

Paraguay Economic Outlook 2017

November 2017



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Key messages

1

Following the slowdown in Q2, the most recent indicators for activity and domestic spending show the economy recovering momentum. We expect these trends to hold steady in the latter part of the year.

2

In this context, our outlook for GDP growth for this year stands at 3.7% (with an upward bias).

3

For 2018, we project that the economy will grow 3.5%. This forecast is conditioned on a positive external environment and on the dynamism of the public investment.

4

We expect the guaraní to depreciate somewhat further in the coming months. The monetary tightening process in the USA and somewhat lower export prices will lead to a rising trend in the (PYG to USD) exchange rate.

5

The Central Bank has managed to hold the year-on-year inflation rate at around the mid-point of the target range, and expectations are well anchored. The reference rate stands at 5.25% and we do not expect any changes in the next few months.

6

However, mid-term challenges remain in place and need to be tackled in order to reassure a strong and less volatile GDP growth.

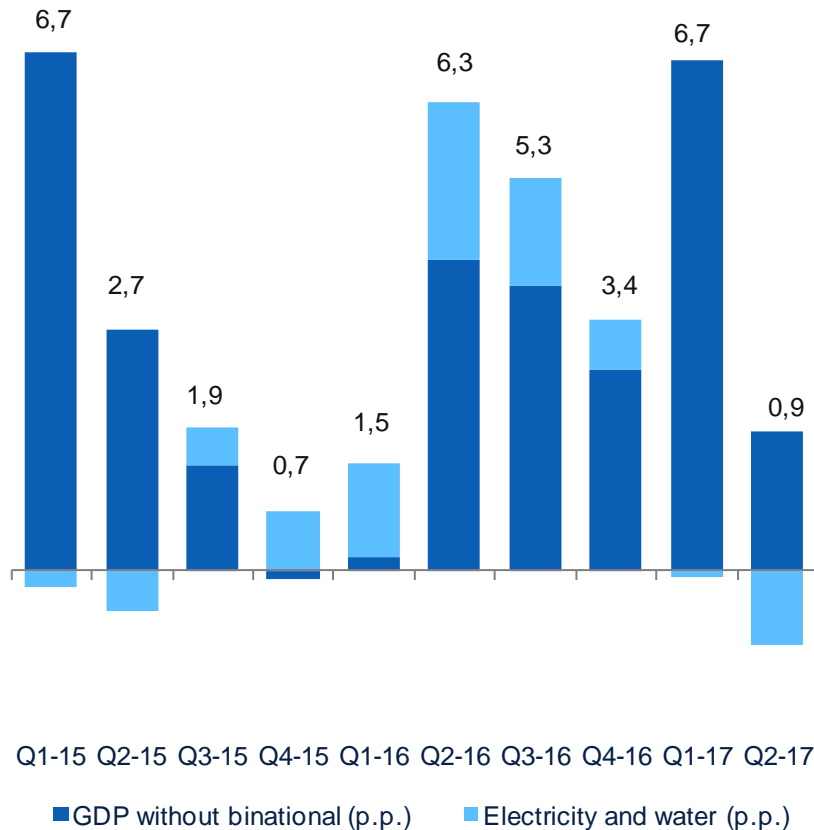
01

How is evolving GDP in the latter part of the year?

Following the slowdown of the second quarter...

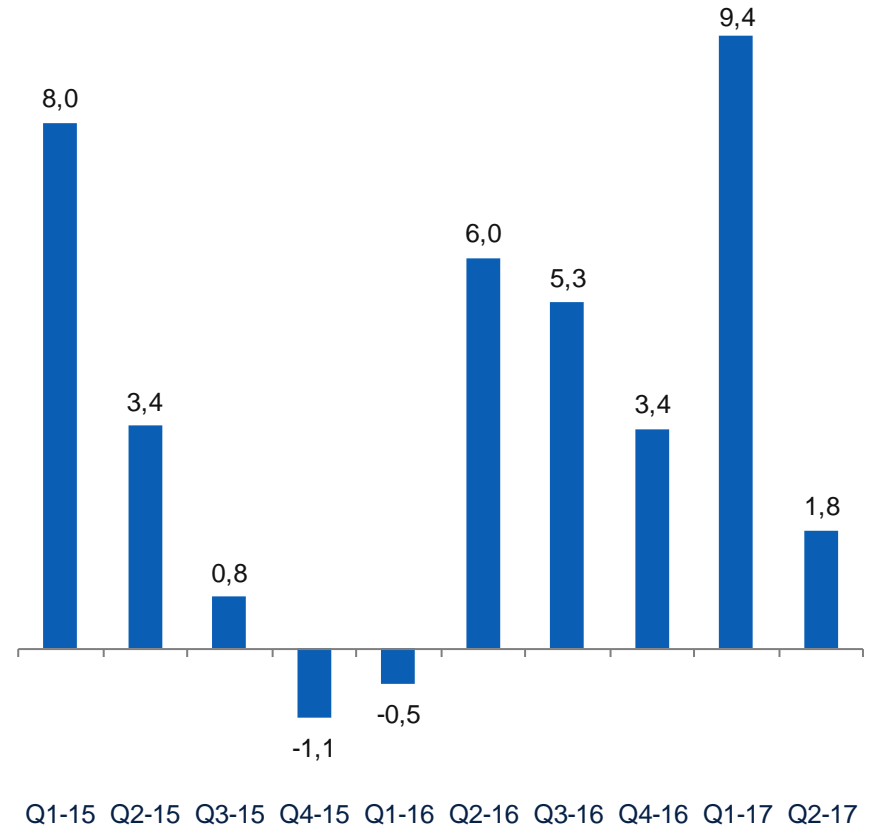
Total GDP

(% var. YoY and contribution in percentage points)



GDP excl. agriculture and binationals*

(% var. YoY)

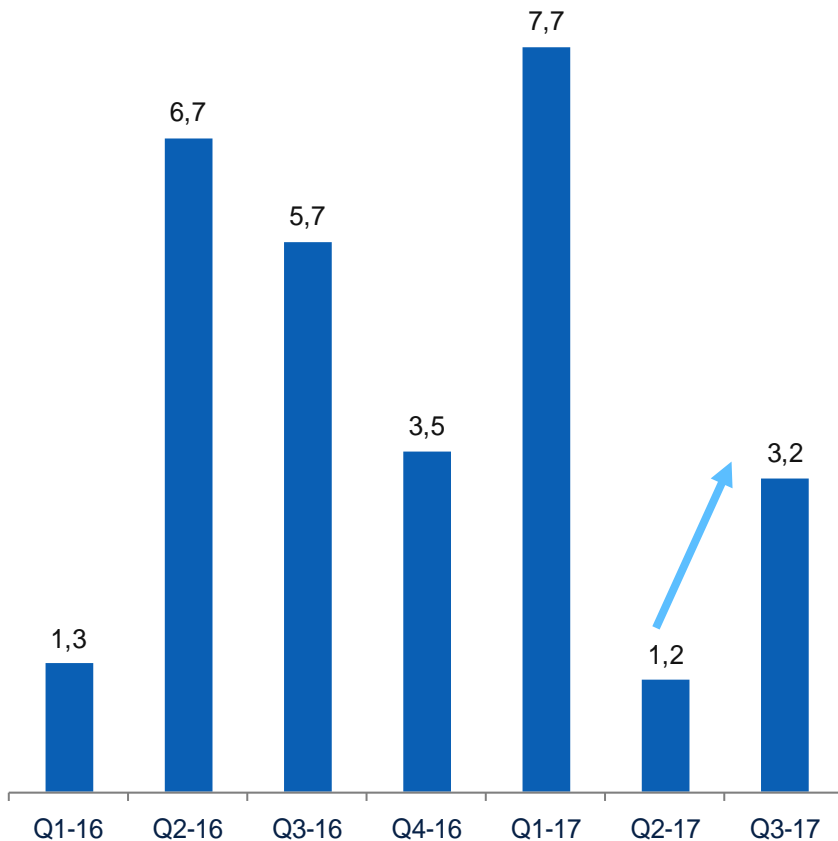


Source: Banco Central de Paraguay and BBVA Research

*. The Itaipú and Yacyretá hydroelectric projects, shared with Brazil and Argentina respectively
Source: Banco Central de Paraguay and BBVA Research

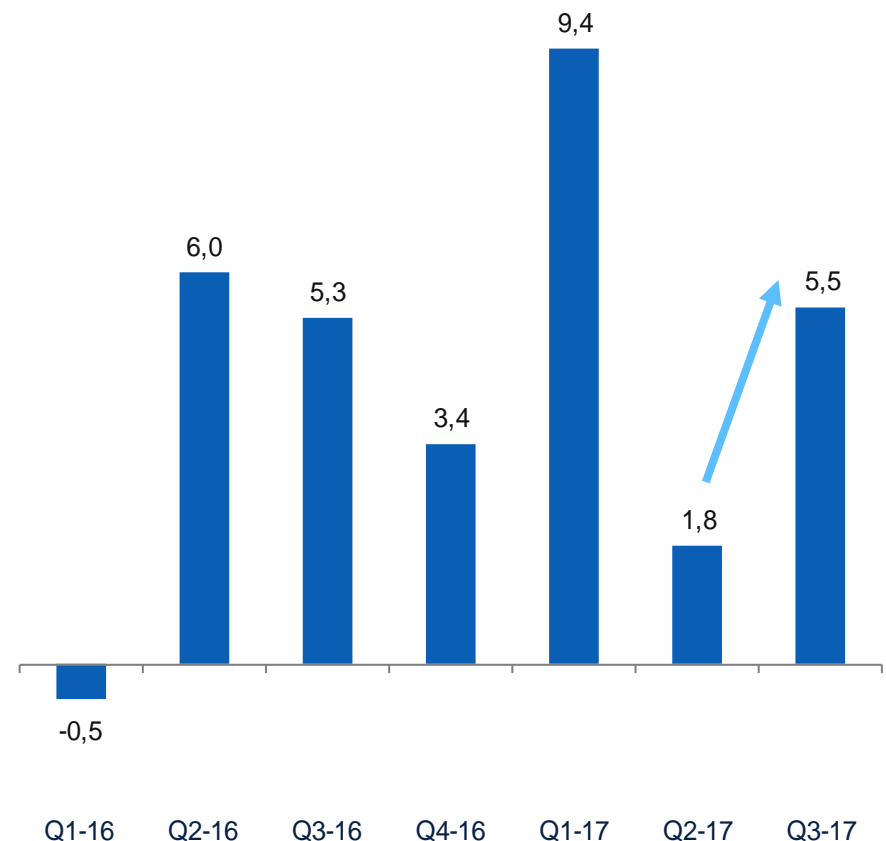
...the most recent indicators for activity and domestic spending show the economy recovering momentum

Total IMAEP*
(% var. YoY)



* IMAEP = Monthly Indicator of Economic Activity in Paraguay.
Source: Banco Central de Paraguay and BBVA Research

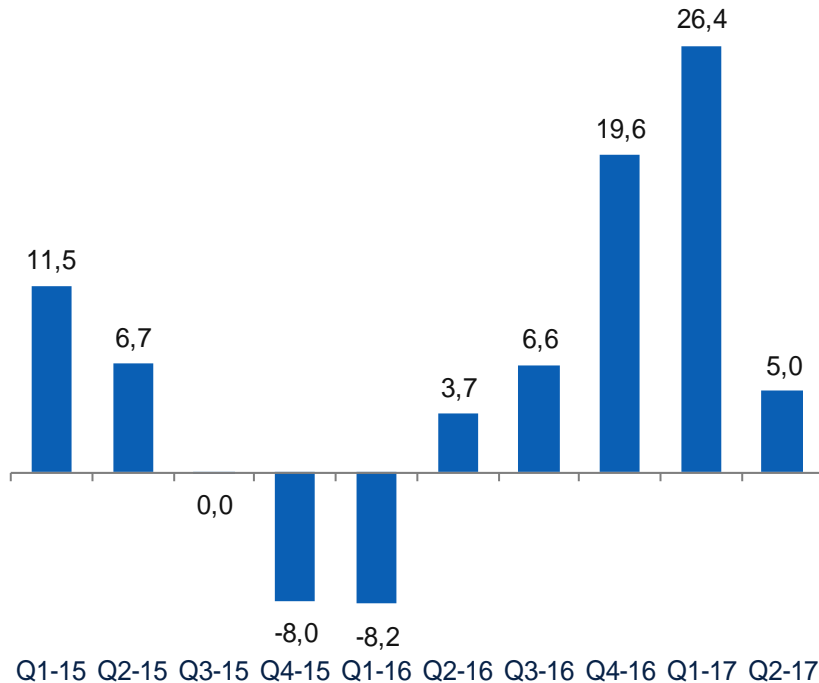
IMAEP excl. agriculture and binationals*
(% var. YoY)



*The Itaipú and Yacyretá hydroelectric projects, shared with Brazil and Argentina respectively.
Source: Banco Central de Paraguay and BBVA Research

