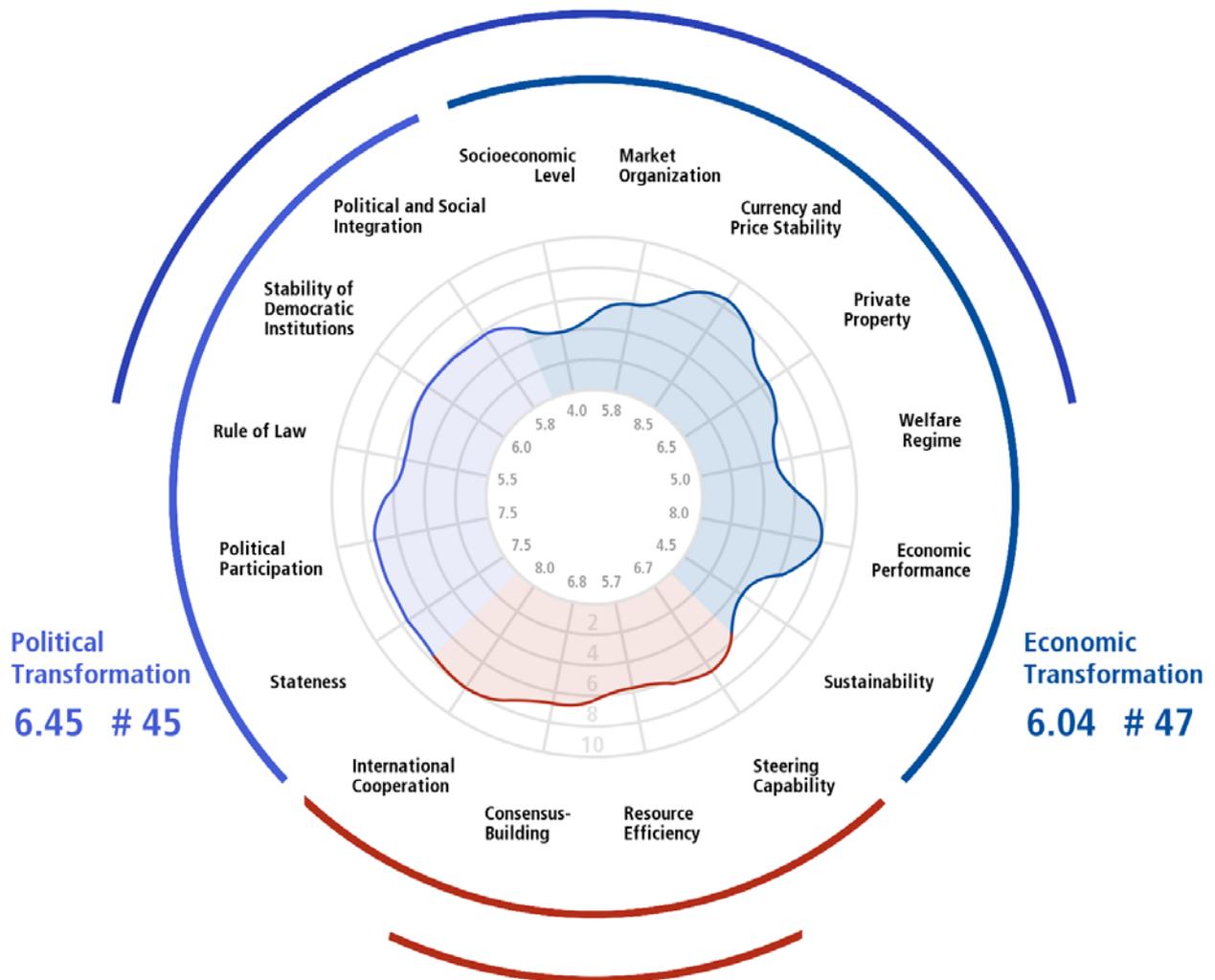


Paraguay

Status Index

6.24 # 47

on 1-10 scale out of 129



Governance Index

6.04 # 23

on 1-10 scale out of 129

This report is part of the Bertelsmann Stiftung's Transformation Index (BTI) 2018. It covers the period from February 1, 2015 to January 31, 2017. The BTI assesses the transformation toward democracy and a market economy as well as the quality of political management in 129 countries. More on the BTI at <http://www.bti-project.org>.

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Key Indicators

Population	M	6.7	HDI	0.693	GDP p.c., PPP \$	9577
Pop. growth ¹	% p.a.	1.3	HDI rank of 188	110	Gini Index	48.0
Life expectancy	years	73.0	UN Education Index	0.637	Poverty ³	% 7.4
Urban population	%	59.9	Gender inequality ²	0.464	Aid per capita \$	8.5

Sources (as of October 2017): The World Bank, World Development Indicators 2017 | UNDP, Human Development Report 2016. Footnotes: (1) Average annual growth rate. (2) Gender Inequality Index (GII). (3) Percentage of population living on less than \$3.20 a day at 2011 international prices.

Executive Summary

The April 2013 general elections brought the Colorado Party back to power. The elections were carried out correctly; no party was excluded or discriminated against. In August 2013, Horacio Cartes assumed the presidency and Paraguay returned to a democratic routine. The positive evaluation of the electoral process abroad and the unambiguous result cleared the way for a reintegration of the new Paraguayan government into Mercosur and UNASUR.

President Cartes' government defined a comprehensive reform agenda. The main objectives of his government at the beginning included regaining fiscal stability, improving the infrastructure by engaging the private sector in public investment, more social investment and a resolute suppression of the rural insurgency of the Paraguayan People's Army (EPP). With its National Development Plan 2014-2030, the government defined some long-term objectives for Paraguay.

At the beginning, President Cartes was quite successful at obtaining the necessary legislative support from Congress to initiate his agenda. He received broader authority to deploy the military in the fight against the EPP. Congress approved a fiscal responsibility law, and a public-private partnership framework bill to facilitate and encourage infrastructure investments. Moreover, he introduced a new law for agribusiness to pay increased taxes.

However, the government has lost steam since 2014, making little progress with regard to its self-declared objectives (such as the planned public-private-partnership infrastructure investments). Moreover, resistance from within the government party has become stronger, occasionally blocking government initiatives. In December 2016, President Cartes vetoed the 2017 national budget after Congress introduced various modifications to the original budget proposal including large increases to public-sector salaries, a reduction in the approved volume of government bonds to be used for external financing, and a measure that encroached on the independence of the central bank.

Social discontent has led to various demonstrations (by students and small-scale farmers, for example) and strikes (including a general strike in December 2015). Despite the commitment of new resources to the fight against the Paraguayan People's Army (EPP), a guerrilla organization operating in the country's northern regions, the government has been unable to defeat the group. Moreover, the incidence of violence related to drug trafficking has increased, with government forces unable to control the violence in some areas of the country. Corruption has remained prevalent within the state and administrative cultures.

History and Characteristics of Transformation

Following elite power struggles, Paraguay's democratic transition began in 1989 after 35 years of dictatorship under General Alfredo Stroessner. The transition to democracy was characterized by extensive continuity among the elites in politics and the bureaucracy (public administration, military and judiciary) tied together in the still-governing Colorado Party. The era of presidents Rodríguez (1989 – 1993) and Wasmosy (1993 – 1998) was characterized by political instability and turmoil, and by the powerful role of the military. In 1996, a putsch by General Lino Oviedo, the commander-in-chief under President Wasmosy, failed. On March 28, 1999, President Raúl Cubas Grau – elected in 1989 and considered to be the puppet of General Oviedo – resigned to avoid impeachment for his alleged role in the March 23 murder of Vice President Luis María Argaña. After mass protests, especially by young Paraguayans, resulting in deaths and injuries, Cubas and Oviedo eventually left the country (for Argentina and Brazil, respectively), seeking political asylum.

After the resignation of President Cubas, the head of the Chamber of Senators, Luis Ángel González Macchi, was sworn in as the new president for the remainder of the term. In August 2003, Nicanor Duarte Frutos of the Colorado Party – elected in April of that year – assumed office. Despite high approval rates, however, Duarte's structural-reform push dissipated over the course of his term and politics refocused on power struggles within the Colorado Party and on President Duarte's re-election plans, thus reviving the political opposition and civil-society organizations. Fernando Lugo, bishop emeritus of San Pedro, one of the poorest departments in Paraguay, emerged as the leader of the opposition movement and was nominated as the candidate of the Patriotic Alliance for Change (*Alianza Patriótica para el Cambio*, APC).

On April 20, 2008, after 61 years of Colorado Party domination, Fernando Lugo won the presidential election, but his APC failed to win a majority in Congress. Most of the legal initiatives of President Lugo in the area of social politics were blocked. His coalition was internally divided, and some factions of the coalition often voted with the opposition. While the government did not advance its land reform plans, it did renegotiate the Itaipú Treaty with Brazil in July 2009. The renegotiation tripled the annual compensation payments from Brazil.

After the Colorado Party regained electoral strength in the 2010 municipal elections, the following years were marked by strategic maneuvering both within the government and in the opposition

camp with regard to the 2013 general election. President Lugo's support base was further debilitated after the eviction of landless farmers from a property occupied in the department of Canindeyú ended with a shoot-out that killed six police officers and 11 farmers. While political discontent increased, the Liberal Party initiated impeachment proceedings against President Lugo. On June 21, the Chamber of Deputies voted overwhelmingly (76-1) to proceed with the impeachment. The next day, the Senate voted to remove Lugo from office with a vote of 39 to 4. Surprisingly, there was not much public protest in the streets against the impeachment. As stipulated in the constitution, Vice President Federico Franco was sworn in for the rest of the presidential term ending in August 2013. The Mercosur and Union of South American Nations (UNASUR) countries interpreted the impeachment as an "institutional coup" and suspended the new Paraguayan government from both organizations.

The general elections on April 14, 2013, brought the Colorado Party back to power. In general, the elections were carried out correctly. Horacio Cartes, a successful and rich businessman, who had joined the Colorado Party only in 2009, won the election with 45.8% of the vote. The positive evaluation of the electoral process abroad and the unambiguous result cleared the way for a reintegration of the new Paraguayan government into Mercosur and UNASUR. In 2015, Paraguay took over the rotating presidency of Mercosur.

The BTI combines text analysis and numerical assessments. The score for each question is provided below its respective title. The scale ranges from 1 (worst) to 10 (best).

Transformation Status

I. Political Transformation

1 | Stateness

In principle, the state maintains a monopoly on the use of force nationally. However, especially in border areas and in the northeastern region, the Chaco, the state presence is weaker. Large areas of the country are sparsely populated; border controls as well as airspace controls are few. In the tri-border area where Paraguay, Argentina and Brazil meet, near the border city of Ciudad del Este and in the department of Amambay around its capital Pedro Juan Caballero, state institutions have failed to curb arms smuggling, drug trafficking and illegal immigration. The public-security situation has deteriorated in some parts of these regions, with police forces unable to control violence related to drug-trafficking organizations. Conflicts between drug traffickers in the trilateral border area sometimes feature the use of heavy weapons (as when Jorge Rafaat Toumani was killed in 2016). The First Capital Command (Primeiro Comando da Capital, PCC), which according to Insight Crime is Brazil's largest and best-organized criminal organization and controls drug-trafficking routes between Brazil, Bolivia and Paraguay, is also active here.

The government of the United States sees Paraguay as a center for money laundering. Paraguay is the principal producer of marijuana in South America, a significant transit country for drugs (cocaine) and is also becoming a processing location for cocaine.

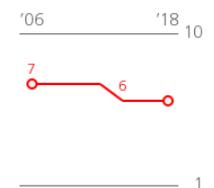
In the course of conflicts between landowners and landless small farmers, the police have clashed violently with peasants who have occupied land, resulting in casualties. The legal status of disputed land has not been definitively clarified by either the administration or judiciary, a fact that has exacerbated the conflicts.

