MONETARY POLICY REPORT

September 2016

Central Bank of Paraguay

Executive Summary*

The international and regional scenarios remain complex. The forecasted global growth for 2016 remained at 2.4% as in the June Monetary Report. This result includes compensations of upward and downward revisions in the growth projections of the different countries, globally and regionally. The United States recorded a pronounced downward revision in its growth projection for 2016, while the Eurozone and China showed positive revisions. In the region, Brazil's growth projections improved compared with the previous Monetary Policy Report.

World growth
Annual change, percent

	2014	2015 (e)	2016 (f)	2017 (f)
World (*)	2.8	2.8	2.4	2.7
United States	2.4	2.6	1.5	2.2
Eurozone	0.9	2.0	1.6	1.4
China	7.3	6.9	6.6	6.3
Brazil	0.1	-3.8	-3.3	0.8
Argentina	0.5	2.4	-1.5	3.0
Trading partners	1.5	0.3	0.6	2.0
Trading partners - Mercosur	0.5	-2.1	-2.5	1.3

(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 United States, the Gross Domestic Product (GDP) grew 1.4% quarterly annualized during the second quarter, above the 0.8% recorded in the first quarter. This result was explained by the increase in personal consumption expenditures, exports and non-residential fixed investment. On the other hand, in the manufacturing sector, the PMI of August was placed in contraction zone for the first time after five months of expansion. In the labor market, the unemployment rate has remained stable at 4.9% since June.

In the Eurozone, quarterly growth rate observed in the second quarter was lower than that registered in the first quarter of the year. This reduction was explained by smaller increase in the household consumption, lower gross capital formation and increase in imports. The unemployment rate has remained stable at 10.1% since April.

The annual growth in China in the second quarter of the year was the same to the registered in the first one (6.7%). In the manufacturing sector, the PMI decreased in August related to July. This result was due to lower production growth, new orders, declining exports and the contraction of employment.

In Brazil, the GDP showed a slightly greater reduction than the private sector expectations in the second quarter. The manufacturing sector remained weak which is shown in the PMI that remained in contraction area. Although some indicators remain fragile, consumer and industry confidence have improved at the margin. In line with this, growth expectations reported by the Focus Survey of the Central Bank of Brazil (BCB) have been revised upwards compared to those observed until the previous Monetary

* The Spanish version prevails.

Gross Domestic Product by sectors
Annual change, percent

	2015	2016(f)	2016(i)
Primary Sector	5.2	3.2	0.8
Agriculture	6.5	2.5	0.5
Livestock	0.2	5.0	0.3
Others	7.1	7.0	0.1
Secondary Sector	2.4	9.1	2.3
Manufacturing	3.1	4.0	0.4
Construction	2.5	18.0	0.7
Binationals (Electricity & water)	1.6	11.1	1.2
Tertiary Sector	2.4	1.6	0.7
Public Administration	4.3	-2.0	-0.2
Trade	-0.8	1.9	0.3
Communications	0.8	-0.9	0.0
Other Services	4.8	3.8	0.6
Taxes	0.5	3.5	0.2
GDP at market prices	3.0	4.0	4.0
GDP w/o agriculture and binationals	2.3	3.3	

Source: Central Bank of Paraguay
(f): Forecast.
(i): Incidence.

Economic growth and current account
Annual change, percent

	2014	2015	2016(f)
GDP	4.7	3.0	4.0
Domestic demand	5.3	1.7	2.5
Gross capital formation	11.0	1.2	5.0
Gross fixed capital formation (GFKF)	8.8	2.2	5.0
Total consumption	3.8	1.9	1.8
Private consumption	3.7	1.5	2.4
Public consumption	4.2	4.3	-2.0
Exports of goods and services	4.3	-1.3	2.1
Imports of goods and services	5.3	-4.0	-1.0
Current account (% of GDP)	0.1	-1.1	0.5
GFKF (% of nominal GDP)	15.9	16.5	16.6
GFKF (% of real GDP)	18.8	18.7	18.8

Source: Central Bank of Paraguay

Policy Report. Regarding monetary policy, at its August meeting the BCB maintained its SELIC annual rate at 14.25%.

