

ECONOMIC OUTLOOK PARAGUAY

SECOND HALF 2016



We expect GDP to grow by 2.9% next year. Growth will be supported by the start of infrastructure works and a gradual recovery in consumption.

Looking ahead, the national currency will depreciate somewhat further due to global uncertainty, the US Federal Reserve's interest rate adjustment and fundamental factors

The Central Bank has managed to control inflation, and expectations are anchored. In this context, we foresee no changes in monetary policy.

Contents

1 Paraguayan economy

- How has activity evolved so far this year?
- Macroeconomic projections for 2017
- Looking to the medium term

2 Main messages

PARAGUAY

Growth will be supported by infrastructure projects

SECOND HALF 2016



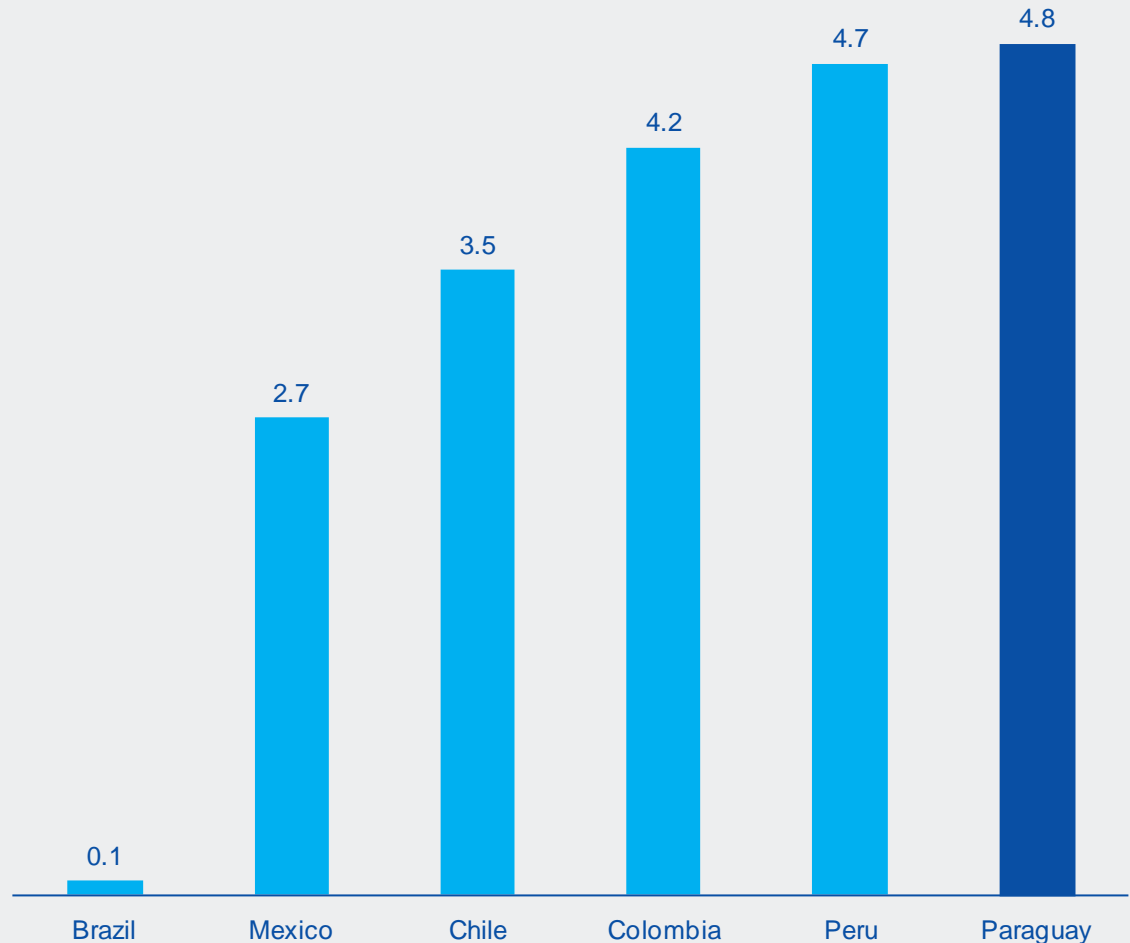


1. How has activity evolved so far this year?

The Paraguayan economy is proving resilient in the face of a highly volatile external environment

- Uncertainty in financial markets due to the **upcoming adjustment in US Federal Reserve rates**
- Contraction of the Brazilian economy
- Fall in the price of soybeans

GDP: LATAM5* AND PARAGUAY
(Average chge.% YoY 2011-2016)

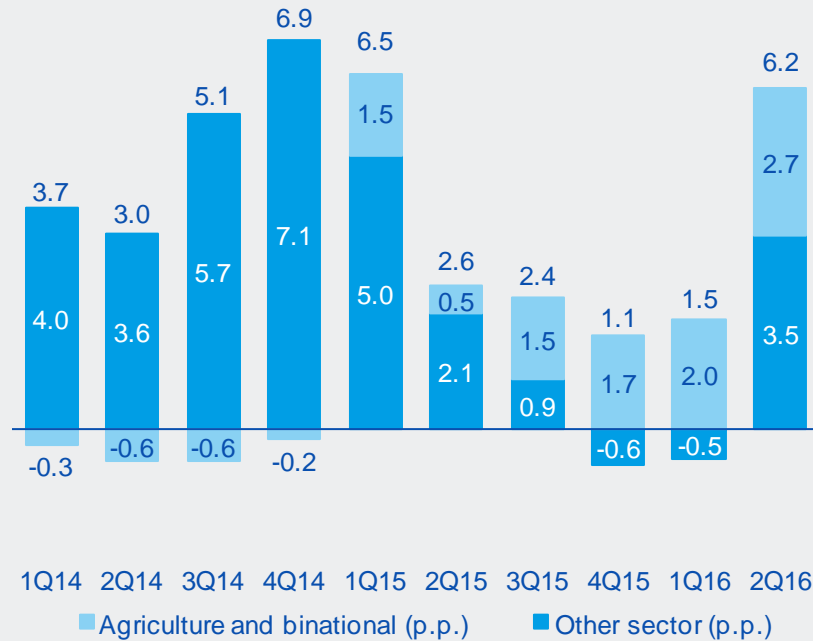


*Latam5: Brazil, Chile, Colombia, Mexico and Peru

GDP growth slowed in the second quarter

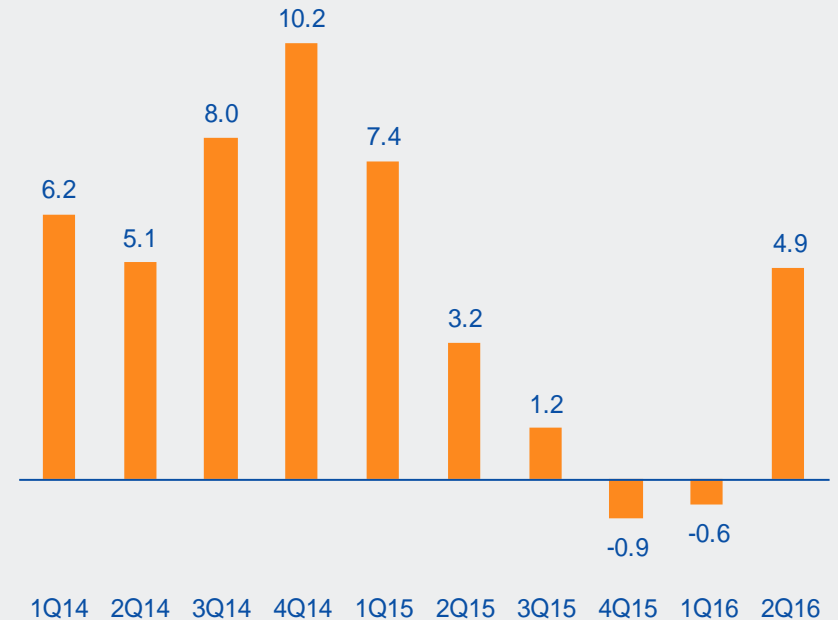
TOTAL GDP

(Chge. % YoY and contribution in percentage points)



GDP EXCL. AGRICULTURE AND BINATIONALS*

(chge. % YoY)



* The Itaipú y Yacyretá hydroelectric projects, shared with Brazil and Argentina respectively.

This result was driven by recent trends in power production and general activity

GDP ON THE SUPPLY SIDE

(chge. % YoY)

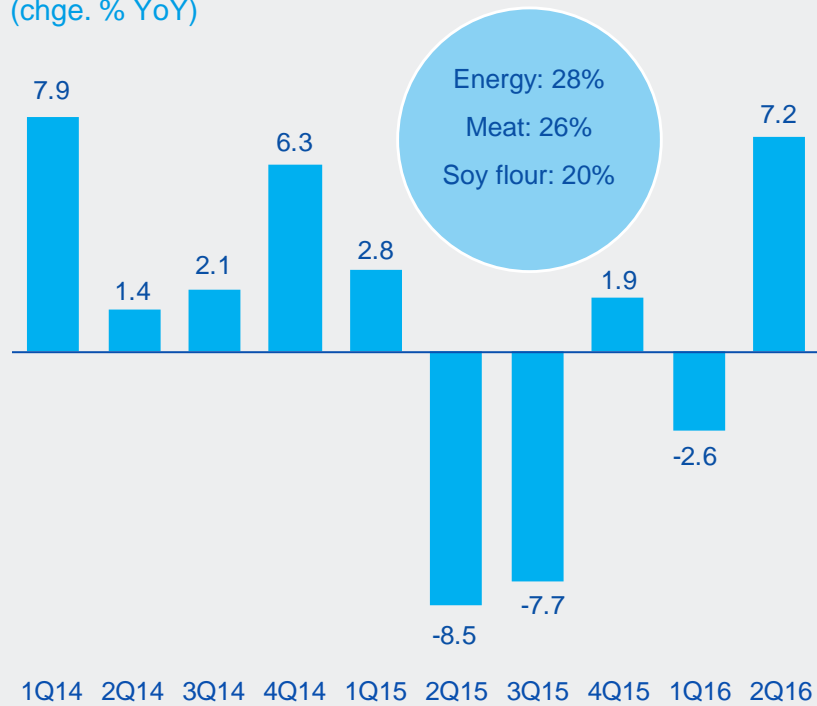
	1Q16	2Q16
Agriculture:	3.2	2.9
Electricity and water	11.8	20.0
Livestock, forestry and fisheries	-0.8	14.4
Mining and manufacturing	-3.6	10.6
Construction	2.7	23.0
Services	-0.4	1.6
Taxes	1.6	6.5
Total Added Value	-0.6	1.3
Total GDP	1.5	6.2
GDP excl. agriculture and "binationals"	-0.6	4.9

- Greater use of installed capacity and **favourable hydrological conditions.**
- **Increased slaughter of livestock** led to improvements in the meat industry and availability of raw materials (leather goods and footwear).
- **Upturn in central government investment**, in reaction to normal execution of works.