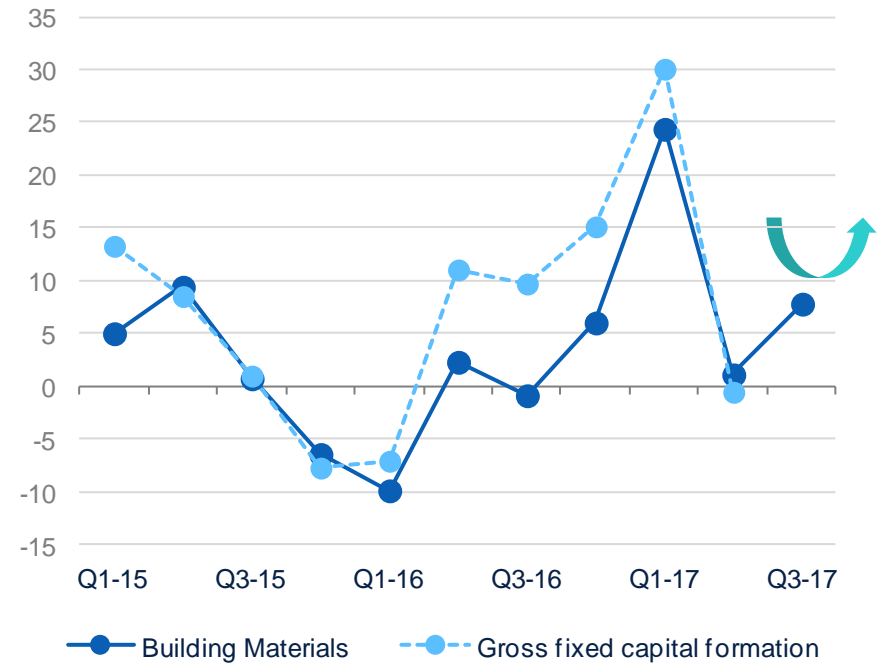
...the most recent indicators for activity and domestic spending show the economy recovering momentum

Gross fixed capital formation
(% var. YoY)



Source: Banco Central de Paraguay and BBVA Research

ECN: Businesses linked to investment
(% var. YoY)

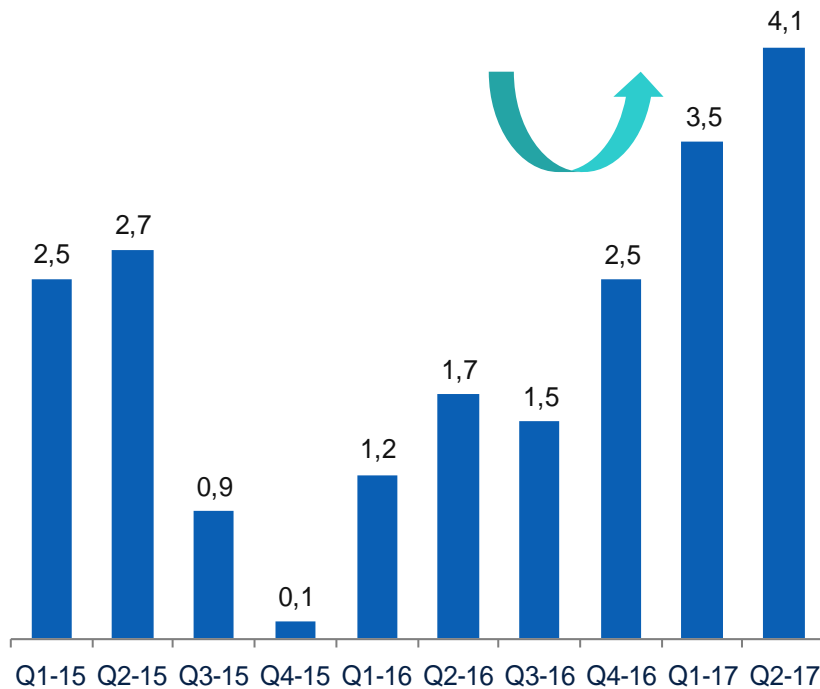


Source: Banco Central de Paraguay and BBVA Research

Sales of construction materials, which correlates with investment, showed recovery in the third quarter

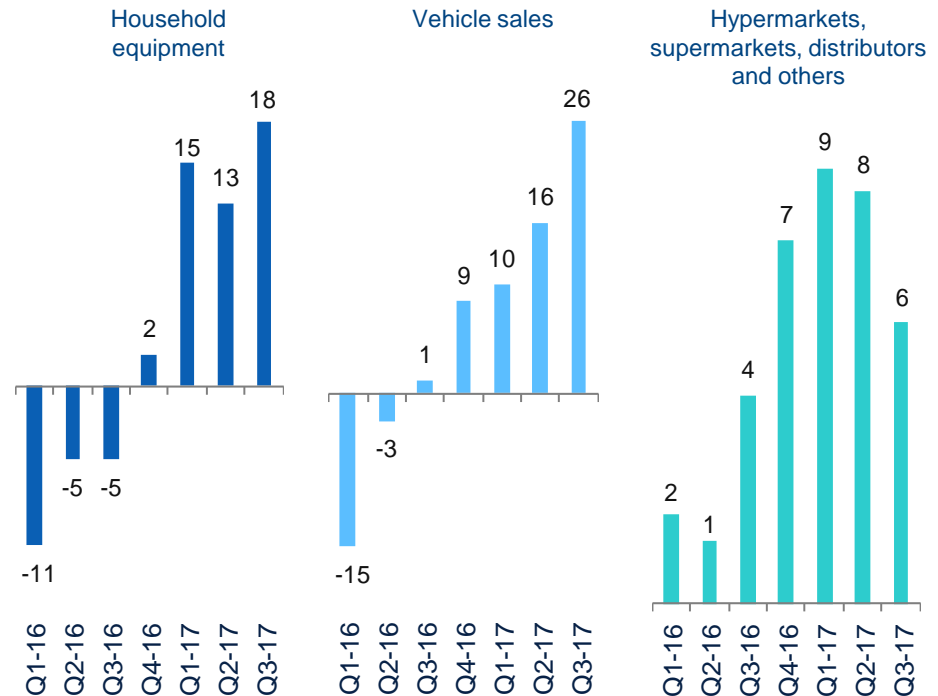
...the most recent indicators for activity and domestic spending show the economy recovering momentum

Domestic consumption
(% var. YoY)



Source: Banco Central de Paraguay and BBVA Research

ECN: Business associated with consumption
(% var. YoY)



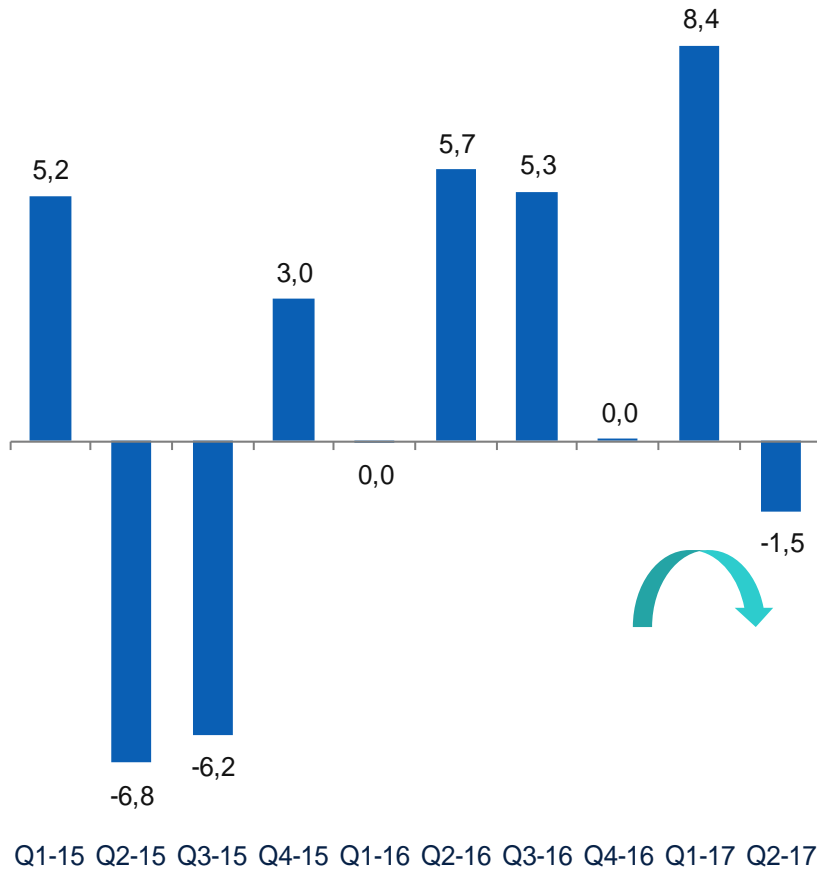
Source: Banco Central de Paraguay and BBVA Research

Consumption indicators, such as vehicle sales, continued to perform strongly during the third quarter

On the other hand, exports moderated due to lower energy sales, following the record levels of the previous year

Exports of goods and services

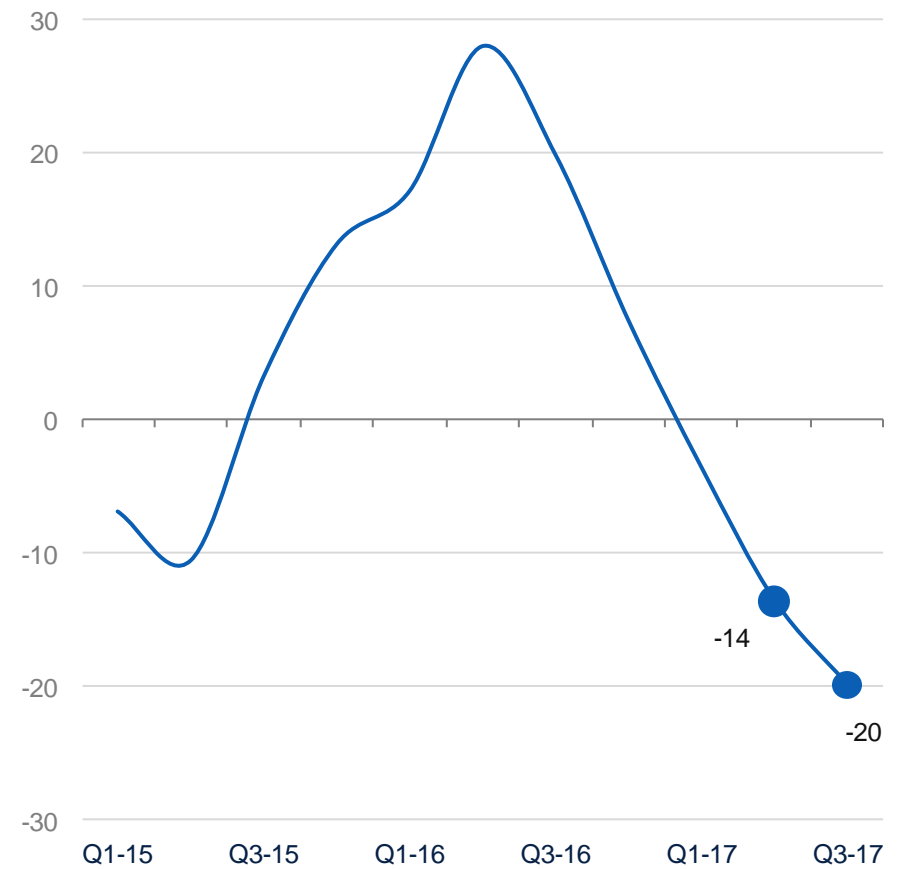
(% real var. YoY)



Source: Banco Central de Paraguay and BBVA Research

Export of electrical energy

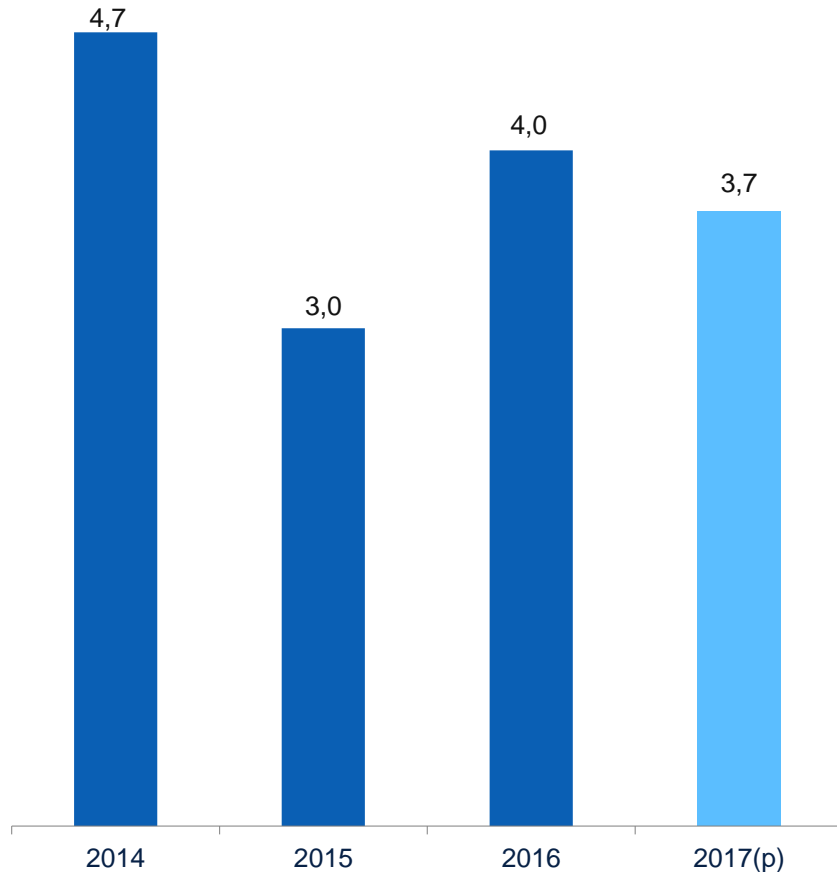
(% real var. YoY)



Source: Banco Central de Paraguay and BBVA Research

In this context, we foresee the Paraguayan economy growing by 3.7% in 2017, albeit with an upward trend

Total GDP
(% var. YoY)



(p) projected

Source: Banco Central de Paraguay and BBVA Research

Support

In the first quarter
the GDP grew by 3.9%

Better performance in the sectors
linked with domestic demand

...but...

