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Paraguay

2011 ARTICLE IV CONSULTATION

August 1, 2011

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 2011 Article IV consultation with Paraguay, the following documents have been released and are included in this package:

- **Staff report** for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 14, 2011, 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 July 29, 2011. 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 July 29, 2011 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.

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International Monetary Fund
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PARAGUAY

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

July 29, 2011

KEY ISSUES

Context. The economy is projected to continue growing above potential in 2011, at a time when overheating pressures have already emerged. Supportive macroeconomic conditions will contribute to inflation of close to 10 percent this year and a widening external current account deficit. While the banking system remains sound, risks are increasing, mainly as a result of very rapid credit growth (40 percent), particularly credit in foreign currency (58 percent). Economic policies need to be geared toward reducing overheating pressures and protecting financial sector stability.

Monetary policy. Given current stimulative monetary conditions, tightening needs to continue. The menu of options should include higher reserves requirements, especially to address the very rapid expansion of credit in foreign currency. Continued exchange rate flexibility would also help reduce inflationary pressures.

Fiscal policy. Fiscal policy is adding stimulus to activity and should become at least neutral. It is important to contain current expenditure growth and save any revenue overperformance. Pressures to further loosen fiscal policy ahead of the 2013 elections also need to be resisted.

Macro-prudential and financial sector policies. Macro-prudential measures would help address financial sector risks while contributing to reducing credit growth. Higher specific provisions and stricter limits on loan-to-income ratios would help deal with very high consumer credit growth and currency mismatches. It is also important to continue moving forward with efforts to strengthen regulation and supervision of cooperatives, and address legal constraints that limit a more effective risk-based supervision for banks.

Monetary policy framework. The recapitalization of the central bank (BCP) is crucial to increase monetary policy's room for maneuver. The recent decision to adopt inflation targeting calls for increased efforts to clarify the BCP's operational framework, including by limiting FX intervention and thus sending a clearer signal that inflation is its main objective.

Approved By
David Vegara and Dominique Desruelle

Discussions took place in Asuncion during June 1–14. The staff team comprised L. Abrego (head), N. Magud, H. Zavarce, T. Roy, Resident Representative (all WHD), and V. Tulin (MCM). Mr. Maciel (OED) attended the meetings.

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I. BACKGROUND

1. ***Paraguay weathered the global economic crisis well, supported by an appropriate policy response.*** The authorities responded to the crisis through countercyclical fiscal and monetary policies while bolstering financial sector supervision. Output contracted by 3¾ percent in 2009, though this reflected mainly the effects of a severe drought that hit the agricultural sector. The country's relatively low public debt ratio was broadly unchanged, as the fiscal accounts still recorded a small surplus; the external adjustment was smooth, aided by a flexible exchange rate regime; and the financial system remained sound, with adequate capital levels and low non-performing loans.

2. ***Economic growth rebounded strongly in 2010, and the economy has started showing signs of overheating*** (Figure 1)**.** Real GDP grew by 15 percent, driven by a record crop, strong monetary stimulus and credit growth, and a favorable external environment. The non-agricultural sector expanded by 8½ percent, while domestic demand grew by 17 percent. The output gap for the nonagricultural sector is estimated to have closed in mid-2010 and stood at 1¾ percent at end-year. Inflation has picked up from 2 percent in 2009 to 8¾ percent in June 2011, reflecting strong domestic demand growth and rising commodity prices. Core inflation as measured by the authorities (i.e., excluding the most volatile food items) has experienced a similar increase and stood at 9½ percent in June.

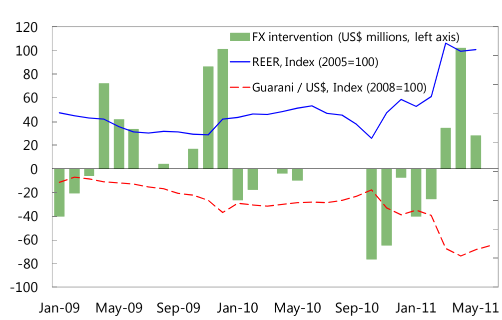
3. ***Despite very favorable terms of trade, the external current account weakened in 2010, driven mainly by rapid domestic demand growth*** (Figure 2)**.** The current account deficit rose to 2¾ percent of GDP (from near balance in 2009), reflecting very rapid import growth and a drop in remittances. However, with strong private capital inflows (notably foreign direct investment, FDI), the Central Bank (BCP) continued accumulating international reserves, which rose to US$4.2 billion (23 percent of GDP) at end-2010. The real effective exchange rate appreciated slightly during the year, driven by the strengthening of the guarani against the U.S. dollar.

4. ***Against the backdrop of rising inflation and rapid credit growth, the BCP started to tighten monetary policy in mid-2010*** (Figure 3)**.** The central bank has raised policy interest rates by 775 basis points since mid-2010 (375 basis points this year), starting from a level close to zero. Real policy rates, however, have remained in negative territory, and given weaknesses in the monetary transmission channel, deposit and lending rates have increased only modestly in real terms. In this context, credit growth has remained very high (40 percent y/y in May), especially credit in foreign currency (58 percent). The latter reflects its relatively

low cost, abundant dollar liquidity from export proceeds, and strong capital inflows (notably FDI). In an effort to curb credit growth faster, the BCP raised reserve requirements (RR) effective May (by 3 and 4 percentage points for domestic and foreign-currency deposits, respectively), bringing them back to their pre-crisis levels.

5. ***The BCP has allowed the guarani to appreciate substantially in recent months, while intervening in the FX market***. As of end-May, the guarani had risen by about 10 percent vis-à-vis the U.S. dollar (13 percent in real effective terms) compared to end-2010. The appreciation reflects mainly improved terms of trade, seasonal liquidation of export proceeds and increased private capital inflows, especially FDI . The BCP started to purchase FX (without full sterilization) in March, and stepped up its presence in the market in April, trying to contain appreciation pressures. As the guarani stabilized, the BCP reduced its intervention in May and did not intervene in June.

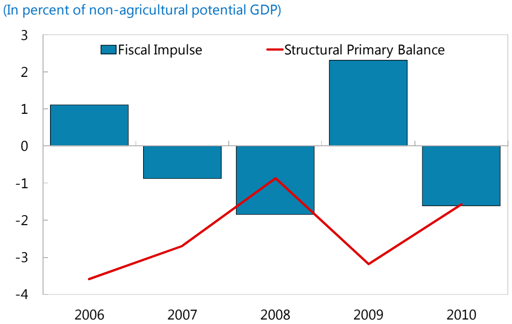
Exchange Rate and Foreign Exchange Intervention 1/



1/ ER decreasing implies appreciation. REER decreasing implies depreciation.

6. ***Fiscal policy remained countercyclical in 2010, while public debt continued on a declining path*** (Figure 4). Real growth of primary spending fell sharply to around 8 percent, while tax revenue growth accelerated to 19 percent on the back of strong activity and import growth, as well as improvements in administration. In cyclically-adjusted terms, the primary balance (excluding electricity royalties and grants) strengthened by 1½ percent of non-agricultural GDP, implying withdrawal of most of the stimulus provided in 2009 (Box 1). Public debt declined by over 4 percentage points to 19 percent of GDP.

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



1/ Excludes electricity royalties, and grants.

7. ***The banking sector remains generally sound*** (Figure 5). The overall capital adequacy ratio for banks remains above the regulatory level (10 percent), although it is somewhat lower (by about 3 percentage points) when Basel I definitions are used. The nonperforming loan (NLP) ratio is low, but the level of NPLs is growing fast (17 percent y/y in May),[1] and overall provisions are low.

[1] NPLs for guarani operations are higher than for foreign-currency loans (2.3 percent vs. 0.4 percent), and growing faster (21 percent vs. 8 percent, y/y).

Profitability has remained very high. In late 2010, the Bank Superintendency (SBP) approved measures to strengthen financial system buffers, including higher general provisions and minimum capital, which will become effective in January 2012.

II. MACROECONOMIC OUTLOOK AND RISKS

8. ***Economic growth is projected to decelerate in 2011, but would remain above potential.*** GDP growth is projected at 6¾ percent, reflecting solid agricultural growth, stimulative macroeconomic conditions, and strong confidence. Domestic demand is projected to grow at 9 percent, reflecting continued high credit growth and fiscal stimulus (paragraph 11). With nonagricultural potential growth estimated at 4–4¼ percent (see Chapter 1 of the Selected Issues Paper), the output gap would average 2¼ percent. Risks to growth in 2011 are slanted to the upside, mainly because agricultural growth could turn out higher. Growth is expected to decelerate over the medium term and return to its potential level in 2013–14.

Paraguay: Medium-Term Outlook

				Proj.					
	2008	2009	2010	2011	2012	2013	2014	2015	2016
	(Annual percentage change, unless otherwise indicated)								
Production and prices									
Real GDP	5.8	-3.8	15.0	6.7	5.5	4.5	4.0	4.0	4.0
Consumer prices (end of period)	7.5	1.9	7.2	9.8	7.3	6.0	5.0	4.0	4.0
	(In percent of GDP, unless otherwise indicated)								
Public finances									
Central government primary balance	3.1	0.7	1.8	1.0	-0.1	0.0	0.3	0.2	0.2
Central government overall balance	2.5	0.6	1.4	0.5	-0.5	-0.4	-0.1	-0.2	-0.2
Central government structural primary balance 1/	-0.9	-3.2	-1.6	-2.9	-3.9	-3.5	-3.1	-3.1	-2.8
General government overall balance	2.9	2.0	1.7	1.0	-0.2	0.0	0.2	0.0	0.0
Consolidated public debt (in percent of GDP)	23.2	23.0	19.1	18.0	16.1	15.0	13.9	13.2	12.6
External sector									
Terms of trade 2/	38.9	-19.1	6.7	4.5	-3.0	-1.9	-1.8	-1.7	-1.4
Current account	-1.9	-0.1	-2.8	-3.8	-4.0	-3.9	-3.6	-3.2	-3.1
Foreign direct investment	1.6	1.4	2.1	3.1	2.5	2.7	2.9	3.0	3.1
Net international reserves	16.9	27.2	22.6	22.3	19.5	18.8	18.9	18.9	18.7

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

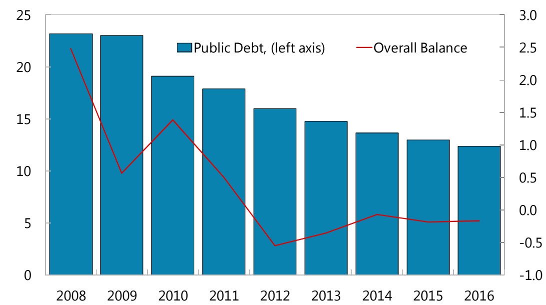
9. ***Inflation is projected to remain well above the BCP's target range this year, and remain relatively high over the next couple of years.*** While inflation has declined somewhat in recent months, it is projected at close to 10 percent for end-2011, given a positive output gap, continued high commodity prices, and cost-push factors (e. g., the minimum wage was raised by 10 percent in April). Risks are tilted to the upside in line with those to domestic growth, and as commodity prices could turn out

higher than currently projected. Going forward, and assuming that tighter monetary conditions continue and commodity prices ease, inflation would subside but remain above the BCP's target through 2013.

10. ***The external current account deficit would continue widening in 2011, before easing over the medium term.*** Despite improving terms of trade, the current account deficit is projected to rise to 3¾ percent of GDP this year, led by continued strong import growth, a less favorable services account, and lower remittances. Staff expects the deficit to gradually decline and stabilize at around 3 percent of GDP over the medium term. This is predicated on a significant moderation of import growth, as domestic growth and global commodity price inflation ease, and solid (though lower than in 2010-11) growth of agricultural exports.

11. ***The fiscal stance would turn expansionary in 2011.*** Driven by large increases in current and capital spending, the overall balance is projected to weaken by 1 percent of GDP, to ½ percent of GDP.[2] This would imply a fiscal impulse of about 1¼ percent of non-agricultural GDP (Box 1). Fiscal balances will likely continue deteriorating in 2012 as pressures to increase spending rise ahead of the 2013 presidential and congressional elections. However, with output growing at around potential and provided that overall deficits remain moderate, public debt would continue to decline and would fall to 15 percent by 2013.

Central Government Balance and Public Debt
(In percent of GDP)



12. ***Risks to the medium-term outlook are as follows:***

- *Balanced risks to growth and upside risks to inflation*. Domestic demand growth could decelerate more slowly than envisaged in the baseline, resulting in higher growth. At the same time, global growth could turn out lower than currently projected, hurting domestic growth. The possibility of higher global commodity prices and more stimulative macroeconomic policies than envisaged in the baseline pose upside risks to inflation.

- *Downside fiscal risks*. The government lacks a majority in Congress, which has strong powers and tends to favor expansionary fiscal policies. This could complicate government efforts to increase tax revenues and to contain expenditure pressures originating in the Legislature. Spending pressures could rise particularly ahead of the 2013 elections.

[2] This includes additional revenue from Itaipú equivalent to about ½ percent of GDP this year (paragraph 28).

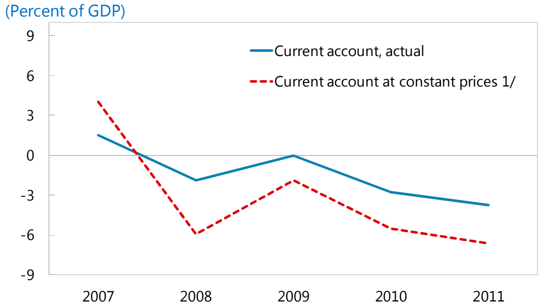
III. POLICY DISCUSSIONS

13. ***Focus of the consultation.*** The 2011 consultation focused on the macroeconomic and financial sector policies needed to reduce the risks of a hard landing from the current high economic and credit growth. The authorities need to moderate domestic demand pressures and return to a more balanced growth path while protecting financial stability.

A. Near-term Macroeconomic and Financial Sector Policies

14. ***Rapid credit growth and excess demand pressures pose significant risks to macroeconomic and financial stability.*** Economic policies should be geared toward containing domestic demand growth in order to lower inflation faster and moderate the external current account deficit, while preserving financial soundness. Capital inflows are expected to remain strong enough to finance the projected current account deficits. However, the relatively large size of these deficits poses an important risk as an abrupt reversal of private flows or the terms of trade could cause serious macroeconomic disruptions.[3] In the financial sector, while bank financial soundness indicators have held up well so far, the authorities would need to pre-empt a deterioration of bank portfolios (the *level* of NPLs is growing rapidly at a time of high economic growth) and excessive risk-taking by financial institutions, while strengthening cushions to increase resilience to a reversal of favorable macroeconomic conditions.

Current Account Balance at Current and Constant 2005 Prices
(Percent of GDP)



1/ Current account assuming terms of trade are unchanged since 2005.

15. ***The mission advised to continue tightening monetary policy.*** Staff recommended resuming interest rate increases while giving consideration to further raising RR. The mission emphasized the need for higher RR on U.S. dollar deposits to deal with the very rapid growth of credit in this currency. It also called for extending RR to term deposits, which are currently exempt. These measures should be adopted without delay, given the still high pace of overall credit growth and the extremely rapid expansion of loans in foreign currency. While indicating that

[3] Staff estimates show that had commodity prices remained at 2005 levels, the current account deficit would have been about 3 percent of GDP higher in 2010 (text figure).

additional monetary tightening might be needed, the authorities were of the opinion that they should wait for new data and the effects of recent measures before resuming monetary tightening. They may also consider the proposal to raise RR on foreign currency deposits. Staff noted that increasing RR on guarani deposits would have a faster impact on liquidity conditions while helping avoid creating excessive incentives for carry trade. At the same time, it would still be necessary to increase the RR differential across currencies, with higher RR on foreign currency, to lower incentives to borrow in foreign currency.

16. ***Staff recommended targeting at least a neutral fiscal stance in 2011–12.*** The stance of fiscal policy needs to become at least neutral, but preferably countercyclical, to contain domestic demand pressures and ease the burden on monetary policy. A neutral stance would require tightening by 1¼ percent of non-agriculture GDP in 2011 relative to current projections. To achieve this, the mission recommended saving any revenue over-performance—including from the potential adoption of revenue measures currently in congress and higher Itaipú royalties—while reducing the growth rate of primary expenditures, notably of current outlays, and avoiding supplementary budget appropriations. The authorities agreed with the need for a non-expansionary fiscal stance but thought that this was extremely difficult to achieve this year in light of existing political constraints, notably the government's lack of a majority in congress. They shared the mission's concern regarding the risk of a continued loose fiscal stance next year. In light of the growth and inflation outlook for 2012, staff stressed the importance of avoiding an expansionary fiscal policy next year.