Most notable on the expenditure side in 2Q were the increase in exports and the improvement in domestic demand

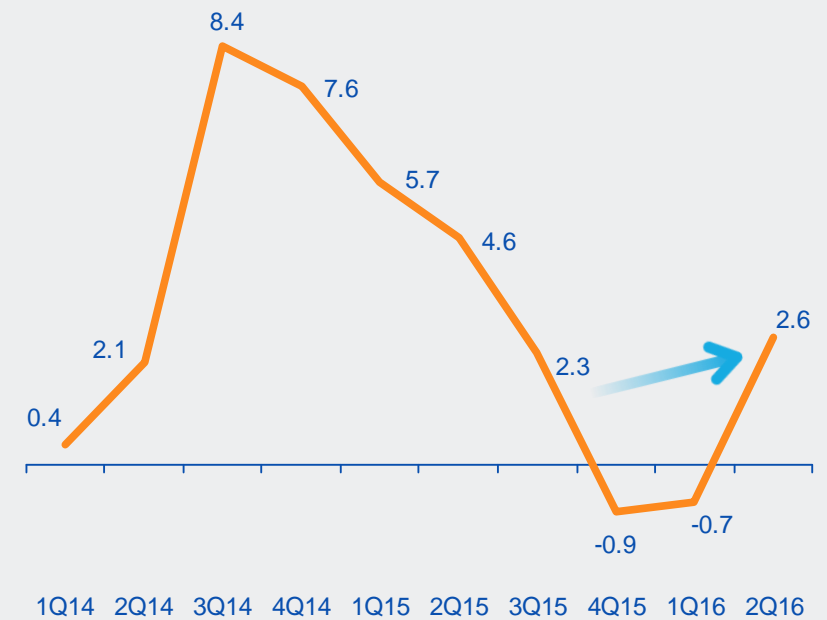
EXPORTS OF GOODS AND SERVICES

(chge. % YoY)



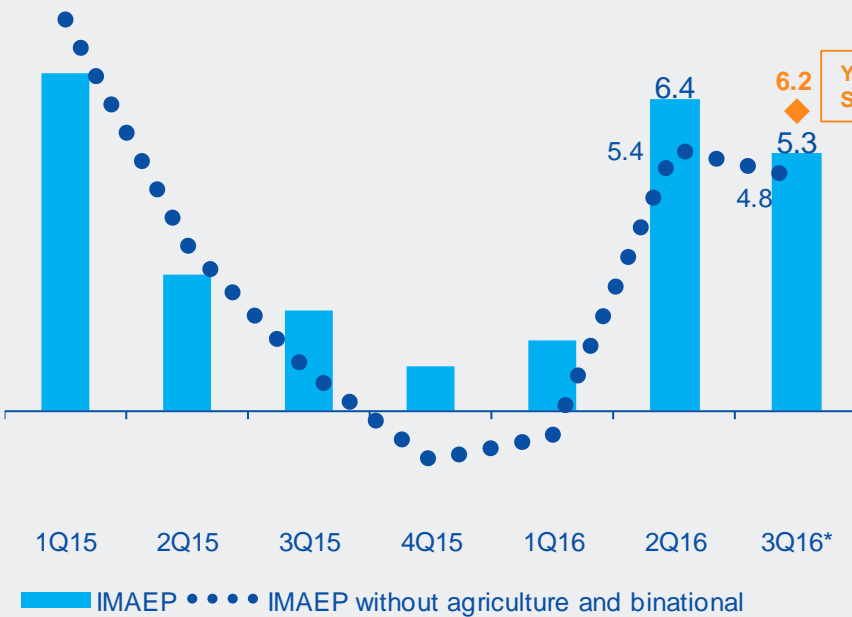
DOMESTIC DEMAND EXCLUDING INVENTORIES

(chge. % YoY)

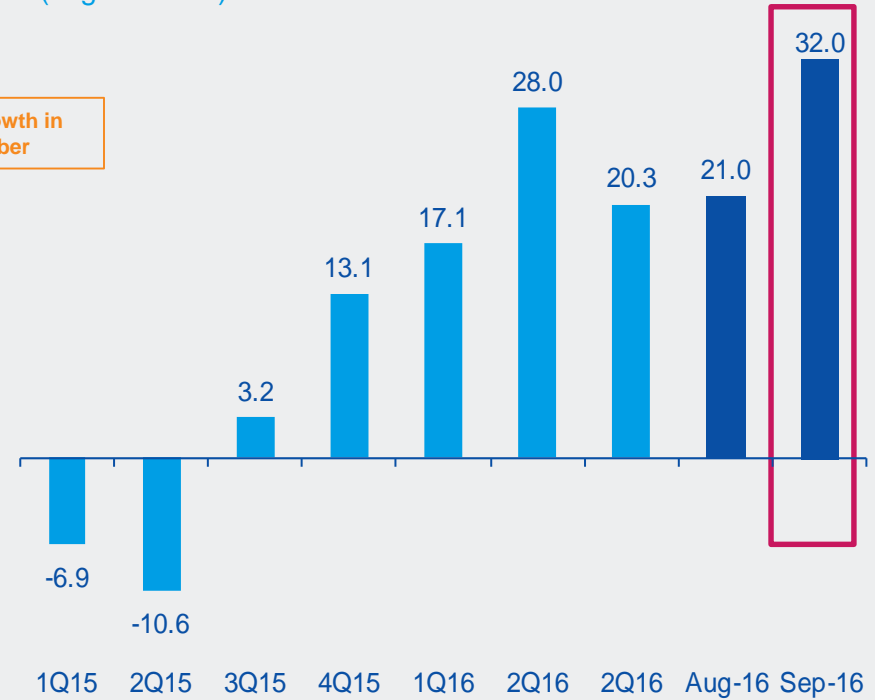


Available indicators for 3Q show activity and exports maintaining their dynamism

ECONOMIC ACTIVITY INDICATOR
(chge. % YoY)



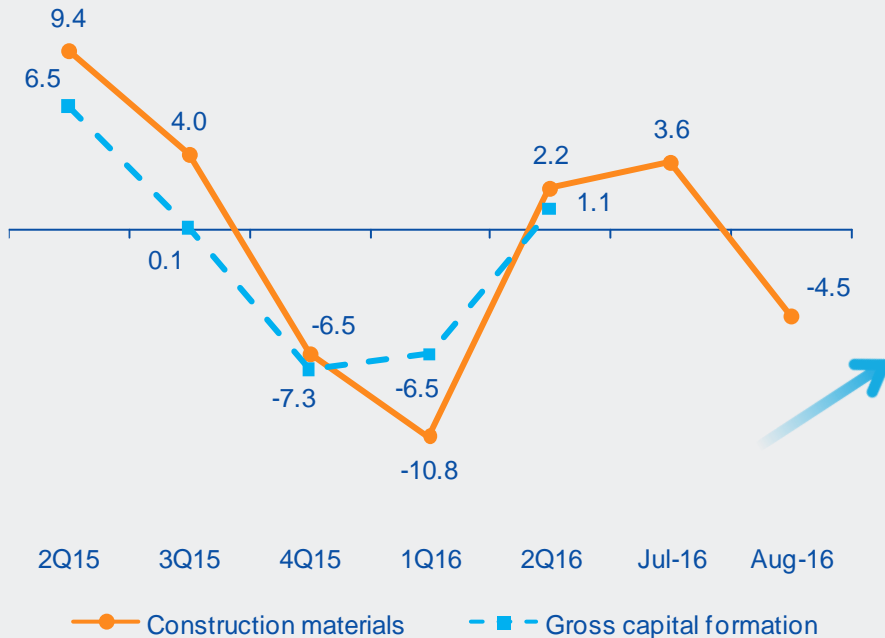
EXPORT OF ENERGY
(chge. % YoY)



* Average of July, August and September.

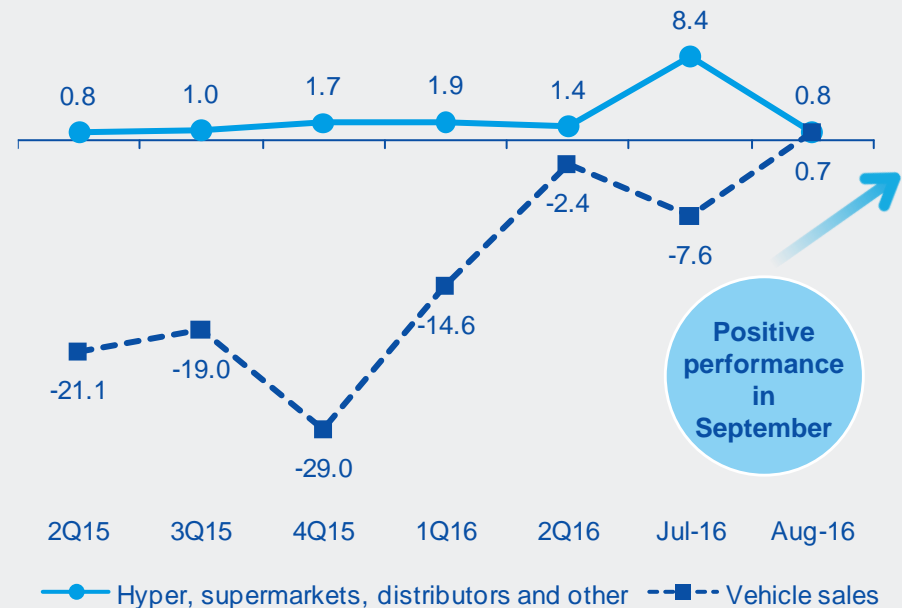
However, indicators for investment and consumption continue to show weakness

ECN: BUSINESSES LINKED TO INVESTMENT*
(chge. % YoY)



* ECN: *Estimador de Cifras de Negocios* (turnover estimator)

ECN: BUSINESS ASSOCIATED WITH CONSUMPTION*
(chge. % YoY)



* ECN: *Estimador de Cifras de Negocios* (turnover estimator)

In this context, we foresee the Paraguayan economy growing by 3.8% in 2016

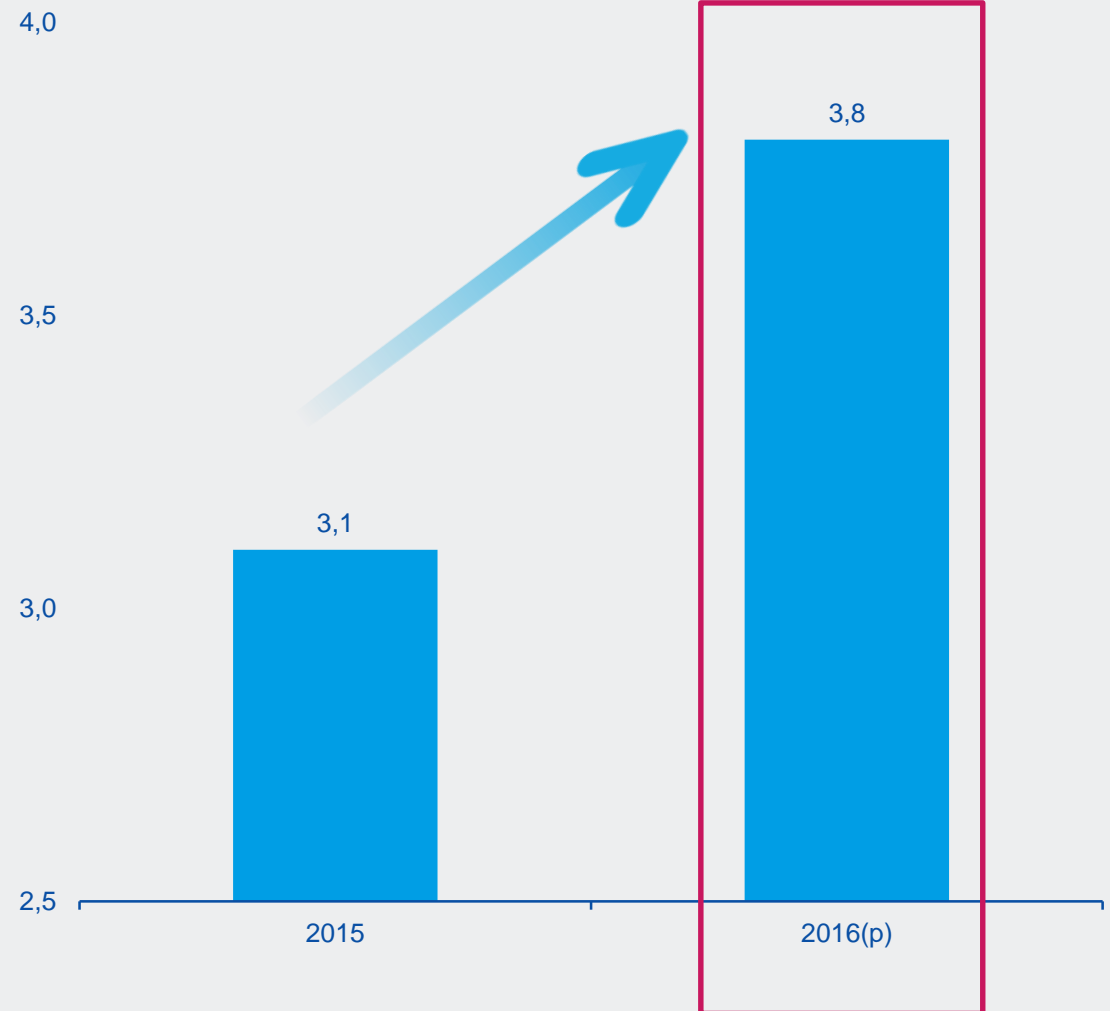
Support...