Softening of momentum in the
energy production sector

02

Growth forecast for 2018

Key factors which underlie our projected base scenario

External

Global GDP

- Brazil
- Argentina

Monetary policy

in the most developed economies

Soybeans prices

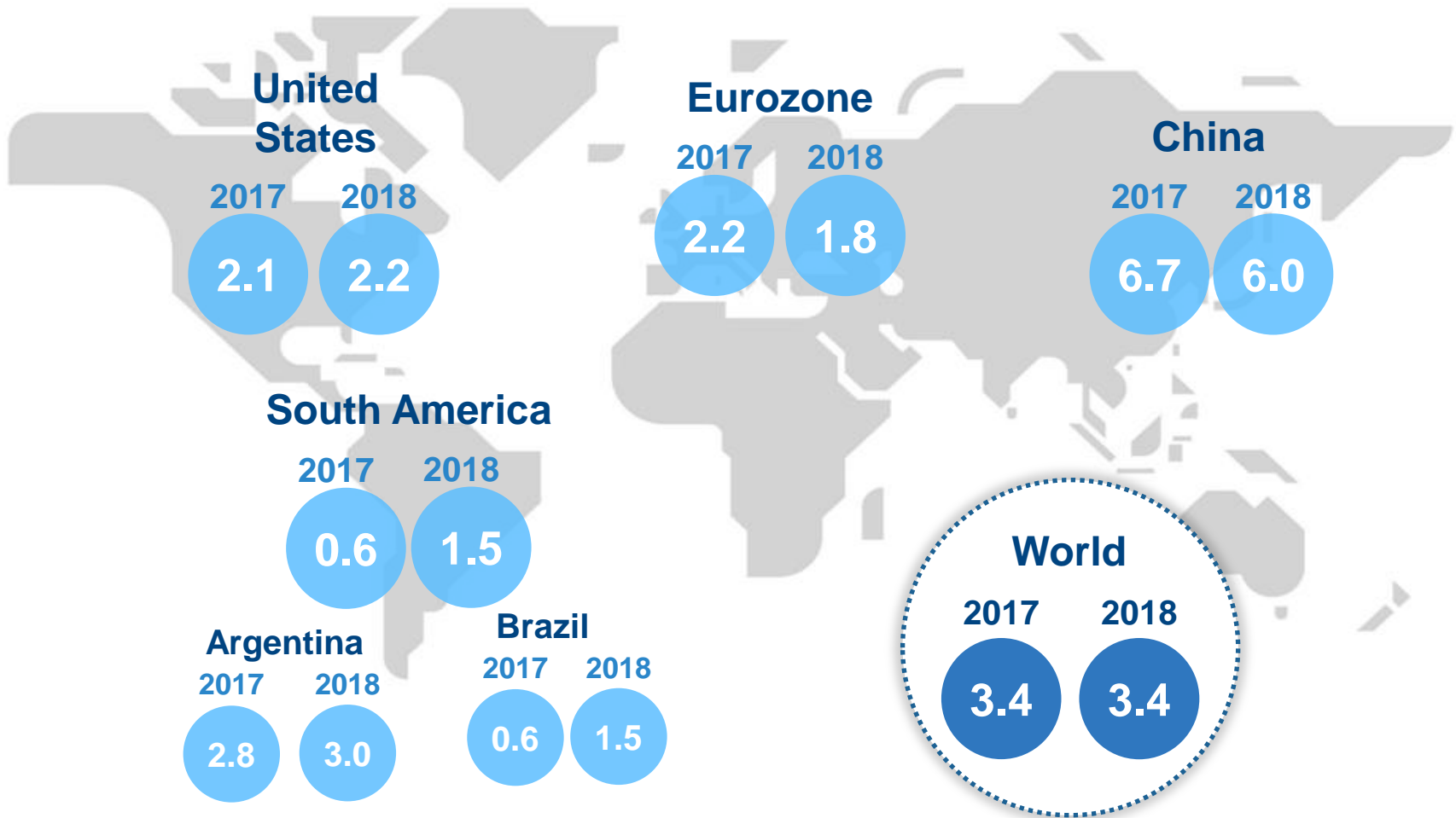
Local

Moderation of agricultural
production levels

Public investment
Infrastructure

Expenditure consistent
with the fiscal rule

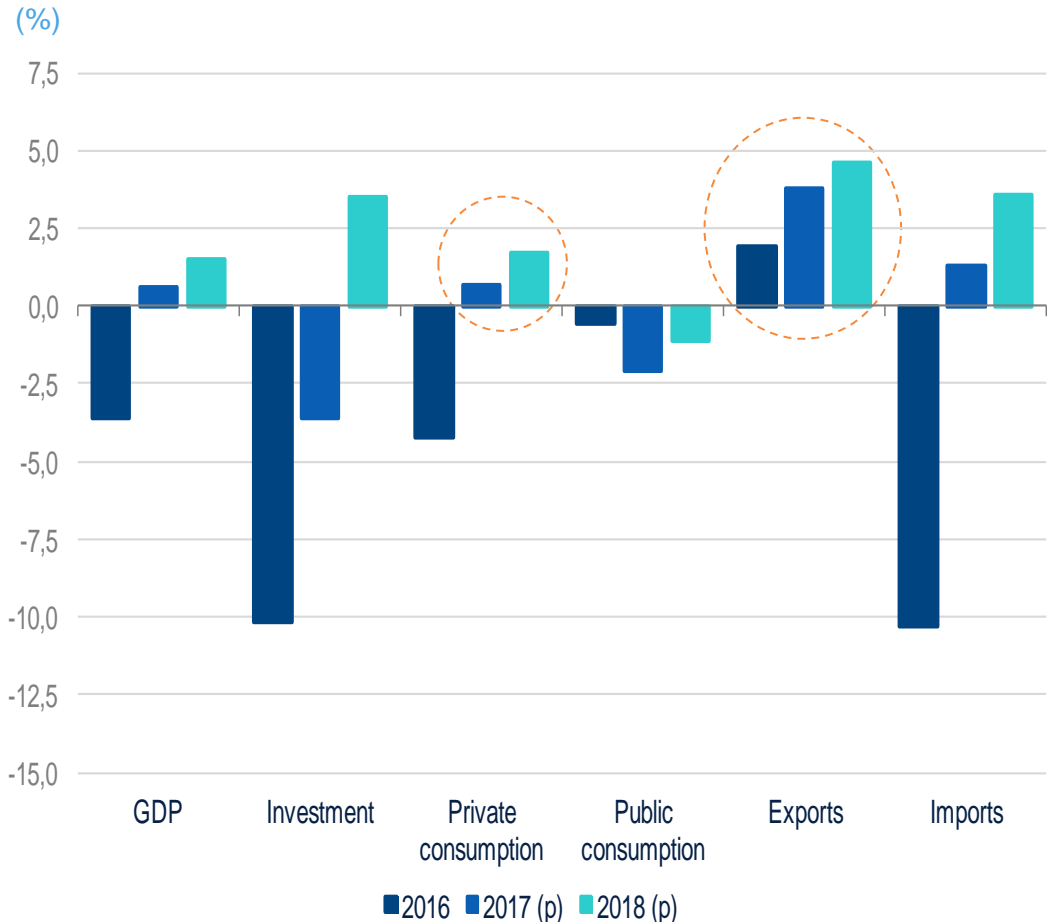
Global GDP growth remains robust and embraces more regions



Brazil: cyclical recovery following the recession. GDP should grow by 0.6% in 2017 and 1.5% in 2018

- ◆ The fiscal situation and the political noise preclude greater optimism regarding growth. Even so, recent data suggest that the recovery could be stronger than expected.
- ◆ The economic recovery is being led by private consumption and exports. Low inflation, looser monetary policy and the gradual improvement in the labour market will underpin private consumption. Improved terms of trade, a more favourable exchange rate and increased global demand will continue to stimulate exports.
- ◆ Inflation, currently at 2.5%, will reach 3.2% in 2017 and 4.3% in 2018. These relatively low levels create a margin for a more accommodative monetary policy: the SELIC rate should soon approach 7.0%.

Brazil: Growth of GDP and its components



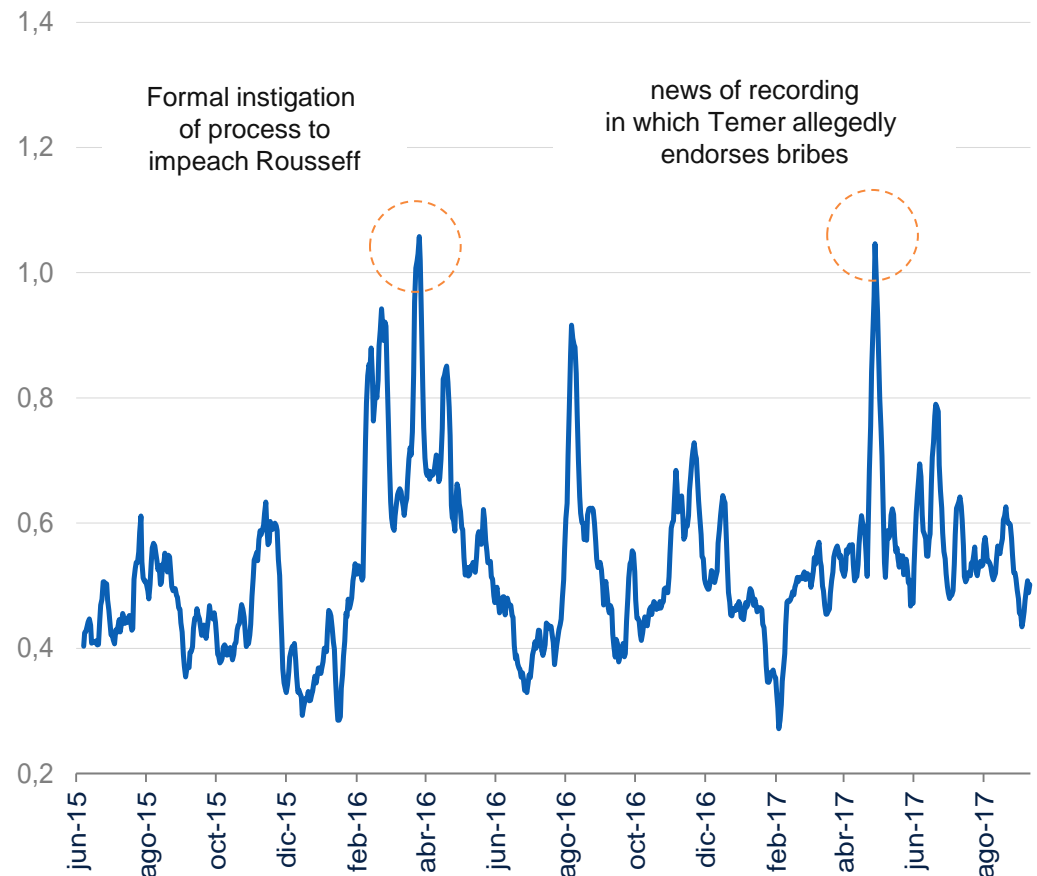
(p) projected.

Source: BBVA Research and IBGE (Brazilian Institute of Geography & Statistics)

Brazil's structural recovery seems unlikely in the short term, mainly because of the political situation

- ◆ The recent signs of congressional support for President Temer increase the probability of his completing his term of office which expires at the end of 2018. Even so, **only 3% of the population approve of the current government.**
- ◆ **It will be difficult to get approval before 2019 of an ambitious reform of the social security system** (which is essential for ensuring the country's fiscal solvency) or other reforms needed to boost its potential GDP (currently around 2%).
- ◆ **Whichever government emerges from the elections of 18 October could have enough support to be able to pass the necessary reforms.** However, great uncertainty remains as to the next government's profile.

Index of political tensions in Brazil by BBVA Research
(moving average for the last seven days)

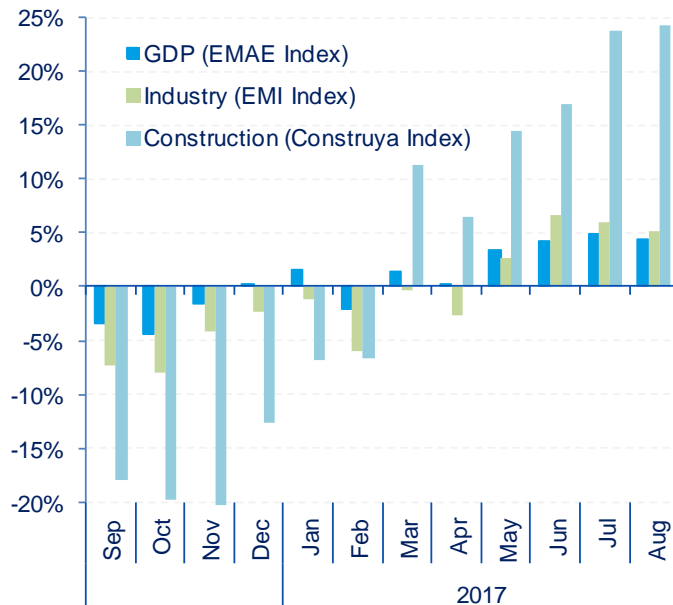


Argentina: the improvement in economic activity is consolidating, but inflation is falling more slowly than hoped.

