



MONETARY POLICY REPORT

June
2017

BCP © Derechos Reservados 2017



Central Bank of Paraguay

Executive Summary*

World growth

Annual change, percent

	March 2017			June 2017		
	2016	2017	2018	2016	2017	2018
World	3.1	3.2	3.4	3.1	3.4	3.5
United States	1.6	2.2	2.3	1.6	2.2	2.3
Eurozone	1.8	1.6	1.6	1.8	1.9	1.7
China	6.7	6.5	6.2	6.7	6.6	6.3
Brazil	-3.6	0.7	2.2	-3.6	0.5	2.1
Argentina	-2.3	2.9	3.2	-2.3	2.8	3.0
Trading partners	0.6	1.9	2.4	0.6	1.9	2.4
Trading partners - Mercosur	-2.7	1.1	2.3	-2.9	1.0	2.2

Source: Bloomberg

In the international scenario, the indicators show that the global economy continues with the expected momentum, while in the region the economic panorama has become more complex in the last few months. With respect to this, the estimate for world economic growth has been revised upward, boosted by the recovery of economies in the Eurozone and of other advanced economies. In the United States, while growth prospects remained stable, both economic activity and the labor market continued to become more consolidated. On the other hand, regional growth prospects in Brazil and Argentina were revised downwards with respect to the previous IPoM report, given that the main short-term indicators continued to show signs of fragility, coupled with the recent situations of political uncertainty in both countries. As regards price levels in Brazil and Argentina, a downward trend of the principal inflation measures was observed during the second quarter of the year.

In the United States, a moderate growth of the Gross Domestic Product (GDP) was observed in the first quarter 2017, although this behavior is expected to be transitory taking into account the favorable evolution of the leading indicators in the second quarter. In this regard, the expenses of both consumers and businesses have increased, the manufacturing sector continues to show important momentum, and the labor market is consolidating, as reflected in the continued decrease of the unemployment rate. With respect to prices, the different measurements of inflation have decreased in relation to the previous report. In this context, the Federal Reserve, in consideration of the observed and expected labor and inflation conditions, decided at its June meeting to increase the range of the Federal funds interest rates.

In the Eurozone, economic activity and labor market indicators continue to expand beyond the expected levels. The labor market continued to strengthen, while the unemployment rate in May decreased to its lowest level (9.3%) since March 2009. As regards prices, inflation was controlled to levels below the target, a context in which the European Central Bank (ECB) announced that it will maintain its current reference rates. In relation to the non-conventional monetary policy, the ECB reduced the amount of its assets purchase program, in April, and announced that it will maintain this policy until at least December 2017.

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

	2016	2017(f)	2017(i)
Primary Sector	2.9	3.7	0.9
Agriculture	2.5	4.0	0.7
Livestock	3.7	2.5	0.1
Others	5.8	5.2	0.1
Secondary Sector	10.4	3.9	1.0
Manufacturing	5.4	8.5	0.9
Construction	18.6	7.0	0.3
Binationals (Electricity & water)	12.6	-1.5	-0.2
Tertiary Sector	1.4	4.8	2.0
Public Administration	-2.8	0.0	0.0
Trade	2.9	7.0	1.0
Communications	-2.7	2.0	0.1
Other Services	3.3	5.9	1.0
Taxes	0.9	3.5	0.2
GDP at market prices	4.0	4.2	
GDP w/o agriculture and binationals	3.2	5.3	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

In China, the economic activity indicators continued to evolve favorably, although at more modest paces than observed in the last few years. GDP growth in the first quarter of the year was above the expected rate, and was explained especially by the increase of manufacturing output, retail sales, government spending, and investment in fixed assets. In the manufacturing sector, the PMI grew above the market's expected level, given the greater demand for export products.

In Brazil, the GDP grew during the first quarter of the year with respect to the previous quarter, after the falls registered since 2015, while it contracted in annual terms, although with a lower rate. Said behavior is due mainly to the positive contributions of farming and livestock activities on the supply side, and of exports on the demand side. Likewise, the monthly economic activity indicator registered positive growth in May and the manufacturing sector stood in the expansion zone, in contrast to the situation of contraction reported in the former IPoM. In spite of the better results with respect to the last few years, the political tensions presented since the middle of the second quarter have negatively affected the growth prospects of this economy. Regarding monetary policy, the inflation rate has decelerated, allowing the Central Bank of Brazil's Monetary Policy Committee (Copom) to continue with its expansive monetary policy.

