MONETARY POLICY REPORT

March
2017

Central Bank of Paraguay

Executive Summary*

In the international scenario, the economic growth prospects are more favorable with respect to what has been observed in the last few years. These improved expectations are supported largely by the recovery of advanced economies. Nevertheless, some sources of uncertainty persist, deriving mainly from concern about the effects that the United States' new administration's economic measures could have at the world level. As regards the region, the regional scenario also presents a more encouraging economic outlook, in comparison to recent years. Although, lately regional growth prospects –even though they continue to be positive– have been weakening.

World growth
Annual change, percent

	December 2016			March 2017		
	2016	2017	2018	2016	2017	2018
World	2.9	3.2	3.4	3.1	3.2	3.4
United States	1.6	2.2	2.3	1.6	2.2	2.3
Eurozone	1.6	1.4	1.5	1.8	1.6	1.6
China	6.7	6.5	6.1	6.7	6.5	6.2
Brazil	-3.4	1.0	2.1	-3.6	0.7	2.2
Argentina	-1.9	3.1	3.1	-2.3	2.9	3.2
Trading partners	0.6	2.0	2.4	0.6	1.9	2.4
Trading partners - Mercosur	-2.7	1.1	2.1	-2.9	1.1	2.3

Source: Bloomberg
Note: As of this report, only observed data and Bloomberg projections are used.

In the United States, the Gross Domestic Product (GDP) continued to expand in the fourth quarter, although at a more moderate pace than that observed in the third quarter. This deceleration was due mainly to the decrease of exports and federal government spending, as well as the increase of imports. Regarding manufacturing, the PMI remained in the expansion zone, with better results in relation to the previous IPoM report, boosted largely by the increase of output, new business orders, and employment. In the labor market, the downward trend of the unemployment rate continues to be observed, diminishing to 4.5% in March. With respect to prices, the different measurements of inflation have increased in relation to the previous year. In this context, the Federal Reserve, at its March meeting, decided to increase again the range of the reference interest rates.

In the Eurozone, economic activity and labor market indicators continue to evolve favorably. The GDP growth in fourth quarter 2016 was similar to the level registered in the previous quarter, and was largely due to the positive contributions of internal demand components. Regarding manufacturing, the PMI has been trending upward since September 2016, boosted by the increase of output volume. In the labor market, the unemployment rate reduction to its lowest level since May 2009 (9.5% in February) is highlighted. The European Central Bank announced that it will maintain the current level of its reference rates, and will continue with

* The Spanish version prevails.

its assets purchase program until at least December 2017.

In China, the GDP expanded in the first quarter 2017 above both the expected rate and the one observed in the fourth quarter last year. This growth is explained by the increase of investments, the recovery of manufacturing output, and retail sales. In addition, government spending on infrastructure was an important source of growth. In the manufacturing sector, the PMI has remained in the expansion zone since the second half of 2016.

Gross Domestic Product by sectors
Annual change, percent

	2016	2017(f)	2017(i)
Primary Sector	3.0	4.1	1.0
Agriculture	2.6	4.0	0.7
Livestock	3.8	4.0	0.2
Others	5.4	5.2	0.1
Secondary Sector	10.4	4.0	1.1
Manufacturing	5.3	6.0	0.6
Construction	18.6	10.0	0.4
Binationals (Electricity & water)	12.6	-0.1	0.0
Tertiary Sector	1.6	4.3	1.8
Public Administration	-2.8	-1.0	-0.1
Trade	3.4	6.0	0.9
Communications	-2.7	2.0	0.1
Other Services	3.3	6.1	1.0
Taxes	0.9	4.8	0.3
GDP at market prices	4.1	4.2	
GDP w/o agriculture and binationals	3.2	5.0	

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

In Brazil, the economic activity indicators present mixed results, and growth prospects, while positive, do continue to be fragile. The GDP in the fourth quarter contracted by 0.9%, quarterly, explained by negative contributions of the manufacturing sector and the supply of services, together with the contraction of private consumption and gross capital formation, on the demand side. On the other hand, by March 2017 gradual improvements were observed in the manufacturing sector, even though the PMI remains in the contraction zone. In the labor market, the unemployment rate continues to rise. Regarding monetary policy, the inflation rate has decelerated, allowing the Central Bank of Brazil's Monetary Policy Committee at its January and February meetings to again reduce the Selic reference rate.

In Argentina, the economic activity indicators show signs of recovery, while the manufacturing sector continues to be weakened. The GDP performance registered contraction in fourth quarter 2016, although less than observed in the previous quarter. Regarding manufacturing, steep falls were registered in textile, automobile and metallurgical industries. Regarding prices, a gradual decrease of inflation is expected in upcoming months, while the formal adoption of the inflation target scheme as of January 2017 is highlighted.

