

Paraguay Economic Outlook

Second Half 2014
Economic Analysis

- Overall activity will rise by 3.2% in 2014, which is similar to that of 2013, and we expect that this will then accelerate in 2015 to 3.7%, an effect to which both the advanced and emerging economies will contribute.
- Growth so far this year has been below the levels expected, standing at 3.5% for the first half of 2014. Factors such as public spending being lower than originally budgeted for, the slowdown in the Brazilian economy and slower growth in the agricultural and energy sectors (after reaching record levels in 2013) have contributed to this slowdown in growth.
- We expect to see GDP growth of 3.8% and 4.2% for 2014 and 2015, respectively. The buoyancy of the economy will tend to revert to more sustainable levels, in line with potential GDP, which we estimate at around 4.5%.
- We have maintained our inflation forecast of 4.7% for the end of 2014 and 5% for 2015. Inflation will remain in line with Central Bank targets; hence, we do not expect to see movements in the rate over the coming months.
- The main risk factors for Paraguay: trading partners experiencing a sharper slowdown and a fall in the soybean price.

Table of Contents

1. Summary	3
2. Slow global recovery with greater financial volatility	4
3. Paraguay: we forecast growth of 3.8% and 4.2% for 2014 and 2015	6
Box 1. The soybean price and its effect on activity	11
4. Fiscal accounts will continue to show a deficit	14
5. A smaller deficit in external accounts reduces vulnerability to volatility in the global financial markets	16
6. Inflation will remain within the PCB meta range.....	18
7. Main risks	19
8. Tables.....	20

Closing date: 15 November 2014

1. Summary

Overall activity will rise by 3.2% in 2014, which is similar to that of 2013, and we expect that this will then accelerate in 2015 to 3.7%. This recovery will be seen in both the advanced and the emerging economies. In particular the US will advance 2.0% this year and 2.5% in 2015. This outlook is generally supported by the indicators relating to activity, spending and jobs, which all point to a consolidation of economic strength, along with the prudent stance taken by the Fed in the face of these improvements. As regards the emerging economies, we believe that both the Latin American and Asian economies will perform better over the coming year. One of the exceptions will be China, where growth will continue to move towards more sustainable rates and will slip back from 7.2% in 2014 to 7.0% in 2015. This will take place in an environment in which the country will continue to reshape the sources of its expansion, moving towards domestic demand and reducing risk in its financial system.

We have revised our growth forecast for the Paraguay economy down from 4.9% to 3.8% for 2014 and from 4.3% to 4.2% for 2015. This adjustment is mainly due to the lower level of execution observed over the first six months of the year, and to less favourable external conditions (a significant fall of around 15% in soybean prices so far this year and weakening of the Brazilian economy). Despite the expected slowdown in growth, the Paraguayan economy continues to expand at one of the fastest rates recorded among all the countries in the region. The lower levels of activity as compared with 2013 are due to the normalisation of growth towards levels that are more sustainable (following record production in the agricultural and energy sectors) and more in line with potential GDP, which we estimate to be in the region of 4.5%.

Our projection scenario is based on investment of around 4.9% over the course of this year, a figure that will increase somewhat over 2015 and 2016 (to around 6%), as the reforms aimed at boosting the execution of public spending and promoting private spending (such as the Public-Private Associations Act, the “APP”) begin to take shape. **The prospects remain good in the agribusiness sector, which accounts for between 40% and 50% of GDP.** The record levels of production recorded over the past two soybean seasons will mean it will be difficult for agriculture to record levels of growth similar to those seen in 2013. However, it is not expected that there will be any slowdown in production, and climate-related factors are not giving rise to any significant concerns for the time being. Economic growth will not generate any pressure on demand, and we therefore **expect inflation to remain at around the established meta range (5%). We also expect the central bank to keep its benchmark rate at the current level.**

As regards the fiscal result, we expect a deficit of 1.7% of GDP, falling to -1.5% in 2015, in line with the Fiscal Transparency and Responsibility Act (“LTRF”), which became law in 2013. Nevertheless, this deficit will not represent any risk to the sustainability of the country’s fiscal accounts, bearing in mind that the government’s gross borrowings are among the lowest in the region at around 12% of GDP.

The main risk to growth in Paraguay comes from the outside. The lower growth recorded in the Mercosur countries, particularly Brazil, will greatly affect economic activity in Paraguay, given the levels of commercial activity (re-exports, among other things) between these countries.

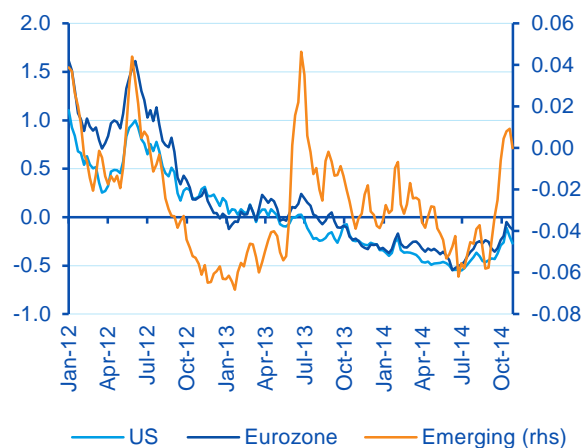
2. Slow global recovery with greater financial volatility

World growth is still rising, closing 2014 at 3.2% in 2014 and 2015 at 3.7%. But financial tensions and geopolitical risks are on the increase as well

Global economic growth continued in the third quarter. However, quarterly growth is very moderate in the more developed economies, and of these, more in Japan and the eurozone than in the US.

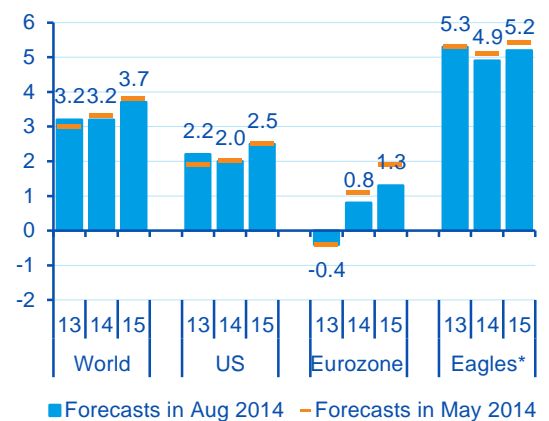
The confidence indicators for September remain consistent with the expansion of manufacturing activity, although it has been some months since they stopped improving in the key economic areas. An additional sign of the fragility of the present cyclical recovery is the uptick of the tension indicators in the financial markets since mid-September. In the case of the emerging economies (EMs), these have reached levels not seen since May 2013 (Figure 2.1). Then the market discounted a rapid withdrawal of Fed stimuli that actually never happened and is still pending. At the same time, geopolitical risks have been multiplying and negative surprises are building up on the consensus in the activity indicators, particularly in the eurozone and South America.

