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PARAGUAY NOW FOR THE HARD PART

Paraguay has achieved a lot in the last decade. A raft of laws to underpin the management of its economy – such as inflation targeting and the fiscal responsibility law – created a stable macro-economic environment just before the commodities bust that sent other economies in the region into a downward fiscal spin.

A landlocked territory in the middle of Latin America might not be the best place to position an export-orientated business but Paraguay – big on territory (it is roughly the same land mass as Germany) and small on people (a population of about 8 million) – realized it needed international finance and international business partners to develop its economy. It introduced a simple and low-cost tax regime (income, corporate and export) to attract companies to set up operations there.

The result has been startling. The country's economic growth has averaged around 4% during the past decade and foreign direct investment (FDI) in dollar terms has doubled. Meanwhile, financial discipline means that government debt-to-GDP is just 21%.

The rating agencies have responded: Moody's upgraded Paraguay five notches during the 2010s (and no downgrades) and the agency now has the country sitting just one notch below a much-coveted investment grade. Fitch's rating is similarly close to its investment grade category and Standard & Poor's is two back.

But while the country and its capital city, Asunción, have changed noticeably in this time (the number of skyscrapers is increasing rapidly) there are many issues still to face. Income per capita remains low, at around $6,000. Public services are generally low quality and availability is patchy. Many in the country haven't felt any benefit from the decade-long prosperity – estimates put the proportion of the population that operates in the informal, unregulated and unbanked sector at close to 60%.

And so the government has identified the need for a two-pronged strategy to take the country to the next level of development – and with it to investment grade.

The first issue, as the rating agency analysts always point out, is the need for increased institutional strength. Previous governments have acknowledged this weakness – and made steps in many areas – but the present government seems to be expending the requisite energy to meet the size of the challenge. A raft of legislation has brought the country's anti-money laundering regulations up to international standards.

> "THE DIRECT AIM IS ACHIEVING INVESTMENT GRADE"

The government is also pushing ahead with laws to better regulate and provide greater transparency in political party funding. It is also planning to increase the independence of the judiciary. Meanwhile, areas of the financial world that have operated in the fringes – and therefore the shadows – are being brought into the central bank's supervisory orbit. The central bank itself is modernizing as it expands its regulatory horizon and is working with the IMF to introduce risk-based supervision of the banking and insurance sectors.

The second issue is even more complex: how to improve the efficiency and delivery of the country's public services. This requires overhauling the country's civil service and complete reforms of key service areas, such as education and health.

The fiscal boon from the Itaipu hydroelectric dam, coming in 2023 (albeit the exact form and level of revenues is to be determined) should help fund these improvements. This will be crucial because while Paraguay's politicians are frank about the need for huge improvement, it is also clear that this is not the signal for a decade-long public spending binge. Those fiscal rules will be maintained. That's why the country's first public-private partnership (PPP) project – a highway linking Asunción to Brazil – was so important. With such a long checklist of needed infrastructure – including hospitals and schools – financial innovation and partnership with the private sector will be vital if Paraguay is to make the 2020s successful on these new, much harder, goals.

The challenges intertwine: improved institutional strength will likely bring a host of positive externalities, but the direct aim is achieving investment grade. That – it is hoped and expected – will place a seal on the country as a solid destination for international capital, and turbo-charge the country's efforts to diversify and industrialize the economy.

Paraguay's recent trade agreements with Brazil and Argentina alone provide a huge opportunity for the creation of thousands of jobs in new export-based manufacturing sectors.

This expansion of the economy will help to build financial inclusion and to pay for the improvements in public services that should further the population's lot – and thus its desirability as a workforce (the country's demographic bonus should last for another 40 years, and this would be even more of a natural advantage if the population was well-educated, and healthy).

These are the challenges and the theoretical benefits from successfully addressing them. The tough part will be making a success of these complex, politically sensitive and human-dominated reforms. ■

MOVING FORWARD WITH ENERGY

"It was a perfect storm," says Benigno López, Paraguay's minister of finance, of last year's economic headwinds. A drought, then flood, combination hit production in the agricultural and protein sectors – still two of the most important sectors for the country's economy, despite a drive for industrial diversification.

The drought also hit production of electricity at the Itaipu hydroelectric dam, the joint project between Brazil and Paraguay that once claimed the world record for water-generated power, at 103.1 million MWh in 2016. The energy produced by the Itaipu in 2016 would have been enough to supply the world's energy consumption for two days without interruption, or power Argentina for more than a year (or Paraguay for 12 years).

However, in 2019 the dam produced 18% less energy than in the previous year, reducing revenues.

Nevertheless, the topic that tends to dominate conversations among business and finance professionals in Asunción isn't so much about Itaipu's generation capacity, but rather what agreement will be reached between Paraguay and Brazil when their current power-sharing agreement expires in 2023.

The existing agreement is very favourable to Brazil (the dam's production is divided equally, but Brazil has exclusive rights to buy, at cost price, whatever Paraguay does not use – which is roughly 85% of the Paraguayan share).

In 2019 Paraguay received $700 million directly from the dam's operations and estimates it contributes a further $350 million to the economy indirectly, and a total of 30% of all the country's internal tax generation.

> "WE BUILT THE DAM TO USE THE ENERGY TO INDUSTRIALIZE OUR ECONOMY AND DEVELOP OUR COUNTRY. WE SHOULD CONTINUE TO FOLLOW THAT PATH."

