BBVA Research

Paraguay

Economic Outlook

Fourth Quarter 2010

Economic Analysis

- The growth forecast for 2010 has been revised upwards, from 8.4% to 10.1%. This reflects a notable upturn in agricultural activity following the recovery from the drought affecting production the previous year. For 2011 we expect growth to be more in line with its medium-term trend (around 4%).
- The current account and the fiscal balance will both show a surplus in 2011. The former forecast is based on the moderation of domestic demand, which will slow down imports; the latter relies on the lower rate of growth in public spending as the Economic Reactivation Plan ends.
- Due to a more positive growth outlook and the reduction in the public debt to GDP ratio, Moody's recently upgraded Paraguay's sovereign debt from B3 to B1. The debt/GDP ratio is currently around 13%, one of the lowest among countries with a similar rating.
- Banking system loans have grown at over 40% as economic activity continued strong. We expect credit expansion to continue in 2011, although at a more moderate pace, reflecting both increased output and more restrictive monetary conditions.
- The main risk factor in our forecast is a deterioration of the economic external situation. This would negatively affect soybean prices and Paraguayan exports, although economic authorities would still have some room to implement countercyclical measures.

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Closing date: December 3rd, 2010

1.Global outlook: slow north, fast south

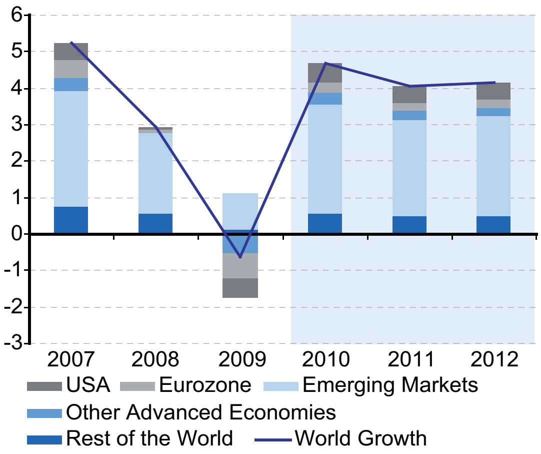
The global economy keeps growing strongly, mostly in emerging countries, whereas cyclical and financial concerns dominate advanced economies

Global growth continues to be strong, and is expected to reach 4,7% in 2010, and 4,1% in 2011 (Chart 1), mostly unchanged with respect to our forecast three months ago. This encouraging performance is mostly due to strong outturns in emerging economies, which have been less affected by the financial crisis, as their banking sector was in very good shape, and have thus recovered rapidly. In contrast, renewed cyclical concerns in the US have joined financial concerns still dominating Europe, where macroeconomic and financial adjustments are still underway. Thus, in line with our expected scenario, the outlook for the next two years continues to highlight the growth gaps between the advanced north and the emerging south (Chart 2) even if the latter also embarks on a controlled slowdown to ameliorate the risk of overheating.

But there are also significant policy differences inside each of these groups. In the US, monetary expansion is set to intensify in relative terms with respect to Europe (and most other countries), and has thus been reflected in a depreciation of the dollar against the euro and complicating Europe's recovery. In emerging economies, a strong asymmetry in exchange rate policy between Asia and Latin America continues, forcing the latter to bear (together with the euro) a significant part of the exchange rate appreciation derived from renewed monetary easing in the US.

Chart 1

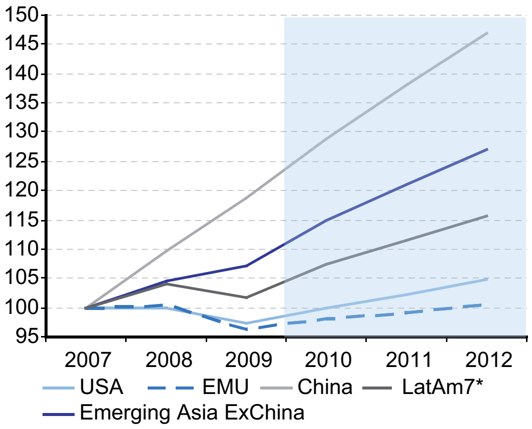
Global GDP growth and contributions



Source: BBVA Research

Chart 2

GDP level: 2007=100



Source: BBVA Research and Datastream

Growth in the US will remain low given ongoing household deleveraging, but a double dip scenario is very unlikely.