In the domestic context, the positive dynamism and greater sectorial diversification observed since the second quarter was maintained towards the end of 2016. Thus, in the fourth quarter, the GDP registered an expansion of 3.4% y-o-y, closing the year with a cumulative variation of 4.1%, in line with growth projections. On the supply side, the results for the last quarter are mainly explained by the favorable performance of commerce and services, electricity, water, manufacturing, and construction sectors. On the expenditure side, growth was mainly sustained on internal

Economic growth and current account
Annual change, percent

	2015	2016	2017(f)
GDP	3.0	4.1	4.2
Domestic demand	1.7	2.1	5.3
Gross capital formation	1.2	6.5	12.0
Gross fixed capital formation (GFKF)	2.2	8.0	12.0
Total consumption	1.9	0.9	3.3
Private consumption	1.5	1.4	3.9
Public consumption	4.3	-2.8	-1.0
Exports of goods and services	-1.3	3.0	4.0
Imports of goods and services	-4.0	-0.8	6.0
Current account (% of GDP)	-1.0	1.7	1.2
GFKF (% of nominal GDP)	16.4	17.7	18.8
GFKF (% of real GDP)	18.7	19.4	20.8

Source: Central Bank of Paraguay

demand (consumption and investment). Regarding external demand, exports did not register any growth, while imports showed a significant recovery.

Annual inflation in the first quarter of 2017 averaged 2.3%, below the 3.9% observed in fourth quarter 2016. This result was primarily due to the moderation of the increases of the prices of certain food products, and to a lesser extent, of those related to durable goods, which have benefitted from the appreciation of the local currency. Concerning prices, fruit and vegetable components of the food group registered a fall in annual terms, which contributed to offset the increases observed for the remaining items in this group of products in the aggregate. Core inflation has also moderated, following the behavior that has been pointed out in previous reports. Between January and March, the average y-o-y core inflation stood at 2.9%, below the 3.2% registered in the previous quarter.

As for the monetary policy meetings of the first quarter, the Open Market Operations Committee (CEOMA), generally, has pointed out the greater uncertainty in the international scenario, which stems largely from the potential effects of the measures instated by the new U.S. government. With respect to the region, the Committee highlights that growth prospects have moderated in the chief neighboring economies. However, at the domestic level, both economic activity and the evolution of inflation maintain favorable behavior. In this context, at its January, February and March meetings, the CEOMA deemed it appropriate to maintain the monetary policy reference rate at 5.5% annually, given that no significant risks were perceived that could deviate inflation away from the expected trajectory.

In the baseline scenario, taking into account the favorable performance of the economy during the first months of the year, and the favorable economic prospects for the remainder of the year, the 2017 growth projection was revised upward, going from 3.7% to 4.2%. This correction was explained basically by the improvement of estimates for agricultural production in the primary sector, for manufacturing and construction in the secondary sector, and for commerce in the tertiary sector. On the expenditure side, the greater dynamism expected is based on the greater growth of private consumption and investment, given that public consumption has been adjusted downwards, essentially as a result of the improvement of the composition of public spending. On the other hand, while exports were revised upward, the positive change was greater for imports. For this reason, net external demand would have a negative incidence on growth this year.

Inflation projection
Annual change, percent

	2016	2017(f)	2018(f)	2019(f)
Average CPI inflation(*)	3.9	4.0	4.0	
December CPI inflation (**)	3.9	3.5	4.0	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	3.7	3.8	4.0	
December underlying CPI (**)	3.6	3.7	4.0	
Underlying CPI inflation in around 2 years (***)				4.0

(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 first quarter of 2019.

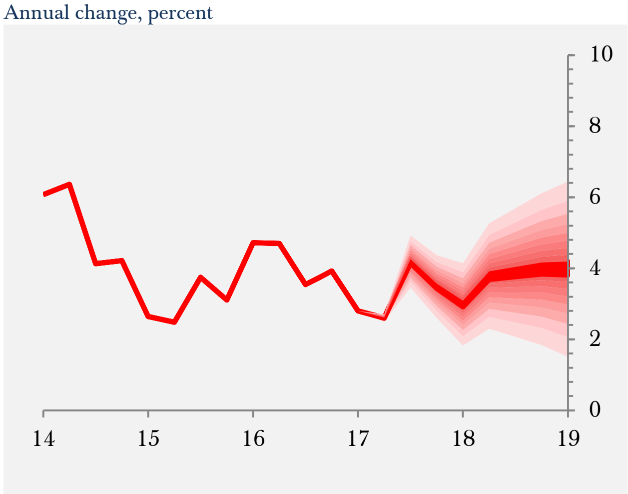
Regarding prices, in the baseline scenario, projected inflation stands at 3.5% for the close of the year, while underlying inflation stands at around 3.7%. Thereafter, according to the predicted trajectory of internal and external macroeconomic variables, and to the extent that there are no exogenous shocks, inflation will remain below the target during the greater portion of 2018, converging gradually to the target in the relevant horizon of monetary policy, in this case the first quarter of 2019.

