



MONETARY POLICY REPORT

MARCH
2018



CENTRAL BANK OF PARAGUAY

Executive Summary*

World growth

Annual change, percent

	December 2017		March 2018		
	2017	2018	2017	2018	2019
World	3.6	3.7	3.7	3.8	3.7
United States	2.2	2.5	2.3	2.8	2.4
Eurozone	2.3	2.1	2.3	2.4	2.0
China	6.8	6.4	6.9	6.5	6.2
Brazil	0.8	2.5	1.0	2.7	2.7
Argentina	2.8	3.2	2.9	2.8	3.2
Trading partners	2.2	2.6	2.3	2.9	2.9
Trading partners - Mercosur	1.4	2.8	1.5	2.8	3.0

Source: Bloomberg

Since the last IPoM, the global economy has continued to grow steadily, boosted by the favorable performance of the main advanced economies as well as that of the emerging ones. World growth prospects have improved for both 2018 and 2019, due mainly to the better performance foreseen for the advanced economies, specifically the United States and the Eurozone. In this context, the monetary tightening process has continued, particularly that of the Federal Reserve, and its pace in upcoming months will depend upon inflationary conditions. In China, first data have been located above the expected level, allowing for a slight correction upward in 2018 growth estimates, although remaining below the expansion level observed in 2017. In the region, Brazil and Argentina continue to show signs of improvement, even though the need of adjustments in both economies are necessary in order to consolidate economic recovery. One of the main risks for the medium-term outlook of the global economy, is the potential impact of commercial disputes between the United States and China.

In the United States, the economic situation has continued to improve in the last months. In fourth quarter 2017, the Gross Domestic Product (GDP) grew with an annualized rate of 2.9%, explained by the positive contributions of personal consumption expenditures, exports, and government spending. In the first months of 2018, short-term economic and labor market indicators continue to evolve favorably. On the other hand, the recently approved fiscal reform could generate additional momentum in the short term. In consideration of these factors, growth prospects for 2018 and 2019 have been revised upward with respect to the estimates presented in the previous IPoM report. Inflation, on the other hand, has shown signs of an upturn in recent months. Given this scenario, the Federal Reserve continued with its process of monetary normalization in March, with a new adjustment of the interest rates range. Meanwhile, more adjustments are foreseen for the rest of the year, the pace of which will depend greatly upon both the observed and expected evolution of inflation.

In the Eurozone, economic activity and the labor market indicators have continued to evolve favorably. In fourth quarter 2017, the GDP grew by 2.7%, similar to the rate registered in the previous quarter, but far above the rates

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

	2017	2018 (f)	2018(i)
Primary Sector	4.8	0.8	0.2
Agriculture	5.7	1.0	0.2
Livestock	1.5	0.0	0.0
Others	4.9	0.4	0.0
Secondary Sector	2.0	5.8	1.5
Manufacturing	9.4	6.4	0.7
Construction	5.0	2.0	0.1
Binationals (Electricity & water)	-6.0	6.6	0.7
Tertiary Sector	5.3	5.9	2.5
Public Administration	1.8	6.3	0.5
Trade	9.0	5.4	0.8
Communications	0.0	5.0	0.2
Other Services	5.1	6.4	1.0
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	5.2	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

registered in the last few years. Regarding manufacturing sector, the PMI showed less dynamism during the first months of 2018, although it remains in the expansion zone. In the labor market, the unemployment rate continued to improve, to stand at 8.5% in February, its lowest level since 2008. In light of this, growth estimates have been revised upwards, both for this year and for next year. As regards monetary policy, the European Central Bank (ECB), while maintaining its current reference rates with no variations, has decreased the volume of its assets purchase program, dropping from 60 billion to 30 billion since January, a level that is expected to continue until at least September 2018.

