



The World Bank

Paraguay First Economic Management Development Policy Loan (P169505)

Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 24-Jan-2020 | Report No: PIDA28447

**BASIC INFORMATION****A. Basic Project Data**

Country Paraguay	Project ID P169505	Project Name Paraguay First Economic Management Development Policy Loan (P169505)	Parent Project ID (if any)
Region LATIN AMERICA AND CARIBBEAN	Estimated Board Date 19-Mar-2020	Practice Area (Lead) Macroeconomics, Trade and Investment	Financing Instrument Development Policy Financing
Borrower(s) Ministry of Finance	Implementing Agency Ministry of Finance		

Proposed Development Objective(s)

The Development objectives of the proposed DPL are to (a) improve the enabling conditions for more resilient, private sector-led growth, (b) promote economic growth that is more environmentally sustainable and resilient to climate-induced shocks, and (c) increase resilience through more efficient and accountable management of public resources.

Financing (in US\$, Millions)**SUMMARY**

Total Financing	200.00
-----------------	--------

DETAILS

Total World Bank Group Financing	200.00
World Bank Lending	200.00

Decision

The review did authorize the team to appraise and negotiate



B. Introduction and Context

Country Context

Since 2004, Paraguay has been characterized by solid economic growth supported by prudent macroeconomic policies and leveraging of the country's natural wealth. Economic growth has been above the regional average, inflation is under control and public debt is low. Foreign reserves have remained at prudent levels. The financial sector is sound, with well-capitalized banks with low non-performing loans. Growth has been based on extensive leveraging of the country's natural wealth, particularly land and hydroelectric potential, and on an expanding services sector. Due in large part to the strong performance of the agricultural exporting sector, Paraguay stands out in the region for the positive contribution of net trade to growth. Demographic change in Paraguay has led to a sizable expansion of the working-age population, adding to economic output. However, in the first half of 2019, Paraguay faced a recession due to weak growth of the main trading partners and adverse climatic conditions. The economy is expected to return to positive growth in 2020.

In line with the solid economic growth, Paraguay has experienced substantial poverty reduction and shared prosperity, though the rate of this progress has noticeably slowed-down since 2013. Measured as the share of individuals living on less than US\$5.5 (2011 PPP) per day, the poverty rate in 2017 is less than half of what it was in 2003, and the income of individuals at the bottom 40 percent of the population grew at an annualized rate of 4.2 percent (larger than both mean income growth of 2.5 percent and median income growth of 3.5 percent). However, in rural areas, the growth of commercial agriculture has not been mirrored by the performance of family-based agriculture; in urban areas, job creation was mostly in low-productivity sectors, especially services. Following a stagnation of gains between 2013-2016, poverty and shared prosperity resumed positive trajectories over 2017-2018. However, the sharp deceleration of economic growth in 2019 is estimated to have stalled further progress.

Paraguay's real GDP growth has been one of the most volatile in Latin America over the last decades, highlighting its structural characteristics of its economy and vulnerability to external shocks. This reflects an increase in the volatility of agricultural GDP, which generates about 60 percent of merchandise exports, with limited diversification achieved in the past decade. While the agriculture sector is affected by international commodity prices, weather-related shocks alone account for more than 50 percent of agricultural GDP volatility. Although Paraguay has built strong macroeconomic buffers, its vulnerability to the current high volatility in neighboring economies and the prospects of weaker global growth increases risks to the outlook. Growth performance is vulnerable to the current economic crisis in Argentina via lower remittances and demand for Paraguayan exports. This could pose a threat to sustainability of social gains, as the poor have limited means to manage the impact of negative shocks.

Another source of vulnerability for Paraguay is the unsustainable expansion of agriculture into natural forests and the extraction of forest biomass for energy. The recent boom in exports of agricultural commodities has come with an expansion of the agricultural frontier - a rapid and sustained change in land use from forest to cropland and pastureland. As a result, significant amounts of renewable natural capital, particularly in the form of native forests, as well as ecosystem services, including carbon storage and sequestration, have been lost. According to the World Resources Institute, from 2001 to 2018, Paraguay lost 5.72Mha of tree cover, equivalent to a 24 percent decrease in tree cover since 2000, and 822Mt of CO₂ emissions. While the country has one of the lowest levels of greenhouse gas emissions in the region (it contributes just 0.08% to GHG emissions internationally), they correlate strongly with deforestation.