BBVA Research Financial Tensions Index



Source: BBVA Research

GDP growth forecasts (%)



* EAGLES is the group of emerging economies which will contribute most to world GDP in the next 10 years. Group made up of China, India, Indonesia, Brazil, Russia, Turkey and Mexico.
Source: BBVA Research

Altogether, the most likely scenario is that global growth improved from the second to the third quarter, rising from 0.6% QoQ to an estimated 0.8% respectively. However, there is downside risk to these figures given that the industrial activity indicators and world trade in September could still moderate, and the effects of the financial volatility on confidence could be more persistent than we expect. Also, there are the geopolitical risks associated with the situation in Syria and Iraq and the fragile agreement between Ukraine and Russia. It is worth noting that sanctions are already having an impact on activity in important sectors such as Russian energy.

In this context, monetary policy will remain focused on supporting activity, while fiscal policy will be less restrictive in tone in 2014-15 in both the US and the eurozone than in the recent past.

Even in China, together with the budget consolidation at the local and regional government level it is felt that additional measures to support growth could be implemented.

Finally, we must point to the fall in oil prices as a favourable factor for global growth expectations although not for exporter countries to the extent that this is a result of a positive supply shock.

Growth in the US remains in line with expectations, and is likely to reach 2.5% in 2015

After the unexpected and transitory drop in activity in 1Q14, the activity, spending and employment indicators have recovered, implying that the pace of GDP growth could be around 2.5% in the second half of the year, and thus average 2% for 2014 as a whole (Figure 2.2). The role of the Fed, which emphasises caution and patience before acting on the signs of improvement in the economy, continues to support our scenario of a cyclical recovery in the US underpinned by the solid creation of employment and the increase in household wealth.

Our outlook for China is unchanged, but with a downward bias due to the external environment and the supervision of shadow banking

In the third quarter GDP growth continued to decelerate, to 7.3%, reflecting the moderation in domestic activity, particularly in the construction and real estate sectors, but partially offset by an unexpected and intense upturn in exports. We maintain our outlook for GDP growth at 7.2% in 2014. Altogether, the risks to growth in China continue to be to the downside from 2015 onwards (7.0%), precisely because of the brake on external demand that the situation in Europe might imply and the adjustment underway in the real estate sector in a context of high leverage and the introduction of measures to control its less regulated banking system.

China is facing the task of managing the present deceleration of economic growth while reducing its financial risks and rebalancing growth in favour of domestic demand. In this scenario, the authorities will intervene so that the deceleration does not intensify, and growth does not fall below the targets set. Thus we would not be surprised to see additional monetary policy easing (with cuts in the reserve ratio or liquidity injections), expansive central government fiscal policy (albeit with consolidation at the local government level) and on-going execution of structural reforms.

In the eurozone the recovery will be even slower than we were expecting

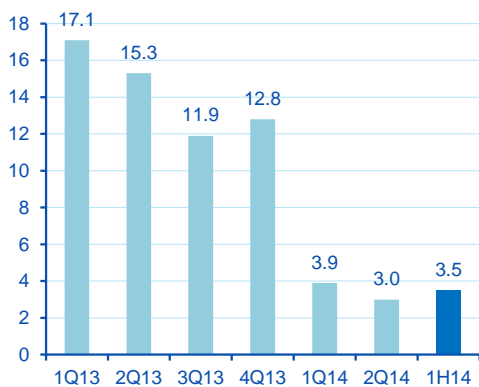
The stagnation of GDP growth in the second quarter, with weaker performances in general in the larger economies, has led us to revise our outlook for growth in the region downwards for 2014 and 2015 (Figure 2.2). The Ukraine/Russia crisis is having an impact on trade and the confidence indicators of the economies in the centre of Europe, including Germany. The ECB has continued to take action, with measures designed to bring inflation expectations more closely into line with the objective of price stability, which have been de-anchoring since 2012. In our most likely scenario, euro depreciation has to make a contribution, given the different expectations of Fed and ECB actions, with a withdrawal of stimuli by the former and balance-sheet expansion by the latter.

3. Paraguay: we forecast growth of 3.8% and 4.2% for 2014 and 2015

Growth in 2014 tailed off slightly compared to the strong growth registered the year before. The slowdown in levels of activity has been rather greater than expected

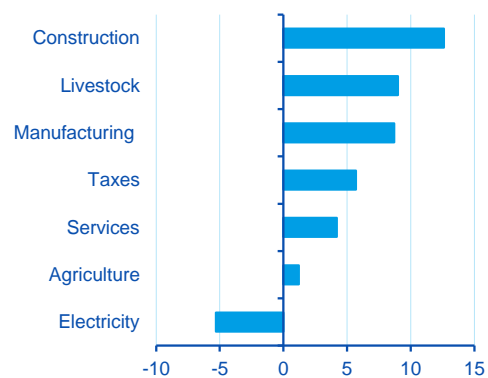
In 2Q14, GDP grew by 3.0% YoY (3.9% in Q1), reaching 3.5% YoY for the first half year (see Figure 3.1), which was below the figure expected in our previous forecast. The activities that performed better included construction (see Figure 3.2), which recorded an overall YoY growth figure of 12.6% for the first half year as the result of initiatives in the private sector. Another activity that performed strongly was the livestock sector, which grew by 9.0% over a similar period, boosted by an increase in beef production, the result of the good positioning of Paraguayan meat on the international markets and the recovery of its status as a “country free of foot-and-mouth disease where vaccination is practised” according to the World Organisation for Animal Health (OIE), which has allowed it once again to export to a number of international markets from which it was excluded in 2011. Also notable was the significant growth in the agricultural sector, bearing in mind that the bar was set very high following the record production levels reached during the previous agricultural season. Its strong performance can be attributed to the high yields achieved in the main crops such as soybeans, wheat, rice and sugar cane, among others. We should add that the good performance of the agricultural sector has led to positive effects in other related sectors, such as industry and transport.

