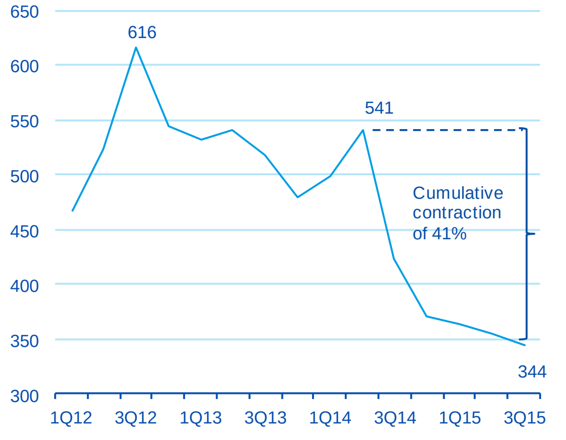
3 Paraguay: growth of over 3% in 2015 and 2016

The deterioration in the international setting has taken its toll on local economic activity, which slowed down in the first half on lower sales abroad

The international environment relevant to Paraguay's economy has continued in decline in recent months. The price of the soybean, which is the country's main export good, has carried on falling (for further details, see Box 1. Commodity prices: soybeans and oil), which has resulted in a cumulative drop of over 40% since the middle of last year[1] (see Figure 3.1). This was coupled with the weakness of Brazil (in the first half it contracted by 2%, see Figure 3.2), which is Paraguay's foremost trading partner to which around 30% of exports are destined. Finally, the proximity of lift-off for 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.

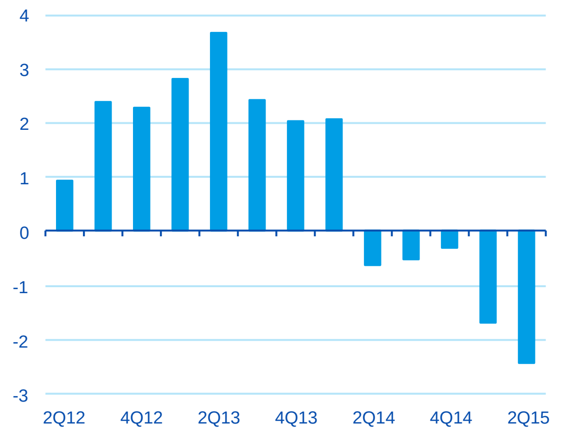
Against this backdrop, economic activity advanced by 3.3% YoY over the first half, which was below the rate of the second half of 2014, due to lower agricultural output (20% of total GDP), which came to a virtual standstill (the sustained falls in agricultural product prices, especially that of the soybean, dampened business confidence, investment and production). Besides this, certain one-off supply-side factors were observed, such as lower water-flow levels at hydroelectric facilities, which affected electricity production (energy output and water fell 3.0% in the first half). All of this was reflected, on the spending side, in the performance of exports, which contracted by 3.3% in the first half of the year and shaved around 2pp off GDP growth (soybeans and electricity together account for about 45% of overall exports).

Figure 3.1
Soybean price (USD/tonne)



Source: Bloomberg and BBVA Research

Figure 3.2
Brazil's GDP (% var. YoY)



Source: World Bank and BBVA Research

…yet domestic demand continued to prop up GDP

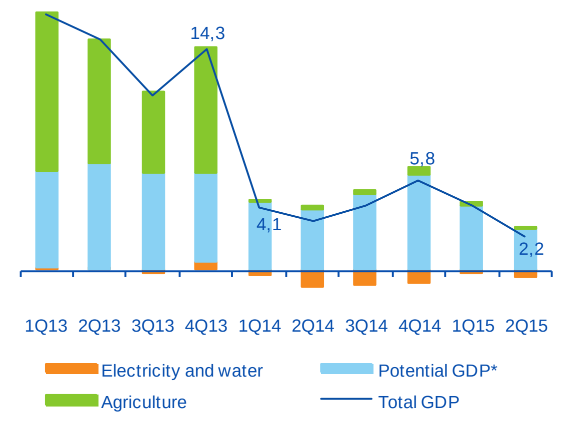
The most trend-representative measure of GDP (which excludes agriculture, and electricity and water) grew at 5.0% YoY and continued to underpin activity in the first half (see Figure 3.3). The most notable growth was in the construction sector (10%), given ongoing major private-sector projects involving, for example, corporate buildings, shopping centres, housing and hotels, as well as that in industry and mining (7.7%),

