MONETARY POLICY REPORT

JUNE
2018

CENTRAL BANK OF PARAGUAY

Executive Summary*

Since the last IPoM, the global economy has continued to show a favorable although more heterogeneous performance. However, uncertainty about growth prospects has intensified in the last few months, mainly due to the recent global trade tensions. In the United States, the economy has continued to be brisk, as reflected in the improvement of its short-term growth prospects. On the other hand, the economic activity indicators in the Eurozone were below the foreseen level for the first months of the year, which, in the midst of the recent political and trade tensions, motivated downward adjustments of growth forecasts. In China, the prospects are similar to those foreseen in the last report, although with a downward bias, taking into account the negative effects that could arise from its trade disputes with the United States. In the region, the growth projections of Paraguay's main neighboring economies (Brazil and Argentina) are increasingly lower, mainly as the result of certain domestic factors.

World growth
Annual change, percent

	March 2018			June 2018		
	2017	2018	2019	2017	2018	2019
World	3.7	3.8	3.7	3.7	3.7	3.6
United States	2.3	2.8	2.4	2.3	2.9	2.4
Eurozone	2.3	2.4	2.0	2.3	2.2	1.9
China	6.9	6.5	6.2	6.9	6.5	6.3
Brazil	1.0	2.7	2.7	1.0	1.8	2.6
Argentina	2.9	2.8	3.2	2.9	1.8	2.7
Trading partners	2.3	2.9	2.9	2.3	2.6	2.8
Trading partners - Mercosur	1.5	2.8	3.0	1.5	2.0	2.7

Source: Bloomberg

In the United States, the short-term economic outlook has remained strong. In the first quarter of the year, the Gross Domestic Product (GDP) grew at an annualized rate of 2%, explained by the positive contributions of non-residential fixed investment, personal consumption expenditure, exports, and government spending. In turn, leading activity indicators revealed greater dynamism for the second quarter of the year, boosted by fiscal stimuli and greater domestic demand. In this context, growth prospects for this year have been adjusted upward with respect to the estimates presented in the previous *Report*. Notwithstanding, uncertainty remains about the government's economic policy actions, mainly as concerns the effects of a broadening of trade tensions. Inflation, on the other hand, has continued to increase up to a level around the medium-term target (2%). In such a scenario, at its June meeting the Federal Reserve increased the monetary policy interest rate to the range of 1.75% - 2% annually.

In the Eurozone, economic activity and the manufacturing sector indicators have continued to expand, albeit at a slower

* The Spanish version prevails.

Gross Domestic Product by sectors
Annual change, percent

	2017	2018 (f)	2018(i)
Primary Sector	**4.0**	**1.7**	**0.2**
Agriculture	4.0	1.3	0.1
Livestock	5.0	1.8	0.0
Forestry, fishery and mining	1.3	4.6	0.0
Secondary Sector	**3.8**	**6.0**	**2.0**
Manufacturing	9.0	7.5	1.5
Construction	-1.5	3.0	0.2
Electricity & water	-3.7	4.5	0.4
Tertiary Sector	**5.6**	**4.4**	**2.1**
Public Administration	2.9	6.0	0.5
Trade	11.9	6.2	0.7
Other Services	4.2	3.3	0.9
Taxes	5.0	5.0	0.4
GDP at market prices	**4.8**	**4.7**	
GDP w/o agriculture and binationals	5.7	5.0	

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

pace. In the first quarter, the GDP grew at a lower annual rate than registered in the previous quarter, explained by the slowing down of economic activity in Germany, Italy, and France. Regarding manufacturing, the PMI again stood at a lower level than registered in the previous quarter, a behavior that has been observed since November 2017; however, it remains in the expansion zone. In the labor market, the unemployment rate continued to decrease, to stand at 8.4% in May, the lowest rate since 2008. As regards monetary policy, the European Central Bank (ECB) at its last meeting in June decided to maintain the current reference interest rates with no variations. As concerns the non-standard monetary policy measures, the Council announced that it would maintain the net assets purchases at the current pace of 30 billion euros per month until the end of September this year. In addition, according to the evolution of inflation, it would reduce the assets purchases by half from October until the close of the year 2018.

In China, the economy has maintained a favorable dynamism, although it is consistent with the scenario of moderation foreseen for both this year and the next one. In the first quarter 2018, GDP grew 6.8% annually, explained largely by the positive contribution of private consumption. Likewise, the manufacturing PMI has shown an improvement since the last report. Looking forward, a slower pace of expansion is expected due to adjustment measures established by the government in order to decrease credit risks and deflate the real estate bubble. Given that this scenario was already foreseen, the growth forecasts for 2018 have been maintained without any changes with respect to the previous *Report*. For 2019, growth forecasts have been revised slightly upward, although they remain below the expansion rate in 2018. As regards the risk factors for a downturn, the uncertainty about the resolution of trade tensions with the United States is highlighted.

