



# MONETARY POLICY REPORT

## March 2016



BCP © Derechos Reservados 2016

Central Bank of Paraguay

## Executive Summary\*

In the international context, world economic activity points towards a less dynamic scenario. With respect to developed countries, in the United States it is expected that recovery will be slower than that indicated in the previous report (December 2015). Likewise, growth projections in the Eurozone have been slightly revised downward. Among the emerging countries, China continues to decelerate, while in Brazil, reports of growth expectations have been adjusted further downwards in the last few months. On the basis of these events, the expected growth rates for Paraguay's main trading partners have been revised downward.

### World growth

Annual change, percent

	2014 (e)	2015 (f)	2016 (f)	2017 (f)
World(*)	2.8	2.6	2.5	2.9
United States	2.4	2.4	2.3	2.4
Eurozone	0.9	1.5	1.6	1.6
China	7.3	6.9	6.4	6.2
Brazil	0.1	-3.8	-3.5	0.5
Argentina	0.5	1.0	-0.3	2.4
Trading partners	1.5	0.3	0.6	2.1
Trading partners- Mercosur	0.5	-1.9	-2.3	1.5

(e): Estimate.

(f): Forecast.

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

Source: Simple average of Bloomberg and Consensus Forecast.

In the United States, the growth rate in the fourth quarter 2015 was revised upward, although it still continues below the level registered in the third quarter. On the other hand, the manufacturing sector's PMI remained in the contractive zone, despite the higher level registered in February. As regards the labor market, the outlook remains positive, keeping the unemployment rate at its lowest level since 2007, on par with the continuous increases in non-farm payrolls.

As concerns the Eurozone, economic activity remains at a moderate pace of expansion, recording a similar rate in the previous quarter. Although the manufacturing sector continues in the expansionary zone, the PMI level in March was below the one indicated in the December Monetary Policy Report (IPoM). Meanwhile, the unemployment rate continues to decrease, although it still remains above its historical average. At the March meeting, the European Central Bank took another monetary stimulus to the economy by reducing the main interest rates and with the expansion of its assets purchase program.

In China, the deceleration of economic activity continues, closing the year 2015 with the lowest growth rate registered in the last twenty-five years. In addition, the manufacturing sector registered a greater contraction in February, explained in part by the larger deterioration of output and new business orders.

\* The Spanish version prevails

### Gross Domestic Product by sectors

Annual change, percent

	2015	2016(f)
Primary Sector	4.7	2.7
Agriculture	6.3	3.1
Livestock	-1.3	1.5
Others	7.3	0.8
Secondary Sector	2.0	4.2
Manufacturing	1.9	1.9
Construction	4.4	7.5
Binationals	1.3	5.2
Tertiary Sector	2.8	2.5
Public Administration	5.5	3.6
Trade	0.0	-1.8
Communications	-0.2	3.0
Other Services	4.7	5.7
Taxes	1.2	3.0
GDP	3.0	3.0
Non-agricultural GDP at market prices	2.2	3.0
GDP w/o agriculture and binationals	2.4	2.7

Source: Central Bank of Paraguay

(f) Forecast

### Economic growth and current account

Annual change, percent

	2015	2016*
GDP	3.0	3.0
Domestic demand	2.5	3.2
Gross capital formation	1.5	4.8
Gross fixed capital formation (GFKF)	2.0	4.6
Total consumption	2.8	2.8
Private consumption	2.4	2.7
Public consumption	6.2	3.0
Exports of goods and services	-3.2	-6.6
Imports of goods and services	-4.7	-7.5
Current account (% of GDP)	-1.8	-1.4
GFKF (% of nominal GDP)	16.4	16.6
GFKF (% of real GDP)	18.6	18.9

Source: Central Bank of Paraguay

Considering that the growth rate is below the government's target, the Congress approved a five-year plan aimed at reaching an annual growth rate of 6.5% to 7% until the year 2020.

In the region, Brazil continues to show a deterioration of its main economic activity indicators. Thus, the Gross Domestic Product (GDP) again showed a contraction in the last quarter 2015. Likewise, in February the manufacturing PMI registered a level far below that registered in the previous month. This result is explained by the accelerated pace of contraction of output, as well as a significant drop in employment. As regards prices, high inflation continues, although with a slight deceleration at the margin. The Central Bank of Brazil (BCB), at its last meeting, decided to maintain the monetary policy rate with no change. In Argentina, a slowdown of its pace of expansion was observed in the last quarter 2015, while a moderate rate of growth is expected for this year. According to the in Greater Buenos Aires Consumer Prices Index (IPCBA), February annual inflation was far above the rate registered at the end of 2015, while private sector inflation expectations for the close of 2016 increased in March.

In the domestic context, economic activity was moderate throughout 2015, particularly in the second semester, largely affected by the weaker international and regional scenarios. Thus, in the fourth quarter, GDP registered a growth rate of 1.1%, less than in the previous quarters, explained by the lower dynamism observed in tertiary and secondary sectors. By the expenditure side, this result is due to the deceleration of the growth of consumption (both private and public), coupled with the fall of investments. However, net external demand showed better performance during the reference period. With this outcome, GDP accumulated 3% growth rate in 2015.

As regards inflation, it has increased since the last IPoM, inflation has increased, mainly explained by price increases in certain food products and services related to education. Meanwhile, the recent appreciation of the Guaraní influenced the reduction of durable goods prices. In addition, the drop of fuel prices in the domestic market was due to the decrease of oil

### Inflation projection

Annual change, percent

	2015	2016(f)	2017(f)	2018(f)
Average CPI inflation	3.0	5.6	4.4	
December CPI inflation	3.1	5.2	4.2	
CPI inflation in around two years (*)				4.5
Average underlying CPI inflation	2.5	4.2	4.2	
December underlying CPI	3.5	3.7	4.2	
Underlying CPI inflation in around 2 years (*)				4.5

(f) Forecast

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

prices. In the first quarter 2016, the annual inflation average stood at 5%, above the 3.1% registered in fourth quarter 2015.