Figure 3.1
Paraguay: Quarterly GDP (% var. YoY)



Source: PCB, BBVA Research

Figure 3.2
GDP 1H14 by sectors (% var. YoY)

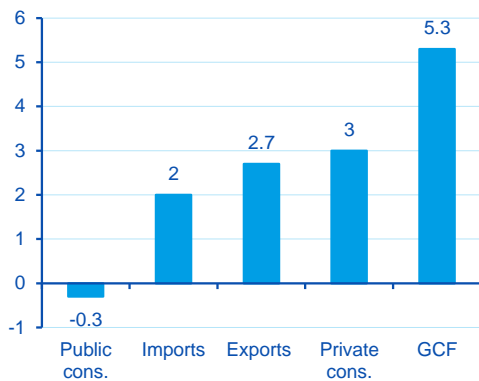


Source: PCB, BBVA Research

From a spending point of view (see Figure 3.3), the first six months of 2014 saw a YoY variation of 3.0% in private consumption, supported by a rise in nominal average monthly salaries for primary jobs of 1.9% as compared with the same period of 2013. The increase in private consumption contrasted with the fall in government spending (-0.3% over a similar period), while gross capital formation expanded at a rate of 5.3% over 1H14. On the public investment side, there was notable growth over the early months of the year compared with a similar period in the previous year. As a result, around USD400mn was spent on physical investments from January to August 2014, more than was spent in 2013 and an increase on the average of 280mn spent over previous years (see

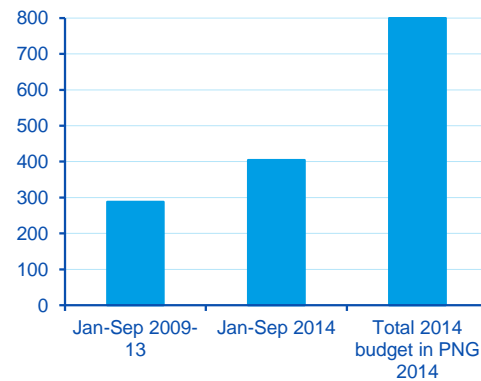
Figure 3.4). Nevertheless, it is predicted that the levels of execution achieved by the government this year will fall short of the amounts initially expected (they will probably reach around 65% of the total amount budgeted). We believe that the lower level of public investment, compared with the amounts budgeted, will cost the country around a half a percentage point of growth in GDP this year.

Figure 3.3
GDP 1H14
 (% var. YoY)



Source: PCB, BBVA Research

Figure 3.4
Execution of physical investment by central government (USD mn)

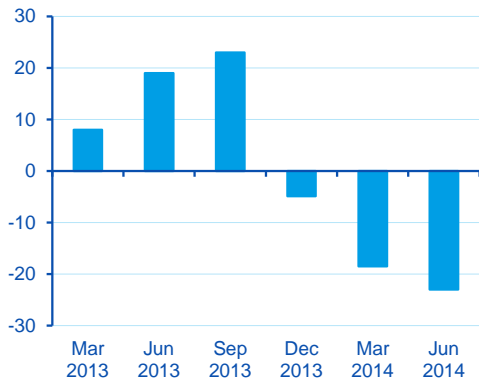


Source: PCB, Tax Office, BBVA Research

A number of different factors explain the lower-than-budgeted execution of public spending. First, management capacity has not improved in terms of either quantity or quality. In fact, the number of staff has fallen over recent months (see Figure 3.5), and only 6% of public sector workers are technically qualified. The existence of salary caps means that public sector pay is not so attractive, so it is difficult to win qualified people over from the private sector. To alleviate this problem in the short term, the government has engaged a project management company that will take charge of certain APP-associated projects and other projects regarded as a priority by the government. An institutional team has also been formed to take charge of the “green channel” project, the aim of which will be to speed up processes through the creation of a data centre that will offer reports on individual processes from all the bodies involved. Although such solutions may help to speed processes up in the short term, it will also be necessary to adopt structural measures that will improve the management of public investment (issues such as personnel training, salaries to match those of the private sector and the reduction of bureaucratic processes, among other things).

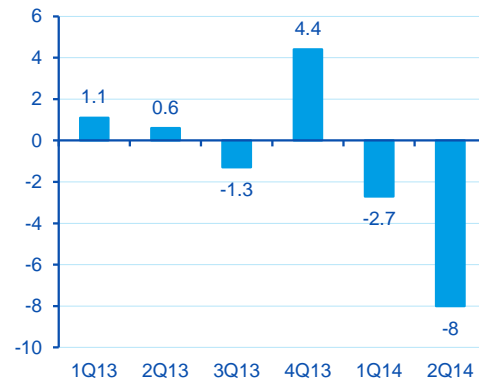
As regards external demand, exports recorded a year-on-year fall of 1.2% in 2Q14, explained mainly by the fall in electricity and soybean exports. It should be pointed out that both of these sectors, energy and soybeans, have recently hit record levels that would be difficult to beat. In the case of energy, production by the main hydroelectric plants has shrunk by 8% due to climate-related factors (lower rainfall), following record production in 2013. Given that this sector accounts for around 10% of GDP, its slowdown has stripped around 1 percentage point from the GDP growth figure (see Figure 3.6).

Figure 3.5
Variation in the number of public sector employees (% YoY)



Source: PCB

Figure 3.6
GDP electricity (% var. YoY)

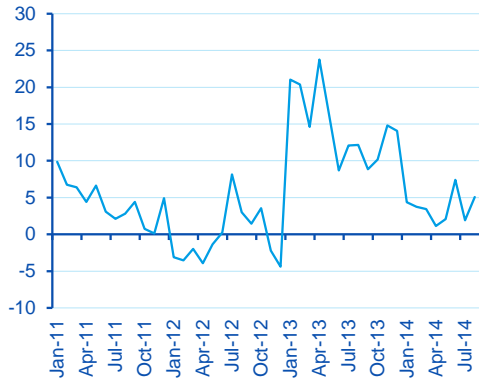


Source: PCB

The most recent indicators for activity, sales and confidence display mixed results, though generally speaking they suggest that in the second half of the year the Paraguayan economy has continued to perform at similar levels to the first six months. For example, the Monthly Economic Activity Index (IMAEP) published by the Central Bank (PCB) indicated a year-on-year variation of 5.1% in August, an improvement on both the 1.9% figure from the previous month and the 3.7% average for the first six months of the year (see Figure 3.7). We estimate that the average growth shown by this indicator for the year so far is consistent with a GDP growth figure of close to 4.0%. We should add that the index that excludes agricultural production and electricity generation (an indicator that is more closely linked to product trends and internal demand) also showed positive improvement (year-on-year growth of 7.7% in August 2014).

