Country report

PARAGUAY

Summary

Paraguay benefited from the benign global economic environment in the past years. The country's main exports are agricultural products for which demand was high. In addition, Paraguay has mended its ways since it entered the IMF stand-by arrangement in 2003. The fiscal surpluses and reduced public debt levels in the past years now allow Paraguay to take anti-crisis measures to mitigate the impact of the global economic downturn. However, this will come at the expense of a higher public debt level. The external accounts have deteriorated, as exports, investment inflows and remittances have slowed. The depreciation of the guarani has helped to cushion the effect, as imports have also slowed rapidly on its back. President Lugo was inaugurated in August 2008, ending 61 years of Colorado Party rule peacefully. One major political issue remains, however. The promised land reforms, which should improve the life of landless farmers are being implemented too slow. This has led to significant social tensions and sometimes violent public unrest. If not resolved, this could undermine his administration in the medium-term.

Things to watch:

- Impact of global downturn on economic performance
- Fiscal situation
- Social unrest

Author: **Erwin Blaauw**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-62648
E.R.Blaauw@rn.rabobank.nl

Paraguay

National facts		
Type of government	Constitutional Republic	
Capital	Asuncion	
Surface area (thousand sq km)	406	
Population (millions)	6.1	
Main languages	Spanish	
	Guarani	
Main religions	Roman Catholic (90%)	
	Protestant (6%)	
Chief of State (president)	Fernando Armindo Lugo	
Head of Government (prime-minister)	Fernando Armindo Lugo	
Monetary unit	guarani (PYG)	

Economy (2007)		
Economic size	*bn USD*	*% world total*
Nominal GDP	16	0.03
Nominal GDP at PPP	29	0.04
Export value of goods and services	8	0.04
IMF quotum (in mln SDR)	100	0.05
Economic structure	*2008*	*5-year av.*
Real GDP growth	5.8	4.4
Agriculture (% of GDP)	24	23
Industry (% of GDP)	17	20
Services (% of GDP)	59	57
Standards of living	*USD*	*% world av.*
Nominal GDP per head	2489	26
Nominal GDP per head at PPP	4710	42
Real GDP per head	1412	18

Social and governance indicators	rank / total
Human Development Index (rank)	98 / 179
Ease of doing business (rank)	115 / 181
Economic freedom index (rank)	79 / 179
Corruption perceptions index (rank)	138 / 180
Press freedom index (rank)	90 / 169
Gini index (income distribution)	57.8
Population below $1 per day (PPP)	16.40%

Foreign trade (2007)			
Main export partners (%)		*Main import partners (%)*	
Brazil	20	Brazil	31
Uruguay	9	Argentina	14
Argentina	41	China	31

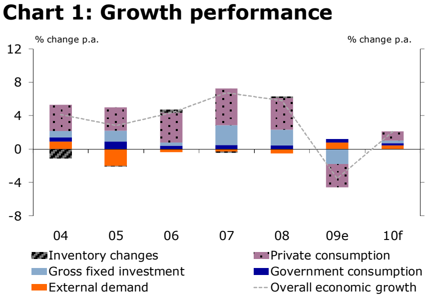
Main export products (%)	
Soybeans	32
Cereals	14
Wood	4
Meat products	13
Main import products (%)	
Consumer goods	26
Capital goods	46
Intermediate goods	28
Openness of the economy	
Export value of G&S (% of GDP)	49
Import value of G&S (% of GDP)	52
Inward FDI (% of GDP)	0.7

Source: EIU, CIA World factbook, UN, Heritage foundation, Transparency International, Reporters without borders, World Bank.

