



# MONETARY POLICY REPORT

## December 2017



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Central Bank of Paraguay

## Executive Summary\*

### World growth

Annual change, percent

|                             | September 2017 |      | December 2017 |      |      |
|-----------------------------|----------------|------|---------------|------|------|
|                             | 2017           | 2018 | 2017          | 2018 | 2019 |
| World                       | 3.4            | 3.5  | 3.6           | 3.7  | 3.6  |
| United States               | 2.2            | 2.3  | 2.2           | 2.5  | 2.1  |
| Eurozone                    | 2.1            | 1.8  | 2.3           | 2.1  | 1.8  |
| China                       | 6.7            | 6.4  | 6.8           | 6.4  | 6.2  |
| Brazil                      | 0.7            | 2.4  | 0.8           | 2.5  | 2.5  |
| Argentina                   | 2.8            | 3.1  | 2.8           | 3.2  | 3.1  |
| Trading partners            | 2.1            | 2.5  | 2.2           | 2.6  | 2.7  |
| Trading partners - Mercosur | 1.3            | 2.5  | 1.4           | 2.6  | 2.7  |

Source: Bloomberg

Since the last IPoM, the global economy has continued to show favorable dynamism, boosted by the good performance of both advanced and emerging countries. In the United States, the estimate of economic growth has been maintained for this year and it has increased for the next, while the continuity of the interest rate increase process is foreseen for 2018. In the Eurozone, the favorable evolution of different economic indicators responds to the consolidation of economic activity, which has led to the improvement of growth projections. In China, although the growth is above the level registered in the previous year, moderation has been observed in recent months. In the region, the observed data reflect a better performance of the most important neighboring countries in the last few months, which has generated greater growth expectations in Mercosur trading partners for the next two years.

In the United States, economic conditions have continued to improve in the second semester of the year. With respect to this, the expansion of the Gross Domestic Product (GDP) in the third quarter surpassed the market's expectations as well as the level registered in the previous quarter. This result was explained, largely, by the positive contributions of consumption, private investment, non-residential fixed investment, and exports. Leading economic indicators point towards similar dynamism for the fourth quarter of the year, in a context of uncertainty regarding the new administration's economic policy actions. As regards monetary policy, the Federal Reserve adjusted its interest rates at the December meeting, and additional adjustments are expected in 2018. Likewise, the monetary authority initiated its balance sheets normalization program in October of 2017.

Regarding the Eurozone, economic activity and manufacturing sector indicators continued to show a favorable performance. In the third quarter, the GDP grew at a higher annual rate than that registered in the previous quarter, while the PMI continued to exhibit an upward trend in the expansion zone. In the labor market, the unemployment rate has decreased, standing at 8.9% in September, its lowest level since January 2009. As regards monetary policy, the European Central Bank (ECB) maintained its reference interest rates with no variations, and announced that it will decrease the volume of its assets purchase program, starting in January 2018.

\* The Spanish version prevails.

### Gross Domestic Product by sectors

Annual change, percent

|                                     | 2017 | 2018(f) | 2018(i) |
|-------------------------------------|------|---------|---------|
| Primary Sector                      | 4.8  | 2.6     | 0.7     |
| Agriculture                         | 5.7  | 1.2     | 0.2     |
| Livestock                           | 1.5  | 8.5     | 0.4     |
| Others                              | 4.9  | 0.4     | 0.0     |
| Secondary Sector                    | 2.0  | 5.8     | 1.5     |
| Manufacturing                       | 9.4  | 6.6     | 0.7     |
| Construction                        | 5.0  | 7.0     | 0.3     |
| Binationals (Electricity & water)   | -6.0 | 4.5     | 0.5     |
| Tertiary Sector                     | 5.3  | 4.7     | 2.0     |
| Public Administration               | 1.8  | 1.8     | 0.1     |
| Trade                               | 9.0  | 6.0     | 0.9     |
| Communications                      | 0.0  | 3.0     | 0.1     |
| Other Services                      | 5.1  | 5.4     | 0.9     |
| Taxes                               | 5.0  | 5.0     | 0.3     |
| GDP at market prices                | 4.3  | 4.5     | 4.5     |
| GDP w/o agriculture and binationals | 5.6  | 5.4     |         |

