequality, with emphasis on understanding why Paraguay's inequality is so high. Gender issues will also be considered. The Bank is in the process of initiating a new work on teenage pregnancy and a new study on inequality.
- *Education and social programs.* The Bank will provide technical assistance on education programs, social assistance, and rural and agricultural development.
- *Pensions.* The Bank will continue providing advisory services to improve the pension system, including with best practices.
- *Public expenditure and revenues.* The Bank will provide TA on public expenditure, including fiscal policy in volatile environments, efficiency of public expenditure, tax revenues, fiscal policy and equity, and commodity prices and fiscal policy. It will also continue supporting the government on the 2004 tax reform and development.
- *Financial and social inclusion*: The Bank is initiating a new Development Policy Lending program to promote financial and social inclusion.

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

Work Programs of the World Bank and IMF Teams:

Title	Products	Provisional Timing of Missions	Expected Delivery Date
Bank Work Program			
	Public expenditure review	Summer 2012	Winter 2013
	TA on medium-term debt strategy	Fall 2012	Winter 2013
	TA on pension system reform	November 2012	Winter 2013
	TA on poverty and income inequality	Fall 2012	Fall 2012
	TA on the impact of royalty transfers on municipalities	Fall 2012	Fall 2012
	Workd on gender	Mid-2012	Fall 2012
	Study on inequality	Late 2012	Late 2013
	New DPL	Mid-2012	Late 2012 or 2013
	TA on education programs	Continuing.	
	TA on conditional cash transfers programs	Continuing.	

Fund Work Program	Staff visits to review macroeconomic and financial sector developments	November 2012	November 2012
	Article IV Consultation	May 2012	June 2012
	TA on national AML/CFT strategy development	Fall 2012	Winter 2013
	TA on public financial management	Spring 2013	Summer 2013
	TA on revenue administration	Fall 2012	Winter 2013
	TA on stress-testing for cooperatives	Winter 2013	Winter 2013

ANNEX 3. STATISTICAL ISSUES

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.

A. Real Sector

1. **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 censuses and surveys exists (an industrial survey was conducted in 2002, and an economic census is currently being undertaken) and 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. While the periodicity of annual GDP meets GDDS recommendations, timeliness does not because data are disseminated with a lag of 9 months. Several STA missions on the compilation of quarterly national accounts (QNA) were fielded in August 2007, August 2008, November 2009 and March-April 2011. Production of definite QNA series would need to await a revision of the national accounts base year and the compilation of supporting basic data, which are tentatively scheduled for 2013, to be completed within 3 years. The STA mission of November 2009 assisted the authorities in outlining a work program for updating the national accounts' base year.

2. **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. 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 December 1995 and its basket (150 items) is not fully representative of current national output; electricity, water, and gas are not covered.

3. **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 Asuncion area only. The last

available observation for the quarterly series is the first quarter 0f 2012, whereas the annual data for 2011 has not been released yet.Wage indices are updated twice a year.

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 provisional QNA series.

B. Fiscal Sector

5. **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.

6. **Annual data covering general government for 2009 have been reported for publication in the 2010 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.

C. Money and Banking Sectors

7. **Paraguay completed the establishment of a unified compilation and reporting system for the whole range of monetary data.** This new system intends to harmonize monetary data for use within the BCP, for reporting to STA for publication in IFS, and for operational and monitoring purposes. A revision of the classification criteria has led also to a marked reduction in the discrepancies of interbank positions. Data on credit cooperatives, which account for

around ¼ of deposits and loans of the banking sector, are reported to the BCP on a monthly basis since January 2011. The BCP, with assistance from STA, plans to include monthly data of the 20 largest credit cooperatives in the monetary survey during 2012. The Superintendency of Banks publishes a detailed and informative report on the soundness of the financial system.

D. External Sector

8. **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 and annual data on balance of payments and the IIP are available from 2001 onwards on the central bank website, and are reported only once a year to STA for publication in the IFS. 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.