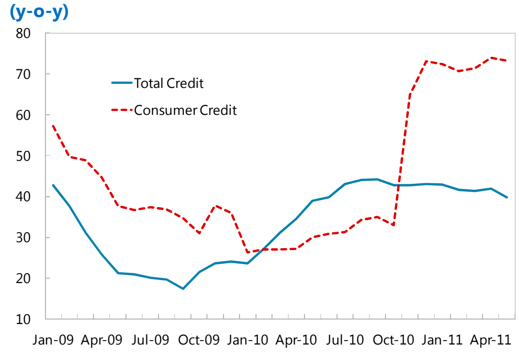
17. ***Staff highlighted the importance of continued exchange rate flexibility to lower inflationary pressures.*** Given Paraguay's highly-open economy and a significant exchange rate pass-through, a strong guarani would help contain inflationary pressures, as evidenced by the behavior of tradable goods inflation in recent months. The mission suggested intervening only if there is a need to correct a markedly overvalued exchange rate or excessive volatility, and to fully sterilize any intervention. It stressed that FX intervention is costly and casts doubts on the BCP's commitment to lowering inflation, while potentially encouraging one-sided bets.

18. ***There was agreement that broadening the use of macro-prudential (MaP) measures would help protect financial stability***. In addition to RR, the toolkit could include tighter limits on loan-to-value and debt-to-income ratios, higher

capital requirements and increased provisions, including through the adoption of dynamic provisioning (Box 2). The authorities noted that this approach underlay the measures approved in late 2010 (paragraph 7) and that they were considering adopting additional similar measures from 2012, including the introduction of dynamic provisioning. Staff stressed the need to adopt MaP measures without further delay this year, and encouraged the authorities to bring forward the implementation of the measures approved in late 2010. Given weaknesses in the monetary transmission channel, these measures would also help to contain credit growth.

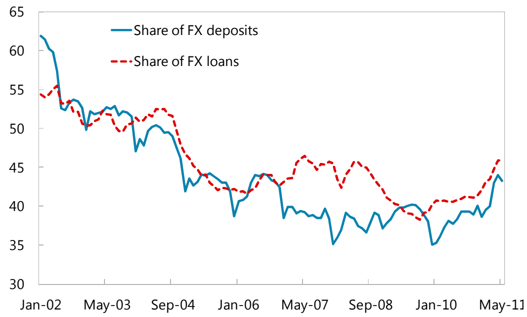
19. ***The mission recommended the introduction of measures targeting consumer credit, and to enhance monitoring of other key credit and asset markets.*** Credit has been growing particularly strongly in the consumer segment (73 percent in May), where the share of NPLs is the highest. Staff noted that the pace of growth in this sector poses a significant risk to financial stability going forward. With strong bank competition and high credit demand, real interest rates for consumer credit have increased significantly less than the average during the current tightening cycle. The mission recommended using stricter debt-to-income ratios and increasing specific provisions to reduce consumer credit growth faster and bolster financial institutions' buffers. The authorities agreed that these measures were needed and will consider putting them in place. Staff also suggested stepping up monitoring of developments in construction and mortgage lending, as well as in real estate markets, including by improving the compilation of statistics. While hard data is lacking, anecdotal evidence suggests that in some regions real estate prices have been growing very rapidly, both in the residential and commercial segments. Although available information points to an expansion of construction that is mostly self-financed, with limited bank exposure, close monitoring of market developments and bank exposure is warranted.

Consumer Credit Growth (y-o-y)



20. ***Measures are needed to deal with currency mismatches.*** Financial dollarization in Paraguay remains high, with the share of deposits and loans in foreign currency at over 40 percent and growing. Addressing currency mismatches would help

Bank Credit and Deposit Dollarization
(In percent of total)



limit the balance-sheet effects of a sudden reversal of capital flows and an ensuing depreciation. Staff noted that there was some evidence of currency mismatches in borrower's balance sheets and recommended imposing additional specific provisions for such lending. The authorities agreed with this proposal and indicated they were considering increasing provisions for consumer loans involving currency mismatches, more likely from 2012.

B. Monetary Policy Framework and Exchange Rate

21. ***The mission welcomed the recent announcement to move to an inflation-targeting (IT) regime and encouraged further improvements in the monetary framework.*** The authorities expect the move to an IT regime to take two years and indicated that they are taking the necessary steps to support the transition. Banks' chronic excess reserves are an important factor behind the weak monetary transmission channel and limit the effectiveness of monetary policy (see Chapter 2 of the Selected Issues Paper). Staff supported existing initiatives to address this problem by allowing compliance with RR on an average basis. It also encouraged the BCP and the Finance Ministry to step up efforts to exchange forward-looking information on budget execution and revenues and other sources of liquidity changes. The mission also stressed the need for the BCP to strengthen and clarify its operational framework, including by (i) limiting (and sterilizing) interventions in the FX market and thus sending a clearer signal that inflation is its main objective; and (ii) focusing its policy actions on a short-term interest rate, leaving the yield curve to be determined by the market. The authorities agreed with these recommendations, and noted that the BCP has started to move away from fixing interest rates for longer maturities, allowing them to become market-determined.

22. ***The recapitalization of the BCP is crucial to improve the effectiveness of monetary policy and enhance further the credibility of the BCP*** (Box 3). The BCP's negative capital position has been an important factor in the slow response of monetary policy to rising inflation during the current cycle, as the central bank incurred in additional losses when rising interest rates. The mission welcomed the authorities' plans to accelerate the implementation of the

recapitalization law approved in April 2010. The recapitalization will also be crucial to support the move to an IT regime. The mission also encouraged the authorities to carry out the recapitalization following sound international practices. These would include, *inter alia*, issuance of tradable bonds at market rates and appropriate maturities, and ensuring that the BCP gets a regular cash flow in the form of interest.

23. ***The exchange rate seems broadly consistent with its equilibrium level*** (Box 4)**.** Paraguay has a relatively flexible exchange rate regime. While FX intervention has been frequent in recent months, the BCP has allowed the guarani to move within a relatively wide range. Staff estimates suggest that the exchange rate was aligned with its medium-term fundamentals as of end-2010, with a slight (1-2 percent) overvaluation. Given the appreciation of the guarani in the last five months, the extent of currency overvaluation might have increased, although probably not significantly since some fundamentals (e.g., terms of trade and prospects for continued solid agricultural growth) have also strengthened.

C. Structural Financial Sector Issues

24. ***The mission welcomed the development of a program to strengthen regulation and supervision standards for cooperatives, in line with FSAP recommendations*** (Box 5)**.** A program supported by the Inter-American Development Bank (IADB) has been developed and is being implemented to strengthen regulation and supervision for cooperatives, with the aim of eventually converging to the standards applied to banks. The program also includes setting up a financial safety net for the sector. The mission encouraged further work to address shortcomings of the sector's regulator (the INCOOP), notably the lack of sufficient resources and enforcement powers, and a governance structure that generates conflict of interests. Staff noted that while cooperatives are losing ground to banks, they remain important players in the financial system (accounting for 20–25 percent of deposit and credit) and could still pose significant financial and fiscal risks.

25. ***Bank regulation and supervision have improved significantly in recently years, but there is scope for further progress***. As noted in the FSSA, several important prudential norms have been strengthened and supervision has become more risk-based. The mission encouraged the authorities to work toward implementing FSAP recommendations to address legal constrains (e.g., the banking law) that have limited updating prudential standards required for more effective risk-based supervision. These include bringing the definition of capital and loan classification

fully in line with international standards, and enhancing the monitoring of large exposures, as well as amending existing banking legislation to focus it on establishing principles while giving the BCP more powers to specify concrete requirements and technical details. The mission also encouraged the authorities to implement other FSAP recommendations, including strengthening the resolution regime for systemic crises and emergency liquidity assistance and bolstering contingent funding for the deposit insurance scheme, given its large coverage.

26. ***Coordination and information sharing among all agencies responsible for financial sector stability and oversight needs to be improved***. As recommended in the FSSA, the authorities should consider setting up a high-level committee comprising all regulators (including the INCOOP) to regularly discuss financial stability issues and ensure harmonization of prudential standards. This committee should also play a role in guiding the implementation of the IADB-supported program for the cooperative sector.

D. Structural Fiscal Issues

27. ***Higher tax revenues are key to addressing basic shortcoming in infrastructure and expanding social programs.*** The authorities are strongly committed to increasing Paraguay's tax ratio, which (at 13½ percent) is one of the lowest in the region. Staff noted that cyclical considerations impart more urgency to the need to advance on this front. Proposals for the implementation of the personal income tax (which congress has postponed several times since its approval in 2004) and introducing exports taxes on selected agricultural products (sponsored by individual parliamentarians) are currently in congress. The mission supported the goal of raising tax revenues and the government's efforts to implement the personal income tax without further delay while expressing its preference for a broad-based tax (at a low rate) on agricultural sales, rather than an export tax.

28. ***It is essential to ensure sound management of increased revenues from Itaipú.*** Revenue from electricity sales to Brazil will treble in U.S. dollars, following the recent approval by the Brazilian congress of the 2009 agreement.[4] The mission supported the authorities' proposal to safeguard the additional revenues by placing them in a special fund, which would finance high-return infrastructure projects and human capital and

[4] The parameter governing the compensation that Paraguay receives for the sale of excess electricity to Brazil was renegotiated through an agreement signed in July 2009 and ratified by the Brazilian congress in May 2011. As a result, the annual compensation would rise from about US$120 million to about US$360 million (1.6 percent of 2011 GDP).

build a countercyclical reserve.[5] Nonetheless, it recommended that a significant part of these revenues is used to build up the countercyclical reserve.

29. ***The development of a forward-looking framework for public-private partnerships (PPPs) would reduce contingent fiscal liabilities.*** Staff welcomed the authorities' plans to expand the role of PPPs in the provision of infrastructure services, particularly in airports and the transportation network. For the near term, the mission suggested amending and enforcing the concessions and public sector financial administration laws to provide a binding framework for specific legislation. It also recommended developing a more comprehensive PPP legal framework over the medium term. On the institutional side, there is a need to strengthen the role of the Ministry of Finance in assessing and approving PPPs, with a view to achieving value for money and managing fiscal risks.

30. ***There have been advances in developing a medium-term fiscal framework (MTFF), but there is scope for further progress.*** The Ministry of Finance (MoF) has started to prepare a fiscal policy report containing, *inter alia*, three-year macroeconomic and fiscal projections. The first such report was published jointly with the 2011 budget bill last year. The MoF is in the process of creating a macro-fiscal unit, charged with preparing macro-fiscal projections, identifying contingent risks, and preparing reports on the macro-fiscal outlook. There is scope for further improvement to the MTFF, including by integrating it to the budget, identifying and assessing fiscal risks and reporting them in budget documents, and by setting up a medium-term expenditure framework. The mission encouraged the authorities to consider adoption of a fiscal rule targeting the structural primary balance (excluding revenue from electricity royalties and grants). This could serve as an anchor for the MTFF and facilitate its integration to the budget.

[5] The current proposal allocates the extra revenue as follows: health and education infrastructure and water sanitation, 40 percent; transportation infrastructure, 40 percent; human capital formation, 10 percent; and counter-cyclical stabilization fund, 10 percent.

E. Employment and Poverty

31. ***Poverty has declined in recent years but remains high.*** Higher economic growth and employment levels have contributed to a significant reduction in the poverty rate, although this is still high (35 percent in 2009). While unemployment seems low (6 percent at end-2010), underemployment affects a large proportion (23 percent) of the working population. Some progress has been made in the last few years in addressing basic social needs, including a considerable expansion of the conditional cash-transfer program (*Tekopora*) and improvements in access to public-health services (e.g., free services for mothers and children). There is scope, however, for further improvements in the targeting of *Tekopora*. Increasing the low tax ratio and improving the quality of public spending are key to boosting the government's ability and effectiveness to address Paraguay's social needs. Maintaining a stable macroeconomic framework, including low inflation, would also be important to continue reducing poverty.

Paraguay: Growth, Employment and Poverty
(In percent)

	Real per capita GDP growth	Employment 1/	Underemployment 2/	Unemployment 2/	Poverty
2002	-2.0	66.8	25.1	10.8	49.7
2003	1.9	69.2	24.1	8.1	44.0
2004	2.8	69.9	24.2	7.3	41.3
2005	1.1	71.4	25.1	5.7	38.6
2006	2.3	71.1	23.5	6.5	43.7
2007	4.7	72.3	26.6	5.5	41.2
2008	3.8	73.4	26.5	5.7	37.9
2009	-5.7	71.7	25.1	6.4	35.1
2010	12.8	71.9	22.9	6.1	...

1/ Percent of working age population (15 to 64 years).
2/ Percent of labor force.

IV. STAFF APPRAISAL

32. ***An appropriate policy response helped Paraguay weather the global crisis.*** Countercyclical macroeconomic policy cushioned the effects of lower external demand. While GDP still contracted in 2009, this owed mainly to a severe drought and the nonagricultural sector still experience modest growth. Despite significant stimulus, public debt remained broadly unchanged, given the strong initial position of the fiscal accounts, while a flexible exchange rate regime helped a smooth external adjustment. The financial system was unscathed, with adequate capitalization and low NPLs.

33. ***The strong rebound of economic growth in 2010 has given rise to overheating pressures.*** GDP grew by 15 percent in 2010, reflecting a record harvest, strong credit growth, and favorable external conditions. Driven by excess demand pressures and higher commodity prices, inflation has risen sharply over the last year, while the external current account has deteriorated substantially, despite term-of-trade improvements. Fiscal policy was appropriately countercyclical in 2010, withdrawing most of the stimulus provided in 2009. Monetary policy remained accommodative, however, with real policy

rates well in negative territory and abundant liquidity.

34. ***Macroeconomic policies are currently expansionary***. Despite a large increase since mid-2010, real policy rates remain negative, while real deposit and lending rates have increased only modestly and credit growth is still very high. Reflecting strong expenditure growth, fiscal policy is being expansionary, with the structural primary balance projected to weaken by 1¼ percent of nonagricultural GDP in 2011. There is also the risk that the fiscal stance remains loose in 2012 as pressures to increase spending rise ahead of the 2013 general elections.

35. ***Policies need to adjust further to ensure a soft landing of the economy***. Policies should be geared toward moderating 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. Monetary policy tightening should continue without delay, with the menu of options including further increases in RR, particularly on foreign currency deposits. The fiscal stance should become at least neutral, but preferably ountercyclical. To this end, constraining current expenditures and saving any revenue over-performance, including from the potential approval of revenue measures currently in congress, will be critical. It would also be important to avoid loosening the fiscal stance in 2012, given a positive output gap and an inflation rate above the BCP's target. Broadening the use of MaP measures would help protect financial stability going forward while contributing to a faster reduction of credit growth.

36. ***The banking system remains sound, but there is a need to guard it against emerging risks***. Bank financial soundness indictors are generally strong, including very high profitability. However, provisions are low overall and the level of NPLs is growing rapidly. Very high credit growth, particularly in foreign currency, and currency mismatches pose considerable risks that should be dealt with immediately. Macro-prudential measures, such as higher specific provisions and stricter limits on debt-to-income ratios, would help contain such risks and strengthen buffers. Developments in construction and mortgage lending, as well as in real estate markets, warrant close monitoring, including by improving the compilation of statistics. Staff welcomes the existing program to strengthen regulation and supervision and to set up a financial safety net in the cooperative sector. It encourages the authorities to also move forward with changes to legislation required for a more effective risk-based supervision for banks.

37. ***The monetary policy framework should be strengthened further to support the move to an IT regime.*** Many necessary components for this step are already in place,

thanks to long-lasting and continued reforms and institutional strengthening at the BCP. Swift implementation of the recapitalization of the BCP and better liquidity management are also needed to further enhance the credibility of the central bank and increase the effectiveness of monetary policy. It would also be important for the BCP to strengthen and clarify its operational framework, including by limiting (and sterilizing) interventions in the FX market and thus sending a clearer signal that inflation is its main objective.

38. ***Higher tax revenues are needed to address important deficiencies in infrastructure and basic social services***. Staff supports government efforts to implement the personal income tax without further delay and continue improving tax administration. It will also be essential to ensure sound management of increased revenues from Itaipú energy sales. Staff supports the authorities' proposal to safeguard the additional revenues by placing them in a special fund, and suggests allocating a significant part of these revenues to build up a countercyclical reserve.