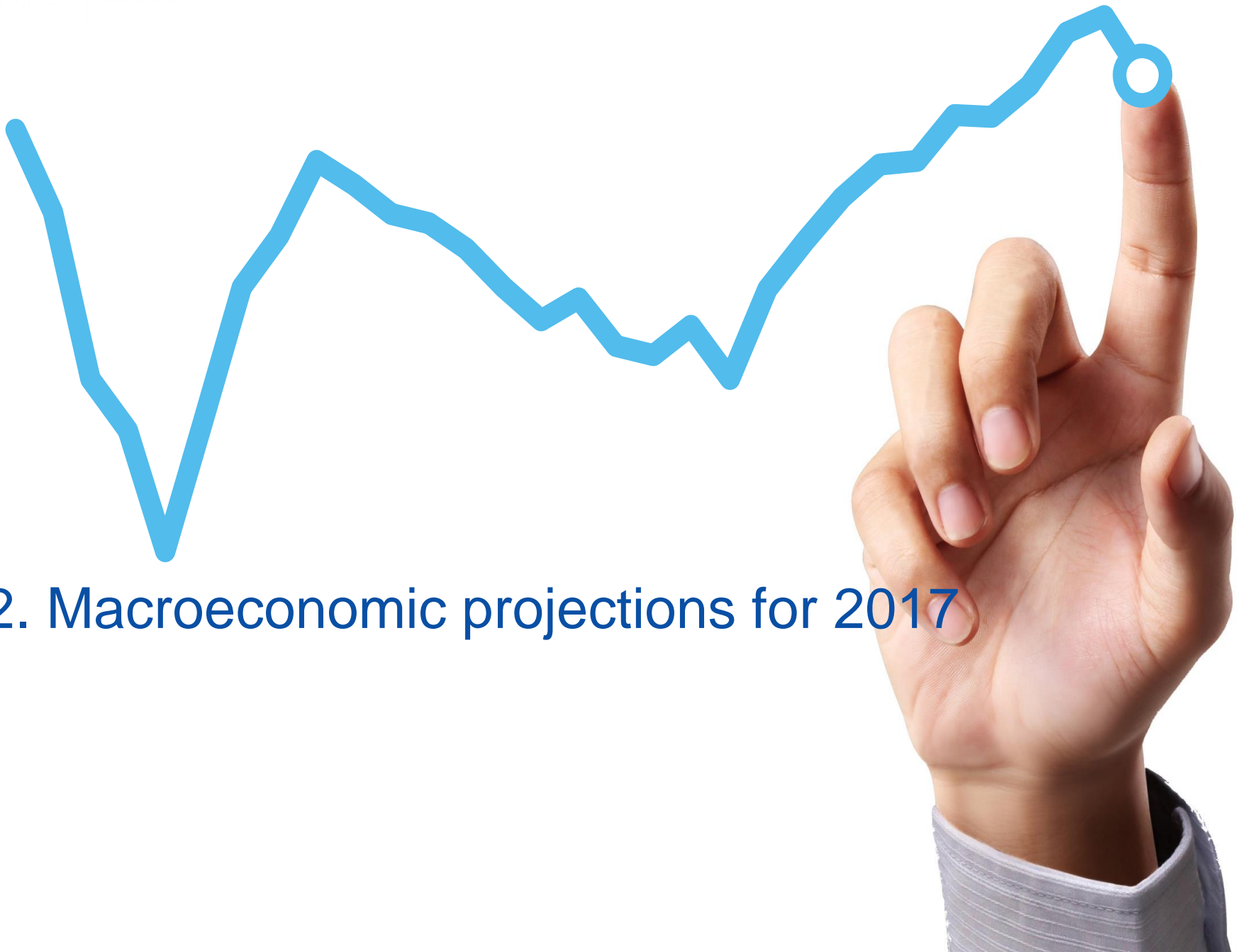
- In the first half of the year **GDP grew by 3.7%**
- Improved performance of the **Construction** and **Services** sectors

... but

- **Slackening of dynamism in the energy generation sector**

TOTAL GDP
(Average chge.% YoY 2011-2016)





2. Macroeconomic projections for 2017

Macroeconomic projections



Economic activity

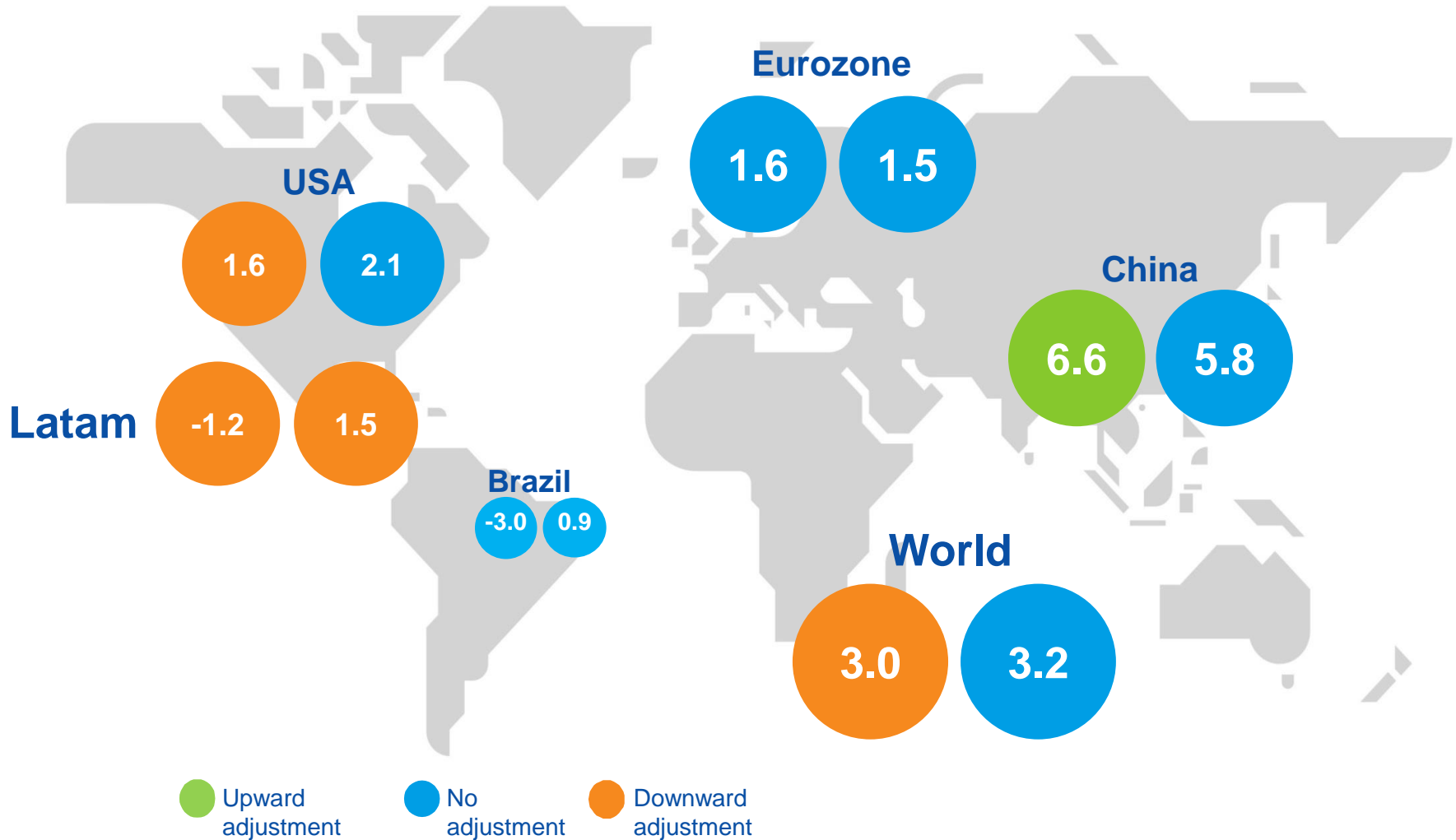
Growth will be 2.9% in 2017, underpinned by investment in infrastructure and the recovery of consumption

Our baseline scenario for 2017 assumes the following exogenous factors

On the
external
side

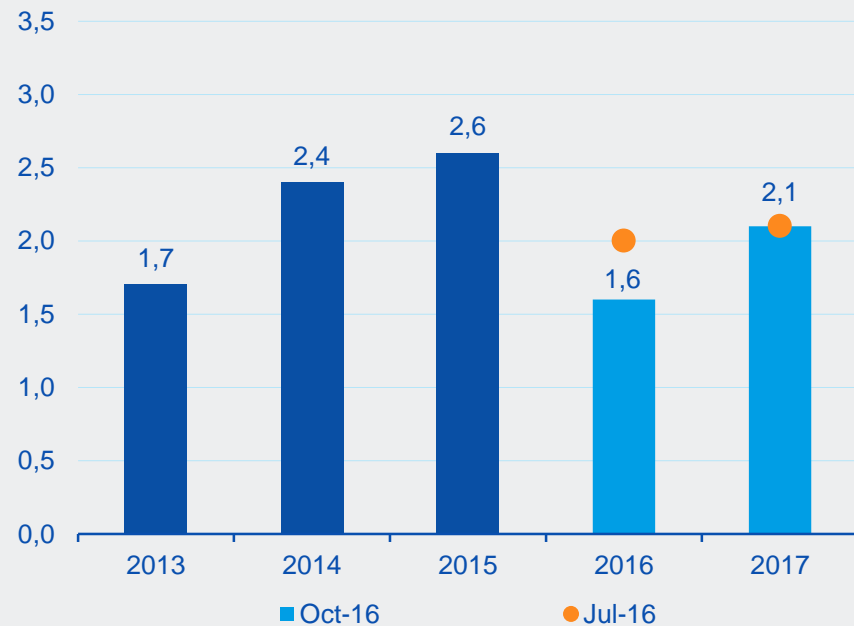
1. The world economy will show moderate growth, in an environment of great uncertainty
2. Global interest rates will remain low, with gradual adjustment on the part of the US Federal Reserve
3. Recovery of the Brazilian economy (in positive territory after two consecutive years of declines)
4. Terms of trade will continue to deteriorate due to the increase in the price of oil and the low price of soybeans