9. **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 o**f 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 temp**late for reporting data on international reserves and foreign currency liquidity.**

Paraguay: Table of Common Indicators Required for Surveillance
(As of May 21, 2012)

	Date of latest observation	Date received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of publication[1]	Memo Items: Data Quality–Methodological soundness[10]	Memo Items: Data Quality–Accuracy and reliability[11]
Exchange Rates	April 2012	4/13/12	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	April 2012	4/13/12	D	M	D		
Reserve/Base Money	April 2012	4/13/12	D	M	D	O, LNO, LO, O	O, O, O, LO, LO
Broad Money	April 2012	5/28/12	M	M	M		
Central Bank Balance Sheet	April 2012	4/13/12	D	M	D		
Consolidated Balance Sheet of the Banking System	April 2012	5/28/12	M	M	M		
Interest Rates[3]	April 2012	5/28/12	M	M	M		
Consumer Price Index	April 2012	5/2/12	M	M	M	O, LO, O, O	O, LO, LNO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[4] – General Government[5]	April 2012	5/3/12	M	M	M	LO, LO, LO, LO	LO, LNO, O, LO, LO
Stock of Central Government and Central Government-Guaranteed Debt[7]	March 2012	5/3/12	Q	Q	Q		
External Current Account Balance	Dec 2011	3/27/12	Q	Q	Q	O, LO, LO, LO	LO, O, LO, LO, LO
Exports and Imports of Goods and Services[8]	March 2012	4/1/12	M	M	M		
GDP/GNP	Dec 2011	3/27/12	Q	Q	Q	O, LO, LO, LO	LO, O, LNO, O, LO
International Investment Position	March 2012	4/1/12	M	M	M		

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

2 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 25–February 8, 2006. For the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

3 Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

4 Any reserve assets that are pledged of 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.

5 Both market-based and officially-determined, including discounts rates, money market rates, rates on treasury bills, notes and bonds.

6 Foreign, domestic bank, and domestic nonbank financing.

7 The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

8 Including currency and maturity composition.

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 12/85
FOR IMMEDIATE RELEASE
July 20, 2012

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2012 Article IV Consultation with Paraguay

On June 22, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Paraguay.[1]

Background

GDP growth slowed down markedly in 2011 and turned negative in 2012Q1. After a strong rebound in 2010, growth decelerated to 3.8 percent in 2011, reflecting both monetary tightening to contain inflationary pressures and country-specific supply shocks (cement shortages and an outbreak of foot-and-mouth disease followed by a beef export ban). A severe drought hit the country in late 2011-early 2012 causing large losses in the agricultural sector, especially for key export products (e.g., soybeans).

Inflation has declined below the central bank target, but core inflation has remained relatively high. After peaking in early 2011 (over 10 percent y/y), inflation began easing in the second half of 2011, reaching 5 percent (the central bank's target) at year-end, and falling further to 3¼ percent in April 2012. This decline reflects mainly lower food inflation due to reductions in meat prices following the export ban, although tighter monetary conditions and a substantial appreciation of the guaraní also played a role in 2011. Despite a negative output gap, core inflation remained above the mid-point of the official target range, reflecting still strong domestic demand growth and one-off factors. On the back of monetary tightening, credit growth moderated to 19 percent in April 2012 (43 percent at end-2010). Growth of credit in U.S. dollars decelerated faster, though from a higher base, reflecting problems in the primary sector and reduced FX earnings. Against this background, domestic demand growth moderated and financial sector risks diminished.

The BCP began cutting interest rates in late 2011. It reduced the policy rate by 200 bps between November 2011 and February on the grounds of softening of inflation and risks from an uncertain global

[1] 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 summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

economic outlook, and by an additional 25 bps in May (to 6¼ percent), citing weakening domestic demand growth. The real policy rate, at around 1¼ percent, remains below its neutral level, which seems broadly consistent with the current negative output gap.

The current account deficit improved and international reserves continued to grow in 2011. The external current account deficit declined to 1¼ percent of GDP in 2011 (from 3½ percent of GDP in 2010) owing to better terms of trade, a stronger services account, and higher worker remittances. Strong capital inflows allowed the BCP to increase net international reserves by 1½ percent of GDP in 2011 (to 24 percent of GDP). Aiming at limiting excessive exchange rate volatility, the BCP continued to intervene on both sides of the market during 2011 and 2012.

