

Paraguay

Economic Outlook

1ST HALF 2016 | PERU UNIT



01 Growth of around 3.0% in 2016 and 2017. Domestic demand, due to infrastructure projects, will be the main driver of growth

02 Lower depreciation of the currency but with episodes of volatility. This adjustment will be a reflection of the deterioration in the fundamentals

03 Inflation will continue to be contained around the mid-range of the target. Thus, the Central Bank would keep its policy monetary rate

04 Main risks: more pronounced slowdown in Brazil and China, and slower progress in infrastructure projects

Contents

1	Editorial	3
2	Fragile global growth, dependent on China	5
3	Paraguay: we projected growth of around 3% for 2016 and 2017	7
	Box 1. Updating of the potential growth of Paraguay	10
	Box 2. The importance of infrastructure development	15
4	We anticipate a more modest depreciation of the Guaraní	17
5	Inflation will remain close to the centre of the BCP target range	18
6	Central Bank eases stance of monetary policy	20
7	The balance of risks on our growth projections for 2016-2017 has a negative bias	22
8	Tables	23

Closing date: 24 May 2016

1 Editorial

Economic activity started the year with a similar momentum to that of previous months. Thus, the growth rate, measured by the IMAEP, remained at 1.3% in the first quarter (0.7% in the fourth quarter 2015). Activities more closely linked to domestic demand, such as trade, construction and industry, continued to fall. In particular, the commercial activities of durable goods such as sales of vehicles, retailing, clothing and household equipment were in negative territory, which related mainly to weakening sales in border cities, due to the lower economic activity in neighbouring countries (especially Brazil). On the positive side, the set of sectors that respond to supply items such as power generation (bi-national) and agriculture continue to have positive results in the first three months. It is estimated that the soy campaign increased by more than 10% over the production of the previous year, due to higher yields, and power generation was boosted by the increased water flow as a result of the “El Niño” weather phenomenon. These elements, on the expenditure side, have resulted in increased exports (soya beans and electricity together have a weight of around 45% of total exports).

We expect that from the second quarter, **the product will begin a process of gradual recovery, and thus GDP in 2016 will record growth of around 3%.** By sectors, activity will be driven by agriculture (for the coming quarters, in addition to soya beans, there are good prospects for other crops), electricity and services, which would continue with the good performance of the first part of the year, and construction, which would begin to show a recovery alongside the reversal of the specific shocks that affected the first quarter. In addition, a recovery in livestock is expected after contracting in 2015 because, according to industry benchmarks, to date, the average price of meat has risen and this would ensure a good margin for the breeder, boosting investment and production. On the expenditure side, growth will be driven by exports (soya beans and their derivatives, electricity and meat) and domestic demand due to increased construction.

On the fiscal side, **we expect that the public deficit will be situated at about 2.0% of GDP this year,** in a context where incomes will be weaker due to the slowdown in tax-significant economic activities and decreased prices of raw materials. Also, **increased capital expenditure will be recorded oriented towards the infrastructure projects prioritised by the government.** While the Transparency and Accountability Act (FRTL) sets a limit for the fiscal deficit at 1.5% of GDP, our forecast assumes that the government, despite making adjustments to keep the deficit within the limits set out in the Act, will not meet the limit established for this year. Going forward we estimate a gradual reduction of the deficit so that the limit in the Transparency and Accountability Act is fulfilled, which will help consolidate the credibility of the fiscal rule.

In the currency market, **the Guaraní recently strengthened,** as did the currencies of other emerging markets and, in general, assets perceived to be higher risk. We believe **that this will be temporary** and that **soon the local currency will resume its upward trend.** Why? Firstly, because our view of what will happen with some of the key factors which affect the short-term exchange rate trend differs somewhat from market consensus. For example, we expect the FED to increase rates during the rest of the year because the labour market remains robust, downward inflationary pressures are beginning to ease off, and global financial tensions have retreated, although market consensus does not expect this to happen. We believe that the market's sense of surprise will trigger upward pressure on interest rates. And secondly, because there are structural factors that support a devaluation of the local currency. Capital inflows towards the more tradable sectors of the economy, such as the agricultural sector, are on the wane and this situation looks set to continue against a background in which we do not expect a substantial recovery in commodity prices, in particular in relation to soya beans, and in which lending conditions worldwide will gradually grow tighter.

The currency will be around PYG 5950 per USD towards the end of the year and closer to PYG 6,200 per USD by the end of 2017.

As for the outlook for prices, **year-on-year inflation registered significant increases** over the rates implemented during 2015. **However , it has started to give way** within a more favourable environment, which is linked to the fall in prices of domestic transport services as a result of lower fuel costs, and lower upward pressures on the exchange rate. **We estimate that in the remainder of the year inflation will remain near the centre of the target range.** In the short term, we estimate that inflation will ease a little further. However, during the latter part of the year inflation will record a slight upturn and will thus **close 2016 at around 4.7%** (this forecast considers the return of the currency to a depreciatory path and a statistical effect that will have an upward effect on inflation in the fourth quarter). In this context of easing inflation, inflation expectations aligned to the target and the absence of demand pressures, the Central Bank will have more room to keep the policy rate at its current level (5.75%) during 2016.

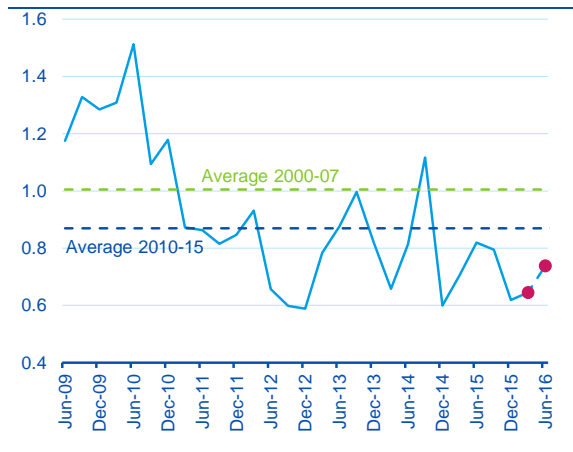
Finally, **the balance of risks on our growth projections for 2016-2017 in Paraguay is skewed downwards.** On the external front, there are downside risks from Brazil and China (due to its indirect effect on Brazil); and on the home front, any possible delays in the execution of the large infrastructure projects.

2 Fragile global growth, dependent on China

The data available for the first quarter of 2016 confirm our forecasts of stabilising growth in the global economy, with low rates albeit slightly higher than in late 2015. The BBVA-GAIN¹ indicator puts the qoq increase in global GDP at 0.6% (2.6% annualised rate), although below the average registered between 2010 and 2015 (Chart 2.1). This rate of growth may pick up slightly in the second quarter if the signs of less deterioration apparent in production, trade and business confidence indicators are consolidated, but it is still not enough to bring annual growth in the world economy to around 3.2% (which is our forecast for 2016 as a whole).

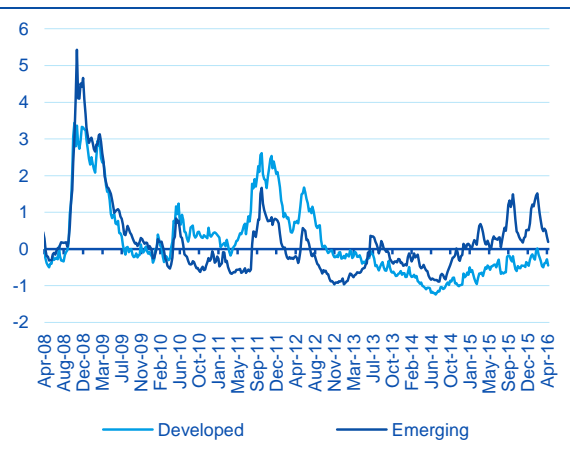
The sharp spike in financial volatility seen between December 2015 and February 2016 was not only a reaction to slowing global activity, but it also threatened to compound the situation if it continued on such a scale and led to a reduction in expenditure decisions. The better than expected pattern of economic indicators in China, and lower downward pressures on the yuan, the recovery in commodity prices and cooling of expectations for interest rate hikes by the Fed, have proved crucial in playing down financial turbulence from then on and in turn, in reducing the likelihood of a short term global stress scenario occurring.