For a number of years, the Paraguayan People's Army (EPP) has carried out attacks in the countryside (with isolated acts in Asunción). The group has attacked military and police outposts and patrols, private-security guards, and ranchers; has kidnapped prominent figures in order to obtain ransom funds; and has carried out attacks with explosives. While the EPP poses no real threat to the state or government as a whole,

Question
Score

Monopoly on the
use of force

6



it has revealed the ineffectiveness of state and local security forces. Despite an increase in the military and police resources devoted to this issue, the Cartes government has not made discernable progress in the fight against the EPP.

All citizens enjoy civil rights protections in theory. In practice, however, indigenous groups' rights are often neglected by the government. This is partly because indigenous groups are small (around 113,000 people or 1.8% of the population in 2012) and partly because they are poorly organized. Property interests of the indigenous peoples are not adequately protected and many have been displaced from ancestral lands. Mestizos, or citizens of mixed racial background, make up 95% of the population. The constitution recognizes Paraguay as a multicultural, bilingual country, with Guaraní and Spanish as the official languages. The numbers vary strongly, but between 40% and 60% of Paraguayans communicate predominantly in Guaraní and between 60% and 90% are bilingual.

There is a significant population of Brazilians in the border area (the so-called Brasiguayos), with estimates of between 300,000 and 600,000 people. Many are landowners in possession of large parcels of arable land used for soybean production (about 14% of all farms with more than 1,000 hectares are owned by Brazilians; 9% by other foreigners). The loyalty of such landowners lies more with Brazil than with the Paraguayan state, and the Brazilian government defends its interests against expropriation and expulsion. The possession of large tracts of land by foreigners adds a special dimension to the conflict over land in Paraguay. In a nutshell, apart from the few state conflicts based on issues of social exclusion, the nation-state is widely accepted.

Church and state are separate, according the constitution. However, as a pressure group, the Catholic Church has considerable influence on certain subjects discussed in bills introduced by Congress, such as abortion, divorce or gay marriage. The Catholic Church is also constantly voicing its concern about corruption, social inequality and poverty, as well as of the system of justice in Paraguay. Around 90% of the population is Roman Catholic, with another 6% belonging to evangelical Protestant denominations. Other religious groups constitute less than 5% of the population. An estimated 135,000 to 150,000 people, concentrated in remote areas of the central Chaco and some eastern regions, are members of the Mennonite Church.

Some religious groups have expressed concern that the government disproportionately supports Catholic schools and does not pay many of the teachers working in registered non-Catholic religious schools. Labor unions and human-rights organizations report favoritism by Mennonite employers in hiring indigenous laborers who have converted to the Mennonite faith over those who have not.

State identity

9



1

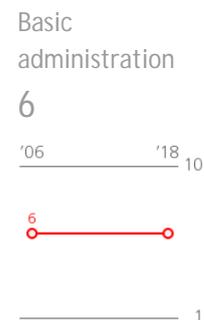
No interference of religious dogmas

9



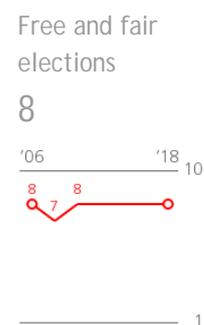
1

The state maintains a functioning basic infrastructure throughout most of the country, including staffing administrative institutions, hiring officials, administering justice and making and implementing government policies. But corruption and the political colonization of the administration have affected the functioning of the state. The courts and law enforcement are heavily compromised because of structural corruption. As well, there is a low state presence in the San Pedro, Amambay and Chaco regions. The administration of basic infrastructure such as roads, water services, education and health care generally functions but is flawed in some rural areas. According to the World Bank's 2016 World Development Indicators, 98% of the population had access to clean water in 2015, and 89% had access to sanitation facilities.



2 | Political Participation

The general elections on April 14, 2013, which brought the Colorado Party back to power, were carried out correctly, and no party was excluded or discriminated against. The EU electoral observation mission did not register any complaints regarding systematically biased action on the part of the electoral administration with respect to any relevant aspect of the electoral process. Small parties do not consider the electoral administration to be independent, as minority parties are excluded from positions of responsibility.



Media outlets of various kinds covered the electoral campaign in a free and active manner. Although the constitution forbids media-company owners from standing as candidates in presidential, legislative or local elections, the EU electoral observation mission learned of several candidates who own radio stations or TV networks, or who exercise direct influence over media companies owned by close relatives.

Parties that comprise the whole political spectrum from right to left participated. Both freedom of assembly and freedom of expression were ensured. Turnout in the last presidential election was quite high by Paraguayan standards (68.2% in 2013, compared with 65.5% in 2008). In the November 2015 municipal elections, turnout reached 56.5%, more or less the same rate seen in the 2010 elections (56.9%).

National and municipal elections largely satisfy the formal requirements of a liberal democracy. However, patronage and political dependencies (particularly in the civil service and the Supreme Electoral Court) influence the election process. Vote buying, extortion and irregularities are still practiced both within political parties' internal elections and national elections. The majority of Paraguayans vote, but because few are willing to switch party allegiances, the quality of democracy is low.

Democratically elected representatives have the power to govern, and the influence of veto powers, especially the military, has declined. The military is plainly subordinated to civilian government control.

However, due to the mobilization power and economic influence of landowners, land reform and the taxation of agricultural exports have been repeatedly blocked before such plans could be seriously debated in Congress. Landowners (especially soybean producers and cattle ranchers) have enough power to avoid taxes altogether, or to evade those they are obliged by law to pay. Economic growth in Paraguay is based essentially in the agribusiness sector. However, tax revenues have not increased at the same pace as GDP, an indication of significant tax evasion in rural regions.

In addition, other business sectors have been able to persuade Congress and the executive to enact laws expanding VAT and corporate-income tax exemptions. The country has a low overall rate of taxation (12%–13% of GDP), which is clear evidence of economic pressure groups' veto power. The Brazilian government occasionally meddles in the internal affairs of Paraguay to defend the interests of its citizens (mostly landowners) who live within Paraguay's border areas.

The freedoms of association and assembly are guaranteed by the constitution. Independent political and civil society groups are generally allowed to form.

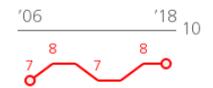
However, there are legal and bureaucratic barriers to the possibilities of union organization due to a high minimum membership requirement. Private-sector employers oppose the formation of unions. Laws that prohibit union discrimination are not always enforced. Rights violations and anti-union practices remain commonplace, both in the private and public sectors. Labor legislation does not promote trade union activities. The level of unionization is around 11% of the formal labor force.

Farmers have largely organized around the land problem in Paraguay and they have lately demanded a more comprehensive agrarian policy for smallholders. The main organization is the Federación Nacional Campesina (FNC). The Liga Nacional de Carperos is of recent formation and without the weight of the FNC. However, in total, only 4% of workers are covered by collective bargaining.

Social discontent has led to various demonstrations (by students and small farmers, for example) and strikes (including a general strike in December 2015). In general, these mobilizations and citizen protests have been tolerated and not subject to repressive action.

Effective power to govern

8



1

Association / assembly rights

8



1

Freedoms of opinion and of the press are constitutionally guaranteed and in general, citizens can express their opinions freely. In the 2016 Latinobarómetro survey, 63% of Paraguayans (as compared to a Latin American mean of 51%) affirmed that people can say what they want or offer criticisms with virtually no restrictions. Legislation guaranteeing access to public information was approved quite recently. In October 2014, a freedom-of-information law was introduced, requiring public institutions (including Congress) to divulge information (for example, related to salaries and contracts). The corresponding regulatory decrees were enacted in September 2015. Investigative journalists have used the new law to uncover corruption networks.

There is a pluralistic media sector, including private and public radio and TV broadcasters. Generally, media pluralism is threatened by the consolidation of ownership and by the influence that political parties and economic interest groups exert on the media. There are no legal limits on media concentration, the degree of which has increased in recent years. Four media groups dominate the market, with one group linked directly to President Cartes. The National Telecommunications Commission (CONATEL), which grants and denies broadcasting licenses, is not autonomous. A 2011 law limits the broadcasting power (to 50 watts) of community radio stations and prohibits them from accepting advertisements.

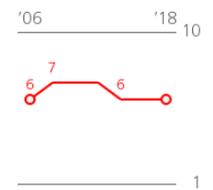
In addition to the oligopolistic character of ownership among the country's principal media companies, a company owned by the current president has over the last year purchased a significant quantity of media organizations, including newspapers and digital journals, and TV and radio stations. The government has furthermore put pressure on rural radio stations to broadcast government propaganda, at the same time that the president's company has begun purchasing radio stations in the countryside. These factors indicate that Paraguay is heading down a dangerous path toward monopolization of the news media by a single political party or even by the president's personal interests.

Journalists critical of the government are sometimes physically threatened. Some reporters have even been killed, especially when focusing on corruption or organized crime (especially in remote border areas). Reporters have also been threatened by the EPP. In 2015, one Paraguayan journalist was killed in Brazil in an attack attributed to a transnational organized crime group. Defamation and libel laws can be used to intimidate journalists and media owners, but this has become decreasingly common in recent years. Freedom House classifies Paraguay as partly free with regard to press freedom. It is ranked 29th (out of 35) in the Americas on this issue.

The government does not restrict internet access or content. About 44% of the population has access to the internet. In the 2016 Latinobarómetro survey, 32% of Paraguayans (compared to a Latin American mean of 21%) declared that the internet was their principal source for political information. A recent study by the Institute for the Integration of Latin America and the Caribbean (INTAL) and El País indicated that social networks are widely used in Paraguay.

Freedom of
expression

6



3 | Rule of Law

Paraguay has enshrined the separation of powers and mutual checks and balances in its constitution. These checks and balances function particularly well when the president does not have a majority in Congress. The Supreme Court may also act independently, even though judges are selected according to political criteria and quotas; newly elected presidents have repeatedly attempted to change the composition of the Supreme Court. In comparison with the constitutional attributes of other Latin American presidents, the Paraguayan president is not strong. Congress demonstrated its strength by unseating President Lugo in the June 2012 impeachment. In this case, the impeachment was realized as a no-confidence vote against the president by the congressional majority. Therefore, in a certain way, Congress did not respect the basic principles of a presidential system, in which both president and legislature have a separate electoral mandate (dual legitimacy) for a fixed term. While President Cartes has sought to consolidate presidential powers, for example, with regard to the nomination of ministers and control over the budget, he has had to adjust his policy to take account of congressional majorities. For example, in December 2016, he vetoed the 2017 budget after a majority in Congress, including members of his own party, had made significant modifications to the original proposal including a reduction in the value of bonds to be released by the government. In June 2016, a member of the opposition was elected as president of the Senate with the support of a dissident Colorado Party faction.

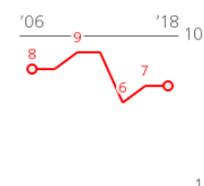
On the whole, the judiciary is the subject of as well as an actor in recurring power struggles merely at the margins of the rule of law, sometimes fostered by ambiguities of the constitution itself.

The murder of a journalist by hitmen in October 2014 had brought the corruption of judges and the infiltration of the judiciary by drug traffickers and organized crime into the public spotlight. The president of the Council of Magistrates, who has disciplinary power over the magistrates, declared in November 2014 that 25% of the judges in Paraguay are corrupt. Under pressure from the media and the public, President Cartes and members of Congress from all parties asked for a cleanup of the judiciary and initiated impeachment procedures against four of the nine Supreme Court judges (as a result, one resigned voluntarily) and one judge of the Supreme Electoral Court (who also resigned).

