

Paraguay

Economic Watch

Lima, 1st March 2011

Economic Analysis

Macroeconomic outlook

- **After growing a historic 14% last year, the Paraguayan economy is expected to expand at a more sustainable rate of around 4.5% in 2011.** Over the coming years, economic growth will be around its trend level of 4%.
- **GDP growth in 2011 will reflect agricultural conditions that, in general, will be better than initially anticipated, making it possible to maintain the high yields of the last harvest.** This will have a favorable impact on sectors linked to agricultural activity, including the processing industry, transportation, and commerce.
- **Commodity food prices will remain high** and this, together with increasing oil prices, will result in inflation increasing to around 9% in 2011.
- **In this context, the Central Bank will continue tightening the monetary policy stance,** although perhaps at a somewhat milder pace than that seen over recent months as a sizeable part of the adjustment would have been already made.
- **The fiscal surplus will continue to be relatively high in 2011 due to increases in revenues and the ending of the Economic Reactivation Plan.** We also expect an improvement in foreign trade figures, resulting from better terms of trade and a lower domestic demand that will slow down imports. Against this background, the domestic currency will tend to appreciate in 2011.

After expanding by 14% in 2010, the economy will converge to more sustainable growth rates

Paraguay's economy grew by 14% in 2010, the fastest rate since records began. This growth reflected weather conditions returning to normal following the serious drought in the previous year, which had a significant impact on agriculture, the main economic activity in the country, accounting for around 30% of total output. This was accompanied by the recovery in the global economy, which supported foreign demand and international commodity prices for the country's main exports.

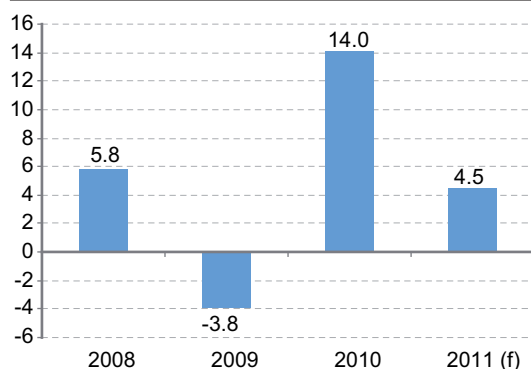
We expect the economy to grow by 4.5% in 2011, continuing the recent upward trend in growth although at more moderate rates, converging on growth rates which can be sustained over coming years (around 4.0%). In general, agricultural conditions will be good during the year and better than previously expected when there was still a possibility of negative impact from the La Niña phenomenon; this will make it possible to maintain the high yield of the last harvest. This will have a favorable impact on sectors linked to agriculture, such as for example the processing industry, transport and trade. This will be supplemented by livestock and associated activities and construction, which have been performing very positively. However, it should be noted that the effect of the low basis for comparisons in 2009 will have been diluted and therefore economic growth will be more moderate this year.

On the demand side, the momentum will mostly come from investment and private consumption. As a result external factors will continue to be favorable (including terms of trade which will increase by around 10%); there are positive expectations in the private sector; and, in more general terms, Paraguay's economy is gradually becoming more attractive.

However, increases to international food commodity and energy prices will put upwards pressure on prices; this will result in the Central Bank continuing to adjust its monetary position

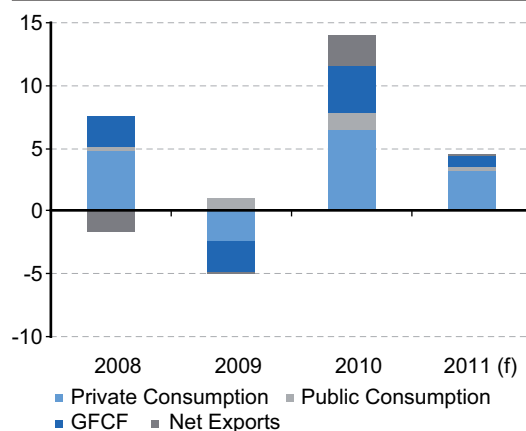
Increases to international food commodity and energy prices are putting upwards pressure on domestic prices, resulting in inflation of 7.2% in 2010. This pressure will continue in 2011. International prices for food commodities have returned to the highs seen in 2008, according to the FAO index, and will remain high throughout this year, increasing the transmission of increases to local prices. International oil prices will continue to trend upwards over the year, based on demand which will increase at a rate dependent on the recovery in advanced economies continuing, whilst OPEC production will not be able to maintain a similar increase. In addition, prices are also being affected by uncertainty about the supply of crude from countries in the Middle East and North Africa resulting from social and political unrest in some countries in the area; this premium will continue for some time. As a result, inflation will reach around 9% by year-end, exceeding the monetary policy reference range (5%, +/- 2.5 percentage points).