The renegotiation is going to be fraught. Brazil has already signalled that it does not expect a radically different outcome in the next agreement. However, many Paraguayans see the talks as a test of national sovereignty and there are expectations that the government should try to reassert its independence.

López says he has brought Jeffrey Sachs, an economist from Columbia University, into the team that will help plan for the added revenues expected from the new deal (whatever happens in those talks, Paraguay will be more than $1 billion a year better off from debt payments for the dam's construction).

In 2013 Sachs wrote a report that concluded that Paraguay has been "dramatically undercompensated" for its surplus energy that Brazil has been using.

Another study quantified the level of under-compensation: Miguel Carter, of the Paraguay-based Demos think-tank calculated it to be a $75 billion loss income, a huge nominal loss for any economy but particularly for one that is valued at $40 billion.

The negotiations will start this year and, given their hugely sensitive nature, few want to go on the record about how Paraguay should approach them but, within the private sector at least, there seems to be an emerging consensus view.

That view is that Brazil won't increase the price for its payments unless Paraguay is in a position to begin to use more of its 50% share of the energy. To do that, Paraguay will need to develop the transmission lines to be able to take and distribute energy from Itaipu into the country's grid.

Without developing transmission lines Brazil would, rightly, see such claims to use their allocation as a bluff.

"If you are going to build that transmission capability we need to start now," says one senior banker in Asunción. "And if you are going to build the transmission and distribution infrastructure, we may as well use the electricity to grow our industrial base. Let's get to 50% usage as quickly as possible."

What does López think about this consensus view?

Benigno López, minister of finance: If you follow the consumption of energy by Paraguay, it has been increasing sharply; it's just a matter of time before Paraguay uses its share. Some people say that we will have reached our capacity in five to seven years, others that it will take more than 15 years before we will need to have developed additional generation capacity.

We built the dam to use the energy to industrialize our economy and develop our country. We should continue to follow that path. We have developed a pipeline to invest in electricity distribution and the transmission lines in the coming years in order to be ready to use all of it.

Euromoney: If you need another dam in 15 years, wouldn't you need to start work on that now?
López: Our challenge is to start thinking about other sources of energy for Paraguay, and any single project for such a source would take years to be completed. In those projects 15 years is 'tomorrow'.

Euromoney: As well as helping with the public finances, how can Paraguay best use Itaipu's energy? Are you interested in high-energy businesses such as bitcoin mining?
López: I think we have to be careful. We have to make investments that will have a real impact on the economy and create jobs. It also has to be environmentally friendly. As to bitcoin and projects like that, I do not want to go ahead at the moment – we should wait and evaluate the market as it develops. There are others ideas such as green bonds, public transport, solar energy and so on that will have a deep impact in our economy.

Euromoney: What do you plan to do with the added revenues and the money you are currently spending on Itaipu debt, post-2023?

López: We have a whole team working on the proposal, including Jeffrey Sachs, and they have yet to report to the president. The discussion will go on Annex C [of Itaipu Agreement] and not the whole treaty, which, by the way, can be renegotiated at any time. Annex C concerns the financial conditions, the cost of energy and so on. However, the main discussion is about what we do with the debt that will be paid off by 2023: How will the cost of energy be calculated (of which the debt component is about 60%)?

Should we reduce tariff? Or should we keep the tariff as it is? I don't dislike the proposal to keep the tariff as it is and share the energy between the two countries, with each keeping the added revenues, such as the $1 billion expiring in debt repayments.

And if either country wishes to change the tariffs, they can do that unilaterally with their own share in their own country or, for instance, Paraguay can create a sovereign wealth fund to finance the many future needs we have as a country.

Such a fund for infrastructure education and health will enable Paraguay to be able to provide quality services for its people and enable us to better prepare for the challenges of the future. There are also many other ideas that the team of experts is working on.

Benigno López Benitez,
Paraguay's Finance Minister

Euromoney: Would a sovereign wealth fund further differentiate Paraguay's financial model to that of the rest of the region?

López: The key to our success is the reputation we have built up for responsible macroeconomic behaviour over the past 15 to 20 years. We have a fiscal responsibility law, the golden rule [where government budget deficits can't be financed with debt issuance], low debt-to-GDP [22%] and a business-friendly taxation regime [the country has a 10% income tax, 10% corporation tax and 10% VAT].

We have a 'trademark' now, regarding macroeconomic responsibility, and we don't want to lose that – we will keep on being a responsible country.

I also think that in the near future we are also going to be recognised for our commitment to structural reforms.

If you see our recent history it is a country like a coin; on one side we have the economic side, which is doing very well. On the other side are the social indicators, in which we are working hard to improve the quality of life for the Paraguayan people. That's the challenge we have to improve.

We are rated high in macro, and low in institutional effort, and low on quality of public services, such as the provision of education and health. We are working very hard on these issues, and the rating agencies, investors and the investment banks have noticed this. In the near future, these efforts will produce results.

To finance those challenges we need to remain competitive in terms of taxation, and this is where the sovereign wealth fund can make a huge impact in Paraguay.

Euromoney: These are the reforms that are very difficult to do and do well. How confident are you that Paraguay can be successful here – have you a model from another country in mind?

López: The president is giving us the best chance to succeed by bringing together the private and public sectors to develop a roadmap to present to congress. This will happen before the end of this year.

It will develop a roadmap for the education reform, which will set out how we will educate our young people for the next 15 to 20 years. We have to face this challenge, to anticipate what the future labour market will be so that we prepare our children for a totally different environment. If we don't prepare our children for that challenge then we are missing a large opportunity.