- ◆ **Growth is firming up and spreading to more sectors.** Growth will be close to 3% in 2018, for the second year in a row, driven mainly by investment.
- ◆ **Inflation remains outside the target range,** with some stagnation in core inflation, leading the BCRA to toughen its monetary policy even further.
- ◆ The slow fiscal consolidation (-1% of GDP p.a.) and the external financing of the deficit **exert upward pressure on the peso and** reinforce the need for structural reforms to improve competitiveness

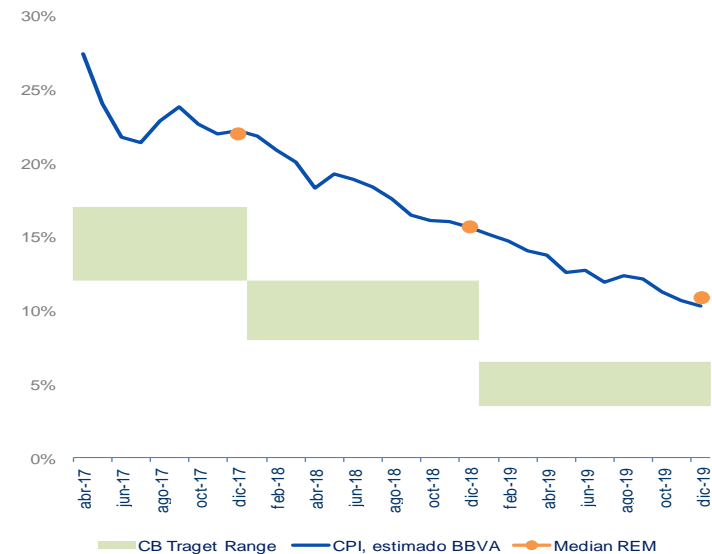
Activity indicators

(% YoY change)



Source: INDEC and BBVA Research

National CPI, central bank targets and expectations (% var. YoY)



Source: Indec, BCRA (central bank) and BBVA Research

The Paraguayan economy shows significant sensitivity to macroeconomic changes in Brazil and Argentina

Impact on the Paraguayan economy¹
(percentage points)

	GDP ...an increase of 1 percentage point in growth	Exchange rate ...a real increase of 10% of the (real/peso) against the Guaraní
Brazil	0.5	0.4
Argentina	0.4	NA

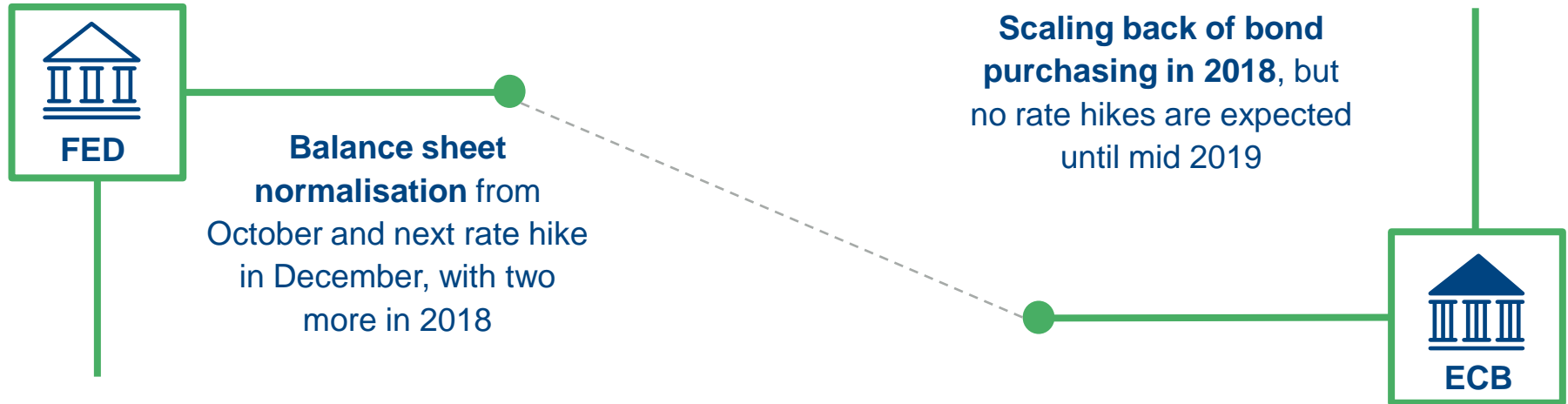
^{1/} Impact accumulated in a year.

Source: IMF. Selected topics, "Paraguay: the importance of the contagion effect". February 2015 and BBVA Research ([Paraguay Economic Outlook, Second Half 2015](#))

IMF: the effect accumulated in 8 quarters on the Paraguayan GDP of 1 percentage point lower growth in Brazil is 0.4

In line with the IMF estimates (and ours), a one-percentage point increase in Brazil's GDP growth produces an increase of between 4 and 5 tenths of a percentage point of GDP growth in Paraguay

Global financial markets will still favour emerging economies, although increasingly less so...



Great uncertainty:

- In the **United States** due to slowing inflation and the expected changes in the FOMC in 2018

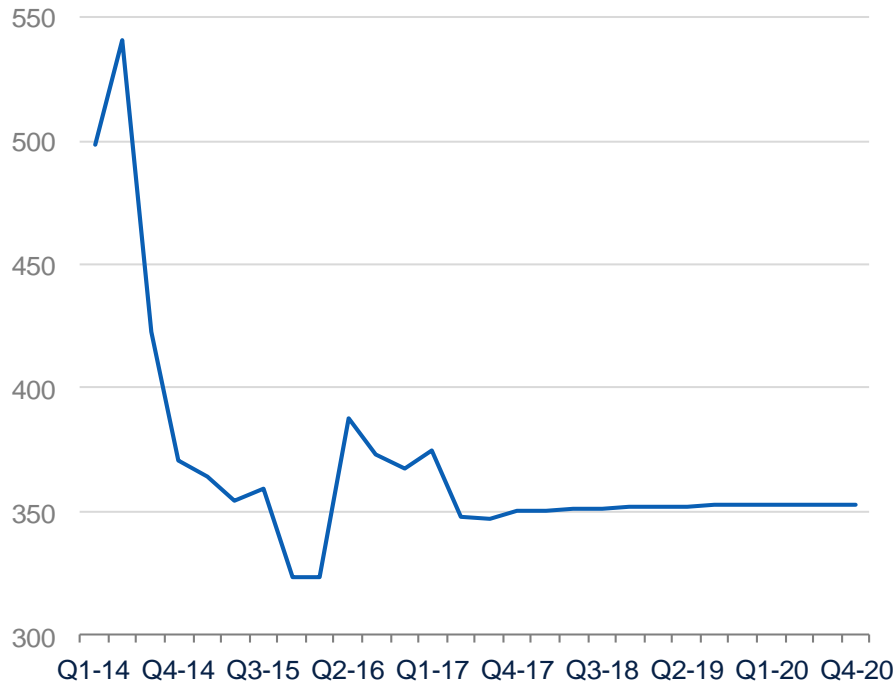


- In the **euro zone**, bias towards more gradual *tapering* (euro strength) and a delay to the rate hike cycle (low inflation)

Central banks are moving towards a very gradual normalisation process

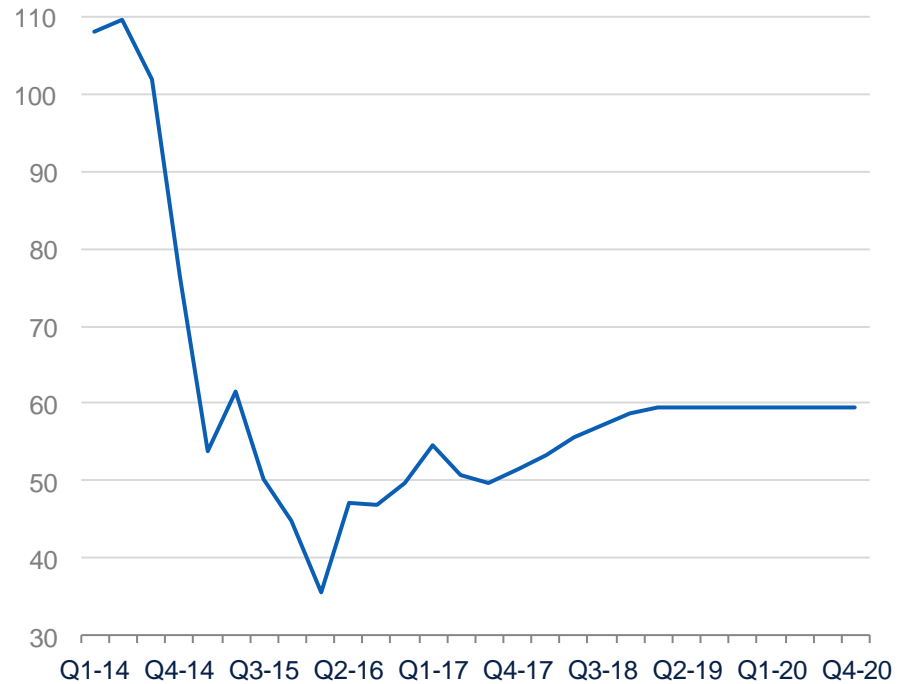
Metal prices, particularly the price of Soybeans?

Soybeans prices
(USD/ton)



Source: Bloomberg and BBVA Research

Brent Crude
(USD/barrel)



Source: Bloomberg and BBVA Research

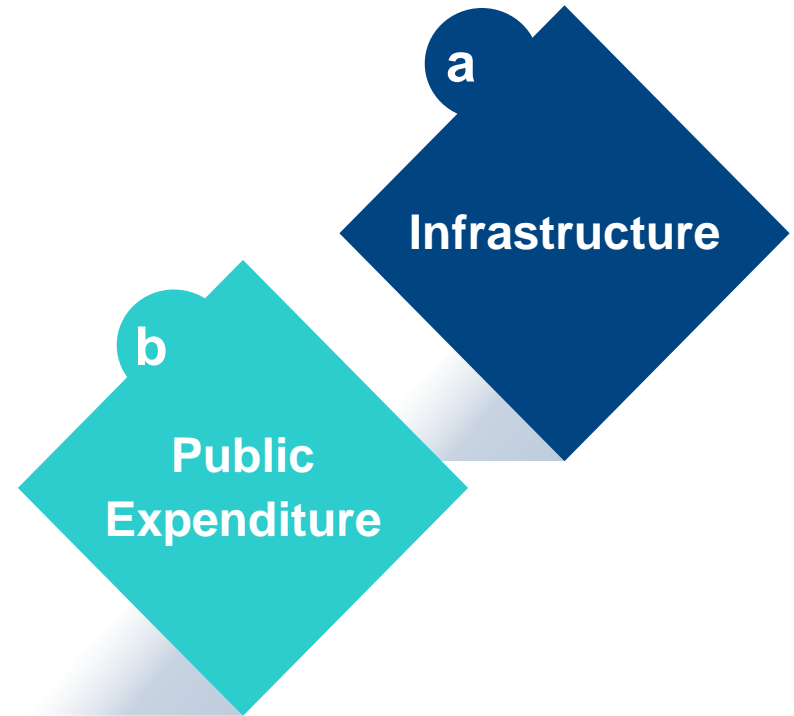
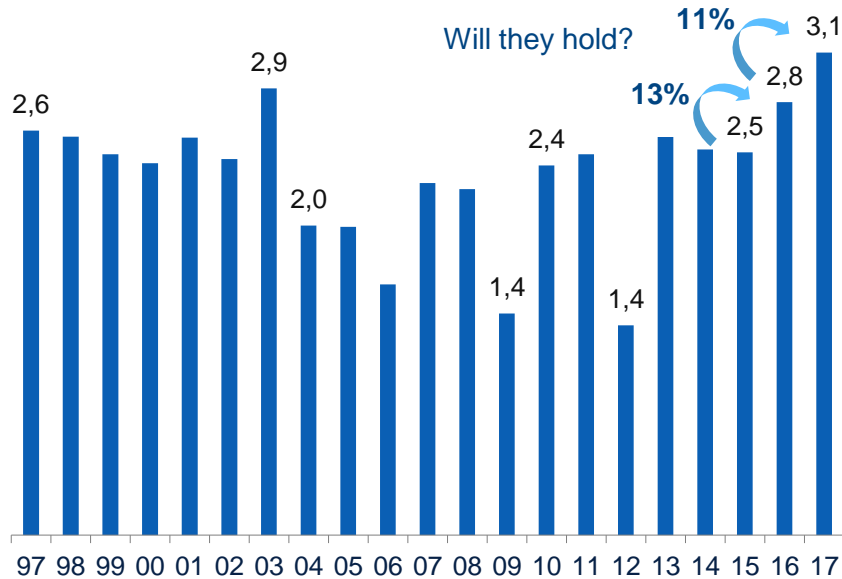
The prices of oil and soybeans maintain their outlooks of a few months ago: gradual convergence towards their long-term levels

Locally...