Figure 2.1
Global GDP, % qoq 1Q and 2Q forecasts for 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2
BBVA financial stress index (normalized values)



Source: BBVA Research and Haver

China: fewer short-term risks, but more long-term doubts

The fact that Chinese authorities have bolstered both monetary and fiscal stimulation policies has helped to cool the effects of the reshaping the of the manufacturing sector on aggregated production, and, thus on the country's trade flows with respect to the rest of the world. In the short term, deploying countercyclical measures may help to allow a more gradual economic slowdown (softer landing) than is expected; however, if it entails putting off the correction of fundamental imbalances such as the high leverage in the corporate sector or excess supply in certain branches of industry and construction, then China's economy would become more vulnerable to shocks such as that observed in summer 2015, and this would also heighten its destabilising effects for the rest of the world. Taking these factors into account, we have revised our growth estimates for China in 2016 upwards to 6.4% and maintained growth of 5.8% in 2017.

1: See <https://www.bbvarsearch.com/en/publicaciones/global-gdp-growth-remains-stuck-at-2-6-yoy-in-q1-less-cloudy-outlook-but-the-same-risks/>

The Fed's decisions are shaped by the international backdrop, which helps to allay pressures on emerging markets

The delay in expectations regarding the forthcoming interest rate hike is due to the importance given to the deterioration in the international setting with regard to the Fed's reaction function. While FOMC predicted two hikes in 2016, the market has now put off the following increase to early 2017. The dollar's reaction, of further devaluation despite the good relative performance still apparent in domestic demand in the US, and the easing of the long tranches of the dollar curve, has helped to relieve funding restrictions in the emerging block, as shown by: (i) the BBVA financial stress index for this region, which has corrected the entire rebound observed in the first months of 2016 (Figure 2.2), and (ii) reactivation of foreign capital inflows, with net capital inflows in emerging countries since mid February partly due to the relocation of investment flows towards higher-return instruments.

Furthermore, insofar as central banks maintain the same direction of monetary policy in recent months (reinforcing or maintaining stimuli in the case of the ECB or the Bank of Japan; prudent approach in normalisation of interest rates by the Fed), emerging countries' authorities will have greater leeway to give priority to economic recovery, amongst their other targets. Aggressive interest rate hikes are less necessary because of the gradual approach which the Fed is expected to adopt (which supports capital flows towards the region) and the recent recovery in currencies (containing the possible increase in inflation from higher prices of imported goods).

However, the relative improvement in the global economic backdrop in the first quarter remains precarious and, in the short term, hinges very much on the performance of the Chinese economy and also on how sources of geopolitical instability in Europe will play out. In any event, bouts of financial turbulence such as those seen in early 2016 may occur again (with higher or lesser intensity), against a background of great uncertainty about emerging countries' ability to cope with the slowdown and for developed central banks to revive growth.

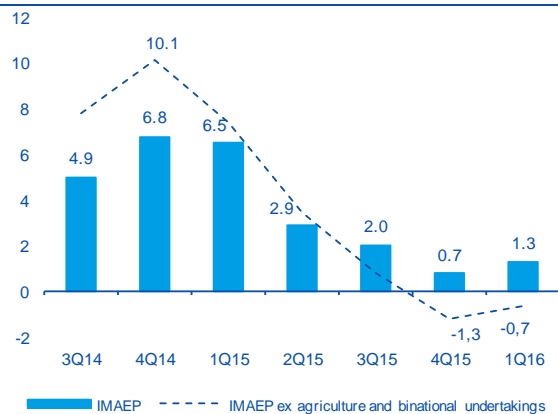
3 Paraguay: we projected growth of around 3% for 2016 and 2017

Sluggishness of GDP in the first half of the year given the weakness of the activities related to domestic demand

The economic activity indicator, IMAEP², rose 1.3% YoY in the first quarter, maintaining a similar pace to the previous three months (see Figure 3.1). Domestically, however, the growth recorded was differentiated by components. On the one hand, the set of sectors that respond to supply items such as power generation (bi-national) and agriculture continue to have positive results in the first three months. On the other, activities more closely linked to domestic demand, such as trade, construction and industry, continued to fall. Thus, the IMAEP, which excludes agriculture and binational industries, contracted by 0.7% in the period.

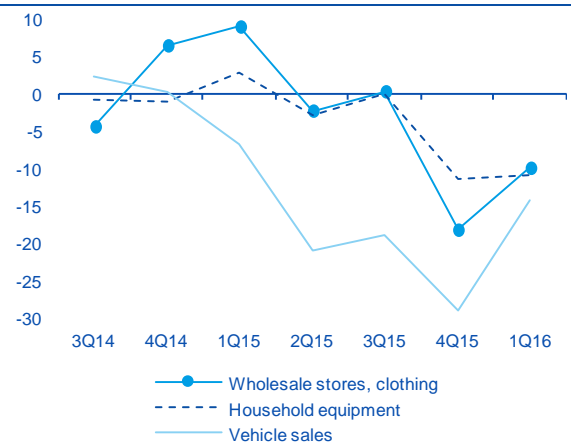
During the quarter, commercial activities of durable goods such as vehicle sales, retailing, clothing and household equipment were in negative territory (see Figure 3.2). This slowdown in commercial sector is due to weakening sales in border cities, which is mainly explained by lower economic activity in neighbouring countries, particularly Brazil. In addition, some specific supply factors were recorded, such as a significant slowdown in construction, as a result of higher rainfall (the “El Niño” phenomenon), which hindered the normal execution of works in the private and public sectors. On the expenditure side, these factors reflect slower growth in consumption and investment.

Figure 3.1
Economic activity indicator, IMAEP (chge. % YoY)



Source: BCP and BBVA Research

Figure 3.2
Turnover indicators, ECN (chge. % YoY)



Source: BCP and BBVA Research

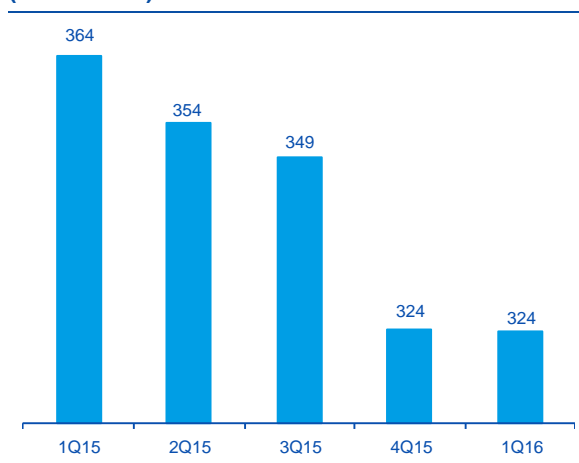
Extractive industries gave support to GDP

On the positive side, the agricultural sector (20% of total GDP) has shown favourable results in the first half of the year. It is estimated that the soya beans campaign increased by more than 10% over the previous year’s production, due to higher yields, which has provided some relief in the margins of farmers which were already being squeezed or which in some cases were negative. This, in an environment where the international price has begun to show some stability (see Figure 3.3). Also noteworthy in the first months was the increased power generation, following the increased water flow brought about by the presence of the “El

2: The Monthly Economic Activity Indicator in Paraguay (IMAEP) is designed to deliver signals in the short term on the evolution of the economy in constant terms. The IMAEP incorporates preliminary information and does not include all the data for economic activities that make up Gross Domestic Product, and must therefore be regarded as an indicator of the path of the Paraguayan economy in the short term.