1: Even though the recent slump in the world crude oil price has helped to keep the cost of imports in check (the country imports all of its fuel requirements), this is not enough to offset the impact of the steady fall in the soybean price.

driven on by items linked to the production of dairy goods and oils, grain mills and bread-making. This is also borne out on the domestic demand side (which grew by 4.3%, one point more than GDP, see Figure 3.4), where gross capital formation saw growth of 4.9% and contributed 1.1 percentage points to GDP growth, and total consumption grew by 3.7%.

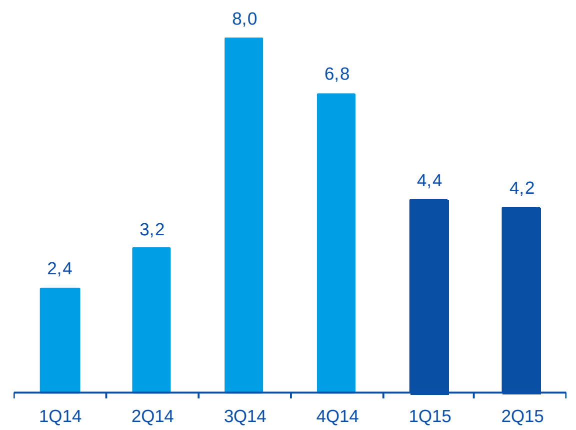
It should be pointed out that even though trend GDP continued to grow in the second quarter, it also exhibited a far more sedate rate of progress (after showing growth of 6.3% in the opening three months of 2015, it moved ahead at a mere 3.8% in the second quarter). In particular, a slowdown was noted in construction, which moved from a rate of 15% to 5%, due to adverse weather conditions which hit the normal execution of work, and in the services sector (43% of total GDP), which grew at 3.6%, or almost two percentage points lower than in the first quarter, on lower sales activity in the border cities owing to economic weakness in the key neighbouring countries (most of all, Brazil) and the marked depreciation of their currencies.

Figure 3.3
Contribution to GDP by sector (percentage points, % var. YoY)



* Ex agriculture, and electricity and water.
Source: BCP and BBVA Research

Figure 3.4
Domestic demand ex inventories (% var. YoY)

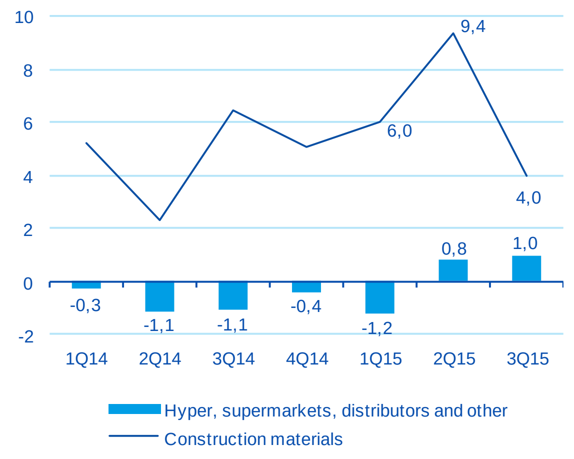


Source: BCP and BBVA Research

In this context, we forecast GDP growth of 3.2% in 2015, though this carries downside risk

