BBVA | RESEARCH

Paraguay Economic Outlook

2ND HALF 2015 | PERU UNIT

01
Growth of over 3.0% in 2015 and 2016. Domestic demand will be the key driver thanks to infrastructure projects

02
Less depreciation of the PYG, though with bouts of volatility. This adjustment will reflect the deterioration of the fundamentals

03
Inflation will remain contained at around the mid-range of the target. The central bank should thus hold its benchmark rate unchanged

04
Major risks: a more marked slowdown for Brazil and China, and a quicker Fed funds rate adjustment

Contents

Closing date: 2 December 2015

1 Overview

The international scenario, as this affects Paraguay's economy, has continued to deteriorate in recent months. The price of the soybean, which is the country's core export good, has remained in decline. Added to this was the weakness of Brazil, which is Paraguay's chief trading partner, as it moved into acute recession. Moreover, the proximity of the lift-off in the cycle of Federal Reserve rate rises in the United States has led to a heightened perception of risk attaching to the emerging economies, outflows of capital from such countries and depreciations for their currencies.

In these circumstances, the GDP's growth rate has eased up in recent months. Economic activity moved forward by 3.3% in the first half (with respect to the same period last year), due to weaker agricultural output, which ground to a virtual standstill, and certain one-off supply-side factors (lower water flows at hydroelectric facilities) which hit electricity production. All of this has led to thinner exports, which dipped by 3.3% in the opening six months. **On the spending side, domestic demand has continued to be the major component that has underpinned growth. Our central scenario assumes that GDP will post a better performance towards the end of 2015,** buoyed by the primary sectors and the turnaround of the supply shocks in the first half. GDP will thus grow by 3.2% in 2015. That said, according to the central bank, the IMAEP ex agriculture and binational undertakings (energy) only advanced by 0.7% in the third quarter, which suggests that the slowdown of the GDP's key trend component is likely to have continued, which gives a downward bias to our projection for the year.

Looking at 2016, in what remains a challenging context, we foresee growth of 3.4%, which will mean that Paraguay's economy will still be one of the most dynamic in the region. On the spending side, domestic demand will be the prime driver of growth, in particular due to heavier levels of investment (infrastructure projects). With respect to demand from abroad, its contribution to growth for the year will remain neutral. From 2017, we expect growth to be slightly above 4.2%, in keeping with its potential level. **Although macroeconomic stability is one of Paraguay's distinguishing features, focussing progress on competitiveness and productivity is key to ensuring medium-term growth**. The main challenges should concentrate on implementing policy measures aimed at: i) boosting human capital and reducing informality; ii) narrowing the infrastructure gap, and iii) whittling away the cost overruns which certain productive sectors face.

On the fiscal accounts side, our forecast for the fiscal balance for 2015 assumes that the government will fail to keep this below the established upper limit, despite having made adjustments to keep the deficit within the bounds laid down by law. Going forward, we predict a gradual reduction of the deficit until the upper limit set under the Law on Transparency and Fiscal Responsibility is observed, which will help to consolidate the credibility of the fiscal rule.

The local currency has depreciated by around 21% so far this year, and we foresee it continuing to weaken in the coming months (the observed trend throughout the whole region). Looking ahead, we forecast that the PYG's exchange rate will depreciate at a far slower pace, to shadow the weakening of fundamentals.

The path of inflation has held in line with the target level. So far in 2015 (January to November), inflation has been mainly accounted for by the rise in the prices of services and durable goods, which are closely linked to exchange rate movements. These aspects were mitigated by falls in the prices of fuels and certain foods (especially cereals). Generally, we forecast that inflation will hold within the target band for the remainder of 2015 and also throughout 2016.

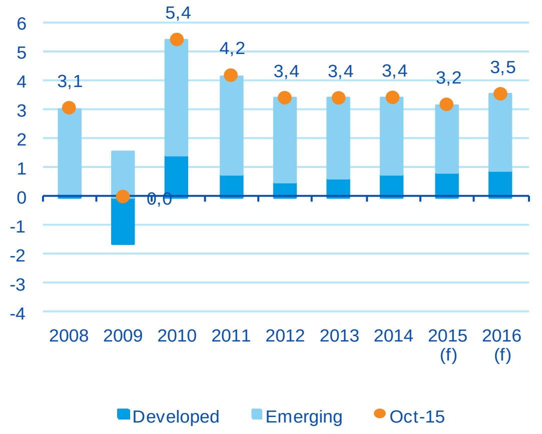
Finally, bearing in mind that inflation is under control and that expectations are anchored to the target level, **the monetary policy rate has so far been held at 5.75% since July**. Our forecast assumes that the central bank will keep the rate at its present level until the end of 2016. Further ahead, we expect the policy rate to rise gradually, in line with the pick-up in GDP growth.

2 Slower global growth in 2015 and a limited improvement in 2016

According to our estimates, global GDP has chalked up four consecutive quarters of growth below the 2010-14 average, mainly due to the ongoing deceleration in the principal emerging economies, in a context in which doubts over the strength of the economic cycle and the financial stability of China have triggered a significant spike in financial tensions and further corrections in commodity prices.

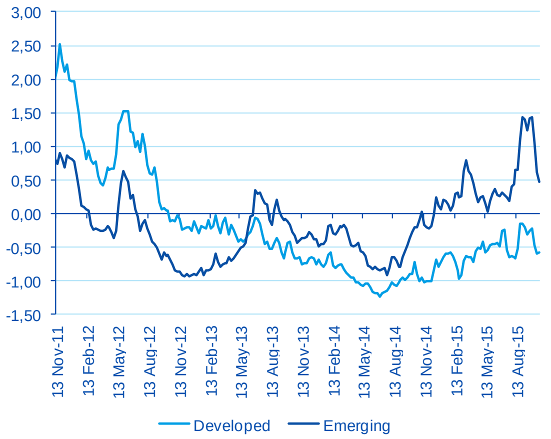
As a result, global GDP should grow at 3.2% in 2015 (0.2% less than we forecast three months ago), the lowest since 2009 (see Figure 2.1), with growth in the emerging markets moderating to barely 4% YoY, compared to average growth in the five previous years of more than 5.5%. The outlook for 2016 is slightly more favourable, with global growth recovering to 3.5% (0.3% below our forecast three months ago), sustained by a better relative performance of both the developed and the emerging economies.

Figure 2.1
World GDP: annual growth (%)



Source: BBVA Research

Figure 2.2
BBVA Financial Tensions Index (Index)



Source: BBVA Research and Bloomberg

All in all, the stabilisation of commodity prices at low levels and the sustained rise in financial tensions in the emerging economies — accompanied by heavy capital outflows, sharp currency depreciation and a widening of sovereign spreads — are evidence that the balance of global risks is still to the downside. Even though monetary policy in the developed countries could mitigate the impact of a scenario of slower growth, the scope it has to kick-start the economic cycle is reduced, taking into account the low levels of interest rates and the high volume of liquidity already in existence. The combination of a financial shock in China, that takes the annual growth of that economy well below 6%, with an even slower recovery of the developed economies block than has been observed to date, is without a doubt a significant risk scenario, both because of its degree of plausibility (limited, but not extreme) and its severity, given its potential impact on the world economy generally and on Latin America in particular (see Box 1 regarding the specific impact on Latin America).

USA: downward growth revision due to the deterioration in the external environment

An overview of the principal economic areas shows a notable stabilisation of economic growth in the US at lower rates than in other recovery episodes. Private consumption remains key to the dynamics of economic recovery, although it will probably not be sufficient to wholly offset the drops in both exports (owing to the dollar's appreciation and the weakness of the emerging economies) and investment in the energy sector. GDP growth should thus be 2.5% in 2015 and 2016 as well.