Over the last quarter, relatively weak indicators of economic activity in the US have raised the specter among market participants of a possible relapse into a recession –a double dip in economic activity–. The weakness observed in some key sectors that had benefited directly from fiscal support through incentives for purchases (durable goods and housing) is a strong signal that the recovery in private sector demand is still not self sustaining. This weakness is a consequence of an ongoing household deleveraging process and a weak labor market, which will continue to push households to save more than what was observed since the second half of the 1990s. Even though this is to be welcomed in the process of rebalancing growth in the US, it increases cyclical concerns since consumption (one of the pillars of recovery in past recessions) will remain muted and only partially compensated by stronger investment in equipment by firms and exports.

Recent concerns about the health of the housing sector are, in our view, excessive and the possibility of a relapse into further significant real estate price drops is very small, given that prices have declined by about 30%. There are certainly elements of concern, such as elevated house inventory levels and the potential impact of an unexpected further supply of housing from new foreclosures, which may come either from increased delinquencies or due to owners walking away from increasingly negative housing equity. But there are also elements of support, such as the huge gains in housing affordability since the crisis started and the demographic trends that should help prop up demand going forward. It is true that if house prices continue to decline, it might have a non-negligible impact on consumption, but at least the banking system seems in a relatively good shape to withstand a moderate shock to prices. All in all, the scenario of further significant price drops is highly unlikely. Instead, a period of relatively stable house prices seems more likely, while past excesses are finally reabsorbed.

Overall, the drags on consumption and the low probability of further fiscal stimulus –out of concerns about the size of current deficits and the political arena, especially if there is a change in the balance of power after November's congressional elections– will be partially compensated by recovering private investment as sales improve and regulatory uncertainties diminish. This will imply an exit from the crisis in the US at a pace much lower than in previous cycles (Chart 3), as we have been forecasting for a long time. While the probability of a double dip in the US is low, in any case, the lack of strength of domestic demand will induce the US more and more to press the rest of the world (especially countries with a current account surplus and high domestic saving rates) to increase their demand and contribute to the necessary global rebalancing. The renewed monetary expansion in the US can be interpreted in this context as one way to force part of this adjustment onto the rest of the world.

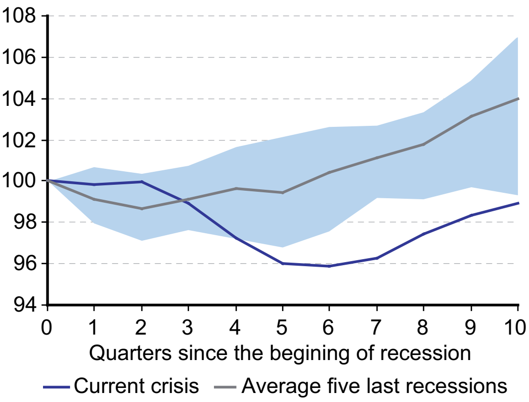
Financial stress in Europe is still a source of concern, though systemic risk is lower than before the summer. Fiscal consolidation remains crucial to sustain confidence, and will not have a large negative impact on growth beyond the short-term

After decisive advances in fiscal consolidation, measures to provide support to distressed governments and especially after the financial sector stress tests, there has been a qualitative change in the dynamics of the crisis in Europe. Even if average sovereign spreads have remained relatively stable, markets have highlighted the differentiation between sovereign assets, thus reducing the risk of a systemic event. In addition, financial markets have started to open –though selectively– and renewed debt issuance is a further sign of lower tensions.

