

7 Deeper recession in Brazil is the main source of downside risk

Deviations to the developments assumed in our baseline scenario for several key variables on the external and local side could shape a more challenging environment for Paraguay's economy in the coming months. Even so, it is important to make the point that Paraguay has strengths that can limit the potential effects of more adverse scenarios.

On the external side, a deeper and longer-lasting recession in Brazil would have a substantial effect on Paraguay's growth...

The major downside risk as regards the GDP forecast is from greater-than-expected deterioration of the Brazilian economy. Brazil is the principal market for Paraguay's exports, accounting for about 30% of those recorded (this share jumps considerably if re-exports are included). According to our estimates, a drop of one percentage point in Brazil's GDP growth arising from idiosyncratic elements (after controlling for global factors) would bring about a reduction of between 0.4pp and 0.5pp in Paraguay's GDP growth.

...moreover, a harder landing for China would hit both soybean prices and Brazil

Our baseline scenario assumes that the process of a dampening of growth in China down to more sustainable levels, such as a rebalancing among its drivers of growth on the demand side (less investment vs. more consumption) will be gradual and orderly. Nonetheless, the financial frailties that are coming to light in China have sparked doubts over the strength of its growth and its ability to maintain rates of close to 6%. Given this situation, lower growth in China would have an adverse effect on Paraguay's economy through a direct channel, materialising in heavier and more persistent falls in the prices of those commodities which it exports (chiefly soybeans), as well as via the indirect path of weaker external demand in Brazil's case, since it is highly exposed to shocks in China (for further details, see Box 2. What would be the impact on Paraguay of a harder landing for China?).

The imminent Fed adjustment is still generating uncertainty, too

The uncertainty that has been surrounding lift-off for the Fed's normalisation process, and the pace at which the adjustment will be made, have touched off bouts of volatility on emerging financial markets. Surprises from US activity figures or a shift in perceptions of what the Fed's intentions are have prompted a reshuffling of investor portfolios that has been echoed by swings in the prices of assets and currencies among the economies of Asia and Latin America. However, what could give rise to major upsets in how global activity performs is the process of how markets receive the Fed's rate adjustment. For example, faster hiking of the federal funds rate (which is not discounted) will lead to further reallocation of portfolios worldwide, that will produce a preference for holding dollar assets. In such a scenario we could expect greater upward pressure on the PYG exchange rate, as well as an increase in risk premiums and, consequently, in funding costs. On top of this, in such a situation further strengthening of the dollar could not be ruled out, such that might generate additional downward pressure on commodity prices in the short term and upward adjustments in price levels generally. If these pressures on local financial markets and the PYG are persistent (and translate into tougher borrowing conditions, balance sheet effects, etc.), the real impact could be more notable and growth would be held back.

On the domestic side, accelerating the programme of infrastructure projects would push up the forecast for economic growth

Among the domestic factors that would push up the growth forecast would be an acceleration of the implementation of infrastructure projects in the pipeline. From a sector standpoint, this would be reflected in greater growth for construction and, on the expenditure side, more marked investment growth.

In view of the likelihood that we attach to each of these events occurring and the impact that they would have on economic activity (downward as regards external factors and upward for domestic ones), the risks to the GDP forecast are balanced.

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This report has been produced by the Peru Unit

Chief Economist for Peru

Hugo Perea
hperea@bbva.com
+51 1 2112042

Francisco Grippa
fgrippa@bbva.com

Yalina Crispin
Yalina.crispin@bbva.com

Vanessa Belapatiño
Vanessa.belapatinho@bbva.com

Ismael Mendoza
Ismael.mendoza@bbva.com

Marlon Broncano
Marlon.broncano@bbva.com

BBVA Research

Group Chief Economist

Jorge Sicilia Serrano

Developed Economies Area

Rafael Doménech
r.domenech@bbva.com

Spain

Miguel Cardoso
miguel.cardoso@bbva.com

Europe

Miguel Jiménez
mjimenezg@bbva.com

US

Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area

Cross-Country Emerging Markets

Analysis
Alvaro Ortiz
alvaro.ortiz@bbva.com

Asia

Le Xia
le.xia@bbva.com

Mexico

Carlos Serrano
carlos.serrano@bbva.com

Turkey

Alvaro Ortiz
alvaro.ortiz@bbva.com

LATAM Coordination

Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina

Gloria Sorensen
gsorensen@bbva.com

Chile

Jorge Selaive
jselaive@bbva.com

Colombia

Juana Téllez
juana.tellez@bbva.com

Peru

Hugo Perea
hperea@bbva.com

Venezuela

Julio Pineda
juliocesar.pineda@bbva.com

Financial Systems and Regulation Area

Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems

Ana Rubio
arubiog@bbva.com

Financial Inclusion

David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy

María Abascal
maria.abascal@bbva.com

Digital Regulation

Álvaro Martín
alvaro.martin@bbva.com

Global Areas

Economic Scenarios

Julián Cubero
juan.cubero@bbva.com

Financial Scenarios

Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes

Oscar de las Peñas
oscar.delaspenas@bbva.com

Contact details:

BBVA Research Perú

Av. República de Panamá 3055
San Isidro
Lima 27 - Perú
Tel: + 51 1 2112042
E-mail: bbvaresearch_peru@bbva.com
www.bbvaresearch.com