The risks for the US economy in a more unfavourable global environment are influencing the Fed response and when the initial rate hike takes place, which ought to be in December. Whatever happens, the pace of rate increases is expected to be very gradual, probably reaching levels at end-2016 below those that we expected a quarter ago, and no higher than 1%.

China: upward revision of GDP growth expected for 2015, although this will not dispel the uncertainties over the pace of future economic deceleration

China's cyclical position is obviously one of the principal variables to watch at a global level. The sharp stock market correction in August served as a warning of the risks posed by a financial shock in the country of a severity to compromise the growth in domestic spending. The magnitude of the capital outflows and the spike in financial volatility resulted in the introduction of a considerable battery of monetary policy measures directed at easing the deterioration in liquidity and its potential impact on the financing model of the corporate sector, which is heavily leveraged. The unexpected official announcement of change regarding the daily yuan exchange rate and the progressive cuts in reference rates fall into the same context, and are also characterised by a progressive deceleration of economic activity, which has taken GDP growth below 7% YoY in the third quarter.

It seems that the authorities will continue to employ monetary stimulus measures (further interest-rate cuts have not been ruled out) and to exploit the central government's scope to use fiscal policy to ensure that economic growth does not fall below 6% YoY. Our forecasts suggest GDP growth of 6.9% for 2015 and 6.2% for 2016.

Eurozone: resilient domestic demand with the ECB ready to avoid further declines in inflation

In the eurozone, the economic recovery continues although the pace has not intensified as we anticipated some months ago. The pace of eurozone GDP growth could increase to 1.8% in 2016 (only 10bp less than we expected last quarter) due to the upturn in Italy and France. The accentuation of the risks to the downside to inflation forecasts, largely due to cheaper imported goods, together with the recent appreciation of the euro, appears to be pushing the ECB towards adopting new stimulus measures in the short term, as it has suggested.

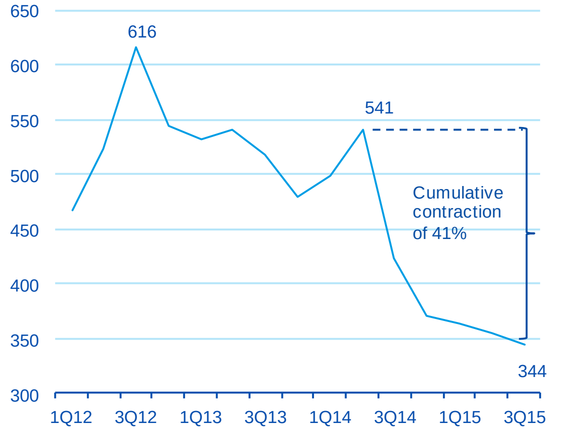
3 Paraguay: growth of over 3% in 2015 and 2016

The deterioration in the international setting has taken its toll on local economic activity, which slowed down in the first half on lower sales abroad

The international environment relevant to Paraguay's economy has continued in decline in recent months. The price of the soybean, which is the country's main export good, has carried on falling (for further details, see Box 1. Commodity prices: soybeans and oil), which has resulted in a cumulative drop of over 40% since the middle of last year[1] (see Figure 3.1). This was coupled with the weakness of Brazil (in the first half it contracted by 2%, see Figure 3.2), which is Paraguay's foremost trading partner to which around 30% of exports are destined. Finally, the proximity of lift-off for the cycle of Federal Reserve rate rises in the United States has led to a heightened perception of risk attaching to the emerging economies, outflows of capital from such countries and depreciations for their currencies.

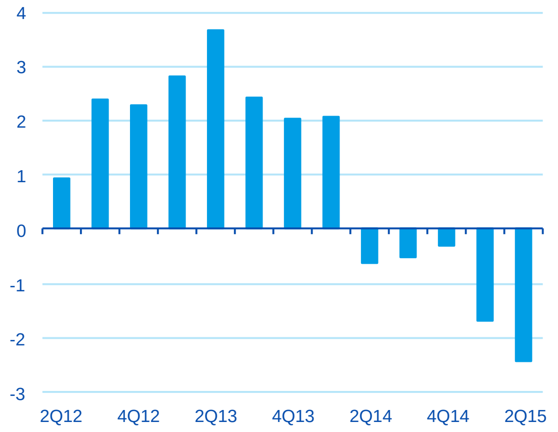
Against this backdrop, economic activity advanced by 3.3% YoY over the first half, which was below the rate of the second half of 2014, due to lower agricultural output (20% of total GDP), which came to a virtual standstill (the sustained falls in agricultural product prices, especially that of the soybean, dampened business confidence, investment and production). Besides this, certain one-off supply-side factors were observed, such as lower water-flow levels at hydroelectric facilities, which affected electricity production (energy output and water fell 3.0% in the first half). All of this was reflected, on the spending side, in the performance of exports, which contracted by 3.3% in the first half of the year and shaved around 2pp off GDP growth (soybeans and electricity together account for about 45% of overall exports).

Figure 3.1
Soybean price (USD/tonne)



Source: Bloomberg and BBVA Research

Figure 3.2
Brazil's GDP (% var. YoY)



Source: World Bank and BBVA Research

…yet domestic demand continued to prop up GDP

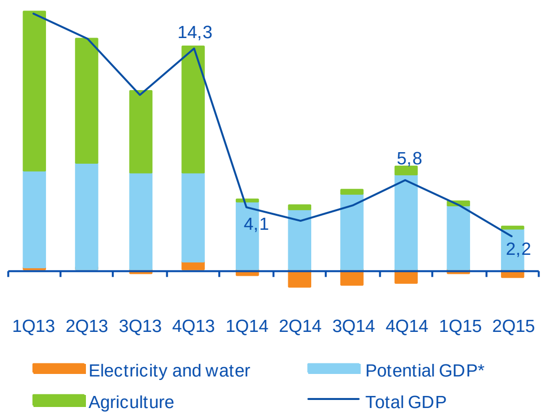
The most trend-representative measure of GDP (which excludes agriculture, and electricity and water) grew at 5.0% YoY and continued to underpin activity in the first half (see Figure 3.3). The most notable growth was in the construction sector (10%), given ongoing major private-sector projects involving, for example, corporate buildings, shopping centres, housing and hotels, as well as that in industry and mining (7.7%),

1: Even though the recent slump in the world crude oil price has helped to keep the cost of imports in check (the country imports all of its fuel requirements), this is not enough to offset the impact of the steady fall in the soybean price.

driven on by items linked to the production of dairy goods and oils, grain mills and bread-making. This is also borne out on the domestic demand side (which grew by 4.3%, one point more than GDP, see Figure 3.4), where gross capital formation saw growth of 4.9% and contributed 1.1 percentage points to GDP growth, and total consumption grew by 3.7%.

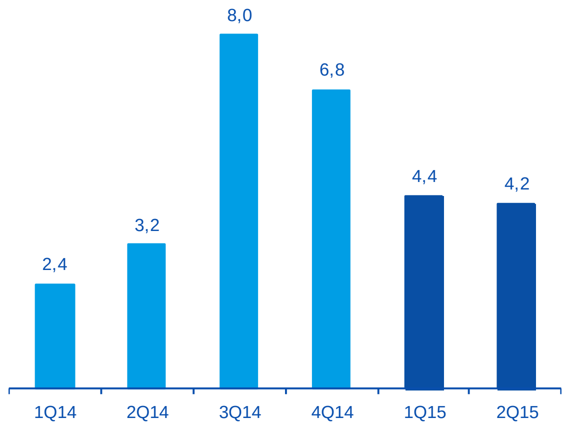
It should be pointed out that even though trend GDP continued to grow in the second quarter, it also exhibited a far more sedate rate of progress (after showing growth of 6.3% in the opening three months of 2015, it moved ahead at a mere 3.8% in the second quarter). In particular, a slowdown was noted in construction, which moved from a rate of 15% to 5%, due to adverse weather conditions which hit the normal execution of work, and in the services sector (43% of total GDP), which grew at 3.6%, or almost two percentage points lower than in the first quarter, on lower sales activity in the border cities owing to economic weakness in the key neighbouring countries (most of all, Brazil) and the marked depreciation of their currencies.