Notwithstanding this, financial market stress in Europe is still the main source of risk for the region (Chart 4) especially given the link between sovereign concerns and risks to the financial sector, given their national and cross-border exposure. In addition, the recent strengthening of the euro means an added challenge given that best performing economies had been supported by external demand. This makes it more imperative to tackle decisively in the short run the sources of macroeconomic vulnerability in the region, namely fiscal sustainability and external imbalances, as well as avoiding further de lays in restructuring the weak part of banking systems. The key is to continue rebuilding confidence to reduce market tensions and rebuild the autonomous strength of private sector demand. In addition, to sustain growth in the long run, it will be crucial to undertake much needed structural and institutional reforms, the latter especially geared towards preventing and resolving future fiscal imbalances. The focus on structural reform more than sustaining demand has been precisely the differentiating factor between the ECB and other central banks, prompting a less expansive stance than the Fed.

Chart 3

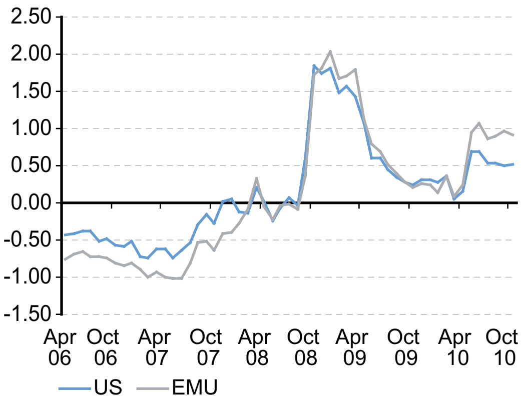
US GDP: current cycle vs. previous recessions*. Beginning of each recession=100



* Shaded area: range of GDP during last 5 recessions
Source: BBVA Research and NBER

Chart 4

Financial Stress index



Source: BBVA Research

Monetary policy in advanced economies will be lax for a long time, adding pressure to exchange rates worldwide

Prospects of very low growth and subdued inflationary pressures in advanced economies will translate into low interest rates for a prolonged period in the three most important advanced areas (US, Europe and Japan). However, against the backdrop of renewed cyclical concerns and the much-reduced scope for further fiscal stimulus, markets were focused on the US embarking into a new bout of unconventional monetary easing (so-called Quantitative Easing 2, or QE2). The expectation of this further increase in liquidity lowered the exchange rate of the dollar across the board, including vis-à-vis the euro. Going forward, given that most of QE2 has been already priced in by markets, euro-dollar exchange rates will depend more on relative growth prospects (which favor the US vis-à-vis EMU) but also on the relative perception of monetary policy in both areas and the evolution of investment flows. At the same time, we expect appreciating pressures on emerging economies to continue due to increased global liquidity, stronger macroeconomic fundamentals and positive return differentials favoring renewed capital inflows.

Emerging markets face increasing policy dilemmas from strong growth, abundant global liquidity and neighbors' foreign exchange interventions

Emerging economies continue to grow strongly, with emerging Asia leading the world recovery. In both Asia and Latin America, private domestic demand is taking over policy-induced stimulus as the source of the recovery. Going forward, growth in Asia will slow down because of a reduction in momentum from the ending of the global inventory cycle, weaker external demand and a withdrawal of policy stimulus, thus reducing the risk of overheating. But the region will continue to contribute the most to global growth.

Both Asia and Latin America confront increasing monetary and exchange-rate policy dilemmas, between cooling strong domestic demand and preventing strong capital inflows and preserving competitiveness in foreign markets. Some countries have started introducing administrative measures to discourage strong capital inflows and some others have slowed their rate of monetary tightening.

