Rabobank

Country report

PARAGUAY

Summary

Paraguay has posted a very high economic growth rate in 2010, thanks to rapid growth of exports of soybeans and meat. However, the economic structure of the country remains weak, in particular through the strong dependence on agricultural export products. Furthermore, political and social risks are relatively high because of the large social inequalities and the strained relationship between left-wing president Lugo and the congress, which is dominated by the conservative forces that ruled Paraguay until 2008. Paraguay’s institutions are weak, although some improvement has been realized in recent years. Despite a small tax basis, public debt is now low, thanks to fiscal consolidation, particularly in the pre-crisis years. While foreign debt is rather low, foreign exchange reserves have grown strongly, which results in an acceptable external position.

Things to watch:

- The strained relationship between president Lugo and the opposition-controlled congress.
- Prices of agricultural commodities, in particular soybeans
- The weather in Paraguay, an important determinant of agricultural production

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Paraguay

National facts	
Type of government	Constitutional republic
Capital	Asuncion
Surface area (thousand sq km)	406
Population (millions)	6.4
Main languages	Spanish Guarani
Main religions	Roman Catholic (90%) Protestant (6%)
Head of State (president)	Fernando Armindo Lugo
Monetary unit	guarani (PYG)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	17	0.03
Nominal GDP at PPP	32	0.04
Export value of goods and services	9	0.05
IMF quotum (in mln SDR)	100	0.05
Economic structure	*2010*	*5-year av.*
Real GDP growth	10.0	3.2
Agriculture (% of GDP)	22	23
Industry (% of GDP)	18	20
Services (% of GDP)	60	58
Standards of living	*USD*	*% world av.*
Nominal GDP per head	2565	26
Nominal GDP per head at PPP	4895	42
Real GDP per head	1440	18

Social and governance indicators	rank / total
Human Development Index (rank)	96 / 169
Ease of doing business (rank)	106 / 183
Economic freedom index (rank)	77 / 179
Corruption perceptions index (rank)	146 / 178
Press freedom index (rank)	54 / 178
Gini index (income distribution)	53.2
Population below $1 per day (PPP)	3%

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Argentina	21	Brazil	30
Brazil	17	Argentina	23
Uruguay	11	China	16

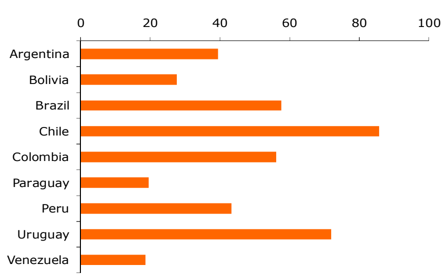
Main export products (%)	
Soybeans	25
Meat products	18
Cereals	14
Wood	3
Main import products (%, 2008)	
Capital goods	38
Intermediate goods	33
Consumer goods	28
Openness of the economy (2010)	
Export value of G&S (% of GDP)	55
Import value of G&S (% of GDP)	59
Inward FDI (% of GDP)	2.2

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

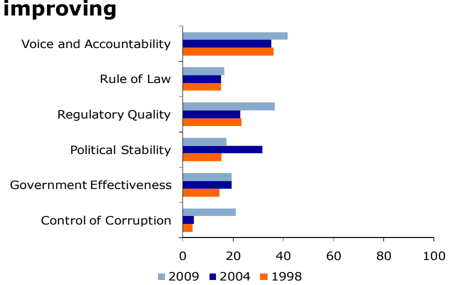
Paraguay is one of the poorest countries of South America and has a weak economic basis. As can be seen in chart 1 and 2 the country's institutions are weak. Corruption is endemic, property rights are weak and the effectiveness of the government is low. Nonetheless, in most areas the trend is clearly upward. The country is rich in natural resources, but the level of diversification of the economy is very low. Paraguay is the world's fourth largest producer of soybeans. It is the most important export product of the country, accounting for 25% of total exports. Soybean farming has grown drastically in the last fifteen years, with the area used for soybean cultivation increasing