Moderation in agricultural production levels (normalisation in the Soybeans campaign)

Public expenditure consistent with the fiscal rule

Prod. Soybeans: average yield per hectare
(MT per hectare)



Source: CAPECO and BBVA Research

A It is assumed the momentum of public works will continue. Implementation of major projects would provide additional impulse

Paraguay: infrastructure projects approved or under study*
(USD millions)

Public Initiative	State	Amount (US\$ millions)	% of GDP
Total		2 845	10.2
Route 2 and 7	Contract signed	507	1.8
Extension and improvement of Silvio Pettrossi International Airport	Approved and in bid evaluation	132	0.5
Hidrovia**, Routes 1 and 6, Upper Paraná Clean-up	Under study	2 206	7.9

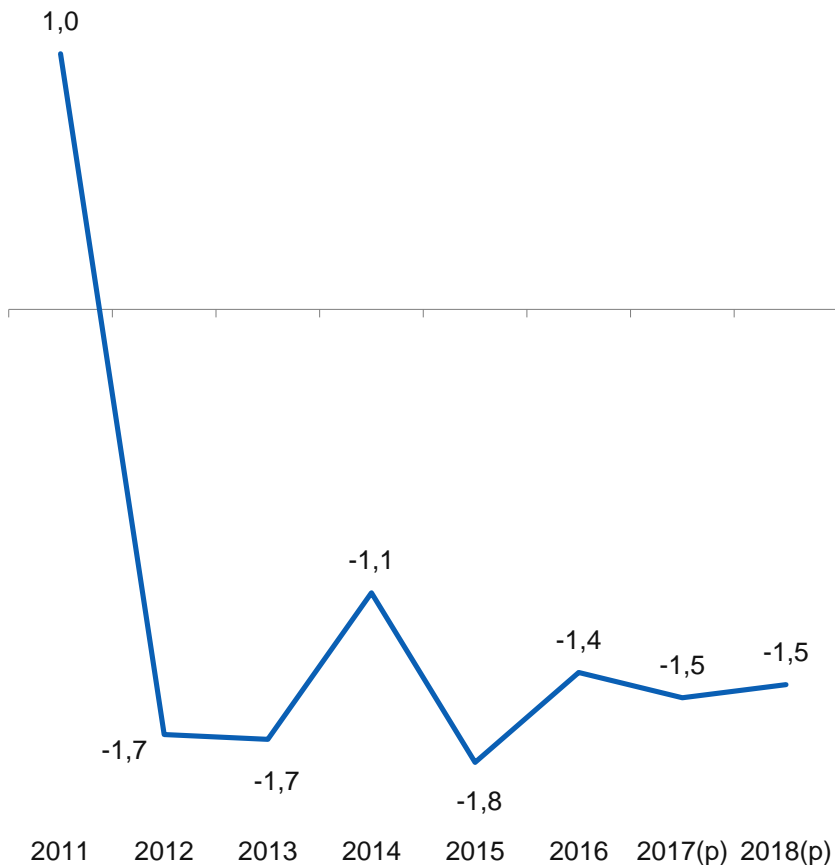
These projects are in addition to the public projects already under way (road improvements, etc.)

Infrastructure generates significant positive externalities for levels of productivity

* There are also Private Initiative projects, but until they are declared of Public Interest, they are confidential pursuant to Article 51 of Law 5.102/13
 ** (a plan by the five countries of the La Plata Basin to convert the Paraguay and Paraná rivers into an industrial shipping channel)
 Source: DNCP (Dirección Nacional de Contrataciones Públicas or "National Directorate for Public Contracts")

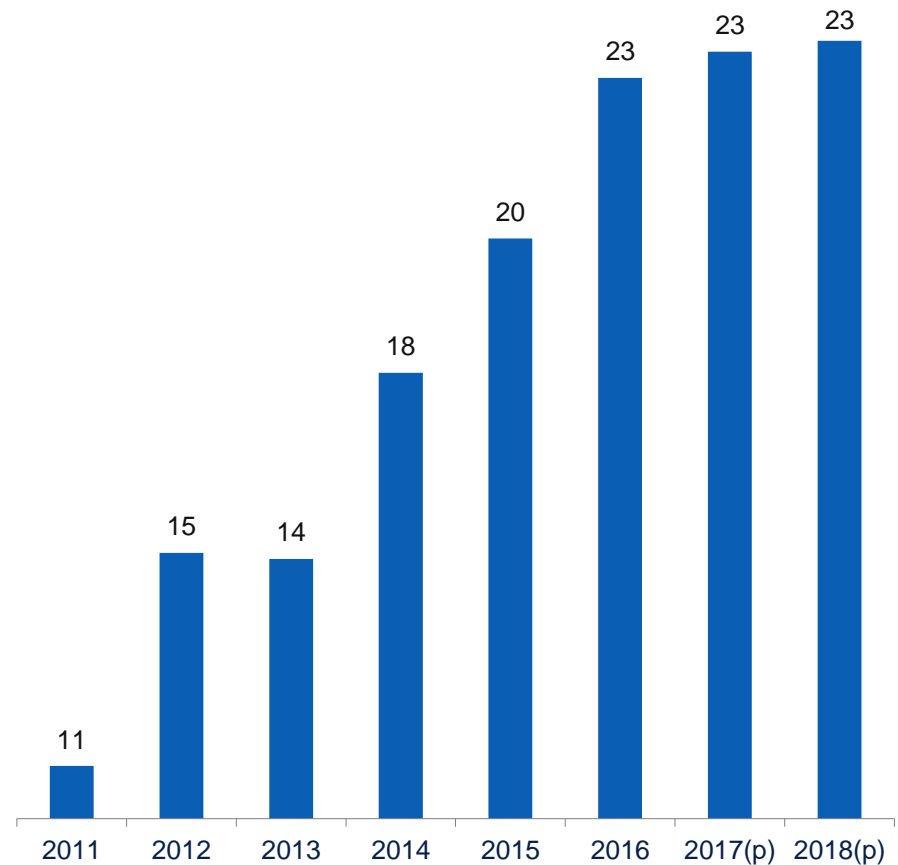
B We project public deficits in line with the limit set by the fiscal rule (no larger than 1,5% of GDP), and a sustainable increase in the public debt ratio

Fiscal balance
(% of GDP)



(p) projected.
Source: Banco Central de Paraguay and BBVA Research

Public debt
(% of GDP)



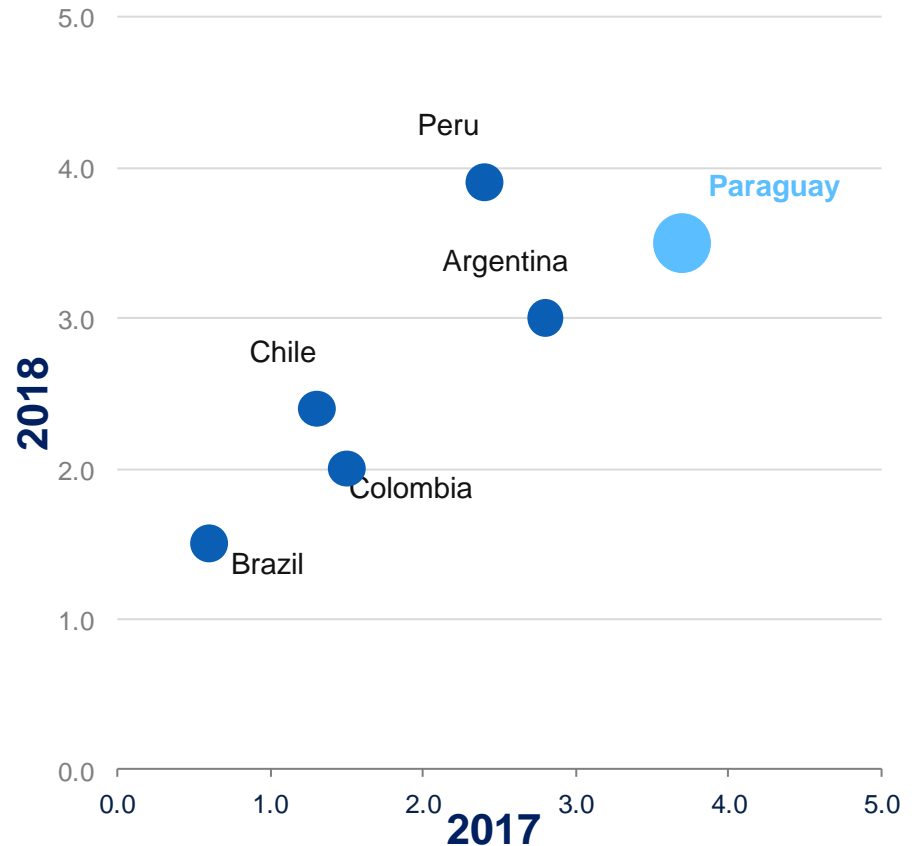
(p) projected.
Source: Banco Central de Paraguay and BBVA Research

We estimate that the GDP will grow by around 3.5% in 2018, so that the economy will continue to figure among the most dynamic in the region

GDP and domestic demand
(% var. YoY)



GDP
(% var. YoY)

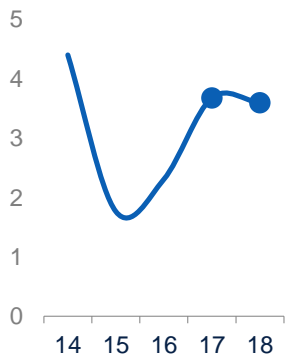


On the expenditure side, one highlight is the performance of domestic demand

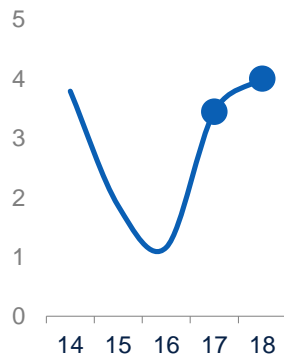
GDP on the expenditure side (var. % YoY, percentage points)

Domestic demand

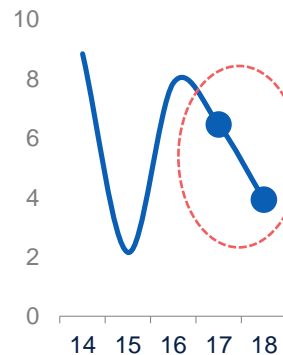
Domestic demand
(contribution, percentage points)



Consumption



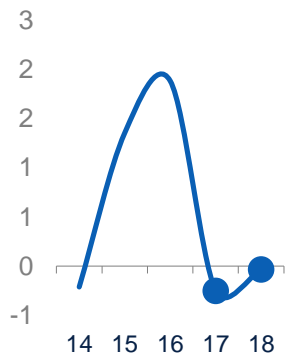
Investment



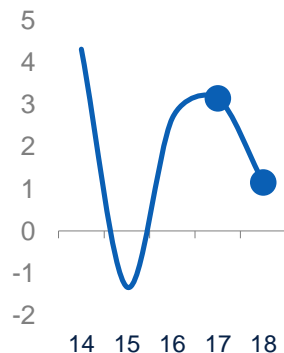
Gradual progress in construction of major infrastructure projects. Faster completion would result in greater growth.

External demand

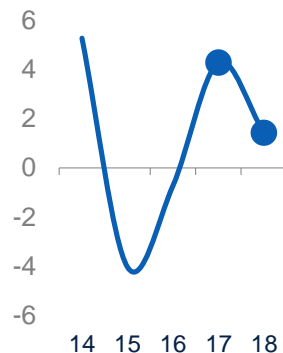
External demand
(contribution, percentage points)



Exports



Imports



Risks to GDP growth forecast for 2018

External

Brazil

FED

China

Local

**Delays to
construction
on infrastructure projects**

**Faster moderation
in agricultural
production levels**

Electoral year

03

Exchange rate: current trends and forecasts

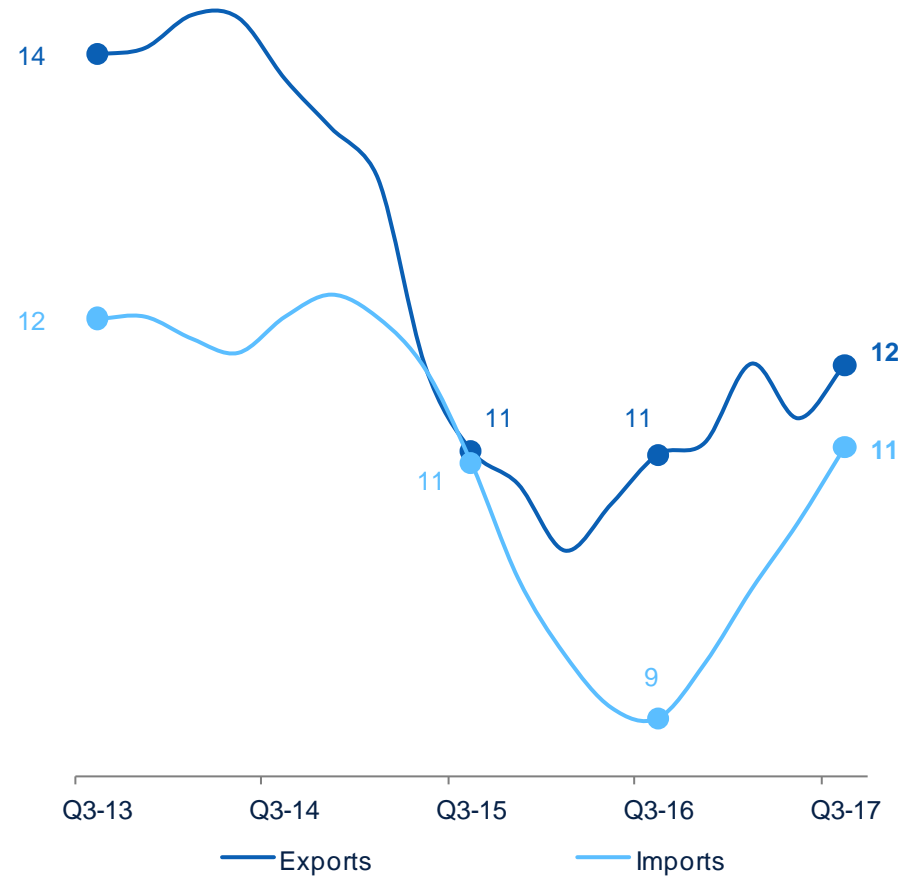
The Guaraní has remained relatively stable, in an environment with a trade surplus