39. ***There is scope to strengthen the fiscal framework***. Plans to expand the role of PPPs in the provision of infrastructure services are welcome. It would be important to strengthen the legal framework governing concessions and develop a more comprehensive PPP framework, while increasing the MoF's role in assessing and approving PPPs to achieve value for money and manage fiscal risks. There is also room to strengthen the MTFF, including by integrating it to the budget, adopting a systematic reporting and assessment of fiscal risks, and setting up a medium-term expenditure framework. A fiscal rule targeting the structural primary balance (excluding revenue from electricity royalties and grants) could serve as an anchor for the MTFF and facilitate its integration to the budget.

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

Box 1. Measuring the Fiscal Stance in Paraguay

Different measures can be used to gauge the effects of fiscal policy on domestic demand. The fiscal impulse, defined as the change in a cyclically-adjusted balance, is commonly used to assess the impact of fiscal policy on domestic demand. Several alternative measures of adjusted balances can be used for Paraguay: (i) the structural primary balance (SPB), which adjusts revenues by the output gap;[1] (ii) the SPB excluding electricity royalties and foreign grants; and (iii) the SPB corrected for the cyclical deviations of domestic absorption from its trend. These structural balances can be used as complementary measures of the fiscal stance. An additional indicator is given by comparing growth of real primary spending with potential output growth.

The SPB excluding electricity royalties and grants could provide an appropriate measure of the fiscal stance for Paraguay. It is better measure than the traditional SPB. In addition to correcting for the output gap, it abstracts from revenues unrelated to domestic economic activity and that may be subject to large fluctuations due to exchange rate movements often unrelated to domestic policies. It is also important to appropriately scale and adjust this balance. In this respect, given the features of agriculture in Paraguay (developments in the sector are driven largely by external and weathered-related factors and the sector's linkages to the rest of the economy are weak), non-agricultural GDP seems a superior normalization option, and the output gap for the non-agricultural economy is more appropriate to correct for the cycle. Estimates based on this measure show that in 2010 fiscal policy withdrew stimulus by 1½ percentage points of non-agricultural GDP. This measure points to a positive stimulus of 1¼ and 1 percent of non-agricultural GDP for 2011 and 2012, respectively.

Table 1: Alternative Measures of Fiscal Policy Stance

	2008	2009	2010	2011	2012
1. Structural primary balance					
(In percent of nominal potential GDP)					
Structural revenues	17.4	19.4	19.3	20.4	20.2
of which royalties & grants	3.8	4.2	3.6	3.9	3.7
Primary expenditure	14.6	17.5	17.7	19.9	21.0
Primary balance	2.8	2.0	1.6	0.5	-0.8
Fiscal impulse	-1.2	0.9	0.4	1.1	1.3
2. Non-royalties non-grants structural primary balance (NRSPB)					
(In percent of nominal non agricultural potential GDP)					
Structural revenues	16.3	17.2	14.0	14.6	14.5
Primary expenditure	17.2	20.4	15.5	17.5	18.3
Primary balance	-0.9	-3.2	-1.6	-2.9	-3.9
Fiscal impulse	-1.8	2.3	-1.6	1.3	1.0
3. NRSPB adjusted for structural absorption					
(in percent of nominal non agricultural potential GDP)					
Structural revenues	16.8	17.9	13.7	14.3	14.1
Primary expenditure	17.2	20.4	15.5	17.5	18.3
Primary balance	-0.4	-2.5	-1.8	-3.2	-4.2
Fiscal impulse	-2.1	2.1	-0.7	1.4	0.9
4. Expenditure Growth					
Real primary spending growth	-2.8	21.7	7.6	16.0	8.7
Long-term real potential GDP growth	4.4	4.4	4.4	4.4	4.4

The SPB could also be corrected for temporary deviations of domestic absorption from its trend.[2] This is particularly relevant for the current cycle in Paraguay, given the strong domestic demand growth, including from imports, which provide a significant share of tax revenue. This measure shows similar results to the previous one, except for 2010, where the withdrawal of stimulus is now significantly lower, reflecting the large expansion of imports that took place that year.

[1] $R^S = R * \left(\frac{Y^*}{Y}\right)^{\epsilon}$, where R^s stands for structural revenues, R for revenues, Y^* for potential GDP, Y for actual GDP, and ε for the elasticity of potential GDP with respect to actual GDP.

[2] The procedure is similar to the footnote 1 above, controlling for the ratio of observed absorption to long-run absorption ($R^S = R * \frac{\left(\frac{Y^*}{Y}\right)^{\epsilon}}{\left(\frac{a^*}{a}\right)^{\beta}}$, where a* stands for long-run absorption and a for observed absorption; β is its elasticity).

Box 2. Paraguay: Use of Macro-prudential Tools

Macro-prudential (MaP) policy instruments have been widely used across emerging markets in recent years. They should be used to address financial stability concerns and can, under certain conditions, complement traditional macroeconomic policies. International experience has shown that periods of high favorable terms of trade and strong capital inflows can mask underlying macroeconomic imbalances and financial sector vulnerabilities. Current account deficits and exchange rate volatility can exacerbate these vulnerabilities if capital inflows suddenly reverse or the terms of trade decline, potentially causing boom-bust cycles.

With credit expanding at 42 percent, substantial capital inflows, and favorable terms of trade, MaP policies could be used be used in Paraguay to help deal with risks to macroeconomic and financial stability. Combined with further monetary tightening, a less stimulative fiscal stance, and continued exchange rate flexibility, MaP measures could help lower financial stability risks and bolster financial sector cushions. They would also contribute to achieving a faster deceleration of credit growth and reducing overheating pressures. MaP measures could play a particularly important role in complementing monetary policy in Paraguay, given a weak monetary transmission channel, with a slow and limited pass-through from policy rates to market rates. Furthermore, they could contribute to limiting incentives to carry-trade oriented capital inflows that can further complicate macroeconomic management.

Paraguay has made some use of MaP measures in recent times. Measures already in place include reserve requirements (RR) on bank deposit liabilities, with different rates being applied to deposits in local and foreign currencies. In April, these were raised to pre-crisis levels from 15 to 18 percent for domestic-currency deposits and from 21 percent to 25 percent for foreign-currency deposits. The BCP has also set limits on banks' net open foreign exchange positions, which were tightened in August 2010. From January 2012, the central bank is also raising general provisions and minimum capital, as well as tightening the definition of overdue loans.

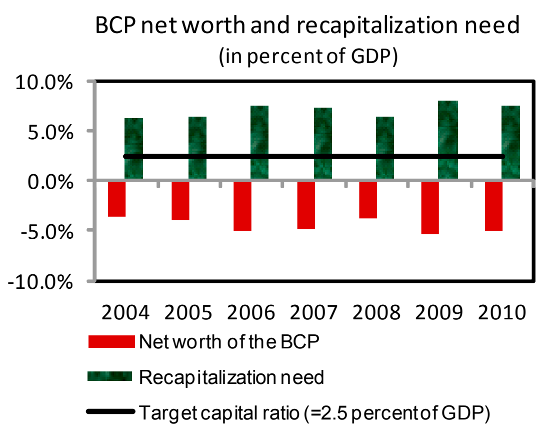
However, there is scope for greater use of MaP instruments. An expanded toolkit could include: (i) tighter loan-to-value and debt service-to-income ratios to make access to credit for durable goods and housing more stringent; (ii) RR on external credit lines to banks; (iii) higher RR on foreign-currency deposits, given the very high growth in credit in US dollars; (iv) higher capital requirements and increased provisions to lower the pace of consumer credit growth and currency mismatches; and (v) introduction of dynamic provisioning. Currently, RR on local currency deposits are applied to sight deposits only, and are broadly in line with regional levels (see chapter 2 of the Selected Issues Paper). Nevertheless, with credit in guaranies still expanding at close to 30 percent, there is a case for raising them further. Unlike other countries in the region, term deposits in local currency are exempt from RR. While they constitute a relatively small share of total deposits (around 30 percent), there is also a case for subjecting them to RR.

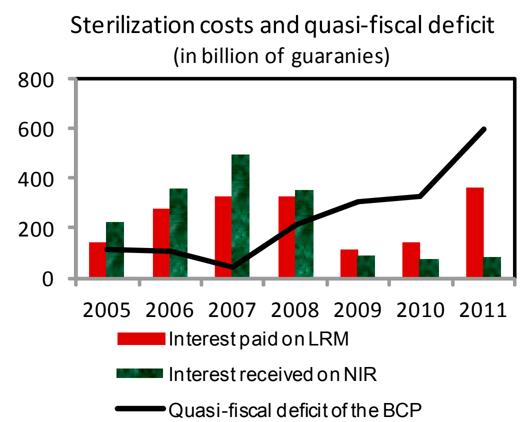
Box 3. Paraguay: Recapitalization of the Central Bank

International experience suggests that financially weak central banks suffer from higher inflation rates. Concerns about the impact of interest rate decisions on central bank balance sheets undermine central bank credibility and effectiveness and increase the costs of inflation stabilization in terms of output losses.[1] A credible path toward central bank recapitalization is needed to stabilize inflation expectations and to support the implementation of an effective monetary policy strategy.

The monetary policy operations of the BCP have been severely hampered by its negative capital position. The BCP's negative capital is a legacy of the past, reflecting non-performing claims related to loans to the public and to the financial sector that were largely incurred before the BCP's 1995 charter prohibited such practices. Carrying costs on NIR (the interest differential between BCP sterilization papers and NIR yields) have also contributed to BCP losses, though to a lesser degree. As a consequence, monetary policy steps have at times lagged the underlying economic cycle.

Differences in the speed of economic recovery with respect to advanced economies pose particular challenges for the BCP, as diverging policy rates exacerbate pressures on its balance sheet. In line with regional trends and responding to inflationary pressures, the BCP has appropriately embarked on a monetary tightening cycle, raising policy rates on its sterilization instruments (LRM) from close to zero to between 8.0 and 9.0 percent during the past 12 months. Given that interest rates of reserve currencies remain subdued, the BCP's carrying costs on NIR and non-yielding domestic assets are projected to rise substantially during 2011 and possibly beyond. Resolving the pending balance-sheet issues of the BCP is vital for sustaining monetary policy credibility and increasing its effectiveness.





A BCP recapitalization law was approved in April 2010, and the Ministry of Finance and the BCP are working on its implementation. The law authorizes the Ministry of Finance (MoF) to issue and transfer to the BCP securities in the amount of up to 6.25 percent of 2009 GDP (4,419 billion guaranies, equivalent to about US$1 billion). In return, the BCP's non-performing claims against public entities will be extinguished, and any remaining legal claims on guaranties by third parties to the BCP will be conveyed to the MoF. Interest rates and maturities on the bonds to be transferred will be defined between BCP and MoF. Both institutions are currently working on defining the financial conditions of the transfer.

Besides the need for prompt and effective implementation of the law, to guarantee the success of the operation the recapitalization bonds should possess certain properties:

- The securities should be marketable and defined in line with the terms of existing treasury securities that are traded in the market, with a maximum maturity of five years. This is necessary so the BCP can use these securities as collateral for reverse repo operations within the financial system.
- Willingness to roll-over expiring securities should be guaranteed by the BCP. Rollover dates should be set according to discrete time intervals, to avoid bunching of the rollover at one particular date.
- The transfer could be phased in according to a strict and credible time schedule, to facilitate the inclusion of interest payments on the securities in the central government budget.

[1] Klüh, Ulrich, and Peter Stella (2008), "Central Bank Financial Strength and Policy Performance: An Econometric Evaluation," IMF Working Paper 08/176.

Box 4. Exchange Rate Assessment

CGER methodologies. As of December 2010, the real effective exchange rate (REER) remained broadly in line with fundamentals according to standard CGER approaches. The average of the three methodologies suggests a slight overvaluation, in contrast with the assessment at the time of the 2010 Article IV consultation, which found a small undervaluation.

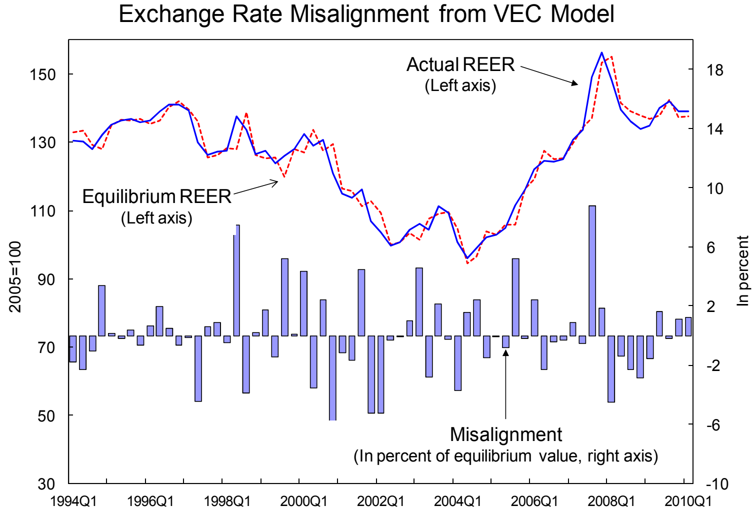
REER Deviation from Equilibrium
(In percent)

	2010 Art IV	2011 Art IV
I. Macroeconomic Balance approach	-5.5	-1.8
II. External Sustainability approach	-1.9	3.2
III. Equilibrium Real Exchange Rate approach 1/	2.9	1.4
IV. Vector Error Correction Model approach		1.2
Overall CGER misalignment (average I-III)	-1.5	0.9
Overall REER misalignment (average I-IV)		1.0

Source: IMF staff calculations.
1/ Considers the REER as a historical average 2004-2010.

Country-specific VEC model. Staff also estimated a vector error correction (VEC) model for Paraguay, using quarterly data for 1994Q1–2010Q4. The model specification includes relative productivity growth, trade openess, the terms of trade, net foreign assets (NFA), an interest rate differential, and government consumption. The analysis finds one cointegrating relation between the REER, relative productivity growth and NFA. Results from the model are very similar to those from the CGER's equilibrium exchange rate approach, and suggest a small overvaluation as of end-2010. The model indicates that the rapid increase in the equilibrium real exchange rate that Paraguay experienced during 2004-08 reflected mainly a stronger net international position and positive productivity developments. The subsequent decline in the equilibrium rate in the context of the global crisis seems to be associated with a weakening of the terms of trade and a negative shock to productivity .

Exchange Rate Misalignment from VEC Model



Note: Higher values of the REER means appreciation

Box 5. Financial Sector Assessment Program: Main Recommendations

This Box summarizes the key recommendations of the FSAP Update.[1]

Financial Institutions Soundness and Vulnerabilities

- Adopt a capital ratio definition following Basel Accords (Basel I).
- Proceed with the planned introduction of forward-looking provisioning.
- Enhance the regulatory approach to renewed, refinanced and restructured operations.

Monetary Policy and Systemic Liquidity Management

- Proceed with the planned recapitalization of the BCP to ensure its financial and operational independence and strengthen its lender-of-last-resort capacity.
- Enhance the BCP capacity for systemic liquidity management.

Payment and Security Settlement Systems

- Approve the draft payment system law to provide legal support to the new payment system.
- Complete implementation of the new payment system, including real-time gross settlements, a security repository, and automated clearing house.

Financial Sector Oversight

- Amend the legal framework to empower the BCP to issue and develop prudential regulations, and to apply due discretion.
- Review the legal framework to avoid suspension of INCOOP's corrective actions by ongoing judiciary appeal process and strengthen INCOOP's enforcement capacity.
- Align cooperatives' prudential framework with banking sector standards, particularly regarding capital adequacy and provisioning requirements of large cooperatives.
- Strengthen INCOOP's governance by instituting appointment of its Board by the President of the country in accordance with fit and proper qualification criteria.
- 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.

Financial Safety Net and Crisis Resolution Framework

- Strengthen the Deposit Guarantee Fund's contingency funding to ensure sufficient capacity to resolve a medium to large scale bank.
- Set up a liquidity assistance facility for cooperatives to ensure effective and timely emergency liquidity assistance.
- Setup a deposit insurance scheme for cooperatives to increase public confidence in the sector.