Chart 1: Government effectiveness low



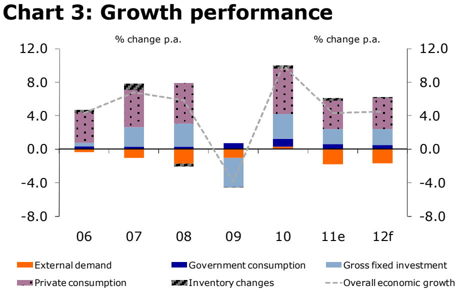
Source: World Bank (maximum score = 100)

Chart 2: Quality of governance low but improving



Source: World Bank (maximum score = 100) from 1mln hectares in 1996 to 2.7mln in 2010. Other important export products are meat, vegetable oils and cereals, underlining the strong dependence of the economy on agriculture. Indeed, agriculture accounts for 20% of GDP and nearly 50% of total employment. Subsistence farming is still highly prevalent and land ownership on the countryside is very concentrated, leaving a large part of the rural population (at least officially) landless. Unemployment is high, and a relatively large part of the economy is informal. Paraguay has huge hydroelectric resources. Together with Brazil, the country operates the Itaipu dam, which is the world's second largest hydro dam. Furthermore, in late 2010 a large deposit of ilmenite, a titanium ore which can be used to make a base pigment in paint, paper and plastics, was discovered. Processing ilmenite is very energy intensive. As Paraguay has cheap energy through hydro dams such as the Itaipu dam, the country may turn into a major producer and processor of the ore, which would give a boost to the development and the diversification of the economy. The existing importance of agriculture not only makes the country vulnerable to a fall of prices of a narrow range of agricultural export products, but also to the weather. This was clearly demonstrated in 2009, when the effects of the global economic crisis were augmented by a drought, resulting in a contraction of the economy of 3.5%. However, in 2010 the country turned into Latin America's growth champion. According to preliminary government estimates, GDP may have grown by 14.5%[1], thanks to record beef and soybean exports. As the rapid growth in 2010 was partially the result of good weather (and bad weather in 2009), growth in the coming years will be lower. Nevertheless, the country should be able to post growth of around 5%. However, an important condition for realizing the growth potential is the maintenance of a minimum of political stability.

Chart 3: Growth performance



Source: EIU

Chart 4: Public finances

Source: EIU

Political and social situation

Political stability is surely not guaranteed in Paraguay, a country with a turbulent political history. In 2008, the Colorado party, which had ruled Paraguay more or less for sixty years, including through a dictatorship between 1954 and 1989, lost the presidential elections. Fernando Lugo, a former bishop, was chosen president, after his promise of realizing social change in socially unequal Paraguay found widespread popular support. It was the first time in Paraguayan history that power was handed to the opposition in a peaceful manner. However, the party of the so-called "bishop of the poor" was not in control of parliament. Thus, the relations between the president and the parliament were difficult, and there were even calls among the opposition for his impeachment. Nonetheless, the congress has cooperated with Lugo on the budget and some of his most important policy reforms. New uncertainty arose in the summer of 2010, when Lugo was hospitalized after he had been diagnosed as having non-Hodgkin's lymphoma, a form of cancer. Lugo returned to Paraguay from a Brazilian hospital in December 2010. According to the

[1] The graphs and tables are based on the EIU growth estimate for 2010, which is still 10%.

government, he has recovered and is now able to take up once again all his responsibilities as president. Relations between Lugo and the army leadership have also been strained and Lugo has fired high army leaders on several occasions. In September 2010, the last time such a shakeup took place, the government said it was not related to politics, but we note that the previous shakeup of November 2009 was accompanied by rumors of a coup. Meanwhile, the Colorado party won the late 2010 local elections, which may embolden it to once again take up a more combatant approach towards the president. Lugo has not made much progress when it comes to land reform and the fight against corruption, which were two important themes of his campaign. The popularity among the electorate of these themes is understandable given the endemic corruption, the high rate of poverty and the wide social inequalities in the country.
Under Lugo, relations with the United States have remained good. Traditionally, the landlocked country had limited foreign political relations, with most contact taking place with Paraguay's large neighbors Argentina and Brazil. However, the Lugo administration has opened diplomatic relations with 20 countries in Africa and the Middle East. External political risk is limited. Overall though, political and social risks remain high.

