



MONETARY POLICY REPORT

September
2015

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Central Bank of Paraguay

Executive Summary*

World growth

Annual change, percent

	2014 (e)	2015 (f)	2016 (f)	2017 (f)
World(*)	2.8	2.6	3.0	3.4
United States	2.4	2.5	2.8	1.5
Eurozone	0.9	1.4	1.7	1.6
China	7.3	6.8	6.5	6.5
Brazil	0.1	-2.2	-0.2	1.5
Argentina	0.5	0.6	0.9	2.9
Trading partners	1.5	0.7	2.0	2.5
Trading partners Mercosur	0.6	-1.3	0.1	2.2

(e): Estimate.

(f): Forecast.

(*): Corresponds to world growth at market FX rate.

Source: Simple average of Bloomberg and Consensus Forecast.

In the international scenario, the greater degree of uncertainty over the last few months is highlighted. In developed economies, while growth expectations in the United States are higher than those indicated in the June Monetary Policy Report, the Euro zone would have a more moderate dynamics than previously foreseen. On the other hand, the Chinese economy has decelerated more than expected, a situation that has led the government to adopt exchange rate and monetary measures that seek to attenuate the lower dynamism of economic activity. This situation triggered a marked fall of commodity prices and significant reactions in the main international financial markets. Meanwhile, in Latin America the persistent deterioration of economic activities and medium term growth expectations continues, being the poor economic development of Brazil the main factor behind this behavior.

In the United States, upward revisions in the first and second quarter have contributed to an improvement of growth expectations in relation to previous estimates. This improved outlook is largely explained by data correction regarding non-residential fixed investment, private inventories, government expenditures and personal consumption. In turn, the labor market continues with good momentum, in spite of a slight moderation, at the margin, of certain specific sectoral indicators. Furthermore, beyond the decision adopted at the last meeting of the Federal Reserve, the uncertainty associated with the beginning of monetary normalization and its possible effects in international financial markets does continue.

In the Euro zone, the moderate dynamism of economic activity is highlighted. First and second quarters figures were revised upward, although lower growth was observed in the second quarter. Economic growth resulted from greater levels of consumer expenditures and the positive contribution of net exports. Despite these results, at its last meeting, the European Central Bank lowered its projections of growth for the current

* The Spanish version prevails

Gross Domestic Product by sectors

Annual change, percent

	2014	2015(f)
Primary Sector	4.7	3.9
Agriculture	2.2	4.4
Livestock	14.4	2.0
Others	3.8	4.9
Secondary Sector	2.4	2.6
Manufacturing	9.3	4.3
Construction	13.8	6.0
Binationals	-9.0	-0.9
Tertiary Sector	5.9	4.0
Public Administration	5.0	6.1
Trade	5.8	1.9
Communications	3.2	1.0
Other Services	7.3	5.6
Taxes	6.0	4.6
GDP	4.7	3.7
Non-agricultural GDP at market prices	5.3	3.5
GDP w/o agriculture and binationals	7.4	4.0

Source: Central Bank of Paraguay
(f) Forecast

Economic growth and current account

Annual change, percent

	2014	2015*
GDP	4.7	3.7
Domestic demand	5.3	4.3
Gross capital formation	11.0	6.1
Gross fixed capital formation (GFKF)	8.8	7.1
Total consumption	3.8	3.8
Private consumption	3.7	3.4
Public consumption	4.2	6.4
Exports of goods and services	4.3	-1.0
Imports of goods and services	5.3	-0.5
Current account (% of GDP)	-0.4	-1.6
GFKF (% of nominal GDP)	15.9	16.4
GFKF (% of real GDP)	18.8	19.4

Source: Central Bank of Paraguay

and the next year, due to the weakness of external demand. As regards the labor market, unemployment continues a downward trajectory in line with the favorable results of economic activity.