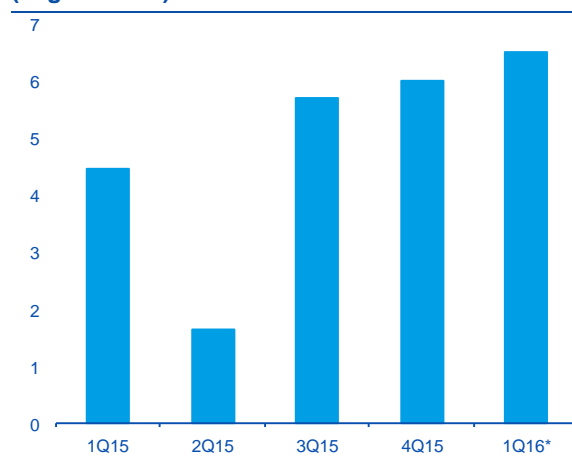
Niño” phenomenon. Thus, the production of all sectors responding to elements of supply (electricity and agriculture) maintained a positive result, which we estimate as having expanded by more than 6.0% (see Figure 3.4). On the expenditure side, these trends were reflected in increased exports (soya beans and electricity together have a weight of around 45% of total exports).

Figure 3.3
Price of soya beans (USD/Tonne)



Source: BCP and BBVA Research

Figure 3.4
Agriculture and electricity sector (binational)* (chge. % YoY)



*Own Estimate
Source: BCP and BBVA Research

Going forward we expect a boost in infrastructure projects such that we project growth of around 3% in 2016 and 2017

The scenario for 2016-2017 will be complex and we are taking the following exogenous factors into account:

- On the external side, our estimates take the following into account:
 - (i) Relatively stable price of soya beans. The adjustments in global supply would be offset by the effects of weaker demand, primarily in China.
 - (ii) The Brazilian economy deteriorated in 2016 (-3.0%), but would show a slight recovery in 2017 (0.9%), strongly conditioned by political uncertainty and the fiscal adjustments to be made.
 - (iii) The Fed rate normalisation process will remain surrounded by uncertainty, suggesting bouts of volatility in local financial markets, which, if persistent, could have a real impact.
- On the domestic side, we assume that:
 - (iv) Government spending on goods and services (particularly salaries) is consistent with the fiscal rule.
 - (v) Infrastructure works will have a more noticeable impact.

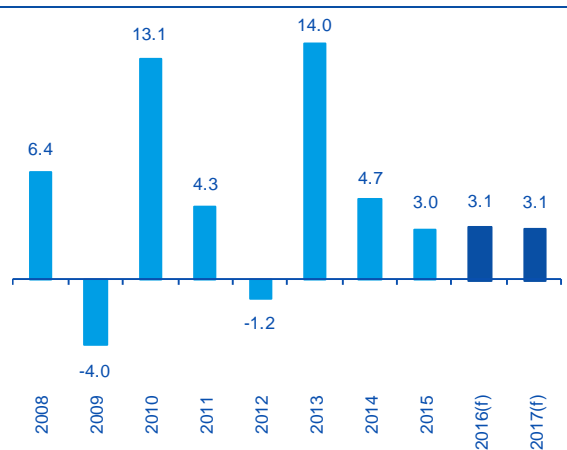
Our central scenario assumes that GDP will begin a process of gradual recovery throughout this year, and will thus record growth in 2016 of around 3% (see Figure 3.5).

By sectors, activity will be driven by agriculture (for the coming quarters, in addition to soya beans, there are good prospects for corn and wheat production), electricity and services, which would continue with the good performance in the first part of the year, and construction, which would begin to show a recovery alongside the reversal of the isolated shocks that affected the first quarter. In addition, a recovery in livestock is expected after contracting in 2015 because, according to industry benchmarks, to date, the average price of meat has risen and this would ensure a good margin for the breeder, boosting investment and production.

On the expenditure side, growth will be driven by exports (soya beans and their derivatives, electricity and meat) and domestic demand due to increased construction (see Table 3.1).

For 2017 we project a similar rate to 2016, where the main driver of growth will continue to be domestic demand, in particular due to higher levels of private and public investment. It is estimated that to the infrastructure projects that are already underway or scheduled (such as the improvement of roads, highways, country roads and so on), new projects will be added which are to be developed under the Public Private Partnership (PPP) scheme, which will confer sustainability to growth. It should be noted that investment in infrastructure, besides favouring the sectoral diversification of total investment by making it less susceptible to the volatility of raw material prices, also generates significant positive externalities and has a direct and widespread impact on the levels of productivity and welfare in society.

Figure 3.5
Annual GDP
(chge. % YoY)



Source: BCP and BBVA Research

Table 3.1
GDP on expenditure side
(chge. % YoY)

	2014	2015	2016 (f)	2017 (f)
Domestic demand	5.3	2.5	2.5	3.0
Total consumption*	3.8	2.8	2.7	3.2
Gross capital formation**	11.0	1.5	4.5	5.5
External demand	-3.1	9.3	3.2	-4.6
Gross domestic product	4.7	3.0	3.1	3.1

*Considers private and public consumption.

**Considers gross fixed investment and inventories.

Source: BCP and BBVA Research

From 2017, with activity still being driven by the sharper recovery in external demand, which will have a noticeable impact not only on export levels but also on border trade, and infrastructure projects in sectors such as roads, water and sanitation, and electric power transmission and distribution, we anticipate that growth in Paraguay will be 4.0% on average, in line with the potential growth (see Box 1. Updating of the potential growth of Paraguay).

Box 1. Updating of the potential growth of Paraguay

Potential GDP is defined as the level of production which an economy is able to create when it is using its resources at full capacity and without creating macroeconomic imbalances.

A characteristic of this variable is that it cannot be directly observed. In order to estimate potential GDP, in fact, we need to apply a number of different methods, which can generally be divided into statistical and economic methods.

Statistical methods mainly use filters to isolate the trend or long-term component (Hodrick and Prescott³, Baxter and King⁴, inter alia). Methods based on economic models adopt a more intuitive approach by using an analytical framework in which potential GDP is an endogenous variable which is related to other variables. The “production function” is one of the methods used in this latter category. This method estimates potential GDP based on its determining factors (in essence, output, employment and capital).

Production function

In this case, a Cobb-Douglas production function is used with constant returns to scale and adjusted by human capital (García-Fuentes and Lynn, 2009⁵, and Hofman and Tapia, 2003⁶):

$$Y_t = A_t K_t^\alpha (h_t L_t)^{1-\alpha}$$

where, Y_t is gross domestic product, A_t is output, K_t is physical capital stock, h_t is the factor of human capital and L_t is the number of workers. All the variables have an annual frequency. Also, α is the participation of physical capital in GDP, while $1 - \alpha$ represents the participation of employment and human capital.

The relevant variables used in the estimate are calculated as follows:

a. Capital stock: As there is no direct measurement of physical capital stock

(K_t), it was decided to generate a historical series from 1994, using the perpetual inventory method:

- **Conventional capital accumulation:** $K_{t+1} = (1 - \delta)K_t + I_t$; where I_t is the level of investment and δ is the depreciation rate. A straight-line depreciation function, with a 30-year useful life span for the capital, is assumed.
- In order to define the initial capital stock (K_0) a steady state scenario is assumed in 1994: $K_0 = \frac{I^*}{g+d}$
 - where, I^* is the average of the Investment/GDP ratio between 1994-2015 and GDP for 1994.
 - On the other hand, g is the average of the rate of growth in GDP between 1994-2015.

b. Capital-GDP elasticity: The value of $\alpha = 0,42$ is taken, in line with the estimates made by the Central Bank of Paraguay⁷.

c. Human capital: As with capital stock, there is no direct measurement of human capital (h_t). The following equation is used to generate this variable:

$$h_t = \exp \left[\left(\frac{\theta}{1-\psi} \right) s_t^{1-\psi} \right]$$

where s_t represents the average years of schooling of the population aged over 15, while θ and ψ are sensitivity and curve parameters of the function which adopt values of 0.32 and 0.58 respectively, in accordance with the proposals of Bils and Klenow (1998)⁸.

d. Workforce: The workforce is considered to be (L_t) the Occupied Economically Active Population.