In Argentina, the economic activity indicators continue to show signs of a gradual recovery, reflected in the positive GDP growth in the first quarter and the evolution of short-term indicators in the second quarter. However, the economic growth prospects were revised downward in a context of political uncertainty concerning elections and the situation in Brazil. Regarding prices, inflation showed a downward trajectory which is expected to continue with the implementation of the inflation target scheme.

At the domestic level, economic activity continued to show important dynamism and diversification at the close of the first quarter 2017. In this period, the GDP registered a growth rate of 6.6% y-o-y, sustained mainly (on the side of supply) by the favorable performance of commerce and services subsectors, manufacturing, and construction, as well as by greater agricultural production. On the expenditure side, growth was boosted principally by internal demand (consumption and investment), and, to a lesser degree, by net exports. According to leading indicators, it is expected that economic activity will be moderated by certain specific factors, particularly those related to weather conditions.

Economic growth and current account

Annual change, percent

	2015	2016	2017(f)
GDP	3.0	4.0	4.2
Domestic demand	1.7	2.3	5.3
Gross capital formation	1.2	6.4	11.3
Gross fixed capital formation (GFKF)	2.2	7.9	11.3
Total consumption	1.9	1.2	3.5
Private consumption	1.5	1.7	3.9
Public consumption	4.3	-2.8	0.7
Exports of goods and services	-1.3	2.7	4.0
Imports of goods and services	-4.0	-0.7	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	20.7

Source: Central Bank of Paraguay

In relation to the evolution of prices, the increase of the distinct inflation measures was observed in the second quarter, although this is explained largely by a few products of the Consumer Price Index's consumer basket. On one hand, the total inflation average increased, going from 2.3% in the first quarter to 3.3% in the period spanning April – June, due largely to the greater annual variation of the prices of some food items (meat, dairy products, sugar, among others), while fruit and vegetable products continued to show a fall, y-o-y, during the reference period. This behavior was also observed in the cases of underlying inflation, underlying X1 inflation, and y-o-y core inflation with average rates of 4.7%, 5.5%, and 3.3%, in annual terms.

Just as noted in the first monetary policy meetings held in 2017, in the second quarter the Open Market Operations Committee (CEOMA) continued to stress the uncertainty regarding the expected evolution of the global economy. In particular, the Committee highlighted the more complex regional scenario as a consequence of heightened political tensions in Brazil. Regarding the domestic scenario, the economic activity has moderated as a result of the effect of specific factors, among which adverse weather is included. At the same time, the Committee underscores that some measurements of underlying inflation have increased, although it emphasized that the increase was explained by the behavior of a few products of the consumer basket. In this context, at its April, May, and June meetings, the CEOMA considered that the most appropriate strategy to ensure the convergence of inflation to the target over the relevant monetary policy horizon is to maintain the monetary policy reference rate, with no changes, to thus stand at 5.5% annually.

In the baseline scenario, the growth projection was maintained at 4.2%, although, with respect to the previous report, there has been an internal recomposition, sustained by the observed evolution of the sectors as well as of the prospects for the second semester. On one hand, the growth prospects were revised upward for both manufacturing and commerce, among the most important sectors. On the other hand, growth estimates were corrected downward for the production of electrical energy and for the construction sector, which in part was affected by adverse weather conditions during the second quarter. On the expenditure side, private consumption, exports, and imports maintained their growth rates, while gross capital formation investment was revised slightly downward, and was offset by the improvement in the public consumption estimates. In general, the 4.2% rate continues to be explained largely by the tertiary and secondary sectors, on the side of supply, while internal demand (consumption and investment) will

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	3.9	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	3.7	3.6	3.9	
December underlying CPI (**)	3.6	3.6	3.9	
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.

continue to be the principal booster of economic growth, on the side of expenditures.

As concerns total inflation, in the baseline scenario, the projected inflation rate for December 2017 stands at 3.5%, the same rate estimated in the previous IPoM report. Meanwhile, the estimates of underlying inflation were reduced slightly from around 3.7% to stand at 3.6%, explained in part by a lower than expected foreign exchange rate for the second quarter. Looking forward, according to the foreseen 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 second quarter of 2019.

