PARAGUAY
ECONOMY

Paraguay's new president has vowed to end the economy's dependency on commodities. Making that happen won't be easy. **By Thierry Ogier and Nancy Areco**

High hopes

There is a new mood on the streets of Asunción, Paraguay's capital , and it's a happy one for foreign investors.

Horacio Cartes, the business magnate who was sworn in as president mid-August, has so far had little trouble convincing investors that he means business when it comes to reforming the country's creaking economy.

But effecting change in a poor country that has long been plagued by corruption and inefficiency is likely to prove tougher than managing his 20-odd private businesses.

The administration's priority is to diversify the economy, helping end abrupt swings in the economic cycle that come from a dependency on agricultural exports.

"The president has the firm intention to generate a greater diversification of the economy," Germán Rojas, the Paraguayan finance minister tells *LatinFinance* in an interview. "The required business environment is being set up to attract industrial investment."

Exploring untapped titanium reserves and rolling out an aluminum smelter project near the Brazilian border are high on the agenda. Rio Tinto Alcan has been involved in the plant, although concrete plans are still elusive.

Another move towards diversification would be to foster the local food industry, based on the country's agricultural wealth, but there is strong resistance to this from multinational trading companies.

"Ultimately the solution to overcoming this volatility has to be diversification from primary production," says Andrew Nickson, honorary reader in Latin American Studies at the University of Birmingham and former director of a European Union project for state reform in Paraguay.

"Paraguay is still a primary producer and it does not defend its industry because so much of its output is smuggled across the border to Brazil and Argentina," he says. "It is a highly open economy. It has not pursued any serious industrialization policy except through the *maquila* sector, which is still very small."

Industrial investment would help the Paraguayan economy – one of the smallest in South America – reduce its dependency on exports of cereal and the agricultural sector, which the government calculates accounts for 23% of GDP.

"This year, thanks to the good weather, we will produce 14 million tons of grain, but last year it was half of that," says Rojas. That means Paraguay expects a spectacular 13% GDP growth this year – it will probably be Latin America's top performer – after shrinking 1.2% last year.

A similarly dramatic swing happened after the global financial crisis, when Paraguay suffered a 3.8% recession in 2009, only to bounce back by 15% the following year. The finance minister puts the country's growth potential at "over 4%". But the main problem for the government is developing a smoother pattern of growth.

In Cartes we trust

The day after his inauguration, the new head of state hosted a breakfast with 350 local and foreign – mainly Brazilian – business leaders to shape the new Paraguay. "I have worked with Paraguay for 25 years. I have never witnessed so much expectation of real change," says Regis Arslanian, a former Brazilian ambassador to Mercosur, who was present.

When Cartes rolled out his plans for public-private partnerships in infrastructure, Aslanian described it as the launch of a "new cycle of efficiency and pragmatism".

Several members of the new government, including finance minister Rojas, the minister of foreign affairs and the minister of public works, were present. The novelty is that these are not long-time members of the Colorado party, which has been in power for most of the past five decades, but technocrats perceived as having no strings attached.

"There are no politicians among the 11-member cabinet, which has caused a bit of a stir among the Colorado party," says Arslanian, who is now a senior partner at GO Associados, a consultancy in São Paulo.

Paraguay is just emerging from yet another period of political turmoil. Fernando Lugo, the former priest who became the first left-wing president in modern Paraguayan history in 2008, was replaced four years later by his deputy Federico Franco after a controversial impeachment.

"This is like a new stage of normalization in the country following the Franco government, which put the country 'offside' on the international scene," said Milda Rivalora, a Paraguayan historian in Asunción. "Now we have a Colorado government, which is not so Colorado. The current administration is rather more technocratic and liberal than the century old populist party."

There are other elements that foreign investors may find reassuring. "In recent years, there has not been any expropriation or nationalization of companies or anything of the kind," notes Oscar Pineda, an historian, in Asunción.

Last year's political crisis led to a sharp fall in foreign direct investment – from nearly $400 million in 2011 to little more than $120 million in 2012. Now, capital may be returning.

"The government is making great strides in encouraging foreign direct investment," says Nickson. "They held probably the largest ever road show in Miami [in June] to attract foreign investment and I understand there is another one planned in November. Cartes has certainly stressed that very much in his campaign: the solution to poverty reduction is to have a big inflow of foreign investment."

Testing the limits

Cartes himself is a relative newcomer to politics. He became famous for acknowledging that he never voted before he joined the Colorado party. That was only four years ago. He was picked as a presidential candidate after the traditional party suffered a devastating defeat against the leftist Lugo. However a successful businessman he might have been, many say he still has much to learn.

Courting foreign investors is a welcome move, but Nickson says Cartes faces some serious restrictions. "The problem is that the public administration is, even by Latin American standards, still extremely weak, extremely corrupt, extremely inefficient, and riddled by nepotism. The whole style of management is still very, very out of date. Foreign investors negotiating with the [local] bureaucracy is still an issue."

The Cartes administration has vowed to clean this up, but it is not easy because the system is deeply embedded, Nickson argues. And the party itself has yet to be reformed.

"My fear is that eventually there will be a conflict, if he is serious about transforming the economy with more modern, far sighted cabinet members in charge," he says. "When they begin to bring about structural changes in the administration, they will meet formidable resistance from the Colorado party and the powerful public sector trade unions that the part controls. That is the danger, this could well happen in the coming months and years."

Dialing up debt

Paraguay, which issued its first dollar-denominated bond at the beginning of the year, intends to "position itself as an investment destination", Rojas says.

But when it comes to issuing more debt, much caution is needed, warns Dionisio Borda, a former finance minister, who served under previous Colorado administrations as well as under Lugo.

"There are plans for more debt issues, but one has to exercise great caution," he says. "The tax burden in Paraguay is low, which means that the capacity to absorb debt is limited and on the other hand, capital market conditions may become more demanding."

At around 12% of GDP, the country's tax take is one of the lowest in the region.

That means there are better solutions to issuing bonds, say some. "It would be better to reform the tax system and increase collection than piling up debt," says Luis Rojas Villagra, founder of the Society of Economic Policy of Paraguay, a local think tank.

"The priority should be the removal of blatant tax evasion schemes that are common in all business sectors in the country," says Aníbal Amado Nunes, an economic adviser of the opposition party Frente Guasu. "This would double tax collection."

Nunes also favors an export tax on non-processed grain. "This would lead a large part of the grain that's due to be exported to be processed locally, which would obviously reduce the country's dependency on commodities."

Paraguay would benefit from a burgeoning food industry, which would also attract investment. But this may be an uphill battle. "There is no political will for that. Folks are rather in favor of pushing soy and other export goods," says Rojas Villagra.

The new government acknowledges the need to change the tax system. It has put forward its own plan to increase the formal workforce and raise more tax from agriculture and livestock. "This sector accounts for some 23% of the GDP, while the income tax collection from this sector accounts for 0.06% of the GDP," says minister Rojas.

HAPPY START: Paraguay's new president Horacio Cartes and finance minister Germán Rojas

Medium and large producers should pay more income tax, he suggests, while unprocessed goods from agriculture and livestock, currently tax exempt, will be levied 5%. "As far as exports are concerned, they are exempt from all kind of specific tax," he says.

The new government has shied away from a radical tax increase that would undermine its political support base. Taxing large soy farmers and foreign trading companies is a sensitive issue and the political will to address this issue in Congress is thin, especially among the ruling Colorado party, which has a strong agrarian base. But there may be an opportunity to boost a burgeoning food industry from the three soy processing plants that are already in operation. **LF**