The cleanup of the judiciary might be a strategy to deflect criticism away from corrupt politicians. The effort has to some degree been undermined by partisan interests. Moreover, there is a high risk that future nominations to the Supreme Court will be – as in the past – subject to political bargains and quotas between the Colorado Party and the Liberal Party. Significant political interference is evident within the Judicial Council (Consejo de la Magistratura), which evaluates judge nominations and

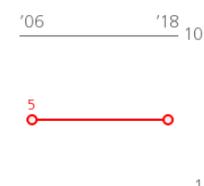
Separation of powers

7



Independent judiciary

5



submits nominees' names to Congress and the executive, and is also involved in the impeachment of judges.

Impeachment motions were active against seven Supreme Court judges in 2016. Two of these motions have been pending since 2014. However, none of these motions advanced in 2016.

Corruption is still a central feature in state and administrative culture; many of the state's resources are distributed based on patronage networks. The Global Competitiveness Report (2016 – 2017) lists corruption (18.2%) as the most problematic factor for doing business in Paraguay, while the inefficiencies of the government bureaucracy are ranked fourth (13.6%). In the 2016 Latinobarómetro Survey, 18% of respondents said they or their relatives had heard of acts of corruption within the last 12 months.

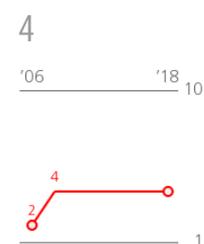
Officeholders who break the law and engage in corruption are not prosecuted adequately. The resulting impunity is closely related to high levels of structural corruption, which include the judiciary and the infiltration of the political and judicial system by organized crime (especially drug-trafficking groups). At the level of political leadership, corrupt officials have been prosecuted in isolated cases, but they often take advantage of legal and procedural loopholes or they can count on political connections. The vast majority of suspected cases of political corruption are not prosecuted. However, corruption charges have also been used politically, creating a significant difference between actually prosecuted cases of corruption and accusations in the mass media.

Nevertheless, there have been some spectacular cases. In May 2015, the national police chief was removed because of a corruption scandal. In September 2015, the rector of the National University of Asunción, a political appointee, had to resign following massive student protests related to corruption allegations, and was subsequently arrested. A month later, the attorney-general opened investigations against former President Federico Franco related to allegations of illicit enrichment and money laundering.

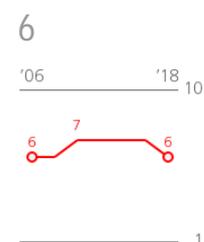
Civil liberties are largely secure. There are no political prisoners. While a new code of criminal procedure, introduced in 1999, better protects the rights of the accused, deficiencies in the rule of law result from the prolonged duration of proceedings and investigations. Conditions in the country's overcrowded prisons have repeatedly sparked criticism. In June 2016, five inmates and a guard died during a fire in Paraguay's largest prison (Tacumbú). However, some progress has been made with the construction of new prisons. There are repeated reports of excesses by the security forces, including torture, illegal arrests and extralegal executions.

Human-rights defenders working to promote small farmers' rights have been harassed and threatened. There have been irregularities in the judicial proceedings

Prosecution of office abuse



Civil rights



against 11 imprisoned campesinos related to the violent incidents that led to the impeachment of Fernando Lugo. Parts of Paraguayan society see these figures as political prisoners. In July 2016, they were given prison sentences ranging between four and 30 years associated with their responsibility for the death of six police officers. However, nobody was charged for the death of 11 peasant farmers. Additionally, human-rights organizations claim that the fight against the EPP has been militarized and that human rights have not been sufficiently respected.

Whereas an increasing number of laws and international treaties protect the rights of indigenous people, they have not always been sufficiently respected. Decisions of the Inter-American Human Rights Court in favor of indigenous communities have been executed only after great delays. Paraguayan law accords indigenous persons the right to participate in the country's economic, social, political and cultural life, but the law has not been enforced sufficiently strongly to ensure that indigenous peoples' human rights are respected – particularly their fundamental right to self-determination and their rights to their own lands, territories and natural resources. A 2015 special rapporteur report for the Human Rights Council noted a widespread lack of legal protection for indigenous peoples' rights to control their own lands, territories and resources, which are vital to their survival and ability to uphold their dignity. Although there are no legal impediments to participation by minorities or indigenous persons in government, no indigenous persons or minority-population members served during the review period as a governor, in the cabinet or legislature, or on the Supreme Court.

No laws explicitly prohibit discrimination against LGBTI persons with regard to employment, housing, access to education or health care. Such discrimination, including societal discrimination, occurs frequently.

In December 2016, the Chamber of Deputies passed Law 5,777 relating to the comprehensive protection of women from all forms of violence. Femicide was recognized as a distinct criminal offense punishable by a minimum of 10 years' imprisonment. In September 2015, the Inter-American Commission on Human Rights (IACHR) ordered the Paraguayan government to give a 10-year-old rape victim access to a medically necessary abortion. The Paraguayan government did not comply.

4 | Stability of Democratic Institutions

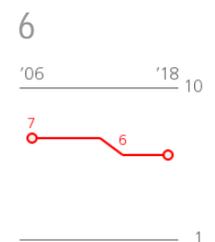
Democratic institutions perform their functions, but frictions can arise in the interplay between the president and the legislature. In the case of President Lugo's impeachment in 2012, Congress did not respect the basic principles of a presidential system, in which both president and Congress have a separate electoral mandate (dual legitimacy) for a fixed term. Instead, Congress used the impeachment procedure as a no-confidence vote against the president.

In August 2013, Horacio Cartes assumed the presidency and Paraguay returned to a democratic routine. While Cartes' party has a majority in the Chamber of Deputies and he has signed a political pact with the main opposition party, there are shifting voting coalitions in Congress and a great deal of conflict over petty politics. The Paraguayan Congress has wide-ranging authority. Governing and lawmaking are complicated by the fact that the governing party and the most important opposition party are both composed of competing factions. In addition, the effect of politics on public administration is another serious flaw in the interplay of democratic institutions. The public administration is highly politicized and is quite inefficient, which in turn hampers public-sector reforms, such as the professionalization of administration. Clientelistic networks that subvert political institutions are much stronger at the regional and the local levels. Finally, the judiciary is not really independent, and does not effectively serve an oversight role as a counterbalance to the government and parliament. It is highly politicized and corrupt.

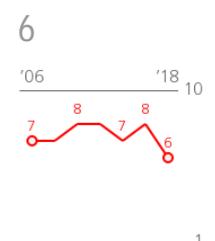
Though most democratic institutions are accepted as legitimate by most relevant actors, political elites frequently display a lack of respect for democratic norms. The 2012 impeachment of President Lugo, though complying with formal constitutional requirements, was clearly driven by political-electoral motives. The subsequent general elections in 2013, which brought the Colorado Party back to power, were carried out correctly. Both the freedom of assembly and the freedom of expression were respected. Ex-President Lugo was elected to the Senate, and was not hindered from exercising his mandate. If the constitution is rewritten so as to allow presidential re-election, he might once again become a candidate for the presidency.

Before President Cartes gave up his re-election plans in April 2017, his re-election bid had placed further strain on political institutions and raised questions regarding the constitutionality of his strategy. When the Senate voted down a constitutional amendment proposal in August 2016, another similar vote would have been possible only in August 2017; moreover, even if a positive vote had been achieved, a referendum would still have to follow. Time constraints would thus have precluded Cartes' candidacy in the 2018 general elections. However, the Colorado Party – despite the opposition of the majority portion of the Liberal Party and a dissenting faction within the Colorado Party – was collecting signatures and campaigning for a

Performance of democratic institutions



Commitment to democratic institutions



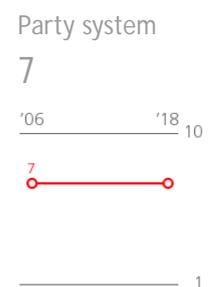
referendum to be held before August 2017. Adversaries of President Cartes were campaigning in favor of impeaching him for seeking re-election and not respecting the rules as defined by the constitution. After the violent protests in April 2017, Cartes renounced his re-election drive, though the re-election issue as such remains on the political agenda.

5 | Political and Social Integration

Even though Lugo's election in 2008 seemed to point to a change in the Paraguayan party system, it is still dominated by two traditional parties, the Colorado Party and the Liberal Party, which is the major opposition party. Each has been operational for more than 100 years. The effective number of parties was 2.39 in the Chamber of Deputies after the 2013 election, and 3.53 in the Senate. After the 2015 municipal elections, the two parties together still controlled nearly 90% of the municipalities. In 80% of municipal contests, the effective number of parties did not surpass 2.2, a figure corroborating the dominance of the two parties in the Paraguayan political system. The Colorado Party won the presidential election in 2013 and is still the strongest party. During more than 60 years in power, the party has created a close-knit patronage network. But this is also true for the Liberal Party, especially in the party's municipal and departmental strongholds.

Nevertheless, party discipline is low, and parties consist of multiple factions. Both traditional parties have a broad social base. Direct elections for executive offices in the party and the nomination of candidates for elective office generate possibilities for mobilization in both traditional parties. The Colorado Party had 2.2 million registered members in 2015. However, around 855,000 persons are affiliated with more than one party. Due to patronage networks, the parties function only partially as instruments for articulating and aggregating social interests. The internal fragmentation of the two parties among competing party leaders is also typical, though stronger in the Colorado Party. At the end of 2016, there were three Colorado factions (plus one independent Colorado deputy) in the Chamber of Deputies, and two Colorado factions in the Senate. While the left now has seven out of 45 seats in the Senate, and former President Lugo is one of the senators, it remains in a minority position. Moreover, the left is divided.

In the 2016 Latinobarómetro survey, only 14% of Paraguayans interviewed (2013: 6%; Latin American mean 2016: 20%) classified themselves as being on the political left on a left-right scale (choosing positions 0–3 on a ten-point scale); 22% were on the right (positions 7–10; down from 31% in 2013; Latin American mean 2016: 28%); and 52% placed themselves in the center (positions 4–6; up from 44% in 2013; Latin American mean 2016: 36%). A total of 12% gave no answer or said they didn't know. Thus, the Paraguayan electorate is basically a center-right electorate (74%), which is



reflected in the dominance of the Colorado Party and the Liberal Party. However, support for the left has increased since 2013, while support for the right has decreased.

Compared to political parties, the system of social interest groups is weak. It is politically fragmented and dominated by only a few issues. Although there is a large number of small-scale organizations at the community level (such as neighborhood organizations), they are poorly interconnected and few ties exist between them and nationwide associations, limiting their ability to articulate common interests. There is no link to political parties in terms of collateral organizations, although one of the umbrella labor groups has a relationship with the Colorado Party.

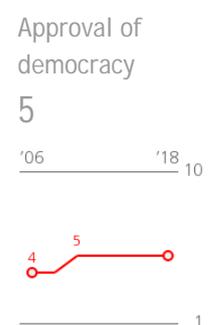
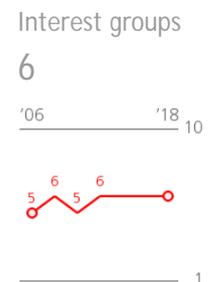
Manufacturers are organized under the Unión Industrial Paraguaya (UIP). The labor movement, however, is weak and fragmented. There are currently several competing trade union federations. Strong organizations represent the interests of rural landowners (cattle ranchers and soybean producers), like the Asociación Rural del Paraguay (ARP), Coordinadora Agrícola de Paraguay (CAP), the Asociación de Productores de Soja (APS) and the Confederación Paraguaya de Cooperativas (CPC).

Peasants in Paraguay have a long tradition of struggle around land and other rural issues and today they remain the main and most important social movement in Paraguay. They are organized in the Federación Nacional Campesina, which, however, often lacks adequate means for articulating and promoting its demands within political institutions. This is related to the fact that the traditional political parties still have very profound roots in the countryside in Paraguay and they are able to water down campesinos' demands and behavior on election days.