Fiscal policy was slightly expansionary in 2011. The overall fiscal surplus declined by ½ percentage points to 1 percent of GDP, driven by a large increase in primary spending (especially capital expenditures). This implied a fiscal impulse (measured by the change in the structural primary balance) of ¾ percent of non-agricultural GDP. Revenue growth decelerated but remained strong, supported by continued improvements in tax administration. Public debt continued on a declining trend, with general government debt falling below 14 percent of GDP, one of the lowest in the region.

The banking sector has remained sound. Profitability is high and capital adequacy ratios remain strong. NPLs are low (2 percent in March), but have risen over the last year. More stringent provisioning measures and higher capital requirements became effective in January 2012, helping strengthen financial institutions' buffers, while a program to bolster the prudential and regulatory framework of the cooperative sector is being implemented. Congress recently approved legislation to shift public sector deposits from commercial banks to a state-owned bank, which would pose a risk to financial stability. The initiative is on hold as the BCP has filed a suit with the Supreme Court challenging the legislation on constitutional grounds.

Real GDP is projected to decrease by 1½ percent in 2012. The strong contraction in the agricultural sector will be partially offset by a close-to-potential expansion in the non-agricultural sector. The latter, in turn will grow on the back of a strong fiscal impulse (3¼ percent of non-agricultural GDP), easy monetary conditions, and strong confidence. Lower agricultural exports will drive a widening of the external current account (to over 3 percent of GDP). Strong expenditure growth and a contracting GDP will result in an overall fiscal deficit of 2½ percent of GDP.

Executive Board Assessment

Directors noted that the Paraguayan economy is projected to contract this year as a result of a severe drought. However, a rapid turnaround in activity and strong growth next year are expected, on account of robust domestic demand, strong confidence, and normalization of weather conditions.

Directors agreed that the current mix of macroeconomic policies is appropriately supportive of economic activity and consistent with the inflation target in 2012. Noting that the non-agricultural sector is operating at close to capacity, Directors stressed the importance of not relaxing macroeconomic policies further. In light of the strong recovery expected for 2013, they also recommended that the authorities stand ready to tighten monetary policy if warranted, allow the exchange rate to adjust flexibly, and start withdrawing fiscal stimulus next year.

Directors commended the authorities for their fiscal prudence over the years. They supported plans to mobilize tax revenue for infrastructure and social spending. The priorities are to expedite the implementation of the personal income tax and limit exemptions, and further strengthen agricultural taxation and tax administration. Directors also saw scope for broadening the financial sector's tax base and increasing its low VAT rate. Directors stressed the need to improve the allocation of scarce budgetary resources. Noting that the large increase in public sector wages will crowd out needed public investment, they called on the authorities to contain current expenditure growth.

Directors welcomed steps toward adopting an inflation targeting regime. They encouraged further efforts to enhance liquidity management and to strengthen the monetary framework and operations, including through the recapitalization of the central bank, and improved communication and coordination between the central bank and the Ministry of Finance.

Directors commended the authorities for the progress in implementing the 2010 FSAP recommendations and upgrading the AML/CFT framework. They emphasized the importance of addressing information gaps to improve financial sector monitoring, and recommended making greater use of macro-prudential tools. Further steps would also be needed to improve banking legislation, set up a high-level committee of regulators, and strengthen regulation and supervision for cooperatives. Directors expressed concern about legislation to abruptly shift to a state-owned bank sizeable public sector deposits kept at commercial banks. They noted that the measure has been put on hold and called on the authorities to consider appropriate alternatives to avoid adverse effects on the funding and liquidity of commercial banks.

Directors called for efforts to raise Paraguay's growth potential and living standards. They encouraged the authorities to formulate a long-term strategy for improving infrastructure, human capital, and overall economic efficiency. Directors welcomed ongoing efforts to enhance the monitoring and performance of state-owned enterprises.