World growth projections for 2016-2017



United States: growth for 2016 revised downwards

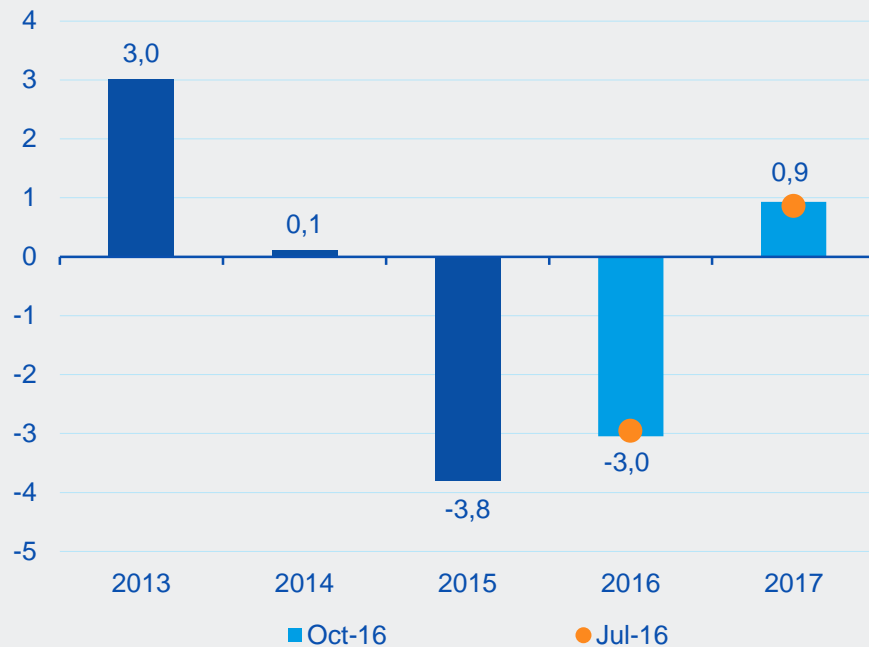
US GDP GROWTH
(%)



- **Revised downwards due to:**
 1. indicators suggesting insufficiently strong growth in 2H16 following the weak first half;
 2. persistently low productivity,
- **Federal Reserve: we expect a process of **very gradual adjustment to key rates****
- **Going forward, **uncertainty about economic policies following the elections****

Brazil: a lurch towards orthodoxy and problems in moving ahead with reforms

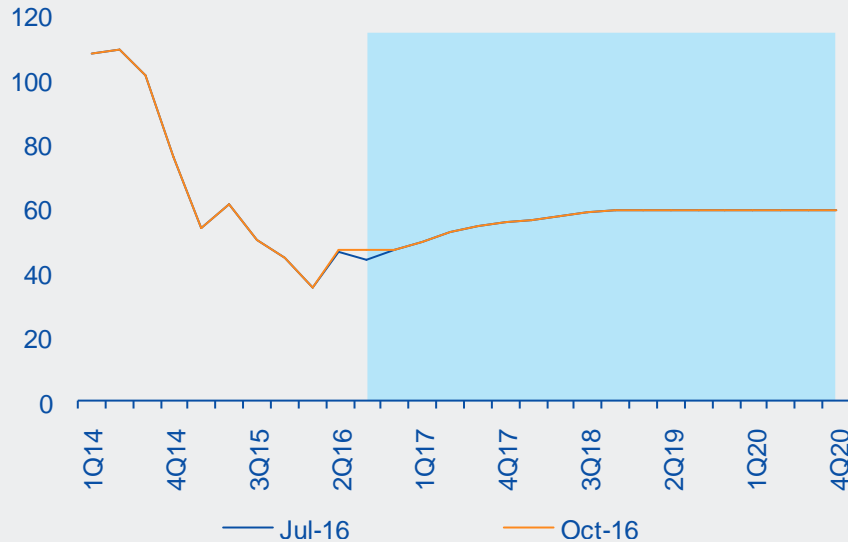
BRAZIL: GDP GROWTH (%)



- **Lurch towards orthodoxy, which looks likely to continue:**
 - Central Bank less tolerant of inflation
 - More prominent role played by the private sector, etc.
- **But the political environment will not help:**
 - Government to face tough opposition
 - Uncertain support of Congress and the population for reforms, etc.
- In this context, we expect a **slow recovery going forward** and a reduction in inflation
- But more robust growth will **require structural reforms**, which will be **difficult to get approved**

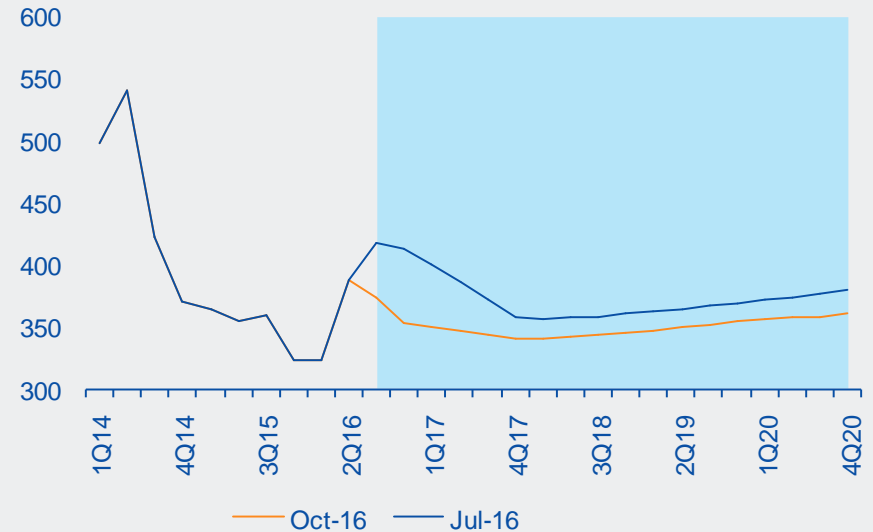
Oil in line with very gradual recovery. Soybeans affected by increased supply

BRENT CRUDE
(US\$ per barrel)



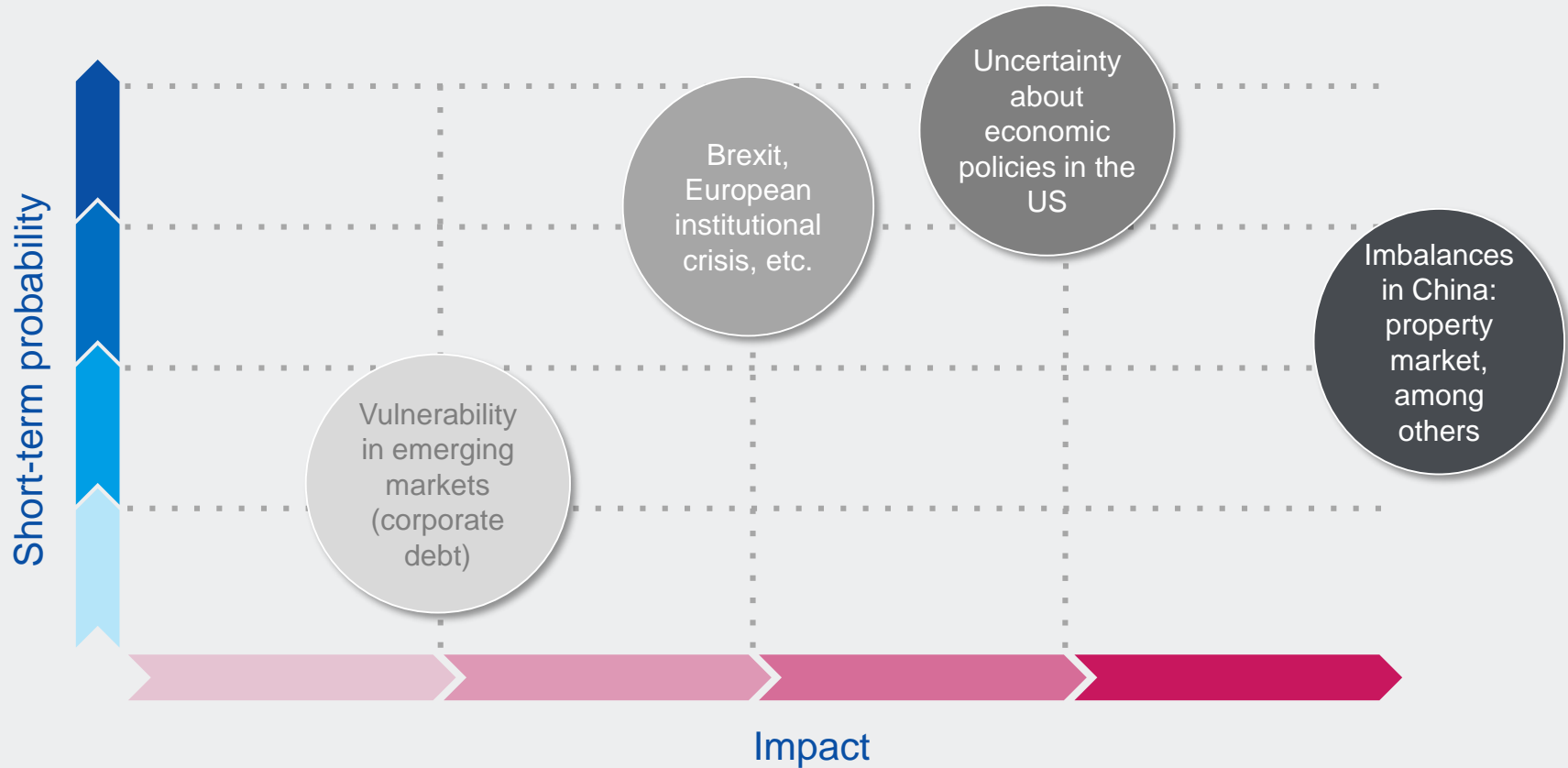
- The price of oil will **recover gradually** as the current surplus is absorbed

SOYBEANS
(US\$ per metric ton)



- The price of soybeans is adjusted downwards due to the **upward surprise in world harvests**, especially in the US and Brazil

Risks in the developed economies intensify in the short term, those in China in the medium term



Our baseline scenario for 2017 assumes the following exogenous factors

On the domestic front:

1. Construction of infrastructure works will have a greater effect on the economy from the second half of 2017
2. Government spending on goods and services consistent with the “fiscal rule”
3. Growth in electricity generation will ease

The increased levels of both public and private investment will provide support to the economy

PARAGUAY | PPP PROJECTS

(US\$ millions)