Economic growth and performance

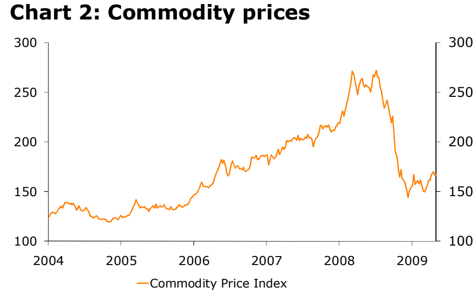
Paraguay's primary sector, especially the production of soy and cotton, is the country's main engine of growth. As a result, the performance of the Paraguayan economy is highly dependent on international agricultural markets and on good weather conditions. As demand for agricultural commodities and, hence, their prices have been rising rapidly and rains have been plentiful, the ingredients for strong growth were present. In addition, government consumption grew by average of 6.2% a year in the past 5 years, while private consumption grew by an average of 5% a year during the same period. Investment growth was also strong in 2007 and 2008, growing by nearly 13% a year on average. As a result, real GDP grew by 6.8% in 2007 and by 5.8% in 2008. However, the global economic downturn has put an abrupt end to this success story. External demand has fallen rapidly, which is adversely affecting the performance of the export sector. More restrictive credit conditions and lower risk appetite among investors will result in a 10% contraction of investment. Moreover, private consumption will decrease by 4%, as consumer and producer confidence dwindles and the inflow of remittances decreases.

Chart 1: Growth performance



Source: EIU

Chart 2: Commodity prices



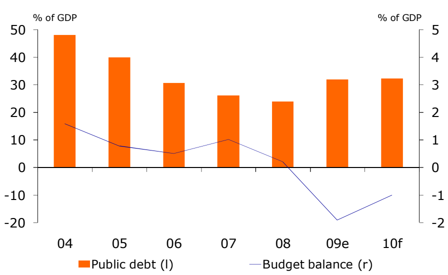
Source: The Economist

Another important factor that is currently impeding growth is the ongoing drought in the southern cone of Latin America. This will have a large and negative impact on the agricultural production, with soy production expected to halve this year. Moreover, as a result of the drought, Paraguay's main river has become too shallow for many vessels, which makes the transportation of the agricultural products more costly. Lastly, Paraguay's economic performance is highly dependent on the performance of its neighbours Argentina and Brazil. As both countries will experience negative growth in 2009, this will further aggravate the downturn in Paraguay. All in all, real GDP is estimated to contract by 3.5% in 2009 before slowly recovering to around 2% growth in 2010.

Economic policy

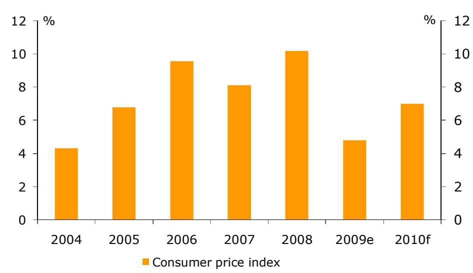
In the past years, Paraguay has broken with its history of poor economic management. Since 2004, the country has followed the guidelines of the IMF stand-by-arrangement. As a result, fiscal policies have been prudent. The fiscal balance had been positive from 2004 up to and including 2007 and the public debt level has been reduced from 50% of GDP in 2003 to 24% of GDP in 2008. In 2008, the fiscal balance started to deteriorate on the back of increased government spending related to the presidential elections. This year, the fiscal balance will deteriorate further to -2% of GDP in the wake of the implementation of the government's economic stimulus plan. The plan consists of increased public investment on infrastructure and well-targeted social programs to improve healthcare and education. In addition to the fiscal stimulus plan, the government has eased monetary policies and the central bank has injected liquidity in the system. The room for looser monetary policies was created by rapidly falling inflation. This was a concern in the past years, as inflation crawled up to a double-digit level. However, as a result of the weakened global environment, inflation is returned to within the central bank's target range. In spite of the worsening fiscal balance, the response of the government to the global economic crisis has been appropriate after a slow start. Downside of these policies is that they will require the government to seek external financing of the USD 300m budget shortfall in 2009, as the increased expenditures coincide with lower tax revenues due to the weakened performance of the economy. If Paraguay is able to secure the funding from institutions such as the World Bank and the Inter American Development Bank, it will lead to an increase of public debt to 32% of GDP in 2009. However, given the current situation, this is acceptable.