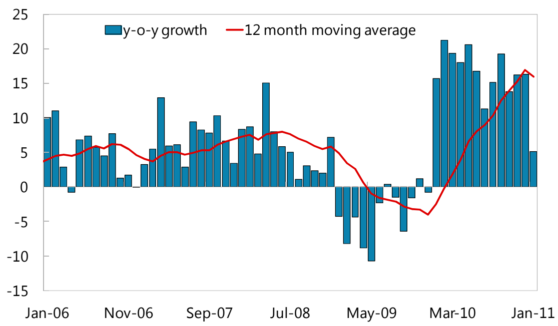
[1] The FSAP Update mission took place in November 2010, and the FSSA (Country Report No. 11/198) was considered by the Board as a stand-alone report and on a LOT basis in May 2011.

Figure 1 Paraguay: Real Sector Developments

After contracting in 2009, the economy rebounded strongly in 2010, growing at 15 percent. The recovery was driven by a record harvest, an improved external environment, and continued monetary stimulus. Excess demand pressures and rising commodity prices have led to a significant increase in inflation.

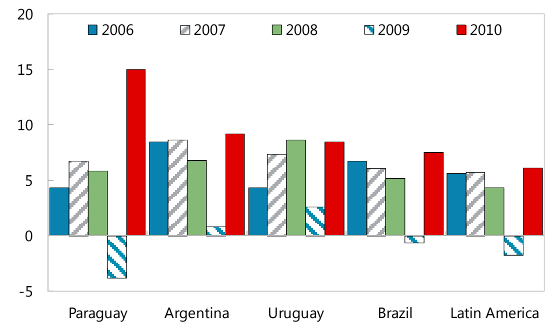
The economy recovered swiftly in 2010 after the 2009 recession.

Index of Economic Activity
(In percent)



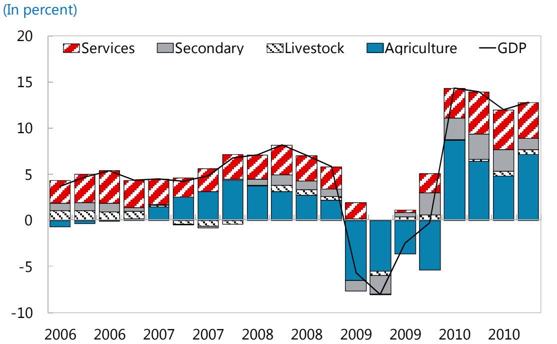
Paraguay's growth rebound was much stronger than that of the rest of the region...

Real GDP Growth
(In percent)



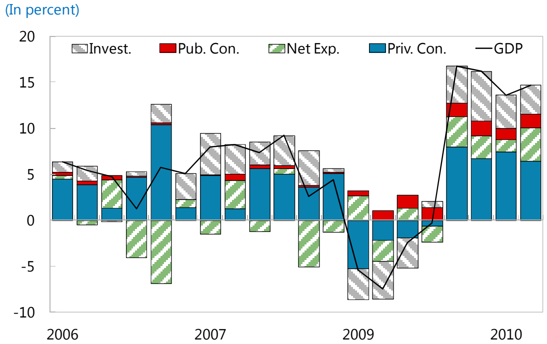
...reflecting a strong expansion of agriculture and services...

Sector Contribution to GDP Growth
(In percent)



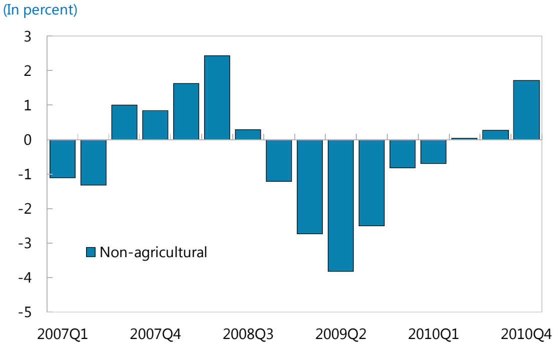
...and very rapid domestic demand growth.

Breakdown of GDP Growth from the Demand Side
(In percent)



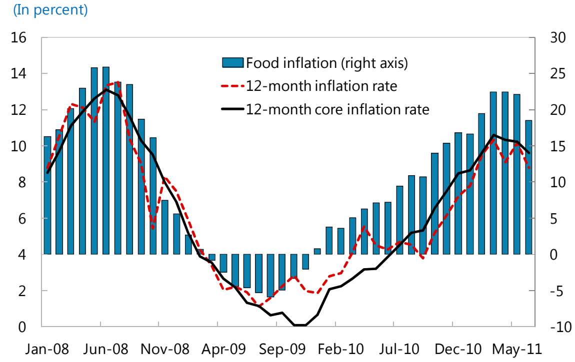
The output gap closed in mid-2010...

Output Gap
(In percent)



...which, coupled with rapidly rising food prices, has contributed to a substantial increase in inflation

Inflation
(In percent)



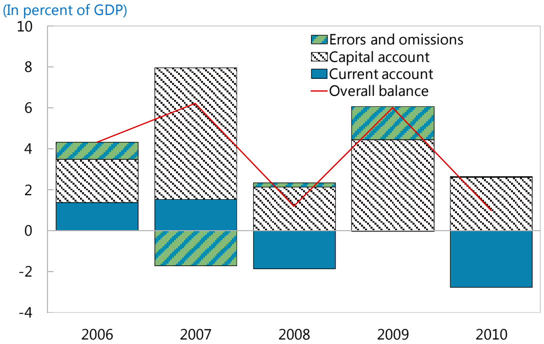
Sources: Paraguayan Authorities and Fund staff estimates.

Figure 2 Paraguay: Balance of Payments Developments

Driven by rapid domestic demand growth, imports recovered strongly in 2010, offsetting a large export rebound and leading to a weakening of the current account. However, high private capital inflows allowed the central bank to continue accumulating reserves.

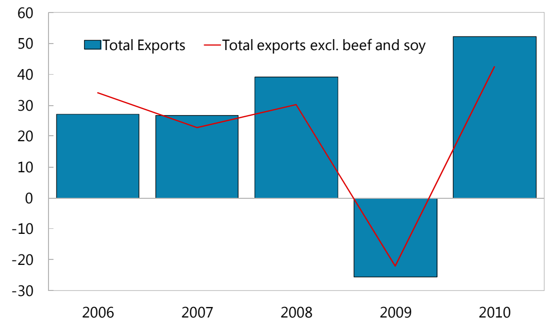
The current account deficit widened in 2010....

Balance of Payments
(In percent of GDP)



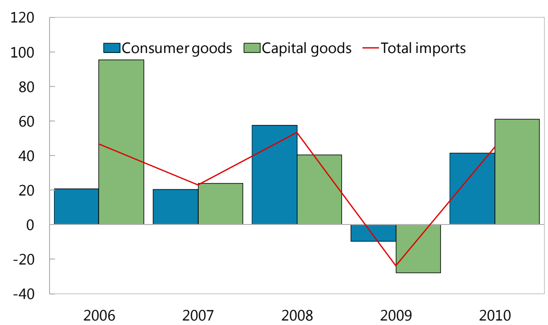
...despite a strong rebound in exports.

Exports
(y-o-y growth rate)



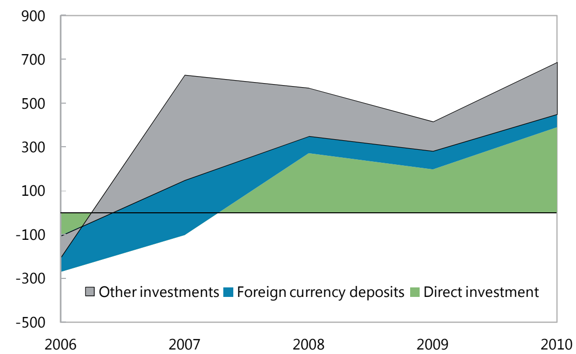
Imports grew strongly on the back of robust domestic demand, especially investment.

Imports
(y-o-y growth rate)



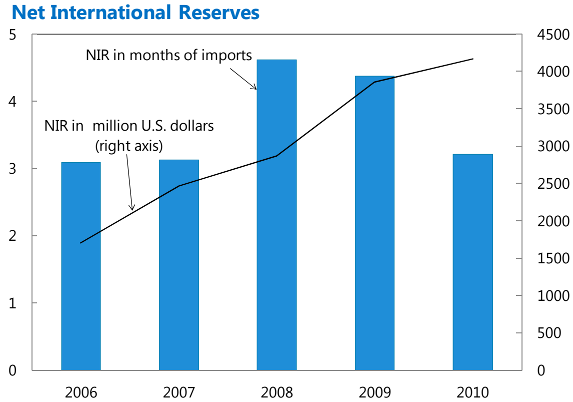
FDI and other private capital inflows experienced a substantial increase....

Net Private Capital Inflows
(In millions of U.S. dollars)



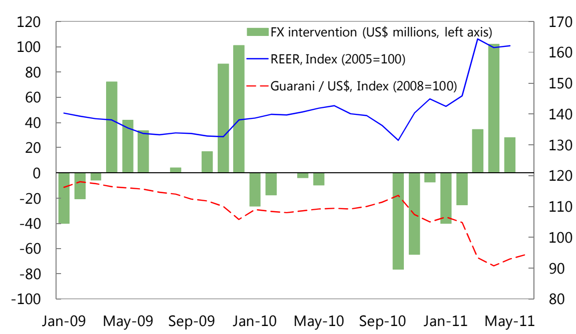
...allowing further accumulation of reserves, although import coverage still declined.

Net International Reserves



The guarani strengthened significantly over the last year.

Exchange Rate and Foreign Exchange Intervention 1/



1/ ER decreasing implies appreciation. REER decreasing implies depreciation.

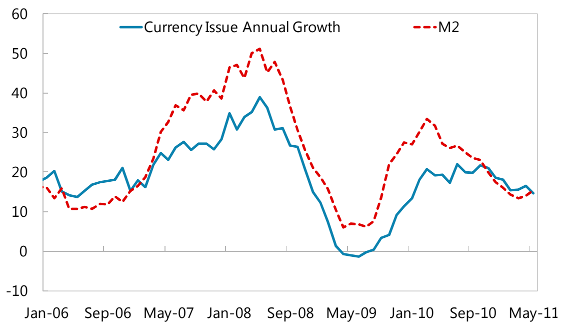
Sources: Paraguayan Authorities and Fund staff estimates.

Figure 3 Monetary Developments

The authorities started withdrawing the monetary stimulus provided during the global crisis very slowly, which led to monetary policy turning procyclical in 2010. Credit growth accelerated sharply, contributing to excess demand pressures and a large increase in inflation, which is now well outside the BCP's target range.

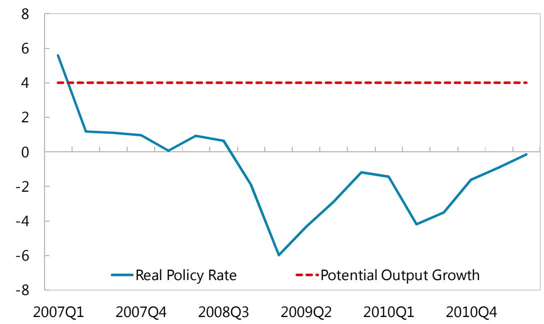
Growth of monetary aggregates is moderating but remains relatively high.

Monetary Aggregates
(y-o-y growth)



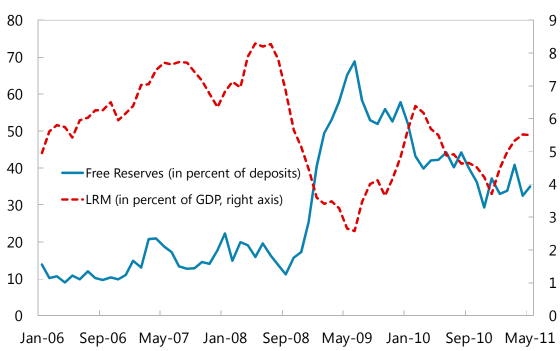
The policy rate has been raised substantially, but is still negative in real terms.

Real Policy Rate and Output Gap
(In percent)



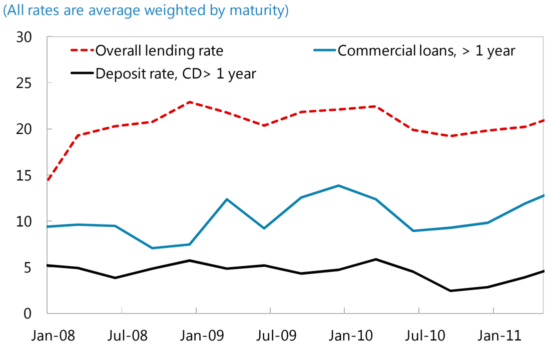
With higher policy rates, the BCP has been able to withdraw liquidity in recent months...

Central Bank Paper and Free Reserves at the BCP



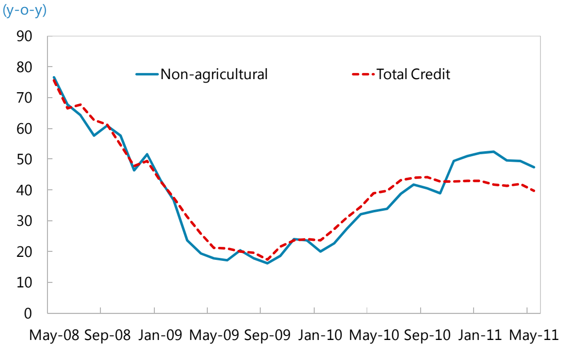
...but market interest rates have risen only modestly....

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



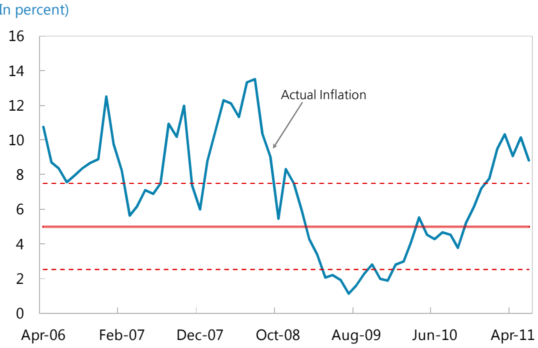
... and credit growth remains very high.

Credit Growth
(y-o-y)



In this context, inflation has increased markedly, moving outside the BCP's range.

Inflation
(In percent)

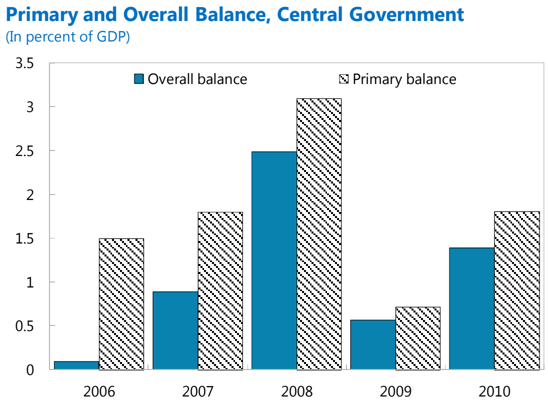


Sources: Paraguayan Authorities and Fund staff estimates.

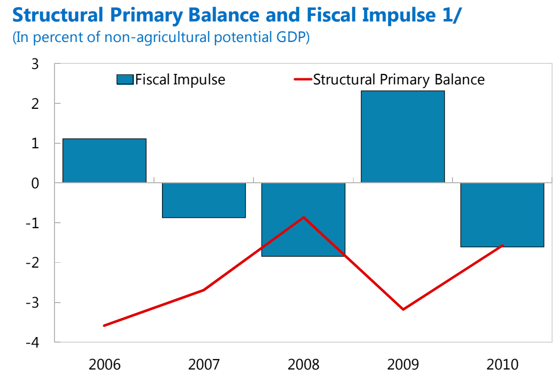
Figure 4 Paraguay: Fiscal Developments

Fiscal policy exhibited a countercyclical tone in 2010. Growth of real primary spending declined sharply, while revenue growth accelerated, driven by a buoyant domestic demand and improvements in tax administration. With the fiscal accounts in surplus, public debt continued its declining trend.

Fiscal balances strengthened substantially in 2010...

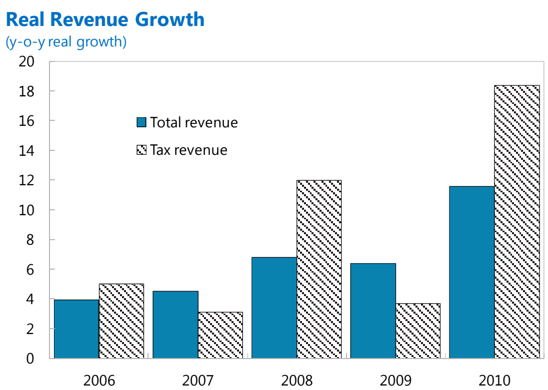


... resulting in the withdrawal of a large portion of the stimulus provided in 2009.