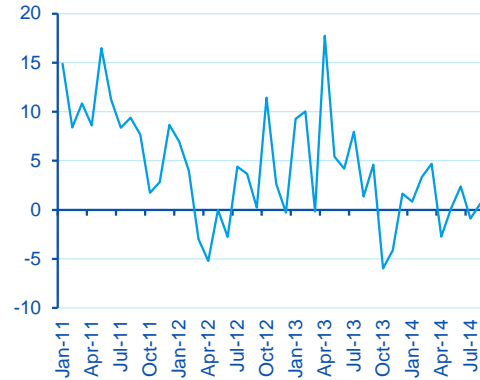
As regards sales, the Turnover Estimator has displayed a certain weakness over the course of the year (see Figure 3.8). Although sales in the industrial and manufacturing sectors have progressed favourably, along with automotive vehicle sales, some areas within the commercial sector such as department stores and clothing, household goods, pharmaceutical products and drinks and tobacco, among other items, performed poorly. It is worth mentioning here that exchange rate controls in Argentina have led to the emergence of an informal market that has affected retail sales of some items in Paraguay, such as cleaning products and personal hygiene items, among other mass consumer goods, all of which have shown significant falls.

Figure 3.7
Monthly economic activity index
 (% var. YoY)



Source: PCB, BBVA Research

Figure 3.8
Turnover estimator
 (three-month moving average)



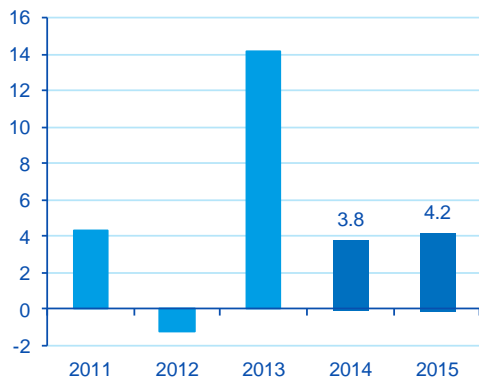
Source: PCB, BBVA Research

During the second four months of the year, the Business Confidence Index (ISCE) fell to 62 points, down from its previous score of 68.2 (which represented the highest level since the middle of 2011). The index thus moved from moderate optimism to discreet optimism. Factors such as competition, smuggling, uncertainty over the economic outlook, corruption, low skill levels among the workforce and inadequate infrastructure were regarded by employers and/or executives as the factors that were most responsible for holding back their businesses. In general terms, current and future expectations regarding variables such as production, sales, jobs, salaries and access to credit are positive.

The Paraguayan economy will move gradually towards a rate of growth that is more in line with its potential

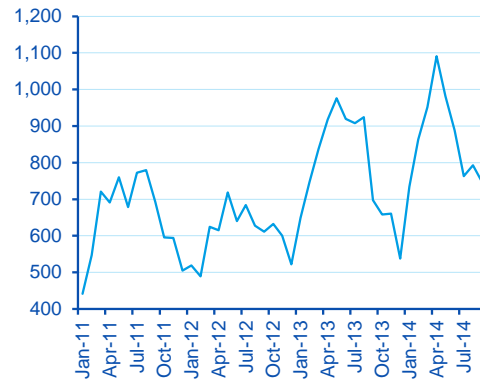
After growth of 14.2% recorded in 2013, we expect GDP to grow at a rate of 3.8% this year and 4.2% in 2015 (our earlier projection was for 4.9% and 4.3% respectively), see Figure 3.9. The downward adjustment in our estimate is due mainly to two factors. The first of these is lower growth than expected during the first six months of the year (3.5% versus 4.8%).

Figure 3.9
GDP growth and projections (% var. YoY)



Source: PCB, BBVA Research

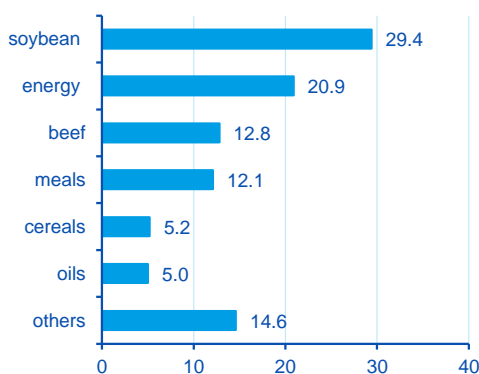
Figure 3.10
Total exports (USD mn)



Source: PCB

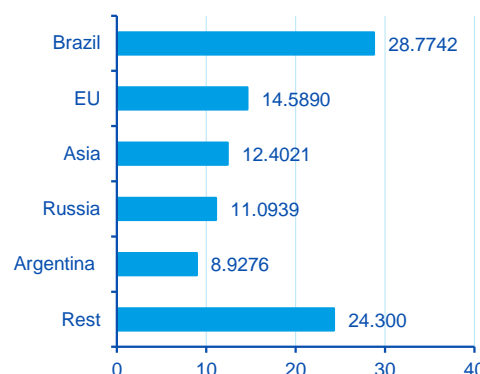
The second factor that has affected growth over this year has been the less favourable external environment, due to: i) a correction in the international soybean price, which has fallen by 15% so far this year (see Box 1), which has in turn affected the value of exports (see Figure 3.10), given the importance of this product and some of its derivatives as a proportion of total foreign sales (soybeans and their derivatives, such as oil and meal, accounted for almost half of the country's total exports, see Figure 3.11), and ii) lower growth in Brazil, which has had a negative impact on the trading of goods with the country (re-exports fell by 17% between January and July 2014, as compared with a similar period in 2013).

Figure 3.11
Share of total exports (%)



Source: PCB

Figure 3.12
Paraguayan exports by country of destination (%)

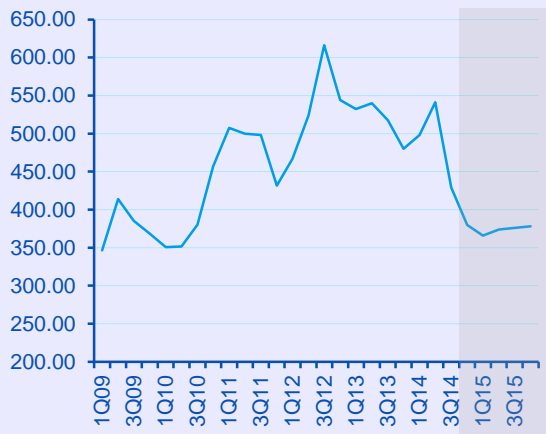


Source: PCB

Box 1. The soybean price and its effect on activity

Between the end of 2013 and the end of September 2014, the price of soybean on the Chicago market fell by around 23%. Our projected scenario forecasts that the soybean price will close this year at USD380/tn and close 2015 at USD378/tn (see Figure B.1.1).