While fiscal management has been generally prudent, it still falls short of reducing Paraguay's vulnerability to shocks, as revenue mobilization remains low, there is insufficient public investments in infrastructure needs, and expenditure tends



to reinforce rather than smoothen economic cycles. The tax base has been eroded by exemptions, deductions, low taxation of commercial agriculture, and incentives with limited reach, coupled with high informality. Revenues from income and profits, as a share of total tax revenue, are the second lowest in the region. In recent years, Paraguay has increased public investment but still faces a substantial gap in terms of its public capital stock. Growth in current spending does not allow to create fiscal space for higher public investment. The nominal deficit target does not take into account the country's cyclical position.

C. Proposed Development Objective(s)

The Development objectives of the proposed DPL are to (a) improve the enabling conditions for more resilient, private sector-led growth, (b) promote economic growth that is more environmentally sustainable and resilient to climate-induced shocks, and (c) increase resilience through more efficient and accountable management of public resources.

Key Results

The proposed DPL supports policy reform measures aimed at reducing Paraguay's vulnerability to external economic and environmental shocks and mitigating their impact. Pillar A aims at enhancing the enabling conditions for a more resilient growth path led by the private sector. The policy actions supported under this pillar promote competitiveness, economic diversification and trade facilitation (business entry and customs reform). Pillar B aims at ensuring that this growth path is more environmentally sustainable and resilient to climate-induced shocks, notably by strengthening natural resource management in the agriculture and forestry sectors. The actions promote improved forest monitoring, the use of modern tools in forest law enforcement and creates the condition for forestry to become an economically more viable activity. Pillar C is centered around measures that strengthen resilience by improved public financial management, by increasing fiscal space, strengthen countercyclical fiscal management and accountability of the public sector. The measures proposed under this pillar seek to enhance resilience through simplified and more efficient collection of domestic resources (tax reform, tax evasion), and improved use of those resources by making expenditure more effective, equitable, and transparent (procurement, citizen budget).

D. Project Description

The proposed Paraguay First Economic Management Development Policy Loan (EMDPL1) in the amount of US\$200 million is a first operation, in a programmatic series of two, aimed at supporting Paraguay's efforts to reduce its external, environmental, and public finance vulnerabilities. The operation is a key instrument for the implementation of the Country Partnership Framework (CPF) for Paraguay for FY19-FY23, presented to the Board in January 2019, and supports select priorities of the Paraguayan Administration within the framework of its *Plan de Gobierno* 2018-2023, "Paraguay de la Gente". The Government plans to use the EMDPL1 with the Deferred Drawdown Option (DDO) as a contingency line of financing to address repercussions from increased regional volatility and weaker global growth.

Reforms proposed under Pillar A aim to improve the enabling conditions for a more resilient growth path led by the private sector. Firms in Paraguay face multiple barriers and competitiveness challenges when conducting business, in the absence of a healthy competitive environment that promotes firm and productivity growth. Starting a business and trading across borders were among the areas with the lowest rankings in Doing Business 2020 for Paraguay, 160 and 128 respectively. Both agricultural and non-agricultural production involve a high degree of market concentration that creates disadvantages for smaller economic actors. In many subsectors, for example, the top four firms account for more than half of all sales, and in some cases over 90 percent. The policy measures supported under this pillar promote



competitiveness, economic diversification and trade facilitation, with a view to developing a more broad-based and resilient economic structure.

Reforms proposed under Pillar B aim at promoting an economic growth path that is more environmentally sustainable and resilient to climate-induced shocks, notably by strengthening natural resource management in the agriculture and forestry sectors. This is pursued by improving the ability to monitor land use change and related greenhouse gas emissions and by strengthening the ability of the Government to identify and declare forest law infractions by using remote sensing technology and by streamlining the process of administrative proceedings. The pillar also supports the development of the forest economy in a manner that is sustainable and creates jobs and valuable inputs to other sectors, by promoting access to appropriate credit conditions and by promoting exports of timber products.