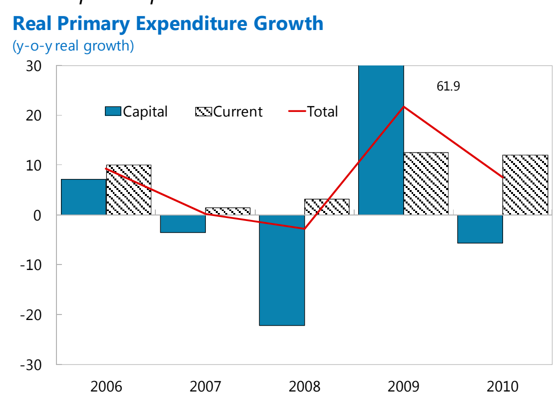


1/ Excludes electricity royalties, and grants.

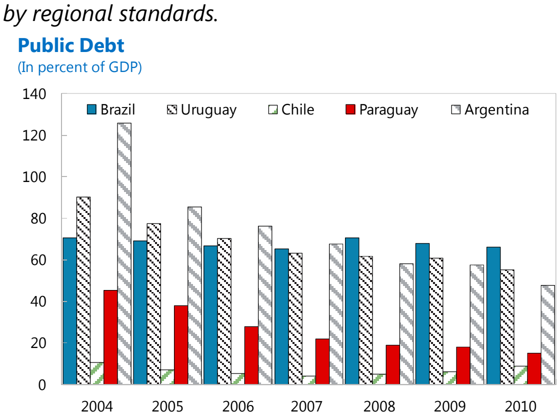
Revenues increased sharply, especially tax revenue...



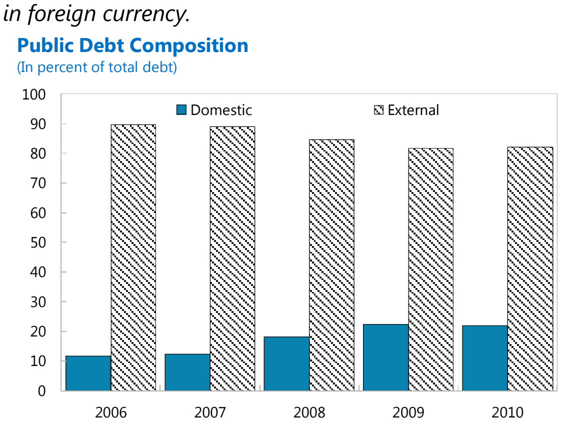
... while real primary spending decelerated, reflecting lower capital expenditure.



Public debt continued to decline in 2010 and remains low by regional standards.



Public debt in Paraguay is denominated overwhelmingly in foreign currency.

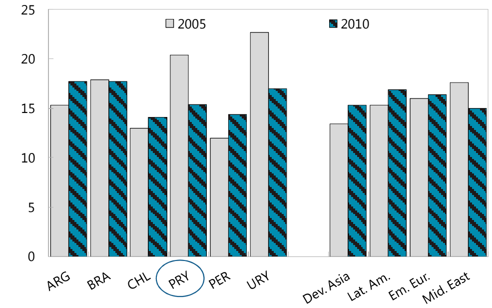


Sources: Paraguayan Authorities and Fund staff estimates.

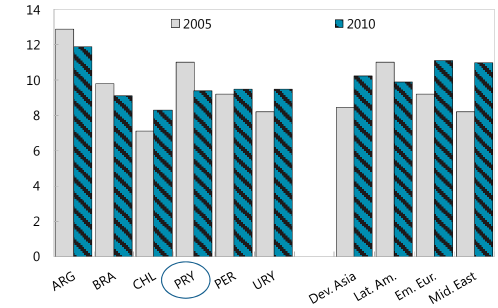
Figure 5 Paraguay: Banking System Indicators in International Perspective 1/

Capital levels are strong overall, and broadly in line with regional levels

Regulatory Capital to Risk-weighted Assets
(In percent)

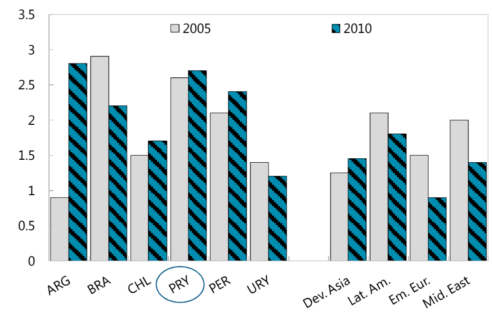


Bank Capital to Assets
(In percent)

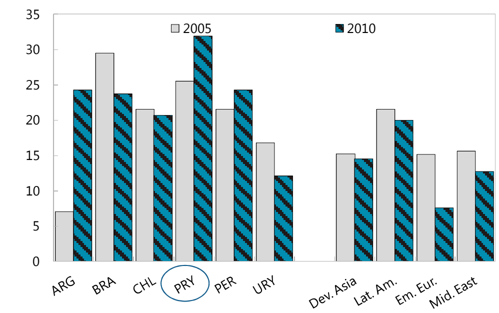


Profits are among the highest in the region

Return on Assets
(In percent)

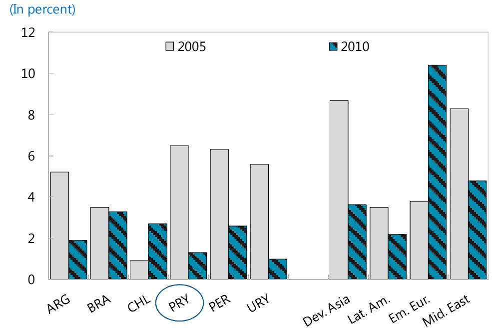


Return on Equity
(In percent)

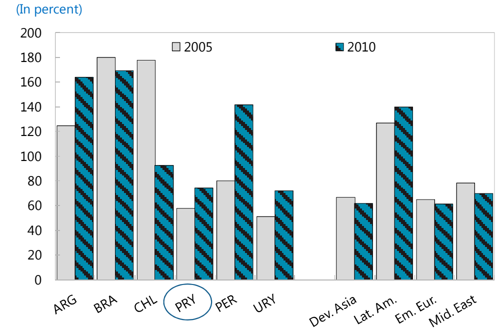


The NPL ratio is low but the NPL level has been growing fast; provisions are among the lowest in region

Nonperforming Loans to Total Loans
(In percent)

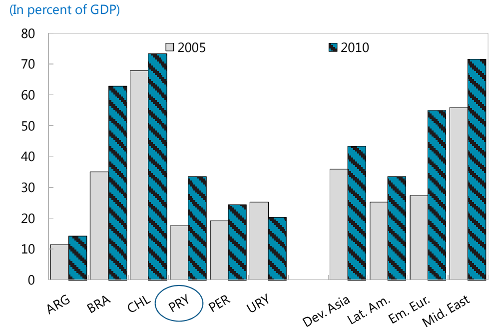


Provisions to Nonperforming Loans
(In percent)

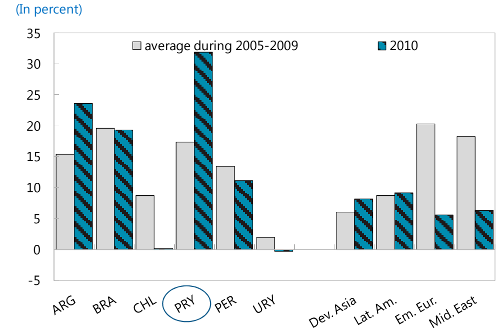


Private sector credit has now reached regional levels and has continued to grow strongly

Claims on Non-financial Private Sector
(In percent of GDP)



Real Credit Growth, to Non-financial Private Sector
(In percent)



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

Table 1 Selected Economic Indicators

I. Social and Demographic Indicators

Population 2010 (millions)	6.5	Gini index (2009/2010)	53.2
Unemployment rate (2010)	6.1	Life expectancy at birth (2010)	72.3
Percentage of population below the poverty line (2009)	35.1	Adult illiteracy rate (2008)	5.4
Rank in UNDP development index (2010)	96 of 169	GDP per capita (US$, 2010)	2,875.1

II. Economic Indicators

	2007	2008	2009	2010	Proj. 2011	2012
	(Annual percentage change, unless otherwise indicated)					
Income and prices						
Real GDP	6.8	5.8	-3.8	15.0	6.7	5.5
Nominal GDP	17.7	19.7	-4.0	19.5	14.2	12.3
Real per-capita income growth	4.7	3.8	-5.7	12.8	4.6	3.4
Consumer prices (end of period)	5.9	7.5	1.9	7.2	9.8	7.3
Monetary sector						
Currency issue	28.3	15.0	11.3	18.5	13.5	15.0
Credit to private sector	46.2	49.3	24.1	42.9	33.6	27.9
Liabilities to private sector	33.3	30.8	26.7	26.1	24.0	22.1
External sector						
Exports (fob)	27.7	38.8	-25.3	43.2	19.4	4.9
Imports (cif)	22.5	44.0	-22.0	43.1	21.5	6.9
Terms of trade	13.6	38.9	-19.1	6.7	4.5	-3.0
Real effective exchange rate 1/	11.0	16.3	-7.4	2.8	...	...
	(In percent of GDP, unless otherwise indicated)					
Current account	**1.5**	**-1.9**	**-0.1**	**-2.8**	**-3.8**	**-4.0**
Trade balance	-4.4	-6.3	-7.6	-8.4	-9.2	-9.0
Exports	46.0	46.1	40.9	45.3	44.7	39.0
Registered	23.0	26.4	22.3	24.6	25.7	22.4
Unregistered	22.9	19.7	18.7	20.6	19.0	16.6
Imports	50.3	52.4	48.6	53.7	54.0	48.0
o/w Oil Imports	5.9	7.7	6.5	5.8	6.9	6.0
Other (export and import of services, income, current transfers)	5.9	4.4	7.6	5.7	5.0	4.2
o/w Remittances	3.1	2.5	3.7	2.9	2.6	2.3
Capital account and financial account	6.5	3.4	4.5	4.4	7.4	5.0
General Government	-1.1	0.1	1.5	0.7	0.3	-0.1
Private Sector	7.6	3.4	2.9	3.7	7.1	5.1
o/w Direct Investment	1.6	1.6	1.4	2.1	3.1	2.5
Errors and Omissions	-1.7	0.4	1.6	0.0	0.0	0.0
Net international reserves (in millions of U.S. dollars)	**2,462**	**2,864**	**3,861**	**4,168**	**4,968**	**5,218**
(Stock in months of next year imports of goods and services)	3.1	4.6	4.4	3.2	4.5	4.4
(Stock over total external short term debt)	**4.4**	**2.9**	**3.5**	**3.4**	**3.9**	**4.1**
Gross domestic investment	**18.0**	**18.1**	**15.5**	**16.9**	**18.2**	**19.0**
Private sector	13.4	14.3	10.0	12.2	12.7	13.2
Public sector	4.6	3.7	5.5	4.7	5.5	5.8
Gross national saving	**19.6**	**16.2**	**15.5**	**14.1**	**14.4**	**15.0**
Private sector	13.5	9.7	9.6	8.1	8.5	10.0
Public sector	6.1	6.4	5.8	6.0	5.9	5.0
External saving (+) Disavings (-)	1.5	-1.9	-0.1	-2.8	-3.8	-4.0
Central Government revenues	17.6	17.3	19.7	19.2	20.3	20.2
Of which: Tax revenues	11.4	11.8	13.0	13.5	14.2	14.2
Central Government expenditures	16.7	14.8	19.1	17.8	19.8	20.7
Of which: Wages and salaries	7.1	7.1	8.6	8.2	8.3	8.8
Transfers	3.8	3.5	4.2	3.8	4.4	4.5
Capital Expenditure	3.7	2.7	4.6	3.8	4.7	5.0
Central Government primary balance	1.8	3.1	0.7	1.8	1.0	-0.1
Central Government overall balance	0.9	2.5	0.6	1.4	0.5	-0.5
Consolidatd public debt (in percent of GDP)	**28.2**	**23.2**	**23.0**	**19.1**	**18.0**	**16.1**
Of which: external	19.9	16.8	15.3	13.2	10.6	8.9
domestic	1.9	2.2	2.7	2.2	2.2	2.3
LRM 2/	6.4	4.2	5.0	3.7	5.2	4.9
Memorandum items:						
GDP (in billion of Guaranies)	61,512	73,622	70,705	84,523	96,498	108,389
GDP (US$ millions)	12,222	16,905	14,216	18,407	22,251	26,763

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 Regulation Monetaria (Central Bank paper).

Table 2 Paraguay: Central Government Operations

	2007	2008	2009	Prel. 2010	Projections 2011	Projections 2012
			(In billions of Guaranies)			
Total revenues	**10,837**	**12,748**	**13,915**	**16,247**	**19,636**	**21,850**
Tax revenues	7,019	8,656	9,208	11,406	13,672	15,359
Income taxes	1,229	1,381	2,140	2,096	2,441	2,744
Excises	1,310	1,555	1,398	1,778	2,063	2,427
Value added tax	3,318	4,313	4,128	5,908	7,153	8,195
Import Duties	853	1,055	977	1,526	1,752	1,766
Other	309	351	565	99	263	227
Nontax revenues 1/	3,794	4,064	4,705	4,837	5,959	6,486
Of which: Public pension contributions	752	907	1,014	1,141	1,206	1,368
Itaipu-Yacyreta	2,042	1,872	2,267	1,952	2,411	2,633
Capital revenues	25	28	2	5	5	5
Current expenditures:	**7,964**	**8,963**	**10,608**	**11,869**	**14,625**	**16,958**
Wages and salaries	4,360	5,216	6,079	6,951	8,034	9,542
Goods and services	704	713	1,055	1,285	1,854	2,022
Interest payments	515	449	443	353	461	435
Transfers	2,366	2,557	2,966	3,220	4,205	4,905
Of which: Pensions and benefits	1,264	1,370	1,475	1,503	2,051	2,287
Other	19	28	65	61	70	54
Capital expenditures and net lending	**2,280.3**	**1,954**	**3,246**	**3,204**	**4,521**	**5,469**
Capital formation	1,514	1,237	2,080	2,265	2,990	3,260
Of which: Net lending	-33	-14	50	77	177	141
Capital transfers and other	799	732	1,116	862	1,355	2,068
Statistical discrepancy 2/	-46	1	0	0	0	0
Overall balance	**547**	**1,831**	**399**	**1,174**	**490**	**-578**
Financing	**-547**	**-1,830**	**-399**	**-1,417**	**-490**	**578**
External debt (increase +)	-207	-334	42	247	262	-98
Disbursements	724	495	1,136	1,193	0	652
Amortizations	932	829	1,094	946	1,070	750
Domestic bonds (increase +)	186	23	396	7	607	405
Net credit from the banking system	-832	-1,478	-980	-1,833	0	271
Other	307	-93	142	162	-25	0
			(In percent of GDP)			
Total revenues	**17.6**	**17.3**	**19.7**	**19.2**	**20.3**	**20.2**
Tax revenues:	11.4	11.8	13.0	13.5	14.2	14.2
Income taxes	2.0	1.9	3.0	2.5	2.5	2.5
Excises	2.1	2.1	2.0	2.1	2.1	2.2
Value added tax	5.4	5.9	5.8	7.0	7.4	7.6
Import duties	1.4	1.4	1.4	1.8	1.8	1.6
Other	0.5	0.5	0.8	0.1	0.3	0.2
Nontax revenues 1/	6.2	5.5	6.7	5.7	6.2	6.0
Of which: Public pension contributions	1.2	1.2	1.4	1.3	1.2	1.3
Itaipu-Yacyreta	3.3	2.5	3.2	2.3	2.5	2.4
Capital revenues	0.0	0.0	0.0	0.0	0.0	0.0
Current expenditures	**12.9**	**12.2**	**15.0**	**14.0**	**15.2**	**15.6**
Wages and salaries	7.1	7.1	8.6	8.2	8.3	8.8
Goods and services	1.1	1.0	1.5	1.5	1.9	1.9
Interest payments	0.8	0.6	0.6	0.4	0.5	0.4
Transfers	3.8	3.5	4.2	3.8	4.4	4.5
Of which : Public pensions and benefits	2.1	1.9	2.1	1.8	2.1	2.1
Other	0.0	0.0	0.1	0.1	0.1	0.1
Capital expenditures and net lending	**3.7**	**2.7**	**4.6**	**3.8**	**4.7**	**5.0**
Of which: Capital formation	2.5	1.7	2.9	2.7	3.1	3.0
Net lending	-0.1	0.0	0.1	0.1	0.2	0.0
Other	1.3	1.0	1.6	1.0	1.4	0.1
Statistical discrepancy 2/	-0.1	0.1	0.0	0.0	1.8	0.0
Overall balance	**0.9**	**2.5**	**0.6**	**1.4**	**0.5**	**-0.5**
Financing	**-0.9**	**-2.5**	**-0.6**	**-1.7**	**-0.5**	**0.5**
External debt (increase +)	-0.3	-0.5	0.1	0.3	0.3	-0.1
Domestic bonds (increase +)	0.3	0.0	0.6	0.0	0.7	0.7
Net credit from the banking system	-1.4	-2.0	-1.4	-2.2	0.0	0.4
Other	0.5	0.0	0.2	0.1	0.0	0.2
Memorandum Items:						
Primary balance	1.8	3.1	0.7	1.8	1.0	-0.1
GDP (In billions of Guaranies)	61,512	73,622	70,705	84,523	96,498	108,389
Structural primary balance 3/	-2.7	-0.9	-3.2	-1.6	-2.9	-3.9

Sources: Ministry of Finance; and Fund staff estimates.