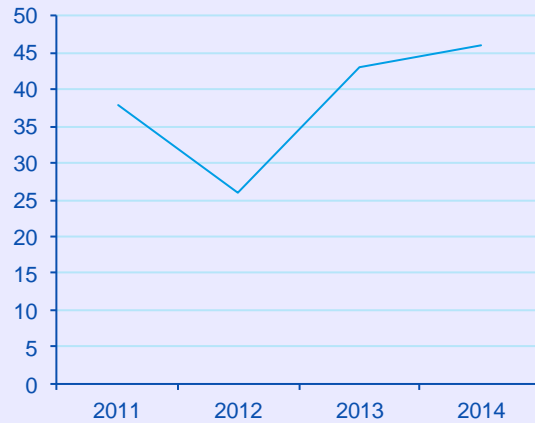
Figure B.1.1 Soybean price and forecast (USD/tonne)



Source: WEF, BBVA Research

The fall in the price of this crop is mainly due to the bumper harvest achieved in the US. Although some climate-related factors, such as a potential drought in Brazil, have led to an increase in the soybean price in recent weeks (October and the first half of November), we believe that the price will remain below the levels of 2013 and 2014. An analysis of the price of this cereal is particularly important for Paraguay, given the importance of the soybean and its derivatives, both in terms of exports (see Figure B.1.2) and as regards the country's economic activity as a whole. Soybean planting is currently around 80% complete, over an area that is expected to be similar to that of 2013, between 3.2 and 3.5 million hectares. Production will amount to between 8.1 and 10 million tonnes, with a yield of 2.53 tonnes per hectare, according to the Paraguayan Chamber of Processors and Exporters of Oilseeds and Cereals (CAPPRO) (see Figure B.1.3), though some other analysts estimate yields closer to 2.8 tonnes per hectare.

Figure B.1.2 Share of the soybean industry in total exports (%)



Source: CAPPRO, PCB, BBVA Research

Figure B.1.3 Soybean production in Paraguay

	Area (has)	Volume (tn)	Yield (tn/ha)
2012	2,700,000	4,200,000	1.56
2013	3,025,500	7,950,000	2.63
2014	3,200,000	8,100,000	2.53

Source: CAPPRO, BBVA Research

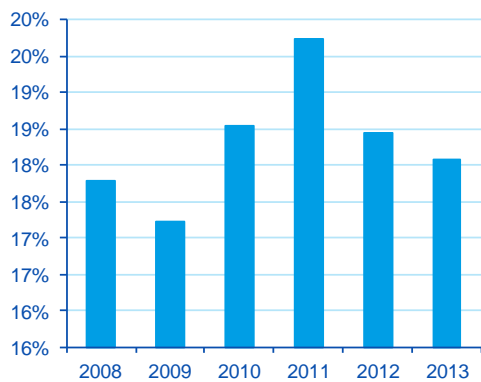
Given the new price forecasts for soybeans, the 2014-15 season will offer very low margins, though the crop will remain profitable. Analysts in the sector estimate average profits of USD227 per hectare, assuming an international price of USD360/tn and an average yield of 2.8tn/ha. The business will reach its equilibrium point at a price of around USD300 per tonne, with production costs estimated at around USD600 per hectare.

Despite the slowdown in growth expected in 2014 and 2015, the Paraguayan economy continues to expand at one of the fastest rates recorded among all the countries in the region. The weaker performance of the economy as compared with 2013 is due to the normalisation of growth towards levels that are more sustainable (following record production in the agricultural and energy sectors) and more in line with potential GDP, which we estimate to be in the region of 4.5%, in a context in which conditions in neighbouring countries (Brazil and Argentina) remain unfavourable.

Our projection scenario is based on investment of around 4.9% over the course of this year, a figure that will increase somewhat over 2015 and 2016 (to around 6%), as the reforms aimed at boosting the execution of public spending and promoting private spending (such as the Public-Private Associations Act, the “APP”) begin to take shape. The prospects remain good in the agribusiness sector, the activity that accounts for between 40% and 50% of GDP. The record levels of production recorded over the past two soybean seasons will mean it will be difficult for agriculture to record levels of growth similar to those seen in 2013. However, it is not expected that there will be any slowdown in production, and climate-related factors are not giving rise to any significant concerns for the time being.

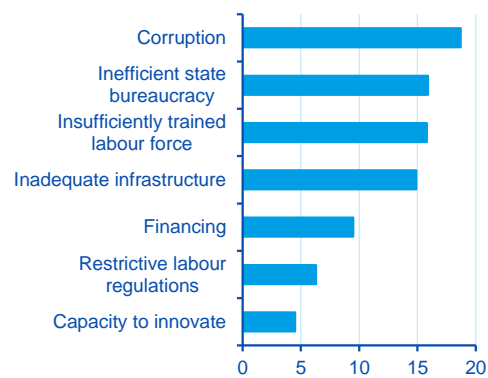
We believe that GDP growth in Paraguay could potentially be higher than it is at present. A central factor in increasing potential remains investment, both public and private. The current Investment/GDP ratio is one of the lowest in the region, around 17% of GDP (see Figure 3.13). In addition, in order to boost productivity and competitiveness, more spending is required in areas such as education, infrastructure and innovation, among other things (see Figure 3.14).

Figure 3.13
Investment/GDP ratio (% investment and GDP expressed in PYG at constant 1994 levels)



Source: PCB

Figure 3.14
Main issues for doing business WEF 2014-15 (% of responses)