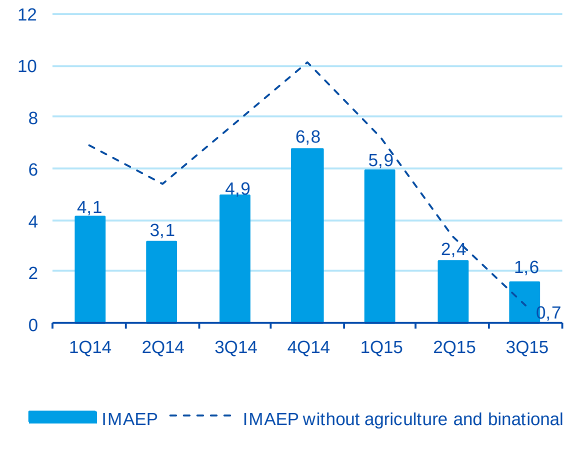
Our central scenario assumes that GDP will embark on a process of gradual recovery towards the end of 2015, especially in agriculture (in the third quarter, volumes of shipments of agricultural products such as wheat, maize, rice and soybeans increased by 20%, which was the first positive result in six quarters), energy and construction (on the turnaround of key supply shocks which affected the first half of the year). GDP will thus grow at 3.2% in 2015. Certain advance indicators, though, suggest that activity, above all in its most trend-representative part, is likely to have continued to show weakness in the third quarter (see Figure 3.5), which adds downside risk to our forecast. The IMAEP (an indicator which is very true to GDP movements) rose 1.6% in the third quarter, while ex agriculture and bi-national undertakings it only moved ahead by 0.7% (see Figure 3.6).

Figure 3.5
Economic activity indicators (% var. YoY)



Source: BCP and BBVA Research

Figure 3.6
Quarterly GDP (% var. YoY)



Source: BCP and BBVA Research

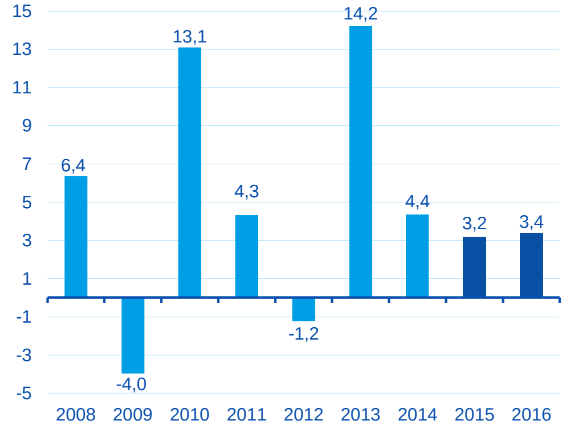
For 2016, in a still challenging environment, we forecast growth of 3.4%

The scenario for 2016 will be complex and we take account of the following elements in our estimates:

- On the external front:
  - i) A relatively stable soybean price. The effects of lower world supply should be offset by weaker international demand, principally from China.
  - ii) Less deterioration of Brazil's economy in 2016, strongly influenced by political resistance to change and adjustments still to be carried out on the fiscal side. In the case of Argentina (trading partner which accounts for around 9% of exports), although future dynamics will hinge very much on the confidence of economic agents given the new government being formed in December, we estimate growth of 1.4% on a par with the previous year.
  - iii) A more gradual approach in adjustment of the Fed's benchmark rate in a context where we have revised our growth forecasts for the United States downwards. Nonetheless, the process of US monetary normalisation will continue to be shrouded in uncertainty, which makes for potential bouts of volatility on local financial markets and, if these persist, they could exert real effects.
- On the local side:
  - i) The infrastructure construction work will have a more palpable impact.
  - ii) Government spending consistent with the fiscal rule.

Bearing this in mind, for 2016 we forecast a mild acceleration of growth to 3.4% (see Figure 3.7), although this would be lower than the level forecast in our July report (3.9%). Domestic demand (3.7%) will again be the prime mover of growth (see Table 3.1), and will be especially driven by heavier levels of both private and public investment (total capital formation will contribute 1.2 percentage points to growth for the year).