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

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

3/ Excludes electricity royalities and grants.

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

	2007	2008	2009	Prel. 2010	Projections 2011	2012
			(In billion of Guaraníes)			
Revenue	**13,508**	**15,879**	**16,950**	**19,646**	**22,959**	**25,663**
Tax revenue	7,044	8,696	9,245	11,452	13,643	15,401
Nontax revenue and grants	6,432	7,137	7,547	8,137	9,292	10,245
Capital revenue	32	46	158	57	24	17
Current expenditure	**10,191**	**11,522**	**13,415**	**14,910**	**17,715**	**20,848**
Wages and salaries	5,357	6,407	7,455	8,607	9,594	11,453
Goods and services	1,194	1,314	1,896	2,130	2,450	2,896
Interest payments	910	829	585	527	751	851
Transfers	2,692	2,896	3,372	3,542	4,830	5,541
Other	38	75	108	104	90	107
Capital expenditure and net lending	**2,832**	**2,757**	**3,913**	**4,233**	**5,416**	**6,279**
Of which: capital expenditure	3,085	3,059	4,479	4,689	5,857	6,776
Primary balance	**2,109**	**2,848**	**999**	**1,718**	**1,737**	**42**
Public enterprises' operating surplus	**715**	**689**	**792**	**689**	**1,158**	**656**
Statistical discrepancy 2/	-268	-30	0	0	0	0
Overall balance	**931**	**2,460**	**414**	**1,192**	**986**	**-809**
Financing	**-931**	**-2,460**	**-414**	**-1,192**	**-986**	**809**
External financing net	-384	-346	22	39	-58	-898
Disbursements	724	593	22	39	-58	-898
Amortizations	1,109	939	1,114	1,154	1,251	898
Domestic financing net	-547	-2,022	-578	-1,301	8,564	1,707
Bond financing	186	23	396	7	-192	405
Net credit from the banking system	-777	-2,261	-1,281	-1,632	8,651	669
Of which : Net credit from commercial banks	56	-840	-496	222	-751	398
Net credit from Central Bank	-832	-1,421	-784	-1,854	9,402	271
Quasifiscal deficit financing	44	216	306	324	596	633
Other	0	-93	142	70	-9,492	0
			(In percent of GDP)			
Revenue	**22.0**	**21.6**	**23.3**	**23.2**	**23.8**	**23.7**
Tax revenue	11.5	11.8	12.7	13.5	14.1	14.2
Nontax revenue and grants	10.5	9.7	10.4	9.6	9.6	9.5
Capital revenue	0.1	0.1	0.2	0.1	0.0	0.0
Current expenditure	**16.6**	**15.6**	**18.5**	**17.6**	**18.4**	**19.2**
Wages and salaries	8.7	8.7	10.3	10.2	9.9	10.6
Goods and services	1.9	1.8	2.6	2.5	2.5	2.7
Interest payments	1.5	1.1	0.8	0.6	0.8	0.8
Transfers	4.4	3.9	4.6	4.2	5.0	5.1
Other	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure and net lending	**4.6**	**3.7**	**5.4**	**5.0**	**5.6**	**5.8**
Of which : Capital expenditure	4.6	3.7	5.4	5.0	5.6	5.8
Public enterprises' operating surplus	**1.2**	**0.6**	**1.1**	**0.8**	**0.7**	**0.6**
Statistical discrepancy 2/	-0.4	0.0	0.0	0.0	0.0	0.0
Overall balance	**1.5**	**2.7**	**0.6**	**1.3**	**0.4**	**-0.7**
Financing	**-1.5**	**-2.7**	**-0.6**	**-1.3**	**-0.4**	**0.7**
External financing net	-0.6	-0.6	0.0	0.0	0.1	-0.2
Disbursements	1.2	0.8	1.6	1.4	1.4	0.6
Amortizations	1.8	1.3	0.0	1.4	1.3	0.8
Domestic financing net	-0.9	-2.2	-0.8	-1.4	-0.5	1.0
Of which: Quasifiscal deficit financing	0.1	0.3	0.4	0.4	0.6	0.6
Other	0.0	-0.1	0.2	0.0	0.0	0.0
Memorandum Item:						
Primary balance	3.0	3.8	1.4	2.0	1.3	0.0

Sources: Ministry of Finance and Fund staff estimates.

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

2/ Measurement error to reconcile above 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	Prel. 2010	Proj. 2011
Currency issue	**4,326**	**4,974**	**5,538**	**6,564**	**7,450**
Growth	28.3	15.0	11.3	18.5	13.5
Net international reserves	**12,309**	**14,322**	**19,304**	**20,841**	**24,841**
(In millions of U.S. dollars)	2,462	2,864	3,861	4,168	4,968
Net domestic assets	**-7,983**	**-9,348**	**-13,766**	**-14,278**	**-17,391**
Net nonfinancial public sector	91	-1,104	-1,794	-3,326	-4,684
Net credit to the central government	-260	-1,513	-2,154	-3,721	-5,080
Net credit to the rest of NFPS	351	408	360	396	396
Net credit to the banking system	-7,421	-7,540	-10,401	-9,724	-11,230
Reserve requirements	-3,051	-3,338	-4,175	-4,854	-5,686
Free reserves	-1,019	-1,460	-3,308	-2,131	-1,431
Monetary control bills (LRM) 1/	-3,352	-2,742	-2,918	-2,740	-4,113
Other	2	0	0	0	0
Other assets and liabilities (net)	-653	-703	-1,571	-1,228	-1,477
Capital and reserves	163	-40	355	680	1,276
Other assets net 2/	-815	-663	-1,926	-1,908	-2,753
Memorandum Items:					
Total stock of LRMs outstanding 1/	3,907	3,282	3,412	3,137	4,897
Quasifiscal balance 3/	-44	-216	-306	-324	-596
In percent of GDP	-0.1	-0.3	-0.4	-0.4	-0.6
Costs of monetary policy operations	386	375	140	308	391
In percent of GDP	0.6	0.5	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	Prel. 2010	Proj. 2011
		I. Central Bank			
Net international reserves	**12,309**	**14,322**	**19,304**	**20,841**	**24,841**
(In millions of U.S. dollars)	2,462	2,864	3,861	4,168	4,968
Net domestic assets	**-7,983**	**-9,348**	**-13,766**	**-14,278**	**-17,391**
Credit to public sector, net	91	-1,104	-1,794	-3,326	-4,684
Credit to banking system, net 1/	-4,069	-4,798	-7,483	-6,985	-7,117
Central bank securites	-3,907	-3,282	-3,412	-3,137	-4,897
Other	-98	-163	-1,077	-831	-693
Currency issue	**4,326**	**4,974**	**5,538**	**6,564**	**7,450**
		II. Monetary Survey 2/			
Net foreign assets	**13,240**	**15,861**	**20,844**	**21,829**	**26,062**
(In millions of U.S. dollars)	2,648	3,172	4,169	4,366	5,212
Net domestic assets	**4,485**	**6,186**	**6,286**	**11,855**	**15,488**
Credit to the public sector	-1,675	-3,265	-5,143	-6,732	-7,950
Credit to the private sector	10,223	15,264	18,941	27,073	36,167
Other	-4,063	-5,813	-7,511	-8,486	-12,729
Broad Liquidity (M4)	**17,725**	**22,047**	**27,130**	**33,684**	**41,550**
Bonds and issued securities	0	110	174	362	399
Other monetary liabilities	82	55	121	159	207
Central bank securities with private sector	555	540	494	397	784
Broad liquidity (M3)	**17,088**	**21,343**	**26,341**	**32,764**	**40,161**
Foreign currency deposits	6,000	7,929	9,237	12,675	17,111
Money and quasi-money (M2)	**11,088**	**13,413**	**17,104**	**20,090**	**23,050**
Quasi-money	2,339	3,884	4,961	6,113	7,022
Money (M1)	8,749	9,529	12,144	13,976	16,028
		(Annual percentage change)			
M0 (Currency issued)	28.3	15.0	11.3	18.5	13.5
Credit to the private sector	46.3	49.3	24.1	42.9	33.6
M1	38.2	8.9	27.4	15.1	14.7
M2	38.6	21.0	27.5	17.5	14.7
M3	31.4	24.9	23.4	24.4	22.6
Of which: Foreign currency deposits	20.0	32.1	16.5	37.2	35.0
Memorandum items:					
Ratio of foreign currency deposits to M3 (percent)	35.1	37.2	35.1	38.7	42.6
Ratio of foreign currency deposits to private sector deposits in banks (percent)	44.8	45.3	41.6	45.3	49.3

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	Prel. 2010	Projections 2011	2012
Current account	**185**	**-318**	**-7**	**-510**	**-849**	**-1,083**
Trade balance	-532	-1,063	-1,085	-1,551	-2,057	-2,399
Exports	5,616	7,793	5,819	8,330	9,947	10,439
Registered	2,817	4,463	3,167	4,534	5,722	5,993
Unregistered	2,799	3,330	2,652	3,796	4,225	4,446
Imports	-6,149	-8,856	-6,904	-9,881	-12,004	-12,838
Registered	-5,630	-8,506	-6,497	-9,400	-11,473	-12,269
Of which: Fuel products	-722	-1,308	-920	-1,073	-1,540	-1,608
Unregistered	-518	-350	-407	-481	-531	-569
Services (net)	499	558	868	868	1,001	1,153
Transport	-141	-169	-152	-220	-250	-272
Travel	-7	-12	76	65	88	126
Other	646	740	944	1,023	1,163	1,299
Factor income	-155	-227	-309	-369	-379	-443
Transfers	373	414	519	542	586	606
Capital and financial account	**789**	**578**	**633**	**814**	**1,649**	**1,333**
General government	-140	9	218	128	60	-24
Disbursements	153	142	231	260	307	161
Amortization	-184	-185	-220	-206	-247	-185
Other	-109	53	207	74	0	0
Private Sector 1/	929	568	415	686	1,589	1,357
Direct investment	199	272	198	390	700	680
Foreign currency deposits	251	77	84	60	-217	-187
Other	479	220	134	237	1,106	864
Errors and Omissions	**-212**	**61**	**229**	**4**	**0**	**0**
Overall Balance	**762**	**321**	**855**	**308**	**800**	**250**
Net International Reserves (increase -)	-759	-402	-996	-308	-800	-250
Exceptional Financing	-2	81	142	0	0	0
Arrears deferral (+)/clearance (-)	-2	81	142	0	0	0
Memorandum items:						
Current account in percent of GDP	1.5	-1.9	-0.1	-2.8	-3.8	-4.0
Gross reserves (in millions of U.S. dollars)	2,462	2,864	3,861	4,168	4,968	5,218
In months of imports of GNFS	3.1	4.6	4.4	3.2	4.5	4.4
External public debt in percent of GDP 2/	19.9	19.3	17.6	15.1	12.1	10.2
Debt service in percent of exports GNFS	5.2	2.9	5.0	3.3	2.9	2.6
Export Volume (percentage change)	5.9	-15.7	-12.1	26.0	6.8	5.9
Import Volume (percentage change)	15.4	21.5	-15.8	34.4	7.1	6.6
Terms of trade (percentage change)	13.6	38.9	-19.1	6.7	4.5	-3.0

Sources: Central Bank of Paraguay; and Fund staff estimates.
1/ Includes public enterprises and binationals.
2/ Based on average exchange rate valuation of GDP.

Table 7 Paraguay: Indicators of External Vulnerability

(In percent of GDP, unless otherwise indicated)

	2006	2007	2008	2009	2010
Monetary and financial indicators					
Broad money (M3), percentage change 1/	14.8	31.5	24.9	23.4	24.4
Credit to the private sector, real (percentage change) 1/	3.5	38.2	38.9	21.8	33.4
Share of nonperforming loans in total loans (percent) 2/	3.3	1.3	1.1	1.6	1.3
Average domestic lending rate, real	15.4	20.8	19.7	25.7	25.9
Central Bank bill yield, real	0.8	-2.3	-5.0	0.3	0.2
International reserves (millions of U.S. dollars)	1,703	2,462	2,864	3,861	4,168
Central bank foreign short-term liabilities (millions of U.S. dollars)	0.0	0.3	0.0	1.2	0.0
External indicators					
Merchandise exports (percentage change)	31.3	27.7	38.8	-25.3	43.2
Merchandise imports (percentage change)	31.7	22.5	44.0	-22.0	43.1
Merchandise terms of trade (percentage change)	-15.0	13.6	38.9	-19.1	6.7
Real effective exchange rate (percentage change)	13.6	11.0	16.3	-7.4	2.8
Current account balance (percent of GDP)	1.4	1.5	-1.9	-0.1	-2.8
Capital and financial account (percent of GDP)	2.1	6.5	3.4	4.5	4.4
Net foreign direct investment (percent of GDP)	1.8	1.6	1.6	1.4	2.1
Other net investment (percent of GDP)	0.0	4.6	1.6	2.7	2.1
External public debt (percent of GDP) 2/	25.4	19.9	19.3	17.6	15.1
Debt service (in percent of exports GNFS)	5.8	5.2	2.9	5.0	3.3
Gross reserves (in U.S. dollars)	1,703	2,462	2,864	3,861	4,168
In months of imports of GNFS	3.1	3.1	4.6	4.4	3.2
Over short-term external debt 3/	2.7	4.4	2.9	3.5	3.4
Over foreign currency deposits in domestic banks	1.5	1.9	2.1	2.7	2.3