Figure 3.3
Contribution to GDP by sector (percentage points, % var. YoY)



* Ex agriculture, and electricity and water.
Source: BCP and BBVA Research

Figure 3.4
Domestic demand ex inventories (% var. YoY)

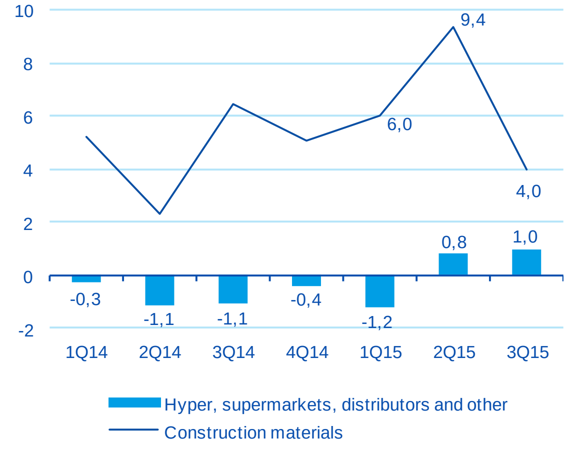


Source: BCP and BBVA Research

In this context, we forecast GDP growth of 3.2% in 2015, though this carries downside risk

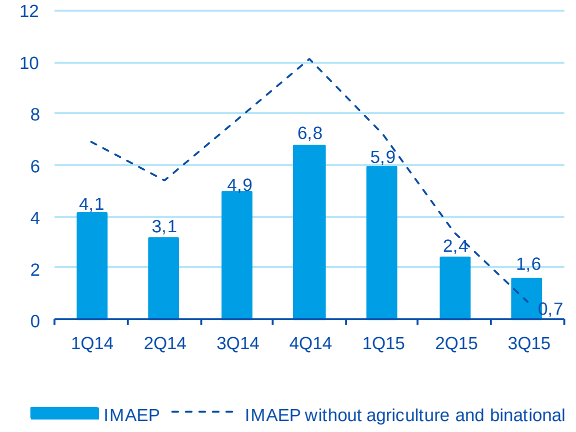
Our central scenario assumes that GDP will embark on a process of gradual recovery towards the end of 2015, especially in agriculture (in the third quarter, volumes of shipments of agricultural products such as wheat, maize, rice and soybeans increased by 20%, which was the first positive result in six quarters), energy and construction (on the turnaround of key supply shocks which affected the first half of the year). GDP will thus grow at 3.2% in 2015. Certain advance indicators, though, suggest that activity, above all in its most trend-representative part, is likely to have continued to show weakness in the third quarter (see Figure 3.5), which adds downside risk to our forecast. The IMAEP (an indicator which is very true to GDP movements) rose 1.6% in the third quarter, while ex agriculture and bi-national undertakings it only moved ahead by 0.7% (see Figure 3.6).

Figure 3.5
Economic activity indicators (% var. YoY)



Source: BCP and BBVA Research

Figure 3.6
Quarterly GDP (% var. YoY)



Source: BCP and BBVA Research

For 2016, in a still challenging environment, we forecast growth of 3.4%

The scenario for 2016 will be complex and we take account of the following elements in our estimates:

- On the external front:

  i) A relatively stable soybean price. The effects of lower world supply should be offset by weaker international demand, principally from China.

  ii) Less deterioration of Brazil's economy in 2016, strongly influenced by political resistance to change and adjustments still to be carried out on the fiscal side. In the case of Argentina (trading partner which accounts for around 9% of exports), although future dynamics will hinge very much on the confidence of economic agents given the new government being formed in December, we estimate growth of 1.4% on a par with the previous year.

  iii) A more gradual approach in adjustment of the Fed's benchmark rate in a context where we have revised our growth forecasts for the United States downwards. Nonetheless, the process of US monetary normalisation will continue to be shrouded in uncertainty, which makes for potential bouts of volatility on local financial markets and, if these persist, they could exert real effects.

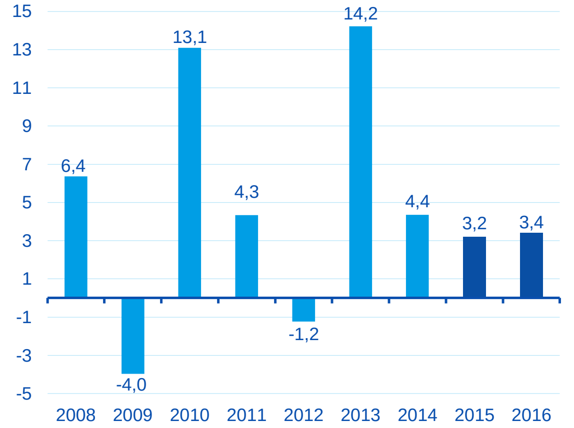
- On the local side:

  i) The infrastructure construction work will have a more palpable impact.

  ii) Government spending consistent with the fiscal rule.

Bearing this in mind, for 2016 we forecast a mild acceleration of growth to 3.4% (see Figure 3.7), although this would be lower than the level forecast in our July report (3.9%). Domestic demand (3.7%) will again be the prime mover of growth (see Table 3.1), and will be especially driven by heavier levels of both private and public investment (total capital formation will contribute 1.2 percentage points to growth for the year).

Figure 3.7
Annual GDP
(% var. YoY)



Source: BCP and BBVA Research

Table 3.1
Expenditure-side GDP
(% var. YoY)

	2013	2014	2015	2016
Domestic demand	7,6	5,7	3,6	3,7
Consumption*	4,7	4,4	3,4	3,0
Gross capital formation**	20,2	10,6	4,5	6,0
Exports	18,4	0,9	-1,5	1,5
Imports	6,8	2,8	-1,2	1,8
GDP	**14,2**	**4,4**	**3,2**	**3,4**

*Includes private and public consumption
* Includes GFI and inventories.
Source: BCP and BBVA Research

In addition to the infrastructure projects that are either already underway or in the pipeline (such as work on improving roads, highways and lanes, among others), there will be new projects to be pursued under the Public Private Partnership (PPP) format, which will enable growth to enjoy some sustainability (see Table 3.2). For example, the extension of Routes 2 and 7 (USD415mn), was put out to tender in September 2015 and is expected to be awarded towards the second half of 2016. It should be noted that, besides encouraging sector diversification of total investment and making it less vulnerable to commodity price volatility, infrastructure investment gives rise to substantial positive externalities and produces a direct and pervasive impact on the well-being of society. In this context, we estimate that the total investment-to-GDP ratio will be around 17.5% in 2016, thus regaining the levels it had seen in 2011 (17.1% of GDP).

Table 3.2
PPP projects either approved or under review* (USD mn)

State	Project	Preliminary amount (USD millions)
	Public Initiatives	**1.446**
Approved	Expansion of routes 2 and 7	415
In study	Total modernization of Silvio Pettirossi Airport	147
	Rehabilitation, improvement and expansion of routes 1 and 6	684
	Dredging opening, signaling, operation and maintenance of the Paraguay River Waterway	200
	Private Initiatives	**446**
In study and with confidentiality clause	6 projects	446
	Total	**1.893**

* The total value of these projects is around 6.0% of GDP.
Source: DNCP and BBVA Research

With respect to external demand, its contribution to growth will hold at a neutral level as exports will provide a boost (1.5%) as primary sector recovery continues, while imports will also gather momentum (1.8%), with the expansionary effect of infrastructure projects on purchases of capital goods and inputs (as things stand, imports of inputs and capital goods associated with construction represent around 35% of total import value).