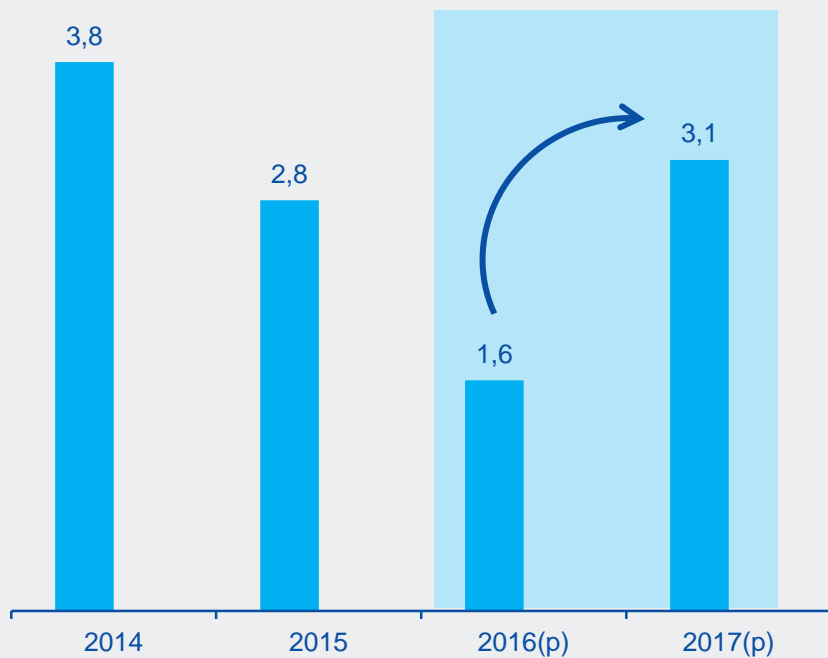
	Preliminary amount (US\$ millions)	% of GDP
Total	2,920	10.1
1. Public Initiative	2,858	10.2
- Awarded (Routes 2 and 7)	520	1.9
- Approved and in the bid assessment stage (Airport)	132	0.5
- Under study (<i>Hidrovia</i> (a plan by the five countries of the La Plata Basin to convert the Paraguay and Paraná rivers into an industrial shipping channel), Routes 1 and 6, Upper Paraná Clean-up)	2,206	7.9
2. Private Initiative	62	0.2
- Under study with confidentiality clause* Article 51 of the PPP Law (Roads and Railways)	62	0.2

* There are more Private Initiative projects, but until they are declared of Public Interest, they are confidential pursuant to Article 51 of Law 5.102/13

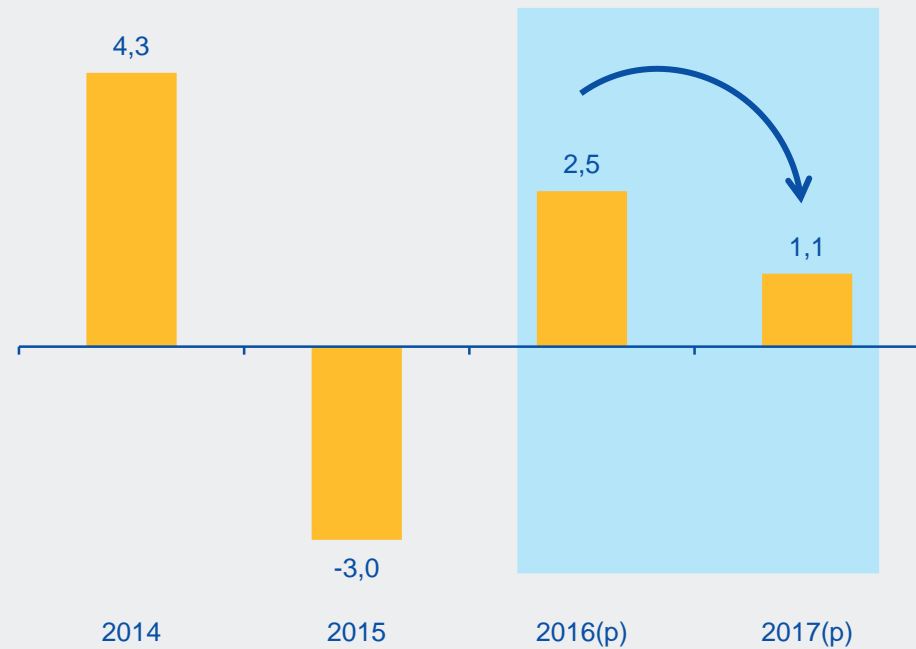
- These projects are in addition to the public projects already under way (road improvements, etc.)
- Infrastructure generates significant positive externalities for levels of productivity

Moreover, consumption will recover, but exports will tend to return to normal

PRIVATE CONSUMPTION
(chge. % YoY)



EXPORTS IN REAL TERMS
(chge. % YoY)



We forecast growth of 2.9% in 2017.

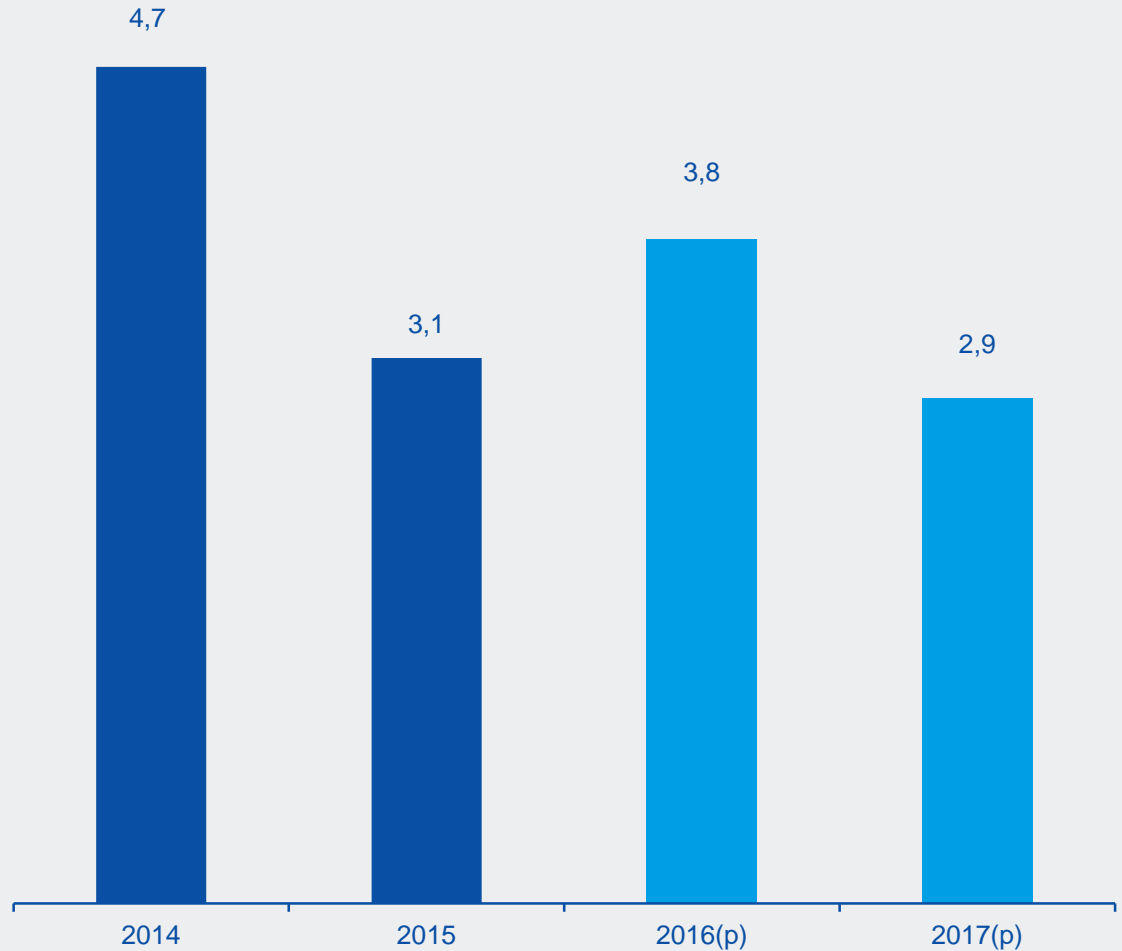
Support...

- Infrastructure projects (PPP)
- Slow improvement in external demand (Brazil)

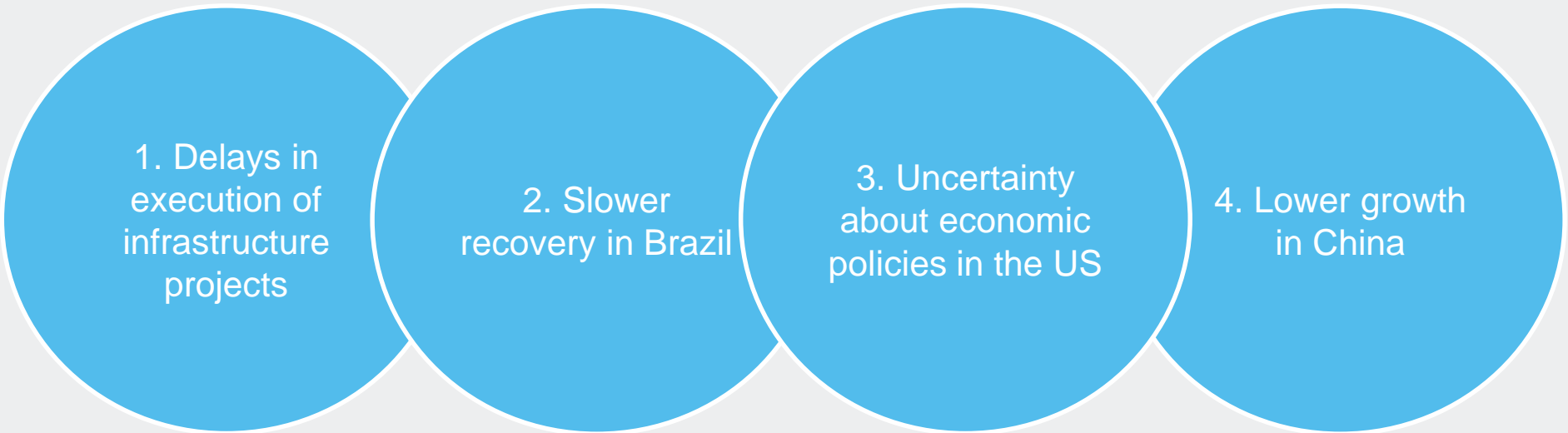
... but

- Reduced dynamism in the Electricity sector

TOTAL GDP
(Chge. % YoY)