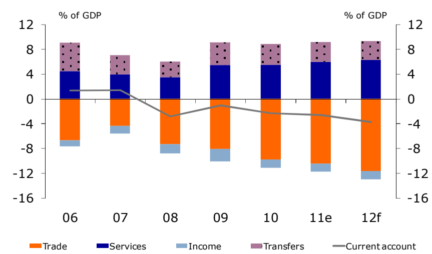
Economic policy

When Lugo was elected, there were some concerns within the investor community about his economic policies, as he had always been an advocate for social change. However, more or less like the Lula administration in Brazil, Lugo has chosen to maintain the rather sound macroeconomic framework, while trying to improve the position of the poorest through more investment in low-income housing and conditional cash transfers. The number of families receiving support from the Tekopora, the conditional cash transfer program, increased from 15,000 in 2009 to 100,000 in 2010. Furthermore, the government has also increased investment in infrastructure, which is more than welcome, as the economic development of Paraguay is constrained by the low level of development of the infrastructure. However, with a tax ratio of 12.7% of GDP, tax revenue of the government is very low, which limits the ability of the state to provide basic government services. The VAT is by far the most important source of government revenue, while the agricultural sector is hardly being taxed. Furthermore, tax collection is constrained by the weak tax administration. Sales of electricity generated at the Itaipu hydro dam to Brazil is another important source of government revenue. The dam now accounts for 20% of government income, and this percentage is likely to increase once the Brazilian congress approves an agreement in principle between the two countries to increase the price Paraguay receives for its electricity exports to Brazil. Despite the narrow income basis, the fiscal position of the government looks sound. Especially in the pre-crisis years the government ran large primary surpluses which helped to bring down public debt from 51% of GDP in 2003 to 23% of GDP in 2010. The government's debt management used to be very weak. However, in recent years the establishment of a specific debt management office within the ministry of Finance has resulted in improvements, although there is certainly room for further improvement. Important from a country risk perspective is the fact that Paraguay's government has no tradition of interference in the important and predominantly foreign owned agricultural sector. At the same time, there is social strain over the very unequal distribution of land. Inflation has increased strongly from 1.9% year-on-year (yoy) in December 2009 to 7.2% yoy in December 2010. Food price inflation in particular has been high, with a rise from 4.4% yoy in December 2009 to 11.2% in December 2010. Nevertheless, inflation is still within the 2.5% to 7.5% inflation target band for 2010 and 2011. The central bank aims to move gradually to an inflation targeting regime. However, the effectiveness of monetary policy is still constrained by the low level of development of the capital markets. Furthermore, the economy is still heavily dollarized, although dollarization has gone down with the percentage of private sector credits denoted in foreign currency declining from 47% in 2005 to 39% in late 2009.

Balance of Payments

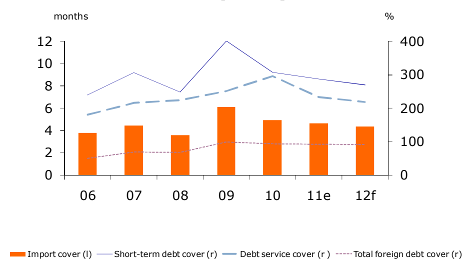
Since 2008, Paraguay has been running current account deficits. While the services account (partially through the aforementioned electricity sales to Brazil) and transfers account (through remittances) are structurally in surplus, the deficit on the trade account has been growing in recent years. The current account deficits have been partially covered by growing net inflows of FDI, which rose to 2.2% of GDP in 2010, up from 1.4% of GDP in 2008. Portfolio lending is nil, but there were some debt inflows, mostly through officially guaranteed loans. Furthermore, there have been large inflows of other kinds of capital transactions, especially in 2008 and 2009. These flows are likely to be related to repatriations of foreign assets of Paraguayan citizens and companies in the face of the global financial crisis. As a result, foreign exchange reserves have grown markedly in recent years. The most important balance of payment risk is the dependence on a small number of agricultural export products. This could have adverse effects should Paraguay be hit by bad weather, or should the prices of these commodities plunge.

Chart 5: Current account



Source: EIU

Chart 6: External liquidity



Source: EIU

External position

Foreign debt is at low and manageable levels and has grown only modestly recently. Most medium- and long term debt is owed to official creditors. Multilateral institutions have been the most important source of medium- and long term loans, as these accounted for roughly half of Paraguay's total medium- and long term debt of USD 3bn. At the same time, foreign exchanges reserves have grown rapidly from USD 1.7bn in 2006 to USD 4.1bn in 2010. Foreign reserves were equal to 5 months of imports in 2010, which we consider an acceptable level.