Given the relative inflexibility of exchange rates in China (and, to a lesser extent, in the rest of emerging Asia), Latin America is facing a significant part of the adjustment, to the point that further exchange-rate appreciations will start to be a problem for growth. Thus, many countries in the region are weighing further exchange rate interventions although experience shows that their effectiveness if rather limited, contributing mostly to slow down the rise in exchange rates, but not prevent them. The risk is that increased intervention into foreign exchange markets ends up sliding into retaliatory trade measures. This highlights the importance of increased exchange rate flexibility in Asia (China, in particular) as a way to provide more policy space to the rest of the world.

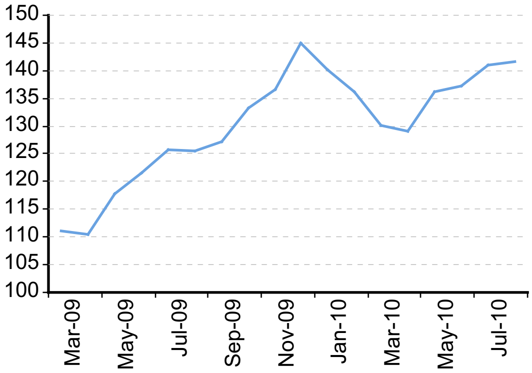
2. Paraguay: strong output growth with positive results in the current and fiscal accounts

This year Paraguay will register its biggest economic growth for the last thirty years

In the first half of the year the Paraguayan economy grew by 11.7%, with the earnings from the 2009/10 agricultural harvest exceptional, due to the reversal of the effects of the drought. As a result agriculture expanded by nearly 30% in the period, with a direct effect of 4.4 percentage points on output.

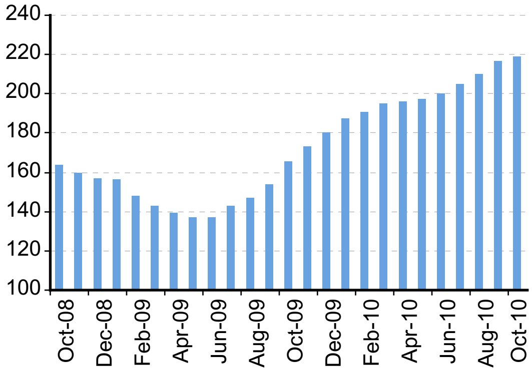
This boost to the economy will have continued into the third quarter and diversified to other sectors. This is suggested by advance indictors such as the Estimate of Business Figures published by the Central Bank, which in August registered a year-on-year increase of 16.6%. Sales in industry and retail trade performed particularly well (apparel, household equipment and vehicle sales). This diversification is also evident in the Monthly Indicator of Economic Activity in Paraguay (IMAEP), which not only reveals a recovery in the agricultural sector but also the strength of industry, particularly in branches such as meat production, drink and tobacco, textiles, leather and footwear, non-metallic minerals and machinery and equipment. A similar scenario is revealed by the index of electrical energy consumption calculated by PwC. This indicator gives an approximate figure for industrial output; in 3Q10 registered significant year-on-year growth rates (just over 7%).

Chart 5
Business figures estimate (Index, rolling three-month average)



Source: BCP

Chart 6
Labor demand index



Source: PWC

There was a similar situation on the side of expenditure. Household consumption will continue to growth strongly in the second half of the year, supported by the favorable trend in employers' willingness to take on workers. The PricewaterhouseCoopers indicator of labor demand continue to rise up to October and reached a maximum level that month, at 32% higher than the previous year. There is a similar situation in the case of private investment, which will continue to reap the rewards of high business confidence and improved access to credit. Although public spending will be more moderate than in the first half of the year as the Economic Reactivation Plan measures end, it will continue to post significant growth rates. Finally, exports will be helped by greater production of items such as soybean and beef, products destined largely for the foreign market (income from meat exports increased 85% in the period January-August compared with the same period last year).

In short, growth remains at high rates and we estimate that the figure for 3Q10 will be around 11%. This suggests that we can increase our growth forecast for 2010 as a whole from 8.4% to 10.1%.

