



MONETARY POLICY REPORT

December
2016



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Central Bank of Paraguay

Executive Summary*

World growth

Annual change, percent

	2015 (e)	2016 (e)	2017 (f)	2018 (f)
World (*)	3.0	2.5	2.8	3.5
United States	2,6	1,6	2,2	2,2
Eurozone	2.0	1.6	1.4	1.5
China	6.9	6.7	6.4	6.1
Brazil	-3.8	-3.4	0.7	1.8
Argentina	2.4	-2.0	2.9	2.9
Trading partners	0.3	0.6	2.0	2.4
Trading partners - Mercosur	-2.1	-2.7	1.1	2.1

(e): Estimate.

(f): Forecast.

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

Source: Simple average of Bloomberg, Consensus Forecast and WEO of October 2016.

In the international scenario, the perspectives for the global economy have shown a certain improvement in the last months, while in the region, the outlook has become less favorable since the previous Monetary Policy Report. Among advanced economies, in the United States, both economic activity and employment have continued to consolidate recoveries, which encourage the Federal Reserve to resume the process of normalization of its monetary policy. The Eurozone maintains its projections of moderate growth, while in China the projections have been revised slightly upward. Within the region, even though the recovery of the economies of the main neighboring countries is foreseen, the risk of a downturn persists, which is beginning to be reflected in growth estimates.

In the United States, in spite of the initial uncertainty generated by Presidential elections, which was later dissipated, both economic activity and employment indicators have shown continuous improvements in the last months. The Gross Domestic Product (GDP) grew 3.2% quarterly annualized in the third quarter, well above the 1.4% registered in the second quarter of 2016. This improvement was due to the increase of private inventories, federal government spending, and the greater dynamism of exports. Regarding manufacturing, the PMI improved in relation to the previous Monetary Policy Report, to stand once more in the expansion zone. This result is largely explained by the increase of new orders, production and employment. In the labor market, the unemployment rate was reduced to 4.6% in November, showing an important degree of consolidation. With respect to prices, inflation has increased in relation to the previous report, although it still remains below the target. Better economic conditions led the Federal Reserve, at its December meeting, to increase the range of interest rates. For the next year there are expectations of additional increases which will be based on the performance of relevant macroeconomic variables.

The Eurozone maintains a path of moderate expansion and growth expectations have not changed since the last report. While GDP growth in the third quarter remains similar to the level registered in the previous quarter, certain activity indicators improved as is the case with the

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

	2016	2017(f)	2017(i)
Primary Sector	3.1	2.4	0.6
Agriculture	2.5	2.0	0.4
Livestock	4.5	3.8	0.2
Others	7.0	2.1	0.0
Secondary Sector	9.5	4.1	1.1
Manufacturing	3.9	3.8	0.4
Construction	18.0	7.7	0.3
Binationals (Electricity & water)	12.2	3.1	0.4
Tertiary Sector	1.3	4.0	1.7
Public Administration	-2.5	2.0	0.2
Trade	1.2	2.8	0.4
Communications	-0.2	3.5	0.1
Other Services	3.6	6.2	1.0
Taxes	3.5	4.8	0.3
GDP at market prices	4.0	3.7	
GDP w/o agriculture and binationals	3.1	4.2	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

PMI which stood at 53.7, its highest level since January 2014.

Regarding the labor market, the reduction of the unemployment rate to a one digit figure (9.8%) is highlighted, since unemployment reached over 10% for more than five years. Although inflation increased slightly in the last quarter, the European Central Bank maintained its reference rates without any variations, and will continue with its asset purchase programme (APP) until the end of December 2017, although at a slower pace starting in April.

In China, short term indicators as well as growth expectations have improved slightly. The GDP expanded in the third quarter at the same rate as that registered in the first two quarters (6.7%), boosted with strong investment by the government. The manufacturing sector accompanies this behavior, as evidenced by greater output, favorable dynamism of exports and less contraction of employment. The PMI registered an increase in November, standing at 50.9, above the level published in the September report.

In the region, the Brazilian economy has shown a weakening of activity, which is reflected in the downward correction of growth estimates, in relation to what was indicated previously. The GDP in the third quarter contracted more than in the second quarter and manufacturing sector indicators remain in the contraction zone. In this context, market expectations of growth in 2017 stood at 0.58%, far below the level foreseen in the previous report (1.3%). In the labor market, the unemployment rate continues to rise, standing at 11.8% (the average for the August to October period). Regarding prices, inflation has presented a downward trajectory since the beginning of this year, which, basically, has led the Monetary Policy Committee of the Central Bank of Brazil (BCB) to decide to lower again its reference rate, which currently stands at 13.75% annually.

