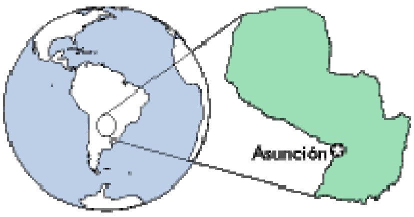
COUNTRY REVIEW

Paraguay



14 January 2010

ANALYST: David Atkinson

EULER HERMES COUNTRY RISK GRADE: C

Country Risk Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest risk.

Strengths

- Satisfactory indicators heading into global downturn
- Adequate external liquidity position
- Relatively low public and external debt

Weaknesses

- History of political instability and weak political institutions. Relatively weak position of President Lugo.
- High dependence on agriculture, commodity exports and bigger neighbours Brazil and Argentina
- Poor long-term track record (e.g. real GDP per head contracted in past decade)

Country Risk Assessment

Ratings	Paraguay		Median	Peers		
	Latest	Previous	Grade C	Algeria	Dominican Rep	Bulgaria
Systemic Political Risk:	**P3-**	**P3-**	**P2-**	**P3-**	**P2-**	**P2+**
Systemic Economic Risk:	**E5**	**E4**	**E5**	**E5**	**E5**	**E5**
ME rating:	ME4	ME4	ME5	ME4	ME5	ME5
Structure	*5.7*	*5.7*	*5.8*	*6.0*	*5.9*	*3.3*
Policy	*5.2*	*6.0*	*5.2*	*6.0*	*4.8*	*5.2*
Solvency	*1.3*	*1.3*	*3.3*	*1.0*	*1.3*	*4.8*
External Liquidity	*3.2*	*2.2*	*4.7*	*1.9*	*6.0*	*5.6*
SBE rating:	SBE5	SBE4	SBE4	SBE5	SBE4	SBE3
COUNTRY GRADE:	**C**	**C**	**C**	**C**	**C**	**C**

Nomenclature:
Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Asuncion
Population:	6.24 mn (2008)
GDP:	USD 16877 mn (2008)
Currency:	Guarani (PYG)
Form of state:	Republic
Head of government:	President Fernando Lugo
Next elections:	2013 (presidential & legislative)

Major Industries (% of GDP at market prices, 2008)	
Agriculture, forestry & fishing	22.0%
Manufacturing	29.7%
Utilities	1.6%
Construction	5.3%
Services	41.3%

Global Assumptions	2009	2010
Real GDP grth (% yr/yr) *	-3.9	0.9
Inflation (%, av) *	-0.1	1.3
Dated brent (USD/b)	61	72

* Major economies

Main Exports (% of total, 2009)	
Soybean	24.7%
Meat	18.3%
Cereals	14.7%
Flour	11.9%

Main Imports (% of total, 2009)	
Consumer goods	33.4%
Intermediate goods	30.4%
Fuels & lubricants	14.0%
Capital goods	36.2%

Lead Export Markets (% of total exports, 2007)	
Argentina	28.1%
Uruguay	15.2%
Brazil	12.7%
Chile	5.9%

Lead Import Markets (% of total imports, 2007)	
Brazil	30.4%
US	22.8%
Argentina	14.4%
China	8.6%

Basic indicators

Selected economic indicators	2006	2007	2008	2009e	2010f
Nominal GDP (USD mn)	9,275	12,222	16,877	14,494	15,847
Population (mn)	6.02	6.13	6.24	6.35	6.46
GDP per capita (USD)	1,541	1,994	2,705	2,283	2,453
Real GDP growth (% yr/yr)	4.3	6.8	5.8	-3.8	3.5
Inflation (%, eop)	12.5	5.9	7.5	1.9	5.0
Fiscal balance (% of GDP)	0.5	1.0	2.6	0.1	-1.0
Current account balance (% of GDP)	1.4	1.4	-2.0	-1.7	-2.0
External debt/GDP (%)	36.9	29.2	19.8	23.0	23.3
External debt/Exports of goods & services (%)	60.8	52.4	36.4	47.3	45.3
Interest payments/Exports of goods & services (%)	2.6	2.5	1.5	1.7	1.6
Foreign exchange reserves (USD mn)	1,702	2,462	2,845	3,575	3,500
Import cover (months)	2.9	3.1	3.1	4.8	5.2
Exchange rate assumption, PYG:USD (av)	5,636.0	5,033.0	4,362.0	4,988.0	4,950.0
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Paraguay has a long history of dictatorship and unstable democracy. The 35-year Stroessner dictatorship was not ended until 1989 and only then by a military coup, the leader of which was elected president. A new constitution was introduced in 1992 and in 1993 the first civilian in nearly half a century was elected as president. President Wasmosy served his full term but in 1996 had to face down a serious challenge from General Lino Oviedo who subsequently fled into exile. The next elected president, however, facing impeachment proceedings after the assassination of his vice-president, was forced to leave for exile in Brazil in March 1999. Senate leader Gonzalez Macchi then assumed the presidency, as allowed for in the constitution, but his term was dogged by corruption scandals, widespread social unrest and economic stagnation. Under President Duarte, elected in 2003, there was more stability and he served his full term, ending in 2008.