We also introduced a tax reform to make the system more equal, and we are working also on developing systems to improve the efficiency of public expenditure. We are also planning reforms to the pensions system and incorporating technology in the everyday lives of our system, which will also have a tremendous impact on our quality of life.

Euromoney: Do you expect that congress will be receptive to these next-stage challenges?

López: I would say, in respect to congress, so far so good. We were able to pass 12 laws last year to strengthen the anti-money laundering regime.

“THE KEY TO OUR SUCCESS IS THE REPUTATION WE HAVE BUILT UP FOR RESPONSIBLE MACROECONOMIC BEHAVIOUR OVER THE PAST 15 TO 20 YEARS.”

We have also recently passed legislation that provides transparency to political party funding, and we are working on ways to improve the efficiency of the civil service – through better procurement for example.

We also passed a law to improve the business climate.

If we don't go ahead with these reforms, we believe the ceiling of our growth will be near 4%. We need higher growth and more inclusive results, and so there are many initiatives in the labour market as well.

Everything happens through a good education and health system, and we are absolutely committed to improving the quality of these services.

At the end of the day, congress wants the same as us: to improve the quality of lives of the Paraguayans. We will work together to achieve that.

Euromoney: Will these improvements in institutional strength and transparency lead to Paraguay attaining an investment-grade rating?

López: Well, the direction is right – we are on the right path. The effort is being noticed. The market is already treating us as investment-grade country and the improvement and commitment is there. Eventually they will see it and recognize it.

Euromoney: The market is already pricing you well inside investment grade [Paraguay re-tapped its benchmark 2050s in January with a net negative new issue premium] – that has to be encouraging?

López: It is very encouraging indeed. Those are very good signs from the international market. Not only on the bond issuance side but also to close two important infrastructure projects such as Bioceanica [transport routes connecting the Pacific and the Atlantic] and the first public private partnership project [which links Asunción to Brazil through the improvement of Rutas 2 and 7] reinforce the feeling we are being recognised internationally as a solid and improving financial jurisdiction.

Euromoney: How can you develop infrastructure financing without leveraging the country's balance sheet?

López: We have closed the financing of the country's first PPP, two highways that will connect Asunción to Brazil. We are also going to use PPPs to develop an important pipeline of roads, bridges, energy grid upgrades. We're also going to upgrade the airport, both the runway and the terminal, so that we can receive visitors from all over the world.

It has been many, many years since we made an investment to improve the connections between Paraguay and Argentina, and we are going to build three or four bridges to make us more connected. We also need to boost the country's internal infrastructure to the Chaco region, because that is going to be very important for the economy in the coming years.

One way to develop infrastructure without leveraging our balance sheet is doing exactly this, attracting private investors.

Euromoney: Is soy production ramping up in that region?
López: Soy production is expected to make a record high this year, and it is very important for the economy. Last year's drought proved that.

Euromoney: Rating agencies typically like to see governments have a greater ability to finance themselves in the local markets before awarding investment grade – is that a challenge?
López: We are working on that. We have money and assets that could be better invested in longer-term investments, and so if we unleash pension funds to invest, they will be more productive, while remaining safe. We could develop the market further, and there would even be interest in 30-year government debt locally. We need to be able to tap domestic liquidity, as well as the international, and if we can achieve this, it would be very good for the future of the economy.

Euromoney: When – if – the investment-grade rating comes, do you think it will lead to a big increase in FDI [which has already been steadily increasing, reaching $6.7 billion in 2018, the latest full years statistics, up from under $1 billion in 2003]?
López: I believe that the investors who come first, those that come before we attain investment grade, will receive more benefit. Investment grade will happen – it's just a matter of time – because we are working on our weaknesses and these remedies will be in place very soon. Every country has its problems and at least we are facing ours.

We have so much to offer investors: a strong economy, business-friendly taxes and lots of cheap energy. We also have great demographics – the average age of our population is under 30 years of age – but we are few people for such a big country. We are as big as Germany but have just close to seven million people, so we have the room to grow in Paraguay. But our market is very small, so we have to look outside for partners.

Euromoney: How important will Mercosur's trade deal with the EU be for Paraguay?
López: I have no doubt it's going to have a big impact on Paraguay. We are developing an export-orientated economy, and this will give us access to the third biggest economy in the world.

Euromoney: Are you concerned that political issues, specifically around some European country's concerns about Brazil's environmental policies and record, will lead to the postponement or abandonment of the deal from the EU side?
López: No, we think ratification will proceed. Paraguay has environmental standards and all the countries in Mercosur are signatories to the Paris Climate Agreement, so I am optimistic this treaty will become operational in the near future. ■

Modernising Paraguay's low tax status

Óscar Orué Ortíz, vice-minister of taxation at the ministry of finance

Part of the Paraguayan success story in the last decade was the country's easy-to-understand and business-friendly tax laws. Paraguay introduced a 10:10:10 regime, with the same low rate of income tax, corporation tax and VAT.

However, while the regime undoubtedly differentiated Paraguay's tax regime from other Mercosur nations, it leaves a very narrow base. The OECD estimates that the ratio of tax to GDP in Paraguay was just 13.8% in 2017, the lowest in South America, where the average is 23.5%.

As well as being narrow, it was also extremely regressive. About 60% of total taxes were generated by indirect taxes (VAT and excise).

