1 Overview

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

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

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

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

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

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

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

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