Paraguay: Selected Economic and Social Indicators

	2008	2009	2010	2011	Projections 2012	2013
(Annual percentage change, unless otherwise indicated)						
Income and prices						
Real GDP	5.8	-3.8	15.0	3.8	-1.5	8.5
Nominal GDP	19.7	-4.0	22.8	10.5	7.4	13.4
Real per-capita income growth	3.8	-5.7	12.8	1.8	-3.4	6.4
Consumer prices (end of period)	7.5	1.9	7.2	4.9	5.0	5.0
Monetary sector						
Currency issue	15.0	11.3	18.5	11.6	10.9	14.5
Credit to private sector	49.3	24.1	42.9	26.3	18.2	24.2
Liabilities to private sector	30.8	26.7	26.1	20.6	17.9	21.2
External sector						
Exports (fob)	38.8	-24.8	45.3	22.0	-5.9	20.3
Imports (cif)	44.0	-22.0	43.6	21.5	-0.5	12.9
Terms of trade	38.9	-19.1	6.7	3.8	-0.8	-0.3
Real effective exchange rate 1/	16.0	-6.4	2.0	-0.5	...	...
(In percent of GDP, unless otherwise indicated)						
Current account	**-1.9**	**0.5**	**-3.4**	**-1.2**	**-3.1**	**-1.3**
Trade balance	-6.3	-7.3	-7.4	-7.8	-9.4	-6.4
Exports	45.9	41.2	44.9	48.9	41.6	42.2
Imports	52.2	48.5	52.3	56.7	51.1	48.5
o/w Oil imports	7.7	6.5	5.7	7.1	7.0	6.1
Other (export and import of services, income, current transfers)	4.4	7.8	4.0	6.2	5.8	4.6
o/w Remittances	2.4	3.6	2.9	3.3	3.1	2.7
Capital account and financial account	**3.4**	**3.4**	**4.1**	**3.3**	**4.0**	**2.5**
o/w Direct investment	1.6	1.4	1.8	2.3	1.9	2.1
Net international reserves (in millions of U.S. dollars)	**2,864**	**3,861**	**4,168**	**4,984**	**5,184**	**5,515**
(Stock in months of next year imports of goods and services)	4.6	4.3	3.9	4.7	4.3	4.4
(Stock over total external short term debt)	2.9	3.5	3.4	3.9	4.1	4.3
Gross domestic investment	**18.1**	**15.5**	**17.7**	**19.3**	**19.1**	**18.5**
Private sector	14.3	10.0	13.2	14.0	13.8	13.8
Public sector	3.7	5.5	4.6	5.2	5.3	4.7
Gross national saving	**16.2**	**16.0**	**14.4**	**18.1**	**16.0**	**17.2**
Private sector	9.8	10.2	8.5	12.2	13.5	14.9
Public sector	6.4	5.8	5.8	5.9	2.5	2.3

Paraguay: Selected Economic and Social Indicators

	2008	2009	2010	2011	Projections 2012	2013
External saving (+) disavings (-)	**-1.9**	**0.5**	**-3.4**	**-1.2**	**-3.1**	**-1.3**
Central government revenues	**17.3**	**19.7**	**18.7**	**19.8**	**20.1**	**20.0**
o/w Tax revenues	11.8	13.0	13.1	13.8	13.6	13.8
Central government expenditures	**14.8**	**19.1**	**17.3**	**19.0**	**22.6**	**21.9**
o/w Wages and salaries	7.1	8.6	8.0	8.4	10.3	10.3
Capital expenditure	2.7	4.6	3.7	3.8	4.5	3.9
Central government primary balance	**3.1**	**0.7**	**1.8**	**1.2**	**-2.2**	**-1.6**
Central government overall balance	**2.5**	**0.6**	**1.5**	**0.9**	**-2.5**	**-2.0**
Consolidated public debt (in percent of GDP)	**23.1**	**23.0**	**18.6**	**18.0**	**19.6**	**19.0**
o/w external	16.7	15.3	12.8	11.8	11.9	11.0
domestic	2.2	2.7	2.2	1.8	2.3	2.4
LRM 2/	4.2	5.0	3.6	4.3	5.4	5.6

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

1/ Average annual change; a positive change indicates an appreciation.

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