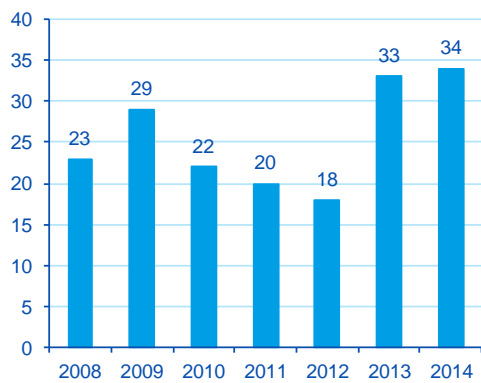


Source: WEF

Industrialization, new sectors and new markets

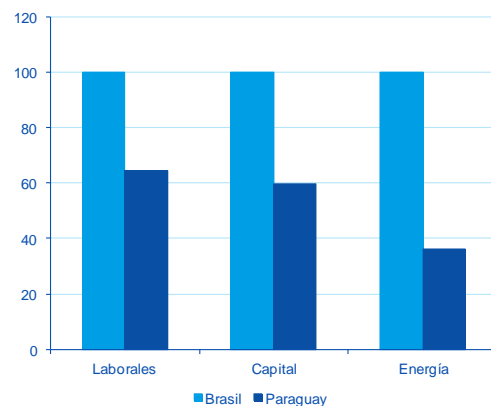
Over the past few years the industrial sector in Paraguay has grown more robust. Production volumes of oil and soybean have increased, and the refrigerated meat industry has strengthened. According to the Paraguayan Chamber of Processors and Exporters of Oilseeds and Cereals (CAPPRO), industrialised soybeans accounted for 34% of the crop up to September 2014, with the industrialised production of around 2.7 million tonnes of soybeans (see Figure 3.15). As regards the meat sector, this has seen significant growth following the recovery of markets lost as a result of the outbreak of foot and mouth disease in 2011. Levels of employment and meat consumption have increased significantly, and exports are being directed towards markets that look for higher quality and therefore offer better prices (such as Chile and Brazil, which are paying an average of USD5.30 per kilo). There is also a move to replace consignments to Russia (which pays a lower price, USD3.75 per kilo) with exports to new markets in Europe (average price, USD5.60 per kilo). Investment has also been made in areas that offer certain complementary benefits with Brazil. In this regard, the restructuring of some production processes and the use of competitive advantages resulting from lower costs in comparison with Brazil (see Figure 3.16) - in some cases, cost differences amount to as much as 30% or 40% - have provided a boost for the assembly, automotive and plastic industries, among others. This process is expected to continue over the coming years, in such a way that exports of products with a higher added value will tend to increase.

Figure 3.15
Soybean industrialization (soybean production/CAPPRO industrialization, %)



Source: CAPPRO

Figure 3.16
Cost differences between Paraguay and Brazil

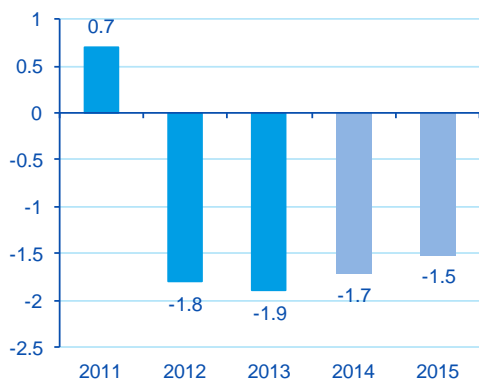


Source: Trade Association for the Industries located in the State of Sao Paulo (*Federación de Industrias del Estado de Sao Paulo - FIESP*)

4. Fiscal accounts will continue to show a deficit

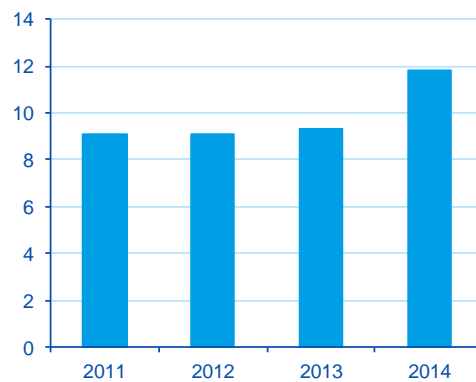
In 2014 we expect a fiscal result equivalent to -1.7% of GDP, falling to -1.5% in 2015, in line with the Fiscal Transparency and Responsibility Act (“LTRF”) which became law in 2013 (see Figure 4.1). Nevertheless, this deficit will not represent any risk to the sustainability of the country’s fiscal accounts, bearing in mind that the government’s gross borrowings are among the lowest in the region at around 12% of GDP (see Figure 4.2). It should be pointed out that the LTRF includes limits on the growth of primary current spending (it may not exceed the year-on-year inflation rate plus 4%) and on general public sector salary increases (public sector salaries may only rise when there is an increase in the legal minimum salary, and at most in the same proportion). The Act also imposes a cap on the central government’s fiscal deficit, which may not exceed 1.5% of GDP during both the preparation and approval of the budget.

Figure 4.1
Fiscal result



Source: PCB, BBVA Research

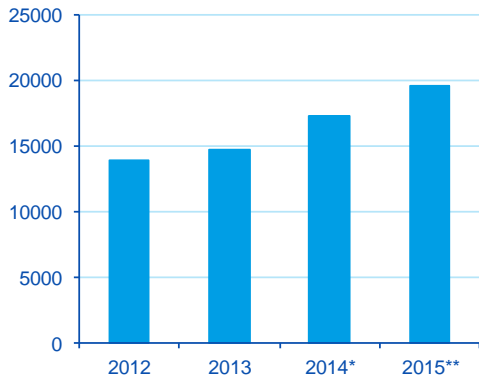
Figure 4.2
External public debt (% GDP)



Source: PCB, BBVA Research

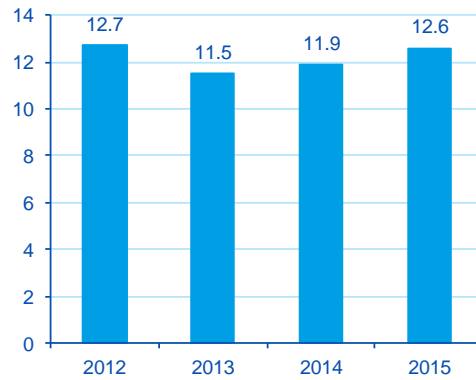
On the income side, the reforms introduced in 2013 (which established VAT on agricultural and livestock activities, personal income tax and taxes on loans, among other measures) have combined with economic growth to generate an increase in tax revenues of around 20% this year. Around a third of this growth is accounted for by these new taxes and, in addition, revenue from taxes on goods and services, the tax on foreign trade and taxes on income and utilities increased by 19.1%, 9.9% and 20.2% respectively. As a result, total accumulated tax income to September 2014 amounted to PYG17.89bn, a 14% increase on the amount recorded over a similar period in 2013 (see Figure 4.3). The public budget for 2015 includes a total income forecast that is 12.3% higher than the income figure in the adjusted budget for 2014, and tax revenues over the coming year will be 16.1% higher than they were in 2014. Bearing in mind the contents of the National Budget Statement, a tax burden equivalent to 11.9% of GDP in 2014 will rise to 12.6% in 2015 (see Figure 4.4). The increase in the number of taxpayers that has resulted from tax reforms has placed greater pressure on the tax authorities and their management capabilities.

Figure 4.3
Tax income (PYG bn)



*End of year estimate **Contemplated in public budget. Source: Tax Office

Figure 4.4
Tax burden (tax income as % of GDP)



Source: Tax Office

On the spending side, public salaries rose sharply in 2011 and 2012, a counter-cyclical measure that resulted in a fiscal deficit. From the 2013 budget onwards, the government asked for a freeze on salaries. This was approved by Congress both for 2013 and again for 2014. The number of staff has also been cut, and contracts are no longer being renewed, bringing the salary bill down by approximately 30%. For 2015, the draft Public Budget allocates a total central government spending figure that is 6.2% up on the adjusted budget figure for 2014. In addition, current spending rises by 10.4% and capital spending increases by 5.1%, with a reduction of 3.8% in physical investment. This model of lower growth in spending compared with income explains the reduction that we expect to see in the deficit over the course of the period to which this forecast applies.