3 Hodrick, R. and Prescott, E. (1997), “Postwar U. S. Business Cycles: An Empirical Investigation”, *Journal of Money, Credit And Banking*, Vol. 29, No. 1.

4 Baxter, M. and King, R. (1995), “Measuring Business Cycles Approximate Band-Pass Filters For The Economic Time Series”, National Bureau Of Economic Research, Working Paper No. 5022.

5 García-Fuentes, P. and Lynn, P. (2009), “Remittances and Economic Growth in Latin America and the Caribbean: The Impact of Human Capital Development”. Southern Agricultural Economics Association Annual Meeting, Atlanta, Georgia.

6 Hofman, A. and Tapia, H. (2003) “Potential output in Latin America: a standard approach for the 1950-2002 period”, *Serie Estudios estadísticos y prospectivos No25*, CEPAL.

7 See IPoM box, December 2014.

8 Bils, M. and Klenow, P. (1998), “Does Schooling Cause Growth or the Other Way Around?”. National Bureau of Economic Research (Cambridge, MA) Working Paper No. 6393.

e. Total Factor Productivity (TFP): The TFP is obtained as the result of the following:

$$A_t = \exp[\log Y_t - \alpha \log K_t - (1 - \alpha) \log h_t - (1 - \alpha) \log L_t]$$

Lastly, to construct the series of potential GDP, Y_t^* , the procedure is as follows:

$$Y_t^* = A_t^* K_t^{*\alpha} (h_t^* L_t^*)^{1-\alpha}$$

A_t^* , h_t^* , k_t^* and L_t^* are the trends of output, human capital and employment obtained using the Hodrick-Prescott filter.

Main results

If we analyse potential GDP, it is apparent that the growth of the economy during the boom phase was not only a temporary or cyclical phenomenon. Table 1, which contains the breakdown of the growth of potential GDP between production and output factors (controlling for human capital), shows the prominence of all the factors in the accelerated growth of the Paraguayan economy between 2002 and 2013.

This same approach also shows that not only short-term factors are behind the slowdown observed in recent years (since 2013). For example, a significant decline in the contribution made by output is apparent, which suggests that there are structural factors behind this growth trend that is shifting the economy towards permanently slower growth rates (see Table R.1.1).

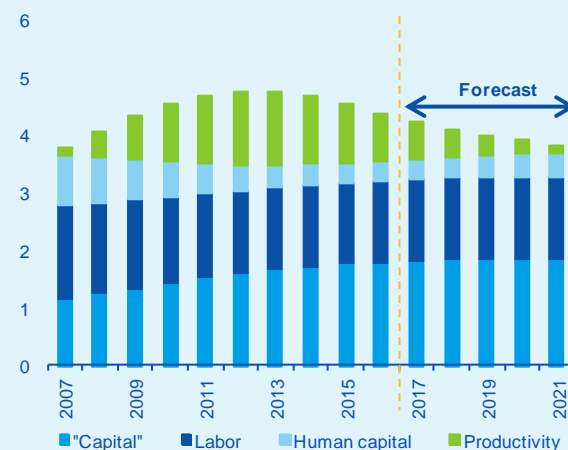
Table R.1.10
Potential GDP (chge. % annual, percentage points)

	Potential growth	Contribution to growth			
		A	K	h	L
1994-2001	1.1	-1.8	1.1	0.7	1.1
2002-2013	3.7	0.1	1.2	0.8	1.6
2014-2015	4.6	1.1	1.8	0.4	1.4
2016-2020	4.1	0.5	1.9	0.4	1.4

Where, A: Output, K: Physical capital, h: Human capital, L: Employment.
Source: BCP, World Bank and BBVA Research

For the next few years, in line with our macroeconomic projections, it is estimated that the contribution of both productivity and employment to the growth of potential GDP will stagnate at the low levels currently being recorded. Meanwhile, the contribution of capital (linked to investment) would still provide support to overall activity. As a result of these projected trends, sustainable growth of the Paraguayan economy is expected to decline in future years and be in the vicinity of 4.0% (see Figure R.1.1).

Figure R.1.1
Potential GDP: contribution to growth (percentage points)



Source: BCP, World Bank and BBVA Research

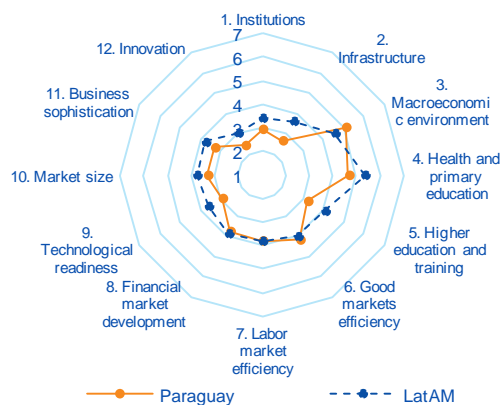
Ensuring a faster rate of growth in the medium term will require a focus on making advances in competitiveness and productivity

According to the Global Competitiveness Index published by the World Economic Forum (WEF) 2015-2016, Paraguay is ranked 118 out of a total of 140 countries. An examination of the 12 factors covered by the WEF shows that, within the region, the country lags behind in key areas such as Infrastructure, Higher Education and Training and Innovation (see Figure 3.6). These elements negatively affect the potential growth of the Paraguayan economy.

Mainly in infrastructure, various indicators show that Paraguay has a level of development that is still below its needs. According to the Central Bank⁹, less than 20% of the entire road network is paved, while 75% is made up of dirt and gravel roads. Regarding ports, the infrastructure shortcomings mainly reside in the lack of dredging and buoying of rivers that restricts the carrying capacity of vessels and impedes navigation by night. As for electrical infrastructure, while Paraguay is the leader in per capita generation in Latin America, the greatest deficiencies are associated with losses during the transmission and distribution processes. Thus, an average loss of electricity of 32% is estimated, much higher than that recorded in Latin America as a whole (17%), and the 6% verified in high-income countries which is used as a benchmark threshold (see Figure 3.7).

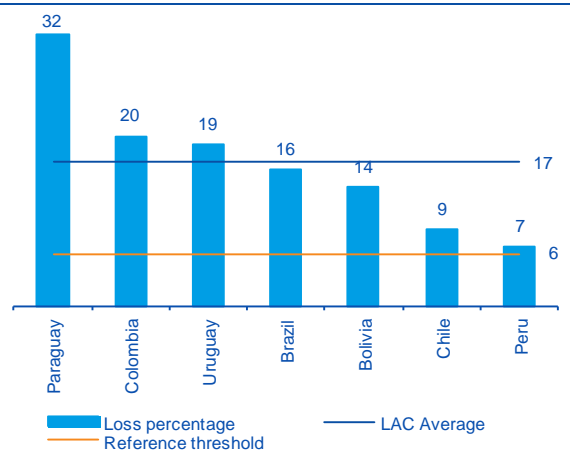
Considering the foregoing, and although macroeconomic stability is a distinguishing feature of the economy of Paraguay (according to the WEF, the country has a better macroeconomic environment than the Latin American bloc in general, see Figure 3.6), it is clear that to sustain economic growth at around 4.0% beyond the forecast horizon, it is essential to implement measures and/or reforms to strengthen productivity and competitiveness.