In Argentina, indicators of economic activity continue to show signs of fragility. Annual GDP growth was negative in the second quarter of the year. As for industrial activity, in July there was a contraction of the Monthly Manufacturing Estimator (EMI), both in monthly and annual terms. Regarding prices annual inflation, measured by the Index of Prices of the City of Buenos Aires (IPCBA), decreased in August in comparison with the previous month.

The Paraguayan economy has remained resilient before the more complex external context. Even though the economic activity moderated since mid-2015, as of the second quarter of 2016 it has regained momentum. The GDP grew 6.2% quarterly annualized, greater than the 1.5% observed in the first quarter. This result was mainly explained by the recovery of some branches of the manufacturing industry, construction, commerce and livestock sectors. On the expenditure side, external demand remains the key growth factor. As of the first semester, accumulated growth stood at 3.7% in line with the current growth forecast.

As regard to inflation, its trajectory has moderated since the last Monetary Report. In the third quarter, the average y-o-y inflation rate stood at 3.2% below the rate observed in the previous quarter (4.2%). The reversal of some volatile basket prices and the lower pressures on the exchange rate reflected in the behavior of imported goods (mainly durable goods) continue to be the main factors explaining the latest inflation trend.

As concerns the various inflation measures, the core inflation continued to show a downward trajectory. The core inflation stood at 3.5% annually in the third quarter, below the 3.8% registered in the previous quarter. Considering this favorable outlook for inflation and that there was room for further consolidation of some sectors in the medium term, the Open Market Operations Committee (CEOMA) at its July meeting considered appropriate to provide an additional monetary stimulus. The CEOMA reduced the monetary policy rate by 25 bps, at 5.5% per year, the rate maintained at the next two meetings (August and September meetings).

In line with the greater dynamism of economic activity, in the baseline scenario, the GDP growth estimate for 2016 was again revised upward, in this case from 3.5% to 4%. Likewise, the improvement in diversification has been reflected in sectoral adjustments. In the secondary sector, forecasts for construction, electricity production and manufacturing were corrected positively. On the other hand, in the tertiary sector, although trade was revised up, overall, the growth of the sector verified a downward adjustment, mainly explained by a drop in the public administration services. On the expenditure side, the upward correction in external demand largely explains the change in the product revision, taking into account that the estimates of public and private consumption were adjusted downwards. According to short-term indicators, prospects for the remainder of the year remain favorable for economic activity.

On the price side, in the baseline scenario, projected inflation is around 3.3% for the year-end, below the one forecasted in June. The downward adjustment is explained, on the one hand, by the reduction of some volatile basket prices, higher than initially forecast, which conditions the projection of inflation to a lower level. In addition, the exchange rate has continued to appreciate in recent months, so the expectation of it implies lower inflationary pressures in the short term. Nevertheless, the uncertainty regarding the rate adjustment by the Fed and its potential effect on the exchange rate remains. For its part, core inflation would close around 3.5%, higher than projected in the previous report. This behavior is largely due to the recent increase in the prices of some specific products of the food sector, affected by factors of supply. This change in relative prices is expected to reverse in the short term. Beginning in 2017, the different inflation measures will be located above 4%, reaching values close to the target, particularly in the second part of next year, converging gradually to 4.5% in the relevant horizon of projection, in this case the third quarter of 2018.