The problems involved in executing public investment persist, and while the amount being managed is almost twice the amount spent in the past, it is still not sufficient to comply with the budgeted figure. As mentioned earlier in this report, this increase in levels of budget execution has been achieved using existing capacity and even fewer staff, and this has limited the possibility of taking on and speeding up more of the projects in the portfolio. In addition to issues of human resources and skills, there is a need to reduce bureaucracy in the public sector, and ways must be found to simplify processes, avoid duplication and prevent delays.

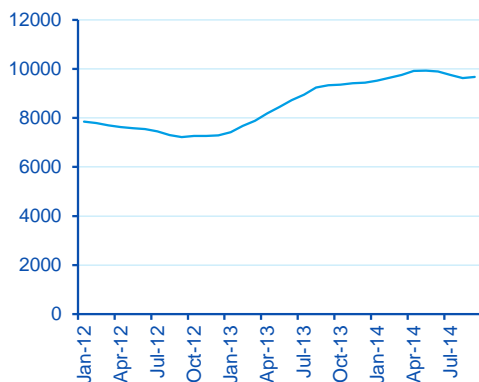
5. A smaller deficit in external accounts reduces vulnerability in the face of volatility in the world's financial markets

Between January and September 2014, Paraguayan exports totalled USD7.81bn, up 3.2% on the figure recorded for a similar period in 2013. This rise in the volume of exports accounted for 0.7% of the increased growth figure, with the remaining 2.5% coming from improved export prices. Mercosur remained the country's main export market, with a 41% share.

Although soybean and electricity exports fell by 6.6% and 2.4% respectively in nominal terms, both products had reached record levels during 2013. Meat and soy meal, which respectively accounted for 12.8% and 11.8% of total exports, grew by 26.3% and 34.4%, thus offsetting the fall seen in the above two export sectors (see Figure 5.1). In the case of meat, the main customers were Russia, Chile, Brazil, Hong King and Israel.

The slowdown in Brazil affected cross-border trade. In this regard, re-exports contracted by around 13% year-on-year for the period from January to September 2013. In addition, exports of assembled goods during September totalled USD170.7mn, 44.4% higher than the USD118.2mn figure recorded in 2013, with notable performance from products such as skins and leather, wire, cable and other conductors, clothing and accessories and footwear, among other items.

Figure 5.1
Accumulated exports over the past 12 months (USD mn)



Source: PCB, BBVA Research

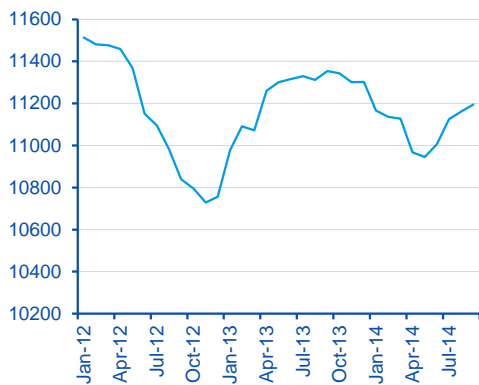
Figure 5.2
Accumulated exports of main products, January-September (USD mn)

	2013	2014	Var %
Total	7575	7815	3.2
Soybean	2461	2299	-6.6
Electricity	1670	1630	-2.4
Beef	792	1001	26.4
Soymeal	687	924	34.5
Cereals	537	405	-24.6
Soy oil	337	370	9.8
Leather	115	143	24.3

Source: PCB, BBVA Research

Imports, on the other hand, fell by 1.3% in nominal terms over the period from January to September 2014. This fall was explained in the main by the imports made under tourism regulations (which contracted by -12.4%), which are linked with re-export activities. If this segment is excluded from the total imports figure, the result is an increase of 2.4% in imports directed at the internal market over a similar period. The main boost came from consumer goods, which saw YoY growth of 4.7%. Particularly notable were the higher imports of cars and light goods vehicles. In addition, the foreign purchase of capital goods for internal consumption shrank by 3.8%, with items such as electrical generators and tractors, bulldozers and graders showing the most pronounced falls (-23.6% and -10.6% respectively).

Figure 5.3
Accumulated imports over the past 12 months (USD mn)



Source: PCB, BBVA Research

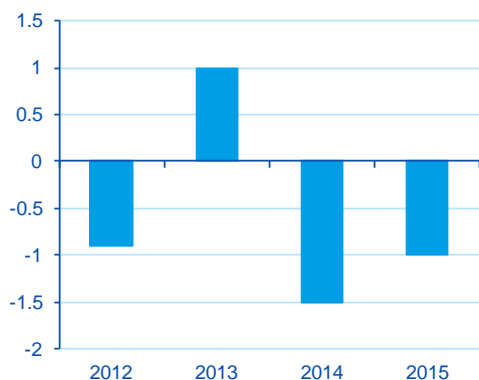
Figure 5.4
Accumulated imports, January-September (% var. YoY)

	Consumo nacional	Regimen de turismo	Total
Total	2.4	-12.4	-1.3
Consumer goods	4.7	0.9	3.7
Non-durable	1.9	-0.3	1.4
Durable	16.8	3.7	11.9
Intermediate goods	5.1	4.7	5.1
Capital goods	-3.8	-21.3	-11
Machinery, equipment and engines	-6.9	-21.6	-15.1
Transport machinery and fixtures	-4	-13.5	-4
Others	8.2	-8.9	6.6

Source: PCB, BBVA Research

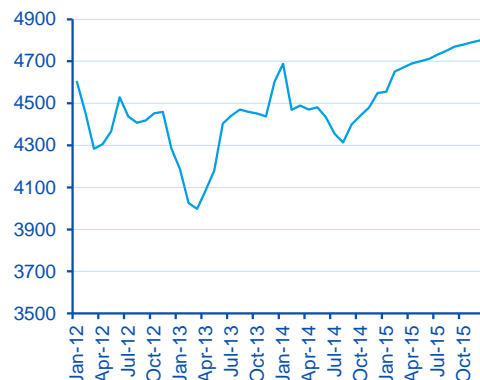
Against this backdrop, we expect to see current account deficits equivalent to 1.5% in 2014 and 1% in 2015. The Paraguayan economy's low level of external vulnerability and the appreciating trend of the dollar, against a background of future rate rises as part of the Fed's economic policy, have led us to predict exchange rates of around USD/PYG4,550 by the end of 2014 and PYG 4,800 in 2015. PCB policy is one of highly moderate intervention in the exchange rate market, since it believes that the impact that a depreciation in the guarani's value would have on the economy would be relatively limited in a context in which the dollarization of the financial system stands at around 40%, and would not therefore result in significant currency mismatches. The PCB's intervention would be limited to episodes during which the currency fell sharply and would be aimed at attenuating movement in the exchange rate.

