



# MONETARY POLICY REPORT

SEPTEMBER  
2018



CENTRAL BANK OF PARAGUAY

## Executive Summary\*

### World growth

Annual change, percent

	June 2018			September 2018		
	2017	2018	2019	2017	2018	2019
World	3.7	3.7	3.6	3.7	3.6	3.5
United States	2.3	2.9	2.4	2.3	2.9	2.5
Eurozone	2.3	2.2	1.9	2.3	2.1	1.8
China	6.9	6.5	6.3	6.9	6.6	6.3
Brazil	1.0	1.8	2.6	1.0	1.5	2.4
Argentina	2.9	1.8	2.7	2.9	-1.6	0.0
Trading partners	2.3	2.6	2.8	2.3	2.3	2.4
Trading partners - Mercosur	1.5	2.0	2.7	1.5	0.7	1.8

Source: Bloomberg

Since the last report, the global economy has continued to expand, although with more uneven rates among countries. In the United States, the economic indicators remain strong, while in the Eurozone a moderation of economic activity continues to be observed. Among the emerging economies, China continues its convergence towards a slower pace of growth. In the region, the economic context remains complex, particularly in Argentina. In the last few months, the perception of global risks has increased, due to the tightening of international financial conditions with the normalization of the Federal Reserve's monetary policy, geopolitical and trade tensions, as well as the domestic conditions of each country.

In the United States, the economy has maintained a strong evolution and the market's records have continued to improve during the last few months. In the second quarter of the year, the Gross Domestic Product (GDP) expanded at an annualized rate of 4.2%, explained by the positive contributions of personal consumption expenditures, exports, non-residential fixed investment, and government spending. In turn, short-term activity indicators have shown signs of similar performance in the third quarter. In such a scenario, growth prospects for this year remain the same with respect to the estimates presented in the previous report, in spite of the uncertainty about the effects of the trade tensions with China. Inflation measures, on the other hand, have continued to increase, up to levels around the medium-term target (2%). In this context, at its September meeting, the Federal Reserve increased again the monetary policy interest rate, to stand within the range of 2.0% - 2.25% annually.

In the Eurozone, economic activity indicators have moderated following the significant growth observed in 2017. In the second quarter, the GDP grew by 2.1% annually, a lower rate than registered in the previous quarter, continuing with the downward trajectory observed in the previous report. In a similar manner, manufacturing activity has slowed down even more in the third quarter. Thus, the

\* The Spanish version prevails.

**Gross Domestic Product by sectors**

Annual change, percent

	2017	2018 (f)	2018(i)
<b>Primary Sector</b>	<b>4.3</b>	<b>0.6</b>	<b>0.1</b>
Agriculture	4.1	0.5	0.0
Livestock	2.2	-2.5	-0.1
Forestry, fishery and mining	10.4	8.0	0.1
<b>Secondary Sector</b>	<b>4.7</b>	<b>4.8</b>	<b>1.6</b>
Manufacturing	8.4	6.5	1.3
Construction	5.3	3.0	0.2
Electricity & water	-3.7	2.0	0.2
<b>Tertiary Sector</b>	<b>5.8</b>	<b>4.7</b>	<b>2.2</b>
Public Administration	1.6	6.6	0.6
Trade	11.2	5.8	0.6
Other Services	5.2	3.7	1.0
Taxes	5.5	5.0	0.4
<b>GDP at market prices</b>	<b>5.2</b>	<b>4.3</b>	<b>4.3</b>
GDP w/o agriculture and binationals	6.3	4.9	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

PMI indicator continued to exhibit a downward tendency explained by a lower expansion of exports and the increase of both political and trade tensions. With respect to the labor market, the unemployment rate has continued to decrease. As regards prices, annual inflation remains stable at 2%, similar to the data reported in the June report. In said scenario, the Governing Council of the European Central Bank has maintained the current reference interest rates with no variations and announced the reduction of the volume of its assets purchase program, by 15 billion euros, during the last quarter this year.

In China, the economic and manufacturing activities have continued to expand, although at a lower rate. The GDP grew 6.7% y-o-y in the second quarter of this year, marginally below the previous quarter. Likewise, the recent evolution of the PMI shows a certain moderation in the expansion of the manufacturing sector. In this scenario, the intensification of the trade war with the United States has induced the Chinese government to relax restrictions established to decrease credit risks, in order to avoid a greater deceleration of economic growth. Consequently, the growth forecasts for 2018 have been revised slightly upward, although they remain below the rate registered in 2017.

In the region, the Brazilian economy showed the weakening of economic activity in the second quarter, which was also reflected in the downward revision of growth projections, in relation to data given in the previous report. The deceleration of the GDP in the second quarter was explained, especially, by the slower pace of expansion of manufacturing and services, which were affected to a certain extent by the truck drivers' strike and political uncertainty. On the other hand, the short-term indicators have shown an improvement of economic activity in recent months. With respect to monetary policy, the Central Bank of Brazil's Monetary Policy Committee (Copom) has maintained its Selic rate, with no changes (6.5% annually). Looking forward, market expectations suggest that this rate will be maintained without any changes during the remainder of the year.