Regarding China, GDP growth in the fourth quarter 2017 expanded by 6.8%, slightly higher than the market's expected level (6.7%), explained by the favorable performance of manufacturing, exports, and the real estate market. On the other hand, the effects of the more restrictive measures adopted by the government to reduce its exposure to credit risks are beginning to be reflected in the short-term activity indicators. Such is the case in the manufacturing sector, where the PMI has shown a downward trajectory in the last few months, although it remains in the expansion zone. The scenario of moderation for this year is within the expected, but it would be less intense than anticipated, taking into account the recent evolution of certain indicators, particularly those related to foreign trade, which have not weakened as much as projected. In this context, growth estimates for 2018 have been revised slightly upward, rising from 6.4% to 6.5% in this report.

In the region, Brazil gradually continues to consolidate its economic recovery. In the fourth quarter, the GDP registered an annual variation of 2.1% (1.4% in the previous quarter), explained largely by the expansion of consumption and investments. With this result, growth in 2017 stood at 1%, above the initial estimates. Likewise, the leading indicators have continued to strengthen in the first months of this year, including the PMI, which has remained in the expansion zone, showing an upturn in relation to the previous report. On one hand, inflation remains low, a context in which the Monetary Policy Committee (Copom) decided to reduce again its reference rate to 6.5% in March, with expectations of an additional reduction at the next Copom meeting. In this scenario, growth projections for 2018 and 2018 have been revised upward in relation to the December IPoM. Currently, the most relevant risk for the perspectives derives from the political field.

In Argentina, an improvement of economic conditions continues to be observed, while inflation remains high. In

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	5.1
Gross fixed capital formation (GFKF)	7.9	11.5	4.8
Total consumption	1.2	4.6	5.0
Private consumption	1.7	5.0	4.8
Public consumption	-2.8	1.5	6.3
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	-1.3	-1.6
GFKF (% of nominal GDP)	17.7	19.0	19.4
GFKF (% of real GDP)	19.4	20.7	20.8

Source: Central Bank of Paraguay

the fourth quarter, GDP growth was 3.9%, boosted primarily by the expansion of internal demand (consumption and investment). These favorable results have continued in 2018, as reflected in the trajectory of short-term indicators in both the manufacturing sector as well as in the economy as a whole. In spite of this, growth data were revised downward, mainly because of the drought that affects the agricultural sector. Regarding prices, annual inflation has increased since the last report, due mainly to the depreciation of the peso vis-à-vis the United States dollar and the adjustment of some regulated prices.

Regarding the domestic scenario, economic activity has continued with robust dynamism. In fourth quarter 2017, the annual variation of the GDP was 4.5% y-o-y (3.1% in the previous quarter), explained mainly by the positive performance of services, manufacturing, and agriculture. On the side of expenditures, domestic demand (consumption and investment) was the principal growth factor, given that net exports had no incidence at all. With this result, the cumulative variation rate for 2017 stood at 4.2%, in line with estimates. Likewise, during the first months of 2018, the short-term indicators continued to show the favorable performance of economic activity and domestic demand, particularly as related to consumption and investments in machinery.

As regards the evolution of local prices, in the first quarter, annual inflation averaged 4.3%, lower than the 4.7% registered in fourth quarter 2017. This result is explained largely by a smaller increase y-o-y in the prices of some food items, particularly those with significant volatility. The annual average rates of underlying inflation and underlying X1 inflation were 4.1% and 4% in the first quarter, above the rates registered in the last quarter of 2017 (3.7% and 4%, respectively). This behavior is due, in part, to the increase of the prices of certain food items, services, and some administered goods (diesel fuel and urban bus fare). On the other hand, core inflation remained at 2.9%, similar to the rate observed in the previous quarter.