Exchange rate
(USDPYG)



Source: Bloomberg

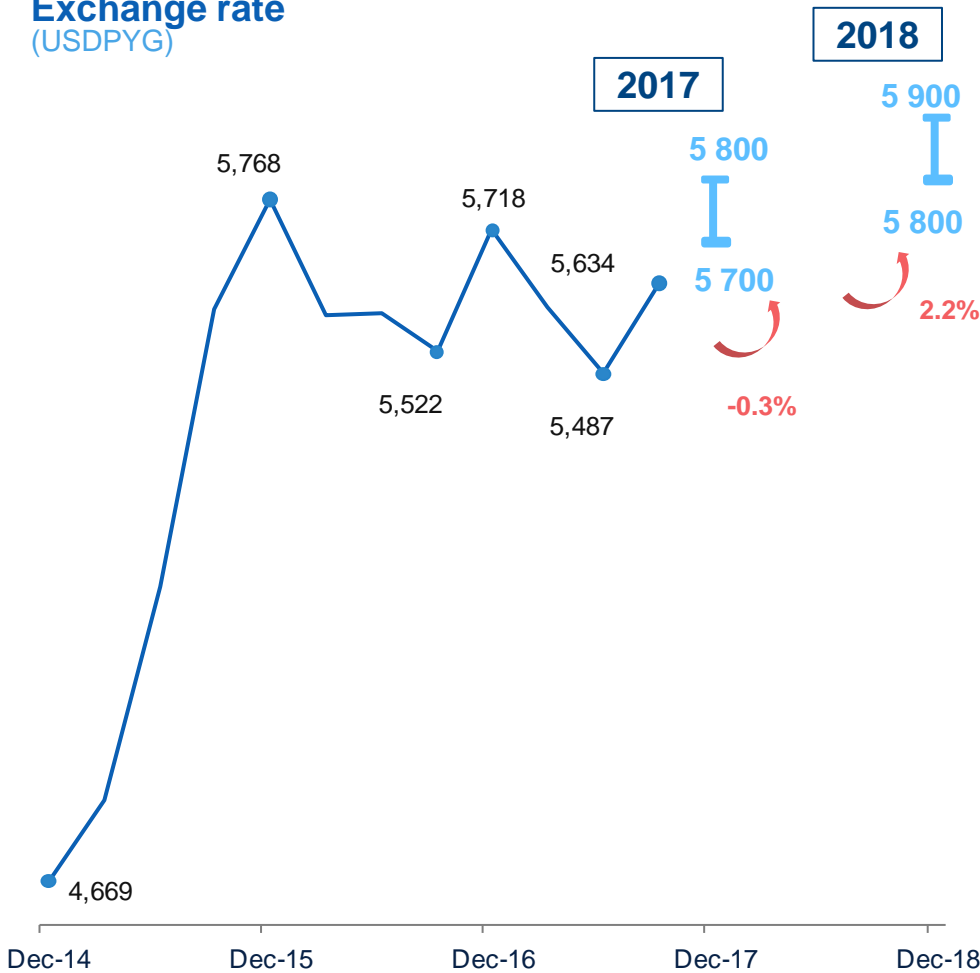
Paraguay: balance of trade
(USD billion, YoY)



Source: Banco Central de Paraguay

In this context, we project that the exchange rate will show a slight upward trend

Exchange rate
(USDPYG)



Inflation differential
Inflation higher than the US

Lower rate differential
FED will raise its policy rate

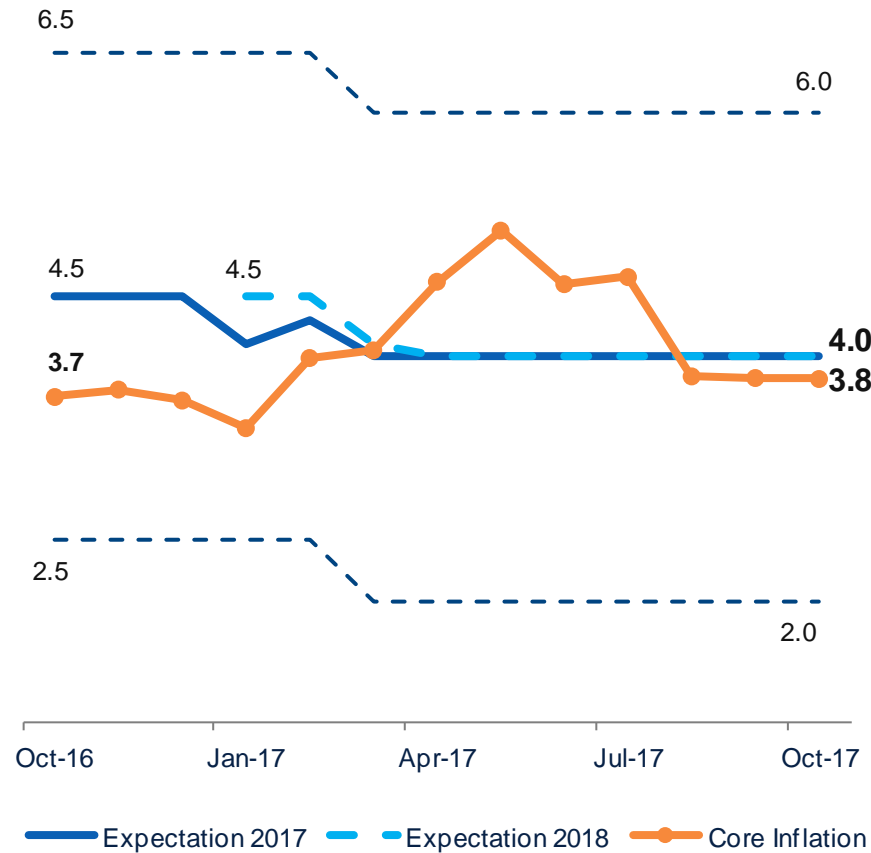
Comfortable NIR balance
Good level of liquidity in foreign currency of the BCP

04

Prices and monetary policy

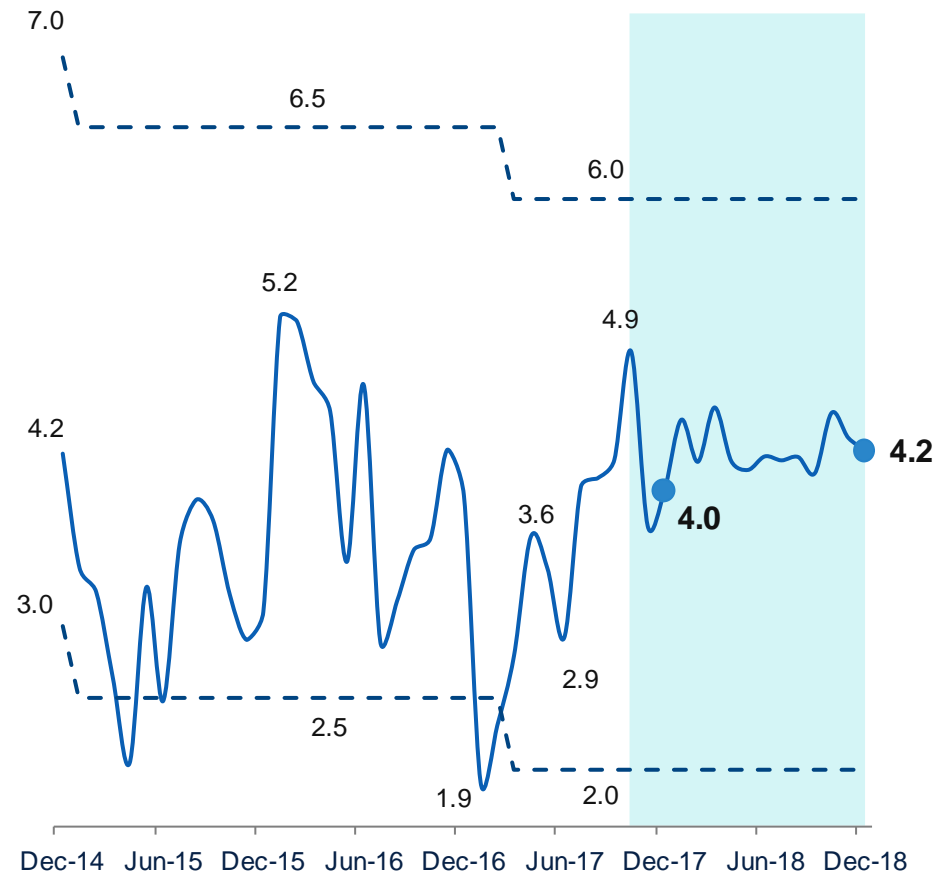
With no demand pressures on prices and well-anchored expectations, inflation will remain close to the mid-point of the target range

Expectations and underlying inflation
(%)



Source: Banco Central de Paraguay and BBVA Research

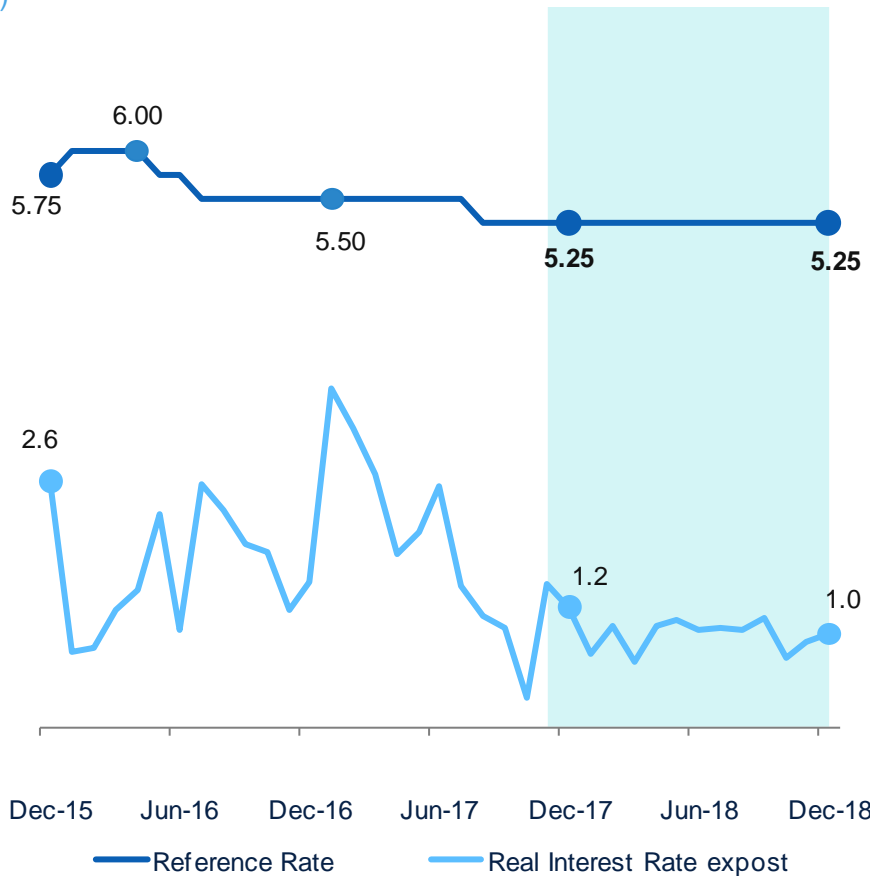
Total inflation
(CPI % var. YoY)



Source: Banco Central de Paraguay and BBVA Research

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

Reference rate
(%)



