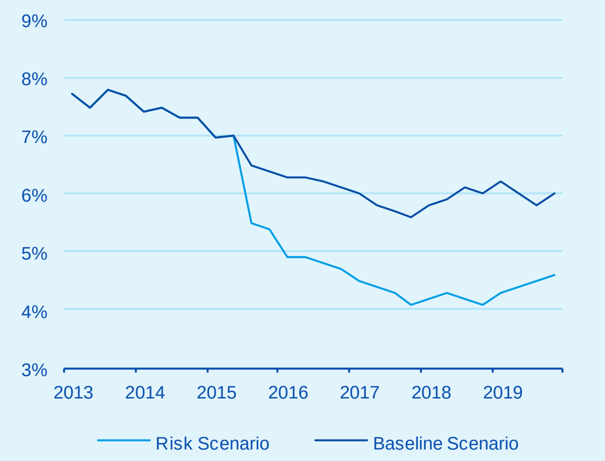
Box 2. What would be the impact on Paraguay of a harder landing for China?

A risk scenario for China: persistent slowdown

Even though our central scenario assumes that the authorities will continue to support growth of no less than 6% YoY, it is well worth examining the effect of a sudden and persistent slowdown in China which leads to growth that is significantly below these levels.

Such a scenario could, for example, arise from excess pressure on the parallel banking system or a sharp tightening in the interbank market, such as occurred in June 2013, which might lead to a financial crisis and a drop in confidence among both consumers and corporates. A shock of this kind could produce a collapse of consumption due to a deceleration for disposable income. Nonetheless, the main impact would be on investment, owing to financial instability and decreased appetite for risk. Such a weakening of domestic demand could drag down growth to rates of around 4% instead of the figure of 6% posited in the central scenario (see Figure B.2.1).

Figure B.2.1
China: gross domestic product (% var. YoY)



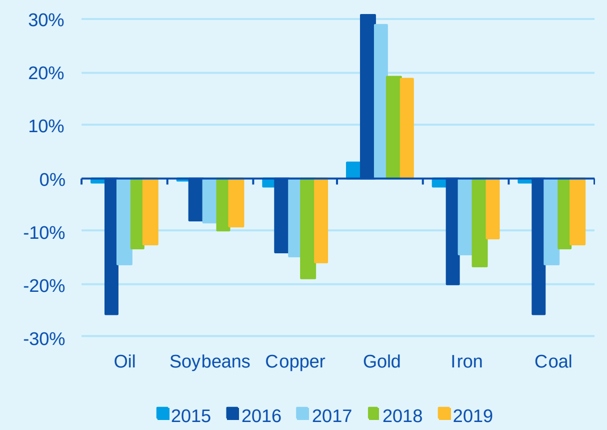
Source: IMF and BBVA Research

A negative shock for growth in China: the transmission channels

The above-mentioned risk scenario would affect Paraguay via two main channels: i) a direct channel, which would materialise in heavier and more persistent falls in commodity prices[1] (see Figure B.2.2), including soybeans, since China represents over 60% of demand worldwide, and ii) an indirect path due to weaker external demand for Brazil (which is very vulnerable to shocks in China).

In this context, Paraguay's growth rate would suffer a downward correction (see Figure B.2.3). On a sector level, there would be effects on the agriculture side (from lower soybean margins, that lead to a scaling down of cultivated land) and in the services sector (owing to greater sluggishness in the trade subsector, especially border trade with Brazil). The adverse effect will also be noted in industry, especially *la maquila* (low-cost assembly activity) that targets the Brazilian market.

Figure B.2.2
Effect on key commodity prices* (% difference with respect to the baseline scenario)



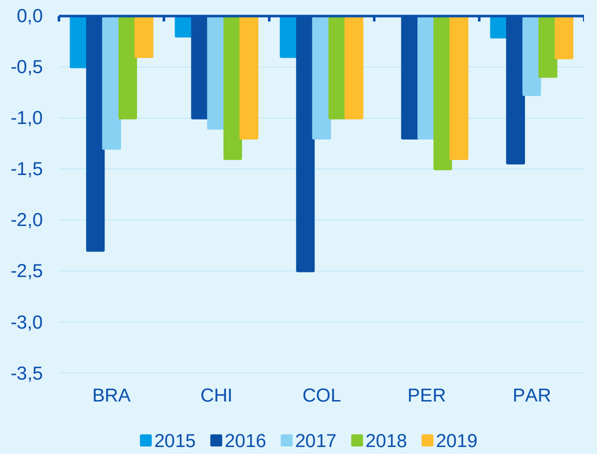
*Potential impact on commodity prices one year after a 1pp drop in the growth of fixed asset investment in China
Source: BBVA Research

[1] It should be noted that prices of energy commodities (such as oil) would also be strongly affected, which would benefit Paraguay.

On the expenditure side, the main effects will be noted in: i) exports, especially those of soybeans given the lower production levels, as well as assembly and re-exports, due to the increased weakness of demand from Brazil; ii) investment, with the rise in the PYG's exchange rate (this raises the cost in PYG of imported machinery, equipment and inputs) and a lower level of reinvestment of the profits of foreign companies, especially those in agriculture and those oriented towards satisfying domestic demand; iii) consumption, due to fewer jobs being created and a higher cost of credit. Beyond this, families would not ease up on their consumption because the negative shock is permanent as regards GDP level and its growth rate, and iv) imports, in line with lower domestic demand, especially in relation to investment, and depreciation of the PYG.

On the fiscal front, there is some margin to implement counter-cyclical fiscal policies (at least initially) that would soften the effects of the initial impact, although at the moment the intention is to consolidate the credibility of the fiscal rule, which only permits a deficit of 3% in the event of a national emergency, international crisis or a fall in domestic economic activity. In such circumstances, implementing counter-cyclical fiscal policies is far more tricky if we also bear in mind the permanent nature of the shock.

Figure B.2.3
Impact on growth
(difference with respect to the baseline scenario in percentage points)



Source: BBVA Research

On the external side, the strong dip in domestic demand would more than outweigh the decline in external demand and the terms of trade, which would mean the external deficit being worse off in relation to the baseline scenario.

It is worth noting that this scenario has been replicated as regards other economies in the region, which enables comparison of which ones would be most sorely hit. The findings from a simulation of this kind show that most of the region's countries would be affected to the tune of over 1pp, given a shock from China. Brazil and Colombia would come off the worst, since they have high exposures to China. This would be more so in Brazil's case, given that it would have to face up to the shock with very badly weakened fundamentals, and because it has to press ahead with its fiscal adjustment. Therefore, in the risk scenario, Brazil would be beset by a truly punishing recession in 2016 (deeper than that included in our baseline scenario), which would compromise Paraguay's growth, shrinking it by around 1.4 percentage points in 2016 in relation to our baseline scenario (for which reason GDP growth would be 2.0%, and consequently lower than the level of 3.4% that we forecast in our baseline scenario).

DISCLAIMER

This report has been produced by the Peru Unit

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