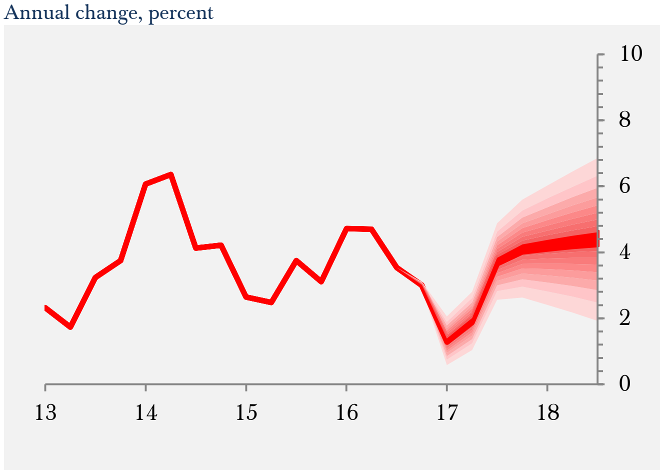
Inflation projection
Annual change, percent

	2015	2016(f)	2017(f)	2018(f)
Average CPI inflation(*)	3.0	3.6	4.3	
December CPI inflation	3.1	3.3	4.1	
CPI inflation in around two years (***)				4.5
Average underlying CPI inflation(*)	2.5	3.4	4.3	
December underlying CPI (**)	3.5	3.5	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 third quarter of 2018.

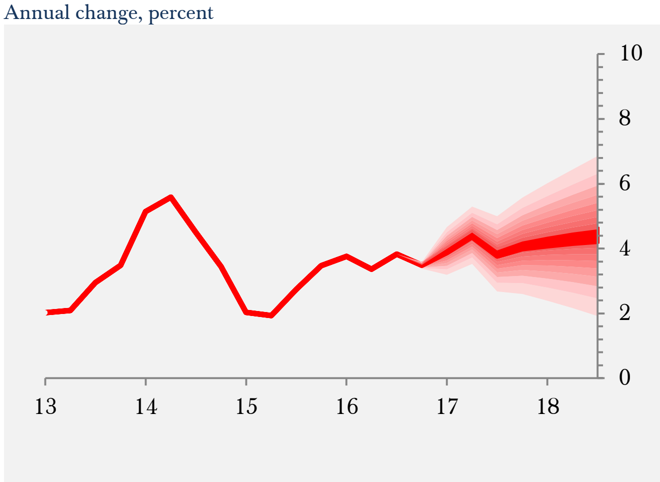
The risk scenarios raised in this report remain relatively similar to those of the previous Monetary Policy Report. At the international level, although the Fed kept the interest rate again at its meetings in July and September, the higher odds of a possible short-term adjustment are concentrated for the December meeting, although it will continue to be based on the strength of economic activity and the labor market. An increase in rates would lead to an increase in the cost of external funding and greater pressure on the currencies of emerging economies. On the other hand, the uncertainty of the Brexit process remains a downside risk factor for the global economy. As for China, short-term risks have moderated, given the greater stability of its growth, driven largely by stimulus policies implemented by the government. However, there are some risk factors, such as the sustainability of these

CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

measures and the functioning of the financial and real estate system.

At the regional level, Brazil's confidence indicators and growth prospects have improved in recent months. This context, together with the significant appreciation of its currency, represents an upward risk factor for local economic activity, due to the effect it could have on bilateral trade, mainly the border trade. In fact, re-exports have begun to improve substantially in recent months. However, with respect to the Brazilian economy, there are still challenges that the government must face, such as unemployment, high inflation and fiscal reforms. The recovery of activity will depend to a large extent on further strengthening confidence and reducing internal uncertainty and political tensions that could affect the government's ability to successfully implement planned reforms.

At the domestic level, pressures from the external sector on the nominal exchange rate declined, following the successive postponements of the Fed rate adjustment. However, some pressure on currencies could be verified if the labor market and activity continue to strengthen in the United States. Additionally, the relevant external inflation for our country is another factor that must be considered. The measures adopted by the new Argentinian government led to a rise in prices, generating important incentives for trade in areas bordering Argentina, especially in Encarnación. This higher demand could have a positive impact on the activity but could also exert some pressure on the prices of certain local products.

When evaluating the alternative scenarios, the CEOMA considers that the balance of risks for inflation is in equilibrium. In this regard, the Committee follows the evolution of the most relevant macroeconomic variables for domestic inflation, applying in a timely manner the monetary policy measures that allow the convergence of inflation by 4.5% annually in the projection horizon.