

## Paraguay: Country outlook

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FROM THE ECONOMIST INTELLIGENCE UNIT

**DOMESTIC POLITICS:** Although the risks are rising, the Economist Intelligence Unit does not expect opposition congressmen to try to impeach the president, Fernando Lugo. But governability is set to remain weak, amid simmering government-opposition relations and Mr Lugo's diminished popularity. He has recently taken steps to try to put a series of paternity scandals that damaged his standing last year behind him and has held meetings with businessmen to improve frosty relations, but we consider this will do little to improve his beleaguered position. A Honduran-style removal of the president is unlikely, since in recent years the armed forces have been institutionalised and are unlikely to mastermind or support an institutional rupture, while sufficient politicians in the opposition, with their sights set on regaining the presidency in 2013, are also likely to see their ambitions most favoured by the current government completing its full term in a weakened position. Our forecast remains based on the assumption that Mr Lugo (of the Alianza Patriótica para el Cambio, or APC) will serve out his five-year term ending in 2013.

**INTERNATIONAL RELATIONS:** Relations with Brazil and international donors will dominate the agenda. Ties with Brazil could sour if ratification of the new Itaipu treaty is delayed. Land invasions, mainly targeting Brazilian soybean producers, which have increased during Mr Lugo's term, are likely to continue. Despite ideological similarities between Mr Lugo and Venezuela's president, Hugo Chavez, Mr Lugo will remain wary of aligning himself too closely, partly because of the tensions it would cause with forces opposed to Mr Chavez in Congress. Mr Lugo will maintain working bilateral relations with the US, despite his recent decision to curtail joint military exercises on Paraguayan soil.

**POLICY TRENDS:** Paraguay's relatively weak fiscal and financial position will complicate efforts to support a recovery from the 2009 recession and deliver on Mr Lugo's campaign promises to improve the livelihoods of the poor, which account for around 40% of the population (around 50% in rural areas) according to the 2008 census. Mr Lugo is maintaining the orthodox macroeconomic framework adopted in 2003 by the government of Nicanor Duarte Frutos (2003-08). Continuity is being provided by the minister of finance, Dionisio Borda, whose track record has earned him credibility. Assisted by increased multilateral financing, Paraguay has some room to maintain the countercyclical policies adopted last year over the next 12 months, but policymakers will need to remove the stimulus later in the forecast period. The challenging economic environment, coupled with the Lugo administration's weak implementation capacity and a strong opposition in Congress, will weigh on the business environment and compound the government's difficulties in delivering on promised improvements in social conditions. It is uncertain when the extra Itaipu revenue will materialise: the extra revenue would be around 1.5% of GDP and will be used in part to raise social expenditure. It has not been formally incorporated into the 2010 budget, so delays would not imperil this year's fiscal and financing programme.

**INTERNATIONAL ASSUMPTIONS:** We expect that global economic activity will pick up more steam on the back of fading inventory reductions and aggressive fiscal and monetary stimulus. But there will be a fallback in some developed markets in 2011, as the stimuli wane against a background of continued fragile corporate and household sentiment. However, Brazil (Paraguay's largest export market) will grow by 4.5%. Paraguay's terms of trade are forecast to weaken slightly. But soybean prices will be high by historical standards in 2010-11, supporting agricultural production and exports and providing an income boost to overall GDP growth. Oil prices are expected to average US\$72.5/barrel, weighing moderately on Paraguay, an oil importer.

**ECONOMIC GROWTH:** After falling by 3.8% in 2009, owing to drought that caused the key agricultural sector (excluding livestock) to contract by 24% and, to a lesser extent, the impact of the global financial crisis, we expect real GDP to pick up in 2010-11 to an annual average of 4.1%, on the assumption of a return to normal weather conditions, which will lift agricultural production, and a pick-up in external demand,

particularly from Brazil. Last year's contraction was sharp in the first half (5.6%), but a recovery began in the third quarter. Nonetheless, for the year as a whole, investment and exports experienced sharp declines and private consumption fell by an estimated 3.5%, and these factors were only partly offset by a double-digit rise in government spending, as a result of fiscal stimulus, and a sharp contraction of real import volumes. Our forecast for growth of 4.2% in 2010 assumes a recovery in private consumption (lifted by positive income effects from a bumper soya harvest), investment and exports, as well as an increase in government spending. The forecast also assumes that the contribution from the external sector will be positive. In line with a softening of growth in key export markets in 2011, GDP growth will ease slightly, to 4%.

**INFLATION :** After easing in 2009 owing to the contraction in domestic demand, inflation will pick up to above 5% in 2010-11 as the forecast recovery in domestic demand and relatively high oil prices exert price pressures. Annual consumer price inflation fell swiftly last year, to 1.1% in July, and is now on the rise. However, the rise is expected to be gradual since the economic recovery will not close the output gap in its early stages, before inflation picks up later in 2010 as economic expansion creates more demand-side pressures. Annual producer price inflation is still slightly negative, but will turn positive in the fourth quarter and rise as the economy recovers and the effects of the rebound in oil prices since the lows earlier in 2009 feed through.

**EXCHANGE RATES:** Assuming a strengthening of the US dollar in 2010, we expect mild nominal currency depreciation, but the guarani will remain around 10% stronger than its real effective exchange rate in the past 15 years. Nevertheless, a stronger currency is supported by productivity gains in the agricultural sector. Our currency forecasts assume that a planned US\$200m bond issue goes ahead in 2010, with the guarani ending 2010 at G5,015:US\$1 and 2011 at G5,137:US\$1. Ample reserves coverage will help sustain the guarani (reserves have recovered from the falls in the fourth quarter of 2008 and have risen to record levels of US\$3.8bn at end-2009). As the US dollar weakened in late 2009, the Banco Central del Paraguay (BCP, the Central Bank) intervened, but the guarani ended the year at G4,581:US\$1, a real appreciation of 8.5%.

**EXTERNAL SECTOR:** After a narrowing of the current-account deficit to 0.9% of GDP in 2009, we expect a widening to an average of 2.1% of GDP in 2010-11 as imports pick up. Export earnings fell by 24% in 2009 and imports by 23%, but the rate of decline decelerated in the second half of the year, and as the local and external environment recovers Paraguayan trade will turn around in 2010, but will not recover to 2008 levels until 2011. The trade deficit as a share of GDP is expected to rise from 6.9% in 2009 to 8.4% in 2010 and 9.3% in 2011 as import demand recovers. The service surplus will rise in GDP terms in 2010-11 as both energy demand in Brazil and Argentina rises, lifting inflows of binational hydroelectricity royalties, and the Itaipu bonus comes on stream.

**SOURCE:** Country Outlook