



MONETARY POLICY REPORT

DECEMBER
2018



CENTRAL BANK OF PARAGUAY

Executive Summary*

World growth

Annual change, percent

	September 2018		December 2018		
	2018	2019	2018	2019	2020
World	3.6	3.5	3.6	3.4	3.2
United States	2.9	2.5	2.9	2.6	1.9
Eurozone	2.1	1.8	1.9	1.6	1.5
China	6.6	6.3	6.6	6.2	6.0
Brazil	1.5	2.4	1.3	2.4	2.5
Argentina	-1.6	0.0	-2.3	-0.6	2.9
Trading partners	2.3	2.4	2.1	2.2	2.6
World	0.7	1.8	0.2	1.4	2.7

Source: Bloomberg

During 2018, the global economy has maintained a favorable performance, although lower than expected at the beginning of the year. Trade tensions between the United States and China, the tightening of financial conditions, the volatility of international stock markets, and the idiosyncratic factors of each country have caused increased uncertainty at the world level. Among the advanced economies, in the United States, growth has remained strong and with no changes since the last report. However, growth prospects in the Eurozone have again been revised downward, for both this year as well as the next one, due to the weakening of the industrial sector and of external demand, in addition to rising political turmoil. Among the emerging economies, in China the Gross Domestic Product (GDP) growth rate for 2019 has been revised downward, in a scenario of deterioration of the manufacturing sector and of the risks generated by the trade war. In the region, the economic conditions in Argentina continue to be fragile, while Brazil shows a modest growth rate, in a context of uncertainty about the policies to be implemented by the new government.

In the United States, the economic outlook has remained robust. In the third quarter of the year, the GDP expanded at an annualized rate of 3.5%, explained by the positive contributions of personal consumption expenditures and government spending. In turn, leading activity indicators have shown a similar performance in the fourth quarter. In this context, growth prospects for this year remain the same with respect to the estimates presented in the previous report. However, uncertainty remains regarding the government's economic policy actions, especially as concerns the effects of a broadening of trade tensions. Inflation has decreased with respect to what was observed in the previous report, standing around the medium-term target (2%). In such a scenario, at its December meeting, the Federal Reserve increased the monetary policy interest rate, to stand within the range of 2.25% - 2.50% annually. A highlight of the last Fed Meeting was the downward

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

	2018	2019(f)	2019(i)
Primary Sector	2.2	0.5	0.1
Agriculture	4.0	0.5	0.0
Livestock	-5.0	1.0	0.0
Forestry, fishery and mining	3.3	0.0	0.0
Secondary Sector	3.4	3.8	1.3
Manufacturing	5.0	4.4	0.9
Construction	1.2	3.5	0.2
Electricity & water	1.4	2.5	0.2
Tertiary Sector	4.8	4.7	2.2
Public Administration	6.5	2.5	0.2
Trade	6.5	4.5	0.5
Other Services	3.7	5.5	1.5
Taxes	4.1	5.5	0.4
GDP at market prices	4.0	4.0	4.0
GDP w/o agriculture and binationals	4.3	4.5	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

adjustment of both growth prospects and of inflation in 2019, context in which the process of rate hikes would be more moderate than previously expected.

In the Eurozone, the slowdown in economic activity persists. With respect to this, in the third quarter GDP grew by 1.6% annually, below the rate registered in the previous quarter (2.2%), continuing with the downward trajectory observed since the beginning of 2018. Leading indicators show a similar behavior in the last quarter of the year. As regards the PMI indicator, it has decelerated also, a behavior that has been observed since November 2017, although it remains in the expansion zone. With respect to the labor market, the unemployment rate has continued to decrease, now standing at low levels similar to those reported in 2008. As regards prices, annual inflation stood at 2%, similar to the rate presented in the previous report. Concerning monetary policy, the Governing Council of the European Central Bank (ECB) has maintained both the current reference interest rates, with no variations, and its net assets purchases, at 15 billion euros, during the last quarter.

