

# Development Challenges in Paraguay

Alejandro Quijada

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# Development Challenges in Paraguay

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## Medium-Term Economic and Social Trends

Paraguay has been one of the fastest-growing economies in Latin America and the Caribbean (LAC) over the last decade. Growth has been driven by strong factor accumulation and traditional exports. Since 2008, real Gross Domestic Product (GDP) has increased on average 4.9% per year, above the region's 2.0% per year. Results from a growth accounting exercise indicate that human capital-adjusted labor explains 46% of observed GDP growth, followed by physical capital (30%) and total factor productivity (24%). From a sectoral perspective, traditional exports (agriculture and electricity) account for 1/3 of economic growth.

Economic growth, however, has been volatile. Paraguay's GDP growth volatility, as measured by its standard deviation, ranks amongst the highest in the region (5.5% since 2008). Output fluctuations are linked to export vulnerability, to swings in international commodity prices (soybeans, bovine meat), weather-related shocks (rainfalls, droughts) and trade partners concentration (Brazil and Argentina account for 45% of total exports and 39% of total imports).

Against this backdrop, sound macroeconomic policies have been key to mitigating economic fluctuations. Over the last decade, the country has strengthened its monetary and fiscal policy frameworks (inflation targeting regime, fiscal responsibility law), which has contributed to price stability (average annual inflation below 5.0% since 2008) and fiscal consolidation (average central government deficit of 0.6% of GDP since 2008).

In the social arena, poverty and inequality indicators have improved, although challenges remain for vulnerable segments in rural areas. Since 2008, poverty, extreme poverty, and income inequality have decreased by 33.2%, 45.3% and 5.1%, respectively. During the same period, several human capital indicators (years of education, life expectancy) show a positive trend, particularly in rural areas and among women. Poverty remains very unevenly distributed across rural and urban areas, as rural poverty is almost two times higher than urban poverty, while extreme poverty in rural areas is seven times larger than in urban centers. Regarding health and education services, one of the main challenges has to do with reducing provision gaps for vulnerable groups: youth, women, and indigenous people.

## Medium-Term Economic and Social Outlook

Growth prospects remain positive. Global economic growth resumed in 2017, driven by recoveries in aggregate demand from advanced economies and international commodity prices. Paraguay benefited from this advantageous external backdrop, as real GDP growth registered 4.3% in 2017 and is expected to reach 4.5% per year in the medium term. Expected growth could be even stronger, however, given the country's comparative advantages in energy costs and preferential access to Mercosur. Moreover, as mortality and fertility rates decline and the dependent population grows more slowly than the working age population, Paraguay has a window of opportunity for rapid economic growth. Recent estimates indicate that the country's demographic dividend will last until 2050, among the longest durations in LAC.



## Risk Factors

Risks arise from external factors. A less favorable global financial environment and a slower than expected recovery in neighboring economies could pose challenges to economic growth and macroeconomic stability, given the country's reliance on commodity exports, low number of trade partners, and vulnerability to climatic events.

## Development Challenges

Structural changes are at the core of the development debate. Thinking about ways to foster long-run growth and sustainable development, the country faces the twofold challenge of promoting structural changes that will generate sustainable productivity gains across all sectors and, at the same time, creating the proper conditions for translating these productive transformations into tangible benefits for the population as a whole, with particular emphasis on the most vulnerable groups.

Using a battery of methodological approaches, four development areas to boost socially inclusive productive transformation in Paraguay can be identified: i) integration and economic diversification, ii) productive infrastructure, iii) human capital and living conditions, and iv) public management and institutions.

**Integration and economic diversification.** In order to achieve growth-enhancing structural changes, the export sector must be dynamic and diversified, capable of competing in global markets and able to add value to productive chains and develop new products. This requires strengthening trade integration and productive diversification through improvements in trade promotion and integration mechanisms and increases in private sector participation in global value chains and innovation, and in access to finance.

**Productive infrastructure.** Strengthening integration and productive diversification requires more and better infrastructure, which in turn can contribute to lowering production and trading costs, using natural resources in a sustainable way, and mitigating the impact of climate change. The challenge here is improving productive infrastructure under conditions of socioeconomic and environmental sustainability through actions aimed at increasing the quality and coverage of transport and logistics infrastructure, energy transmission and distribution, broadband connectivity and telecommunications.

**Human capital and living conditions.** While improving infrastructure is crucial to increasing productivity and competitiveness, strengthening human capital accumulation and enhancing living conditions are essential to make this productive transformation sustainable. Hence, it is fundamental to support knowledge accumulation and skill development, efficient provision of health and social protection, and improvements in living and dwelling conditions, including access to water and sanitation services.

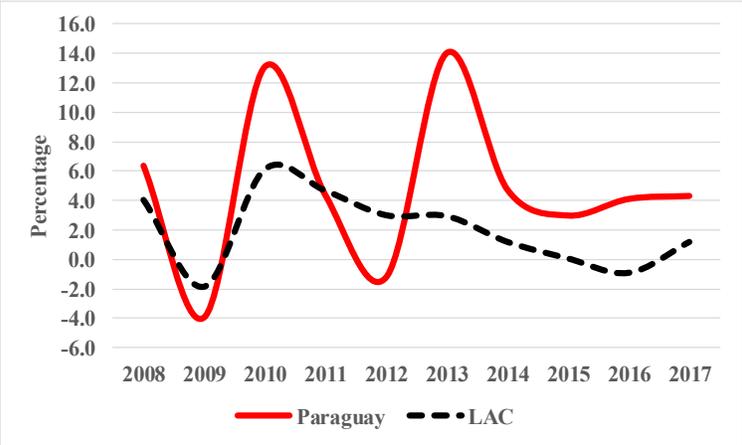
**Public management and institutions.** Finally, stronger government institutions and better public management are crucial to generating fiscal space and supportive conditions for private participation in productive activities, and to reinforcing incentives and policy frameworks for an efficient use of public and private resources.



**Conclusion**

Paraguay has improved in several development dimensions and could potentially become one of the most dynamic emerging economies on the global stage. Rapid economic growth and significant reductions in poverty have translated into better social conditions. Sound macroeconomic policies have been crucial to mitigate the effects of external volatility and support the private sector. In addition, the country’s relative advantages in terms of preferential access to two of the largest markets in LAC (Brazil and Argentina), low energy costs, and a young labor force, are likely to reinforce current development trends. Nevertheless, the country still faces important development challenges in several areas that need to be tackled in order to ensure the sustainability of current positive developments and achieve long-term inclusive growth.

**Figure 1. Real GDP Growth 2008-17**



Source: Central Bank of Paraguay and IMF (2017).



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