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

In China, GDP expanded slightly below the expected level in the third quarter of 2017 and was lower than the rate observed in the previous quarter. This growth was explained, especially, by increases in manufacturing output, retail sales, and investment in fixed assets. With respect to this, the government's policy to reduce the exposure to risks has impacted, to a certain extent, in the performance of some short-term indicators. In the manufacturing sector, the PMI reduced marginally in October, although it has remained in the expansion zone since the second half of the 2016.

In the region, the Brazilian economy continues to show stronger signs of recovery, although still at a modest pace. Thus, GDP in the third quarter showed a positive annual variation for the second consecutive quarter, after experiencing twelve consecutive quarters of negative results. The leading indicators in the fourth quarter continued to evolve favorably, including the PMI, which remains in the expansion zone. In addition, the unemployment rate has registered a downward trend over the last months. Nevertheless, political uncertainty remains as a risk factor that could affect the better performance observed during the year. Regarding monetary policy, inflation remains controlled, at levels below the target, which has allowed the Central Bank of Brazil's Monetary Policy Committee (Copom) to continue with the reduction of its Selic rate.

In Argentina, the economic activity indicators continue to show signs of gradual recovery, reflected in a positive GDP growth in the first semester and the evolution of short-term indicators in the second half of the year. Regarding prices, annual inflation has resumed the downward trajectory observed since the end of 2016, after having increased slightly in August and September.

At the local level, economic activity registered greater dynamism in the third quarter of 2017, with a GDP growth rate of 3% y-o-y, above the 1.1% registered in the second quarter. On the supply side, this greater growth was explained, mainly, by a better performance of services and manufacturing, and to a lesser extent, by livestock production and construction. A greater expansion of domestic demand (consumption and investment) was registered, which thus continues to boost growth on the expenditure side. For the fourth quarter, taking into account the evolution of short-term indicators, it is expected that economic activity would registered a higher expansion, while indicators related to consumption and machinery investments continue with the positive behavior observed during the year.

In relation to local prices, total inflation increased to 4.8% in the fourth quarter, with respect to the rate observed in the

### Economic growth and current account

Annual change, percent

|                                      | 2016 | 2017 | 2018(f) |
|--------------------------------------|------|------|---------|
| GDP                                  | 4.0  | 4.3  | 4.5     |
| Domestic demand                      | 2.3  | 6.1  | 5.0     |
| Gross capital formation              | 6.4  | 11.5 | 7.0     |
| Gross fixed capital formation (GFKF) | 7.9  | 11.5 | 7.0     |
| Total consumption                    | 1.2  | 4.6  | 4.4     |
| Private consumption                  | 1.7  | 5.0  | 4.7     |
| Public consumption                   | -2.8 | 1.5  | 2.0     |
| Exports of goods and services        | 2.7  | 6.5  | 5.0     |
| Imports of goods and services        | -0.7 | 10.5 | 6.0     |
| Current account (% of GDP)           | 1.5  | -1.2 | -1.1    |
| GFKF (% of nominal GDP)              | 17.7 | 19.1 | 19.3    |
| GFKF (% of real GDP)                 | 19.4 | 20.7 | 21.2    |

Source: Central Bank of Paraguay

third quarter (4.1%). However, it must be highlighted that this result is explained largely by the increase in the prices of specific products within the food category, particularly volatile items included in the consumer basket. In addition, a slight increase in the prices of services was registered, while a reduction for some products affected by the foreign exchange rate was observed. The high concentration of inflation in this period indicates that the inflation trend measures have continued with the downward trajectory, as pointed out in the previous IPoM report. The annual average rates of core inflation (3%), underlying inflation (3.7%), and underlying X1 inflation (4%) were below those registered in the third quarter of 2017 (3.1%, 4.1%, and 4.7%, respectively).