Reforms supported by Pillar C are centered around measures that strengthen efficiency, countercyclical and accountability of public resource management. Limited capacity in the public sector reduces Paraguay's capacity to reduce vulnerability to different types of shocks. This includes low accountability of public sector management, as well as high public perceptions of corruption. The measures proposed under this pillar seek to improve public sector performance by (i) simplifying and making more efficient the collection of domestic resources (tax reform, tax evasion), and (ii) improving the use of those resources by making expenditure more effective, equitable, and transparent (procurement, citizen budget). Under the second operation, these actions are complemented by measures aimed at improving countercyclical and supporting sustainability of fiscal policy, enhancing efficiency and equity of social security, and strengthening the statistical system to underpin policy making with timely and good-quality data.

E. Implementation

Institutional and Implementation Arrangements

The monitoring, evaluation, and results framework has been agreed with the Ministry of Hacienda (MoH), which has the responsibility to coordinate actions across relevant ministries and agencies involved in the operation. The agencies responsible for the implementation of the prior actions listed in the operation include: MoH; Customs; Secretary of Prevention of Money or Property Laundering (SEPRELAD); National Forestry Institute (INFONA); Central Bank of Paraguay (BCP); National Development Bank (BNF).

F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

The poverty and social impact of the policies supported by the DPL is expected to be neutral or positive in the short run, and positive in the medium and long-term. Prior actions supported under the pillar A are expected to improve labor market conditions in the formal sector and small effects on poverty and inequality. Prior actions supported under the pillar B are not expected to have any direct impact on poverty or inequality in the short term and may have neutral or positive social impacts in the medium term. Prior actions supported under pillar C are expected to have neutral or positive poverty and social impacts in the short term, and overall positive effects in the medium and long term.

Environmental, Forests, and Other Natural Resource Aspects

The policy measures on incentives to commercial forestry and coordinated forest monitoring are likely to have significant positive effects on the environment and forests. The measure to boost commercial forestry activities is expected to have



two main effects. The first is an increase in timber biomass and carbon sinks in the areas where the plantations are located. Exotic timber species plantations are not likely to crowd out natural forests which are currently located either in remote rural areas of Western Paraguay (hence far from export routes) or in protected areas in the Eastern Paraguay. The second is a reduction in the domestic demand for wood biomass obtained from natural forests, leading in turn to reduced deforestation. The National Forest Monitoring System (NFMS) will facilitate comparison of actual changes in land use to those permitted under the legal regime. This will provide a transparent and publicly accessible information base that will contribute to strengthening of the monitoring and enforcement capacity of environmental agencies, notably INFONA.

G. Risks and Mitigation

The overall risk to achieving the operation's development objective is assessed as Substantial. The major risks identified include: (i) political and governance; (ii) institutional capacity for implementation and sustainability; and (iii) sector strategies and policies. Risks will be monitored throughout preparation of the DPL series. Downside political and governance risks are considered substantial as carrying through with reforms will require strong political consensus in a complex context. The government's reform agenda is ambitious, and some prior actions involve traditionally sensitive areas, including customs, fiscal policy, and forest law. Institutional capacity for implementation and sustainability is substantial, particularly as the operation involves multiple agencies. The implementation risks, which arise from the lack of resources, capacity constraints, resistance from special interest groups, changes in reform directions, could hinder the effective implementation of the reforms to legal frameworks and undermine the impact of the operation. Achievement of the DPL's objectives could also be adversely affected by inadequacies in sector strategies. Discrepancies between the legal and policy framework, the supporting ecosystem, communications and the sector leadership may reduce reform effectiveness. The key mitigating factors against these risks are Government's commitment to implementing important reforms, the targeted approach to sequencing main reforms, also embedded in the programmatic approach of the proposed series, and strong technical assistance program that complements the EMDPL objectives.

CONTACT POINT

World Bank

Ruslan Piontkivsky
Senior Economist

Borrower/Client/Recipient

Ministry of Finance

Implementing Agencies



Ministry of Finance

Ivan Haas

Director

ivan_haas@hacienda.gov.py

FOR MORE INFORMATION CONTACT

The World Bank

1818 H Street, NW

Washington, D.C. 20433

Telephone: (202) 473-1000

Web: <http://www.worldbank.org/projects>

APPROVAL

Task Team Leader(s):	Ruslan Piontkivsky
----------------------	--------------------

Approved By

Country Director:	Paul Procee	07-Jan-2020
-------------------	-------------	-------------