The Partido Colorado (CP) enjoyed unbroken rule for 61 years, albeit backing different regime styles and leaders—adapting to dictatorship and democracy as appropriate—largely owing to superior organisation and the power of patronage, until presidential elections in April 2008—won comfortably by Fernando Lugo, a former catholic bishop who resigned in order to run for the presidency, who is also an establishment outsider and populist/left-winger—broke the party's hold. Lugo's Alianza Patriotica para el Cambio (APC) coalition, however, fell short of a majority in congress and the CP, though losing seats retained a significant presence.

President Lugo has faced a number of issues, however, that have damaged his authority, including a series of paternity scandals. His position is weak and the institutional framework strained. His coalition in congress was weakened by the withdrawal of the conservative Partido Liberal Radical Autentico, the second largest in congress in July 2009, leaving mainly small left-wing parties and congress is dominated by the uncooperative opposition. The institutional framework has also been strained further by a recent (and ongoing) dispute between the Supreme Court and congress over the re-instatement of two former judges. Moreover there have been opposition calls for his impeachment, which is allowed under the Paraguayan constitution. President Lugo has also had to re-shuffle the top echelons of the armed forces at least three times since he took office, the latest amid speculation of a coup attempt. While the president has talked of reforming the constitution, the issue of term limits has not been raised as yet (and would be unlikely to get legislative approval) though Lugo has resorted to calling out his supporters on to the street against the formal opposition in congress, a move which could raise the risk of instability if used too frequently.

The previous administration pursued adjustment policies within the framework of an IMF programme—successfully with regard to the main macroeconomic aggregates, though less so with regard to the pace of structural reforms, a reflection of political limitations, but this was completed in 2008 and was not renewed by the present administration. While President Lugo is a populist, with at least two big items on his agenda, land reform (little progress) and renegotiation of the tariff structure of electricity exports to Brazil (awaiting approval by the Brazil's congress) the FM is a conventional, orthodox and locally well-respected Finance Minister (Dionisio Borda) who also served in the Duarte administration and was an instigator of several pro-market reforms.

Internationally there are no major political threats to stability. Close ties with Taiwan have been important in terms of potential external financing, but there are some indications that President Lugo could favour normalising relations with China (which would mean breaking them with Taiwan) part of a common pattern among smaller economies in Latin America and the Caribbean. Paraguay is a full member of Mercosur.

Economic Stability

The economy is heavily dependent on agriculture—soya is the main commercial crops—and border trade with Brazil and Argentina (mainly assembled manufactures). Paraguay is also vulnerable to economic and financial contagion from its larger neighbours, as occurred during 2000-02, given the close links and relative size. The informal economy is large and the savings ratio low. Long-term growth has been low and real per capita GDP growth in the past decade was barely positive.

Real GDP contracted by an annual average 0.5% in 1998-2002—a combination of contagion from economic crises in Argentina, Brazil, and Uruguay, domestic political crises, drought and foot-and-mouth disease and weak commodity prices—but grew at a solid annual average 4.6% in 2003-08, as stabilisation policies took hold, harvests improved, commodity prices picked up and demand from Mercosur partners recovered. However, in 2009 the economy contracted by 3.8%—much worse than neighbouring economies—but this reflected a drought which hit agriculture, as well as the downturn in demand in key markets. Signs of recovery were evident in H2 2009 and assuming that the weather is more normal and with improving demand for exports in key markets (particularly Brazil) we expect growth of around 3.5% in 2010.