Figure 3.6
Global Competitiveness Index 2015-2016
(Index between 1 “worst” and 7 “best”)



Source: World Economic Forum and BBVA Research

Figure 3.7
Losses in power generation
(% of total, average 2007-2011)



Source: BCP and BBVA Research

In this context, the main medium-term challenges must be focused on implementing policy measures that seek to: i) continue cutting the gap in infrastructure (see Box 2. The importance of infrastructure development), ii) improve the business climate and increase competition and, iii) reduce overruns in the economy.

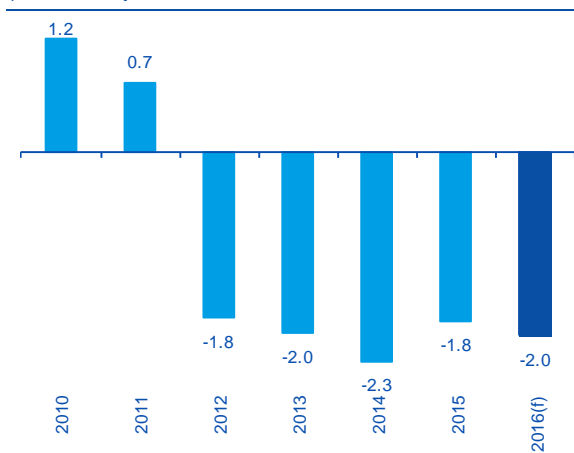
9: Central Bank of Paraguay (2016). “Paraguay: beyond macroeconomic stability. Achievements and challenges”.

Fiscal accounts will continue to record deficits

By 2016, we expect that the fiscal deficit will be at about 2.0% of GDP, in a context where incomes will be weaker due to the slowdown in highly taxed economic activities (services sector and re-exports) and the decrease in the prices of raw materials. Also, increased capital expenditure will be recorded oriented towards the infrastructure projects prioritised by the government. While the Transparency and Accountability Act (LTRF) sets a limit for the fiscal deficit at 1.5% of GDP, our forecast assumes that the government, despite making adjustments to keep the deficit within the limits set out in the Act, will not meet the limit established for this year. Going forward we estimate a gradual reduction of the deficit so that the limit in the Transparency and Accountability Act is met, which will help consolidate the credibility of the fiscal rule (see Figure 3.8).

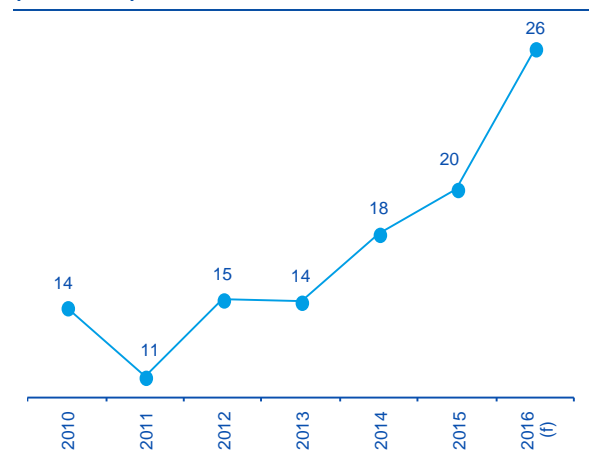
In the context of the fiscal deficits of the last four years, external financing needs have become more significant. Indeed, since Paraguay entered the international financial markets in 2013, 4 public debt issues have been carried out for a total amount of USD 2.38 billion (9.1% of GDP). Thus, the balance of gross public debt increased by about 9 percentage points of GDP between 2013 and 2016. This year, meanwhile, it is estimated that gross public sector debt will exceed 26% of GDP (see Figure 3.9). Also, according to the IMF, this debt will reach levels above 28% of GDP as of 2018. While this increase in the public debt ratio would be fast, it does not reveal the beginning of growing momentum affecting the sustainability of public finances (to the extent that spending on infrastructure remains the top priority, in particular the improvement of power distribution and transport).

Figure 3.8
Fiscal balance
(% of GDP)



Source: BCP and BBVA Research

Figure 3.9
Public debt
(% of GDP)



Source: BCP, IMF and BBVA Research

Finally, it should be noted that according to a recent report by Moody's, and considering a combination of low debt and reduced use of resources for the payment of interest, apart from Chile, Paraguay is the only country in the Latin American bloc that has the ability to increase public spending without causing a deterioration of the health and sustainability of its fiscal accounts.

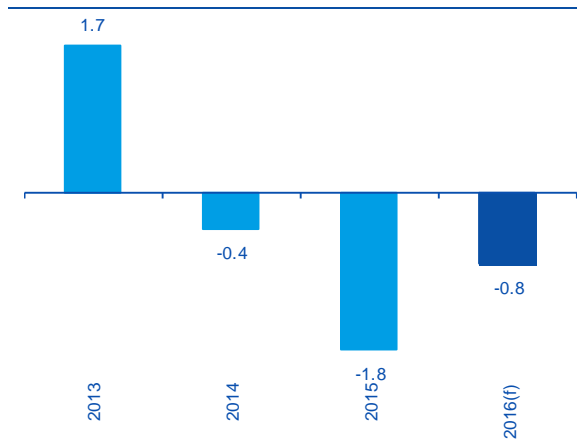
The external deficit will be corrected and will be funded largely by long-term capital

During the first quarter, the trade balance recorded a surplus of USD 575 million, in a context where imports (-21%) decreased more than exports (-15%). In the case of imports, the biggest declines were seen in inputs (-27%) and capital goods (-19%), reflecting the weakness of domestic demand. Exports, meanwhile, fell as a result of lower soya beans and derivatives shipments (-15%, particularly due to prices) and meat (-15%), which together represent 50% of total exports.

In this scenario, our projection of the current account deficit for 2016 is 0.8% of GDP, lower than in 2015 (1.8% of GDP, see Figure 3.10). This result is explained by a higher surplus in the trade balance, mainly due to lower imports, especially of capital goods. For the period 2017-20, our forecasts assume a gradual reduction of the external deficit, given the recovery in energy exports and Brazilian demand for products with higher added value.

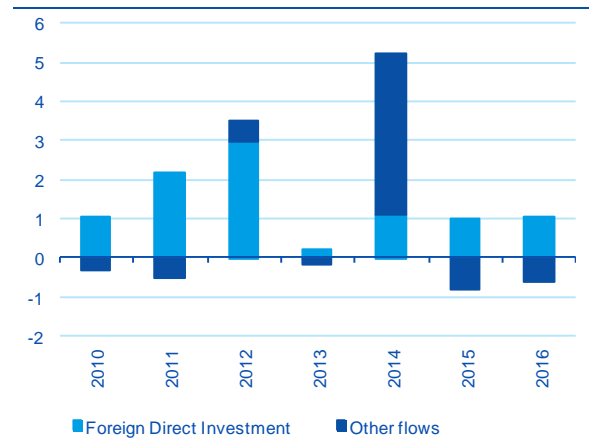
Regarding sources of funding, by 2016 we expect foreign direct investment (FDI) flows similar to those of last year (1.0% of GDP, see Figure 3.11), which would allow for more than the mere financing of the external deficit. In the coming years, it is estimated that FDI into the country will continue to be favoured by infrastructure projects that would provide an opportunity for the entry of this type of capital.