From 2017, with a more marked recovery of external demand which will have a notable impact not only on export levels but also border-trade activity (Brazil should emerge from contractionary territory and grow at between 1% and 2%), and infrastructure projects in sectors such as roads, water and drainage, and electricity power transmission and distribution still driving activity onwards (at present the combined value of on-road projects which are to be awarded as concessions from 2016 is in excess of USD1bn), we forecast that Paraguay's growth will be a little over 4.2%. We note that, owing to the fact that the imported component of infrastructure projects is normally concentrated over the first years of execution, over this horizon such projects will have a larger impact on GDP growth.

Focussing progress on competitiveness and productivity is key to ensuring medium-term growth

According to the Global Competitiveness Index 2015-16, published by the World Economic Forum (WEF), Paraguay is ranked 118th, which is up two places on the previous year but still unsatisfactory when compared to the other 140 countries in the ranking. Inspection of the 12 factors included by the WEF shows that Paraguay's improvement in competitiveness in the last year has been in the area of the macroeconomic environment, which ranks the country in 43rd place, having previously been placed 100th. The country actually has a better macroeconomic environment than the Latin America region. However, the WEF also reveals that the country lags the region in key aspects such as the Supply of Physical Infrastructure (quality of roads and air transport infrastructure), which was considered inadequate, as well as Innovation and Higher Education and Training (see Figure 3.8).

On the other hand, according to Doing Business 2016 (the indicator of the ease of doing business), Paraguay's Distance to frontier indicator showed a better ranking relative to its Mercosur peers (see Figure 3.9), yet the country was ranked 100th out of 189 and slipped back five places compared to the previous ranking. Of a total of 10 indicators, the biggest falls in ranking were observed in Starting a business (down nine places), Getting credit (eight places), Getting electricity (four places) and Resolving solvency (two places).

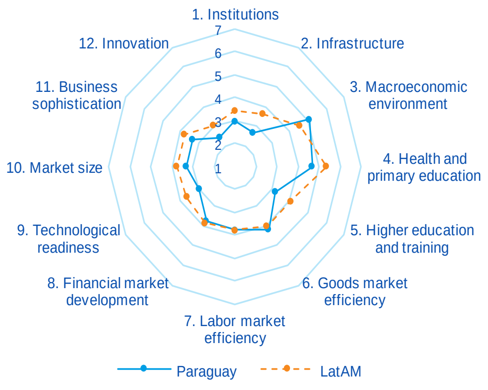
Given the above, and even though macroeconomic stability is a distinguishing feature of the Paraguayan economy, it is clear that, to maintain economic growth at around 4.0% in the medium term, it is essential to implement measures and/or reforms aimed at enhancing the country's productivity and competitiveness. In this context, the key challenges must focus on applying policy measures to: i) reinforce human capital and reduce informality; ii) narrow the infrastructure gap, and iii) cut through red tape and scale down cost overruns in the economy.

Ensuring sustained growth is a necessary pre-condition to becoming a high-income country, as high short-term growth is no guarantee of long-term success. According to Agénor, Canuto & Jelenic (2012)[2], following a period of rapid progress most developing countries have experienced a sharp slowdown in growth and fallen into the so-called "middle-income trap"[3]. There is a lengthy list of countries which have suffered such a deceleration. The World Bank (2012) estimates that out of 101 middle-income economies in 1960, as of

2: Agénor, P., Canuto, O. & Jelenic, M. (2012), "Avoiding middle-income growth traps", World Bank.
3: Gill & Kharas (2007) define the "middle-income trap" as the decline in historical growth rates which stops middle income countries from making the jump to having the standing of high-income countries.

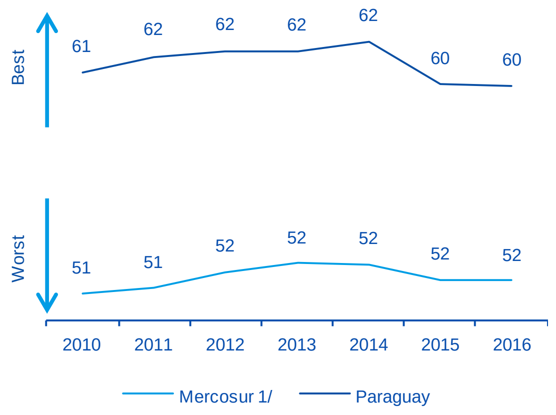
2008 only 13 had become high-income economies: Spain, Equatorial Guinea, Greece, Hong Kong, Ireland, Israel, Japan, Mauritius, Portugal, Puerto Rico, South Korea, Singapore and Taiwan[4].

Figure 3.8
Global Competitiveness Index 2015-16 (Scale from 1 "worst" to 7("best")



Source: World Economic Forum and BBVA Research

Figure 3.9
Doing Business: Distance to frontier* (Scale of 0 "worst" to 100 "best")



* Gap between the performances of a particular economy and the best worldwide at any point in time.
1/ Does not include Paraguay
Source: Doing Business – World Bank and BBVA Research

The fiscal accounts will continue to show a deficit

Even though the Law on Transparency and Fiscal Responsibility (LTRF), which came into effect this year, sets a cap on the fiscal deficit of 1.5% of GDP, our forecast for the fiscal balance in 2015 assumes that the government will fail to comply with this upper limit despite having made adjustments to keep the deficit below the level envisaged under the said law.

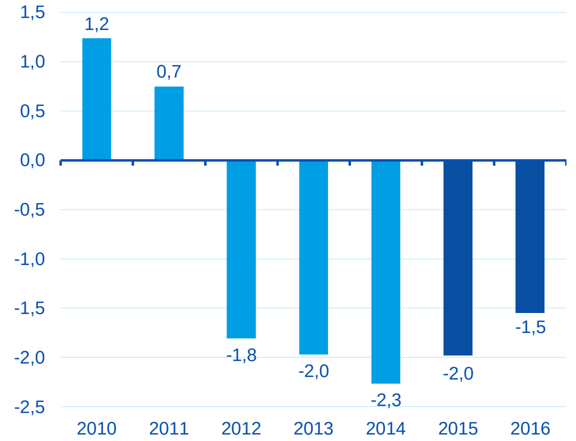
From January to July, the fiscal deficit was PYG752bn, this being mainly accounted for by higher expenditure (12.0%) in relation to revenues (6.7%). Within expenditure, there was an increase in employee compensation (9.4%) and goods and services (25.5%). Meanwhile, fiscal revenues rose, due to higher collections of personal income tax (10.0%), although certain one-off factors were also observed. We thus estimate that for 2015 the fiscal deficit will come in at around 2.0% of GDP (see Figure 3.10), in a situation where there will be higher capital expenditure (aimed at the infrastructure projects that were given priority by the government) and a slowdown in tax collection, given the greater sluggishness of the economy.

In future, we foresee a gradual paring down of the deficit until it becomes compliant with the cap under the Law on Transparency and Fiscal Responsibility, which will help to consolidate the credibility of the fiscal rule[5].

In a scenario of fiscal deficits, between 2013 and 2014 government debt was issued on international markets (bonds raising USD500mn and USD1bn respectively) to finance infrastructure projects in the next few years. We predict that these external borrowing requirements will still remain latent, so we estimate that public sector debt (excluding the central bank) should move from 16% of GDP in 2014 to over 20% in 2016 (see Figure 3.11) and will stabilise at around 25% from 2018. Even though this increase in the public debt ratio should be swift, it is no indicator of any rising pattern that might affect the sustainability of the public finances, because in the future infrastructure projects are expected to be pursued using the PPP format.