The central government recorded fiscal surpluses in 2004-08, in marked contrast to preceding years, and despite a fall in revenues and increase in spending in real terms may have been in rough balance/marginal surplus in 2009 (following a surplus of 2.6% of GDP in 2008). In 2010 revenues should recover ground as the economy expands again but assuming that expenditure increases at around the same pace as in 2009 a small overall deficit of around 1% of GDP could emerge. A key aspect of improved stability has been the Fiscal Adjustment Law introduced by the Duarte administration. Structurally, however, tax revenues as a proportion of GDP remain relatively low and spending will need to be reined-in as the recovery takes hold. As a result of the fiscal surpluses up to 2009 the public sector debt-GDP ratio is estimated to have dropped to less than 20% (relatively low) in 2008, but is likely to rise to 22% in 2010.

Monetary policy is geared towards a flexible, though managed, exchange rate system via quantitative targets and interest rates. Inflation decelerated sharply from 7.5% yr/yr at end-2008 to 1.9% at end-2009, as energy price pressures and domestic demand fell. Monetary policy was eased in 2009 as inflation fell below the target range of 5% +/-2% and credit expansion (though still relatively strong eased). The exchange rate has been volatile in the past year or so, but has depreciated in real terms easing the earlier strong overvaluation. Headline inflation appears to have bottomed in July 2009 and underlying inflation began to turn up in December. We expect inflation to return to around the mid-point of the target range by end-2010, as domestic demand picks up and the impact of energy price falls reverse.

The external current account balance was in surplus in 2002-07 (annual average 1.5% of GDP) but returned to deficit in 2008 of 2% of GDP. In 2009 both exports and imports fell sharply as commodity prices fell and domestic and export demand fell. As both recover in 2010 the deficit may widen to around 2% again. FDI inflows have also decreased and may cover only 50% of the deficit in 2010. Foreign exchange reserves, which declined at the height of the global financial crisis increased in H2 2009 and were higher at end 2009 than before, covering around 5 months of imports and 360% of external debt falling due (ST and M/L term principal) in 2010. Total FX reserves also amount to 300% of the sum of our projected current account deficit for 2010 plus principal repayments on medium-term plus short term debt outstanding at end-2009**.** M2 is a modest 140% of FX reserves

External debt decreased as a proportion of GDP from 58% in 2002 to an estimated 20% (low) in 2008 and from 116% of exports of goods and services in 2002 to an estimated 36% in 2008. Both ratios probably will have risen in 2009 (to 23% and 47% respectively) but remain relatively low.

Structural Business Environment

The Structural Business Environment is well below average in our assessment. Based on data and definitions from the World Bank's 2010 Doing Business Survey, of ten areas surveyed five—Starting a Business, Dealing with Construction Permits, Paying Taxes, Enforcing Contracts, Closing a Business, were weaker areas, ranking below average and two—Employing Workers and Trading Across Borders—were very weak. The World Bank Institute's Governance Research Indicator puts regulatory quality was below and rule of law and control of corruption well below average for the Latin American region, with a similar pattern against the lower middle income group of countries. Transparency International's Corruption Perception Index, 2009, assigns Paraguay a score of 2.1—on a scale of 1 (bad) to 10 (good)—and a ranking of 154= out of 179 (the same as Papua New Guinea and Yemen). As a broad measure of the pro-business environment The Heritage Foundation 2009 Index of Economic Freedom ranks Paraguay 87 out of 179.