Over the last two years, a strong new social movement has developed in Paraguay, as secondary-school and university students have mobilized and demonstrated in support of greater education expenditures (as a percentage of GDP), improvements in school infrastructure and a higher quality of education, and against corruption and authoritarianism in educational institutions. The mobilization of secondary students led to the resignation of the minister of education in 2016. Protest by university students led to the removal of the president and all deans of the National University.

Support for democracy has traditionally been low among Paraguayan citizens (33% in 2007), but rose substantially after the election of Fernando Lugo, to 53% in 2008, according to the Latinobarómetro surveys. After declining through 2015 (44%), it increased by 11 percentage points to 55% in 2016 (compared to a Latin American mean of 54%).

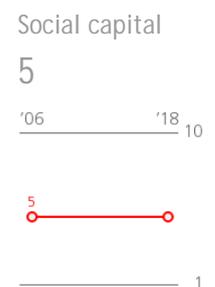
In the 2015 Latinobarómetro survey, only 14% of respondents said they felt represented by Congress (compared to a Latin American average of 23%). In 2016, only 10% agreed that the country was governed for the common good of the people (Latin America as a whole: 22%), while 88% said the country was governed in the



interest of and for the benefit of small powerful groups (Latin America: 73%). The work of the government was approved by 26% of respondents in 2015, and by 29% in 2016. In 2016, 52% of the population agreed with the statement that the political sphere and politicians had lost trustworthiness, and would be unable to recover it (Latin America: 46%).

Compared to the rest of Latin America, a relatively high percentage of the population is open to the idea of an authoritarian solution. In 2016, 59% of Paraguayan respondents (Latin American mean: 47%) agreed that it would not matter if an authoritarian government came to power if it was able to solve the country's economic problems. A total of 61% of respondents (Latin American mean: 52%) said they would prefer a well-regulated society with some liberties restricted to a society where liberties and rights were respected, but some disorder was evident. In contrast, 37% said they would prefer the latter society (Latin American mean: 44%).

Autonomous organization in civil society is uneven. Groups face various socioeconomic barriers to organizing, and there is a general lack of civic culture. The question remains whether citizens participate in independent or clientelistic organizations. There is a large number of small-scale organizations at the community level, however, and more than two-thirds of the Paraguayan population is active in such organizations. But their main objectives are usually limited to immediate measures, such as building roads or improving the local water supply. A characteristic of Paraguayan organizing is the strong division between small-scale social groups and solidarity on a community level, and other types of civic engagement that is oriented toward the common good. Trust within the population is still at a low level, but has strengthened somewhat in recent years; according to the 2016 Latinobarómetro survey, 20% of Paraguayans said they trusted their fellow citizens (2011: 22%; 2010: 14%), which is higher than the Latin American average (17%). According to 2014 LAPOP survey data, community participation in Paraguay is not very high (around 12%), but is higher than in most other Latin American countries.



II. Economic Transformation

6 | Level of Socioeconomic Development

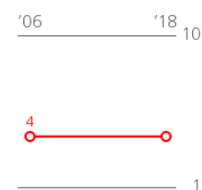
Paraguay is a lower-middle-income country with gross national per capita income (PPP) of \$9,198.5 in 2015. It is ranked 112th out of 188 countries in the 2015 Human Development Report (with a HDI value of 0.679) and is classified as a medium human development country. Paraguay's HDI value (data relate to 2014) is above average (0.630) for countries in the medium human development group, but below the average (0.748) for countries in Latin America and the Caribbean. If adjusted for

Question
Score

Socioeconomic
barriers
4

inequality, Paraguay's HDI value falls by 22.1% (with a IHDI of 0.529). As per the Human Development Report for 2015, the country's Gender Inequality Index ranking was 101st out of 155 countries, with a score of 0.472 (as compared to 0.415 for the overall Latin America and the Caribbean region).

Social exclusion is quantitatively and qualitatively extensive and structurally ingrained. The degree of income inequality is significant, but the country's Gini index value declined between 2011 (0.52) and 2015 (0.48). Inequality in land distribution increased during the last decade. In 2015, 1.5 million people were living in poverty. The poverty rate expressed as a percentage of the population fell to 22.2% in 2015 (national statistics by DGEEC) from 22.6% in 2014. Moreover, the share living in extreme poverty fell from 10.5% of the population in 2014 to 10.0% in 2015. The incidence of poverty in rural areas is three times as high as in urban areas. A total of 72% of the families in extreme poverty (494,000 out of 687,000) live in rural areas.



Economic indicators		2013	2014	2015	2016
GDP	\$ M	28965.9	30881.2	27282.6	27440.6
GDP growth	%	14.0	4.7	3.0	4.1
Inflation (CPI)	%	2.7	5.0	3.1	4.1
Unemployment	%	5.0	6.0	5.3	5.4
Foreign direct investment	% of GDP	0.3	1.5	1.2	1.4
Export growth	%	18.4	4.3	-1.3	3.0
Import growth	%	6.8	5.3	-4.0	-0.8
Current account balance	\$ M	477.4	-127.0	-462.0	-
Public debt	% of GDP	17.0	19.7	24.0	24.6
External debt	\$ M	15710.0	16495.0	16124.9	16323.4
Total debt service	\$ M	1648.5	3065.7	2189.9	1310.7

Economic indicators		2013	2014	2015	2016
Net lending/borrowing	% of GDP	-1.4	-0.1	-2.0	-
Tax revenue	% of GDP	12.0	12.7	12.9	-
Government consumption	% of GDP	12.3	12.3	12.8	11.9
Public education spending	% of GDP	-	-	-	-
Public health spending	% of GDP	4.8	4.5	-	-
R&D expenditure	% of GDP	-	0.1	0.1	-
Military expenditure	% of GDP	1.3	1.3	1.4	1.3

Sources (as of October 2017): The World Bank, World Development Indicators | International Monetary Fund (IMF), World Economic Outlook | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database.

7 | Organization of the Market and Competition

Market-based competition operates under a weak institutional framework. Free-market competition and the protection of property rights are limited by endemic corruption and political influence in government administration and the judiciary. Regulations are sometimes inconsistent and often not implemented. The informal sector is large, and economic activity is characterized by many small and very small enterprises.

Public enterprises produce around 7% of GDP. There is a strong state presence in telecommunications (though this is challenged by private cellular telephone companies, as most Paraguayans use cellular phones rather than land lines), electricity production, gas and oil refineries (albeit with increasing competition), cement production and water industries. However, state telecommunications and water companies are weak in terms of service coverage. The government controls the price of fuel and public-transport fares. In addition, the government sets the minimum wage, which however is often not adhered to. Around 10% (more than 300,000 employees) of the workforce is employed in the public sector, which increased by 32% (almost 70,000 jobs) between 2007 and 2014. There are no formal restrictions on capital investments and capital movements, but domestic companies are favored in government procurement bids.

The informal sector is large and includes, apart from licit but unregistered activities, cross-border smuggling and the illegal production and sale of narcotics, pirated music, stolen automobiles and weapons. Some 50.6% of employment in the urban sector is informal (men 45.6%; women 56.9% for 2014). The Index of Economic Freedom (2016) ranks Paraguay 16th out of 29 countries in the Americas, and 83rd in a global ranking. According to the index, the Paraguayan economy is 61.5% free

Market-based competition

4

'06 '18 '10

5 4

1

(regional average 59.9%), and is categorized as moderately free. The Global Competitiveness Index for 2016 – 2017 ranks Paraguay 117th out of 138, and 131st with regard to institutions. The most problematic factors for doing business are corruption, inefficient government bureaucracy, an inadequately educated workforce and inadequate infrastructure.

The formation of monopolies is generally prohibited by Article 107 of the national constitution. An antitrust law, the Law on the Defense of Competition, was introduced in June 2013. It aims at targeting anti-competitive agreements, abuse of dominant position and predatory pricing. But in practice, monopolies are rarely split up. While oligopolies exist in the private sector (banking, supermarkets, mass media), the state holds a monopoly in some sectors such as telecommunications (Corporación Paraguaya de Comunicaciones, holding the monopoly on fixed-line voice services, including local telephony, international long-distance telephony, and VoIP) and electricity (Administración Nacional de Electricidad, ANDE). The Global Competitiveness Index for 2016–2017 ranks Paraguay 125th (GDI 2014–2015: 128th) out of 138 concerning the effectiveness of anti-monopoly policy.

With total exports and imports accounting for 84.5% of GDP in 2015 (CEPALSTAT), Paraguay's foreign trade share is among the highest in the region, though exports are highly concentrated on a few products (soy, grains and meat). The country's membership in the Southern Cone Common Market (Mercosur) has largely liberalized trade with Argentina, Uruguay and Brazil. The weighted average tariff rate is 4.4%, but non-tariff barriers exist. In addition, cumbersome and time-consuming customs procedures, as well as burdensome labeling procedures, add to the cost of trade. Paraguay has repeatedly addressed these customs procedures, which it perceives to be unfair and exaggerated, within the Mercosur framework. In the World Bank 2017 Doing Business Report, Paraguay was ranked 106th out of 190 countries, in the specific ranking of "trading across borders" it ranked at 116th. It has improved its rank since 2011 by introducing a single window for exporting, reducing the time required for border and documentary compliance. Paraguay has to date been involved in 20 WTO trade disputes, but only as a third party.

After several banking crises in the 1990s and early 2000s, the legal and regulatory framework of banking supervision has improved considerably over the last years and become more risk-based, increasingly meeting international standards. Public financial institutions, such as the National Development Bank (BNF), the Development Financial Agency (AFD) and the central bank (BCP) have been strengthened. The Superintendence of Banks (SIB) within the BCP is responsible for the supervision of the financial sector. A new penal code with enhanced penalties for money-laundering crimes came into effect in July 2009. A new electronic information system to report suspicious financial transactions has been introduced, and a new anti-money-laundering plan was launched in June 2013. Moreover, a regulatory framework for cooperatives has been implemented, although there is no deposit-

Anti-monopoly policy

3

'06 '18 10



Liberalization of foreign trade

8

'06 '18 10



Banking system

8

'06 '18 10



guarantee system for this sector. However, the non-banking financial sector – especially exchange houses – still operates in a weak regulatory environment with limited supervision. In 2015, the government introduced legislation to give the central bank more regulatory powers; when these are implemented, the country will comply with 90% of the core Basel principles for effective banking supervision (up from 70% today).

Banks are well capitalized, and show strong profits. Most lending facilities are short term. Long-term financing for capital investment projects is scarce. As of 2014, the country's financial system consisted of 17 banks with a total of \$18.1 billion in assets and \$13.3 billion in deposits. Non-performing loans in the banking sector totaled just 1.8% of total loans in 2014 and 2.5% in 2015, and the sector's capital-to-assets ratio was 9.8% (2015).

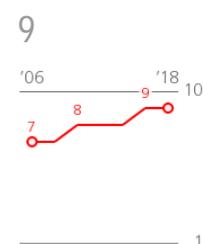
8 | Currency and Price Stability

Controlling inflation and a suitable foreign-exchange policy are recognized goals of government economic policy. Inflation is under control (2014 rate: 4.2%; 2015: 3.1%; September 2016: 3.5%), and has stayed within the range established by the central bank (4.5% +/-2%). In November 2016, a new law was approved calling for the national minimum wage to increase every year by the rate of inflation, provided this is below 10%. Paraguay has a floating exchange rate. Because of close ties to its two big neighbors in the Mercosur, the Paraguayan currency (guaraní) depends on the economic development and currency rates (measured against the U.S. dollar) in Argentina and Brazil. The guaraní depreciated by 25.3% against the U.S. dollar in 2015 due to a decline in prices for exports from the country's primary sector (especially soy), but subsequently gained back a portion of its value, appreciating by a total of 6% through September 2016. The central bank (Banco Central del Paraguay, BCP) coordinates monetary policy, taking into account the baseline of government economic policy. The BCP's independence from political pressures has been strengthened over time.