Figure 3.10
Current account
(% of GDP)



Source: BCP and BBVA Research

Figure 3.11
Financial account
(% of GDP)



Source: BCP and BBVA Research

Box 2. The importance of infrastructure development

Infrastructure and economic development

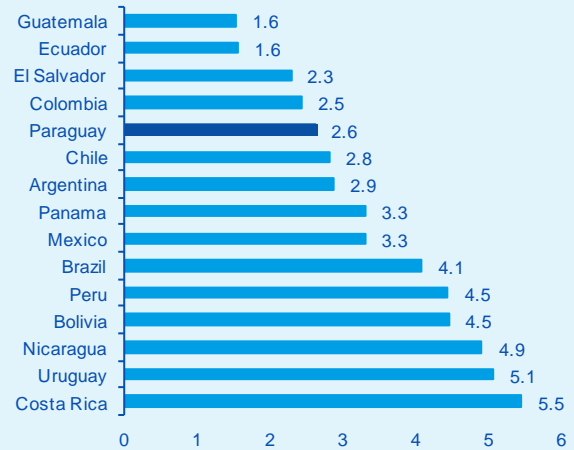
In economic literature, there is much evidence that the efficient provision of infrastructure services is one of the most important factors in development policies due to its positive impact on the productivity of other factors of production.

Accordingly, numerous studies have analysed the correlation between infrastructure investment and economic growth. Easterly and Rebelo (1993), using panel data from 24 countries, found that spending on transport and communications is positively correlated to economic growth¹⁰. Meanwhile, Calderon and Servén (2004), using data from 121 countries, highlight the fact that the level of infrastructure has an important and significant effect on economic growth in the long term, with robust results to changes in the infrastructure measures and estimation techniques used. They also note that both the quality and quantity of infrastructure contribute to lower levels of income inequality¹¹.

Perroti and Sanchez (2011), meanwhile, show that Latin American countries needed to invest an average of 6.2% of GDP per year in infrastructure between 2012 and 2020 to close the gap between infrastructure demand and supply and to meet the needs of businesses and consumers¹².

However, data from the region indicate that, in recent years, the amount of investment in infrastructure has fallen far below levels considered ideal to grow quickly and competitively. In fact, the lack of investment in infrastructure is a common denominator throughout the region. In 2012, the regional average for infrastructure spending was 3.42% of GDP. In particular, Paraguay allocated only 2.63% of GDP to improve its infrastructure, below the regional average (see Figure R.2.1).

Figure R.2.1
LatAm: Investment in infrastructure
(% of GDP)



Source: Cepal, World Economic Forum and BBVA Research

International indicators on infrastructure in Paraguay

One of the most widespread indicators is the Global Competitiveness Index (GCI), which seeks to measure the performance of different countries in the task of ensuring the necessary conditions for sustainable economic progress. Data for the period 2015-2016 leaves Paraguay in ranked 118 out of the 140 countries assessed (just above Venezuela and Haiti in Latin America), and as regards to infrastructure, it is ranked in the same position. The latter is evidence that one of the main weaknesses of the country's competitiveness continues to be the lack of coverage of physical infrastructure. When analysing the indicators individually, we appreciate that the quality of roads and port infrastructure is what drags the country down, being ranked 138 and 110, respectively.

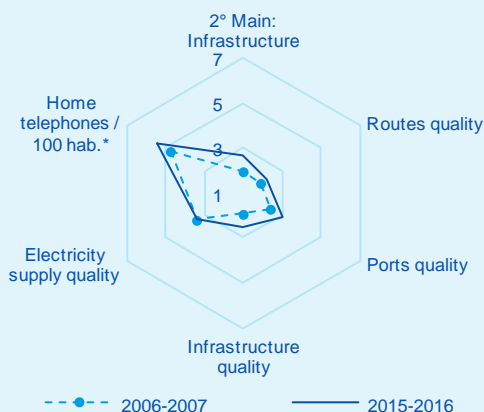
Similarly, a study by USAID (2006) finds that the main logistics costs come from the lack of dredging and buoys of rivers, the poor quality of the road infrastructure and delays in access to ports¹³. It should also be noted that during the recent period, no significant progress was

10 Easterly, W., Rebelo, S. (1993). Fiscal Policy and Economic Growth: An Empirical Investigation. Journal of Monetary Economics, 32, 417-58.
11 Calderón, C., Servén, L. (2004). The Effects of Infrastructure Development on Growth and Income Distribution. Policy Research Working Paper No. 3401.
12 Perroti, D. and Sanchez, R., (2011). The infrastructure gap in Latin America and the Caribbean. Santiago, Chile. Series 153.

13 United States Agency for International Development [USAID] (2006). Impact of transport and logistics on Paraguay's international trade. Document prepared by CARANA Corporation, in collaboration with the National Chamber of Commerce and Services of Paraguay (CNCSP).

observed with regard to the quality of the electrical infrastructure (see Figure R.2.2).

Figure R.2.2
Global Competitiveness Index, Pillar: Infrastructure
(Index between 1 “worst” and 7 “best”)



Source: World Economic Forum and BBVA Research

Another indicator that provides information about the state of the infrastructure of an economy is the Logistics Performance Index of the World Bank, which evaluates the perception of experts regarding logistics. According to this indicator, in comparison with the average for the region, the assessment remains quite unfavourable to Paraguay (see Table R.2.1).

Table R.2.1
Paraguay: Logistical Performance Index
(Index)

	Paraguay		South America
	2007	2014	2014
Logistical Performance Index	2.57	2.78	2.85
Efficiency of customs clearance process	2.2	2.49	2.56
Quality of infrastructure related to trade and transport	2.47	2.46	2.68
Ease of agreeing to shipments at competitive prices	2.29	2.83	2.86
Quality of logistics services	2.63	2.76	2.81
Ability to track and trace shipments	2.67	2.89	2.91
Domestic logistics costs	3.13	n/d	n/d
Frequency with which shipments reach the consignee within the scheduled time	3.23	3.22	3.25

Source: World Bank and BBVA Research

All these factors indicate that Paraguay has a lot of room for growth in relation to the provision and improvement of economic infrastructure (which is

attractive considering that the economy has low levels of infrastructure and therefore a higher marginal productivity).

We anticipate that in the coming years the main driver of growth will be investment, especially infrastructure construction. This is important because it generates significant positive externalities and has a widespread direct impact on productivity levels. Ludeña and Ruiz Diaz (2008), for example, found that reducing transportation costs in Paraguay by 54% would contribute to an increase of 0.24% in GDP, to an increase in exports and imports (by 1.38 % and 6.35%, respectively) and an improvement of 3.88% in the terms of trade¹⁴.

While the Paraguayan government has been developing a series of reforms to improve the investment climate and create a better institutional framework for private sector participation in investment (including the Law on Public-Private Partnerships, PPP), there are crucial challenges ahead to reduce the gap in the existing infrastructure.

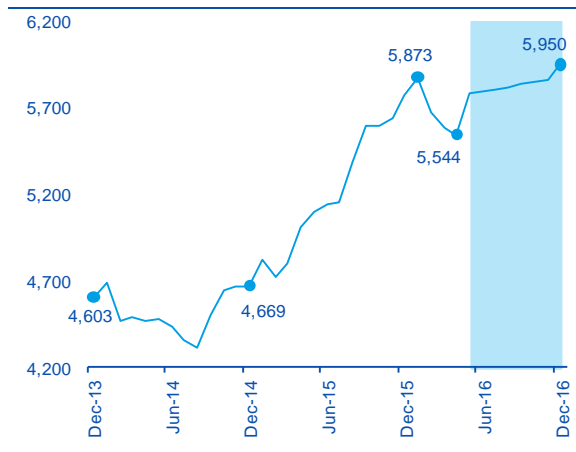
¹⁴ Ludeña, C., Ruiz Diaz, F. (2008). Transport overruns: Geographical curse or infrastructure policy failure? An estimate for Paraguay from a general equilibrium model. Department of Economics, Faculty of Business Administration, Catholic University of Uruguay.