Figure 3.7
Annual GDP (% var. YoY)



Source: BCP and BBVA Research

Table 3.1
Expenditure-side GDP (% var. YoY)

	2013	2014	2015	2016
Domestic demand	7,6	5,7	3,6	3,7
Consumption*	4,7	4,4	3,4	3,0
Gross capital formation**	20,2	10,6	4,5	6,0
Exports	18,4	0,9	-1,5	1,5
Imports	6,8	2,8	-1,2	1,8
GDP	**14,2**	**4,4**	**3,2**	**3,4**

*Includes private and public consumption
* Includes GFI and inventories.
Source: BCP and BBVA Research

In addition to the infrastructure projects that are either already underway or in the pipeline (such as work on improving roads, highways and lanes, among others), there will be new projects to be pursued under the Public Private Partnership (PPP) format, which will enable growth to enjoy some sustainability (see Table 3.2). For example, the extension of Routes 2 and 7 (USD415mn), was put out to tender in September 2015 and is expected to be awarded towards the second half of 2016. It should be noted that, besides encouraging sector diversification of total investment and making it less vulnerable to commodity price volatility, infrastructure investment gives rise to substantial positive externalities and produces a direct and pervasive impact on the well-being of society. In this context, we estimate that the total investment-to-GDP ratio will be around 17.5% in 2016, thus regaining the levels it had seen in 2011 (17.1% of GDP).

Table 3.2
PPP projects either approved or under review* (USD mn)

State	Project	Preliminary amount (USD millions)
	Public Initiatives	**1.446**
Approved	Expansion of routes 2 and 7	415
In study	Total modernization of Silvio Pettirossi Airport	147
	Rehabilitation, improvement and expansion of routes 1 and 6	684
	Dredging opening, signaling, operation and maintenance of the Paraguay River Waterway	200
	Private Initiatives	**446**
In study and with confidentiality clause	6 projects	446
	Total	**1.893**

* The total value of these projects is around 6.0% of GDP.
Source: DNCP and BBVA Research

With respect to external demand, its contribution to growth will hold at a neutral level as exports will provide a boost (1.5%) as primary sector recovery continues, while imports will also gather momentum (1.8%), with the expansionary effect of infrastructure projects on purchases of capital goods and inputs (as things stand, imports of inputs and capital goods associated with construction represent around 35% of total import value).

From 2017, with a more marked recovery of external demand which will have a notable impact not only on export levels but also border-trade activity (Brazil should emerge from contractionary territory and grow at between 1% and 2%), and infrastructure projects in sectors such as roads, water and drainage, and electricity power transmission and distribution still driving activity onwards (at present the combined value of on-road projects which are to be awarded as concessions from 2016 is in excess of USD1bn), we forecast that Paraguay's growth will be a little over 4.2%. We note that, owing to the fact that the imported component of infrastructure projects is normally concentrated over the first years of execution, over this horizon such projects will have a larger impact on GDP growth.

Focussing progress on competitiveness and productivity is key to ensuring medium-term growth

According to the Global Competitiveness Index 2015-16, published by the World Economic Forum (WEF), Paraguay is ranked 118th, which is up two places on the previous year but still unsatisfactory when compared to the other 140 countries in the ranking. Inspection of the 12 factors included by the WEF shows that Paraguay's improvement in competitiveness in the last year has been in the area of the macroeconomic environment, which ranks the country in 43rd place, having previously been placed 100th. The country actually has a better macroeconomic environment than the Latin America region. However, the WEF also reveals that the country lags the region in key aspects such as the Supply of Physical Infrastructure (quality of roads and air transport infrastructure), which was considered inadequate, as well as Innovation and Higher Education and Training (see Figure 3.8).