As a result the government introduced a tax reform to make the burden more equitable within Paraguayan society, as well as increasing revenues slightly (by about $300 million, or roughly 10%).

The reform, which is being driven by Óscar Orué Ortíz, vice-minister of taxation at the ministry of finance, is (unsurprisingly) complex. However, in essence it increases the liabilities for wealthier Paraguayans by increasing the scope of taxable income – for example, residents' income generated outside the country will now be taxable. It also increases the taxes on dividends.

There are also some changes to VAT that close half the credits available for exporters of raw materials – part of the country's wide drive to boost its internal capacity to produce further up the value chain before exporting goods abroad.

Orué believes that the tax reform was essential to make the system more equitable and to boost the quality of public services in the coming decade.

However, Paraguay remains a uniquely attractive tax jurisdiction for international investors. For example, the Maquila regime for companies producing goods and services for export taxes the final value of those exports at just 1%; it also suspends tariffs for imports of materials, machines and other necessary inputs to the manufacturing process (as well as various other incentives).

Paraguay extends similar tax advantages to owners of companies outside the Maquila regime – for example the import tax and VAT rate on capital goods are both zero, as is the rate on raw materials if it can be proved there is no domestic source.

There are also tax incentives across a range of business categories, such as those that govern industrial parks (reduced real estate taxes and VAT exemptions) and free-trade zones (that, for example, have a single 0.5% tax on the invoicing of sales to third countries).

The government has clearly calculated that it can make relatively small tweaks to its regime that do not jeopardise its reputation as a country of low business taxes.

This reputation, coupled with its policy of negotiating improved access to Mercosur markets and pursuing trade agreements with the EU and Asian markets, as well and investing in better infrastructure to improve the efficiency of Paraguayan logistics, is the strategy expected to lead to nominal tax revenue growth.

That growth will be essential if the country is going to deliver added investment in its public sector.

CONSTRUCTING DIVERSIFICATION

As October 2019 was nearing its end, the focus for Argentina – and for many international investors interested in the region – was on the final head-to-head presidential election, scheduled for Sunday October 27.

Commentators were in overdrive talking about the importance of the election for the country – as well as it being crucial for its neighbours. What was less commented on (in fact it was largely ignored) was the ratification of a trade treaty between Argentina and Paraguay, pushed through on Friday October 25.

That agreement, which created a legal treaty for the importation and exportation of cars and car components, was arguably more important in the long-term for Paraguay's economic development than the outcome of the presidential election. Along with a similar treaty with Brazil, which was ratified by the Brazilian Congress in February 2020, it creates the possibility for Paraguay to begin making plans to build a car industry in the country.

"Paraguay is a small internal market so foreign direct investment (FDI) is almost always done with a view to exporting to the regional market," says Liz Cramer, Paraguay's minister for industry and commerce, who points to the deal's significance. "The car industry is one of the biggest in the world and, incredibly, auto also moves about 300 other parallel industries. Today car manufacturing is done on a regional basis and these treaties give us the legal basis to attract investment for pan-regional car manufacturing."

Cramer declines to comment on the negotiations or the timing of the passing of the legislation in Argentina or Brazil, but the weary tone of her voice speaks louder than her words: "The whole of the second half of last year was focused on these negotiations, and it wasn't easy because you have a lot of interested parties."

These interested parties were the reason why car manufacturing and sugar production were the only two industries excluded from the original Mercosur agreement – the Treaty of Asunción – signed by Argentina, Brazil, Paraguay and Uruguay.

It was only the negotiations between Mercosur and the EU that created the possibility for this area finally to be revisited. As the EU-Mercosur treaty covered the car industry, the incongruous prospect of greater liberalization between the two trade blocs than existed internally within Mercosur itself provided the context for Paraguay to win the right to create an export-orientated car industry.

"We are working on a long-term plan," says Cramer. "We need to understand what we can aim at, what types of industries we can attract to incorporate Paraguay into the regional supply chains. But first we needed that [legal] base, otherwise we wouldn't have the possibility to negotiate with new investors."

> "ENERGY IS PROBABLY OUR MAIN RESOURCE AND WE HAVE TO USE IT WISELY"

The possibility of building a car industry in Paraguay, which has much cheaper costs for business in terms of labour, energy, and corporate and export taxes than the rest of Mercosur, should help develop that plan. The demographic bonus will also help attract investors: the average age of the population is under 30 and Cramer says it will enjoy a demographic benefit for at least the next 40 years.

Cramer highlights that diversification is vital – the country's economic stagnation last year when drought severely affected the country's agricultural sector was proof that the significant progress done to date needs to be pushed much further.

"Manufacturing represents 20% of our GDP but it is itself dependent on primary products," she notes, explaining why the economy's GDP growth is still vulnerable to agricultural volatility. That type of manufacturing has been a deliberate strategy – aiming to push the economy further down the value-added chain of its primary products (its exports of vegetables, for example, reached about $1.1 billion in 2019) – but non-correlated diversification is increasingly the goal.

That too has been growing. The country has a Maquila regime, whereby companies are given exemptions from import duties for a number of inputs involved in production for export, as well as various tax benefits. The Maquila regulation was introduced in 1967 but only began to grow at a significant pace following the wider pro-business reforms undertaken since 2010. There are currently 150 companies operating under this regime that export mainly automotive parts, clothing and textile articles, and plastics. Exports have grown from $53 million in 2017 to $546 million in 2018 (the last year for which we have full data).