4 We anticipate a more modest depreciation of the Guaraní

Until mid-February, the Guaraní was being depreciated mainly as a result of increased external volatility. In the last two months, on the other hand, it has undergone a strong appreciation, like other currencies in the region, in line with the revaluation of all assets in emerging economies and the relative stability of the international environment (significant changes have not been observed in the global and regional panorama). Thus, the average exchange rate closed the month of April at around the PYG 5540/USD, close to the levels recorded in September last year (see Figure 4.1).

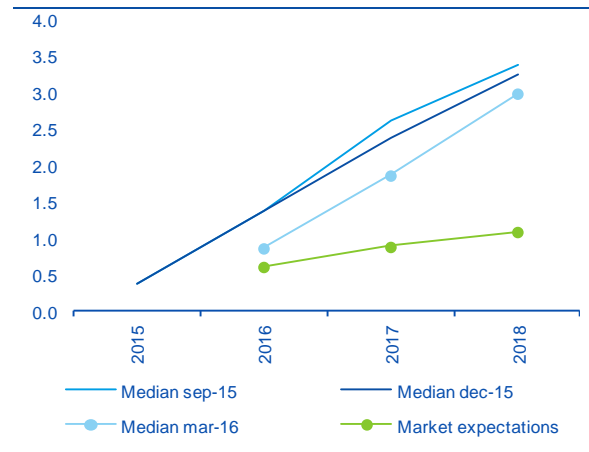
We anticipate that the currency will return to its depreciatory path because, on the one hand, the foundations of the Paraguayan economy have deteriorated in structural terms (fall in the terms of trade and weakening fiscal position). On the other, we expect to see a short-term overreaction in the global markets (including the Paraguayan market) prompted by the adjustment which will take place in emerging country asset prices following the Fed's key interest rate hike (we are assuming two hikes each of 25 bps), considering that the market forecasts expect it to be zero (see Figure 4.2).

Figure 4.1
Nominal Exchange Rate (PYG per dollar)



Source: Bloomberg and BBVA Research

Figure 4.2
Fed interest rate* (%)



*Medians are calculated using individual forecasts by members taking part in the Fed meeting. Market consensus is as of 10 May 2016.

Source: Bloomberg and BBVA Research

Overall, the structural trend of the Guaraní will be towards depreciation. Thus, we expect an additional upward path for the currency to around PYG 5950 per USD towards the end of the year and closer to PYG 6200 per USD by the end of 2017.

5 Inflation will remain close to the centre of the BCP target range

Inflation rose above 5% in the first months of the year, but has begun to yield

So far this year, year-on-year inflation has registered significant increases over the rates implemented during 2015 (during the first months of 2016 it showed growth above 5%). In general, this inflationary momentum has been linked to the increased prices of some foods, affected by weather anomalies (the El Niño phenomenon). In addition, various services, such as transportation and personal care, showed increases in prices and had a significant impact on overall inflation (see Table 5.1).

However, since early 2016 inflation has followed a downward trend (a high of 5.2% was registered in January). Thus, in April prices rose 4.5% year-on-year (the lowest rate so far this year). This more favourable trend has been linked to the fall in prices of domestic transport services due to lower fuel costs (in line with the lower international prices of petroleum), and less upward pressure on the exchange rate (slower rate of depreciation), which influenced lower prices on imported goods and services that are priced in US dollars (see Figure 5.1).

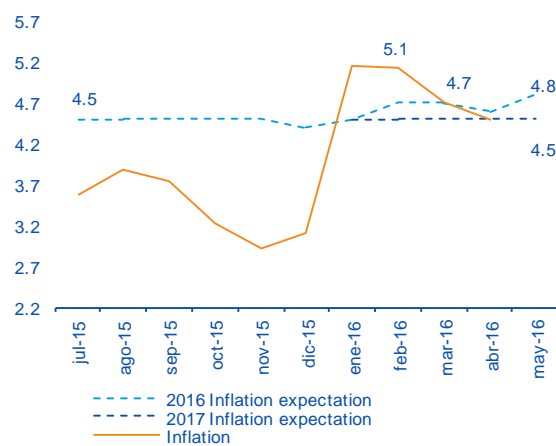
Notably, in this context inflationary expectations have remained within the central bank's target range (between 2.5% and 6.5%). For 2016, the expectation of closing for inflation remains near the centre of the target range (4.5%); while the closing for 2017 remains at the centre of this range (see Figure 5.1).

Table 5.1
Inflation by main groups (chge.% YoY)

	Weighting 2009=100	Jan-16	Feb-16	Mar-16	Apr-16
Inflation	100.0	5.2	5.1	4.7	4.5
Food	32.0	6.4	5.7	5.6	5.5
Transport	14.8	2.2	2.8	2.5	0.9
Accommodation and housing	8.9	3.2	3.4	3.2	3.1
Home furnishings	7.7	6.9	6.8	5.9	6.3
Miscellaneous goods and services	7.3	7.3	8.2	8.6	9.1
Note					
Core inflation	94.5	3.7	3.8	3.8	3.5
Non-core inflation	5.5	21.8	18.5	15.7	17.6

Source: BCP and BBVA Research

Figure 5.1
Inflation and Expectations (%)



Source: BCP and BBVA Research

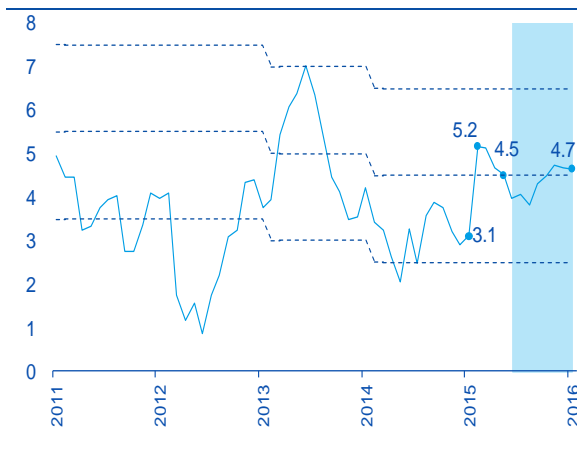
In the coming months, inflation will remain near the middle of the target range

In the short term, we estimate that inflation will ease somewhat and by the end of the second quarter will be below 4.5%, in a context in which we expect a further decline to be recorded in food prices and for the pressures on the currency to continue being relatively limited.

However, during the latter part of the year inflation recorded a slight upturn and will thus close 2016 at around 4.7% (see Figure 5.2). This forecast considers the return of the currency to a depreciatory path (as mentioned in the previous section) and greater implementation of international oil prices (see Figure 5.3). It should be noted that, during Q4 2015, an upward statistical effect on inflation will be observed, given the low comparison base in some products such as food prices (at the end of 2015 specific supply factors were recorded that had a downward influence on these prices).

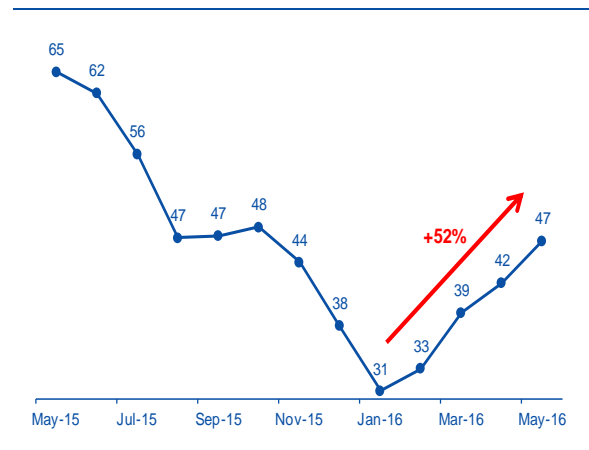
For 2017, we project that inflation will remain around the mid-range of the target, in a scenario where expectations will remain aligned and will have lower inflationary pressures. This will be partly offset by a recovery in oil prices, at end of period, of around 30%, which will have a noticeable impact on inflation (see Figure 5.3).