In Argentina, the macroeconomic scenario continues to be fragile. Although recovery is expected for the year 2017, estimates have been revised downward. According to the Monthly Estimator of Economic Activity (EMAE), the economy contracted 3.7% annually in September. Regarding manufacturing activity, the Monthly Manufacturing Estimator (EMI) presented a greater reduction than that registered in the previous report. This is explained largely by the falls in the metallurgical and automobile industries and the drop in the production of rubber and plastic. Regarding prices,

Economic growth and current account

Annual change, percent

	2015	2016	2017(f)
GDP	3.0	4.0	3.7
Domestic demand	1.7	1.1	3.4
Gross capital formation	1.2	2.5	5.5
Gross fixed capital formation (GFKF)	2.2	5.0	5.5
Total consumption	1.9	0.7	2.8
Private consumption	1.5	1.3	2.9
Public consumption	4.3	-3.0	2.0
Exports of goods and services	-1.3	3.0	2.5
Imports of goods and services	-4.0	-2.5	1.6
Current account (% of GDP)	-1.1	1.3	1.2
GFKF (% of nominal GDP)	16.5	16.6	17.8
GFKF (% of real GDP)	18.7	18.9	19.2

Source: Central Bank of Paraguay

inflation continues to increase beyond the levels registered in the previous quarter. Nevertheless, market expectations point towards a gradual reduction in the coming year, with the implementation of the inflation target scheme announced in September 2016.

At the domestic level, economic activity maintained the positive dynamism and sectorial diversification noted in the previous report. In the third quarter, the GDP grew 5% y-o-y explained largely by activities carried out in the secondary sector (manufacturing and construction) and the tertiary sector (commerce and services). On the expenditure side, while external demand continues to represent the main factor for growth, the performance of investments improved with respect to the previous quarter. Meanwhile, private consumption continues to show moderate expansion. Given this scenario, growth forecasts for 2016 remained at 4%.

As concerns prices, since the last Monetary Policy Report total inflation has increased, mainly due to the rise in the prices of certain food products. The average between October and November stood at 3.9%, higher than the 3.2% registered in the third quarter. However, core inflation continued to show a downward trajectory, the average y-o-y core inflation stood at 3.3% in the last period, below the 3.5% registered in the third quarter. Regarding other underlying measures, greater inflation is observed, due in part to the significant increase of beef prices, explained by supply factors.

Considering the favorable momentum in economic activity and inflation measures in line with the target in the relevant projection horizon, the Open Market Operations Committee (CEOMA), at its October and November meetings, has deemed it appropriate to maintain the monetary policy stance. The Committee considered that there were no relevant factors that could deviate the expected trend of inflation away from the target over the projection horizon. At its last meeting of the year 2016, the Committee pointed out that in the international context, the adjustment of the Federal Reserve's funds rate had not generated important changes in financial markets. On the local level, inflation maintained a favorable behavior, while economic activity had moderated at the margin, although this was explained by sectors not linked to monetary policy. In this context, the Committee decided again to maintain the monetary policy rate, which has stood at 5.50% annually since July 2016.

In the baseline scenario, the growth projection for 2016 remained at 4%, with a slight sectoral recomposition. The

Inflation projection

Annual change, percent

	2015	2016(f)	2017(f)	2018(f)
Average CPI inflation(*)	3.0	3.8	4.3	
December CPI inflation	3.1	3.6	4.1	
CPI inflation in around two years (***)				4.5
Average underlying CPI inflation(*)	2.5	3.5	4.3	
December underlying CPI (**)	3.5	3.6	4.1	
Underlying CPI inflation in around 2 years (***)				4.5

(f) Forecast.

(*) Corresponds to the average of the fourth quarter.

(**) Corresponds the inflation on the end of the period.

(***) Corresponds to the projected inflation for the fourth quarter of 2018.

primary sector growth rate decreased, while growth rates increased for the secondary and tertiary sectors. The GDP growth rate for 2017 is foreseen to reach 3.7%, based largely on the expansion projected for commerce, communications, general government, and services to be provided to businesses and households, among others. In addition, manufacturing and constructions will have a major impact on next year growth. On the expenditure side, private consumption and investment would be the main factors of growth. Likewise, public consumption would show a recovery by 2017 after the fall observed on this year. External demand would have a positive contribution to GDP, although smaller than the growth rate of 2016.

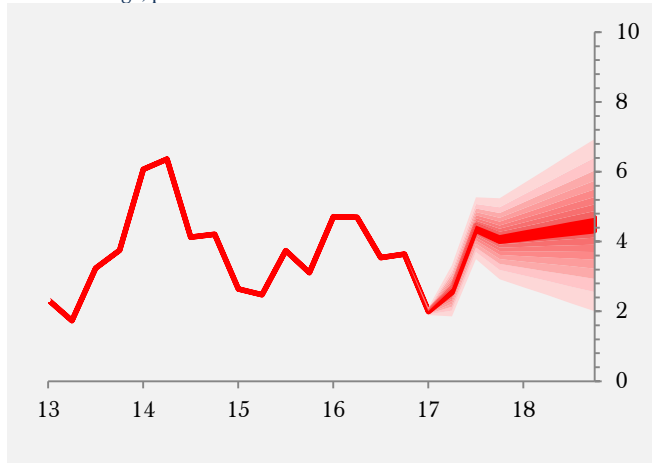
As concerns prices, in the baseline scenario, projected inflation stands at 3.6% at the end of the year, above the level presented in the previous report (3.3%). This change is explained largely by an increase in the prices of certain food items, particularly volatile basket products that caused inflation in the last quarter to rise above the previous forecast. By other side, the projection of underlying inflation in 2016 stands at 3.5%, slightly greater than in the previous quarter, basically due to the slight depreciation of the Paraguayan Guarani, reflected in the prices of imported goods. Looking forward, the inflation trajectory is expected to remain stable over the next two years. No changes are expected in the projections for 2017. Total inflation is expected to stand above 4% starting in mid-2017, with a gradual convergence to the 4.5% annual target in the relevant horizon of projection, in this case the fourth quarter of 2018.