Figure 5.5
Current account (% of GDP)



Source: PCB, BBVA Research

Figure 5.6
Exchange rate (USD/PYG to the dollar)



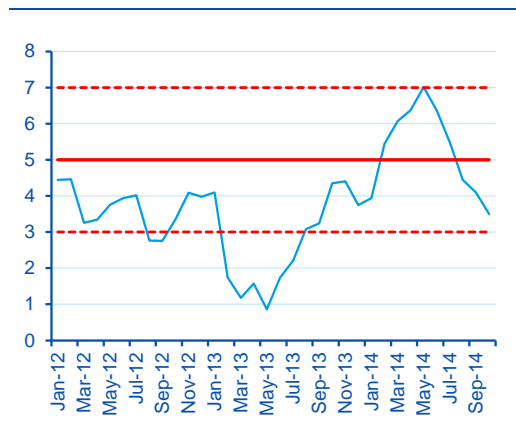
Source: PCB, BBVA Research

6. Inflation will remain within the PCB meta range

In year-on-year terms, the change in the consumer price index in October stood at 3.5%, while underlying inflation stood at 3.8%, continuing the downward trend seen in recent months (see Figure 6.1). There was a particularly notable fall in the price of some food products, wheat flour and maize. As a result, inflation in the foodstuffs sector stood at 1.6% year-on-year. Elsewhere, areas such as services and rents, which are more closely tied to internal demand, showed year-on-year price increases of 6.6% and 7.6% respectively.

The movement of inflation over the course of the year has been consistent with our forecast of a rate of 4.7% for the end of the year. Looking ahead, we expect inflation to remain around the meta rate of 5% established by the PCB. This will happen in a context of GDP growing to around its potential level, which will not place demand pressures on pricing, combined with lower fuel prices on the international markets.

Figure 6.1
Total inflation (% var. YoY)



Source: PCB, BBVA Research

Figure 6.2
Inflation by groups (% var. YoY)

	Inflación interanual (%)
Tariffed services	9.5
Income	7.6
Services	6.6
Goods excl. fruit and vegetables	2.8
Other goods	1.8
Foodstuffs	1.6
Fuels	0.7
Fruit and vegetables	-3.2

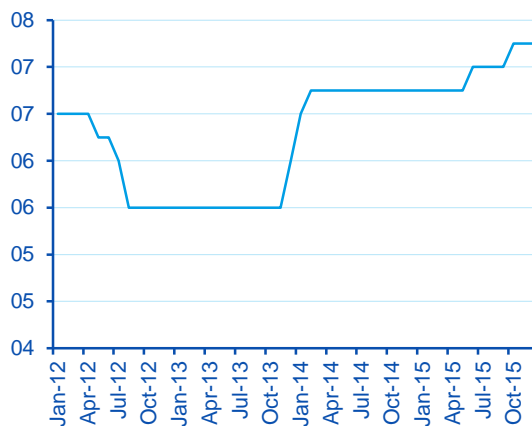
Source: PCB, BBVA Research

In a context free of inflationary pressures and with economic activity showing growth at a rate of 5%, the PCB will maintain its benchmark rate

At its last monetary policy meeting in October, the PCB maintained its benchmark rate at 6.75% (the level at which it has remained since February of this year, see Figure 6.3). The PCB believes that, although some sectors of the economy are continuing to slow due to external factors, these are less dependent on monetary policy than other sectors that continue to show growth. It also stresses that the current monetary policy rate remains around a level that is neutral and consistent with a scenario in which annual inflation reaches 5% over the policy-relevant horizon (18-24 months).

As regards activity, the PCB believes that it has little control over agriculture and the production of bi-annual crops, and both of these components are therefore left out of its analyses. If these effects are removed from the calculation of GDP, growth remains at levels of more than 5%, a figure with which the PCB is comfortable. Given that inflation is in line with the meta rate, and that it believes economic activity to be running at a suitable level, the PCB will maintain the benchmark rate at its current level in the short and medium term.

Figure 6.3
Benchmark interest rate (%)



Source: WEF, BBVA Research

7. Main risks

The following are the main risks that the Paraguayan economy faces:

- First, the external environment. Of particular note is Brazil, which is Paraguay's main trading partner and accounts for around 30% of exports. A greater-than-expected slowdown in the country (we expect to see growth of 0.2% in 2014 and 1.3% in 2015) could significantly affect economic performance in Paraguay, particularly with regards to re-exports. Furthermore, if soybean prices are lower than projected in our outlook, this will affect agricultural income and result in lower amounts of investment and consumption.
- Second, given that Paraguay is primarily an agricultural country, the climate factor is always an underlying risk, although there are currently no indications of a drought or any anomaly that could affect crops, particular with regard to grain crops.

8. Tables

	2013	2014f	2015f	2016f
GDP (% YoY)	14.2	3.8	4.2	4.2
Inflation (% YoY, eop)	3.7	4.7	5.0	5.0
Exchange rate (vs. USD, eop)	4603	4550	4800	4900
Policy rate of interest (% eop)	6.00	6.75	7.25	8.00
Private consumer spending (% YoY)	7.0	2.9	3.8	3.9
Public spending (% YoY)	5.2	0.5	3.5	3.7
Investment (% YoY)	13.4	4.9	6.1	6.4
Fiscal deficit (% of GDP)	-1.9	-1.7	-1.5	-0.7
Current account surplus (% of GDP)	1.0	-1.5	-1.0	-0.7

	GDP (%,YOY)	Inflation (%, YOY, eop)	Exchange rate (vs. USD, eop)	Policy rate (%, eop)
1T12	-3.6	3.3	4284	6.50
2T12	-2.3	3.9	4529	6.25
3T12	3.2	2.8	4419	5.50
4T12	-2.0	4.0	4285	5.50
1T13	17.1	1.2	3997	5.50
2T13	15.3	1.7	4404	5.50
3T13	11.9	3.2	4460	5.50
4T13	12.8	3.7	4603	6.00
1T14	3.9	6.1	4490	6.75
2T14	3.0	6.4	4434	6.75
3T14	2.2	4.0	4400	6.75
4T14	4.9	4.7	4550	6.75
1T15	3.5	3.4	4670	6.75
2T15	4.4	4.0	4712	7.00
3T15	4.4	6.2	4770	7.00
4T15	4.4	5.0	4800	7.25

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