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Search



ABOUT

RESEARCH

COUNTRIES

CAPACITY DEVELOPMENT

NEWS

VIDEOS

DATA

PUBLICATIONS

COVID-19

MISSION CONCLUDING STATEMENT

Paraguay: Staff Concluding Statement of the 2022 Article IV Mission

April 6, 2022

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under [Article IV \(/external/pubs/ft/aa/aa04.htm\)](/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington DC:

1. Since 2019, the Paraguayan economy has suffered a series of external shocks. As the economy was just starting to recover from the 2019 drought and flooding conditions, in early 2020 the COVID-19 pandemic hit, leading to a sharp retrenchment in the services and cross-border trade sectors. In early 2021 the pandemic intensified, but in the later part of the year the economy rebounded due to favorable export prices and a general recovery in the manufacturing and services sectors. Real GDP grew by 4.2 percent, the external current account recorded a surplus of 0.8 percent of GDP, and international reserves rose to US\$10.1 billion (9 months of prospective imports) at end-2021. The economic rebound was brought to a halt by one of the most intense droughts in Paraguay's history during the critical summer months of 2021/22, which led to an abrupt decline in the production of soy and other agricultural products.

2. The economic situation has been further complicated by an international inflation shock. Supply chain obstructions and problems with trade shipping logistics have caused scarcities and sharp price increases for vital import products. The global price inflation is broad-based, but fuels and food have been particularly affected. These factors have been aggravated by the supply shock triggered by the war in Ukraine. Annual headline inflation strongly increased in the second

half of 2021, primarily due to higher food (particularly meat) and fuel prices, and continued in 2022, jumping sharply to 10.1 percent in March.

3. The fiscal position improved in 2021 due to declined spending on COVID-related measures and a rebound in government revenues. The central government's deficit fell to 3.7 percent of GDP in 2021, down from 6.1 percent of GDP in 2020. In 2021, the government used the general IMF SDR allocation (equivalent to about US\$270 million or 0.7 percent of GDP) to finance expenditures related to the COVID-19 emergency plan and issued long-term external sovereign bonds for US\$800 million on favorable terms.

4. The recent recurrence of external shocks reaffirms the need for rebuilding macroeconomic policy space and flexibility for the future. On the monetary policy side, the Central Bank of Paraguay (BCP) reacted quickly to the price shock, raising its policy interest rate in several steps by a cumulative 550 basis points to 6.25 percent by mid-March. This is reducing the excess liquidity in the banking system that was deliberately promoted by the BCP's accommodative policy stance following the pandemic. By contrast, the process of rebuilding fiscal buffers is still ongoing after a substantial debt buildup in recent years.

5. Increased external shocks adds urgency to tackling structural and social obstacles to high and inclusive growth . The pandemic is threatening to leave lasting scars on social indicators, reversing years of progress in the reduction of poverty, gender and income inequality, and affecting the quality of future human capital. In addition, the increased frequency of severe weather events (droughts, flooding) raises concerns about the country's vulnerabilities to current and future climate conditions. For instance, Paraguay stands in the middle ground of climate change adaptability and vulnerability (ranked 94th among 181 countries by Notre Dame Global Adaptation Initiative, ND-GAIN) due to the failure of readiness to compensate for significant vulnerabilities.

6. Paraguay is likely to experience lower economic growth and higher inflation in 2022 than previously expected. This is predicated on the impacts of the drought and of the war in Ukraine on agriculture, exports, and disposable income. In addition, the ongoing evolution of COVID-19 adds some uncertainty to the prospects of the services sector in particular. Real GDP growth is projected to be barely positive at 0.3 percent. Inflation should eventually subside and converge to the BCP's target of 4 percent but may still come out slightly above the BCP's target range ceiling of 6 percent at end-2022. The loss of export revenue would also lead to a higher external current account deficit, currently projected at 2.9 percent of GDP.

7. Monetary policy should remain data dependent and the BCP should tighten it further if inflation expectations become unanchored or inflation turns out to be more persistent . Inflation dynamics have been substantially driven by external factors of uncertain duration, but there is a risk they become entrenched in domestic price setting. At this time, inflation expectations within the monetary policy's horizon are aligned with the BCP's inflation target but the BCP should continue to carefully monitor inflation drivers and the feedback effects between actual inflation and inflation expectations. The exchange rate should continue to be flexible, and the BCP can use foreign exchange interventions as a complementary instrument of monetary policy in order to both limit very short-term exchange rate volatility and reduce excess liquidity.