Paraguay

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	4.3	6.8	5.8	-3.8	10.0	4.3	4.5
Consumer prices (average % change pa)	9.6	8.1	10.1	2.6	4.5	5.7	5.2
Current account balance (% of GDP)	1.4	1.4	-2.8	-1.1	-2.3	-2.6	-3.7
Total foreign exchange reserves (mln USD)	1702	2462	2845	3839	4062	4210	4360
Economic growth							
GDP (% real change pa)	4.3	6.8	5.8	-3.8	10.0	4.3	4.5
Gross fixed investment (% real change pa)	2.5	14.4	15.8	-18.0	18.5	10.0	10.0
Private consumption (real % change pa)	5.1	6.2	6.8	0.0	7.2	4.7	5.1
Government consumption (% real change pa)	4.0	3.0	3.5	9.0	10.0	7.0	5.0
Exports of G&S (% real change pa)	14.6	8.1	12.1	-14.0	20.4	6.4	7.1
Imports of G&S (% real change pa)	16.5	10.7	15.9	-12.0	19.2	9.6	9.9
Economic policy							
Budget balance (% of GDP)	0.5	1.0	2.6	0.1	0.0	-1.1	-1.1
Public debt (% of GDP)	31	25	23	23	23	22	22
Money market interest rate (%)	8.3	3.9	4.5	5.0	4.5	5.0	5.0
M2 growth (% change pa)	9	29	12	11	19	13	12
Consumer prices (average % change pa)	9.6	8.1	10.1	2.6	4.5	5.7	5.2
Exchange rate LCU to USD (average)	5635.5	5032.7	4363.2	4965.4	4771.2	4980.0	5100.9
Recorded unemployment (%)	6.7	5.6	5.4	7.9	6.9	6.6	6.3
Balance of payments (mln USD)							
Current account balance	128	172	-444	-149	-382	-450	-700
Trade balance	-621	-533	-1173	-1134	-1630	-1830	-2190
Export value of goods	4401	5652	7772	5784	7579	8370	9100
Import value of goods	5022	6185	8945	6917	9209	10200	11290
Services balance	414	487	550	762	911	1030	1170
Income balance	-92	-155	-234	-286	-213	-230	-240
Transfer balance	426	373	414	508	550	570	560
Net direct investment flows	167	199	219	266	360	380	380
Net portfolio investment flows	0	0	0	0	0	0	0
Net debt flows	173	39	408	13	458	230	240
Other capital flows (negative is flight)	-63	349	217	869	-216	0	240
Change in international reserves	405	759	402	999	220	150	150
External position (mln USD)							
Total foreign debt	3422	3570	4163	3883	4341	4570	4810
Short-term debt	711	803	1146	956	1323	1470	1620
Total debt service due, incl. short-term debt	942	1143	1271	1529	1372	1810	2000
Total foreign exchange reserves	1702	2462	2845	3839	4062	4210	4360
International investment position	-70	-276	-425	-99	n.a.	n.a.	n.a.
Total assets	4515	4842	5347	6032	n.a.	n.a.	n.a.
Total liabilities	4585	5118	5772	6131	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-6.7	-4.4	-7.3	-8.1	-9.8	-10.5	-11.7
Current account balance (% of GDP)	1.4	1.4	-2.8	-1.1	-2.3	-2.6	-3.7
Inward FDI (% of GDP)	1.9	1.7	1.4	2.0	2.2	2.1	2.0
Foreign debt (% of GDP)	37	29	26	28	26	26	26
Foreign debt (% of XGSIT)	58	49	43	49	43	41	40
International investment position (% of GDP)	-0.8	-2.3	-2.7	-0.7	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	16	16	13	19	14	16	17
Interest service ratio incl. arrears (% of XGSIT)	3	2	2	1	1	1	1
FX-reserves import cover (months)	3.8	4.4	3.6	6.1	4.9	4.6	4.4
FX-reserves debt service cover (%)	181	215	224	251	296	233	218
Liquidity ratio	121	125	118	132	127	121	117

Source: EIU