Chart 7
Business confidence index

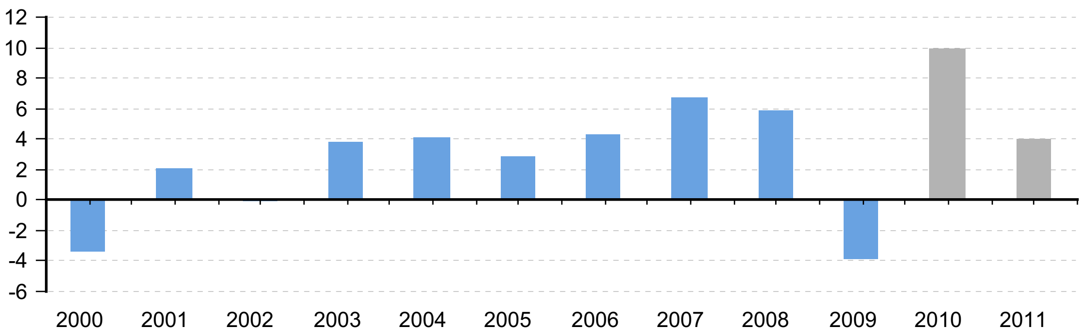
Source: Business Tendency Survey

Chart 8
Beef exports (million USD as of September each year)

Source: BCP

Next year we forecast a slowdown in the rate of economic growth to levels of around 4%, close to their medium-term trend. This is based on the fact that much of the economic strength in 2010 has been the result of weather conditions returning to normal following the major drought that affected the country last year. As a result, there has been a major upturn in the agricultural sector and those sectors most closely related to it. No similar significant growth is expected in the earnings from the agricultural campaign in 2011. By way of an exercise, if in the four quarters of 2011 the level of economic activity increases at a similar rate to what we project for 4Q10 (the period in which the rally effect of the return to normal weather conditions will be lower), GDP growth coincides with a forecast of 4% for 2011. The support for economic output will come from sectors such as livestock (and livestock-linked manufacturing) and construction, with high meat prices and in general continued demand for housing, corporate buildings and civil works. It is worth mentioning in the case of civil works that the administrative procedures required to obtain construction permits have been reduced significantly; in fact by nearly 50%, according to the World Bank.

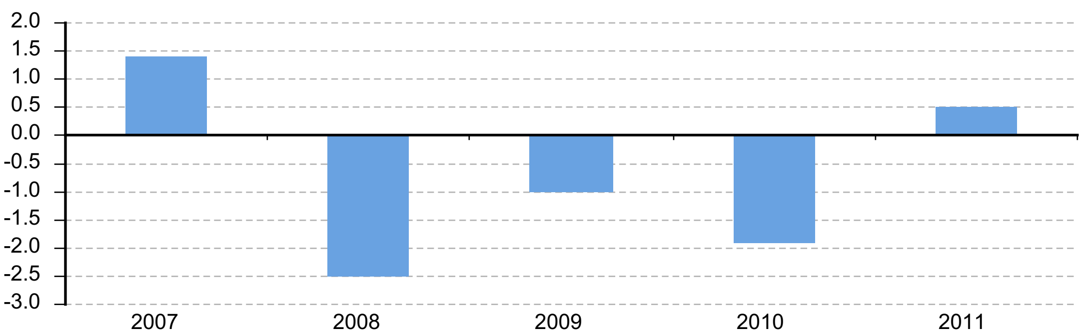
Chart 9
GDP Growth (% y/y change)



Source: BCP and BBVA Research

We expect a surplus in external accounts and the public sector in 2011.
In the foreign sector, the balance of payments account will register a higher deficit in 2010 (1.9% of GDP), compared with 1.0% last year. This can be explained by strong domestic demand, which has resulted in an increase of 50% in imports in the third quarter, in particular the machinery and electrical and mechanical appliances, fuels and lubricants, vehicles, tractors and their spare parts and toys. Exports increased by 40%, with particularly high increases in the case of soybean seeds, beef, wood, leather, tobacco and apparel. With domestic demand moderate and export prices relatively high, we expect the current account will register a slight surplus next year.