As regards monetary policy, at its meetings held in the last quarter of the year, the Open Market Operations Committee (CEOMA) pointed out that it continues to observe the favorable dynamism of both the most important advanced economies and the main countries within the region. Likewise, the Committee stressed that uncertainty indicators stand at relatively low levels. Regarding the domestic scenario, the CEOMA highlighted that the evolution of the different underlying inflation measures was consistent with the convergence of total inflation to the target over the projection horizon. Furthermore, expectations remain anchored to the inflation target. The expansion of economic activity indicators is in line with growth forecasts for 2017. In this scenario, characterized by less inflationary pressures and with economic activity falling in line with what has been foreseen, the Committee deemed it appropriate to maintain the monetary policy reference rate at 5.25% annually.

Taking into account the recent evolution of short-term indicators, the GDP growth estimate for 2017 was revised slightly upward, from 4.2% to 4.3%. This result is explained largely by the services sector (commerce) and by manufacturing, on the supply side, while domestic demand (consumption and investment) is the main factor for growth, on the expenditure side. The initial forecast for 2018 is 4.5%, in which the expansions of both the tertiary sector (commerce and other services) and the secondary sector (manufacturing, construction, and the generation of electrical power) continue to be the main drivers that propel economic growth. To a lesser extent, the primary sector will make a positive contribution, boosted by livestock production and agriculture, in that order.

On the expenditure side, it is foreseen that the favorable dynamism of private consumption and investment will continue, while external demand is expected to have a relatively low contribution.

### Inflation projection

Annual change, percent

|  | 2016 | 2017(f) | 2018(f) | 2019(f) |
|--|------|---------|---------|---------|
| Average CPI inflation(*)                         | 3.9  | 4.5     | 3.9     |         |
| December CPI inflation (**)                      | 3.9  | 4.2     | 3.9     |         |
| CPI inflation in around two years (***)          |      |         |         | 4.0     |
| Average underlying CPI inflation(*)              | 3.7  | 3.5     | 3.9     |         |
| December underlying CPI (**)                     | 3.6  | 3.5     | 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 fourth quarter of 2019.

As concerns prices, in the baseline scenario, the projected inflation rate for 2017 increased to 4.2%, above the rate estimated in the previous IPoM (3.8%). This change is explained to a great measure by the price increase of certain items of the food category, particularly volatile products, thus increasing inflation in the last quarter to levels above those previously forecasted. For 2018, it is estimated that inflation will be similar to the target (3.9%). The underlying inflation projection for December 2017 increased slightly from 3.4% to 3.5%, due in part to the increase of beef prices, thus implying a higher underlying inflation rate than estimated for the fourth quarter, according to the previous report. Looking forward, according to the most likely scenario for domestic and external macroeconomic variables, inflation will converge gradually to the target in the relevant horizon of monetary policy, in this case, the fourth quarter of 2019.

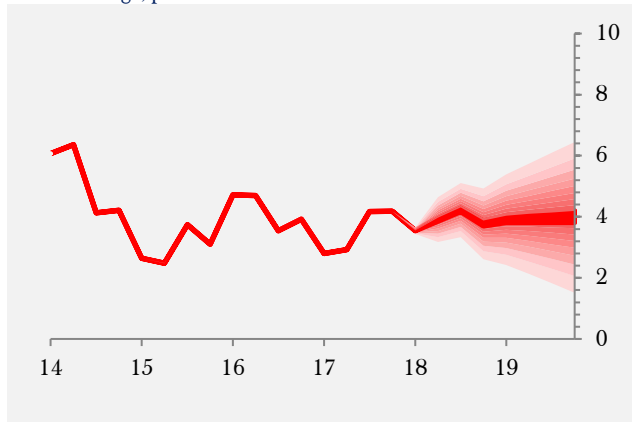
With respect to risk scenarios, at the international level, the improved growth forecasts in advanced countries is highlighted. Together with this, a process of gradual inflation normalization is also foreseen. In the United States, along with the interest rate increases observed in December, three additional rate hikes are expected in 2018, according to statements given by members of the Federal Open Market Committee. Recently, the US Congress passed legislation to reduce taxes. To the extent that this fiscal reform bears a greater influence on growth and inflation than currently foreseen, it could generate uncertainty about the pace of adjustment of reference interest rates. This, in turn, could increase volatility in financial markets, lead to the depreciation of currencies, and increase the external funding costs for emerging economies.