Chart 3: Fiscal accounts



Source: EIU

Chart 4: Inflation

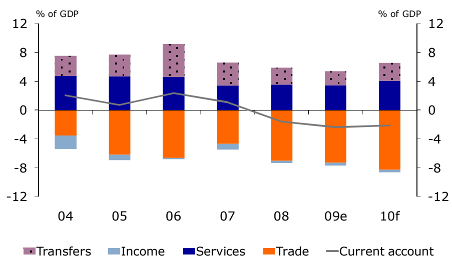


Source: EIU

External accounts

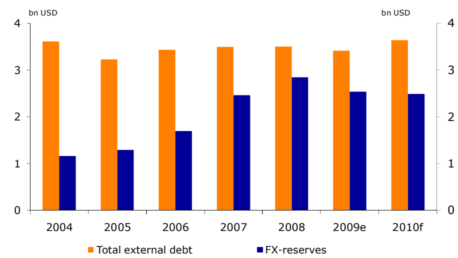
Paraguay's exports mainly consist of primary products, such as soy, cereals and wood. Therefore, the slowdown of global demand for commodities has hit the economy hard. By end-2009, total exports will have declined by 7% compared to a year earlier. However, as a result of the depreciation of the Paraguayan guarani and decreased investments, the drop in imports is even higher, amounting to nearly 9% compared to a year earlier. However, the services- and remittances balance have also deteriorated. As a result, the deficit on the current account will widen from 1.5% of GDP in 2008 to around 2% of GDP in 2009 and 2010. Foreign direct investment inflows will more than halve this year, also as a result of the global economic crisis. The current account deficit and weaker capital balance imply that the gradual build-up of foreign exchange reserves has come to an end. In 2009, Paraguay's level of FX-reserves will decrease from USD 2.8bn in 2008 to USD 2.5bn. However, as imports have fallen rapidly, the import cover of the reserves will actually increase from 4 months in 2008 to 6 months by the end of this year. Total external debt has remained stable at USD 3.4bn in the past years, but is expected to rise slightly in 2010. Debt service, however, is not a concern, as the FX-reserves amount to more than 8 times the 2009 debt service.

Chart 5: Current account



Source: EIU

Chart 6: Foreign-exchange reserves



Source: EIU

Political developments

President Fernando Lugo was inaugurated in August 2008, as the first non-Colorado Party President in six decades. The transition of power passed peacefully and can be seen as an important step towards democratic maturity. In his first six months in office, social tensions have been mounting as a result of the slow implementation of his election promises. Promises such as fighting corruption, land reforms and improving urban housing are implemented slowly because of Lugo's weak and ideologically diverse coalition. In addition, President Lugo is currently at the centre of a scandal. Formerly a priest, he allegedly fathered three children, one of them a currently one-year old baby, before he was released of his vows by the pope recently. Besides managing the impact of the economic downturn, the main political issue in Paraguay, however, revolves around land reforms. The government's planned land reforms are at the basis of the tension. Landless farmers are unhappy with the fact foreign owners control a large part of agricultural land while local farmers are left without enough land to cultivate. These foreign owners are mostly Brazilians who have large soya estates in Paraguay. However, the government has to tread carefully because soy producers form a powerful interest group. At the same time, the landless farmers are an important part of President Lugo's support base. In response to the regular land invasions by the landless farmers, the government has banned the sale of agricultural land to foreigners but opted not to redistribute land. Rather, it aims at rural development through financial assistance and investments in healthcare, roads and school. Although this will appease Lugo's supporters, it is unlikely to stop the sometimes violent land invasions, especially in the wake of declining agricultural activity caused by the drought. In the short-term, none of these issues is likely to undermine political stability. However, in the medium-term, President Lugo will have to make good on his election promises or risk losing his support base. International relations are good, although one issue deserves attention. This issue is related to the shared debt burden from the Itaipu hydroelectric project, which is jointly operated by Paraguay and Brazil. Paraguay wishes to lower its share of the debt burden because most of the energy that is generated is consumed by Brazil.