Risks to our growth forecast for 2017



1. Delays in execution of infrastructure projects

2. Slower recovery in Brazil

3. Uncertainty about economic policies in the US

4. Lower growth in China

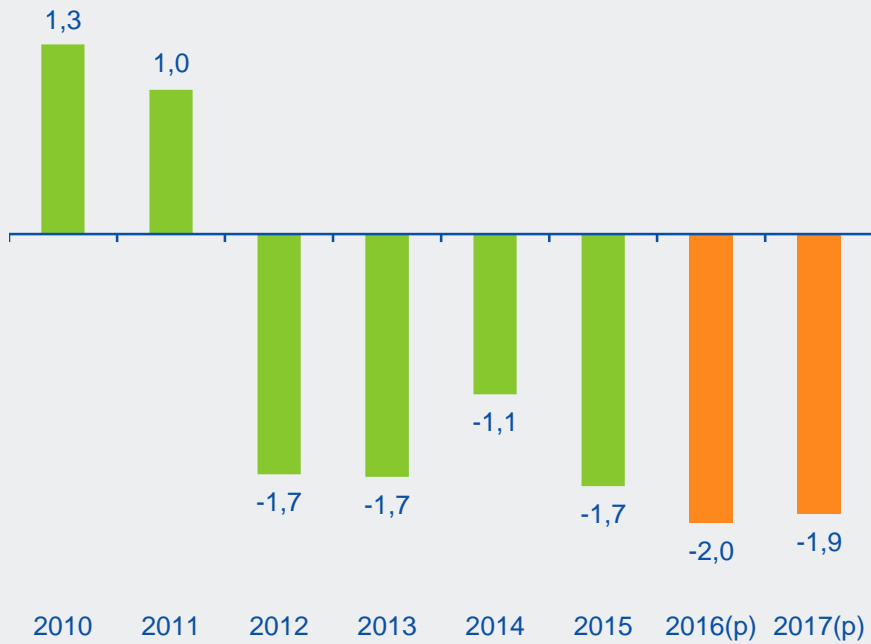
Macroeconomic projections

Fiscal scenario

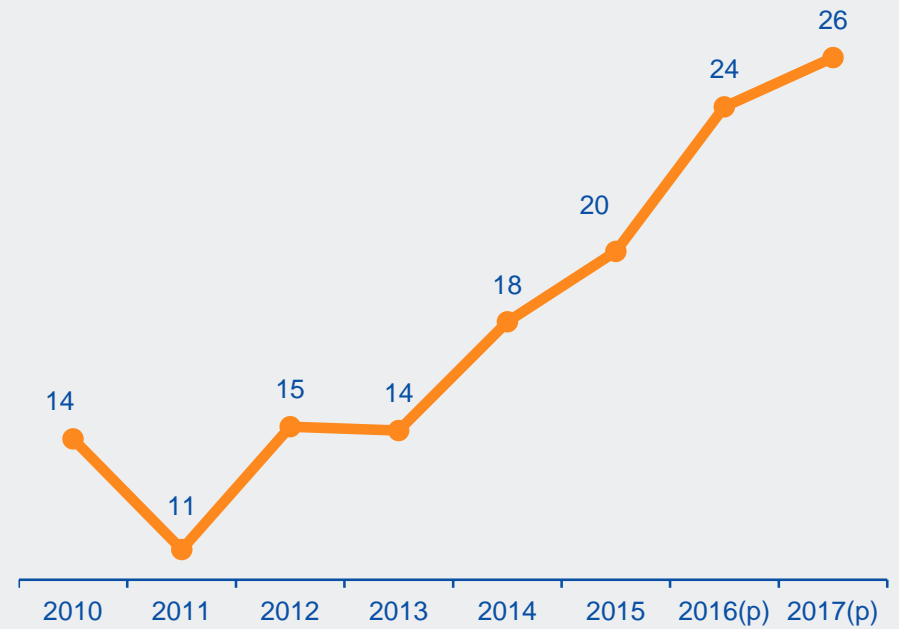
We foresee fiscal deficits of close to 2.0% of GDP and an increase in the public debt ratio, but public indebtedness will remain at low and sustainable levels

The debt ratio will rise next year to finance fiscal deficits, but...

FISCAL RESULT
(% of GDP)

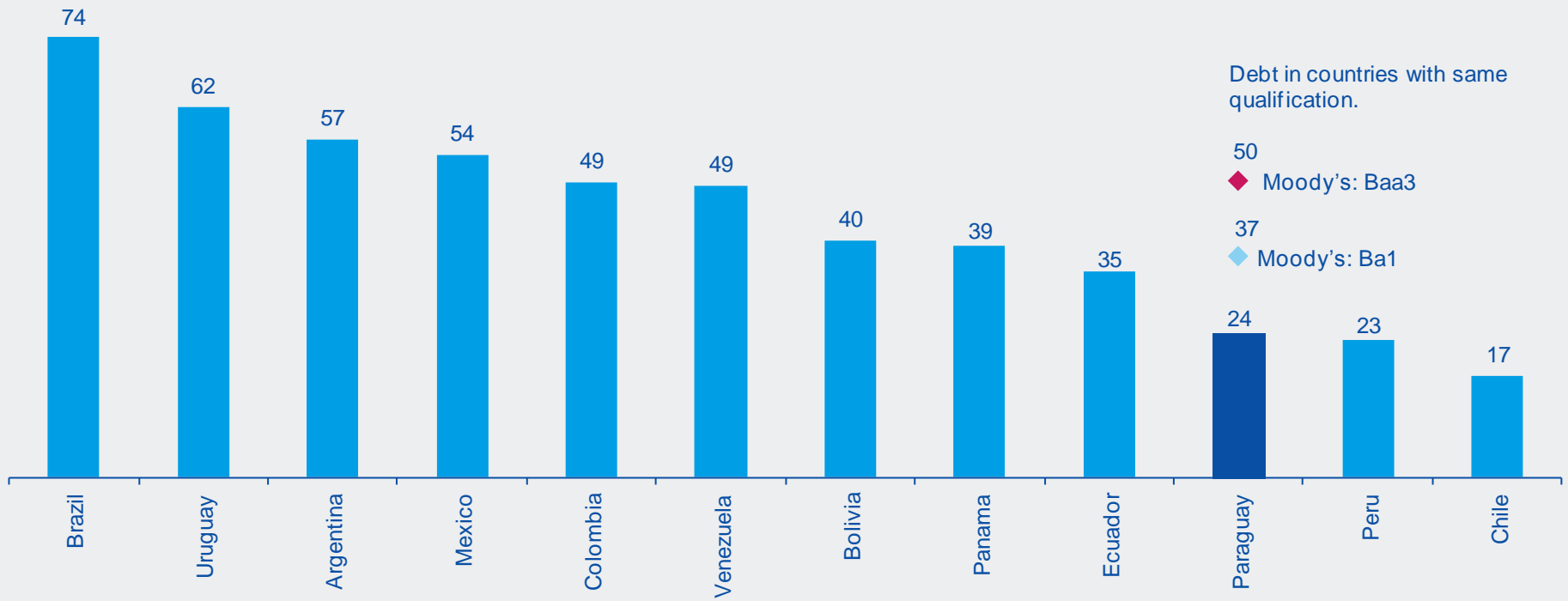


PUBLIC DEBT
(% of GDP)



...in relative terms it will remain at low and sustainable levels

COMPARISON OF THE LEVEL OF PUBLIC DEBT
(% of GDP)



The Fiscal Responsibility Act (LRF in the Spanish abbreviation) requires some adjustments

The LRF has been a success in terms of strengthening institutions, but...

Legal ambiguity surrounding the LRF

- The Budget Laws (approved by Congress) are in a situation of legal parity with the LRF

Low deficit limit

- Plans for investment in infrastructure may end up being curtailed

Limited exception clauses

- These may restrict the scope for applying countercyclical policies

- **A structural rule?**

- The government is considering making amendments to the LRF
- More compatible with the Paraguayan economic environment
- However, amending the LRF so soon after its implementation would **raise doubts** about real commitment to fiscal prudence.

- **Increased pressures on fiscal accounts:**

- Increase in minimum wage, presidential elections
- Increased spending on infrastructure

Macroeconomic projections



Exchange rate

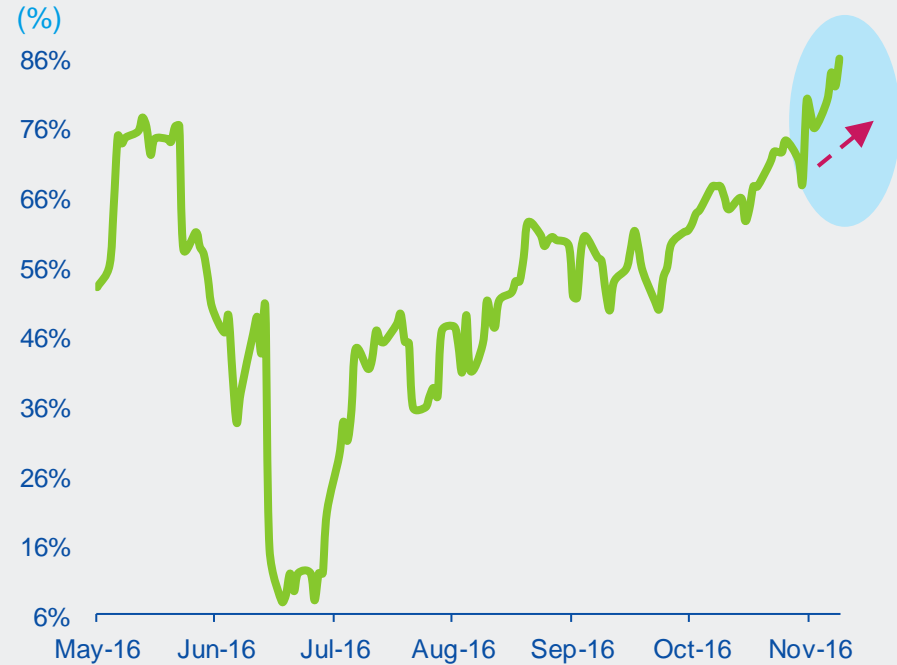
Looking ahead, downward pressures on the national currency due to global uncertainty, the US Federal Reserve's interest rate adjustment and fundamental factors

Exchange rate dynamic influenced by external volatility

**EXCHANGE RATE
(PYG/USD)**

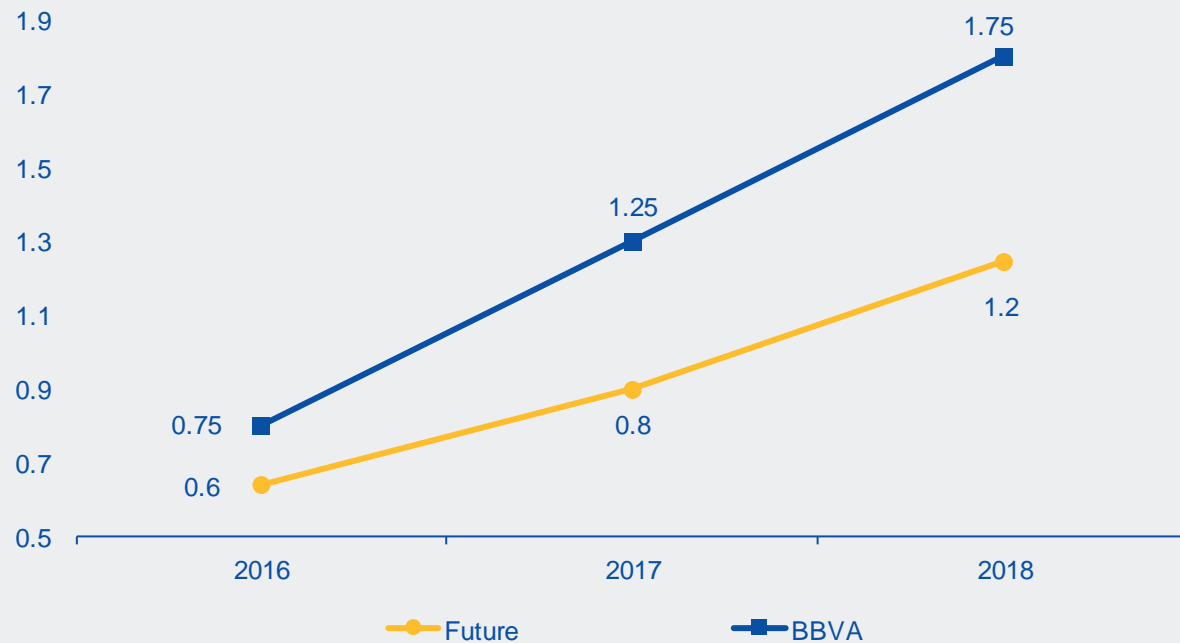


US FEDERAL RESERVE KEY INTEREST RATE: PROBABILITY OF AN INCREASE IN 2016 (%)



An adjustment to the FED key rate will lead to readjustments of portfolios and push the dollar up against the Paraguayan currency