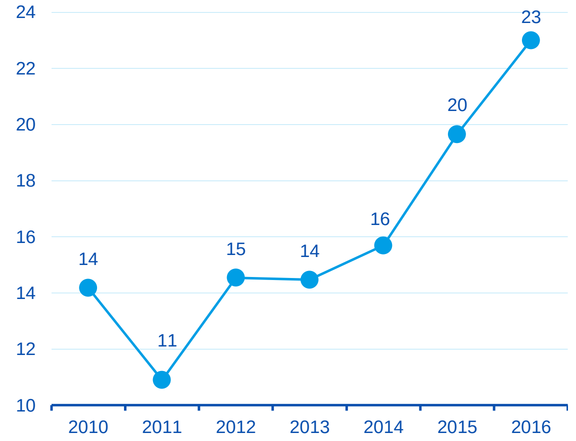
4: World Bank (2012), "China 2030: Building a Modern, Harmonious, and Creative High-Income Society".
5: Notwithstanding this, to the extent that more public spending is carried out, there is the risk that the deficit will climb beyond the upper limit set under the rule.

Figure 3.10
Fiscal position
(% of GDP)



Source: BCP and BBVA Research

Figure 3.11
Public sector debt
(% of GDP)



Source: IMF and BBVA Research

The external deficit will right itself and be mainly financed by long-term capital

Over January to October 2015, the balance of trade showed a surplus of USD1.089bn in a context in which both exports and imports fell off by around 15% (see Figure 3.12). By product groups, the imports which dropped away the most were inputs (-18.4%, on the lower oil price) and capital goods (-16.3%). On the other hand, the value of exports shrank due to a lower figure for shipments of soybeans and derivatives thereof (-26.2%), meat (-14.9%) and electric power (-3.1%), which altogether represented 57% of total exports (see Table 3.3).

Figure 3.12
Recorded exports and imports
(% var. YoY)

Source: BCP and BBVA Research

Table 3.3
Balance of Trade
(USD mn)

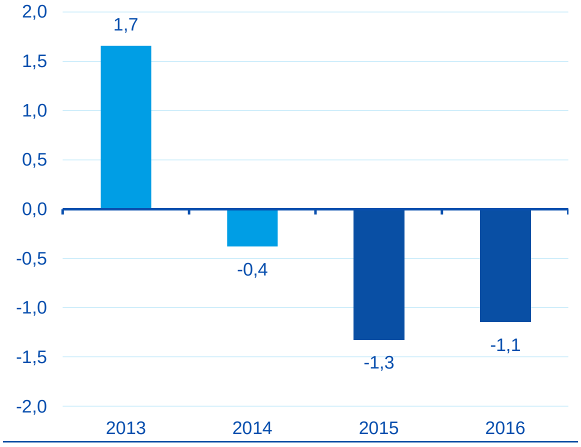
			January - October		
	2013	**2014**	**2014**	**2015**	**Chg. %**
Total exports	**13.605**	**13.116**	**11.433**	**9.701**	**-15,1**
Exports registered	9.456	9.636	8.544	7.264	-15,0
Re-exports	4.065	3.455	2.869	2.349	-18,1
Other	84	25	20	88	334,5
Total imports	**11.942**	**12.079**	**10.081**	**8.613**	**-14,6**
Imports registered	11.302	11.299	9.420	7.953	-15,6
Other	640	780	661	660	-0,2
Trade Balance	**1.662**	**1.037**	**1.352**	**1.089**	**-19,5**

Source: BCP and BBVA Research

In this situation, the forecast for the current account deficit has been revised downwards slightly, to 1.3% of GDP for 2015 (from one of 1.4% of GDP in July) given lower import prices, due to the oil price and smaller outflows such as of factor income, on account of the lower profits made by foreign companies (see Figure 3.13). For 2016-19 our forecasts assume a steady reduction of the external deficit (which on average should be -0.4% of GDP), given the recovery of exports, especially of energy, and demand from Brazil for Paraguayan products.

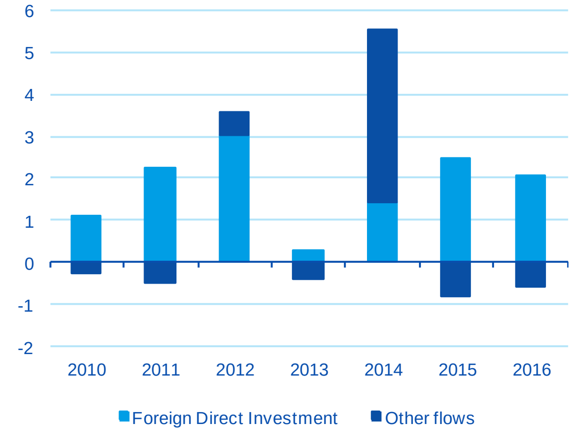
With regard to sources of funding, in the first half of 2015 inflows of 2.3% of GDP in Foreign Direct Investment (FDI) were registered. Such flows are expected to continue over the next few quarters, so that FDI for the year in 2015 (as a percentage of GDP) should come in at a level on a par with the first quarter, which will mean that the financing of the foreign deficit is more than covered. In the next few years, we estimate that FDI coming into the country will continue to be encouraged by infrastructure projects that offer opportunities for this kind of funding (see Figure 3.14).

Figure 3.13
Current account
(% of GDP)



Source: BCP and BBVA Research

Figure 3.14
Financial account
(% of GDP)

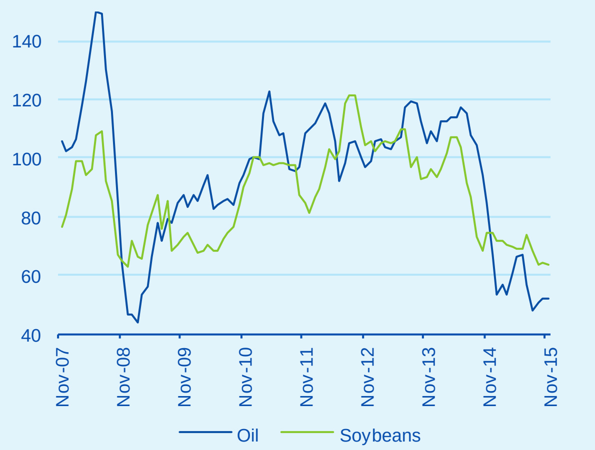


Source: BCP and BBVA Research

Box 1. Commodity prices: soybeans and oil

The world economy is still growing but at a slower pace, especially among the emerging markets. In this context, there is still long-term uncertainty over China, the key source of demand for commodities worldwide. On the other hand, exchange rates continue to weaken in most countries on the deterioration of fundamentals (both domestic and external) and the lift-off for rate hikes by the Fed. All of this gives downside bias to commodity prices (uncertainty over China and the strengthening of the USD move inversely to commodity prices). Thus, in the YtD there have been sharp contractions in the market prices of commodities that are important to Paraguay, such as soybeans and oil (Figure B.1.1).

Figure B.1.1
World oil and soybean prices (January 2011=100)



Source: Bloomberg and BBVA Research

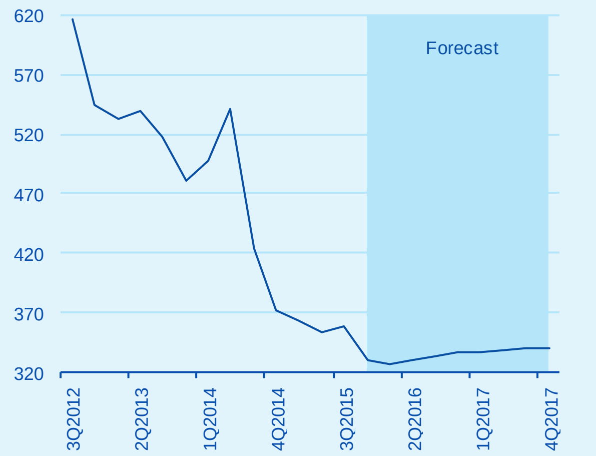
It should be noted that, according to the IMF, even though the drop in the crude oil price has positive effects on GDP, since it helps to dampen the cost of imports, this is not enough to make up for the negative impact of the steady fall in the price of the soybean, which is the country's foremost export product.