In the region, the expectations of a solid recovery of neighboring countries have weakened in the recent period, which has been reflected by the continual downward revisions of growth projections, even though they remain positive. In Brazil, the GDP in the first quarter registered a positive annual variation, explained by the increase in agricultural and livestock production, on the supply side, while household consumption and investment contributed to this growth, on the demand side. In the second quarter, some economic activity and consumer confidence indicators decelerated, due in part to the effects of strikes and uncertainty within the political scenario. In this context, growth forecasts for this year and the next one have been revised downward. On the other hand, the Central Bank of Brazil's Monetary Policy Committee (Copom) at its June meeting decided to maintain the current monetary policy stance, since inflation has remained around the lower limit of the target range.

Economic growth and current account
Annual change, percent

	2016	2017	2018 (f)
GDP	**4.3**	**4.8**	**4.7**
Domestic demand	**1.8**	**6.5**	**5.0**
Gross capital formation	**-1.0**	**15.0**	**4.8**
Gross fixed capital formation (GFKF)	3.6	4.3	4.8
Total consumption	**2.5**	**4.3**	**5.1**
Private consumption	2.7	4.8	4.9
Public consumption	1.5	1.6	6.0
Exports of goods and services	**8.4**	**7.5**	**5.0**
Imports of goods and services	**0.9**	**13.5**	**6.0**
Current account (% of GDP)	1.1	-0.8	-1.0
GFKF (% of nominal GDP)	18.8	18.1	18.4

Source: Central Bank of Paraguay

In Argentina, the economic situation has also become more complex in the last few months, mainly due to certain domestic events that have added on to the adverse effects of drought. The signs of improvement continued to be observed until the first quarter 2018, after which some sectorial indicators, particularly those tied to the agricultural sector, have shown an important deterioration. On the other hand, the tensions in financial markets during April were transmitted as pressures on the foreign exchange market, which led to a significant depreciation of the Argentine peso vis-à-vis the United States dollar. This scenario, coupled with the increase of energy prices, contributed to the increase of inflation. In this context, the Central Bank of the Republic of Argentina (BCRA) significantly adjusted its reference rate and redefined the inflation targets for the coming years. Furthermore, the Argentine government signed an agreement with the International Monetary Fund (IMF), in which it commits itself to the implementation of a series of economic reforms, in exchange of a line of liquidity that will allow it to restrain the recent financial risks.

At the local level, economic activity has continued to show a favorable dynamism during the first months of 2018. In the first quarter, the annual variation of the GDP was 4.1% y-o-y, a relatively high rate taking into account the high base of comparison (a variation of 6.9% in first quarter 2017). On the supply side, the observed growth was explained largely by the performance of services (especially trade), manufacturing, electricity and water, and, to a lesser degree, by agricultural production. As concerns expenditures, the expansion was due mainly to internal demand (total consumption and investment). In the second quarter, the advanced data related to economic activity and demand, continued to be favorable. The services sector and manufacturing maintained its momentum, as well as the indicators linked to domestic spending.

As regards the evolution of prices, in the second quarter, annual inflation averaged 3.8%, a lower rate than the rate registered in the previous quarter (4.3%). The result observed between April and June 2018 is explained largely by the price increases of fuels and durable goods, as well as slight rises of the prices of some services included in the consumer basket. The annual average rates of underlying inflation and underlying X1 inflation were 3.5% and 3.1%, respectively, in the second quarter of the year, below the rates registered in the first quarter (4.1% and 4%). On the other hand, annual core inflation decreased, falling from an average of 2.9% to 2.6% in the same period.

Inflation projection

Annual change, percent

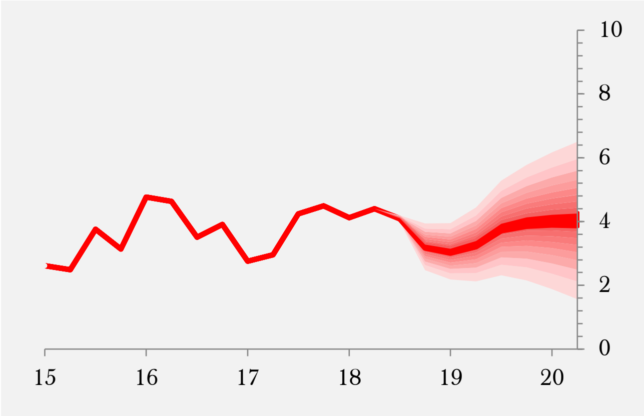
	2017	2018(f)	2019(f)	2020(f)
Average CPI inflation(*)	4.7	3.9	4.0	
December CPI inflation (**)	4.5	3.7	4.0	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	3.7	3.8	4.0	
December underlying CPI (**)	3.6	3.7	4.0	
Underlying CPI inflation in around 2 years (***)				4.0

(*) 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.