Chart 10
Current account (% GDP)

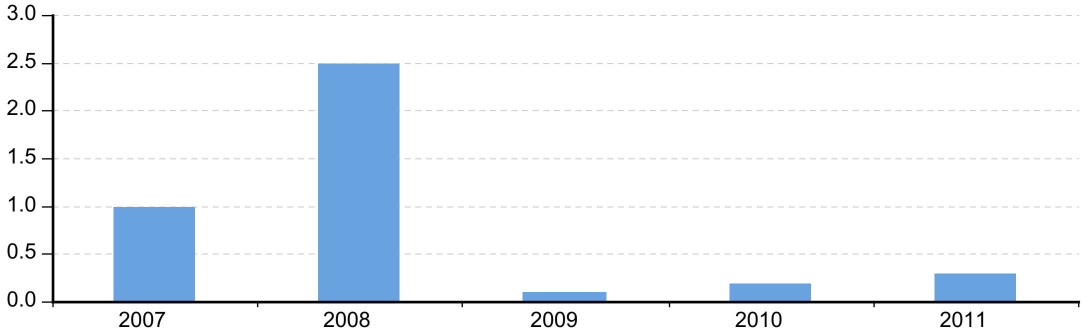


Source: BCP and BBVA Research

On the fiscal side, we expect a surplus of 0.2% of GDP for 2010. This forecast takes into account the major increase in receipts (more than 22% higher so far this year), supported by an expansion of 9% in contributors and strong economic growth. Next year the public accounts will continue positive due to the slowdown of spending in line with the end of the Economic Reactivity Plan. It is worth mentioning that the tax burden will remain at 13%, a relatively low level compared with other countries in the region. In this respect, initiatives such as the plan to introduce personal income tax are of vital importance. However, its implementation was once more postponed by the Senate until 2013.

Chart 11

Fiscal balance (% GDP)



Source: BCP and BBVA Research

Upgrade for Paraguay's debt due to improved economic prospects

In a context of strong economic growth, the rating agency Moody's upgraded the credit rating of Paraguay's government bonds in both local or foreign currency, from B3 to B1 (four notches under investment grade). The agency argued this improvement was due to (i) an outlook of more positive economic growth that has benefited from the upward cycle of commodity prices and the country's growing links with Brazil; and (ii) improved indicators of debt, including one of the lowest ratios of government debt to GDP among the countries with a similar rating. With respect to the debt ratio, it is worth pointing out that this ratio has passed from 45% of GDP in 2003 to 14% in 2010, in a context of repeated fiscal surpluses in recent years. In addition, Moody's mentions that the upgrade of Paraguay's debt takes into account the fact that despite friction between the government and the legislature, the fiscal aspect has not been negatively affected, and the policies that have been implemented so far are expected to be maintained in the future.

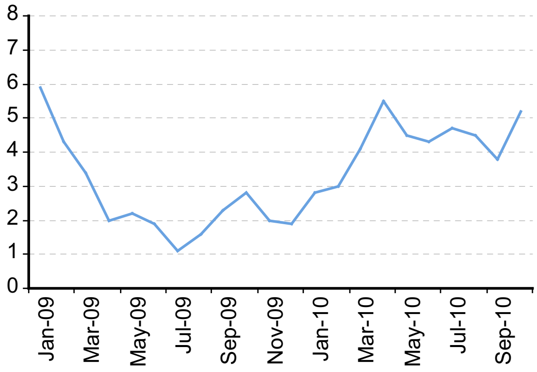
According to Moody's, infrastructure investment and remittances from abroad (amounting to 5.0% of GDP, with the main sources being Argentina, Brazil, Europe and the United States) will support economic activity in the coming years. However, at BBVA we consider that the Paraguayan economy still presents significant structural weaknesses that will have to be overcome to ensure additional credit improvements, such as for example the strong dependence on the agricultural sector and what is still a low tax burden.