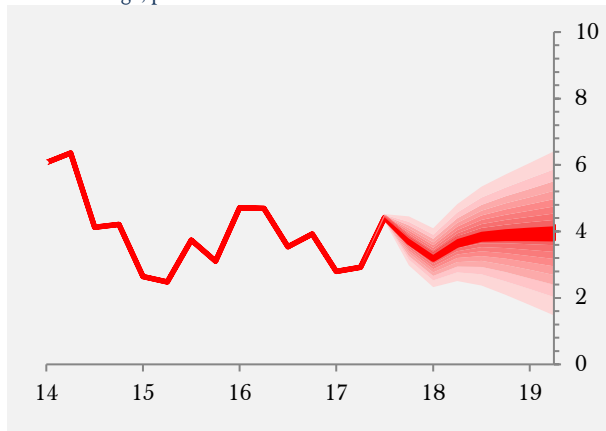
With respect to risk scenarios at the international level, the global economy continues to show signs of greater momentum, although uncertainty persists, which is derived largely from the economic measures proposed for implementation by the United States government. The possibilities of a strong fiscal stimulus of the United States economy are less likely in the short term. Nevertheless, doubts persist with regard to the effective implementation of the protectionist trade policies posed by the new administration. With respect to monetary policy, the Federal Reserve newly adjusted its reference interest rate in June, and at the moment, the probability of an additional change during the second quarter is relatively low. However, there are probabilities that in the short term the Federal Reserve will announce the beginning of the reduction of its balance sheet (decrease of its holdings of bonds and other assets).

In the Euro zone, some of the isolationist proposals of certain political parties have become more diluted in the last few months, as reflected also in the improvement of confidence indicators. However, some risks derived from the Brexit negotiation process still persist. With respect to monetary policy, according to the latest statements of the President of the ECB, the market has interpreted such policies as being the first step towards the monetary normalization process, although the beginning of this process will depend on the evolution and outlook of both the economic activity and inflation.

With respect to the emerging economies, in China, the moderation of economic activity has been lower than previously foreseen, explained in part by the government's short-term fiscal stimulus policies. Notwithstanding, the medium term risks continue to be important, taking into account the need for reforms regarding the corporate debt recovery policy and the restructuring of the state-owned

CPI inflation forecast

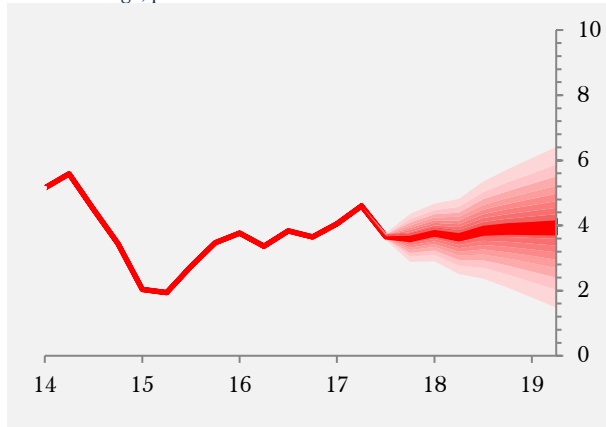
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

enterprises. Likewise, another risk factor is the slowness of the process of rebalancing the economy towards consumption and services, which in a certain measure could exert an unfavorable bearing on the evolution of commodity (particularly food) prices, at the international level.

At the regional level, the spike of political tensions in Brazil generated a greater degree of uncertainty about the growth prospects of its economy. On one hand, the reduction of inflation, the greater ease of the accommodative monetary policy, and the improved panorama for fiscal accounts constitute factors that are likely to favor economic recovery. However, in a complex political environment, the approval of some needed economic measures, such as reform of the social security system, could become difficult, thus generating risks for public debt. To the extent that the Brazilian economy continues its recovery, and its currency strengthens or at least maintains its value vis-à-vis the United States dollar, commerce in the border zones with Paraguay will likely continue to consolidate the positive momentum observed in the last few months. .

The future behavior of the exchange rate continues to be most relevant risk factor for the dynamics of inflation. However, in the current situation, the possibility of a significant depreciation of currencies has moderated, taking into account that the United States' process of monetary normalization might be more gradual than previously expected. Notwithstanding, as pointed out previously, the probable initiation of the reduction of the Federal Reserve's balance sheet could, in part, contribute towards the strengthening of the United States dollar. In any case, in the event of the strengthening of the dollar, given that it 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 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 to 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.