In the Euro zone, the economic conditions continue to be favorable and political tensions have moderated recently. In this context, the region is taking important steps in terms of institutional reforms, such as the proposal of a fiscal union that would include a “Super Ministry” for Economy and Finances, a specific budget for the Eurozone, and the transformation of the European Stability Mechanism (ESM) into a European Monetary Fund (EMF). One source of uncertainty stems from the *Brexit* negotiations. An economic weakening of the block would most probably affect Paraguay in terms of the effects upon the global economy, and/or its trade partners.

Among emerging economies, slow deceleration of the Chinese economy is foreseen. The risk of an abrupt moderation in the medium term could take place if reforms, regarding corporate debt and the restructuring of public debt, are not adopted. In spite of the expected slowdown, the greater dynamism of the world economy contributes to

### CPI inflation forecast

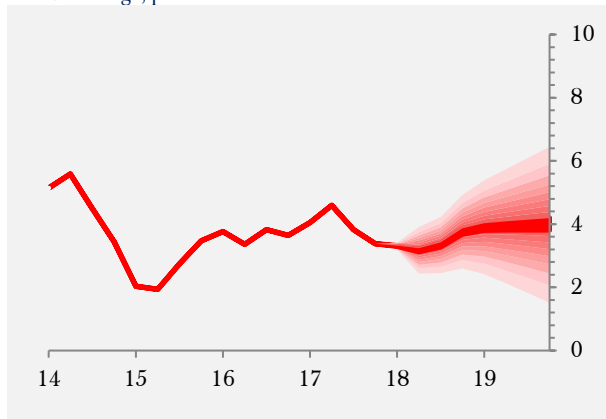
Annual change, percent



Source: Central Bank of Paraguay.

### Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

limiting the risks related to the fall of commodity prices. In fact, price forecasts for the coming year are quite similar to the prices in 2017.

At the regional level, an improvement of economic growth in Brazil is expected for next year. This will depend, in part, on the success of the implementation of governmental reforms. The main risk derives from the political context, which could exert a bearing on the advance of reform proposals. To the extent that the Brazilian recovery is consolidated, bilateral trade (mainly border zone commerce) between Paraguay and Brazil may continue to improve.

On the other hand, Argentina also continues to show signs of recovery, although high inflation and the need for a fiscal adjustment persist. Given this context, the Argentinian government introduced in Congress a reform package that seeks to increase the competitiveness of the private sector (through tax and labor reforms) and achieve fiscal consolidation. To the extent that inflation continues to be high and the bilateral nominal exchange rate remains at current levels, the flow of Argentinians making purchases in the border zones could continue to be observed.

In the domestic scenario, the most relevant risk factor derives from the evolution of the foreign exchange rate. Up until now, the Federal Reserve's monetary policy decisions have been well internalized by the markets, and no episodes of excessive volatility or the significant depreciation of regional currencies has been observed. As pointed out previously, swifter improvement of the United States economy or an increase of inflation that surpasses the foreseen level could be the source of market uncertainties, and could bear an influence on the strengthening of the US dollar. However, this event would affect not only Paraguay, but also Paraguay's main trading partners. Therefore, the risks of significant real depreciation are 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% annually over the relevant projection horizon.