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 2006–10

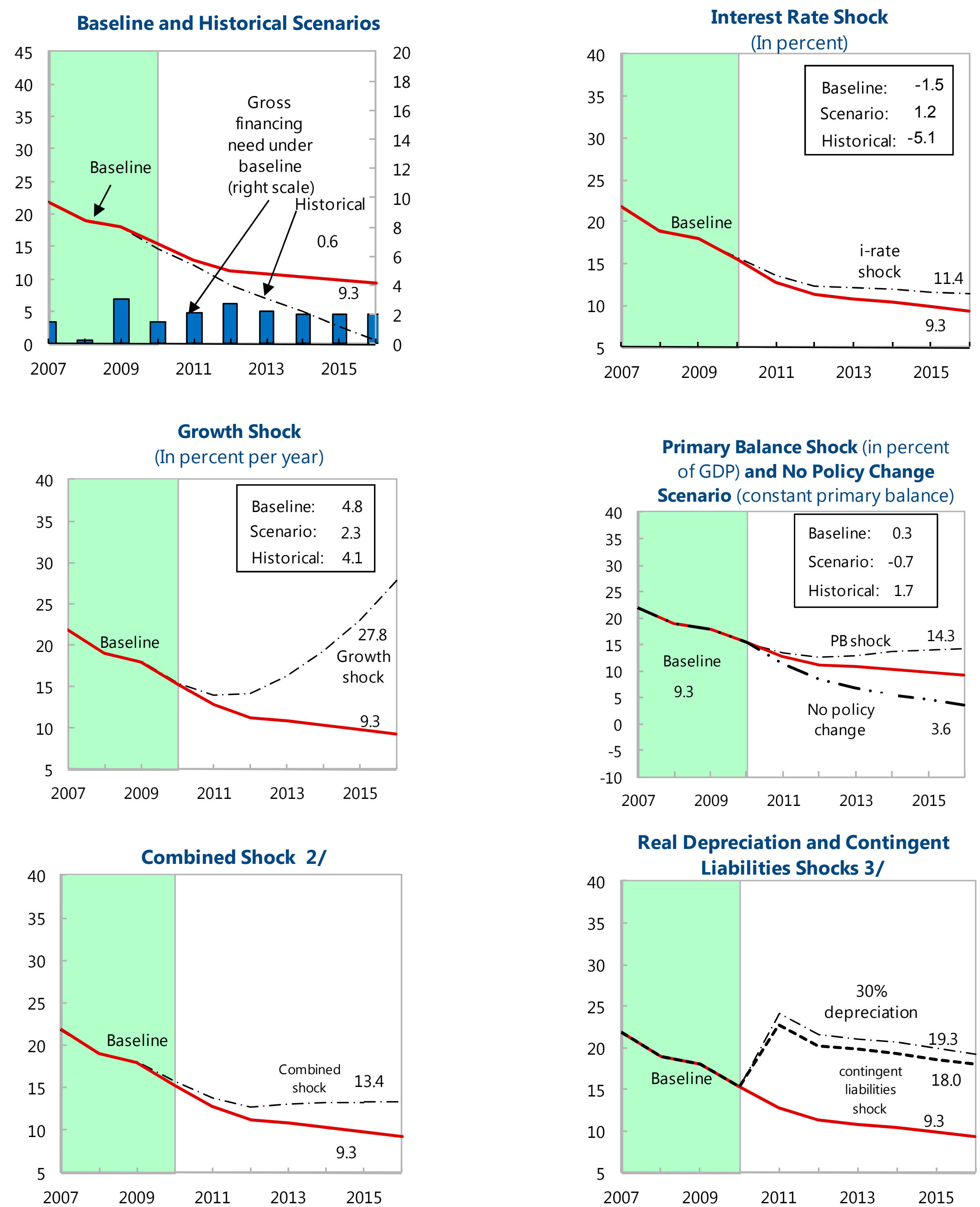
(In percent, unless otherwise indicated)

	2006	2007	2008	2009	2010	May-11
Capital Adequacy						
Regulatory capital to risk-weighted assets	20.1	16.9	16.3	16.3	15.4	18.3
Regulatory Tier 1 capital to risk-weighted assets	14.1	11.6	10.7	11.1	9.1	9.6
Asset Quality						
Nonperforming loans to gross loans	3.3	1.3	1.1	1.6	1.3	1.5
Provisions to nonperforming loans	59.1	78.4	77.7	78.8	74.4	71.9
Earnings and Profitability						
Return on assets (after tax)	3.0	2.8	3.2	2.4	2.4	2.7
Return on equity (after tax)	24.1	25.7	28.4	23.2	22.3	25.9
Liquidity						
Liquid assets to total assets	43.8	44.3	37.0	41.2	33.5	36.5
Liquid assets to short-term liabilities	73.0	73.8	70.4	74.0	64.6	72.5
Customer deposits to total (noninterbank) loans	183.5	173.2	150.8	160.3	131.0	133.1
Sensitivity to Market Risk						
Net FX exposure / capital	19.9	33.3	12.7	-1.2	4.7	11.2
Industry distribution of loans to total loans 1/						
Agriculture and livestock	...	36.6	35.7	35.9	32.4	31.8
Industry	...	12.0	11.2	9.3	9.7	9.9
Trade	...	17.4	19.3	19.6	21.1	20.4
Services	...	11.6	10.8	11.5	13.0	12.1
Consumer credit	...	8.4	9.4	10.4	13.1	13.9
Financial sector	...	14.0	13.5	13.1	10.6	11.7
Other indicators						
Foreign banks asstes in total banking assets	69.5	67.7	64.8	50.4	50.4	50.3
Foreign-currency-denominated loans to total loans	43.8	44.6	42.9	38.5	40.6	41.9
Foreign-currency-denominated deposits to total deposits	48.3	43.0	44.4	40.3	42.2	42.7

Sources: Central Bank of Parguay and IMF staff calculations.

1/ Based on credit registry data.

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



Sources: International Monetary Fund, country desk data, and 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 2011, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

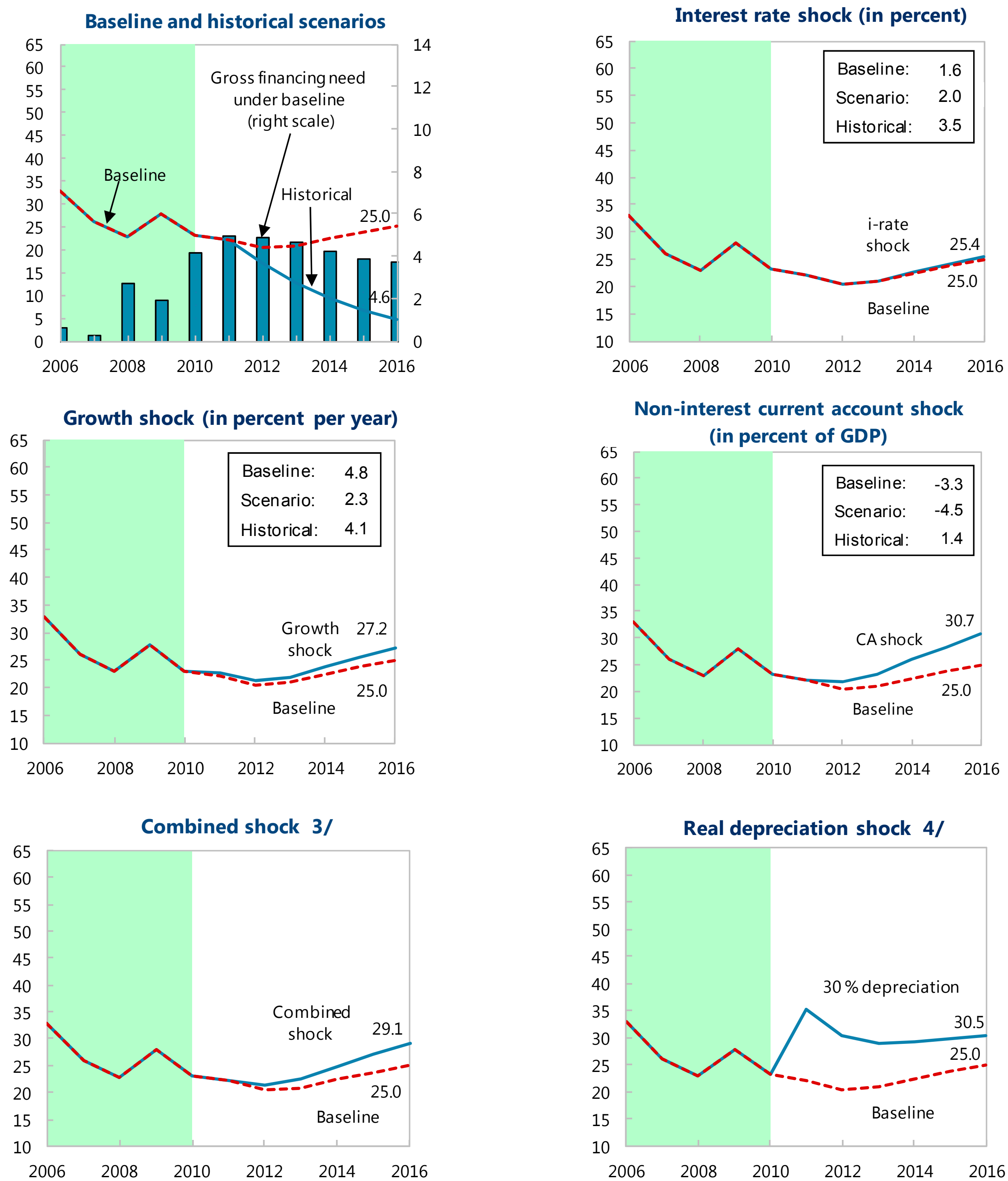
Table A.1 Paraguay: Public Sector Debt Sustainability Framework 2003-2016

(In percent of GDP, unless otherwise indicated)

	Actual				Projections					
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Baseline: Public sector debt 1/	21.8	19.0	18.0	**15.4**	**12.8**	**11.3**	**10.8**	**10.4**	**9.8**	**9.3**
o/w foreign-currency denominated	21.6	19.0	18.0	15.4	12.8	11.2	10.8	10.4	9.8	9.3
Change in public sector debt	-5.9	-2.8	-1.0	-2.6	-2.6	-1.6	-0.4	-0.4	-0.6	-0.5
Identified debt-creating flows (4+7+12)	-7.2	-5.6	-0.6	-3.5	-2.4	-0.7	-0.6	-0.7	-0.4	-0.4
Primary deficit	-2.6	-3.0	-0.9	-1.1	-1.0	0.2	0.0	-0.2	0.0	0.0
Revenue and grants	32.0	30.7	32.9	31.1	33.5	32.2	32.0	32.3	32.2	32.2
Primary (noninterest) expenditure	29.5	27.7	31.9	30.1	32.5	32.4	32.1	32.1	32.2	32.2
Automatic debt dynamics 2/	-4.7	-2.6	0.3	-2.5	-1.4	-1.0	-0.6	-0.5	-0.5	-0.4
Contribution from interest rate/growth differential 3/	-3.2	-2.9	1.7	-2.5	-1.4	-1.0	-0.6	-0.5	-0.5	-0.4
Of which contribution from real interest rate	-1.6	-1.8	0.9	-0.2	-0.5	-0.3	-0.2	-0.1	-0.1	0.0
Of which contribution from real GDP growth	-1.6	-1.1	0.8	-2.3	-0.9	-0.6	-0.5	-0.4	-0.4	-0.4
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
Privatization receipts (negative)	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
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
Residual, including asset changes (2-3) 5/	1.4	2.8	-0.4	0.9	-0.2	-0.8	0.2	0.3	-0.1	-0.2
Public sector debt-to-revenue ratio 1/	68.2	61.8	54.7	49.4	38.3	35.0	33.8	32.2	30.5	28.9
Gross financing need 6/	1.5	0.2	3.1	1.5	2.1	2.7	2.3	2.0	2.1	2.0
in billions of U.S. dollars	0.2	0.0	0.4	0.3	0.5	0.7	0.7	0.6	0.7	0.7
Scenario with key variables at their historical averages 7/					**12.2**	**9.0**	**6.9**	**5.0**	**2.7**	**0.6**
Scenario with no policy change (constant primary balance) in 2008-2013					**11.4**	**8.4**	**6.7**	**5.6**	**4.6**	**3.6**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline										
Real GDP growth (in percent)	6.8	5.8	-3.8	15.0	6.7	5.5	4.5	4.0	4.0	4.0
Average nominal interest rate on public debt (in percent) 8/	4.1	3.8	4.5	3.2	3.9	4.0	4.5	4.5	4.4	4.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-6.1	-9.3	4.6	-0.7	-3.1	-2.5	-1.3	-1.1	-0.6	-0.3
Nominal appreciation (increase in US dollar value of local currency, in percent)	6.5	-1.4	7.3	0.8	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	10.2	13.1	-0.1	3.9	7.0	6.5	5.8	5.6	5.0	4.9
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.6	-0.5	10.8	8.3	15.3	5.3	3.3	4.2	4.4	4.1
Primary deficit	-2.6	-3.0	-0.9	-1.1	-1.0	0.2	0.0	-0.2	0.0	0.0

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/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and 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 current account balance.

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 2011.

Table A.2 Paraguay: External Debt Sustainability Framework 2004–2016

(In percent of GDP, unless otherwise indicated)

	Actual				Projections					
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Baseline: External debt	26.0	22.9	27.9	23.1	**22.2**	**20.4**	**20.9**	**22.4**	**23.7**	**25.0**
Change in external debt	-6.9	-3.1	5.0	-4.8	-0.9	-1.7	0.5	1.5	1.3	1.3
Identified external debt-creating flows (4+8+9)	-10.7	-6.4	5.0	-5.5	2.1	2.7	2.7	2.4	2.0	1.9
Current account deficit, excluding interest payments	-2.6	1.2	-0.6	2.3	3.4	3.7	3.6	3.2	2.9	2.9
Deficit in balance of goods and services	0.3	3.0	1.5	3.7	5.2	5.4	5.2	4.8	4.8	4.8
Exports	53.8	52.9	50.8	53.9	52.4	45.8	44.2	44.2	43.9	43.5
Imports	54.1	55.9	52.4	57.6	57.6	51.2	49.4	49.0	48.7	48.3
Net non-debt creating capital inflows (negative)	-1.2	-1.1	0.6	-2.0	-0.4	-0.3	-0.3	-0.4	-0.4	-0.4
Automatic debt dynamics 1/	-6.9	-6.5	5.0	-5.9	-0.9	-0.6	-0.5	-0.5	-0.6	-0.6
Contribution from nominal interest rate	1.0	0.7	0.7	0.4	0.4	0.4	0.4	0.3	0.3	0.3
Contribution from real GDP growth	-1.7	-1.1	1.0	-3.2	-1.3	-1.0	-0.8	-0.8	-0.9	-0.9
Contribution from price and exchange rate changes 2/	-6.2	-6.1	3.3	-3.1	0.0	-2.7	-0.8	-0.1	-0.2	-0.4
Residual, incl. change in gross foreign assets (2-3) 3/	3.8	3.3	0.0	0.8	-3.1	-4.4	-2.3	-0.9	-0.7	-0.6
External debt-to-exports ratio (in percent)	48.3	43.2	54.8	42.9	42.3	44.6	47.3	50.6	53.9	57.4
Gross external financing need (in billions of US dollars) 4/	0.0	0.5	0.3	0.8	1.1	1.3	1.4	1.3	1.2	1.3
in percent of GDP	0.2	2.7	1.9	4.1	4.9	4.9	4.7	4.2	3.9	3.8
Scenario with key variables at their historical averages 5/					**22.2**	**17.1**	**12.7**	**9.4**	**6.8**	**4.5**
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (in percent)	6.8	5.8	-3.8	15.0	6.7	5.5	4.5	4.0	4.0	4.0
GDP deflator in US dollars (change in percent)	23.4	30.7	-12.5	12.5	13.3	14.0	4.1	0.5	1.1	1.7
Nominal external interest rate (in percent)	4.2	3.6	2.5	2.0	2.1	2.0	1.9	1.6	1.3	1.2
Growth of exports (US dollar terms, in percent)	26.6	36.0	-19.2	37.2	17.5	5.2	5.0	4.6	4.5	4.9
Growth of imports (US dollar terms, in percent)	22.4	42.9	-21.2	42.4	20.9	7.0	5.0	3.7	4.6	4.9
Current account balance, excluding interest payments	2.6	-1.2	0.6	-2.3	-3.4	-3.7	-3.6	-3.2	-2.9	-2.9
Net non-debt creating capital inflows	1.2	1.1	-0.6	2.0	0.4	0.3	0.3	0.4	0.4	0.4

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

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 29, 2011

Prepared By	The Western Hemisphere Department

CONTENTS

ANNEX 1. FUND RELATIONS

(As of May 31, 2011)

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	110.50	116.08

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 31, 2011, the average interbank rate for the U.S. dollar was ₲ 4,040 =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 2010 Article IV consultation on June 4, 2010.

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
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
MCM	Cooperatives	September 2009
FAD	Medium-Term Fiscal Framework	September 2009

Department	Purpose	Date of Delivery
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

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. Tobias Roy has been resident representative since December 2007. He is returning to headquarters in mid-July 2011 and is being replaced by Mr. Mr. Kevin Ross, who is also the resident representative for Peru and is based in Lima.

ANNEX 2. WORLD BANK-FUND COLLABORATION

1. **Meeting of teams**. The Fund and Bank Paraguay teams met on March 23, 2011 to exchange views on economic developments, 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 is to reduce overheating pressures.** Driven by excess demand pressures and increased commodity prices, inflation has been running at around 10 percent, well above the upper bound of the central bank's target band (5 percent +/- 2 ½ percent). At the same time, the external current account has weakened substantially, despite very favorable terms of trade. Bank credit growth has remained high at about 40 percent, while the fiscal stance for 2011 is projected to be expansionary.

3. **Policies need to be geared toward dealing with risks to macroeconomic and financial stability.** These include continuing tightening monetary policy and targeting at least a neutral fiscal stance. Macro-prudential measures would help protect financial sector stability and complement monetary policy efforts to contain high credit growth. In line with the 2010 FSAP recommendations, Paraguay should continue strengthening financial regulation and supervision, including in the cooperative sector, where standards are laxer than those for banks.