In a similar manner, China presented a slight deceleration of economic activity in the last few months. In the third quarter 2018, the GDP expanded by 6.5% y-o-y, below the previous quarter (6.7%). Likewise, the manufacturing PMI showed a weakening in the recent period. Given that this scenario is in line with expectations, the growth forecasts for 2018 remain with no changes with respect to the previous report (6.6%), and were adjusted marginally downward for the year 2019. As regards the risk factors for a downturn, uncertainty persists with respect to the outcome of trade tensions with the United States, in spite of a ninety-day pause for the imposition of new tariffs.

In the region, the economic situation of Brazil has improved with respect to what was observed in the first semester of the year. The expansion of the GDP in the third quarter (1.3%), higher than recorded in the previous quarter (0.9%), was explained mainly by the positive contribution of domestic demand, on the side of expenditures, and by the growth of the services sector, especially that of the transport, warehousing, and postal sub-sectors, on the side of production. Some short-term indicators have shown positive

Economic growth and current account

Annual change, percent

	2017	2018	2019 (f)
GDP	5.0	4.0	4.0
Domestic demand	5.9	4.6	4.2
Gross capital formation	12.7	4.5	5.5
Gross fixed capital formation (GFKF)	5.9	4.5	5.5
Total consumption	4.2	4.7	3.8
Private consumption	4.5	4.4	4.1
Public consumption	2.1	6.5	2.0
Exports of goods and services	8.3	4.5	4.0
Imports of goods and services	12.0	6.5	4.5
Current account (% of GDP)	3.1	0.7	-0.6
GFKF (% of nominal GDP)	18.6	18.7	18.9

Source: Central Bank of Paraguay

signs in recent months, including the PMI, which continued to rebound in the expansion zone, and the unemployment rate, which has decreased. In this scenario, growth forecasts for 2018 have been revised slightly downwards, to a certain extent due to the effects of the lower performance verified in the first half of the year, while growth prospects for 2019 are maintained. As regards risks, uncertainty persists in relation to the policies to be implemented by the new administration, particularly those tied to public finances. With respect to monetary policy, different inflation measures stand below the 4.5% target, while the Central Bank of Brazil's Monetary Policy Committee (Copom) has maintained the Selic rate at 6.5% annually, the same level ever since March 2018.

In Argentina, less volatility of the exchange and stock markets has been observed in the recent period. Despite this, however, the economic and financial conditions continue to be weak. In the third quarter, the GDP decreased by 3.5% annually, a smaller contraction than registered in the second quarter, with private consumption and gross capital formation being the components that explain the greatest part of the decrease in the product. As regards prices, the different measures of inflation continue with an upward trajectory. On the other hand, the new agreement between the Argentinian government and the IMF allowed for the contention of the currency crisis, in addition to the commitment to reforms, among which is included the new monetary policy scheme implemented since October by the Central Bank of the Republic of Argentina (BCRA).

With respect to the domestic economy, the dynamism observed in the first half of the year moderated in the last few months, explained in part by the more complex regional environment, as well as by some internal supply factors. In the third quarter, the GDP registered an expansion of 1.1% y-o-y, far below the levels reported in the first and second quarters (5.2% and 6.4%, respectively). This change is explained mainly by the slower expansion pace of manufacturing and services sectors, in addition to the falls registered in the construction and electricity, and water sectors. On the side of expenditures, although internal demand maintained its positive contribution, an important negative incidence of net external demand was verified, explained mainly by the drop of exports. In the fourth

Inflation projection

Annual change, percent

	2017	2018(f)	2019(f)	2020(f)
Average CPI inflation(*)	4.7	3.7	4.0	
December CPI inflation (**)	4.5	3.1	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 fourth quarter of 2020.

quarter, the short-term indicators show that the expansion of activity will be maintained at moderate levels.