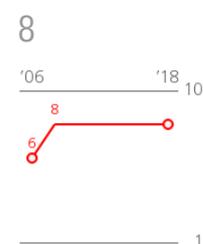
Generally speaking, the government pursues a consistent policy for macrostability, resulting in strong economic fundamentals (low debt, sizable official reserves and small fiscal and external imbalances).

State revenues increased during the review period thanks to an expansion of the country's tax basis and higher incomes from the sale of energy by the binational companies Itaipú and Yacyretá. For several years, Congress had postponed introduction of a 10% personal income tax, which had been established by law. However, this finally went into force in August 2012. Moreover, new taxes (VAT and income) for the agricultural sector were approved in 2013. However, due to the postponement of VAT application within certain sectors (such as cooperatives) and a

Anti-inflation /
forex policy



Macrostability



generous system of tax deductions, tax revenues increased by only 3.4% in 2015. Tax revenues are now estimated at 12.5% of GDP (2015).

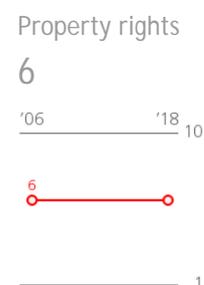
The 2013 Fiscal Responsibility Law establishes budget-deficit limits of 1.5% of GDP starting in 2015. However, in December 2014, Congress approved an amended budget that boosted the 2015 fiscal deficit to 1.8% of GDP (2014: 1.1%). The 2016 deficit was expected to be around 1.5% of GDP. Due to the fiscal deficits in the past years, the central government debt rose from 17.7% of GDP in 2014 to 19.7% in 2015 and 22.3% in 2016. However, this level is still among the region's lowest as a percentage of GDP.

The government has resorted to external borrowing to finance portions of its deficit. In January 2013, the Paraguayan government successfully issued a \$500 million ten-year sovereign bond in the international financial market (with a yield of only 4.625%). Another 30-year bond for \$1 billion (with a yield of 6.1%) was issued in August 2014, with a reopening in April 2015 in which an additional \$280 million was issued. An additional 10-year sovereign bond issue of over \$600 million (with a yield of only 5%) was released in March 2016. Half of the bond's revenues were earmarked for public investment, with the rest being used to refinance old debt. Another bond issue was planned for 2017. As a consequence, external debt increased to nearly 17.1% of GDP in 2016, but is still low compared to other Latin American countries. Standard & Poor's and Fitch's credit ratings for Paraguay are both BB, while Moody gives the country a Ba1 rating.

The Global Competitiveness Index (GCI) 2016–2017 ranks Paraguay at 60th place out of 138 countries with regard to macroeconomic environment, down from 54th place in the GCI 2014–2015. This indicator covers the government's budget balance, gross national savings, inflation, government debt and the national credit rating.

9 | Private Property

Property rights and the regulation of the acquisition of property are generally well defined, but there are problems with their implementation under the rule of law, not least of all because of inefficiency and corruption in the judicial system. Land titles are often ill-defined, especially in the agricultural sector. A latent and sometimes violent conflict exists between interests, in which large agricultural corporations (some of them foreign-owned) look to consolidate and expand holdings, while the landless and small farmers seek agrarian reform and land redistribution. Protesters often occupy land, which generates conflicts that often encourage conduct outside the rule of law. Acquiring the necessary documents for land titles takes much time and a comprehensive cadaster is not in place, adding to conflicts over land titles, and thus property rights. The World Bank (2017) ranks Paraguay 76th out of 190 countries with regard to the ease of registering property, while the 2016 Index of Economic Freedom ranks Paraguay 92nd concerning property rights.



Private activities represent the backbone of the economy, but concentration of market power is tolerated by the state, for instance, in the media sector. In some sectors, such as telecommunications, electric-power generation, oil refineries, cement production and water services, state enterprises exercise a monopoly or subvert fair competition. Ports and airports are also managed by state-owned enterprises. Privatization programs came to a halt during the administration of President Duarte. They proved to be very unpopular because of repeated major irregularities, a lack of transparency and a number of corruption charges. Privatization programs had no future under the Lugo presidency. However, in 2009, the government signed an agreement with the IMF to regularly monitor the performance of state companies.

The current government has passed new laws allowing for more private-sector activities in cooperation with the public sector (private-public partnerships, or PPP) to facilitate and encourage infrastructure investments.

Foreign investors are guaranteed equal treatment and most sectors are open to private investment. The Cartes government still has to define a clear policy with regard to foreign investment in mining and energy-intensive industries. These are both sectors where Paraguay has underutilized potential. Since 2008, foreign direct investment (FDI) has hovered around 1.4% of GDP. Foreign investment in Paraguay profits not only from low taxes, but also from beneficial regulations in terms of profit remittances.

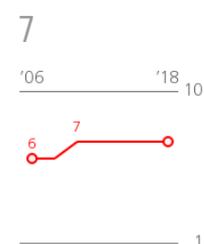
10 | Welfare Regime

Social expenditures as a proportion of GDP have greatly increased in the last 15 years, but are still low in comparison with other South American countries (17.8% of GDP in 2012). There are rudimentary measures to moderate social inequities, but efforts are sharply segmented in terms of territory, class and sector. Social protection is one of the lowest in Latin America. The social security system extends only to those employed in the formal sector of the economy. Currently, eight out of every 10 citizens lack pension coverage, and seven out of every 10 workers lack health insurance.

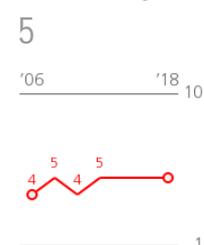
The pension system is organized on a pay-as-you-go basis, that is, it is not financed by assets that are set aside. However, due to the country's demographics (high fertility rates and high population-growth rates), there is less necessity for a general overhaul of the pay-as-you-go pension system. More important is an increase in administrative efficiency and a curbing of corruption. There is a lack of reliable data on the system's liabilities and assets. Paraguay's biggest social-security challenge is to create and implement an integrated social-protection system that reaches the entire population and guarantees benefits in a permanent and sustainable manner.

There are particularly marked differences in the delivery of health care. Public spending for health was 9.8% of GDP in 2014 (CEPALSTAT). Only 24% of the

Private enterprise



Social safety nets



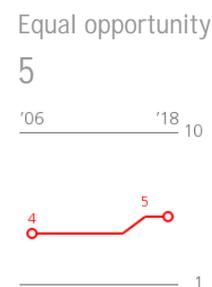
population has health insurance coverage. During the administration of President Lugo, access to public health services improved. In December 2009, the administration of President Lugo had introduced free medical visits and free dental treatment in public hospitals.

President Lugo's government started to pay conditional cash subsidies (in exchange for commitments regarding health and education of children) to about 83,000 poor households in 2011 (up from 15,000 at the beginning of Lugo's presidency), ultimately covering around 400,000 persons (via the Tekopora program). President Cartes' government declared that the number of families covered by the program rose to 130,000 in 2015. Another program gives subsidies to 150,000 elderly people in extreme poverty. Additional funds (*sembrando oportunidades*) are channeled to 32,000 households in extreme poverty. Life expectancy is relatively high, at an average of 74 years. In some rural areas, self-regulated and small-scale "social pharmacies" supplement scarce public-health services and improve primary health care in remote areas.

Society is severely segmented, and there are few institutions with a mandate to alleviate social discrepancies. Accordingly, surveys reveal that most Paraguayans perceive an individual's social background (membership in a family, clan or contact with higher social classes) as the main source of opportunities. Violations of labor laws and other legal protections are not adequately monitored or prosecuted by the government. At the operating level, collective bargaining agreements are often impossible because of the opposition of the business class. Only 10% of private-sector employees and 60% of public-sector employees are covered by collective bargaining agreements.

Women are disadvantaged both economically and politically. In the Human Development Report 2015, the country was ranked at 112th place on the Gender Inequality Index, with a score of 0.472 (as compared to 0.415 for the Latin America and the Caribbean region overall). The labor-force participation rate among women was 55.7%, as compared to 84.8% among men. According to WDI, the share of the labor force made up by women was close to the Latin American average, at about 39% of the total in 2014. Only 17% of Chamber of Deputies seats and 20% of Senate seats are occupied by women. A total of 25% of government ministers and 22% of Supreme Court judges are women. Around 10% of the mayors elected in 2015 were women (2010: 8%). There is less inequality in the educational sector, as girls have a higher enrollment ratio than boys at the secondary and tertiary levels, but the adult literacy rate skews slightly in favor of males (96.1% compared to 95.0%).

Apart from inequalities based on gender, a lack of equal opportunity exists mainly with respect to the indigenous population, which is more than any other group excluded from education, health services, access to public office and general opportunities in the labor market.



11 | Economic Performance

The Paraguayan economy grew at an average rate of 4.8% between 2011 and 2016, a higher rate than was true for most South American countries. In 2015, the Paraguayan economy grew by 3.0% (CEPAL data), compared to 4.7% in 2014. Growth was affected by heavy rainfalls (negative in the case of agriculture and construction; positive in the case of hydropower). The value of exports decreased by 13.2%, dragged down by declines in commodity prices (for example, for soya as the principal export product) and the economic crisis in Brazil and Russia (an important destination for meat exports). In 2016, the Paraguayan economy recovered and grew by 4.0%, according to CEPAL. The forecast for 2017 is similar. The positive results in 2016 were due to an increase in income from the production and export of electricity associated with favorable climatic conditions for hydroelectric plants, government investments in infrastructure, and an increase in meat exports (thanks to quality improvements and export-market diversification). Paraguay is now sixth-largest cattle exporter worldwide, with export volumes exceeding those of Argentina and Uruguay (there is currently a stock of 14.2 million cattle in Paraguay, or more than twice as many cows as people).

The urban unemployment rate fell slightly from 7.8% in 2014 to 6.5% in 2015, rising again to 8.3% in the first semester of 2016. But underemployment, not unemployment, is the main problem of the Paraguayan economy. Some 20% of the workforce is underemployed. Agriculture accounts for more than 20% of the country's GDP, and approximately 60% of industrial activities are linked to the primary sector. The agricultural sector is highly volatile due to weather conditions and fluctuations in commodity prices and external demand.

The fiscal deficit rose from 1.1% in 2014 to 1.8% in 2015. The 2016 deficit was expected to be around 1.5%. Due to recent years' fiscal deficits, the central government debt rose from 17.7% of GDP in 2014 to 19.7% in 2015 and 22.3% in 2016.

The inflation fell from 4.2% in 2014 to 3.1% in 2015 and 3.5% in 2016 (September). The guaraní depreciated by 25.3% against the U.S. dollar in 2015, but had regained about 6% of its value by September 2016. The value of investment (gross domestic investment is expected to grow from around 16% of GDP in 2013 to 18% in 2016) and trade has grown. However, basic infrastructure shortcomings, low productivity, underdeveloped technological capacities and the large share of informality are still the greatest challenges for the Paraguayan economy. There is also a need of public and private investment in infrastructure (for example, electricity transmission lines, paved roads), one of the main objectives of President Cartes' government. FDI has only been around 1.4% of GDP since 2008.

Output strength



The tax base is quite low and regressive (due to the high dependency on indirect taxes); top corporate taxes are 10%, the lowest corporate tax rate in the region. Tax revenue as a percentage of GDP amounted to only 12.5% in 2015, the lowest such ratio in South America. While commercial agriculture accounts for more than 20% of GDP, its contribution to tax revenue is small.