Inflation and expectations
are within the target range

Exchange rate pressures
bounded

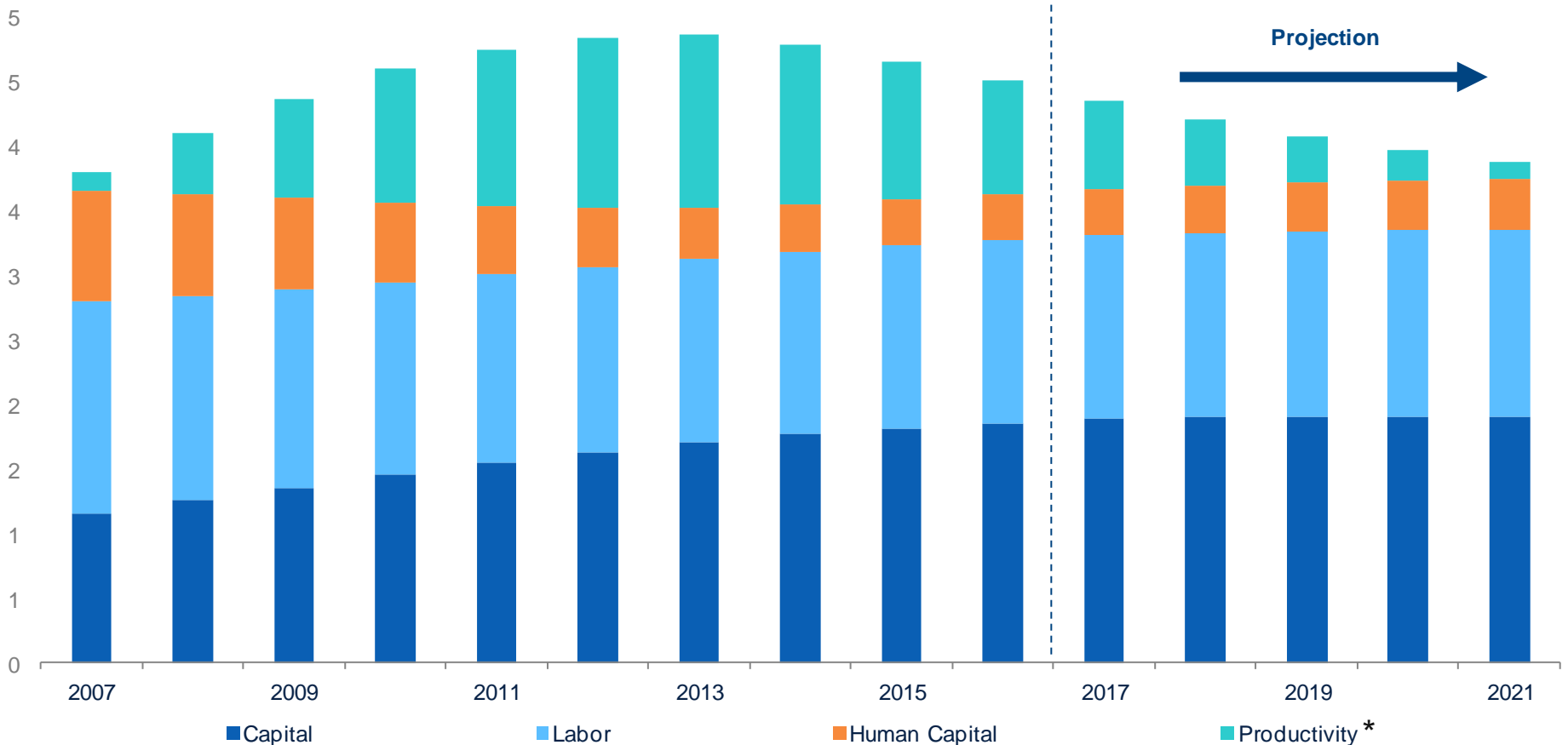
GDP growth close to potential

05

Medium-term challenges

Potential growth could decelerate in the next few years due to a declining contribution from productivity

Potential GDP: contribution to growth
(percentage points)

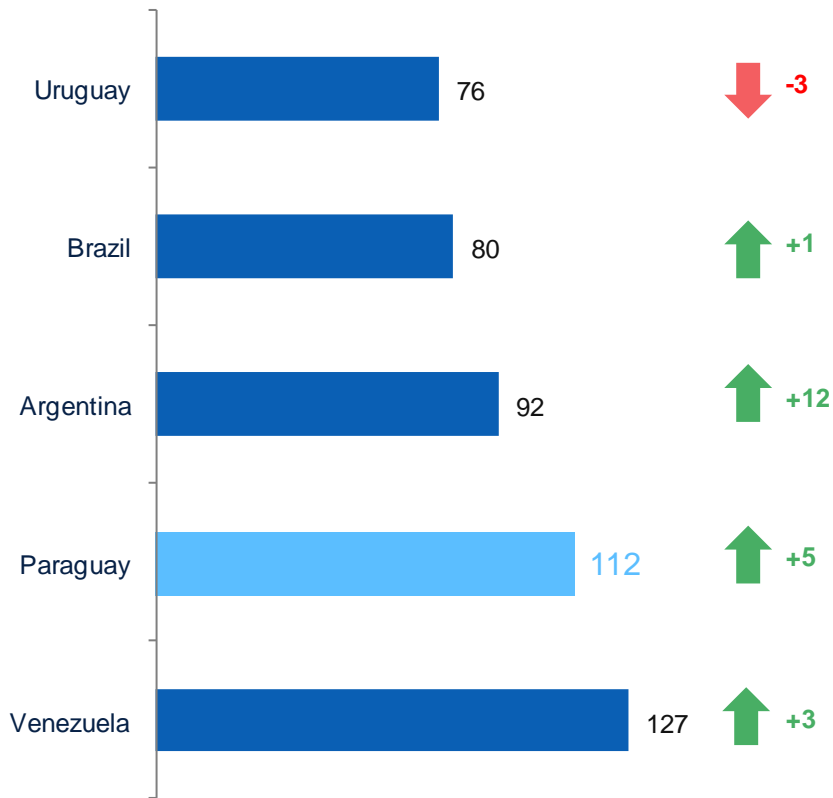


* TFP: Total factor productivity
Source: Banco Central de Paraguay and BBVA Research

In which areas do improvements need to be made?

Mercosur: Global Competitiveness Index 2017-2018¹

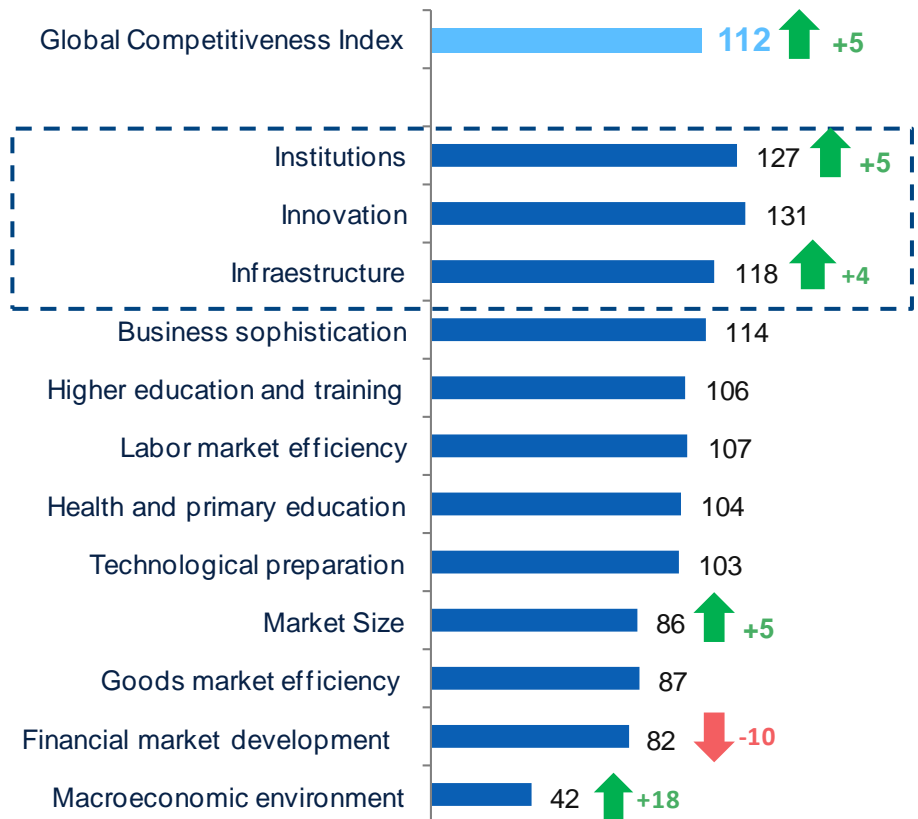
(Ranking out of 137 countries)



1/ Arrows indicate changes compared with the previous report (Global Competitiveness Index 2017-2018 on 138 countries).
Source: WEF and BBVA Research

Paraguay: Global Competitiveness Index 2017-2018 by pillars¹

(Ranking out of 137 countries)

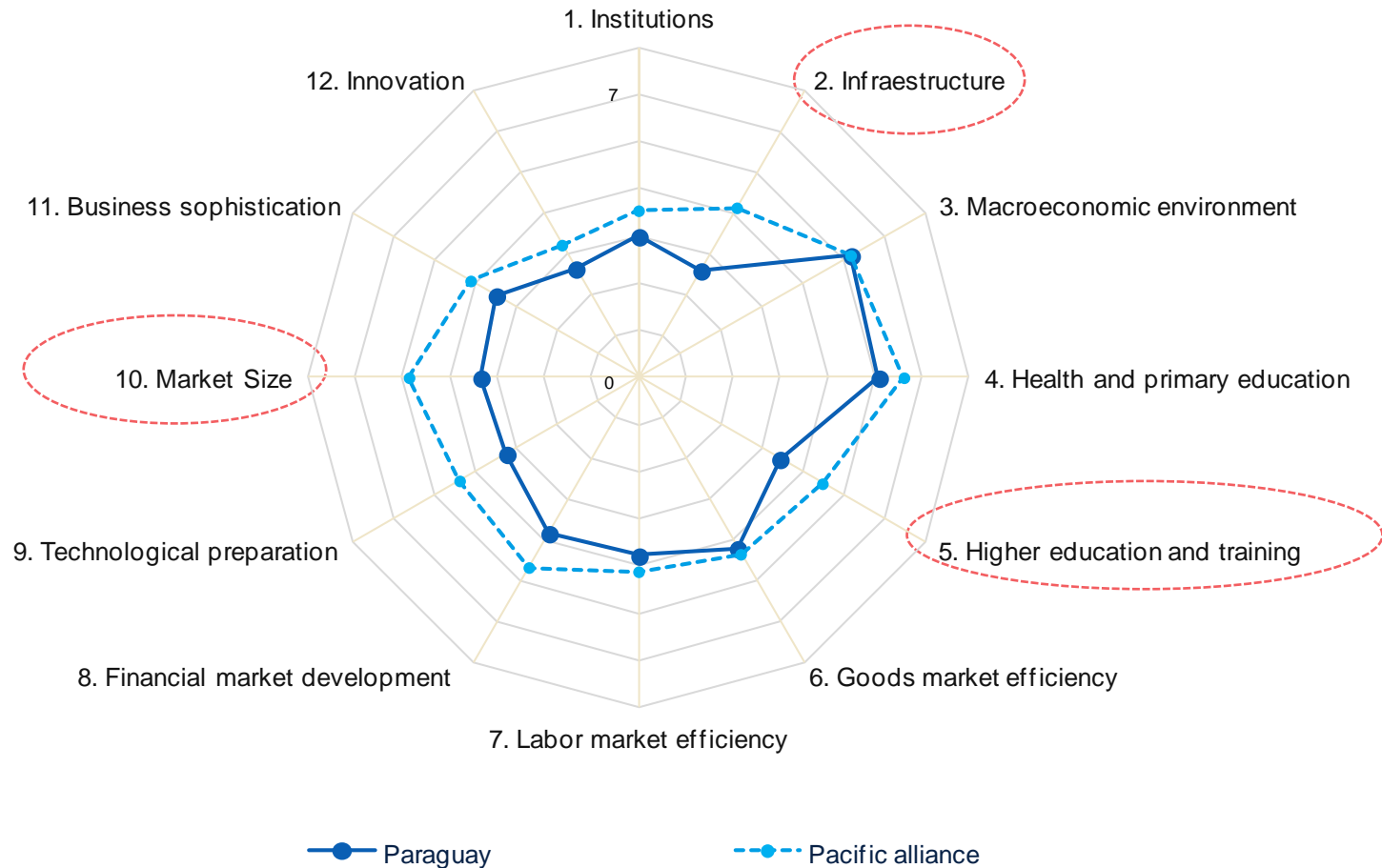


1/ Arrows indicate most significant changes compared with the previous report (Global Competitiveness Index 2017-2018 on 138 countries).
Source: WEF and BBVA Research

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

Global Competitiveness Index 2017-2018

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



In which areas do improvements need to be made? Infrastructure

Pillars of competitiveness index: selected (Ranking)

Indicators	Ranking (out of 137 countries)
1st pillar: Infrastructure	118
Overall quality of infrastructure	124
Quality of highways	131
Quality of railway infrastructure	NA
Quality of port infrastructure	100
Quality of air transport infrastructure	132
Availability of airline seats km/week	109
Quality of electricity supply	119
Mobile phone subscribers	100
Fixed telephone lines	95

} Lag in transport infrastructure

In which areas do improvements need to be made? Education

Pillars of competitiveness index: selected (Ranking)