As concerns risk scenarios, at the international level, the Federal Reserve recently increased its monetary policy rate and a path of gradual adjustments is expected for the year 2017. An important aspect to consider is a faster pace of adjustments than currently expected, which could increase the cost of external financing and exert pressures on the currencies of emerging economies in a more rapid manner. Regarding Europe, the uncertainty associated with the Brexit's process has been reduced in virtue of the governmental plans to design the necessary mechanisms for an ordered exit. Likewise, in China, the short-term risks have been attenuated, taking into account the improvement of private investment and the effects of the stimulus measures applied by the government.

In the regional context, the positive signs regarding the recovery of the Brazilian economy have weakened in the last months. Furthermore, effective implementation of

CPI inflation forecast

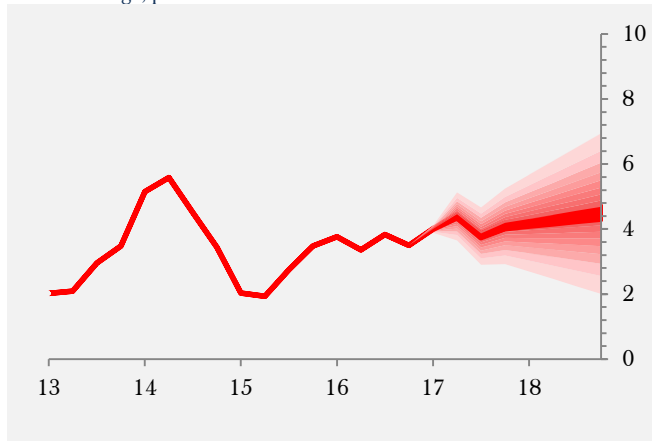
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

the fiscal reform continues to face important challenges, given the complex political situation. The strength of its recovery will depend crucially on the reduction of political and economic uncertainty. Also, Argentina is still going through a complex process of economic transition, although recovery is expected in 2017.

Another risk factor to consider is the evolution of oil prices in the upcoming months, since prices have recently increased in the international markets, as a result of agreements reached among the main world producers to cut production. To the extent in which these commitments are kept, oil prices could continue to rise, which in association with a scenario of strengthening of the United States dollar, would exert pressure on the internal prices of countries that import oil and petroleum-derived fuels.

At the domestic level, an element to take into account is the evolution of the exchange rate in coming months, even though this will depend in great measure on the next steps adopted by the Federal Reserve in 2017. Nevertheless, since the exchange rate effect constitutes a transversal shock for all economies, the impact on the dynamics of domestic prices, in any case, will depend on the behavior of the real exchange rate with respect to the currencies of Paraguay's main trade partners.

Likewise, as mentioned in previous monetary policy reports, the reversal of price differentials in relation to Argentina (given lower prices in Paraguay) continues to generate a significant flow of retail sales in border zones. This factor is also contributing to the momentum of commercial activity. However, to the extent that this demand increases, the prices of certain local products could increase, although this will also depend on domestic output capacity in order to satisfy the additional demand.

As concerns trade with Brazil, despite its fragile economic situation, Paraguay's exports to that country increased in 2016. In the same manner, re-exports have shown significant recovery in the recent months, explained largely by the appreciation of the Brazilian real vis-à-vis the US dollar. In this sense, while growth prospects have weakened, the evolution of the value of Brazilian currency will also be an important element for the consolidation of the recent dynamics of border trade in 2017.

On the other hand, it is important to point out that a new mechanism for the upgrading of the minimum wage This mechanism allows for periodic adjustments on an annual



basis, in contrast with the former rule in which changes could be made only after cumulative inflation had reached or surpassed a 10% increase since the time of the latest change. In recent years, an adjustment of the minimum legal wage has taken place, on the average, every 30 months. The new rule allows for more frequent adjustments, which might generate an increase in the persistence of inflation, to a certain extent, in cases in which the economy faces the effects of external or internal shocks, given that the rule limits the period of time for making accommodations. However, as Paraguay has maintained low inflation in recent years, particularly during the period of implementation of the inflation target scheme, it is not expected that the new rule would jeopardize compliance with the 4.5% annual target.

The CEOMA, having evaluated the alternative scenarios, considers that the balance of risks for inflation is unbiased. In this regard, the Committee will continue to monitor the evolution of the most relevant macroeconomic variables for domestic inflation, applying in a timely manner the monetary policy measures that will allow the convergence of inflation to the target of 4.5% annually over the policy horizon.