Maquilas are mainly owned by Brazilian businesses (80%) and part of the recent growth in these companies has been due to frustration among Brazilian-based companies over that country's economic performance and its relatively high costs of labour, taxes and regulatory compliance.

BOTTLENECK

However, further growth is being hampered by the physical infrastructure – there is just one bridge between Brazil and Paraguay and Cramer points out that this has created a huge "bottleneck". The government has responded with plans for three more bridges between the two countries – one purely for goods. It is also working to upgrade physical infrastructure on its borders with Argentina and Bolivia

Liz Cramer, Paraguay's minister for industry and commerce

Paraguay has also been working with the World Bank to introduce legislation that will boost its position in that international organization's "Doing Business" rankings.

"We are working to improve the productivity of the country in all areas but some – like building infrastructure and improving educational standards – are long-term challenges. We also looked at what short-term changes we could make that would be most effective in improving our attractiveness to FDI – and help our diversification objective," says Cramer.

As a result, the country has already introduced legislation for a new regulatory regime that allows new businesses to open within 72 hours – "the team tells me it will be quicker than 72 hours but I'm committing to 72 hours," says Cramer – and is cheaper and easier for entrepreneurs. Two other reforms are in the works: one will allow SMEs to be able to use non-physical assets, such as receivables, as securities for new credit; and the other will bring a bankruptcy law that will essentially establish a "Paraguayan Chapter 11".

(beyond which it has an agreement with Chile for the export of goods to Asia).

Paraguay is also pursuing trade agreements covering Pacific markets to create export diversification. It is in negotiations with Korea (which Cramer notes is a large player in the car industry), Canada and Singapore. The last of these brings the possibility of wider access to the Association of South East Asian Nations (Asean) markets. This is important, given that Paraguay has no trade or diplomatic relations with China – nor is there any prospect of this in the near future as the country is committed to its strong ties with Taiwan. Paraguay does import plenty of Chinese products, however, through third-party countries – largely Brazil.

"Paraguay is under construction," says Cramer, adding that the government is building internal road and river links to the interior of the country – the Chaco – which was once thought of as unproductive territory but is now, thanks to technological development, suitable for the production of soy and grains. Already Paraguay has jumped to fourth spot in the global production league tables. Cramer says that despite the drive for diversification, agriculture and cattle "will always be extremely important industries – we just want to compete on quality, and on niches, because if we approach the market on a purely commoditized basis we will struggle against markets with greater scale."

The construction of the country goes beyond developing the transportation infrastructure and the international legal framework. For example, Cramer says she believes that a telecommunications cable that will link the country to the other side of the Atlantic, through Brazil, should be switched on "within months" and will improve the country's internet capabilities. A second cable is planned to the Pacific, going through Bolivia, with a third through the Paraguay river to Argentina "that will be more challenging". Cramer says that once they are operational Paraguay will be well placed to attract international technology companies, "or at least part of their business chains", as well as being better placed to foster a domestic tech start-up industry. Better tech infrastructure will also boost the fundamentals for other creative and modern service industries.

As well as working to improve its weaknesses, Paraguay is being careful in how it plays one of its strongest cards to attract FDI – its abundant, cheap energy (cheaper than anywhere in the region and less than half the cost of that in Argentina and Brazil and one-third of electricity in Chile).

CAUTIOUS AND STRATEGIC

Some in the private sector speculate that Paraguay should seek to bring in bitcoin/cryptocurrency manufacturers to generate revenues. However, Cramer indicates that the government intends to be cautious and strategic in the use of its natural energy bounty.

"Energy is probably our main resource and we have to use it wisely, and that means selling to the best investor that brings the best outcome for the Paraguayan economy. That means bringing jobs, environmental benefits and maybe bringing in new industries or positioning us in specific niches," she says. "It's not just a matter of selling energy. We have a surplus now, but we won't have forever."

Cramer says the recent agreement with Brazilian-based ECB Group is a perfect example of the type of investment Paraguay hopes to attract – development of a green or renewable biofuel plant, called Omega Green. The plant will cost $800 million and ECB says it will have an $8 billion impact on Paraguay's economy over the coming decade: 3,000 jobs in the three-year construction period and then 500 direct jobs (many of which will be highly-skilled positions) and 1,500 indirect jobs in the local economy. It will also consume around 20% of the country's soy production.

"It's exactly the right type of industry for Paraguay," says Cramer. "It takes the best of what we have – the surpluses we still have – and it positions us for where the future is. It creates a large number of jobs, of which many will be highly skilled, such as for engineers. And it's all going to be for exportation, at least initially, and may lead to other investment in the renewable energies." ■

BUILDING INSTITUTIONAL STRENGTH

'Werking' is a very modern mixture of working space and café, taking up a large expanse of the ground floor of Asunción's Paseo La Galeria towers complex – the Paraguayan capital's emerging financial centre.

Wooden tables are scattered throughout the open design, there are meeting spaces that companies can hire, and a larger configuration is possible for events (such as lectures given by Koga, a Paraguayan business-orientated version of TED talks).

One of the aims of Werking is to help entrepreneurs and startups meet with other like-minded businesses.

Use of the space is free – just the automated registration of biometrics is required – and it's busy as Euromoney meets William Kent, director of Credicentro, the company that last year created the Werking concept.

We order lunch – naturally by swiping and jabbing at one of the large interactive screens that act as cashier. As we head to our meeting space we pass other screens, the functions of which are closer to the main business of the company that has been operating as a "casa de crédito" in Paraguay since 1984.