With respect to monetary policy, at the meetings held in the second quarter, the Monetary Operations Executive Committee (CEOMA) pointed out that while a favorable dynamism of economic activities in the performance of advanced countries indicators persists, greater uncertainty has been generated also, due to the trade measures announced by both the United States and China. Within the region, a weakening of expansion projections for the main neighboring economies was observed, mainly due to certain internal events. Regarding the domestic scenario, the CEOMA highlights that the recent evolution of inflation and its expected trajectory remained consistent with the medium-term target. As regards economic activity, the short-term indicators continued to show a favorable behavior in the second quarter. In this context, the CEOMA, at its meetings held in April, May, and June, decided to maintain the monetary policy rate (MPR) at 5.25% annually.

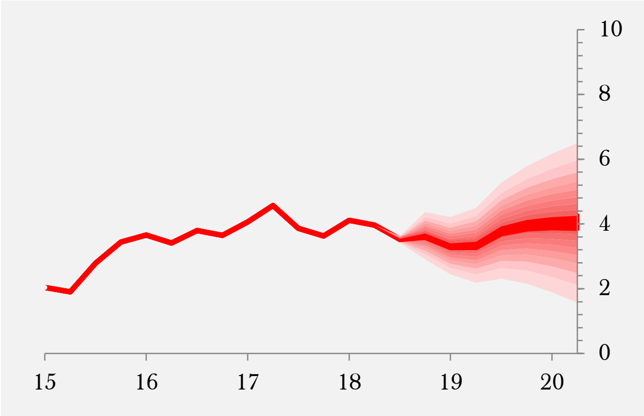
In the baseline scenario at the local level, the GDP growth projection for 2018 stands at 4.7%. This expansion is explained largely by the performance of the commercial and general government subsectors, within the tertiary sector, while in the secondary sector, the principal contributions correspond to manufacturing, and in lesser measure, to electricity and water. On the expenditure side, growth is

CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

explained mainly by internal demand, including both consumption and investment, while net external demand is projected to have a slightly negative incidence.

With relation to projected inflation, in the baseline scenario, the total inflation forecast by the end of 2018 remains at 3.7%. Raw inflation data of the second quarter remained in line with previous projections for this period. Likewise, the output gap and the exchange rate have remained within the expected limits. For this reason, underlying inflation projections also stand close to the level reported in the previous report (3.7%). Looking forward, total inflation will remain slightly below 4% during the first half of 2019, and then will converge gradually to the target towards the end of that year, remaining around that level in the relevant monetary policy horizon (second quarter 2020).

With respect to risk scenarios at the international level, the global economy has continued to expand, although in a less synchronized manner, while uncertainty has increased in recent months as a consequence of the flaring up of trade tensions between the United States and its trading partners. While the United States' economy has maintained favorable dynamism, the other advanced economies (Japan, Eurozone, and United Kingdom) have adjusted their growth forecasts downward, following the results observed in first quarter 2018. Among the emerging economies, and particularly in the region, the expansion rates have also been revised downward. The Federal Reserve has continued with the monetary normalization process, and at its June meeting adjusted the monetary policy rate once again. In this context, the dollar has strengthened in international markets, as well as in the region.

In the Eurozone, economic activity has presented more moderate growth in the last few months, and the monetary policy has maintained an accommodative stance in order to ensure the inflation target. Political uncertainty has continued in the region, although bounded for the time being. In addition, a recent risk stems from the United States' imposition of tariffs on certain products imported from the European Union, which could affect global trade relations.

In China, a deceleration is expected, explained in part by the measures adopted by the government to reduce risks derived from the financial sector. Likewise, the uncertainty generated by the trade dispute with the United States represents an important downturn risk to China's growth prospects. To the extent that the economy of this country moderates more than foreseen, this could have implications on the commodity prices, considering China's important participation in the world demand for these products.

In the region, the signs of a solid recovery of the Brazilian economy have been weakening over the last few months due to the uncertainty related to the political sphere (in an electoral year), which could withdraw support for the approval of fiscal reforms. Furthermore, the truck drivers' strike led to a temporary stop of the productive chain with significant negative effects on Brazil's economy. In this context, the risk premiums have increased and the Brazilian real has depreciated at an important rate. Rooted in these latest events, trade in the border zones with Paraguay has moderated in the recent period.

In Argentina, the growth projections have been revised downward, after certain domestic vulnerabilities that jeopardize the recovery of its economy. The depreciation of the Argentine peso in relation to the dollar could maintain inflation at high levels. Although the current economic situation of Argentina is quite complex, it is expected that the adjustment measures to be implemented in the framework of the agreement signed with the International Monetary Fund might improve the macroeconomic situation in the medium term. Concerning the effects for Paraguay dependence on Argentina has decreased in the last few years. Notwithstanding, it must be highlighted that the high depreciation of the peso could mean, in the short-term, a more appreciated bilateral real exchange rate in of Paraguay, which would ultimately imply lower prices for the products imported from Argentina.

Taking into account 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 4.0% annually over the relevant projection horizon.