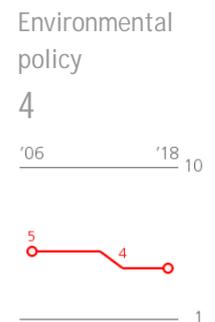
12 | Sustainability

Though there is a Ministry for the Environment (Secretaría del Ambiente, SEAM) and a number of regulations in place, environmentally sustainable growth has been given only sporadic attention by the government and has a weak institutional framework. The National Development Plan 2030 (Plan Nacional de Desarrollo Paraguay 2030) approved in 2014 includes cross-departmental provisions related to environmental sustainability. However, these are formulated in rather general terms and do not specify a specific environmental strategy, though “an institutional weakness in legal, budgetary and management terms” is noted.

While CO₂ emissions are comparatively quite low (0.769 metric tons per capita in 2013), the low profile accorded to environmentally sustainable growth is particularly evident given the environmental impact of the country’s large hydroelectric plants, which are its main energy source. In 2014, a total of 71.4% of the country’s energy consumption drew from renewable sources. Only 15 Paraguayan companies possess an ISO 14001 certification (2015).

There has been little control of deforestation in border regions, which has accelerated because of the recent boom in soybean production. Paraguay showed the world’s sixth-highest annual net loss of forest area in the 2010–2015 period (FAO). In 2004, the Nicanor Duarte government approved the Zero Deforestation Law, but this regulation applied only to the Oriental region, not the Chaco, which holds the majority of Paraguay’s forest regions. Moreover, a 2013 presidential decree softened the law by exempting most estate owners in the Chaco region from evaluation of the environmental impact of their activities.

Reducing air and water pollution has not been a priority. Organizations of small farmers and landless peasants as well as indigenous groups occasionally protest against the indiscriminate fumigation of soybean plantations and the use of herbicides, because of the environmental damage and water pollution caused by such practices and because of the health risks for the people living in the affected regions. A total of 95% of cultivated soy plants come from genetically modified varieties.



Early in its term, the Cartes government approved an agenda (Agenda Educativa 2013–2018) setting educational-policy priorities, aimed at improving the quality of education (as defined in the Plan Nacional de Educación 2024, which is part of the National Development Plan). In reaction to secondary-school student protests, the government has also increased investment in school infrastructure.

The literacy rate within the 15 – 24 age group is quite high at 99.0%, while the rate between men and women is somewhat unequal (male literacy rate, 98.6%; female rate, 99.5%). However, levels of functional illiteracy are much higher, especially in rural areas. There are large inequalities between urban and rural areas with respect to enrollment rates and, above all, concerning tertiary education. Despite rising school enrollment rates (according to CEPALSTAT, the net primary enrollment rate in 2012 was 88.5%, and the secondary enrollment rate 66.5%), the educational system still has significant qualitative deficiencies. These are in many cases related to proper staffing; however, challenges are sometimes as basic as the need to provide food and school supplies for young pupils.

Research and development facilities are rudimentary. Think tanks in Paraguay have taken up the slack for the lack of research activities in universities. However, there are only few think tanks and research institutions devoted to long-term research. Most locally conducted research still happens as part of short-term consultancies funded by international donors. Quantitatively, investment in education and training, as in research and development, is rather low. Recently, the National Council of Science and Technology (CONACYT) received a significant amount of funding to support research in diverse knowledge areas.

In terms of tertiary education, Paraguay has experienced a boom of private universities (as in other Latin American countries). However, those universities do not make any difference when compared to state universities in terms of quality of education, and sometimes they perform very badly. They are basically profit-oriented institutions and not concerned with raising the educational standards.

While public expenditures on education reached 5% of GDP in 2012, R&D expenditures remained low, at just 0.09% of GDP. In 2014, there were 169 researchers in the R&D sector per 1 million people. The Global Innovation Index ranked Paraguay 94th out of 128 countries in 2016 (2014: 89th out of 143) in this area.

Education policy /
R&D

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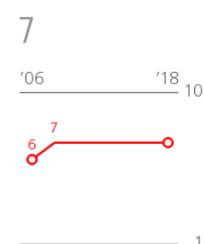
Governance

I. Level of Difficulty

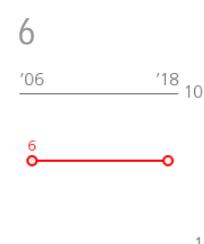
The structural constraints on governance are high. Paraguay has no coast and its geography is challenging. The Chaco region is arid and sparsely populated. These characteristics make the construction and maintenance of road infrastructure (only 9% of roads are paved, of which 25% are severely deteriorated) expensive and render integration with other countries more difficult. Therefore, Paraguay's transportation costs for foreign trade activities are higher than the average cost for other South American countries. Paraguay's main exports are agricultural products. Therefore, the economy suffers in the case of climatic adversities such as droughts or flooding (often caused by the El Niño phenomenon). The country is unable to combat poverty systematically on its own. Future development must contend with persistent and considerable social inequality; the lack of an educated labor force (relatively low levels of human capital); labor market inefficiencies; an inefficient and overstaffed public administration; a weak business climate; widespread corruption in politics, in society and in the private economic sector; and deficiencies in infrastructure. Public-sector reforms are hampered by a highly politicized public administration, which also lacks professionalism.

The democratization process in Paraguay, begun in 1989 after a long phase of authoritarian rule, unfolded amid a weak autonomous civil society, a weak political opposition and broad continuity among the elites in politics and officialdom. Politics has been based on patronage networks, which essentially subverted civil society, resulting in a weak and limited civic participation in public life. The NGO sector in Paraguay depends strongly on support from international donors. There is a network of small civil society organizations that could be used for mobilization processes in times of crisis. However, on an everyday basis, the connection between small, limited organizations and wider social movements is poorly developed. Interpersonal trust is very low in Paraguay, a symptom of low levels of social capital. However, civil society groups formed the core of the political movement and alliance that brought President Lugo to power in 2008, and continued to support his government afterward. Moreover, there has been a strong human-rights movement in Paraguay. As an example, the Paraguayan Human Rights Coordinator (Coordinadora de Derechos Humanos del Paraguay, CODEHUPY) is comprised of 33 organizations (and six supporting organizations). Thus, the picture is very mixed in Paraguay; there is comparatively little social capital, but this is combined with intense but locally focused forms of cooperation and a national human-rights movement.

Structural constraints



Civil society traditions



In December 2015, a coalition of left-wing trade unions, political parties and NGOs – the Congreso Democrático del Pueblo (CDP) – staged a general strike demanding higher wages, a land reform, recognition of new unions and more investment in education. Students and small-scale farmers have also taken to the streets against the policies of President Cartes.

Great ethnic homogeneity is certainly an advantage for the Paraguayan government. There are no religious differences that could be viewed as a source of conflict. The great majority of political parties, such as the Colorado Party and the Liberal Party, do not articulate or draw attention to social cleavages between the poor and the rich. Nevertheless, class conflict between landowners and organized landless small-scale farmers in rural areas has intensified over the last decade. For years, the policy of expanding agriculture lands was an important source of the country's GDP growth. Now there is almost no arable land left in eastern Paraguay. There have been violent clashes between the police and rural peasants.

The intensity of drug trafficking has increased over the last three years, and a considerable portion of the northern zone of the eastern area of the country has been penetrated by drug-trafficking gangs. This is also the region where the small EPP guerrilla group is active. Radicalism and violence in Paraguay can largely be blamed on these two groups, but mainly on the drug traffickers, who cooperate closely with their Brazilian peers. The widespread insecurity and violence related to drug trafficking, including kidnapping and assaults, are not driven by ethnic or regional factors.

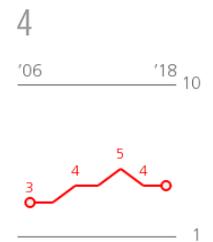
The EPP, which is active in and enjoys some support in rural areas, does not constitute a genuine challenge to the Paraguayan state or to general political stability. However, it has exposed the state's inefficiency with regard to providing security. Observers estimate that the EPP has little more than 30 active members, with around 200 local families supporting it.

II. Governance Performance

14 | Steering Capability

The government of President Cartes is committed to constitutional democracy and a market economy. The main objectives of his government, however, have been concentrated on economic transformation. This included reform of the public sector, regaining fiscal stability, a stronger role for private enterprise in the economy, improving the infrastructure by engaging the private sector in public investment, more social investment and a resolute suppression of the rural insurgency of the EPP.

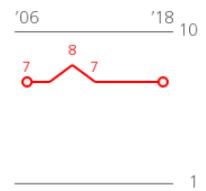
Conflict intensity



Question
Score

Prioritization
7

Initially, the government was able to effectively prioritize and organize its strategic objectives and policy measures. Cartes started his presidency with a surprise when he signed a political pact (“Acuerdo por Paraguay”) with four of Paraguay’s five opposition parties (including the Liberal Party) to engage in cooperation (including joint legislative initiatives and sharing congressional leadership positions).



During the first months in office, President Cartes was quite successful. He received broader authority to deploy the military in the fight against the Paraguayan People’s Army (EPP). He managed to convince a congressional majority to approve a fiscal responsibility law, which introduced a fiscal deficit ceiling of 1.5% of GDP. Against the resistance of the powerful commercial farmers (and their interest groups), Cartes passed a law that will compel agribusiness to make higher tax contributions. Moreover, against strong opposition and protests in the streets, he steered a public-private partnership framework bill through Congress to facilitate and encourage infrastructure investments. And the government initiated actions to control small-scale contraband on the borders with Argentina and Brazil. Furthermore, Congress approved a state financial administration law to improve the government’s cash management.

In addition, in 2014, the government approved the National Development Plan 2030 (Plan Nacional de Desarrollo Paraguay 2030). The plan delineates three strategic axes for public policies between now and 2030: reducing poverty and increasing social development, strengthening inclusive economic growth and improving the country’s integration with the world. The strategic axes incorporate four transversal lines: equal opportunity; efficient and transparent public management; territorial organization and development; and environmental sustainability. However, until now, Paraguayan politicians and policymakers have been unused to following long-term plans and they seldom have maintained policies initiated by previous administrations. In addition, the lack of qualified technical personnel in many ministries has impaired the planning, evaluation (including social and environmental risks), execution and monitoring of projects.

In the second half of 2016, the government’s long-term policy goals were partially overshadowed by the short-term electoral interests of President Cartes, who was bargaining to consolidate the support of his party (and other parties) for a reelection bid, while also campaigning to amend the constitution to enable this prospect. The re-election bid thus had negative repercussions for the government’s strategic priorities, some of which may have been postponed to allow pursuit of short-term political goals.

The government of President Cartes defined a comprehensive reform agenda. At the beginning, Cartes was quite successful at getting the necessary legislative support from Congress to initiate his agenda. He received broader authority to deploy the military in the fight against the Paraguayan People’s Army (EPP). Congress approved a fiscal responsibility law, a state financial administration law and a public-private

Implementation

6

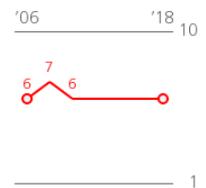
partnership framework bill to facilitate and encourage infrastructure investments. Moreover, taxation on the agricultural sector was substantially increased (basically by requiring agribusiness to pay corporate income tax).

However, in 2015 and 2016, the government failed to advance its policies. In May 2015, the Senate approved legislation requiring congressional approval for large-scale infrastructure tenders for public-private partnership (PPP) projects, which led to a halt in PPP contract approvals. At the beginning of 2016, 13 PPP projects were stalled, including highway construction, airports and the Asunción metrobus. However, the Senate proposal was rejected by the Chamber of Deputies in January 2016. Thus, President Cartes will have more leeway for PPP projects, and be required to provide detailed reports to Congress on all awarded PPP projects only twice per year.