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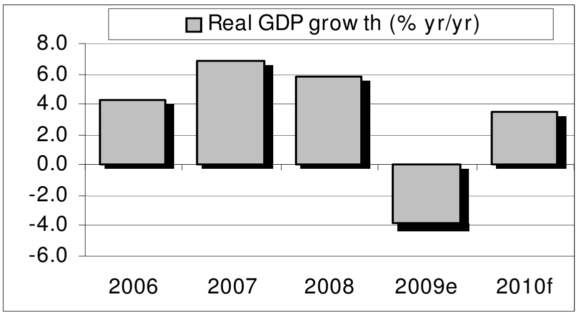
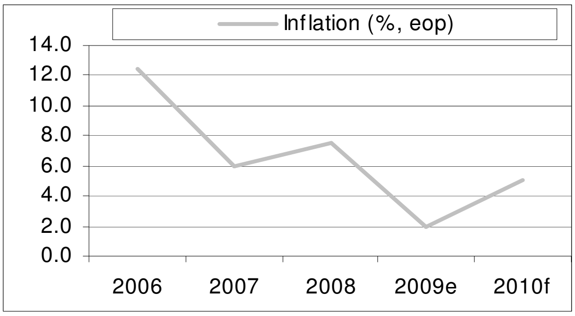
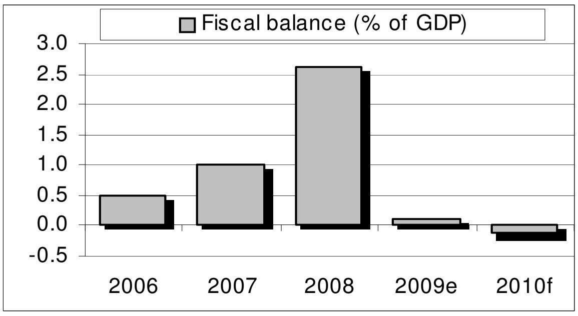
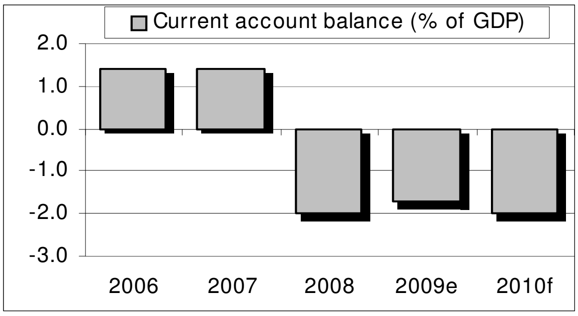
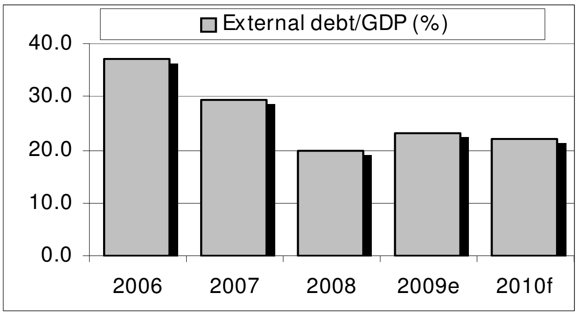
Charts


Real GDP grow th (% yr/yr)
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
2006
2007
2008
2009e
2010f

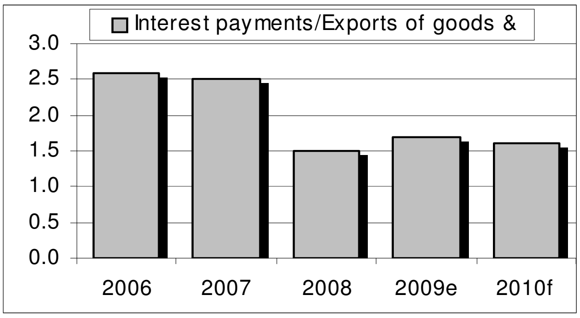

Inflation (%, eop)
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
2006
2007
2008
2009e
2010f

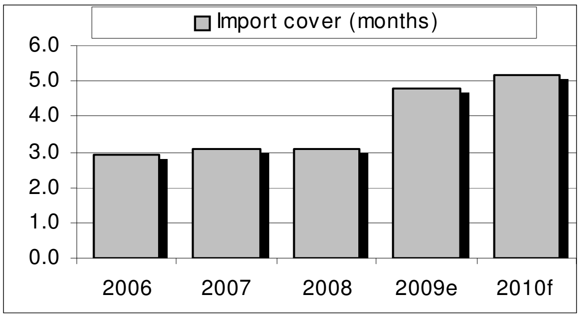

Fiscal balance (% of GDP)
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
2006
2007
2008
2009e
2010f


Current account balance (% of GDP)
2.0
1.0
0.0
-1.0
-2.0
-3.0
2006
2007
2008
2009e
2010f


External debt/GDP (%)
40.0
30.0
20.0
10.0
0.0
2006
2007
2008
2009e
2010f


External debt/Exports of goods & services (%)
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
2006
2007
2008
2009e
2010f


Interest payments/Exports of goods &
3.0
2.5
2.0
1.5
1.0
0.5
0.0
2006
2007
2008
2009e
2010f


Import cover (months)
6.0
5.0
4.0
3.0
2.0
1.0
0.0
2006
2007
2008
2009e
2010f