Soybeans

The soybean price currently stands at around USD325/tonne and shrank by a cumulative 14% between the end of 2014 and November 2015. This downward trend in the price is mainly due to lower demand from China (over 60% of the world demand for soybeans) and the bumper harvest in the United States (33% of global supply). Towards the end of the year, we expect prices to hold at current levels.

Looking forward, we expect the price of soybeans to remain relatively stable (or keep to a slight rising trend), in a context where drops in supply (lower profit margins with price weakness have an adverse impact on the cultivated area) are marginally neutralised by the effects of weaker demand, especially from China. We therefore expect the price to hold at around USD330/tonne over a large part of 2016 and to approach USD340/tonne towards the end of 2017 (Figure B.1.2).

Figure B.1.2
World soybean price (USD/tonne)



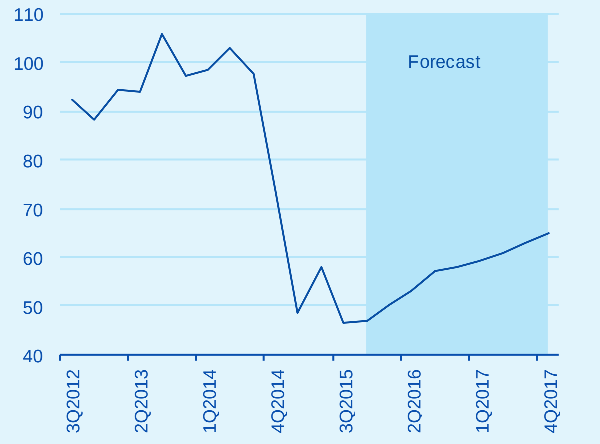
Source: Bloomberg and BBVA Research

Oil

The oil price currently stands at around USD45/bbl, and saw a cumulative drop of 25% between December 2014 and November 2015. This lower level is associated with a glut that has arisen from inventory persistence, the resilience exhibited by shale oil producers in the United States, the maintenance of OPEC's production quotas and expectations of increased exports by Iran and Iraq. Meanwhile lower world demand, especially from China, in an environment of concern over financial volatility and doubts surrounding its growth, accentuated the fall in the price. Towards the end of the year we expect the current oil price level to hold, producing an average of USD50/bbl.

Going forward, we think that the oil price will recover gradually and converge on a long-term level of around USD65/bbl in 2017 (see Figure B.1.3). The recovery will arise from an improvement in global demand and lower supply in a context of low prices, which will lead to a keener balance between demand and supply. On top of this, the geo-political tensions in the Middle East will also have a bearing on the crude price.

Figure B.1.3
World oil price (USD/bbl)



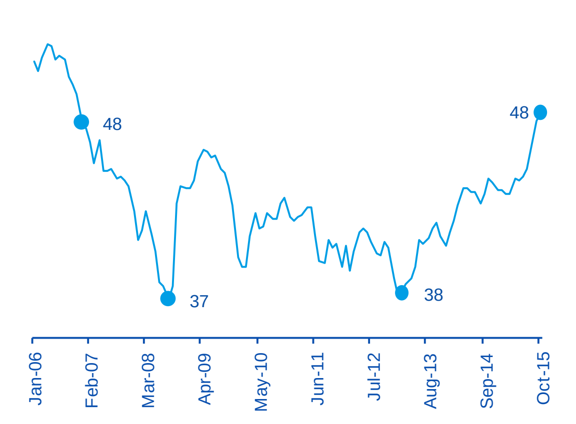
Source: Bloomberg and BBVA Research

4 Less depreciation of the PYG, with bouts of volatility

The average dollar exchange rate at the end of the month in November was USD/PYG5,636, implying a cumulative 21% depreciation compared to the level at the end of last year. Such pressure is attributable to the international environment (Fed rate normalisation, uncertainty over Brazil, China and Europe, among others) and this is expected to persist over the remainder of 2015. It should be noted that in the context of further deterioration of the PYG and expectations of a higher international interest rate in the future, there has been an increase in the dollarisation of foreign currency bank deposits, which reached 48% of the overall deposits figure in October (see Figure 4.1), and which is the highest level since the latter part of 2006.

As per the above, our current dollar exchange rate forecast for the PYG at the end of 2015 is USD/PYG5,750, which is higher than had been ventured in July (USD5,400). From here on out, we foresee the PYG exchange rate depreciating at a far slower pace as it reflects the weakening of fundamentals (a fall in the terms of trade and a weakening of the fiscal position), in a scenario in which the exchange rate has already to a large extent priced in the expected Fed rate hike. The PYG's dollar rate should thus skirt USD/PYG6,000 at the end of 2016 (see Figure 4.2).

Figure 4.1
Dollarisation of deposits (%)



Source: BCP and BBVA Research

Figure 4.2
Nominal exchange rate (USD/PYG)

Source: Bloomberg and BBVA Research

5 Inflation contained within the central bank's target band

In November, consumer prices rose 0.4% MoM. This means that YoY inflation was 2.9% (see Table 5.1), which is below the middle of the target band established by the central bank (4.5%). Over the year, certain one-off supply factors have exerted a favourable influence on the CPI reading (a record wheat harvest and an oversupply of dairy products, that were prompted by the weather conditions) and the low world cereal price, which has been reflected in lower food prices (mainly those of meat and food derivatives). On the other hand, an offsetting influence in the aggregate figure was provided by the rises in other components of the CPI basket which are more closely tied to exchange rate movements, such as imported goods[6] (with the exception of fuels, which continued to fall). Given this situation, we have changed our 2015 inflation forecast to 3.6% from 4.3% in July. Our estimate remains in line with the market consensus (3.7%, according to the November survey of Expectations of Economic Variables).

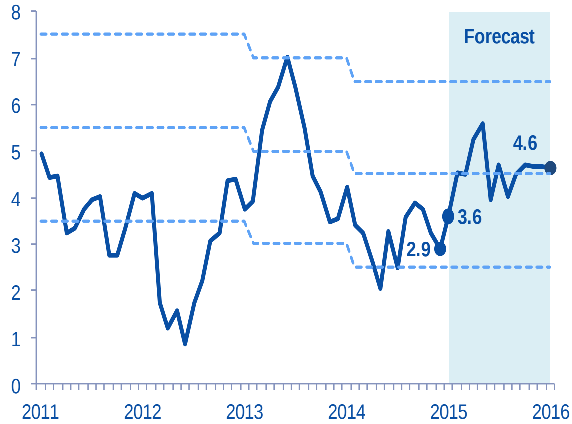
For the subsequent months, we estimate that inflation should continue at around the middle of the target range established by the central bank (see Figure 5.1). Specifically, the mildly negative GDP gap, inflation expectations in line with the target and continuing low world prices of commodities (especially those imported by Paraguay, such as oil and foods) will partially offset the depreciation of the PYG and the turnaround of the supply shocks observed in 2015. We therefore expect inflation to pick up speed towards the middle of 2016, although without posing a risk to achieving the central bank's target. Towards the end of 2016, inflation will be 4.6%, which is similar to the expectations of other economic agents on average.