On the other hand, according to Doing Business 2016 (the indicator of the ease of doing business), Paraguay's Distance to frontier indicator showed a better ranking relative to its Mercosur peers (see Figure 3.9), yet the country was ranked 100th out of 189 and slipped back five places compared to the previous ranking. Of a total of 10 indicators, the biggest falls in ranking were observed in Starting a business (down nine places), Getting credit (eight places), Getting electricity (four places) and Resolving solvency (two places).

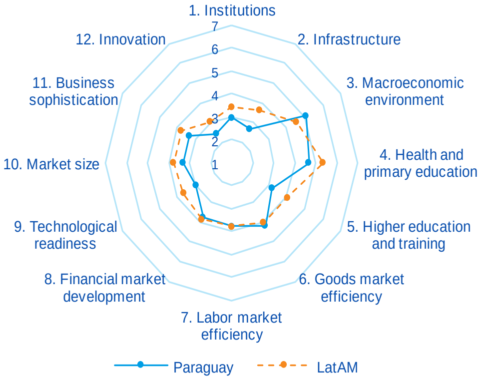
Given the above, and even though macroeconomic stability is a distinguishing feature of the Paraguayan economy, it is clear that, to maintain economic growth at around 4.0% in the medium term, it is essential to implement measures and/or reforms aimed at enhancing the country's productivity and competitiveness. In this context, the key challenges must focus on applying policy measures to: i) reinforce human capital and reduce informality; ii) narrow the infrastructure gap, and iii) cut through red tape and scale down cost overruns in the economy.

Ensuring sustained growth is a necessary pre-condition to becoming a high-income country, as high short-term growth is no guarantee of long-term success. According to Agénor, Canuto & Jelenic (2012)[2], following a period of rapid progress most developing countries have experienced a sharp slowdown in growth and fallen into the so-called "middle-income trap"[3]. There is a lengthy list of countries which have suffered such a deceleration. The World Bank (2012) estimates that out of 101 middle-income economies in 1960, as of

2: Agénor, P., Canuto, O. & Jelenic, M. (2012), "Avoiding middle-income growth traps", World Bank.
3: Gill & Kharas (2007) define the "middle-income trap" as the decline in historical growth rates which stops middle income countries from making the jump to having the standing of high-income countries.

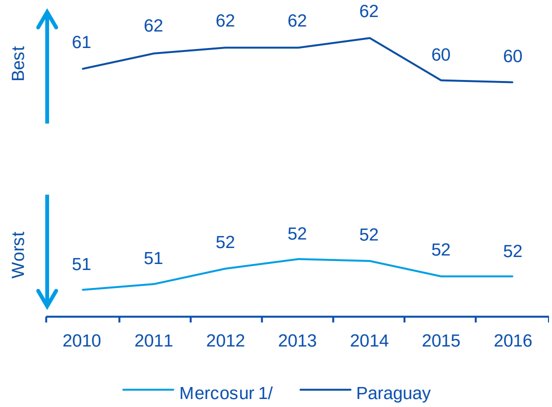
2008 only 13 had become high-income economies: Spain, Equatorial Guinea, Greece, Hong Kong, Ireland, Israel, Japan, Mauritius, Portugal, Puerto Rico, South Korea, Singapore and Taiwan[4].

Figure 3.8
Global Competitiveness Index 2015-16 (Scale from 1 ("worst") to 7 ("best")



Source: World Economic Forum and BBVA Research

Figure 3.9
Doing Business: Distance to frontier* (Scale of 0 ("worst") to 100 ("best")



* Gap between the performances of a particular economy and the best worldwide at any point in time.
1/ Does not include Paraguay
Source: Doing Business – World Bank and BBVA Research

The fiscal accounts will continue to show a deficit

Even though the Law on Transparency and Fiscal Responsibility (LTRF), which came into effect this year, sets a cap on the fiscal deficit of 1.5% of GDP, our forecast for the fiscal balance in 2015 assumes that the government will fail to comply with this upper limit despite having made adjustments to keep the deficit below the level envisaged under the said law.