8. The external shocks are also increasing pressures on the fiscal position. Fiscal revenue will be dented both by the impact of lower growth and continued low electricity generation. The recent creation of a fuel subsidy for PETROPAR customers translates into an increase in expenditure, which we estimate at up to 0.3 percent of GDP. Moreover, the government faces salary increase pressures and various bills in congress that put fiscal stability at risk. Given that the contingencies to counter these fiscal pressures are very limited, we project a fiscal deficit for 2022 of around 3.2 percent of GDP.

9. While the fiscal impulse of the past three years was appropriate, converging back to the 1.5 percent of GDP deficit ceiling over the medium term is critical for maintaining the credibility of fiscal policy. Given large development needs and fiscal risks in some pockets of the public sector, this can only be achieved by stronger domestic revenue mobilization. Paraguay can ill afford a sharp cut in government investment at a time when it needs to close gaps in infrastructure, health, and education. In addition, fiscal space would be needed to help face recurrent shocks and to make room for climate change adaptation investment and transition management. Tax rates are low and Paraguay's tax-to-GDP ratio falls below the averages of any other comparable country. The 2020 tax reform was a step in the right direction, but relatively

substantial tax exemptions from special tax regimes also need to be assessed.

10. The efficiency of public spending should also be enhanced . Paraguay's public sector spends more on wages as share of its total expenditure compared to other Latin American countries , leaving less room for public investment and social services. Close to 80 percent of wage spending corresponds to the health, education, and security sectors. Fiscal risks from an unreformed "Caja Fiscal" and poorly supervised public enterprises are substantial. A 2020 governance diagnostic prepared by the IMF with Inter-American Development Bank (IADB) participation, to be published shortly, made recommendations that would be addressed by a series of reforms that the government has worked on over the last few years. They focus on anti-corruption, public procurement, fiscal responsibility, civil service reform, pension reform and supervision, and a reform of the structure of the state to reduce core government functions' fragmentation and improve coordination, oversight, and control. However, progress towards their implementation has been slow and insufficient, including in the discussion of draft legislation tabled to parliament.

11. There is also room to improve the design and targeting of social programs. During the pandemic, Paraguay successfully implemented assistance programs to protect the most vulnerable population (Programas Pytyvõ) which were effective in reducing the impact on poverty and inequality. But there is still room to improve the determination of the group of beneficiaries. Establishing a well-designed system of beneficiaries would be central to expand or create new social assistance programs, as it would magnify the impact of public transfers on protecting the most vulnerable families. This is especially important given the recent increases in international fuel and food prices, which would last longer than originally expected. Paraguay should avoid generalized subsidies and rather expand the most efficient existing social programs to provide some relief to low-income and vulnerable households by adjusting benefit levels and coverage as needed.

12. It is important to preserve the financial sector's health and resilience . The banking system appears well capitalized and profitable, with non-performing loans representing about 2.6 percent of the total credit portfolio. A key issue is to closely monitor banks' health following the unwinding of any remaining forbearance measures. Supervisory activities should continue to focus on assessing underlying asset quality including under adverse shocks to ensure that future capital and liquidity buffers will be appropriate. To adjust policies effectively, it is critical to continue undertaking comprehensive stress-testing programs that would disclose remaining pockets of solvency risks including beyond the banking system. Supervision needs to be strengthened in the financial cooperatives' sector and extended to pension funds.

13. Paraguay continues to strengthen its Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) regime. Following the recent evaluation conducted by the Financial Action Task Force of Latin America (GAFILAT) this past September, the authorities have proactively and formally established a coordinating body, at the highest level, to liaise with GAFILAT on issues pending following the evaluation, developing a road map and setting priorities, and coordinating the technical assistance requested from the Fund, the IADB, the World Bank, and the "*Banco de Desarrollo de América Latina-CAF*" to further strengthen the effectiveness of the AML/CFT regime. The assistance aims at supporting the authorities beyond the completion of the mutual evaluation to ensure support in implementing pending issues. The results of the mutual evaluation report prepared by GAFILAT will be presented in June 2022.

14. There is a need to regain momentum on the implementation of structural reforms to enhance the business climate. Gaps in transport infrastructure, human capital and education, access to financing for small and medium enterprises, as well as governance and the rule of law continue to be the priority areas for reforms and efforts. Many of these reform areas require additional public investment and spending.

15. To improve climate change adaptation policies, Paraguay should strive to move toward an integrated policy framework . Paraguay's clean electricity matrix contrasts with its relatively large non-CO2 emissions from the agricultural sector and the change of use of land. Paraguay's climate change policies are still in their infancy but there are opportunities in terms of taking advantage of Paraguay's significant hydroelectric energy potential to facilitate adaptation strategies and transition investment.

16. The IMF mission is grateful to the authorities and all our counterparts for their hospitality and the open and productive dialogue during its stay in Asunción and Ciudad del Este.

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