Table 5.1
Inflation
(% var. YoY)

Items	1Q15	2Q15	3Q15	Oct 15	Nov 15
Nontradable goods	4,2	4,0	4,1	4,1	4,0
Domestic products	2,9	2,4	2,6	2,6	2,3
General Index	**3,1**	**2,6**	**3,7**	**3,2**	**2,9**
Core	2,2	2,0	2,5	2,8	2,8
Fruits y vegetables	14,1	9,5	21,5	8,4	8,4
Tariffed services	-0,8	-1,5	-0,7	-0,6	-0,6
Fuels	-9,0	-12,9	-12,1	-13,0	-13,0

Source: BCP and BBVA Research

Figure 5.1
Inflation
(% var. YoY)



Source: BCP and BBVA Research

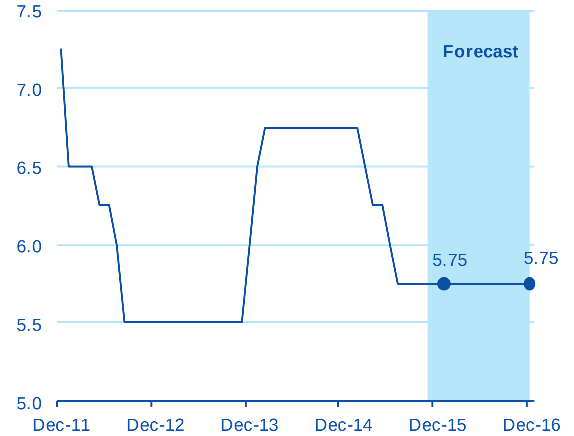
6: It should be pointed out that, even though the PYG has weakened against the USD, the depreciations experienced by the Brazilian real and the Argentine peso have been far greater. This ultimately implies an appreciation (in nominal and real terms) of the PYG against these currencies, which also constitutes a depressing influence on local inflation.

6 Market interest rates are converging towards the MPR

At the moment, the policy rate remains at 5.75% (see Figure 6.1) in a setting where inflation and expectations are still in line with the target level (see Figure 6.2). Even though a slackening of economic activity persists, the central bank continues to await events that might happen on the external front over the next few quarters.

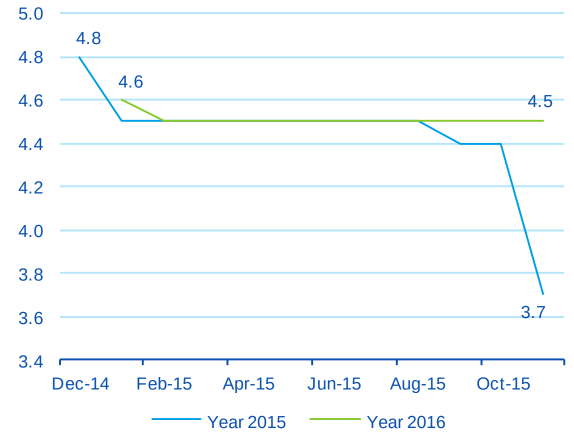
Looking ahead, our forecast assumes that the central bank will hold the benchmark at 5.75% until the end of 2016. This is factoring in that expectations will remain anchored at 4.5%, despite the prospect of a Fed rate hike and its effect on the PYG exchange rate. We thus expect a gradual rise in the MPR in line with the pick-up in growth.

Figure 6.1
Monetary policy rate (%)



Source: BCP and BBVA Research

Figure 6.2
Inflation expectations (% var. YoY)



Source: BCP and BBVA Research

7 Deeper recession in Brazil is the main source of downside risk

Deviations to the developments assumed in our baseline scenario for several key variables on the external and local side could shape a more challenging environment for Paraguay's economy in the coming months. Even so, it is important to make the point that Paraguay has strengths that can limit the potential effects of more adverse scenarios.

On the external side, a deeper and longer-lasting recession in Brazil would have a substantial effect on Paraguay's growth…

The major downside risk as regards the GDP forecast is from greater-than-expected deterioration of the Brazilian economy. Brazil is the principal market for Paraguay's exports, accounting for about 30% of those recorded (this share jumps considerably if re-exports are included). According to our estimates, a drop of one percentage point in Brazil's GDP growth arising from idiosyncratic elements (after controlling for global factors) would bring about a reduction of between 0.4pp and 0.5pp in Paraguay's GDP growth.

…moreover, a harder landing for China would hit both soybean prices and Brazil

Our baseline scenario assumes that the process of a dampening of growth in China down to more sustainable levels, such as a rebalancing among its drivers of growth on the demand side (less investment vs. more consumption) will be gradual and orderly. Nonetheless, the financial frailties that are coming to light in China have sparked doubts over the strength of its growth and its ability to maintain rates of close to 6%. Given this situation, lower growth in China would have an adverse effect on Paraguay's economy through a direct channel, materialising in heavier and more persistent falls in the prices of those commodities which it exports (chiefly soybeans), as well as via the indirect path of weaker external demand in Brazil's case, since it is highly exposed to shocks in China (for further details, see Box 2. What would be the impact on Paraguay of a harder landing for China?).

The imminent Fed adjustment is still generating uncertainty, too

The uncertainty that has been surrounding lift-off for the Fed's normalisation process, and the pace at which the adjustment will be made, have touched off bouts of volatility on emerging financial markets. Surprises from US activity figures or a shift in perceptions of what the Fed's intentions are have prompted a reshuffling of investor portfolios that has been echoed by swings in the prices of assets and currencies among the economies of Asia and Latin America. However, what could give rise to major upsets in how global activity performs is the process of how markets receive the Fed's rate adjustment. For example, faster hiking of the federal funds rate (which is not discounted) will lead to further reallocation of portfolios worldwide, that will produce a preference for holding dollar assets. In such a scenario we could expect greater upward pressure on the PYG exchange rate, as well as an increase in risk premiums and, consequently, in funding costs. On top of this, in such a situation further strengthening of the dollar could not be ruled out, such that might generate additional downward pressure on commodity prices in the short term and upward adjustments in price levels generally. If these pressures on local financial markets and the PYG are persistent (and translate into tougher borrowing conditions, balance sheet effects, etc.), the real impact could be more notable and growth would be held back.

On the domestic side, accelerating the programme of infrastructure projects would push up the forecast for economic growth

Among the domestic factors that would push up the growth forecast would be an acceleration of the implementation of infrastructure projects in the pipeline. From a sector standpoint, this would be reflected in greater growth for construction and, on the expenditure side, more marked investment growth.

In view of the likelihood that we attach to each of these events occurring and the impact that they would have on economic activity (downward as regards external factors and upward for domestic ones), the risks to the GDP forecast are balanced.

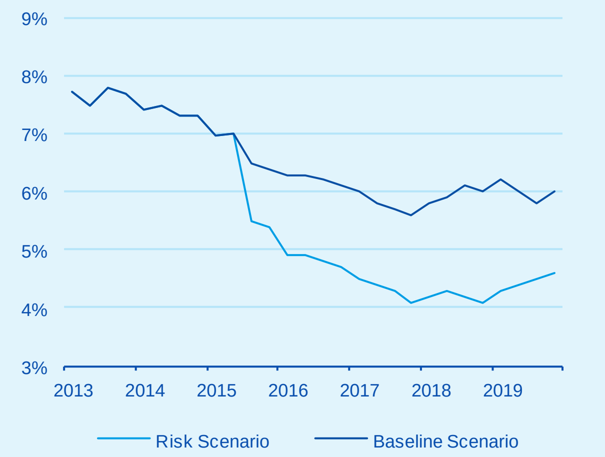
Box 2. What would be the impact on Paraguay of a harder landing for China?

A risk scenario for China: persistent slowdown

Even though our central scenario assumes that the authorities will continue to support growth of no less than 6% YoY, it is well worth examining the effect of a sudden and persistent slowdown in China which leads to growth that is significantly below these levels.

Such a scenario could, for example, arise from excess pressure on the parallel banking system or a sharp tightening in the interbank market, such as occurred in June 2013, which might lead to a financial crisis and a drop in confidence among both consumers and corporates. A shock of this kind could produce a collapse of consumption due to a deceleration for disposable income. Nonetheless, the main impact would be on investment, owing to financial instability and decreased appetite for risk. Such a weakening of domestic demand could drag down growth to rates of around 4% instead of the figure of 6% posited in the central scenario (see Figure B.2.1).