On the other hand, the various measures of inflation continue to show an upward trajectory, started in mid-2015. The annual core inflation average stood at 4.2% in the first quarter of 2016, above the 3.5% registered in the last quarter. In this context, the Open Market Operations Committee (CEOMA), deemed it appropriate to adopt a less accommodative stance, increasing the monetary policy rate (MPR) by 25 basis points at the January meeting, to stand at 6% annually, in order to avoid a deterioration of inflation expectations and ensure the convergence of inflation to the 4.5% target over the projection horizon. At the February and March meetings, the Committee decided that no additional adjustments were necessary, thereby the MPR was maintained at 6% annually, taking into account the more complex international and regional scenarios than previously foreseen and also considering their potential impacts upon the local economy.

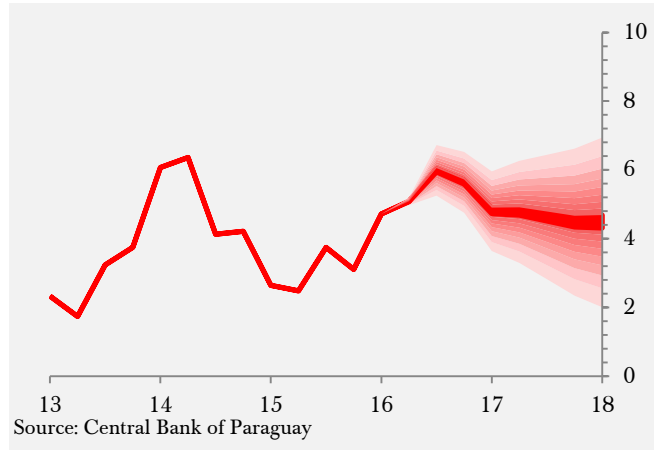
In the baseline scenario, the GDP growth estimate for 2016 stands at 3%, slightly below than indicated in the December IPoM. This correction is fundamentally explained by a downward adjustment in the main activities of the tertiary (commerce) and secondary (manufacturing) sectors, while growth in the primary sector was revised upwards due to an improvement of the growth estimates in the agricultural production.

Projected inflation in the baseline scenario for December 2016 stands at 5.2%, above the level indicated in the previous report. This is largely explained by the significant increase in the prices of volatile products observed in January 2016. Meanwhile, projections of underlying inflation remain relatively stable. In line with the expected evolution of macroeconomic variables relevant for inflation, the path of it would remain within the tolerance range in 2017, with a gradual convergence towards the target of 4.5% annually over the monetary policy horizon, in this case the first quarter of 2018.

With respect to risk scenarios, in the external context the uncertainties regarding future adjustments of the Federal Reserve (Fed) rates are highlighted, given the

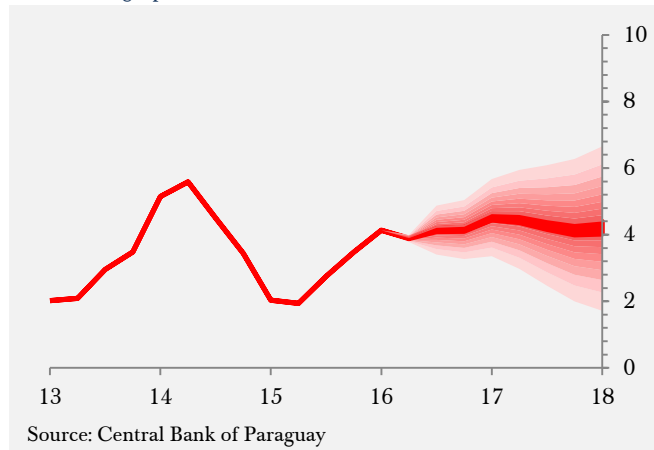
### CPI inflation forecast

Annual change, percent



### Underlying CPI inflation forecast

Annual change, percent



recent performance of the United States economy and the more uncertain global outlook. These factors could eventually generate new episodes of volatility in financial markets, affecting term premium and the performance of the emerging economies currencies. In China, doubts persist about its medium term growth, since a greater deceleration or a slower rebalancing process will influence on the prices of commodities exported by Paraguay. At the regional level, the weakening of economies continues, particularly in Brazil, which faces a complex economic, political and social scenario, and shows no signs of recovery in the short term.

Given this more uncertain global scenario, a relevant risk for local inflation continues to be the future evolution of the exchange rate. In the case that eventually new solid data about the performance of the United States economy arises, expectations about the appreciation of the US dollar will increase and might impact in the local market. To the extent that the Guarani weakens affecting the imported products prices and influencing inflation expectations, increases in the prices of products of national origin might occur. However, while no clear signs of a robust recovery of the US economy are taken and a greater weakness of the global economy is observed, the adjustment of the Fed's rates could continue to be postponed. Under this scenario, external inflation relevant to Paraguay could increase if, on the one hand, the slower pace of appreciation of domestic currency relative to the trading partners, vis-à-vis the dollar continues (as it has been observed in the last months) and, on the other hand, if high inflation rates of neighboring countries persist.

Having evaluated the alternative scenarios, the CEOMA considers that the risk balance for inflation is unbiased. In this regard, the Committee will continue to monitor the evolution of the most important macroeconomic variables most relevant for domestic inflation, implementing monetary policy measures in a timely manner to enable the convergence of inflation to 4.5% annually over the projection horizon.