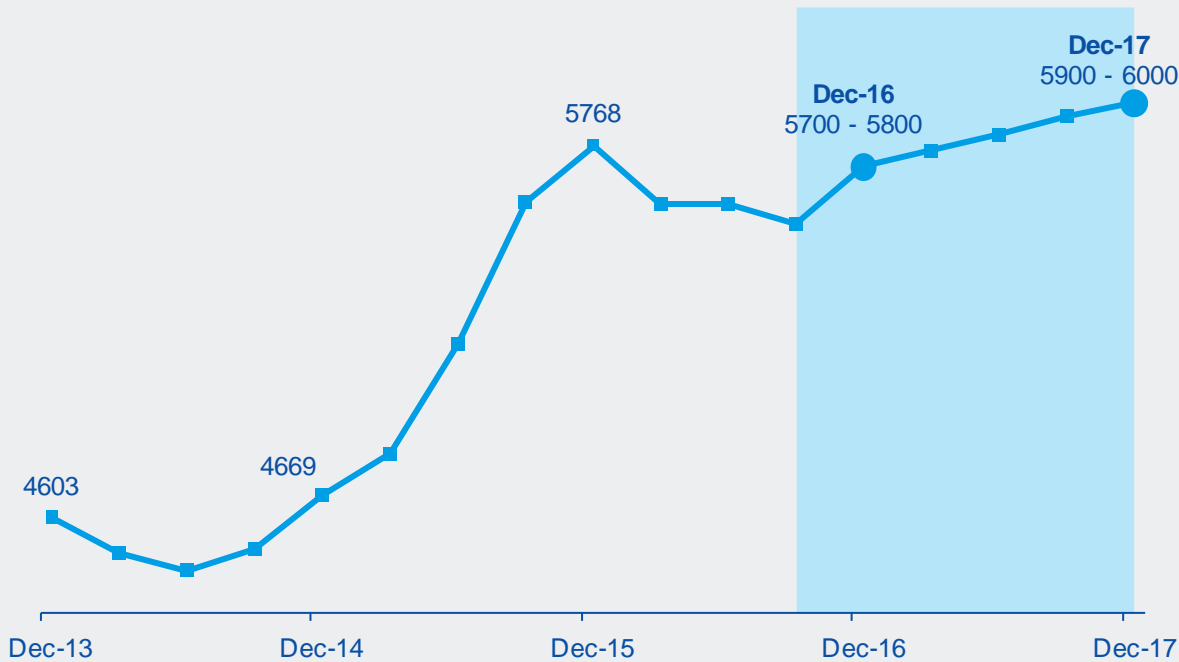
FEDERAL RESERVE KEY RATE PROJECTIONS (%)



- The market expects more gradual moves from the Federal Reserve
- If this expectation proves unfounded (i.e. If the Federal Reserve raises rates faster), **downward pressures on the Paraguayan currency will be intensified**

In this context, we project that the exchange rate (number of guaraní per dollar) will show an upward trend

EXCHANGE RATE
(PYG/USD)



In an environment of greater global uncertainty, we **cannot rule out bouts of volatility** over the course of this **upward trend** in the exchange rate

Macroeconomic projections

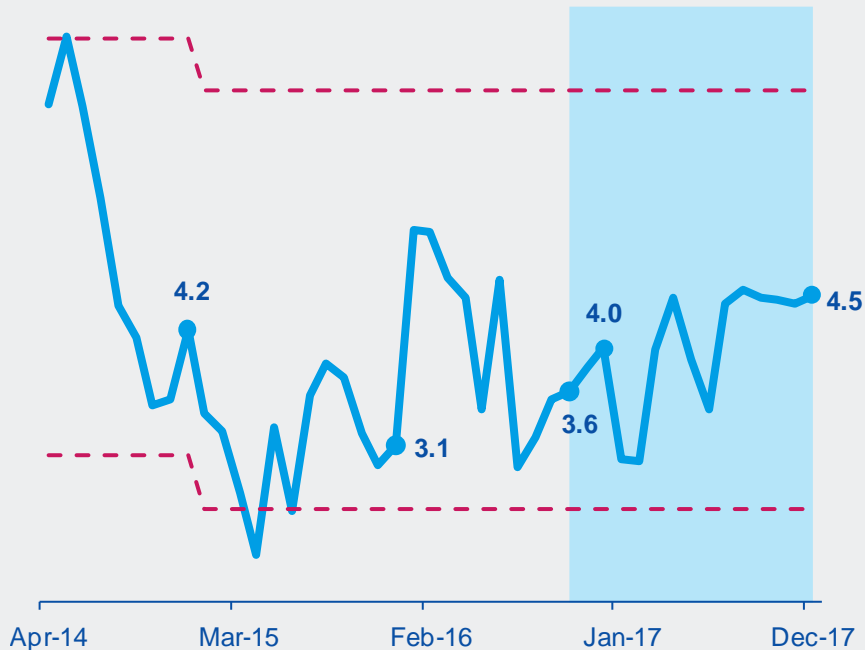


Inflation

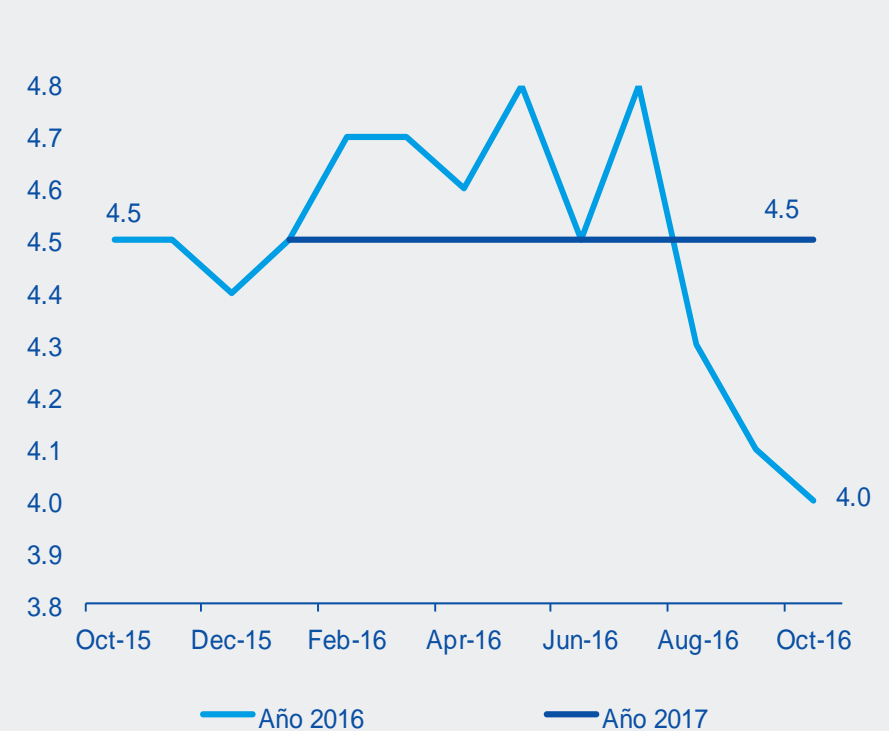
The Central Bank has managed to hold the year-on-year inflation rate at around the target, and expectations are anchored

Inflation is not a problem (around the target) and expectations are anchored

ANNUAL INFLATION
(%)



INFLATIONARY EXPECTATIONS
(%)



Macroeconomic projections



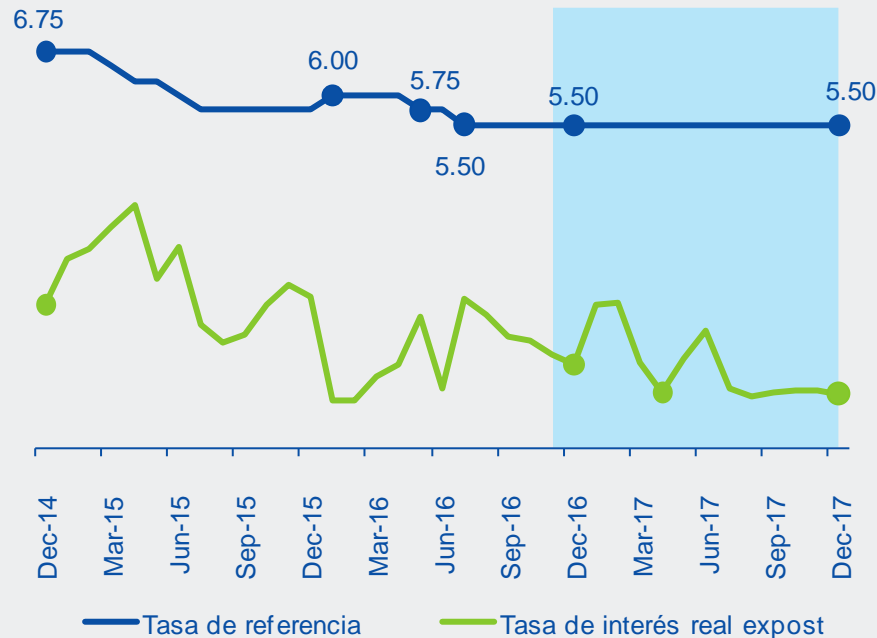
Monetary Policy

The reference rate stands at 5.50% and we do not expect any changes in the next few months

Monetary policy: Banco Central in pause mode in the next few months

BENCHMARK INTEREST RATE

(%)



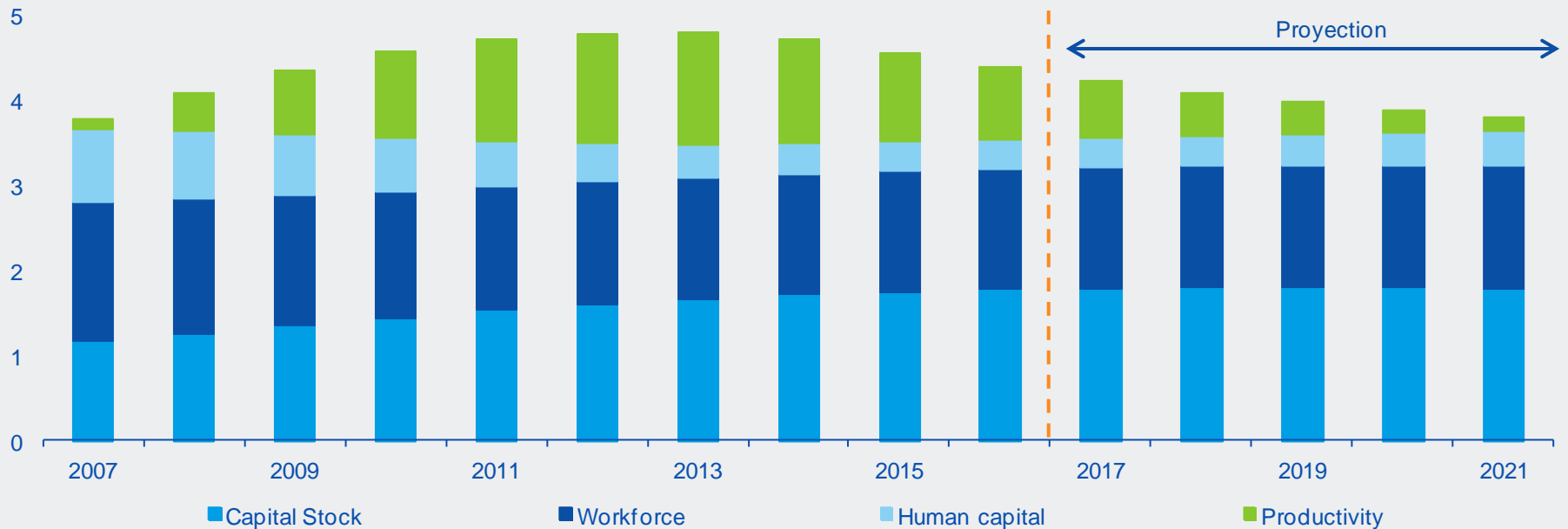
- **Central Bank of Paraguay, no major concerns** in the short term:
 - Inflation and expectations are within the target range
 - Risk of exchange mismatch is limited
 - We foresee reduced pressures on the currency
- However, in this environment we do **not rule out possible monetary easing** if private spending remains weak.