Inflation gains pace, though it remains within the Central Bank's reference range

The economy is growing in an environment in which inflationary pressures increased during the year to over 5% in October. This level, in line with the Central Bank's benchmark range (5%, +/- 2.5 pp) includes the inflationary impact of food prices. Notable in this respect was the increase in the domestic price of beef (+27% so far this year). This increase can be mainly explained because most of the product is supplied to international markets (where there was an increase of 56% in the value exported to October). The rise in the price of beef also generated increases in the price of substitute consumer goods such as chicken and pork. In addition, the international oil price increased, and this resulted locally in the rises in oil-derived fuels. Given these figures, we estimate that inflation will close the year at around 6.4%.

Chart 12

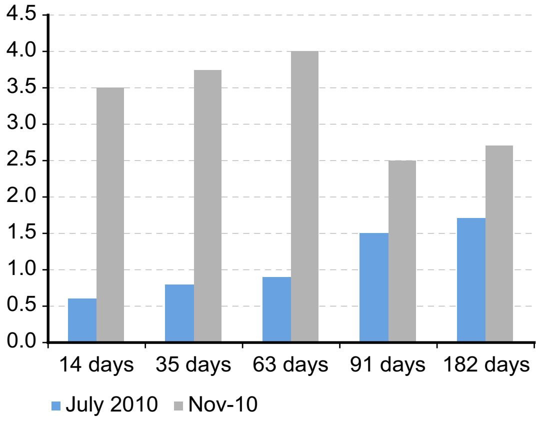
Year-on-Year inflation (%)



Source: Business Tendency Survey

Chart 13

IRM rates (%)



Source: BCP

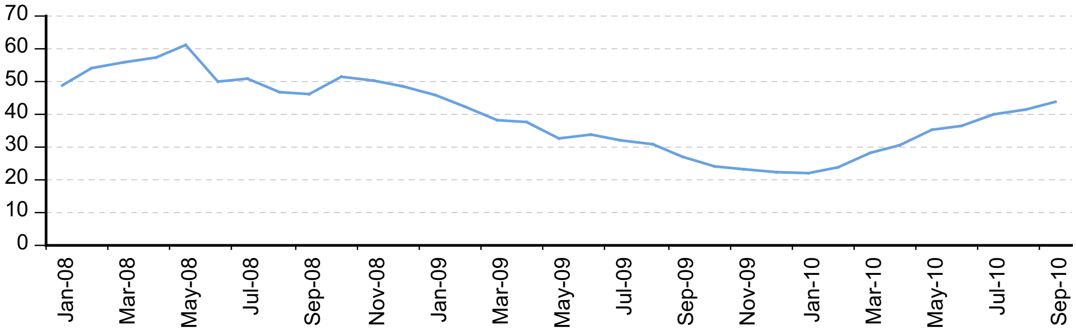
The increased inflation rate and strong economic growth have led the Central Bank to apply a more restrictive monetary policy. There have been increases in the interest rates of the Monetary Regulation Instruments (IRMs) starting in the second half of the year. The increases have been particularly notable in the short section of the curve of returns on these securities. The interest rates of IRMs for 14 and 35 days have increased by 390 and 420 bps respectively so far in the second half of the year, while the rates for longer terms have increased on average by 100 bps in the same period. In addition to the increased rates, the Central Bank has increased the frequency with which it carries out IRM placements with the aim of withdrawing potentially inflationary liquidity from the market.

With economic growth at around its medium-term trend and international commodity prices experiencing some adjustment downward, we forecast that in 2011 inflation will be at levels close to the Central Bank reference range (5%). This will be consistent with a less expansive monetary position, so that next year there will be rises in the IRM interest rates.