With respect to risk scenarios at the international level, the economic performance foreseen for the global economy is better than in recent years. However, a high degree of uncertainty remains that is derived from the policies that are being implemented by the new United States administration. With respect to monetary policy, up until now, more adjustments of the Federal Reserve's interest rates are expected over the course of the year 2017, following the increase registered at the time of the March meeting. However, a fiscal policy that is more expansive than originally expected could motivate additional increases of the reference rate, with potential effects on the foreign exchange quotations of currencies and the cost of external funding of emerging economies.

Likewise, the return to protectionist trends could bear a significant influence on international trade in the medium and long term. Some recent examples include the Brexit, the plans to renegotiate the North American Free Trade Agreement (NAFTA), the introduction of a "border adjustment tax", and the imposition of tariffs and customs duties for countries with great surpluses vis-à-vis the United States. All of these factors pose new risks for the consolidation of global economic recovery.

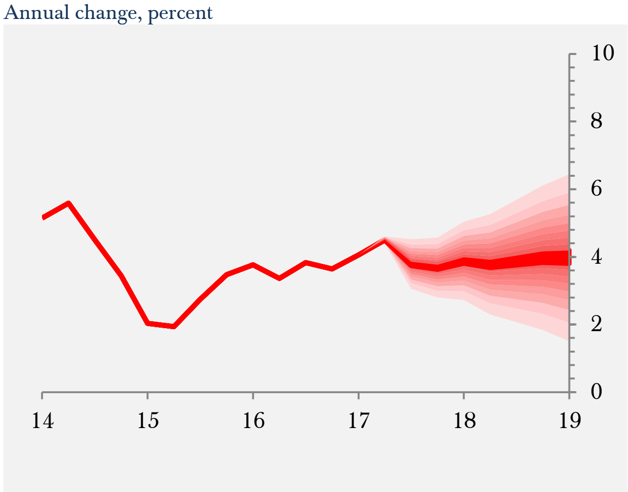
In Europe, in addition to the uncertainty related to the Brexit process, other significant geopolitical risks do exist. Taking into account that 2017 will be an election period in several of the most prominent countries of the region, it should be noted that there are important political parties

CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

that espouse proposals to leave the European Union or the Eurozone.

Among the emerging economies, the deceleration of the Chinese economy has been less than previously foreseen, thanks to the government's monetary and fiscal stimulus policies. In this sense, the risks of greater deceleration in the short term have decreased. Notwithstanding, in the medium term significant risks for growth persist, as long as the economy continues to be supported by these short term policies for easing, without facing necessary reforms such as the consolidation of corporate debts and the restructuring of state enterprises. In addition, the protectionist trade policies that the United States intends to adopt could create additional risks for China. A moderation in economic growth, sooner than expected, could affect the demand for commodities and consequently their prices.

At the regional level, growth prospects in Brazil point toward the recovery of economic activity this year, although at a lower level than estimated in the previous report. The approval of the fiscal reform, fewer inflationary pressures, and a less restrictive monetary policy stance are elements that would contribute towards sustaining growth. However, the political situation continues to be complex and would most likely make it more difficult to obtain approval of other needed reforms (chiefly as regards social security), in order to consolidate economic recovery. The improved performance of the Brazilian economy, reflected in the evolution of certain indicators, will continue to contribute toward the consolidation of bilateral trade improvements, mainly in the border zones, unless Brazilian currency depreciate significantly vis-à-vis the United States dollar.

In Argentina, the recovery of the economy is taking place at a slower pace than estimated in the December 2016 IPoM report. Furthermore, the Central Bank of the Argentine Republic (BCRA) foresees a reduction of inflation, fixing a target range of between 12% and 17% for the year 2017, after closing 2016 with an inflation rate reaching 41%. Nevertheless, the challenges of monetary policy in the short term continue to be very important, since this significant reduction of inflation must be achieved in a context of the consolidation of fiscal accounts and the gradual reduction of fiscal dominance. The better management of macroeconomic policies could motivate greater foreign exchange inflows, contributing to the appreciation of the Argentinian peso with respect to the United States dollar.

The future behavior of the exchange rate continues to be most relevant risk factor for the dynamics of inflation. Until the present, following the elections in the United States and the last adjustments of the Federal Reserve's rates, the dollar has shown volatile behavior. The appreciation of the majority of regional currencies vis-à-vis the dollar has been observed in the last few months. Nevertheless, the probabilities of the strengthening of the dollar remain present, taking into account the upward adjustments foreseen for Fed funds in 2017 and 2018. Since the strengthening of the dollar is a global phenomenon, the currencies of Paraguay's main trade partners would also be affected, and therefore, as concerns domestic prices the effect of the depreciation of the Paraguayan Guarani, with respect to the U.S. dollar, would be partially attenuated.

Taking into account the alternative scenarios, the CEOMA considers that the balance of risks for inflation is unbiased. Nevertheless, the Committee will continue to be alert and aware of the evolution of the relevant macroeconomic variables for domestic inflation, applying the necessary monetary policy measures that will allow for the convergence of inflation to 4.0% annually over the relevant projection horizon.