Once registered, users can apply for loans here – typically small amounts over a maximum of a couple of months – they can receive the cash from these loans from these machines, and use them to pay instalments and get cash advances on cheques. It's the full credit lending business, just re-imagined for the 2020s with glass and wood, plants and coffee.

Kent says Credicentro is planning to franchise out the Werking concept (the company also intends to convert part of its existing three 'branches' into Werking operations), and it has its credit-extending machines in 23 casas de cambios and six at its own branches.

It plans to roll out around 600 more self-service points in petrol stations, supermarkets and pharmacies around the country within the next three years. These physical points of sale will combine with the online strategy of Credicorp to reduce costs – the physical sales force has already been reduced to 13 from 500 just a few years ago – and Kent says the move to technology-based approvals and disbursements has also improved security.

BANKERIZATION

The *casa de crédito* sector has always played an important role in a Paraguayan economy with a low level of bankerization. According to data from Credicentro, of the 4.5 million adults of economically active age, only 1.6 million have bank accounts, with just 41% having an official payroll within the formal sector.

The rest don't have a salary, and when seeking credit either use either a *casa de crédito* or other unofficial sources.

Now the *casa de crédito* business is undergoing rapid changes – and not just the stylistic approach brought to the market by Credicentro – the central bank has, arguably belatedly, decided to begin supervision of the sector, previously a completely unregulated area of activity in Paraguay.

> "THE BIGGEST CHALLENGE WE HAVE IS TO IMPROVE OUR INSTITUTIONS, TO BE MORE TRANSPARENT, AND WE ARE ON THIS TRACK"

Kent says Credicentro saw this as an opportunity: the inevitable consolidation as companies sold up in the face of increased compliance costs and behavioural scrutiny – or simply ceased operations – has led Credicentro to conduct three acquisitions in recent years.

José Cantero Sienra, governor of the Central Bank of Paraguay since September 2018, notes that the move to regulate the *casa de crédito* sector, which starts with requirements for these companies to register with the central bank before it issues proposed regulations for the sector, expected in June, has "already resulted in increased prudence".

Cantero says the move to regulate this sector – though small, at around 1% of total lending – is part of the country's push to improve its institutional strength.

"The biggest challenge we have is to improve our institutions, to be more transparent, and we are on this track," says Cantero. "When we talk with the credit rating institutions, they always say that Paraguay needs to further adopt institutional reforms, and there is a big commitment to do that."

SOVEREIGN RATING

Fitch was the latest ratings agency to increase the sovereign rating. In December 2019 the agency assigned a BB+ rating – just one notch below investment grade and in line with Moody's (S&P remain two notches below).

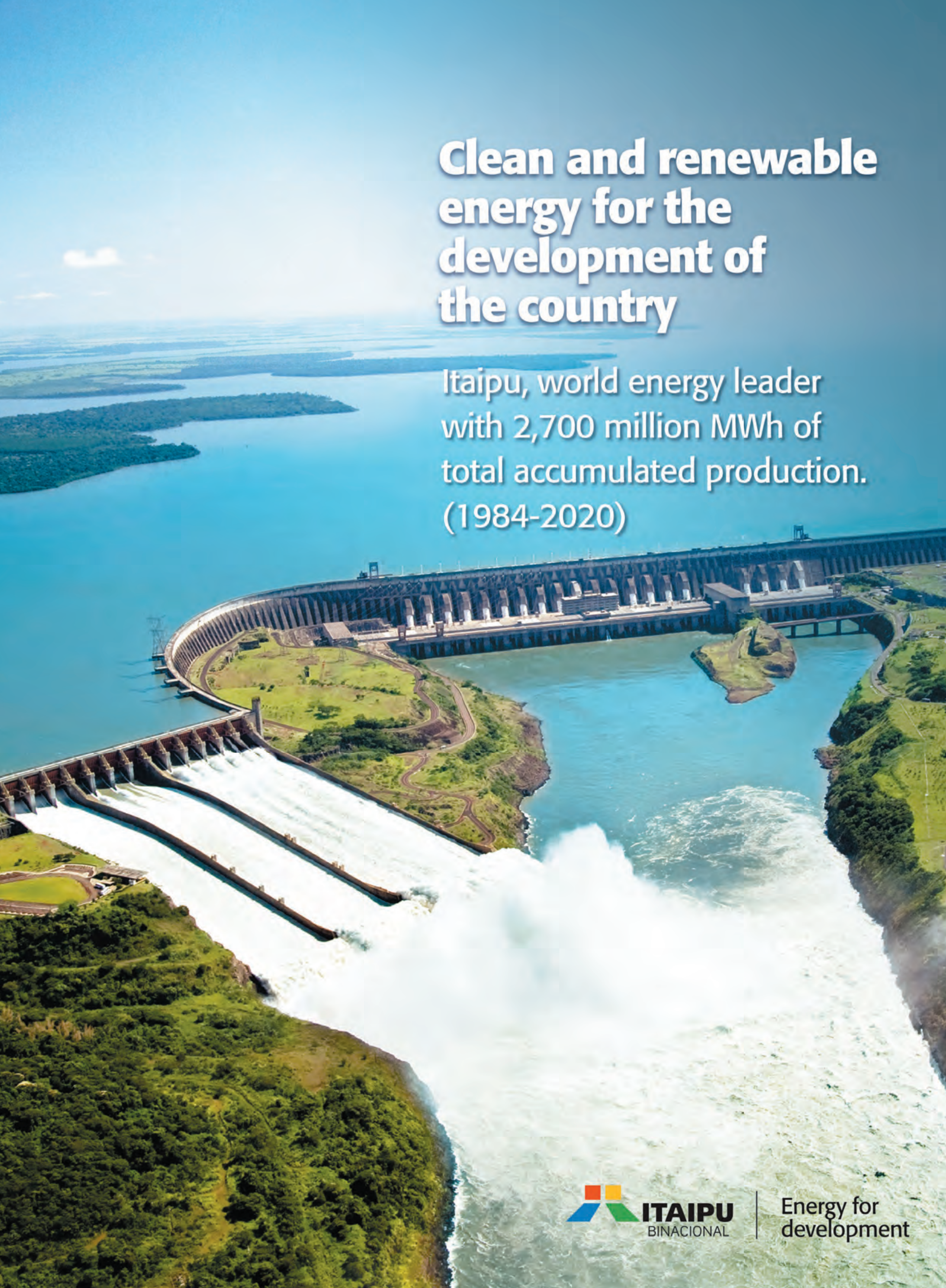
"Paraguay's structural features are weak compared to peers," it said. "However, its governance indicators have improved over the last three years, especially in the areas of government effectiveness, voice and accountability and regulatory quality."