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

- *Tax reform.*Tax reforms are needed to increase low revenues. These includes implementing the personal income tax and reforming agribusiness taxation.
- *Fiscal framework*. The development of a comprehensive forward-looking framework for public-private partnerships (PPPs) could help increase investment in infrastructure while managing associated fiscal risks. Continued progress on developing a sound medium-term fiscal framework (MTFF) is also important to strengthen fiscal management.
- *Financial system*. Reforms to banking legislation are needed to continue bolstering the banking system and strengthening regulation and supervision. There is also a need to strengthen regulation and supervision for cooperatives and establishing a safety net for the sector
- *Monetary framework*. To support the move to an inflation targeting regime, the central bank (BCP) would need to continue strengthening its operational framework and improving systemic liquidity management. It would be important to implement the recapitalization of the BCP.

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

- *Tax reform.* The Fund will continue providing technical assistance (TA) to support authorities' efforts to reform the tax system.
- *Fiscal framework.* The Fund has recently provided technical assistance (TA) on the macro-fiscal aspects of PPPs and the development of a MTFF. Depending on the authorities' TA priorities for this year, it could provide further assistance on establishing a comprehensive PPP framework.
- *Monetary framework.* The Fund plans to provide TA on further strengthening monetary operations and transitioning to an inflation targeting regime.
- *Financial system.* The Fund will continue providing TA to strengthen bank supervision and regulation. It also plans to provide assistance on improving financial soundness indicators and developing stress testing tools for the cooperative sector.
- *State-owned enterprises.* The Bank will continue providing Technical Assistance to the authorities to support the reform of the state oversight and ownership functions of SOEs.
- Wage bill and human resources of public sector. The Bank will continue providing advisory services to identify opportunities to improve efficiency of the public sector performance.
- *Public financial management and public service delivery*. The Bank will continue providing advisory services to the Government to improve internal audit control framework and buget process.

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			
	Development Policy Loan	September 2011	October 2011
	Spanish Fund for Latin America and the Carribean – Public Sector Effectiveness	September 2011	December 2011
	Public Sector Non lLending Technical Assistance	October 2011	June 2012
	Public Expenditure Review	October 2011	June 2012
Fund Work Program			
	Staff visits to review macroeconomic and financial sector developments	October 2011 and March 2012	October 2011 and March 2012
	Article IV Consultation	June 2011	July 2011
	TA on energy subsidies	June-July 2011	September 2011
	TA on monetary policy framework,	Fall 2011	Winter 2011
	TA on strengthening bank regulation and supervision.	Fall 2011 and spring 2012	Fall 2011 and spring 2012
	TA on improving FSI indicators in cooperative sector	Fall 2011	Winter 2012
	TA on stress testing for cooperatives	Spring 2012	Summer 2012

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 completion by 2011-12. 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. 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 2011-12. 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 of Payments Statistics assisted the BCP in November 2006 in implementing recommendations of the ROSC mission. In particular, the mission focused on: (1) assessing the surveys used to capture data on services, direct investment, nonfinancial private sector portfolio investment, and other investment; (2) reviewing and updating the statistical techniques used to calculate unrecorded trade; (3) reassessing the treatment of the binational hydroelectric energy enterprises in the external sector accounts; and (4) reviewing and preparing a preliminary template for reporting data on international reserves and foreign currency liquidity.

Paraguay: Table of Common Indicators Required for Surveillance
(As of June 30, 2011)

	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	May 2011	6/1/11	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	May 2011	6/1/11	D	M	D		
Reserve/Base Money	May 2011	6/28/11	D	M	D	O, LNO, LO, O	O, O, O, LO, LO
Broad Money	May 2011	6/28/11	M	M	M		
Central Bank Balance Sheet	May 2011	6/28/11	D	M	D		
Consolidated Balance Sheet of the Banking System	May 2011	6/28/11	M	M	M		
Interest Rates[3]	May 2011	6/28/11	M	M	M		
Consumer Price Index	June 2011	7/1/11	M	M	M	O, LO, O, O	O, LO, LNO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[4] – General Government[5]	May 2011	6/3/11	M	M	M	LO, LO, LO, LO	LO, LNO, O, LO, LO
Stock of Central Government and Central Government-Guaranteed Debt[7]	Dec 2010	6/3/11	Q	Q	Q		
External Current Account Balance	Dec 2011	3/30/11	Q	Q	Q	O, LO, LO, LO	LO, O, LO, LO, LO
Exports and Imports of Goods and Services[8]	May 2011	6/7/11	M	M	M		
GDP/GNP	Mar 2011	6/23/11	Q	Q	Q	O, LO, LO, LO	LO, O, LNO, O, LO
International Investment Position	May 2011	6/1/11	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
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FOR IMMEDIATE RELEASE
July 29, 2011

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

IMF Executive Board Concludes 2011 Article IV Consultation with Paraguay

On July 29, 2011 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Paraguay, and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis[2].

Background

Paraguay weathered the global crisis well, supported by an appropriate policy response. Countercyclical macroeconomic policy cushioned the effects of lower external demand. While GDP still contracted in 2009, this owed mainly to a severe drought. Growth rebounded strongly in 2010, with real GDP expanding at 15 percent, driven by a record crop, high credit growth, and favorable external conditions.

Reflecting the using up of slack capacity, overheating pressures have emerged. Inflation rose from 2 percent in 2009 to 8¾ percent in June 2011, driven by excess demand pressures and higher commodity prices. Despite very favorable terms of trade, the external current account weakened to 2¾ percent of GDP in 2010 (from near balance in 2009), reflecting very rapid import growth and a drop in remittances. With strong private capital inflows (notably foreign direct investment), however, the Central Bank (BCP) continued accumulating international reserves, which rose to US$4.2 billion (23 percent of GDP) at end-2010.

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[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.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

Against a backdrop of rising inflation and rapid credit growth, the BCP started tightening monetary policy in mid-2010, raising interest rates by 775 basis points over the last twelve months (375 basis points in 2011), starting from a level close to zero. Real policy rates, however, remain negative, while deposit and lending rates have increased only modestly in real terms. Credit growth has remained very high (40 percent y/y in May), especially credit in foreign currency (58 percent). The BCP also raised reserve requirements (RR) effective in May, bringing them back to their pre-crisis levels.

The BCP has allowed the guarani to appreciate substantially in recent months, while intervening in the foreign exchange (FX) market. As of end-May, the guarani had risen by over 10 percent vis-à-vis the U.S. dollar (13 percent in real effective terms) compared to end-2010. The appreciation reflects mainly improved terms of trade, higher private capital inflows, and seasonal liquidation of export proceeds. The BCP stepped up its purchases of FX in April, trying to contain appreciation pressures, but as the guarani stabilized, it reduced its intervention in May and did not intervene in June.

Fiscal policy remained countercyclical in 2010, while public debt continued on a declining path. Real growth of primary spending decelerated significantly, while tax revenue increased sharply reflecting strong activity and import growth, and improvements in administration. In cyclically-adjusted terms, the primary balance (excluding electricity royalties and grants) strengthened by 1½ percent of non-agricultural GDP, implying withdrawal of most of the stimulus provided in 2009. Public debt declined by over 4 percentage points to 19 percent of GDP.

The banking sector remains generally sound. The overall capital adequacy ratio for banks remains above the regulatory level, although it is somewhat lower (by about 3 percentage points) when Basel I definitions are used. The nonperforming loan (NLP) ratio is low (1½ percent in May) and declined slightly over the last year, but the level of NPLs is growing fast (17 percent y/y in May) and provisions are low. Profitability has remained very high. In late 2010, the Superintendency approved measures to strengthen financial system buffers, including higher generic provisions and minimum capital, which will become effective in January 2012.

In 2011, real GDP growth is projected at 6¾ percent, reflecting solid agricultural growth, stimulative macroeconomic conditions, and strong confidence. Inflation is projected to remain well above the BCP’s target range, at close to 10 percent for year-end. The external current account deficit would widen to 3¾ percent of GDP, led by strong import growth, a less favorable services account, and lower remittances. The overall fiscal balance is projected to swing into a deficit of ½ percent of GDP, implying a fiscal impulse of 1¼ percent of non-agricultural GDP.

Executive Board Assessment

In concluding the 2011 Article IV consultation with Paraguay, Executive Directors endorsed the staff's appraisal, as follows:

An appropriate policy response helped Paraguay weather the global crisis. Countercyclical macroeconomic policy cushioned the effects of lower external demand. While GDP still contracted in 2009, this owed mainly to a severe drought and the nonagricultural sector still experience modest growth. Despite significant stimulus, public debt remained broadly unchanged, given the strong initial position of the fiscal accounts, while a flexible exchange rate regime helped a smooth external adjustment. The financial system was unscathed, with adequate capitalization and low NPLs.

The strong rebound of economic growth in 2010 has given rise to overheating pressures. GDP grew by 15 percent in 2010, reflecting a record harvest, strong credit growth, and favorable external conditions. Driven by excess demand pressures and higher commodity prices, inflation has risen sharply over the last year, while the external current account has deteriorated substantially, despite term-of-trade improvements. Fiscal policy was appropriately countercyclical in 2010, withdrawing most of the stimulus provided in 2009. Monetary policy remained accommodative, however, with real policy rates well in negative territory and abundant liquidity.

Macroeconomic policies are currently expansionary. Despite a large increase since mid-2010, real policy rates remain negative, while real deposit and lending rates have increased only modestly and credit growth is still very high. Reflecting strong expenditure growth, fiscal policy is being expansionary, with the structural primary balance projected to weaken by 1¼ percent of nonagricultural GDP in 2011. There is also the risk that the fiscal stance remains loose in 2012 as pressures to increase spending rise ahead of the 2013 general elections.

Policies need to adjust further to ensure a soft landing of the economy. Policies should be geared toward moderating 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. Monetary policy tightening should continue without delay, with the menu of options including further increases in RR, particularly on foreign currency deposits. The fiscal stance should become at least neutral, but preferably countercyclical. To this end, constraining current expenditures and saving any revenue over-performance, including from the potential approval of revenue measures currently in congress, will be critical. It would also be important to avoid loosening the fiscal stance in 2012, given a positive output gap and an inflation rate above the BCP's target. Broadening the use of macro-prudential policies (MaP) measures would help protect financial stability going forward while contributing to a faster reduction of credit growth.

The banking system remains sound, but there is a need to guard it against emerging risks. Bank financial soundness indictors are generally strong, including very high profitability. However, provisions are low overall and the level of NPLs is growing rapidly. Very high credit growth, particularly in foreign currency, and currency mismatches pose considerable risks that should be dealt with immediately. Macro-prudential measures, such as higher specific provisions and stricter limits on debt-to-income ratios, would help contain such risks and strengthen buffers. Developments in construction and mortgage lending, as well as in real estate markets, warrant close monitoring, including by improving the compilation of statistics. Staff welcomes the existing program to strengthen regulation and supervision and to set up a financial safety net in the cooperative sector. It encourages the authorities to also move forward with changes to legislation required for a more effective risk-based supervision for banks.

The monetary policy framework should be strengthened further to support the move to an IT regime. Many necessary components for this step are already in place, thanks to long-lasting and continued reforms and institutional strengthening at the BCP. Swift implementation of the recapitalization of the BCP and better liquidity management are also needed to further enhance the credibility of the central bank and increase the effectiveness of monetary policy. It would also be important for the BCP to strengthen and clarify its operational framework, including by limiting (and sterilizing) interventions in the FX market and thus sending a clearer signal that inflation is its main objective.

Higher tax revenues are needed to address important deficiencies in infrastructure and basic social services. Staff supports government efforts to implement the personal income tax without further delay and continue improving tax administration. It will also be essential to ensure sound management of increased revenues from Itaipú energy sales. Staff supports the authorities' proposal to safeguard the additional revenues by placing them in a special fund, and suggests allocating a significant part of these revenues to build up a countercyclical reserve.

There is scope to strengthen the fiscal framework. Plans to expand the role of public-private partnerships (PPPs) in the provision of infrastructure services are welcome. It would be important to strengthen the legal framework governing concessions and develop a more comprehensive PPP framework, while increasing the MoF's role in assessing and approving PPPs to achieve value for money and manage fiscal risks. There is also room to strengthen the medium-term fiscal framework (MTFF), including by integrating it to the budget, adopting a systematic reporting and assessment of fiscal risks, and setting up a medium-term expenditure framework. A fiscal rule targeting the structural primary balance (excluding revenue from electricity royalties and grants) could serve as an anchor for the MTFF and facilitate its integration to the budget.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Paraguay: Selected Economic Indicators

					Projections	
	2007	2008	2009	2010	2011	2012
(Annual percentage change, unless otherwise indicated)						
Income and prices						
Real GDP	6.8	5.8	-3.8	15.0	6.7	5.5
Nominal GDP	17.7	19.7	-4.0	19.5	14.2	12.3
Real per-capita income growth	4.7	3.8	-5.7	12.8	4.6	3.4
Consumer prices (end of period)	5.9	7.5	1.9	7.2	9.8	7.3
Monetary sector						
Currency issue	28.3	15.0	11.3	18.5	13.5	15.0
Credit to private sector	46.2	49.3	24.1	42.9	33.6	27.9
Liabilities to private sector	33.3	30.8	26.7	26.1	24.0	22.1
External sector						
Exports (fob)	27.7	38.8	-25.3	43.2	19.4	4.9
Imports (cif)	22.5	44.0	-22.0	43.1	21.5	6.9
Terms of trade	13.6	38.9	-19.1	6.7	4.5	-3.0
Real effective exchange rate 1/	11.0	16.3	-7.4	2.8	…	…
(in percent of GDP, unless otherwise indicated)						
Current account	**1.5**	**-1.9**	**-0.1**	**-2.8**	**-3.8**	**-4.0**
Trade balance	-4.4	-6.3	-7.6	-8.4	-9.2	-9.0
Exports	46.0	46.1	40.9	45.3	44.7	39.0
Imports	50.3	52.4	48.6	53.7	54.0	48.0
Of which: Oil Imports	5.9	7.7	6.5	5.8	6.9	6.0
Other (export and import of services, income, current transfers)	5.9	4.4	7.6	5.7	5.0	4.2
Of which: Remittances	3.1	2.5	3.7	2.9	2.6	2.3
Capital account and financial account	**6.5**	**3.4**	**4.5**	**4.4**	**7.4**	**5.0**
Of which: Direct Investment	1.6	1.6	1.4	2.1	3.1	2.5
Net international reserves (in millions of U.S. dollars)	**2,462**	**2,864**	**3,861**	**4,168**	**4,968**	**5,218**
(Stock in months of next year imports of goods and services)	3.1	4.6	4.4	3.2	4.5	4.4
(Stock over total external short term debt)	4.4	2.9	3.5	3.4	3.9	4.1
Gross domestic investment	**18.0**	**18.1**	**15.5**	**16.9**	**18.2**	**19.0**
Private sector	13.4	14.3	10.0	12.2	12.7	13.2
Public sector	4.6	3.7	5.5	4.7	5.5	5.8
Gross national saving	**19.6**	**16.2**	**15.5**	**14.1**	**14.4**	**15.0**
Private sector	13.5	9.7	9.6	8.1	8.5	10.0
Public sector	6.1	6.4	5.8	6.0	5.9	5.0
External saving (+) Disavings (-)	**1.5**	**-1.9**	**-0.1**	**-2.8**	**-3.8**	**-4.0**
Central Government revenues	**17.6**	**17.3**	**19.7**	**19.2**	**20.3**	**20.2**
Of which: Tax revenues	11.4	11.8	13.0	13.5	14.2	14.2
Central Government expenditures	16.7	14.8	19.1	17.8	19.8	20.7
Of which: Wages and salaries	7.1	7.1	8.6	8.2	8.3	8.8
Capital Expenditure	3.7	2.7	4.6	3.8	4.7	5.0
Central Government primary balance	**1.8**	**3.1**	**0.7**	**1.8**	**1.0**	**-0.1**
Central Government overall balance	**0.9**	**2.5**	**0.6**	**1.4**	**0.5**	**-0.5**
Consolidated public debt (in percent of GDP)	**28.2**	**23.2**	**23.0**	**19.1**	**18.0**	**16.1**
Of which: External	19.9	16.8	15.3	13.2	10.6	8.9
Domestic	1.9	2.2	2.7	2.2	2.2	2.3
LRM 2/	6.4	4.2	5.0	3.7	5.2	4.9

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.