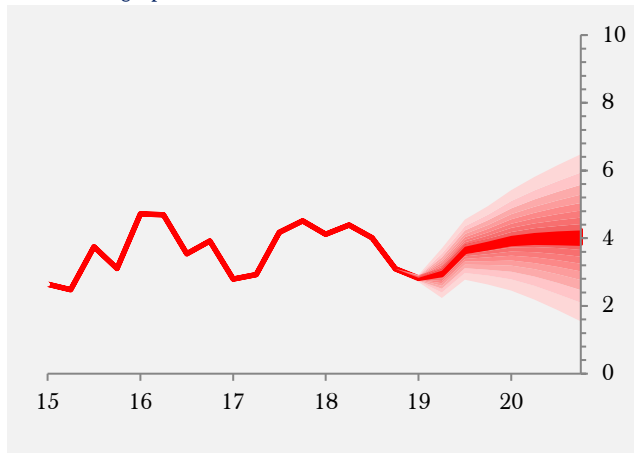
As regards the evolution of prices, annual inflation averaged 4.1%, between October and November, slightly above the rate observed in the third quarter (4.0%). This result is explained mainly by the price increases of food products and durable goods, as well as increases of the cost of certain goods and services included in the consumer basket. The annual average rates of underlying inflation and underlying X1 inflation between October and November were 4.1% and 3.0%, respectively, higher than the rates registered in the third quarter (3.7% and 3.0%, respectively). Annual core inflation increased from 2.9% to 3.1% in the reference period.

With respect to monetary policy, at its meetings in the fourth quarter, the Monetary Operations Executive Committee (CEOMA) pointed out that, in the international scenario, the global economy continued with its trajectory of expansion, although at a slower pace than expected and with greater disparities between some advanced economies. On the other hand, within the region, growth forecasts continue to be revised downward, especially for Argentina, while in Brazil the situation was more favorable during the second semester of the year. Regarding the domestic scenario, the CEOMA highlighted that economic activity has continued to weaken in the last few months, while the behavior of inflation has remained consistent with the target. In this context, the CEOMA, at its meetings held in October, November, and December, decided to maintain the monetary policy rate (MPR) at 5.25% annually.

In the baseline scenario, the GDP growth estimate for 2018 was revised from 4.3% to 4%, taking into account the recent evolution of short-term indicators. For 2019, an expansion rate of 4% is also expected, explained mainly by the tertiary sector (trade and services) and the secondary sector (manufacturing, construction, and generation of electricity), whereas the primary sector is expected to have a lower positive incidence. On the side of expenditures, the greatest contribution to growth would come from internal demand, especially private consumption and investment. Net external demand would also contribute in a positive manner,

CPI inflation forecast

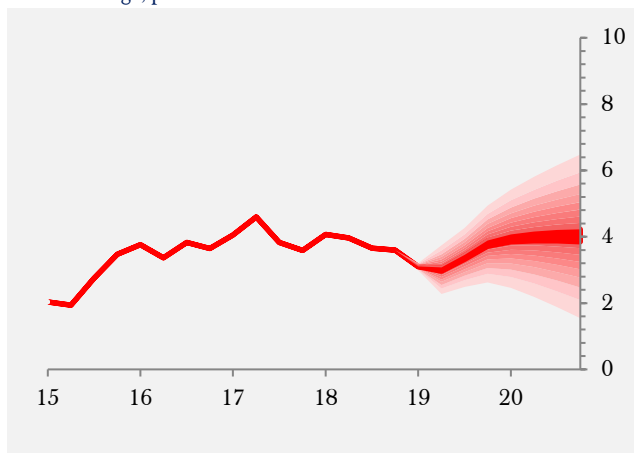
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

although to a minimum extent, given that a similar variation rate is expected for both exports and imports.