For the execution of major joint public-private partnership infrastructure projects, the government must improve public investment management, planning and regulatory capacity. The tax authorities are not sufficiently prepared to absorb an increase in taxpayers. As a result, tax collection remains relatively low (at about 51% of its potential). With regard to the goal of fiscal stability, in December 2014, Congress approved an amended budget, which increased the fiscal deficit in 2015 to 1.8% of GDP (2014: 1.1%). The 2016 deficit was expected to be around 1.5% of GDP. Due to recent years' fiscal deficits, total central-government debt rose from 17.7% of GDP in 2014 to 19.7% in 2015, and again to 22.3% in 2016. Nevertheless, the country's public-debt level (as a percentage of GDP) is still among the region's lowest.

The government has not yet managed to broaden the tax basis or the formal sector of the economy. It postponed the application of the value-added tax on loans made by the cooperative sector until April 2016, and after protest by small farmers, again delayed introduction until July 2016. It did not impose limits on the amount of personal expenditures deemed tax deductible. Personal-income tax (8%) is paid by only around 1% of the workforce. Only half of registered income-tax payers paid the tax in 2015.

The security forces managed to liquidate the Agrupación Campesina Armada (ACA), a small splinter group of the EPP, in 2015. President Cartes' government has launched an offensive against the EPP, and has deployed military forces more carefully, but has nevertheless met with little success in this area. Observers estimate that the EPP has little more than 30 to 40 active members, and is supported by around 200 local families. However, there have been few advances, and the EPP is still actively killing security personnel. For example, in August 2016, the EPP was holding two hostages for ransom, along with a police officer as prisoner. Moreover, the EPP ambushed and killed eight soldiers that same month. In general, drug trafficking and organized crime undermine public security.



The government demonstrates a general ability to engage in policy learning, but its flexibility is limited. An important step has been the signing of the political pact (“Acuerdo por Paraguay”) with four of the five opposition parties (including the Liberal Party) at the beginning of Cartes’ term, signaling the need for a more cooperative policy-making if long-term goals and the continuity of policies are to be upheld. Over the last 10 years, think tanks, research institutions and advocacy organizations have had a certain amount of influence on policy decision-making. Opinion-makers from these institutions are listened to by policymakers. International cooperation, for instance, with the World Bank, the IMF and the Inter-American Development Bank (IDB) has a long tradition in Paraguay, has served as a supporter of continuous reform efforts from one government to another and, to a certain extent, has also facilitated learning from past experiences by observation and knowledge exchange.

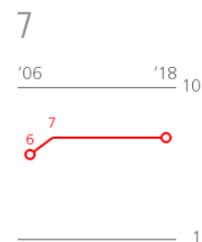
President Cartes’ re-election plans seemed to show a lesser degree of learnings. Similar ambitions previously put strain on the presidencies of Nicanor Duarte and Fernando Lugo, and the same might happen in Cartes’ case.

15 | Resource Efficiency

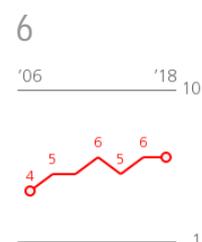
At the beginning of his government, President Cartes was committed to increasing efficiency. He nominated a technocratic cabinet and tried to select office holders on the basis of merit. But soon, he had to back off because of resistance within his own party and the need to placate the opposition. Cartes believes that the state functions like a company and he has stated this publicly. He has been criticized for not governing through his cabinet. Instead, he has designated managers from his own companies as personal counselors and created an inner circle of political advisers. The 2016 cabinet changes resulted in an increase in partisanship within the cabinet, both with regard to the interests of the Colorado Party and President Cartes’ ambitions to stand for re-election. This resulted in a deterioration in the cabinet’s technical quality.

Recruitment of administrative personnel still puts a heavy emphasis on political loyalty (especially at the municipal level), leading to deficient staffing, despite the high number of employed. However, the recruitment system was subject to reform, and recruitment based on merit has expanded. Still, there are several challenges with respect to the modernization of the public sector, such as intra-administrative coordination to implement new steering processes. And there is still a lack of qualified technical personnel in many ministries. This impairs the planning, evaluation (including social and environmental risks), execution and monitoring of projects – including joint ventures for private-public investment in infrastructure and regulatory capacity.

Policy learning



Efficient use of assets



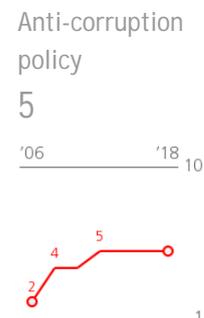
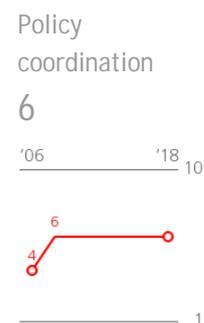
The fiscal deficit rose to 1.8% (2014: 1.1%) in 2015. The 2016 deficit was expected to be around 1.5%. Tax evasion has been curbed, smuggling has been reduced and fiscal revenue increased significantly. However, tax rates within the agricultural sector remain low. The combat against the EPP guerrilla group is hampered by institutional rivalries between the police and the armed forces, as well as professional deficiencies within the security forces.

Effective and coherent policy coordination is hindered by bureaucratic inefficiencies and, despite attempts to reform public administration, by the lack of qualified technical personnel in many ministries. Based on a political pact (“Acuerdo por Paraguay”) made at the beginning of Cartes’ presidency, the political opposition received congressional leadership positions and is included in the political decision-making process. While thereby providing for a broad support for Cartes’ reform policies during his first year in office, this hampered progress during the second and third years, when contradictions among some of the government’s goals became more evident. The most significant example is the contradiction between low taxes, which on the one hand, are presented as a comparative advantage in Paraguay. On the other hand, plans are afoot to raise taxes to achieve the objective of increasing state incomes as a condition for higher social spending. In addition, deficits pertaining to inter-institutional coordination hamper the execution of the government’s reform program.

Some mechanisms ensuring integrity are effective, while others simply do not work. A positive example is the reformed public procurement system, which already in 2003 produced a credible shift in public-sector procurement procedures. Also, credible reforms have been undertaken to modernize the public-sector recruitment system toward a meritocratic system. However, some central institutions, such as the national audit office, lack sufficient funds and independence to properly fulfill its tasks. Also, attempts to modernize the public administration via coherent informational systems have proven to be difficult, but efforts are in motion.

While, in September 2012, Congress approved a new law on the regulation of political financing, the EU Electoral Observation Mission for the 2013 general elections complained about the absence of regulations and effective mechanisms to enforce them in regard to campaign limits, transparency, audit and funding. There are no limits on the amount a donor can contribute to a candidate. Anonymous contributions are not forbidden and donations in kind are not regulated. The balance of income and expenditures (including electoral expenses) are neither audited nor made public. No penalty has ever been imposed.

After protests from civil society and the media, as well as a court decision to disclose the salaries of public officials, a freedom of information law was introduced in October 2014, which requires public institutions to divulge previously confidential information about staff, salaries, audits, et cetera. The new law might, in the future,



help in the fight against corruption. In September 2015, Congress blocked legislation that would have allowed prosecutors to strip assets from suspected drug traffickers.

In January 2016, President Cartes ordered all public entities to publicize their payrolls since 2003, with the objective of exposing nepotism and political favoritism. Within the Supreme Electoral Tribunal, 300 employees came under investigation. In February 2016, the national anti-corruption office (Secretaría Nacional Anticorrupción) created an online whistleblowing tool. In May 2016, following massive protests by students, the minister of education and culture had to resign as a result of a corruption scandal related to inflated prices for school meals.

The president of the Council of Magistrates declared in November 2014 that 25% of the judges in Paraguay were corrupt. Under pressure from the media and the public, President Cartes and members of Congress from all parties asked for a cleanup of the judiciary, and initiated impeachment procedures against four of the nine Supreme Court judges (one of whom resigned voluntarily) and one Supreme Electoral Court judge (who also resigned). However, the impeachment procedures against Supreme Court judges did not advance further during the review period.

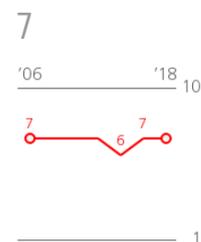
16 | Consensus-Building

The main political actors agree on establishing a market-based democracy. Nevertheless, there are problems with implementation because there are many veto points in the political system, and economic reforms that would result in strengthened democracy and market economy threaten the vested interests of the political elite. Formal democratic institutions are subverted by informal and clientelistic practices. There is a lack of consensus-building mechanisms, for example, between business owners and unions, or between landowners and landless peasants.

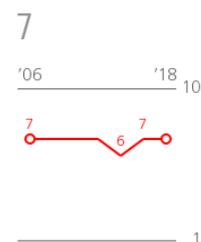
With regard to the market economy, the formalization of the economy through the personal income tax has been blocked for years by veto players. Moreover, high levels of market concentration and economic inequality indicate a considerable way to go to establish an inclusive market economy.

The military respects the democratic legitimacy of the government and is not an independent political actor. There is a risk that social conflicts could get out of control and put political institutions under pressure. A violent clash between landless farmers and the police created the pretext to impeach reform-minded President Lugo in 2012. Anti-democratic actors are not openly visible, but the historically grown systems of clientelism and patronage are essentially anti-democratic and are largely associated with the traditional political parties: the Colorado Party and the Liberal Party. In sum, while neither of the two main political parties oppose democratic norms, clientelistic practices of these organizations partly hamper democratic reforms. The fact that around 60% of the country's population expresses some sympathy for a more

Consensus on goals



Anti-democratic actors



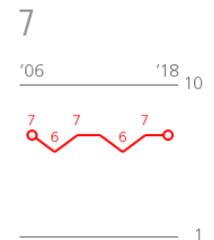
authoritarian type of political regime (or at least is not opposed to such a regime) could ultimately facilitate the rise of antidemocratic politicians.

Although the political leadership tried to prevent the escalation of political cleavages into conflicts, it could not mend existing divisions. Political cleavages do not split primarily along ethnic, class, regional or religious lines. One major political cleavage relates to the traditional parties (ANR and PLRA) on the one hand, and progressive parties on the other. Another division relates to the indigenous population, which is, however, very small in number and not sufficiently organized to forcefully articulate this division. A third major cleavage, conflict over available farmland, has been growing for the last decade. On the one hand, the landless are organized into a broad movement and represented by different organizations. On the other hand, large landowners and soy producers are important and influential economic actors. Moreover, Brazilian landowners in Paraguay receive the strong support of their government in Brazil. The Lugo government had tried to reframe the land reform topic from land redistribution to rural development, putting the focus on the provision of assistance to small landowners and infrastructure investments in the countryside (roads, schools, medical clinics and so on). This approach has also in some measure employed by President Cartes with the Sembrando Oportunidades Program, which supports small-scale farmers with technical, financial and managerial assistance so as to improve their access to markets and value chains. But the political leadership has not demonstrated a willingness to explore a comprehensive solution for the land conflict (at least one that would take the demands of the indigenous population into account).

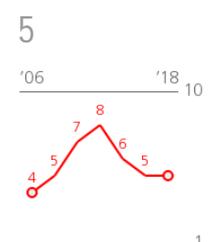
Political parties and their clientelistic networks are still quite strong in Paraguay, which limits the space available to civil-society actors. During Lugo's presidency the government was more open to civil-society participation in politics, and reforms were accompanied by numerous participatory forums. After his ouster, civil society lost some influence. However, overall the executive branch has accorded more space to civil-society organizations as they have demanded change in policy-related decision-making. To give an example, the Law of Access to Public Information or Freedom of Information Act was initiated in 2006 by civil-society organizations, and finally enacted as law in 2014. This initiative was not promoted by the government or political parties. The mass media's discovery of numerous irregularities in public salaries ultimately led to the final outcome. Moreover, protests and demands by secondary and university students have provoked some changes in educational policies and rules. Finally, the mobilization of indebted peasants too produced some positive responses from government and Congress.