One of the key reforms referenced by Fitch was the raft of anti-money laundering (AML) laws passed by Congress in 2019. This year there has already been legislation to bring limits and transparency into the funding of political parties and there are proposals to address the independence of the country's judiciary, as well as reforms aimed at improving the transparency and efficiency of the country's public sector.

Cantero is keen that the central bank plays its part in this push for institutional strength and transparency. As well as extending its supervision into the *casa de crédito* sector, the central bank is also proposing to regulate other areas that are (surprisingly) still completely unregulated, such as the pensions industry.

It is also implementing a 2016 banking law that brings in Basel II standards.

"With the support of the IMF we are in the process of introducing a system of risk-based supervision," Cantero


Clean and renewable energy for the development of the country
Itaipu, world energy leader with 2,700 million MWh of total accumulated production. (1984-2020)
ITAIPU BINACIONAL
Energy for development

José Cantero, governor of the Central Bank of Paraguay.

says. "We are also doing the same with superintendency of insurance.

"I think we are at a turning point in our history," says Cantero, who adds that the country is still weighed down by an all-too-common negative perception among international investors. "Our narrative has been that we have always been a very stable economy – a cheap economy – but in the coming months and years that narrative will start to be complemented by these institutional reforms. That will completely change how we see ourselves – and hopefully how other countries see Paraguay."

Cantero admits that all these new regulations and extensions of supervisory responsibilities are demanding: "We have a lot of projects – for example, we are also working to make the country's payment system 24 hours, seven days a week so that the market will have a much broader and more efficient system. We are also in the process of broadening the legislative capacity [following the multiple AML laws], and that will be the main challenge for the central bank and the country this year – but I think we are prepared."

DAY JOBS

Meanwhile, Cantero also needs to keep the central bank's staff on their day jobs. Inflation is within its target range of 4% plus or minus 2 percentage points, and closed 2019 towards the lower bound, at 2.8%, due to the economic slowdown. The currency has been moving in line with emerging markets and Latin American currencies, weakening against the dollar.

Cantero disputes some views in the country that the bank tends to track the Brazilian real to disincentivize smuggling (which becomes more lucrative if the guarani strengthens against the real).

"The only target is the inflation target [which was legislated in 2011]," says Cantero. "We don't have any forex target. Obviously we need to take into consideration what is going on in the region, and if there is a tendency we have to go with that tendency, but we are not going to intervene with an objective of a foreign exchange price."

Cantero says the central bank's limited net intervention in the exchange markets, at just $130 million, is proof that the bank isn't managing valuations but acting strategically: "The [guarani] forex market is quite narrow. Any type of excess demand or supply has a very strong impact on the markets and [at those times] we need to have some presence."

He also rejects suggestions from certain sectors of Paraguay's private sector that the country's banking sector is too uncompetitive – that it generates 20%-plus return on equities (ROE) without needing to take risk, either by extending credit or working to bring new segments of the population into the system.

"The main ingredient in [banks' ROE results] is efficiency – through the use of technology – which allows us to think that profitability is in line with sustainability," he says. "There is also a high level of competition."

But does he think the incumbent banks will reach out to the unbanked sector or will that come through fintechs?

"Fintech is something that is new to Paraguay and we still don't know how it will evolve," replies Cantero. "We don't know what growth velocity it will have in the future. Up until now most of the bankerization of the country has been through the banking sector. There has been a huge transformation in bankerization in the past 10 years and most banks are in all the states and districts of the country. And now with the implementation of mobile phone technology, their coverage is even greater."

Cantero says that the bank's measurement of the level of indebtedness in the private sector is "low and sustainable", which is backed up by the reported level of the country's banks' loan portfolios – both the total size and the non-performing loans.

A constant critique of the country's banking sector from the rating agencies is the high level of dollarization, but with this point Cantero is less in agreement than when discussing the need for improved institutional strength.

"In the last few years the level of dollarization has declined in the banking sector," he says. "It's now at around 44%, but the management practice of the banks is to only lend in dollars to those who produce dollars. If you analyze the balance sheet of the banking sector, they are hedged in terms of their balance sheet."