At its monetary policy meetings held in the first quarter of the year, the Monetary Operations Executive Committee (CEOMA) continued to stress the positive performance of economic activities in the main advanced economies, as well as the favorable evolution of the principal economies within the region. Likewise, the increase of volatility in financial markets was noted in February, but it was subsequently mitigated. Regarding the domestic scenario, the CEOMA pointed out while the adjustments of some administered prices might bear an influence in the short term, the

Inflation projection

Annual change, percent

	2017	2018(f)	2019(f)	2020(f)
Average CPI inflation(*)	4.7	3.9	4.0	
December CPI inflation (**)	4.5	3.7	4.0	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	3.7	3.7	4.0	
December underlying CPI (**)	3.6	3.8	4.0	
Underlying CPI inflation in around 2 years (***)				4.0

(*) 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 2020.

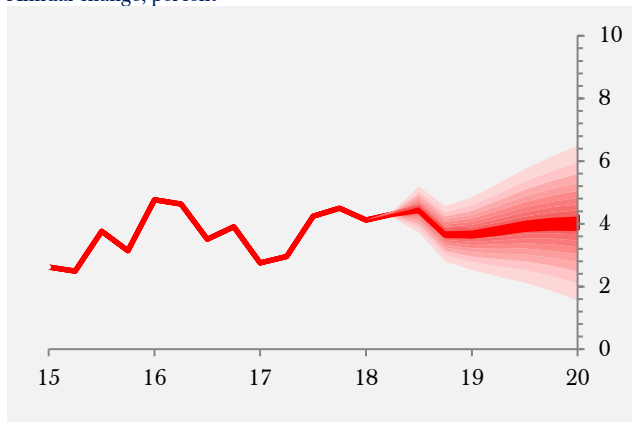
projections show no significant impact on the inflation trend measures nor any important deviations of total inflation, in the medium term, with respect to the target. In fact, underlying inflation indicators show a downward trajectory. As regards economic activity, the growth observed in the first months of 2018 remains in line with the previous estimates. In this scenario, the CEOMA, at its meetings held in January, February, and March, deemed it appropriate to maintain the monetary policy rate (TPM) with no variation, to stand at 5.25% annually.

In the baseline scenario, the GDP growth estimate for 2018 remains at 4.5%, although there has been an intra-sectorial rearrangement, taking into account both the recent and the expected evolution of the various economic sectors. On the side of supply, the most important corrections downward have been registered for livestock production and the construction sector, while estimates for the expansion of commerce, manufacturing, and agriculture have been adjusted only minimally. These decreases were offset by a higher forecast for the growth of the tertiary sector (general government, communications, and other services), as well as electrical power and potable water sector. On the expenditure side, the government consumption growth forecast was revised upward, while the investment forecast was corrected downward. Following these changes, the 4.5% expansion of GDP will continue to be explained, in great measure, by the tertiary and secondary sectors (supply) and by domestic demand (expenditures).

With relation to projected inflation, in the baseline scenario, a 3.7% inflation rate is foreseen for the end of 2018, slightly below the rate forecast in the previous IPoM report (3.9%). This change was due to the lower than expected inflation in the first semester, explained in part by the reverting of the prices of certain items of the food category (fruit and vegetables) that had increased significantly towards the end of last year. In addition, the exchange rate stood below the expected level in the first quarter, which contributed to the decrease in the underlying inflation forecast, which dropped from 3.9% to 3.8%. Looking forward, starting in 2019, inflation will remain close to the 4% target in the monetary policy horizon (first quarter 2020), a trajectory that is conditional upon the most likely evolution of the internal and external macroeconomic variables relevant for domestic prices.