With relation to prices, projected inflation for 2018 was adjusted slightly from 3.8% to 3.1%, explained largely by the price reversals, towards the end of the year, of some volatile items of the consumer basket, fuels, and urban bus fares. In addition, the nominal exchange rate registered a trajectory that stood below the end of the year estimates given in the last report. In line with the above, the underlying inflation estimate was revised downward from 4.2 % to 3.6% for this year. On the other hand, inflation projections for 2019, for both total inflation and underlying inflation will remain at 4% similar to the rates foreseen in the previous report. Inflation will remain relatively low during the first months of 2019 and then will converge gradually to the target towards the end of the year, remaining around the target over the relevant monetary policy horizon (fourth quarter 2020).

With respect to risk scenarios, at the international level, the global economy has continued to grow, albeit at a slower pace and in a less synchronized manner, than expected initially. On the other hand, the risks of a downturn for global growth prospects continue, especially those stemming from the trade tensions between the United States and China. In spite of the recent decision to postpone for ninety days the imposition of new tariffs, uncertainty remains at high levels. In Europe, risks related to the Brexit have intensified in the last few days, due to the lack of consensus in the British Parliament regarding a draft agreement with the European Union, and the Union's rejection of potential renegotiations. As regards the monetary policy of the United States' Federal Reserve, the continuity of the monetary normalization process during 2019 is expected, although in a more gradual manner than previously anticipated, which will likewise impose less favorable international financial conditions, and which might affect to a greater extent the most vulnerable emerging economies. In the case of Paraguay, the macroeconomic foundations remain strong, and in this sense, the effects might be limited, such as was the case during 2018, particularly with reference to foreign exchange rate.

In China, economic activity moderated more than expected, explained in part by the trade escalations with the United States. This scenario caused authorities to implement certain monetary and fiscal flexibilization measures, in order to guarantee a “soft landing” of the economy. However, financial vulnerabilities tied to corporate sector indebtedness and shadow banking activities persist. The agreed upon pause of the trade war and the adopted countercyclical policies present a more favorable scenario for the Chinese economy, although the latent risks of an economic downturn remain. With regard to the impact on commodities prices, at the most complicated moment of the trade war, China’s great demand for soybeans produced in Latin America caused the increase of premiums at regional ports, which attenuated largely the fall observed in the reference price (Chicago). However, in the case that the trade dispute is intensified, or is prolonged, both the Chinese and the global economy might moderate even more, and this would affect negatively the prices of commodities.

In the region, the growth prospects for Brazil stand below the initial forecasts, explained mainly by the fragile performance during the first semester. Second semester records have been better, in terms of economic activity, the unemployment rate, and consumer confidence. On the other hand, political “noise” diminished after the elections, although the challenge of undertaking needed reforms persists, in order to assure the sustainability of public finances. With respect to Paraguay, the important depreciation of the Brazilian real has affected border trade in a negative manner; however, a reversal has been observed in recent months. To the extent in which the economic situation of Brazil continues upward, and its currency does not lose value vis-à-vis the United States dollar, commerce in the border zones could rebound again.

In Argentina, the macroeconomic context remains complex, even though it has improved with respect to previous months. This is due to the stabilization process that has been initiated, together with the scenario of uncertainty that prevails in an election year. The adjustment policies that the government has implemented have been influencing the performance of economic activity, and such policies are expected to continue next year. On the other hand, this



process of macro corrections has influenced favorably both the exchange market and inflation expectation. To the extent that the government complies with the points established in the Stand-By agreement signed with the International Monetary Fund, the greater credibility of its economic policies may lay the foundation for greater growth in the medium term. As concerns Paraguay, trade in border zone cities has been significantly weakened, following the important depreciation of the Argentinean peso recorded up until the end of September 2018. However, in subsequent months, a certain stability and even an appreciation of the Argentinean currency has been observed, which together with the greater inflation, has attenuated the real appreciation of the Paraguayan Guaraní.

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, applying the necessary monetary policy measures that will allow for the convergence of inflation to 4.0% annually over the relevant projection horizon.