In Argentina, the economic and financial conditions have become even more complex since the publication of the previous report. In consequence, the economic recovery process initiated in 2017 has been suddenly interrupted. In

### Economic growth and current account

Annual change, percent

	2016	2017	2018 (f)
<b>GDP</b>	<b>4.3</b>	<b>5.2</b>	<b>4.3</b>
<b>Domestic demand</b>	<b>1.8</b>	<b>7.6</b>	<b>5.0</b>
<b>Gross capital formation</b>	<b>-1.0</b>	<b>18.9</b>	<b>4.8</b>
Gross fixed capital formation (GFKF)	3.6	5.8	4.8
<b>Total consumption</b>	<b>2.5</b>	<b>4.7</b>	<b>5.0</b>
Private consumption	2.7	5.3	4.8
Public consumption	1.5	1.6	6.5
<b>Exports of goods and services</b>	<b>8.4</b>	<b>8.2</b>	<b>4.5</b>
<b>Imports of goods and services</b>	<b>0.9</b>	<b>16.2</b>	<b>6.5</b>
Current account (% of GDP)	3.5	3.4	0.5
GFKF (% of nominal GDP)	18.8	18.6	19.4

Source: Central Bank of Paraguay

the second quarter, the GDP contracted by 4.2% annually, attributed largely to the fall of exports and government spending. Leading activity indicators show that in the third quarter the economic performance would have been similar, due to the effects of the drought, the significant depreciation of the Argentinean peso, and the fiscal adjustment measures. Inflation has continued to accelerate, and therefore the Central Bank of the Republic of Argentina (BCRA) has implemented a series of measures to stabilize the market and safeguard its deflation process. In addition, the BCRA has decided to adopt the control of monetary base as a new scheme for its monetary policy, with the purpose of reducing inflation and recovering the stability and predictability of prices.

In the domestic context, economic activity showed favorable dynamism in second quarter 2018, with GDP registering an annual variation of 6.2% y-o-y, above the 4.1% observed in the first quarter. On the supply side, this higher growth was mainly explained by the better performance of services, manufacturing and construction sectors. On the side of expenditures, the positive performance of internal demand (total consumption and investment) contributed wholly for the expansion, given that the incidence of net external demand was negative in this period. In the third quarter, according to the short-term indicators, a moderation of the pace of growth is foreseen, explained in part by the more complex external scenario, together with the drop in electrical power output and livestock production.

As regards the evolution of prices, in the third quarter, annual inflation averaged 4.0%, slightly above the rate observed in the previous quarter (3.8%). This higher rate is explained, partially, 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 3.7% and 3.0%, respectively, standing above the rates registered in the previous quarter (3.5% and 3.1%). In the same reference period, annual core inflation increased from 2.6% to 2.9%.

With respect to monetary policy, at its meetings, the Monetary Operations Executive Committee (CEOMA) highlighted that in the international scenario it continued to

### 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	3.8	4.0	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	3.7	4.1	4.0	
December underlying CPI (**)	3.6	4.2	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 third quarter of 2020.

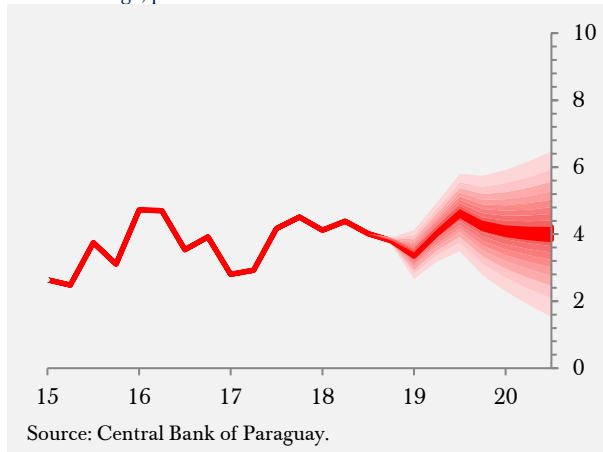
observe a favorable evolution of the main advanced economies, while the uncertainty stemming from trade tensions between the United States and China persists. On the other hand, within the region, the growth projections for the main neighboring economies have been successively revised downwards, as a consequence of internal factors and the more complex international context. Regarding the domestic scenario, the CEOMA pointed out that the expansion pace of economic activity presented a moderation, while inflation trend measures continued to show a behavior consistent with the target. In this context, the CEOMA, at its meetings held in July, August, and September, deemed that the most appropriate strategy was to maintain the monetary policy rate (MPR) at 5.25% annually.