From January to July, the fiscal deficit was PYG752bn, this being mainly accounted for by higher expenditure (12.0%) in relation to revenues (6.7%). Within expenditure, there was an increase in employee compensation (9.4%) and goods and services (25.5%). Meanwhile, fiscal revenues rose, due to higher collections of personal income tax (10.0%), although certain one-off factors were also observed. We thus estimate that for 2015 the fiscal deficit will come in at around 2.0% of GDP (see Figure 3.10), in a situation where there will be higher capital expenditure (aimed at the infrastructure projects that were given priority by the government) and a slowdown in tax collection, given the greater sluggishness of the economy.

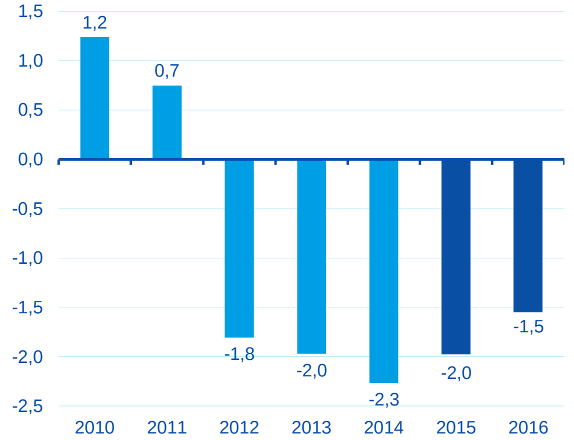
In future, we foresee a gradual paring down of the deficit until it becomes compliant with the cap under the Law on Transparency and Fiscal Responsibility, which will help to consolidate the credibility of the fiscal rule[5].

In a scenario of fiscal deficits, between 2013 and 2014 government debt was issued on international markets (bonds raising USD500mn and USD1bn respectively) to finance infrastructure projects in the next few years. We predict that these external borrowing requirements will still remain latent, so we estimate that public sector debt (excluding the central bank) should move from 16% of GDP in 2014 to over 20% in 2016 (see Figure 3.11) and will stabilise at around 25% from 2018. Even though this increase in the public debt ratio

4: World Bank (2012), "China 2030: Building a Modern, Harmonious, and Creative High-Income Society".
5: Notwithstanding this, to the extent that more public spending is carried out, there is the risk that the deficit will climb beyond the upper limit set under the rule.

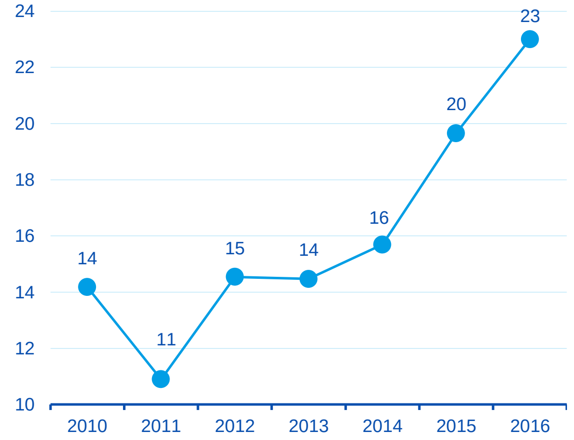
should be swift, it is no indicator of any rising pattern that might affect the sustainability of the public finances, because in the future infrastructure projects are expected to be pursued using the PPP format.

Figure 3.10
Fiscal position (% of GDP)



Source: BCP and BBVA Research

Figure 3.11
Public sector debt (% of GDP)



Source: IMF and BBVA Research

The external deficit will right itself and be mainly financed by long-term capital

Over January to October 2015, the balance of trade showed a surplus of USD1.089bn in a context in which both exports and imports fell off by around 15% (see Figure 3.12). By product groups, the imports which dropped away the most were inputs (-18.4%, on the lower oil price) and capital goods (-16.3%). On the other hand, the value of exports shrank due to a lower figure for shipments of soybeans and derivatives thereof (-26.2%), meat (-14.9%) and electric power (-3.1%), which altogether represented 57% of total exports (see Table 3.3).