Figure B.2.1
China: gross domestic product
(% var. YoY)



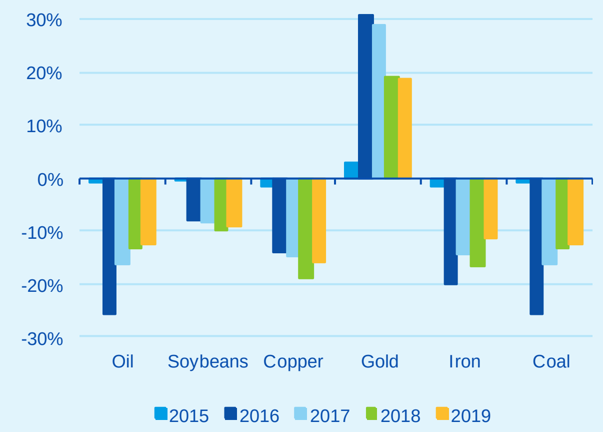
Source: IMF and BBVA Research

A negative shock for growth in China: the transmission channels

The above-mentioned risk scenario would affect Paraguay via two main channels: i) a direct channel, which would materialise in heavier and more persistent falls in commodity prices[7] (see Figure B.2.2), including soybeans, since China represents over 60% of demand worldwide, and ii) an indirect path due to weaker external demand for Brazil (which is very vulnerable to shocks in China).

In this context, Paraguay's growth rate would suffer a downward correction (see Figure B.2.3). On a sector level, there would be effects on the agriculture side (from lower soybean margins, that lead to a scaling down of cultivated land) and in the services sector (owing to greater sluggishness in the trade subsector, especially border trade with Brazil). The adverse effect will also be noted in industry, especially *la maquila* (low-cost assembly activity) that targets the Brazilian market.

Figure B.2.2
Effect on key commodity prices*
(% difference with respect to the baseline scenario)



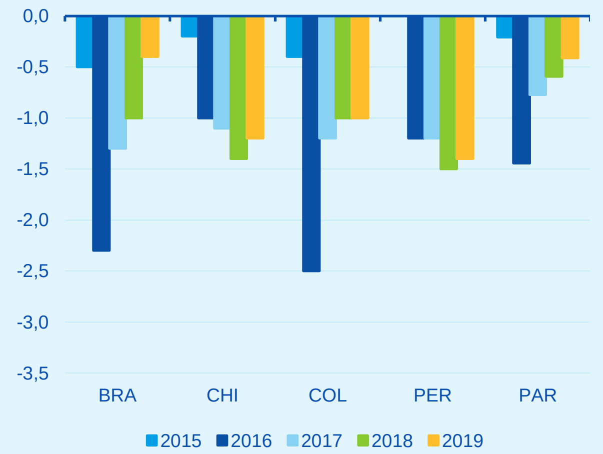
*Potential impact on commodity prices one year after a 1pp drop in the growth of fixed asset investment in China
Source: BBVA Research

[7] It should be noted that prices of energy commodities (such as oil) would also be strongly affected, which would benefit Paraguay.

On the expenditure side, the main effects will be noted in: i) exports, especially those of soybeans given the lower production levels, as well as assembly and re-exports, due to the increased weakness of demand from Brazil; ii) investment, with the rise in the PYG's exchange rate (this raises the cost in PYG of imported machinery, equipment and inputs) and a lower level of reinvestment of the profits of foreign companies, especially those in agriculture and those oriented towards satisfying domestic demand; iii) consumption, due to fewer jobs being created and a higher cost of credit. Beyond this, families would not ease up on their consumption because the negative shock is permanent as regards GDP level and its growth rate, and iv) imports, in line with lower domestic demand, especially in relation to investment, and depreciation of the PYG.

On the fiscal front, there is some margin to implement counter-cyclical fiscal policies (at least initially) that would soften the effects of the initial impact, although at the moment the intention is to consolidate the credibility of the fiscal rule, which only permits a deficit of 3% in the event of a national emergency, international crisis or a fall in domestic economic activity. In such circumstances, implementing counter-cyclical fiscal policies is far more tricky if we also bear in mind the permanent nature of the shock.

Figure B.2.3
Impact on growth (difference with respect to the baseline scenario in percentage points)



Source: BBVA Research

On the external side, the strong dip in domestic demand would more than outweigh the decline in external demand and the terms of trade, which would mean the external deficit being worse off in relation to the baseline scenario.

It is worth noting that this scenario has been replicated as regards other economies in the region, which enables comparison of which ones would be most sorely hit. The findings from a simulation of this kind show that most of the region's countries would be affected to the tune of over 1pp, given a shock from China. Brazil and Colombia would come off the worst, since they have high exposures to China. This would be more so in Brazil's case, given that it would have to face up to the shock with very badly weakened fundamentals, and because it has to press ahead with its fiscal adjustment. Therefore, in the risk scenario, Brazil would be beset by a truly punishing recession in 2016 (deeper than that included in our baseline scenario), which would compromise Paraguay's growth, shrinking it by around 1.4 percentage points in 2016 in relation to our baseline scenario (for which reason GDP growth would be 2.0%, and consequently lower than the level of 3.4% that we forecast in our baseline scenario).

8 Tables

Table 8.1
Macroeconomic forecasts

	2012	2013	2014	2015	2016
GDP (%, YoY)	-1,2	14,2	4,7	3,2	3,4
Inflation (%, YoY, eop)	4,0	3,7	4,2	3,6	4,6
Exchange rate (vs. USD, eop)	4 285	4 603	4 669	5 750	5 980
Policy rate of interest (%, eop)	5,50	6,00	6,75	5,75	5,75
Private consumer spending (%, YoY)	2,8	4,6	4,4	3,0	3,0
Public spending (%, YoY)	21,0	5,3	4,4	6,0	3,0
Investment (%, YoY)	-13,5	20,2	10,6	4,5	6,0
Fiscal deficit (%, of GDP)	-1,8	-2,0	-2,3	-2,0	-1,5
Current account surplus (% of GDP)	-2,0	1,7	-0,4	-1,3	-1,1

Source: BCRP y BBVA Research

Table 8.2
Macroeconomic forecasts

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange Rate (vs. USD, eop)	Policy Rate (%, eop)
T1 13	16,5	1,2	4 029	5,50
T2 13	14,8	1,7	4 499	5,50
T3 13	11,3	3,2	4 460	5,50
T4 13	14,3	3,7	4 603	6,00
T1 14	4,1	6,1	4 490	6,75
T2 14	3,2	6,4	4 434	6,75
T3 14	4,2	4,1	4 500	6,75
T4 14	5,8	4,2	4 669	6,75
T1 15	4,2	2,6	4 799	6,50
T2 15	2,2	2,5	5 144	6,00
T3 15	3,1	3,7	5 591	5,75
T4 15	3,1	3,6	5 750	5,75
T1 16	2,6	5,2	5 780	5,75
T2 16	4,7	4,7	5 814	5,75
T3 16	3,6	4,7	5 851	5,75
T4 16	2,9	4,6	5 980	5,75

Source: BCRP y BBVA Research

DISCLAIMER

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This report has been produced by the Peru Unit

Chief Economist for Peru
Hugo Perea
hperea@bbva.com
+51 1 2112042

Francisco Grippa
fgrippa@bbva.com

Yalina Crispin
Yalina.crispin@bbva.com

Vanessa Belapatiño
Vanessa.belapatino@bbva.com

Ismael Mendoza
Ismael.mendoza@bbva.com

Marlon Broncano
Marlon.broncano@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Developed Economies Area
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

US
Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area

Cross-Country Emerging Markets Analysis
Alvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey
Alvaro Ortiz
alvaro.ortiz@bbva.com

LATAM Coordination
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

Financial Systems and Regulation Area
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Global Areas

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Contact details:

BBVA Research Perú
Av. República de Panamá 3055
San Isidro
Lima 27 - Perú
Tel: + 51 1 2112042
E-mail: bbvaresearch_peru@bbva.com
www.bbvaresearch.com