In the baseline scenario, the GDP growth estimate for 2018 was revised from 4.7% to 4.3%. This lower forecast is explained by the downward correction of electricity and water sub-sectors, and of manufacturing, in the secondary sector. Likewise, in the primary sector, downward adjustments were made for both agriculture and livestock production. On the other hand, in the tertiary sector, the revision was upward, due in great measure to governmental and other services, while, as concerns trade, a lower rate of positive variation is predicted. On the expenditure side, internal demand maintains the same growth rate as reported in the previous report. However, private consumption was revised downward slightly, and was offset by the rise of public consumption. Thus, the adjustment of the GDP forecast is explained mainly by the more negative incidence of net external demand.

With relation to prices, projected inflation by the close of 2018 was adjusted slightly from 3.7% to 3.8%, while underlying inflation was revised upward from 3.7% to 4.2%. These upward revisions were explained largely by price adjustments that took place in the last few months, such as the price increases of fuels, urban bus fares, and certain services, as well as of imported goods, that were affected by the exchange rate depreciations. Looking forward, total inflation will stand above 4% during the second half of 2019, and then will converge gradually to the target over the relevant monetary policy horizon (third quarter 2020).

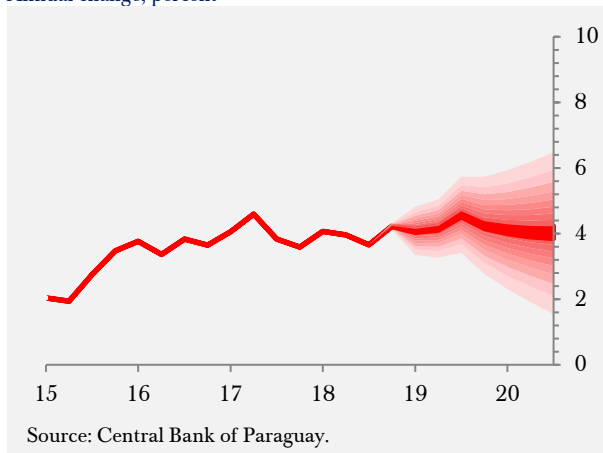
### CPI inflation forecast

Annual change, percent



### Underlying CPI inflation forecast

Annual change, percent



With respect to risk scenarios at the international level, the dynamism of the global economy has moderated in recent months, especially in some advanced economies, such as the Eurozone and the United Kingdom. On the other hand, economic activity and labor market indicators in the United States have continued to evolve favorably, explained in part by the government's fiscal stimulus. However, the risks of a downturn for global prospects has intensified, following the application of tariff measures by the United States and retaliation actions by China. The Federal Reserve has continued with the normalization of its monetary policy rate, which is expected to continue until the end of this year, as well as in 2019, until converging to the long-term levels. In this scenario, the international financial conditions will become more adjusted, and downward pressures on the currencies of emerging economies could continue.

In China, growth moderation is expected, in comparison to 2017, due in part to the deceleration of external demand. In addition, trade tensions with the United States represent a significant risk for the downturn of growth prospects. Taking into account that China has one of the world's highest demand for commodities, a greater than expected deceleration of its economy could exert some downward pressures on commodity prices. As concerns Paraguay, particularly with regard to the Chinese imposition of tariffs on soybeans from the United States, this could mean greater demand for soybeans produced in Latin America, which would attenuate the negative effects on the prices of commodities.

In the region, Brazil has shown less dynamism of its economic activities, explained in part by the truck drivers' strikes that have affected manufacturing output and the supply chain. On the other hand, challenges for the implementation of fiscal reforms continue to persist, mainly in the context of current political uncertainty. While growth prospects continue to be positive, they have been revised downward in the last few months. In this context, the Brazilian real depreciated by an important percentage rate. With respect to Paraguay, this moderation of economic activity and the weakening of its currency have affected the local economy, specifically as concerns trade in the border zones.



In Argentina, the economic situation has become much more complex, as reflected by the significant downward revision of its growth projections. Furthermore, the exchange rate has depreciated substantially in recent months. The recovery of the Argentinean economy, in the medium term, will depend greatly upon the successful implementation of the measures established in the *Stand-By* agreement signed with the International Monetary Fund. With respect to Paraguay, less economic activity, and above all the high depreciation of the Argentinean peso which implies more competitive prices for Argentinean products has also affected border zone commerce in a negative manner.

The increase of petroleum prices has been exerting pressure on domestic prices. Even though the forecasts point towards a normalization of oil prices, or even a drop in prices in the next few years, the uncertainty about the outcome of recent tensions between the United States and Saudi Arabia poses a new scenario for oil prices, which will be better visualized in the coming months. This context, associated with the strengthening of the United States dollar, would imply pressures on the inflation of oil-importing economies or their derivatives. In the case of Paraguay, increases in fuel prices have been verified. However, it is appropriate to point out that, according to the evidence of recent years, its second round effects on inflation have been moderate.

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.