The political leadership recognized the need to deal with acts of injustice and human rights violations perpetrated during the Stroessner dictatorship, but the process of reconciliation has been slow. Only a few victims of the dictatorship have been comprehensively indemnified, and compensation amounts have been quite low. A

Cleavage /
conflict
management



Civil society
participation



Reconciliation

8

museum of memory was created in one of the torture centers of the Stroessner era. The office of the ombudsman supports the investigation of human rights abuses from that time. As a response to pressure from civil society, a Commission of Truth and Justice was created and it started its work in the second half of 2004. On August 28, 2008, the commission presented its final, 1,000-page report, which includes 178 recommendations. As a result of the report, a Truth, Justice and Reparation Department was created within the office of the ombudsman.

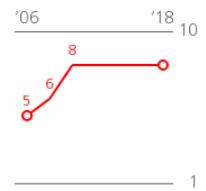
In June 2014, President Cartes signed a law ordering the expropriation of 14,400 hectares of rural lands that the Sawhoyamaxa indigenous community has been trying to reclaim for more than 20 years. The indigenous community was displaced from their land illegally during the Stroessner dictatorship in the 1980s. Later in the year, the Supreme Court rejected claims made by the owners that the expropriation was unconstitutional. With the expropriation and the subsequent restitution process, the Paraguayan government complied with two rulings of the Inter-American Court of Human Rights (IACHR), from 2006 and 2009, respectively. Other IACHR cases related to restitution claims by indigenous communities in Paraguay have not yet been settled. In July 2015, the IACHR sent a reminder to the Paraguayan government that it was out of compliance with three rulings.

17 | International Cooperation

As mentioned before, the Cartes government has affirmed its resolve to undertake political and economic reforms, which include curbing corruption, public-sector reform, poverty reduction and increasing international competitiveness. Moreover, there is a long tradition in Paraguay of international cooperation. The Cartes administration works closely with multilateral international donors and financial organizations, including the IMF, the Inter-American Development Bank (IDB) and the World Bank, with the aim of bringing international assistance to the domestic reform agenda.

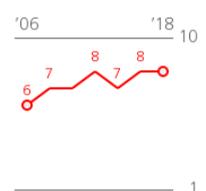
The IMF gives in general a positive evaluation of Paraguayan development and outlooks. The new partnership strategy of the World Bank with Paraguay for the 2015-2018 period envisions financial commitments of around \$1 billion. The World Bank supports the National Development Plan, whose main objectives include eradicating poverty, strengthening economic growth and improving the country's integration with the world through improved competitiveness.

The IDB country strategy for Paraguay (2014-2018) also supports the objectives of the National Development Plan and considers a sovereign-guaranteed lending scenario with a tentative goal of \$1 billion in loans, provided significant progress can be achieved in terms of execution. Priority is given to transportation and connectivity, water and sanitation, energy, productive development, the financial sector and public management. In February 2015, the IDB opened a \$110 million credit line earmarked for the improvement of sanitation infrastructure in the capital, Asunción, and the



Effective use of support

8



nearby town of San Lorenzo. In 2016, the World Bank approved a \$100 million project to reduce transport connectivity costs, improve road safety along selected paved road sections, and improve the Paraguayan government's planning and national road-asset-management capacity.

Apart from financial cooperation, Paraguay cooperates above all with development cooperation organizations based in the United States (USAID, with \$17 million in fiscal year 2015, Germany (GIZ, with a project volume of €8 million) and Japan (Japan International Cooperation Agency, JICA) on technical issues.

However, after a first year of more or less successful reforms, the government's impetus lost steam, and a clear roadmap specifying steps to reach its ambitious goals became less visible. The National Development Plan 2030 provides for a more detailed map, but given the more adverse political scenario, it remains unclear if this will remain a mere blueprint or will indeed guide a consistent use of support. The latter is all the more questionable given the country's pervasive corruption and clientelism.

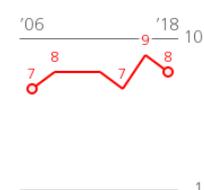
Democracy is not perceived as being at risk in Paraguay by the international community, at least after the return to free and widely fair elections in 2013. Overall, the Cartes government mostly acts as a credible and reliable partner. The U.S. government and Paraguay collaborated extensively on anti-narcotics and anti-smuggling policies. At the same time, Paraguay diversified its international partners. For example, Russia has become an important export market for Paraguayan beef. However, Paraguay is also promoting closer cooperation between Mercosur and the European Union. In March 2015, the Paraguayan government signed a cooperation agreement with the EU.

Despite significant flaws, Paraguay's economic transformation is generally viewed with optimism, as reflected in credit ratings and foreign investments. In January 2013, the Paraguayan government successfully issued a \$500 million, 10-year sovereign bond in the international financial market (with a yield of only 4.625%). Another 30-year bond for \$1 billion (with a yield of 6.1%) was issued in August 2014 with a reopening in April 2015 that resulted in an additional \$280 million issue. An additional 10-year sovereign bond totaling more than \$600 million (with a yield of only 5%) was issued in March 2016. Standard & Poor's and Fitch each give Paraguay a BB credit rating, while Moody assigns the country a Ba1 rating.

In 2011, the Paraguayan Congress ratified the founding treaty (2008) of the new South American regional organization UNASUR (Union of South American Nations). Paraguay is also a founding member of the Southern Cone Common Market (Mercosur), along with Argentina, Brazil, Uruguay and Venezuela. Asunción is the headquarters of the Mercosur Court of Arbitration. The Paraguayan economy is closely tied to those of the neighboring states, so economic crises in Argentina and Brazil have direct consequences in Paraguay. Together with Uruguay, the Paraguayan

Credibility

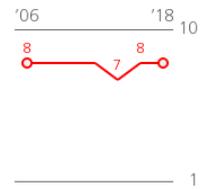
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Regional cooperation

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government from time to time has taken a critical stance vis-à-vis Brazil and Argentina, because interests of the smaller member states in Mercosur have not been sufficiently taken into account. President Lugo, however, was able to renegotiate the Itaipú Dam Treaty with Brazil. But the agreement has yet to be fully implemented. The negotiations with Argentina over the distribution of the accumulated debts for the Yacyretá hydroelectric dam and renegotiation of the treaty are still ongoing. Argentina uses 91% of the produced electric power, Paraguay only 9% (2014).



The relationship with the other Mercosur countries was already strained before Lugo's impeachment in 2012. For reasons related to domestic politics, the Paraguayan Senate blocked the ratification of the protocol for the entry of Venezuela into Mercosur that was signed in 2006, and had been ratified by all other member countries. The Paraguayan Senate also did not ratify the Montevideo Protocol (also called Ushuaia II Protocol), signed in December 2011 and related to the defense of democracy in the Mercosur. In the past, the membership in Mercosur had helped to stabilize the Paraguayan democracy in the sense that its two neighbors have intervened diplomatically in active ways during periods of political crisis (e.g., the threat of coups in 1996, 1999 and 2000).

The positive evaluation of the 2013 electoral process abroad and the unambiguous result cleared the way for a reintegration of the new Paraguayan government into Mercosur and UNASUR. After his electoral victory, President Elect Cartes declared his intention to normalize relations with neighboring countries. The presidents of Argentina, Brazil and Uruguay attended his inauguration in August 2013. Initially, the Paraguayan government tried to impose conditions for Paraguay's reintegration in the Mercosur meetings. In the end, President Cartes did not get any concessions, but it took nearly a year to organize the next regular Mercosur heads of state summit in Caracas (July 2014) with Paraguayan participation. Previously, in December 2013, the Paraguayan Senate (with a 29-10 vote) at the president's request had retroactively approved Venezuela's admission as full member of Mercosur. In the second semester of 2015, Paraguay took over Mercosur's pro tempore presidency.

The Paraguayan government – in conjunction with the Brazilian government – was very active in initially blocking Venezuela's pro tempore presidency in 2016, and then advocating the suspension of Venezuela's Mercosur membership.

President Cartes has promoted closer cooperation and economic integration with neighboring Bolivia, including through the construction of an electric transmission line into the western Chaco region and a road through the Chaco (Transchaco). Moreover, Bolivia will supply Paraguay with cheaper liquefied natural gas.

Since 2013, Paraguay has also observer status in the Pacific Alliance and would like to join the group. This is not possible because the Mercosur membership impedes the country from independently signing trade agreements with third parties. In June 2014, Paraguay hosted the 44th General Assembly of the OAS.

Strategic Outlook

Paraguay's presidential democracy is characterized by a strong, bicameral Congress and a fragmented party system. Consequently, many issues in political decision-making are vulnerable to vetoes, and comprehensive political and economic reforms must draw on broad coalitions. Paraguay's democracy was shaped by more than 60 years of the Colorado Party's dominance, which returned to government in August of 2013. A successful modernization of the state and the economy would undermine part of the power base not only of the Colorado Party, but also of the Liberal Party.

President Cartes is a political newcomer. He joined the Colorado Party only in 2009. As a result, he has no strong foundation within the party, which is traditionally divided into different factions. While the Colorado's have a majority in the Chamber of Deputies, this does not mean that the party will always vote unanimously for the president's proposals. Moreover, for the realization of his reform agenda, the president needs support from other parties as well. Hence, the president took the correct steps at the beginning of his government when he signed a political pact with four of the five opposition parties, including the Liberal Party. This gave him more room to maneuver and greater independence with regard to his own party. While in the first year of his presidency, Cartes met with success in his legislative initiatives, in 2014 his government lost steam and did not advance much with regard to its objectives (the planned PPP infrastructure investments). On the one hand, the resistance from within his party became stronger. On the other hand, social discontent led to various demonstrations and strikes.

A major future challenge is reform of the state apparatus, so that planned reforms can be efficiently executed and monitored. Infrastructure deficits must be confronted to make the economy more competitive. The government has to demonstrate that private-public partnership projects are viable. But it has had to overcome strong political resistance and attempts to exercise more political influence in the tender process (with the corresponding risk of corruption). While poverty has been reduced, the number of poor people is still high and may rise again in times of economic crisis. Especially in the countryside, the potential for conflict, including violent conflict, remains high.

The November 2015 municipal elections represented a first major setback for President Cartes. While the Colorado Party won with 45.8% of the votes, increasing the number of mayoral seats held by the party, it lost in Asunción for the first time in 15 years, as well as in some of the important departmental capitals. The election results demonstrated that an alliance of opposition parties might have chance to win against the Colorado Party. However, the Colorado Party still has a greater chance of winning and continuing to hold the presidency provided that there are no fissures in the party.

In December 2016, President Cartes vetoed the 2017 national budget after Congress introduced various modifications to the original proposal, including large increases in public-sector salaries,

a reduction in the authorized quantity of sovereign bonds to be issued for external financing, and an encroachment on the independence of the central bank. The budget modifications had been approved with the support of dissidents within the Colorado Party. Following the veto, the government has worked on the basis of the 2016 budget.

Finally, one of the major challenges ahead is to confront corruption and organized crime's infiltration of politics, or risk the disintegration of state structures in parts of the country. Notwithstanding an increase in resources committed to fight the EPP guerrillas in the country's northern departments, the government has been unable to defeat the group. Moreover, violence related to drug trafficking has increased, and government forces have been unable to control the violence in some areas of the country. Reestablishing security and state presence in the contested and violent areas should be made a high priority. Otherwise, uncontrolled no-go areas will expand on the borders of Paraguay.

As his term advances, particularly with the failure of his re-election ambitions, governing will become more complicated for President Cartes as both the opposition parties and possible candidates within his own party position themselves for the April 2018 presidential elections. No large political or economic reforms are to be expected for the rest of Cartes' term.