3. Bank lending grows at rates over 40%

Lending in the banking system has recovered its strength, in line with the rate of economic growth, and closed September with a year-on-year increase of 45%. Lending for exports, retail trade and livestock farming saw the biggest growth, with year-on-year increases of more than 55%. This trend has been accompanied by low default levels (currently at 1.5%) and a reduction in dollarization. This has reduced the vulnerability of the economy to possible future shocks.

Chart 14
Credit in the banking system (% y/y change)



Source: BCP

The strong performance of lending will continue for the rest of the year, supported by the strength of economic activity, the still relatively low rates of interest compared with historical levels and companies' perceived easier access to finance (as measured by the latest survey of business expectations by PricewaterhouseCoopers). We estimate that in 2011 the rate of increase in lending will remain high, although it will be slightly limited due to more moderate domestic demand and the adjustment in monetary conditions.

It is important to point out that the International Monetary Fund and World Bank will soon make their assessment report on the Paraguayan monetary system, in particular of the banks' risk control measures. This assessment program will include not only commercial banks, but also cooperatives, which is growing sector. In the previous report carried out in 2005, Paraguay was found to comply only with 17% of all the Basel I standards, so there is risk in a context of strong credit expansion. The Central Bank of Paraguay has approved rules to increase the solvency and efficiency of institutions in the Paraguayan banking and financial system. Among the measures are increases in the levels of minimum capital requirements, a reduction in the time before a debt is considered in default, and new parameters for generic provisions. In addition, the government organized the National Institute of Cooperatives' (INCOOP) Program of Institutional Strengthening, which is partly financed by the Inter-American Development Bank (IDB). Among the aims of the program are to ensure the cooperative sector is properly regulated and supervised, to improve the flow and quality of information on activities in the sector, and to increase the skills levels of employees. The measures are moving in the right direction of strengthening the country's financial sector.

4. Global deterioration is the main risk factor

The increased cyclical and financial concerns that predominate in advanced economies, particularly in Europe, will affect international soybean prices and Paraguayan exports.

In this context, the Paraguayan authorities will have some margin for moderating the negative impact. On the monetary side, the Central Bank may reverse the raises it has introduced to IRM interest rates and thus compensate the increased risk premium. This would aim to moderate the impact on the financing of private spending. On the fiscal side, there is somewhat less room for maneuver. This is because the implementation of a fiscal stimulus would require agreement between the executive and the opposition majority in Congress, so any support measures could take time. In short, although the country has some instruments to tackle a possible future deterioration in global conditions, the negative impacts on the economy could still be substantial.

5. Tables

Table 1
Paraguay: annual macroeconomic forecasts

	2009	2010e	2011e
GDP (% y/y)	-3.8	10.1	4.0
Inflation (% y/y, average)	2.6	4.6	6.1
Exchange rate (against USD, average)	4967	4760	4872
Private Consumption (% y/y)	-3.4	7.0	4.6
Public Consumption (% y/y)	13.7	12.0	4.0
Investment (% y/y)	-11.9	20.5	6.0
Fiscal balance (% GDP)	0.1	0.2	0.3
Current account (% GDP)	-1.0	-1.9	0.5

Source: BCP, BBVA Research Peru

Table 2
Quarterly Macroeconomic Forecasts

	GDP (% y/y)	Inflation (% y/y, average)	Exchange rate (vs. USD, average)
Q1 09	-5.4	4.5	5082
Q2 09	-7.4	2.0	5035
Q3 09	-2.4	1.7	4963
Q4 09	-0.3	2.2	4786
Q1 10	11.2	3.3	4695
Q2 10	12.2	4.8	4737
Q3 10	10.8	4.3	4788
Q4 10	6.3	5.9	4820
Q1 11	5.0	6.0	4836
Q2 11	4.0	6.3	4860
Q3 11	4.0	6.9	4884
Q4 11	3.1	5.3	4908

Source: BBVA Research

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