Figure 5.2
Inflation (%)



Source: BCP and BBVA Research

Figure 5.3
International oil price (USD/barrel)



Source: BCP and BBVA Research

6 Central Bank eases stance of monetary policy and for the rest of the year we anticipate a pause

The Board of the Central Bank of Paraguay (BCP) decided in May to reduce the interest rate of monetary policy by 25 basis points (bps), to 5.75%, which took the market by surprise (see Figure 6.1). The statement accompanying the decision shows that the main reason for doing so was an improvement in the inflation outlook and the slowdown in certain sectors of the economy. In this context, the BCP was considering the timely adoption of a more accommodative monetary policy profile.

Why were we surprised by this decision? Two elements suggested the need for additional demand stimulus and that there was room on the price side to do so. In March economic activity, measured by the IMAEP, contracted by -0.2%. The set of sectors that responds to supply items such as power generation (bi-national) and agriculture continued to show positive results. Nevertheless, the IMAEP, which excludes agriculture and bi-nationals and better reflects the behaviour of the activities most closely linked to domestic demand, such as trade and industry, fell by -1.9%. Thus, as mentioned previously, in the first three months the expansion of activity was only 1.3%. However, it was joined by a more favourable inflationary panorama, linked to the fall in prices of domestic transport services as a result of lower fuel costs and lower upward pressures on the exchange rate. This context, however, did not appear very different from that faced by the BCP in previous months (the IMAEP without agriculture or bi-nationals has been relatively stagnant since July 2015), opportunities in which however it did not lower the rate.

What is prompting the BCP to opt for cuts? In our opinion, the BCP on balance is showing greater concern about the deterioration of economic activity. As explicitly stated in the release, the entity estimates that inflation would continue to slow in the margins in the coming months and 'economic activity continues at a moderate pace of expansion'.

What can we expect going forward? Our central scenario assumes that activity will begin a process of recovery from the second quarter, which together with the increased valuation of local performance by the BCP, reinforces the monetary pause. In addition, recently the probability has increased of a scenario in which the FED adjusts its rates somewhat. This scenario would result in episodes of exchange rate volatility, lower prices of raw materials, and would have an impact on the risk appetite of investors. This context reduces the window of opportunity for the BCP to reduce its benchmark rate again. Finally, while we estimate that in the coming months there will be a reduction in inflation in year-on-year terms, during the latter part of the year inflation will record an upward trend. In this way, we maintain the view that in the remainder of 2016 there will be no change in the benchmark interest rate (see Figure 6.2).

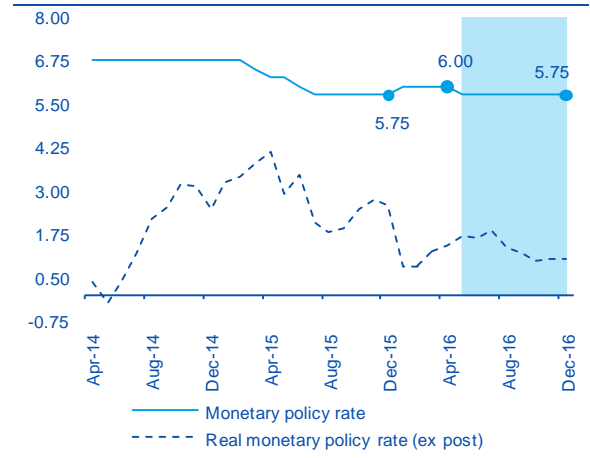
For 2017, our forecast is that the Central Bank will apply an increase of 25bps and the rate would end the year at 6%. This assumes that the expectations will remain anchored at 4.5%, despite the prospect of adjusting to the Fed rate and its effect on the exchange rate remaining controlled. Going forward, we expect a gradual increase in the monetary policy rate, in line with more growth potential.

Figure 6.1
Policy Monetary Rate and expectations (%)



Source: BCP and BBVA Research

Figure 6.2
Policy Monetary Rate (%)



*Inventories not included. Source: BCP and BBVA Research

7 The balance of risks on our growth projections for 2016-2017 has a negative bias

Different patterns to those assumed in our baseline scenario for different key variables can cause deviations in our growth estimates. On this occasion, we believe the main downside risks are lower global growth (especially in Brazil and China) and greater delays in executing infrastructure projects.

A more intense and prolonged recession in Brazil would significantly affect growth in Paraguay

The main downside risk on the projection of GDP is a greater-than-anticipated deterioration of the Brazilian economy. Brazil is the main market for Paraguayan exports with about 30% of recorded exports (this share is substantially increased if re-exports are included). According to our estimates, a decrease of one percentage point of GDP growth in Brazil due to idiosyncratic elements (after controlling for global factors) causes a decrease of between four and five tenths of a percentage point in GDP growth.

Slower growth in China is another downside risk factor

Our baseline scenario assumes that the moderation in China's growth towards sustainable levels, and the reshaping of its demand-side growth drivers (less investment and more consumption), will be gradual and orderly. However, if the monetary, fiscal and credit stimuli being applied turn out to be excessive, then financial weaknesses which are apparent in China could be accentuated, and hamper its growth. In this context, lower growth in China would have a negative impact on the Paraguayan economy directly, as a result of more pronounced and persistent decreases in the prices of the raw materials it exports (mainly soya beans), and indirectly, due to weaker external demand in Brazil, which is strongly exposed to shocks in China.

On the domestic side, further delays in infrastructure projects would adversely affect the economic growth forecast

A slower execution of the infrastructure projects that are in the pipeline are among the domestic factors that would make growth factors deviate downwards.. This would be reflected, on the sectoral side, in slower growth in construction, and on the expenditure side, in a more marked slowdown in investment.

8 Tables

Table 8.1

Macroeconomics forecasts

	2012	2013	2014	2015	2016	2017
GDP (% YoY)	-1.2	14.0	4.7	3.0	3.1	3.1
Inflation (% YoY, eop)	4.0	3.7	4.2	3.1	4.7	4.5
Exchange Rate (vs. USD, eop)	4 276	4 603	4 669	5 768	5 950	6 200
Policy Monetary Rate (% eop)	5.50	6.00	6.75	5.75	6.00	6.25
Private Consumption (% YoY)	2.8	4.6	3.7	2.4	2.7	3.2
Government Consumption (% YoY)	21.0	3.5	4.2	6.2	3.0	3.0
Investment (% YoY)	-13.5	20.2	11.0	1.5	4.5	5.5
Fiscal Balance (% GDP)	-1.8	-2.0	-2.3	-1.8	-2.0	-1.8
Current Account (% GDP)	-2.0	1.7	-0.4	-1.8	-0.8	-0.9

Source: BCP and BBVA Research Peru

Tabla 8.2

Macroeconomics forecasts

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange Rate (USDCLP, eop)	Policy Monetary Rate (%, eop)
Q1 14	3,7	6,1	4 490	6,75
Q2 14	3,0	6,4	4 434	6,75
Q3 14	5,1	4,1	4 500	6,75
Q4 14	6,9	4,2	4 669	6,75
Q1 15	6,0	2,6	4 799	6,50
Q2 15	2,6	2,5	5 144	6,00
Q3 15	2,3	3,7	5 591	5,75
Q4 15	1,1	3,1	5 768	5,75
Q1 16	1,0	4,7	5 582	6,00
Q2 16	4,7	3,8	5 793	6,00
Q3 16	3,8	4,6	5 836	6,00
Q4 16	3,0	4,7	5 950	6,00
Q1 17	3,8	4,0	5 887	6,00
Q2 17	2,8	4,3	6 120	6,00
Q3 17	3,2	4,4	6 166	6,25
Q4 17	2,8	4,5	6 200	6,25

Source: BCP and BBVA Research Peru

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