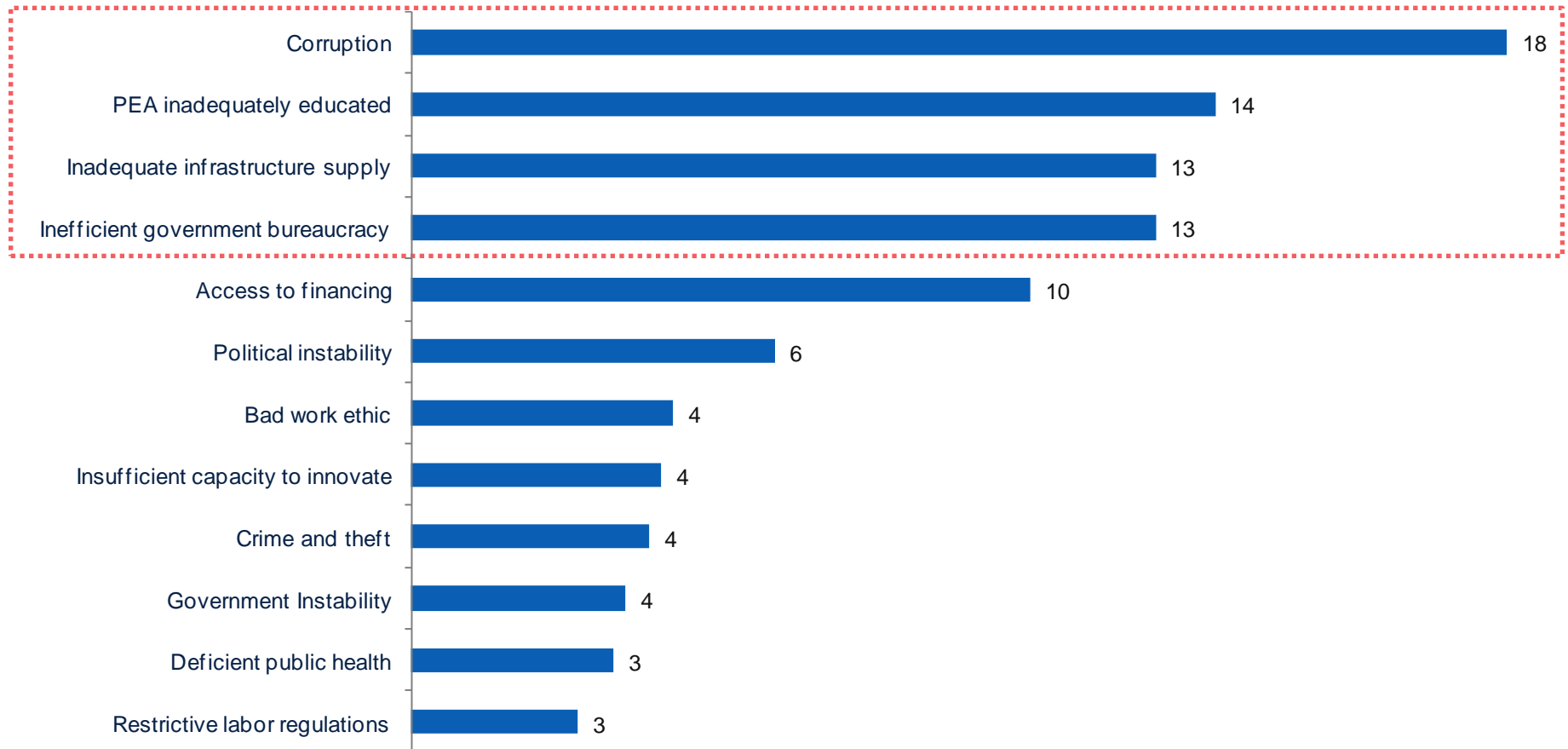
Indicators	Ranking (out of 137 countries)
5th Pillar: Higher education and training	107
Enrolments in secondary education	94
Enrolments in higher education	78
Quality of the educational system	135
Quality of maths and science teaching	136
Quality of business schools	126
Internet access in schools	117
Availability of research and training services	128
Personnel training activities	115

} Lag in quality

Measures are required to strengthen productivity and competitiveness

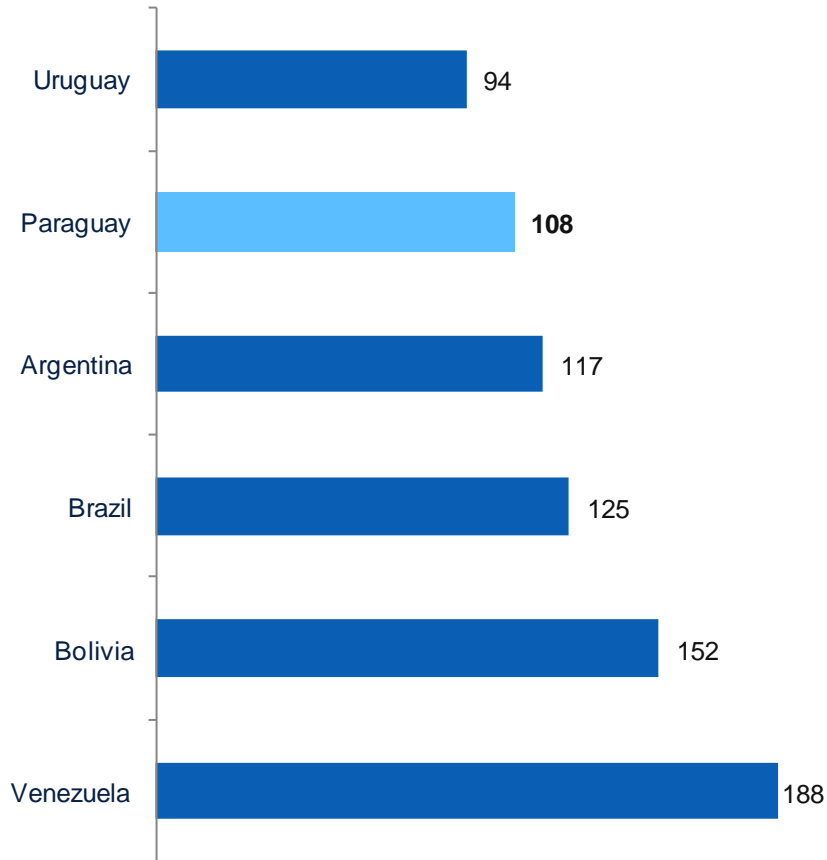
WEF 2017: Most problematic factors for doing business in Paraguay

(% of total responses)



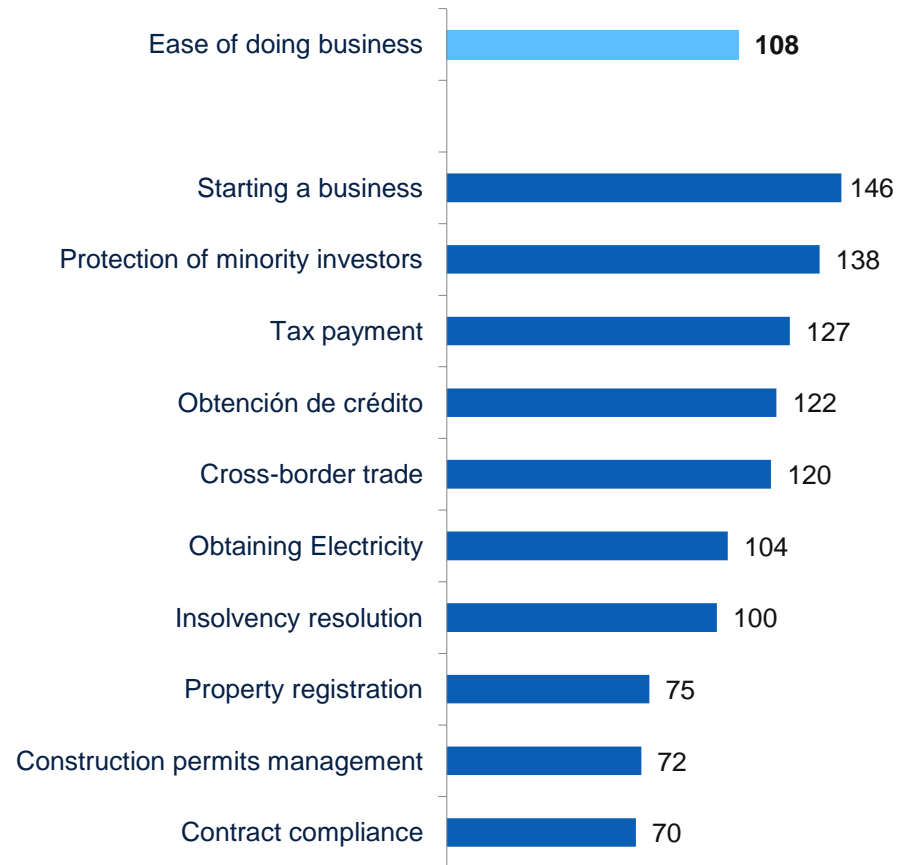
In which areas do improvements need to be made? Improving the business climate

Mercosur: Doing Business 2018
(Ranking out of 190 countries)



Source: World Bank and BBVA Research

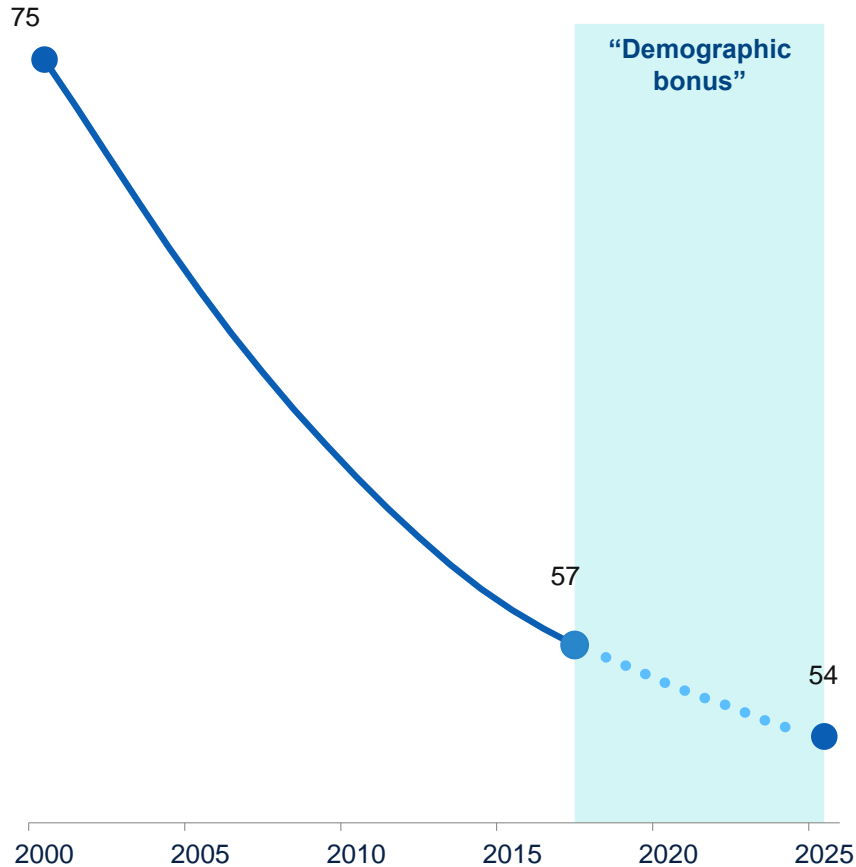
Paraguay: Doing Business per category (Ranking out of 190 countries)



Source: World Bank and BBVA Research

There are also other factors that could underpin GDP growth

Dependency rate
(%)



*1/ Dependent population (under 14 years and over 65 years) versus working population (older than 14 years and younger than 65 years).
Source: DGEEC (Paraguay's statistics institute). Permanent Household Survey 2010-2015

Opportunity for sustained growth

However, the associated benefits are conditional on...

...adopting policies that stimulate productive investment

Key messages

1

Following the slowdown in Q2, the most recent indicators for activity and domestic spending show the economy recovering momentum. We expect these trends to hold steady in the latter part of the year.

2

In this context, our outlook for GDP growth for this year stands at 3.7% (with an upward bias).

3

For 2018, we project that the economy will grow 3.5%. This forecast is conditioned on a positive external environment and on the dynamism of the public investment.

4

We expect the guaraní to depreciate somewhat further in the coming months. The monetary tightening process in the USA and somewhat lower export prices will lead to a rising trend in the (PYG to USD) exchange rate.

5

The Central Bank has managed to hold the year-on-year inflation rate at around the mid-point of the target range, and expectations are well anchored. The reference rate stands at 5.25% and we do not expect any changes in the next few months.

6

However, mid-term challenges remain in place and need to be tackled in order to reassure a strong and less volatile GDP growth.

ANNEX

Summary of projections

Macroeconomic projections for 2017 and 2018

	2012	2013	2014	2015	2016	2017 (e)	2018 (p)
GDP (% YoY)	-1.2	14.0	4.7	3.0	4.0	3.7	3.5
Private Consumption (% YoY)	2.8	4.6	3.7	1.5	1.7	3.7	4.2
Public Consumption (% YoY)	21.0	3.5	4.2	4.3	-2.8	1.9	2.8
Investment (% YoY)	-13.5	20.2	11.0	1.2	6.4	7.2	3.1
Inflation (% YoY, EOP)	4.0	3.7	4.2	3.1	3.9	4.0	4.2
Exchange rate (vs. USD, EOP)	4 276	4 603	4 669	5 768	5 718	5 700	5 830
Interest rates (% eop)	0.00	6.00	6.75	5.75	5.50	5.25	5.25
Tax Revenue (% GDP)	-1.7	-1.7	-1.1	-1.8	-1.4	-1.5	-1.5
Current Account (% GDP)	-1.2	2.1	0.1	-1.0	1.7	0.3	-0.2

(e): estimated. (p): projected.

Forecast closing date: 10 November 2017.

Source: Banco Central de Paraguay and BBVA Research

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This report has been produced by the Peru Division

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