In emerging markets, uncertainty about China has increased, not only because of its economic deceleration but due also to the turmoil in its financial markets. While a growth of 7% was recorded in activity in the second quarter, the manufacturing industry continues to deteriorate, chiefly due to the fall of new domestic purchase orders and fewer exports. In line with the weaker performance of the economy in August, the Central Bank has decided to devalue the Yuan in order to boost economic activity. However, this measure has given rise to sharp depreciations of the currencies of emerging economies and has contributed to a greater deterioration of global financial conditions, and a sharper fall in commodity prices. At the regional level, the successive downward revisions of growth projections of Paraguay's principal trade partners have significantly deteriorated external demand. Brazil again registered a contraction in economic activity in the second quarter, leading once more to a downward revision of growth expectations for 2015 and 2016. In spite of the weak economic performance, annual inflation rose to 9.5% in August, far above the 4.5% target. Given this scenario, at its August meeting the Central Bank of Brazil (BCB) decided to maintain the Selic rate at 14.25%, after having raised the rate by 50 basis points (bp) at the previous meeting. The BCB reiterated that it deemed necessary to maintain the monetary policy rate at these levels for a prolonged period in order to achieve convergence of inflation to the target at the end of 2016. Meanwhile, Argentina has shown a slight rebound of economic activity in the last few months, as economic growth increased by 0.5% quarterly in the second quarter of 2015. This behavior is largely explained by an expansion of investment and public consumption, and to a lesser extent, by private consumption. In this manner, annual inflation indicators have decelerated in the last months.

In the domestic context, the pace of economic activity expansion has moderated in the last few months, a behavior that is mainly affected by the greater weakness

GDP growth

Contribution, percent

	2014	2015(f)
Domestic demand	4.9	4.0
Private consumption	2.4	2.2
Public consumption	0.4	0.6
Gross capital formation	2.1	1.3
Net external demand	-0.2	-0.4
Exports	2.6	-0.6
Imports	2.8	-0.2
GDP	4.7	3.7

Source: Central Bank of Paraguay

(f) Forecast

Inflation projection

Annual change, percent

	2014	2015(f)	2016(f)	2017(f)
Average CPI inflation	5.0	3.3	4.1	
December CPI inflation	4.2	3.7	4.3	
CPI inflation in around two years (*)				4.5
Average underlying CPI inflation	4.8	2.5	4.2	
December underlying CPI	3.4	3.2	4.3	
Underlying CPI inflation in around 2 years (*)				4.5

(f) Forecast

(*) Corresponds to the projected inflation for the third quarter of 2017.

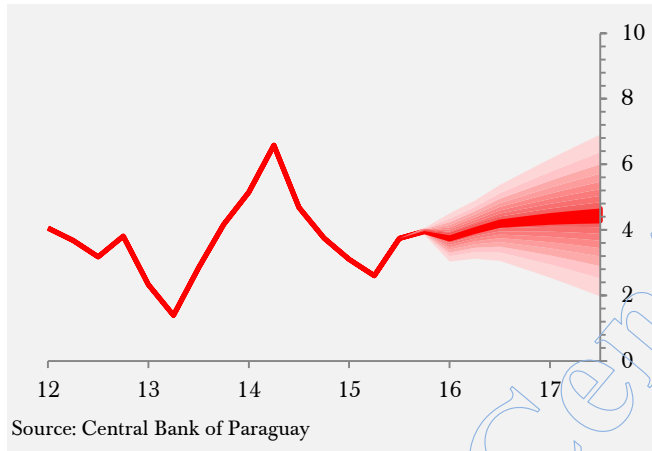
of neighboring countries and the sharp decline in commodity prices. In the second quarter, an annual growth rate of 2.2% was registered, which was largely sustained by the services, manufacturing and construction sectors. The electricity and water sector showed an annual drop of 4.4%, while agriculture showed a slight 0.3% annual growth rate. With this, GDP excluding agriculture and the bi-national hydroelectric dams registered an annual growth rate of 4%, which was again higher than the total. Domestic demand remains the chief component that explains growth on the demand side, while net exports have shown contraction in the same period.