Figure 3.12
Recorded exports and imports (% var. YoY)

Source: BCP and BBVA Research

Table 3.3
Balance of Trade (USD mn)

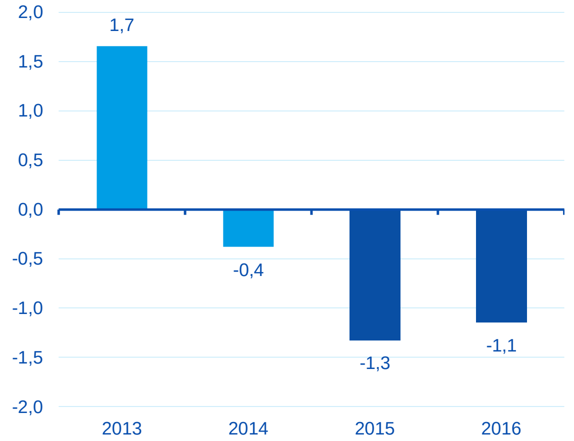
			January - October		
	2013	**2014**	**2014**	**2015**	**Chg. %**
Total exports	**13.605**	**13.116**	**11.433**	**9.701**	**-15,1**
Exports registered	9.456	9.636	8.544	7.264	-15,0
Re-exports	4.065	3.455	2.869	2.349	-18,1
Other	84	25	20	88	334,5
Total imports	**11.942**	**12.079**	**10.081**	**8.613**	**-14,6**
Imports registered	11.302	11.299	9.420	7.953	-15,6
Other	640	780	661	660	-0,2
Trade Balance	**1.662**	**1.037**	**1.352**	**1.089**	**-19,5**

Source: BCP and BBVA Research

In this situation, the forecast for the current account deficit has been revised downwards slightly, to 1.3% of GDP for 2015 (from one of 1.4% of GDP in July) given lower import prices, due to the oil price and smaller outflows such as of factor income, on account of the lower profits made by foreign companies (see Figure 3.13). For 2016-19 our forecasts assume a steady reduction of the external deficit (which on average should be -0.4% of GDP), given the recovery of exports, especially of energy, and demand from Brazil for Paraguayan products.

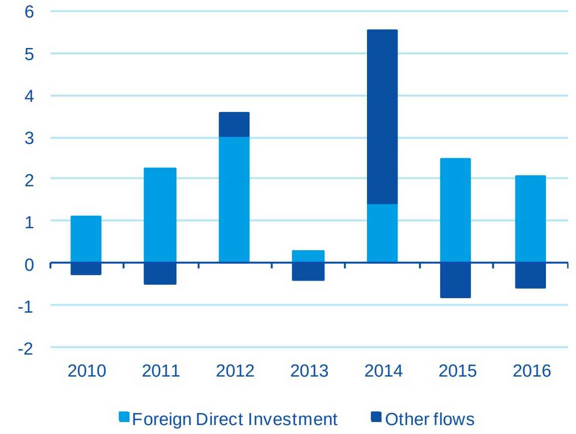
With regard to sources of funding, in the first half of 2015 inflows of 2.3% of GDP in Foreign Direct Investment (FDI) were registered. Such flows are expected to continue over the next few quarters, so that FDI for the year in 2015 (as a percentage of GDP) should come in at a level on a par with the first quarter, which will mean that the financing of the foreign deficit is more than covered. In the next few years, we estimate that FDI coming into the country will continue to be encouraged by infrastructure projects that offer opportunities for this kind of funding (see Figure 3.14).

Figure 3.13
Current account (% of GDP)



Source: BCP and BBVA Research

Figure 3.14
Financial account (% of GDP)



Source: BCP and BBVA Research

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