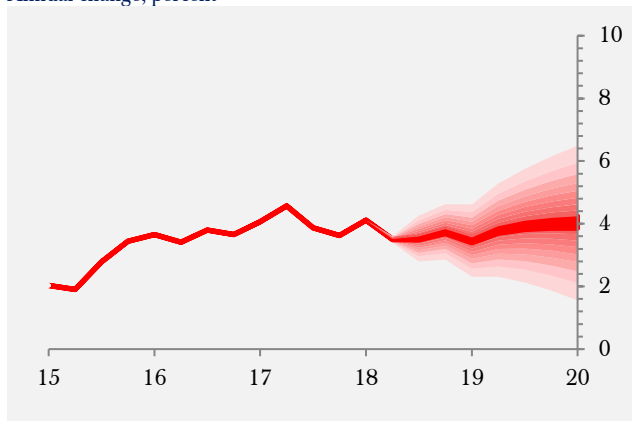
With respect to risk scenarios at the international level, economic activity worldwide has continued to evolve vigorously since the last report, and the United States' fiscal efforts are expected to contribute further to the global

CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

demand in the short term. In this context, the Federal Reserve decided again to increase the range of its interest rates, a measure that until now has had no notorious impact on the value of the United States dollar in international markets, and in the region. However, downturn risks in world economic prospects have intensified recently, with the announcement of customs tariffs by the United States on Chinese products, and vice versa. A priori, the negative effects that might stem from this commercial dispute would be relatively limited for Paraguay, as long as this situation does not become deeper or amplified on a global scale.

In the Eurozone, both economic activity and the labor market have shown a solid performance in the last few months. Some risks derived from developments in the political scenario have arisen following elections in Italy, because of their possible effects as concerns the block's integration process. In addition, uncertainty persists about future trade relations after *Brexit*.

In China, while the economy maintained a robust expansion in the first months, a moderation is expected over the course of the year, explained partially by the more prudent orientation of monetary policy, as well as measures intended to reduce risks derived from the high level of financial leveraging. Furthermore, the threat of a trade war with the United States also represents a downturn risk in the Chinese economy. In the short-term, it is difficult to anticipate precisely the effects of this commercial dispute with respect to commodities prices relevant for Paraguay. Meanwhile, in the long-term, a more accentuated deceleration of an economy as large as that of China could have unfavorable implications for these commodity prices. Nevertheless, in the last few days the uncertainty about a "trade war" has attenuated.

At the regional level, Brazil has continued to show signs of recovery. However, the latest data observed in 2018 are lower than expected. The political environment (in an electoral year) is currently a source of uncertainty with respect to the carrying out of the government's proposed reforms agenda, particularly fiscal reforms. In this context, the Brazilian real has weakened in relation to the US dollar. In spite of this, prospects remain relatively favorable, a factor that might continue to benefit on Paraguay's border trade. However, the Committee points out that the depreciation of the Brazilian currency might offset this positive effect.

Regarding Argentina, signs of the economy's improvement have been observed since the first months of this year, while the downward revision of growth forecasts were due to a



timely exogenous factor (drought). However, the reduction of inflation remains as a major challenge for the government. The variation of prices has rebound recently, explained largely by the increase of some regulated prices and the depreciation of the peso. A moderation in the next months is expected, although predictions indicate that at the end of the year, inflation will stand above the target, which had been revised upward for 2018. Concerning potential effects for Paraguay, high inflation might continue to foster the important flow of Argentinians who make purchases in Paraguayan border cities, although the recent depreciation of the peso might lessen the impact on price differentials.

In the domestic scenario, the principal risk factor that the Committee continues to note is related to the future evolution of the foreign exchange rate. Up until now, the dollar has not shown any clear trend in international markets, following the last adjustments of the Federal Reserve's interest rates. On the contrary, the Guaraní recently has appreciated with respect to the US dollar. Looking ahead, no significant strengthening of the United States' currency is expected, which may reflect the greater uncertainty about the effects of trade disputes, as well as concern regarding the sustainability of the United States' public finances, among other factors.

With the appraisal of the alternative scenarios, the CEOMA considers that the balance of risks for inflation is unbiased. Nevertheless, the Committee will continue to monitor the evolution of the relevant macroeconomic variables for domestic inflation, in order to apply the necessary monetary policy measures that will allow for the convergence of inflation to 4% annually over the relevant projection horizon.