3. Looking to the medium term

Potential growth will decline in the next few years due to the reduced contribution from productivity

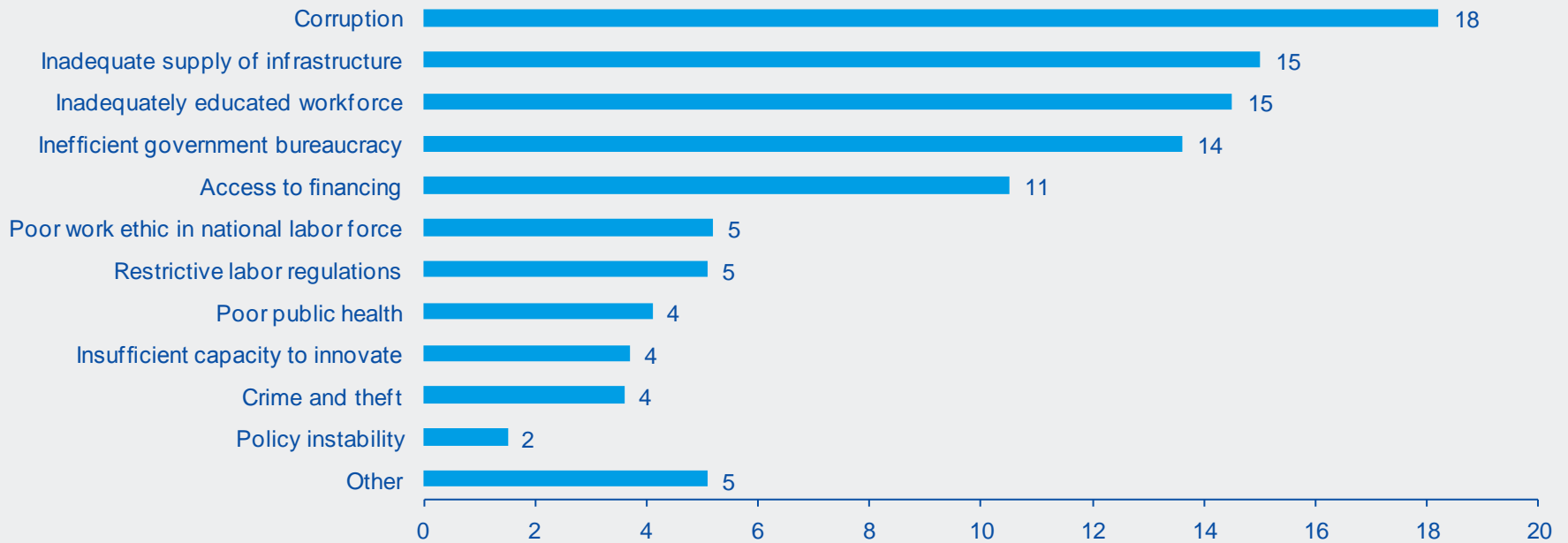
POTENTIAL GDP: CONTRIBUTION TO GROWTH
(percentage points)



Measures are required to strengthen productivity and competitiveness

WEF 2016: MOST PROBLEMATIC FACTORS IN DOING BUSINESS IN PARAGUAY

(% of total responses)



In which areas do improvements need to be made? Infrastructure and education

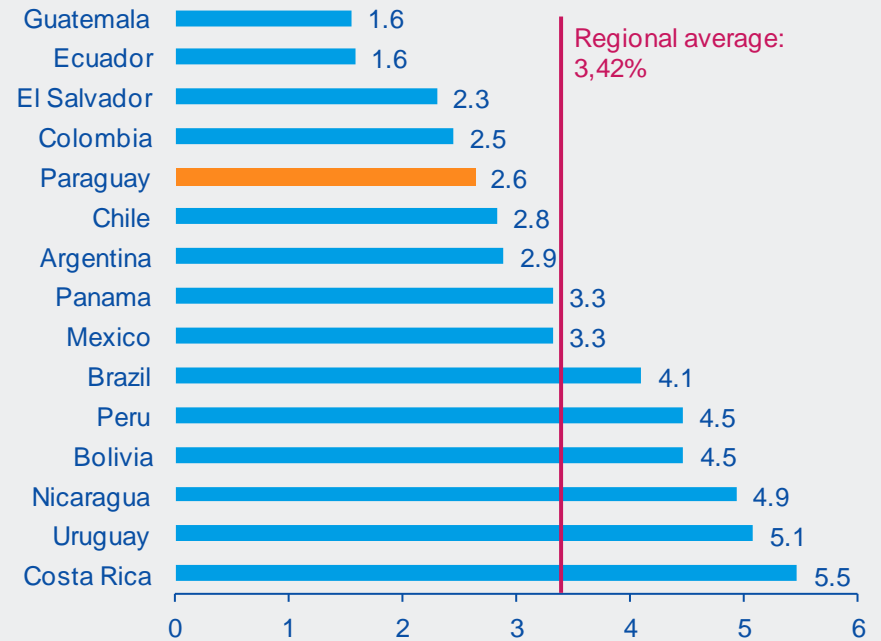
GLOBAL COMPETITIVENESS INDEX 2016-2017

(Index between 1 "worst" and 7 "best")



LATAM: INVESTMENT IN INFRASTRUCTURE

(% of GDP, 2012)



In which areas do improvements need to be made? Infrastructure

PARAGUAY: SELECTED PILLARS OF THE COMPETITIVENESS INDEX 2016

(Ranking)

Indicators	Global	
	Ranking (out of 138 countries)	LatAm* (out of 21 countries)
Second Pillar: Infrastructure	122	21
Overall quality of infrastructure	130	21
Quality of highways	136	21
Quality of railway infrastructure	n.a	n.a
Quality of port infrastructure	108	17
Quality of air transport infrastructure	132	21
Availability of airline seats km/week	113	19
Quality of electricity supply	115	18
Mobile phone subscribers	91	15
Fixed telephone lines	102	21

*Includes the Caribbean

In which areas do improvements need to be made? Education

PARAGUAY: SELECTED PILLARS OF THE COMPETITIVENESS INDEX 2016

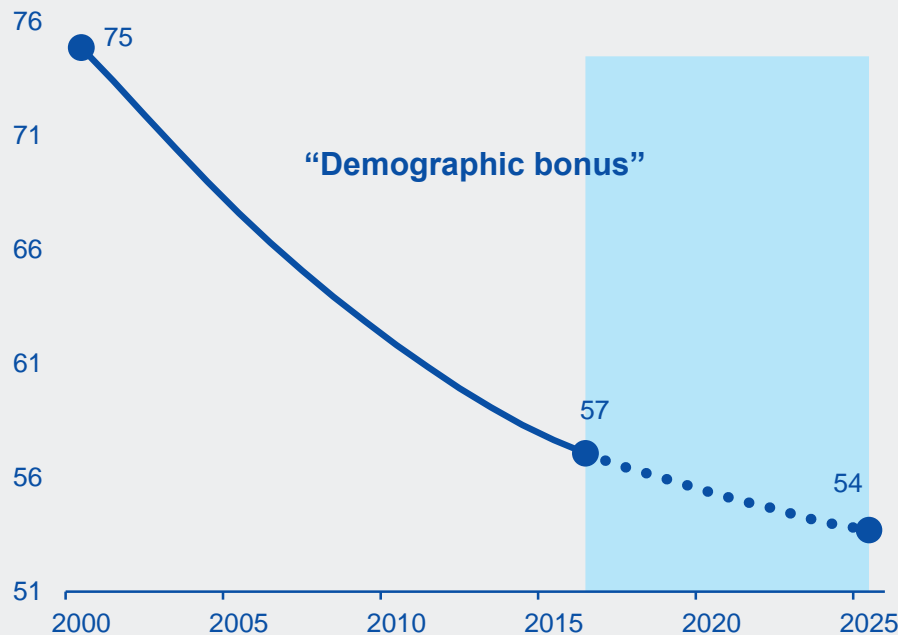
(Ranking)

Indicators	Global	
	Ranking (out of 138 countries)	LatAm* (out of 21 countries)
5th Pillar: Higher education and training	107	20
Enrolments in secondary education	97	16
Enrolments in higher education	77	14
Quality of the educational system	136	21
Quality of maths and science teaching	137	21
Quality of business schools	130	21
Internet access in schools	127	20
Availability of research and training services	132	20
Personnel training activities	118	20

*Includes the Caribbean

There are also other factors that could be made use of to underpin growth

DEPENDENCY RATE^{1/}
(%)



^{1/} Percentage of the working age population represented by those under 15 and over 64 years of age

- This situation (in which the working age population outnumbers the dependent population), **is a good opportunity for sustained development.**
 - The burden on households will continue to diminish, creating room for increasing expenditure on durable goods
- However, the associated benefits are conditional on:
 - the adoption of **policies to encourage productive investment**, to increase job opportunities and promote a stable social and economic environment.

MAIN MESSAGES



Main messages

- The Paraguayan economy posted **annual average growth of 4.8% in the past five years**. This is remarkable, given the challenging external environment
- In the second quarter, growth accelerated. The thrust came from the **Electricity, Construction and Livestock** sectors. In this context, growth will amount to 3.8% in 2016. **We expect GDP to grow by 2,9% next year**. Growth will be supported by the start of infrastructure works and a gradual recovery in consumption. However, the normalisation of electricity generation will lead to a slackening in the pace of GDP growth
- **Risks for 2017**. On the external side, slower recovery in Brazil and lower growth in China. On the domestic front, delays in executing major infrastructure works
- We expect the guaraní to **depreciate somewhat further in the coming months**. Global uncertainty, adjustment to US Interest rates and somewhat lower export prices will lead to a rising trend in the (PYG to USD) exchange rate
- To underpin growth in the medium term there is a need for **measures to boost productivity and competitiveness**. In particular the need for greater development of infrastructure and the need to address lags in education

PARAGUAY: MAIN MACROECONOMIC VARIABLES
Baseline scenario

	2012	2013	2014	2015	2016 (f)	2017 (f)
GDP (% YoY)	-1.2	14.0	4.7	3.1	3.8	2.9
Inflation (% YoY, eop)	4.0	3.7	4.2	3.1	4.0	4.5
Exchange rate (per USD, eop)	4,276	4,603	4,669	5,768	5,700	5,900
Interest rates (% , eop)	5.50	6.00	6.75	5.75	5.50	5.50
Private Consumption (% YoY)	2.8	4.6	3.7	2.4	1.7	3.1
Public Consumption (% YoY)	21.0	3.5	4.2	6.2	0.8	3.0
Investment (% YoY)	-13.5	20.2	11.0	1.5	3.6	3.1
Tax Revenue (% GDP)	-1.7	-1.7	-1.1	-1.7	-2.0	-1.9
Current Account (% GDP)	-2.0	1.7	-0.4	-1.7	0.6	-0.2