Chart 1
GDP (% change yoy)



Source: BCP and BBVA Research Peru

Chart 2
GDP by demand component
(impact on growth, in pp)



Source: BCP and BBVA Research Peru

Against this background, we expect the Central Bank to continue to increase its interest rates. However, the rate of such increases will slow compared to what we have been seeing since October last year, as a substantial part of the adjustment has already taken place through the 500 basis point increase in shortest-term rates.

The fiscal balance will continue to improve in 2011

The Central Government surplus amounted to 1.1% of GDP in 2010, improving the results in the previous year (when there was a surplus of 0.1% of GDP). Tax collection (+15% to October) was driven by the rapid growth in domestic demand, whilst public spending (both current and, in particular, capital) spending slowed in line with the gradual ending of the Economic Reactivation Plan introduced in 2009 to offset the effects of the global economic crisis. This positive trend in public sector accounts will continue in 2011, as the absence of a fiscal stimulus from public spending will be accompanied by the continuing increase in income resulting from increased activity. As a result, the surplus will reach 1.5% of GDP this year.

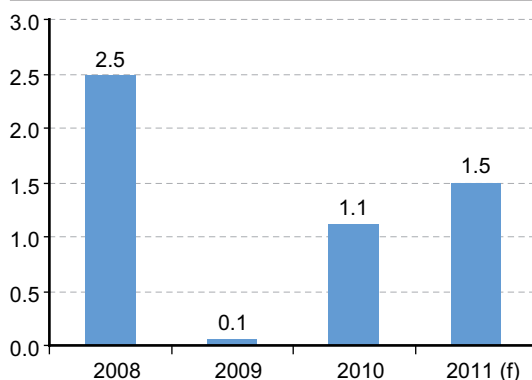
It is worth mentioning that the tax burden in Paraguay (13% of GDP) is relatively low compared to other countries in the region. This makes it difficult to invest in the infrastructure required to increase the productive capacity of the economy and sustain higher growth rates for a prolonged period. Against such a background, initiatives such as Personal Income Tax are of vital importance and it is to be hoped that the authorities will have no further delays in bringing these into effect in order to generate additional resources to undertake the capital expenditure required without damaging the balance in the public accounts.

More favorable external conditions will boost exports, putting upwards pressure on the local currency

The current account of balance of payments deteriorated slightly in 2010 (deficit of 1.4% of GDP) compared to the previous year (deficit of 1.0% of GDP). Although exports increased substantially (+43%) due to the recovery in agricultural harvests and higher prices for exports, the strength of domestic demand led to a larger increase in imports in terms of both capital and consumption (+45%). This situation will reverse in 2011. Firstly the terms of trade will be more favorable for Paraguay in 2011. International food commodity prices –including soya, Paraguay's main export- will remain high and on average significantly higher than in 2010. At the same time, the rate of growth in imports will slow to more sustainable levels in line with the deceleration in domestic demand. In addition, the Binacional Yacyretá hydraulic power station reached full output around mid-February this year and this will have a positive impact on the services account of the balance of payments. As a result, we expect a current account surplus in excess of 2.5% of GDP in 2011 which, together with increased capital inflows, will impact on the local currency, which will tend to appreciate over the year.

Chart 3

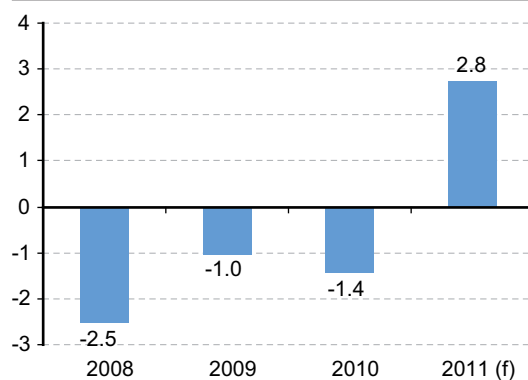
Fiscal Balance (% of GDP)



Source: BCP and BBVA Research Peru

Chart 4

Current account (% GDP)



Source: BCP and BBVA Research Peru

Table 1

Summary forecasts

	2010	2011	2012
GDP (% yoy change)	14.0	4.5	4.0
Inflation (% yoy, average)	4.7	8.8	8.0
Exchange rate (against USD, average)	4,739	4,608	4,599
Interest rate (% , average)	25.3	25.8	26.1
Private consumption (% yoy change)	9.0	4.6	4.3
Public consumption (% yoy change)	13.5	4.0	4.0
Investment (% yoy change)	20.3	7.5	6.0
Fiscal balance (% GDP)	1.1	1.5	1.7
Current account (% GDP)	-1.4	2.8	1.7

Source: BCP, BBVA Research Peru

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