Paraguay

Selection of economic indicators	2004	2005	2006	2007	2008	2009e	2010f
Key country risk indicators							
GDP (% real change pa)	4.1	2.9	4.3	6.8	5.8	-3.5	2.1
Consumer prices (average % change pa)	4.3	6.8	9.6	8.1	10.2	4.8	7.0
Current account balance (% of GDP)	2.1	0.7	2.4	1.1	-1.5	-2.3	-2.1
Total foreign exchange reserves (mln USD)	1168	1297	1702	2462	2845	2530	2480
Economic growth							
GDP (% real change pa)	4.1	2.9	4.3	6.8	5.8	-3.5	2.1
Paraguay, Gross fixed investment (% real change pa)	5.0	8.2	2.5	14.4	11.0	-10.0	1.8
Paraguay, Private consumption (% real change pa)	4.5	3.9	5.1	6.2	5.4	-4.0	1.5
Paraguay, Government consumption (% real change pa)	6.0	11.5	4.0	5.3	4.3	4.5	3.5
Paraguay, Exports of G&S (% real change pa)	8.1	5.5	14.6	9.6	6.5	-7.0	2.4
Paraguay, Imports of G&S (% real change pa)	6.7	11.3	16.5	10.8	7.8	-8.8	1.7
Economic policy							
Budget balance (% of GDP)	1.6	0.8	0.5	1.0	0.2	-1.9	-1.0
Public debt (% of GDP)	48.1	40.0	30.8	26.1	23.9	32.0	32.4
Paraguay, Money market interest rate (%)	1.3	2.3	8.3	3.9	4.5	5.0	4.0
M2 growth (% change pa)	15.7	9.8	8.7	29.5	12.2	5.0	11.2
Consumer prices (average % change pa)	4.3	6.8	9.6	8.1	10.2	4.8	7.0
Exchange rate LCU to USD (average)	5975	6178	5635	5033	4363	5797	7031
Recorded unemployment (%)	7.3	5.8	6.7	5.6	5.4	7.9	7.4
Balance of payments (mln USD)							
Current account balance	143	53	219	126	-239	-280	-230
Trade balance	-244	-463	-613	-545	-1100	-870	-890
Export value of goods and services	2861	3352	4409	5463	6614	4520	4980
Import value of goods and services	3105	3814	5022	6008	7714	5400	5870
Services balance	327	349	425	391	540	410	440
Income balance	-134	-58	-19	-93	-47	-50	-40
Transfer balance	194	224	426	373	368	230	260
Net direct investment flows	32	47	179	189	116	50	60
Net portfolio investment flows	0	0	0	0	0	0	0
Net debt flows	57	-275	173	55	-4	-90	230
Other capital flows (negative is flight)	-47	304	-167	390	510	10	-100
Change in international reserves	185	129	405	760	383	-310	-50
External position (mln USD)							
Total foreign debt	3607	3229	3426	3492	3499	3410	3640
Short-term debt	666	513	711	851	832	580	630
Total debt service due, incl. short-term debt	308	332	269	284	285	300	280
Total foreign exchange reserves	1168	1297	1702	2462	2845	2530	2480
International investment position	-1373	-640	-130	-187	n.a.	n.a.	n.a.
Total assets	2855	3472	4422	4613	n.a.	n.a.	n.a.
Total liabilities	4228	4112	4551	4800	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-3.5	-6.2	-6.6	-4.7	-7.1	-7.3	-8.2
Current account balance (% of GDP)	2.1	0.7	2.4	1.1	-1.5	-2.3	-2.1
Inward FDI (% of GDP)	0.5	0.7	2.0	1.7	0.7	0.4	0.5
Foreign debt (% of GDP)	51.9	43.2	36.9	30.1	22.5	28.6	33.8
Foreign debt (% of XGSIT)	93.7	72.1	57.6	49.8	42.3	58.8	57.0
International investment position (% of GDP)	-19.8	-8.6	-1.4	-1.6	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	8.0	7.4	4.5	4.1	3.4	5.1	4.4
Interest service ratio incl. arrears (% of XGSIT)	4.4	3.2	2.6	2.3	1.5	1.9	1.9
FX-reserves import cover (months)	5	4	4	5	4	6	5
FX-reserves debt service cover (%)	380	391	633	867	998	850	874
Liquidity ratio	118	113	123	125	122	123	126

Source: EIU