The other perennial weakness of the Paraguayan banks – to a greater or lesser extent depending on the specific entity – is a high exposure to the agricultural sector. Cantero sees this as a related point to the dollarization – that is, a function of matching the financial realities of the economy.

"Agriculture remains the main sector of our economy and it's still a very profitable sector," he says. "And it's the sector that will probably lead the economy this year."

Cantero argues that as the Paraguayan economy continues to diversify, so, too, will the loan portfolios of the country's banks.

He adds: "We are in a very important process of diversification and that is the strategy we need for the near future. We estimate that in 2020 the export of manufacturing of an industrial origin will surpass that from an agricultural origin. It will surpass that of meat – which is $1.2 billion. That's something very new for our economy and this diversification is going to accelerate even faster."

BANCO BASA
takes the lead through innovation

Paraguay's positive growth and credit metrics create a compelling investment story and Banco Basa is leading the country's financial evolution – for the benefit of both domestic and international investors, says president Fernando Paciello.

Banco Basa is a leading Paraguayan financial institution and, just like our country's economy, the recent history is a story of strong and sustainable growth delivered through the diversification of revenues.

Our strong management has a clear and differentiated vision for growing the bank, aligned with our country's growth, and this has led Banco Basa to outperform our competitors in recent years. Today that management is changing, though the vision and commitment to being part of the Paraguayan growth story will remain as strong as ever. As incoming president from the beginning of March, I am strongly committed to delivering Banco Basa's strategy into a new era.

Since the end of the global commodities boom in 2014, many of the Latin American economies have experienced slowdowns, even recessions, with many suffering deteriorating public finances and ratings downgrades.

In sharp contrast, Paraguay has sustained strong GDP growth, averaging around 4% annually and – thanks to a strong set of fiscal laws that govern public sector expenditures – improving ratings. Paraguay is now just one notch below investment grade with Moody's and Fitch, and two below with Standard & Poors.

During these changing times, Banco Basa has been helping local and international companies alike embrace the challenges and opportunities – both regional and domestic. And just like Paraguay's economy, we have experienced strong growth – 2019 was the seventh consecutive year in which we grew our revenues and profits above the system average.

Banco Basa is unlike any other bank that operates in Paraguay. First, we are completely local – our managers and shareholders are exclusively Paraguayan. Our knowledge of the country and its companies, and our connections throughout all sectors of the economy, is unsurpassed.

Second, we have a uniquely long-term vision, both of the economy and for our client relationships. Our depth of knowledge of the macro-economic environment combines with our unmatched understanding of the economic and financial fundamentals that affect the industries that drive our clients' businesses. It's not surprising that we have the deepest relationships within the Paraguayan productive sector and Banco Basa sponsors both the Paraguayan Industrial Union and the Paraguayan Cattle-Raising Association.

This long-term vision is why we are uniquely trusted: our funding mix is more than 60% made up of long-term deposits, whereas Paraguay's financial system as a whole is dominated by sight deposits. This stable funding structure gives us the longer-term perspective that truly differentiates Banco Basa as a bank. The economic flatline of 2019 was caused by a slowdown in a drought-affected agricultural sector. Where many of our competitors responded in the first half of the year by seeking to lower its exposure to agriculture and related sectors, Banco Basa increased its commitment, winning market share and – more importantly – new client relationships.

Because at Banco Basa we believe the real reason we have been outpacing the growth of Paraguay's financial sector – our market share has grown to 5.1% from 1.9% just five years ago – is that we have adopted a client-centric approach rather than being another bank selling products. The outlook for future growth is hugely positive: Paraguay's financial system is about 40% of the size of its GDP – both in terms of assets and liabilities – and with a regional average of 60%-65%, the opportunity for structural growth in the financial system is clear.


Fernando Paciello, president, Banco Basa

And these client relationships have not just grown our existing business but they have taken us into completely new areas. In 2019, Banco Basa became the first Paraguayan bank to launch a brokerage service (certified by the central bank). However, Basa Capital is much more than just a trading operation: we offer a full range of investment banking services, including M&A, and we are leading the development of the country's burgeoning infrastructure-finance market. We believe that our capacity to help clients grow shouldn't be limited by our balance sheet, and the creation of Basa Capital is a crucial part of delivering that strategy.

The main driver of Banco Basa's growth in recent years is a genuine belief in Paraguay's bright economic future. We believe that becoming an investment grade country is just a matter of time and Banco Basa is working hard to anticipate the added growth impulse that will come. There is huge potential in the country's capital markets and our commitment to this development process is clear: in February 2020, Banco Basa was the first bank to sell local bonds with a 10-year tenor. The high level of oversubscription for that deal was testament to the strong name the bank has in the local markets. But we are planning for more, with the bank's decade-long track record being verified by international ratings agencies and audit firms, as well as by Kroll from a compliance perspective.

International recognition has already come our way. Euromoney magazine awarded Banco Basa with best bank in Paraguay in its 2019 awards for Excellence – the first wholly Paraguayan financial institution to receive this award.

One of the main challenges for the Paraguayan economy in the coming decade will be to continue to deliver strong growth in a sustainable way – financially and environmentally – for the whole of society. Banco Basa is leading here, too. We are committed to being a strong corporate citizen, as illustrated by our environmental, social and corporate governance policies that include running Arambé school for 350 underprivileged children and our full membership of Sustainable Finance.

Our commitment to drive this growth has a single source: we believe in Paraguay.