Regarding prices, the trajectory of inflation in the third quarter has kept in line with the target. During this period, the total annual inflation average stood at 3.7%, while in monthly terms it was 0.2%, above the rates observed in the second quarter (2.6% and 0.1%, respectively). Inflation during the reference period is explained largely by the increase of the prices of services and durable goods that are closely tied to the evolution of the exchange rate. In this regard, although the Paraguayan Guarani has lost value vis-à-vis the United States Dollar in the last few months, the effect upon headline inflation has been mitigated, on the one hand, by the decrease of fuel prices and certain food items, and, on the other hand, due to greater depreciation of the of neighboring countries currencies with relation to the Guarani. This evolution of price rising currencies with relation to the dollar is a trend that has been observed throughout the region. Paraguay has not been immune from this phenomenon, although the depreciation of its currency has been relatively of lesser scale.

Since the publication of the June Monetary Policy Report, prospects in the international scenario continue to deteriorate, especially at the regional level, which would imply an even weaker external demand. In line with a weakened external scenario, economic activity has registered less dynamism in recent months. Given that inflation is under control, with expectations anchored to the target, in July the Open Market Operations Committee (CEOMA) deemed it appropriate to reduce the monetary policy rate (MPR)

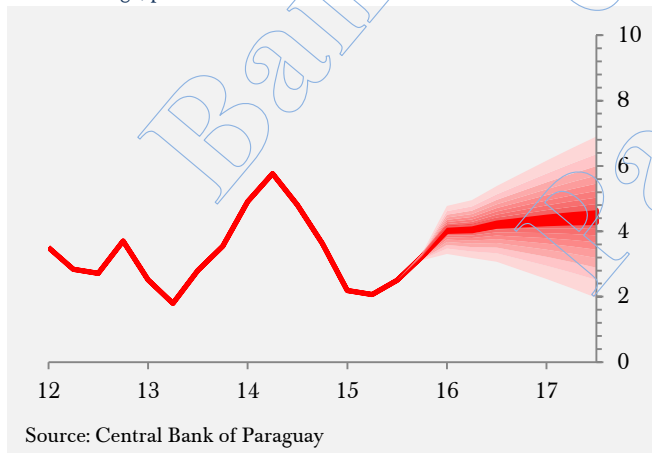
CPI inflation forecast

Annual change, percent



Underlying CPI inflation forecast

Annual change, percent



by 25 basis points to stand at 5.75% annually. This measure was adopted in order to provide additional monetary stimulus to what was done in previous months. Considering that no inflationary risks are foreseen in the medium term, the Committee decided in August and September that the maintenance of its monetary policy stance was the most appropriate measure to ensure that inflation converges to 4.5% over the relevant projection horizon.

In relation to the estimate of GDP growth for 2015, in the baseline scenario, growth estimates were reduced from 4% to 3.7% annually, explained by lower expected dynamism in the manufacturing, construction and services sectors. On the expenditure side, domestic demand would continue to be the principal factor that explains economic growth, taking into account the negative impact that net exports would have. In spite of this revision, Paraguay will remain among the countries that exhibit the most favorable economic performance within the region.

In the baseline scenario, at the end of the year total inflation is expected to stand at around 3.7%, below the rate projected in the June report. The most probable trajectory of inflation is expected to remain within the tolerance range during 2016 and 2017, with gradual convergence to the 4.5% target over the relevant projection horizon, in this case the third quarter of 2017.

The risks indicated in the previous report remain similar. In the international context, greater deceleration than expected of the Chinese economy could further deteriorate the prices of raw materials most relevant to Paraguay, affecting the terms of trade and exert upward pressure on the real exchange rate. Furthermore, risks associated with unexpected changes continue in relation to the time of start and pace of adjustment regarding the normalization of monetary conditions in the United States. At the regional level, a significant risk continues to be a worsening, larger than expected, of economic conditions in Brazil.

At the local level, one of the factors that have attenuated the pass-through effect of the exchange rate to inflation has been the lesser degree of depreciation of the



Guaraní as compared to the currencies of Paraguay's trade partners. However, as the local exchange rate increases more rapidly than that of those currencies and the depreciation gap is reduced, the downward pressure on domestic prices will be increasingly lower.

Having analyzed these alternative scenarios, the CEOMA considers that the risk balance for inflation is unbiased. In this regard, the Committee will remain alert to the evolution of the macroeconomic variables most relevant for domestic inflation, and will apply the monetary policy measures to enable the convergence of inflation to 4,5% over the projection horizon.

Banco Central
del
Paraguay