



MONETARY POLICY REPORT

December
2019



CENTRAL BANK OF PARAGUAY

Federación Rusa y Augusto Roa Bastos

www.bcp.gov.py

Asunción - Paraguay

Executive Summary*

World growth

Annual change, percent

| | September 2019 | | December 2019 | | |
|-------------------|----------------|------|---------------|------|------|
| | 2019 | 2020 | 2019 | 2020 | 2021 |
| World | 3.1 | 3.1 | 3.0 | 3.1 | 3.2 |
| United States | 2.3 | 1.7 | 2.3 | 1.8 | 1.9 |
| Eurozone | 1.1 | 1.0 | 1.2 | 1.0 | 1.2 |
| China | 6.2 | 5.9 | 6.1 | 5.9 | 5.7 |
| Brazil | 0.9 | 2.0 | 1.0 | 2.1 | 2.5 |
| Argentina | -2.5 | -1.1 | -2.8 | -1.7 | 1.5 |
| Trading partners | 0.5 | 1.4 | 0.4 | 1.1 | 2.3 |
| Mercosur partners | -0.8 | 0.7 | -0.8 | 0.4 | 2.1 |

Source: Bloomberg

Since the publication of the last IPoM report, global economic growth has maintained a moderate dynamism, marked by the deterioration of international trade and manufacturing output. The global growth forecast for 2019 has been revised slightly downward, while it remains with no changes for next year. However, economic prospects for 2020 might become more encouraging, to the extent that the recent progress in trade affairs between the United States and China contributes to the constraint of the high levels of uncertainty that have hampered global economic growth during the past year. Another encouraging factor is the accommodative monetary policy orientation of the world's main central banks, a stance that has been maintained in the last quarter.

In the United States, Gross Domestic Product (GDP) registered an annualized growth rate of 2.1% in the third quarter, above the previous estimate (1.9%). This result was explained mainly by the positive contributions of consumer spending, governmental expenditures, residential investments, inventory investments, and exports. However, a negative contribution as regards non-residential fixed investments was observed. The Purchasing Managers' Index (PMI) stood in the contraction zone in November, for the fourth consecutive month, with a drop in all the sub-indexes, except that of order deliveries. In this scenario, growth prospects for this year remained at 2.3%, while for 2020 they have increased slightly, by one decimal point, to stand at 1.8%. On the other hand, inflation, as measured by the Personal Consumption Expenditures Price Index (PCEPI), stood at 1.5% in November; it is estimated that inflation will close the year at 1.6%, below the 2% target. In this context, during the fourth quarter the Federal Reserve (Fed) reduced the range of reference rates in October to 1.50% - 1.75%, and at its December meeting, it remained in the same range.

In the Eurozone, annual GDP growth in the third quarter was 1.2%, the same rate registered in the second quarter. In this period, a favorable result was observed for household consumption, government consumption, and gross fixed

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

| | 2019 | 2020(f) | 2020(i) |
|--|-------------|------------|------------|
| Primary Sector | -4.7 | 3.8 | 0.4 |
| Agriculture | -6.2 | 5.0 | 0.4 |
| Livestock | -0.5 | 1.2 | 0.0 |
| Forestry, fishery and mining | -0.7 | 0.0 | 0.0 |
| Secondary Sector | -2.4 | 4.0 | 1.3 |
| Manufacturing | -0.9 | 4.6 | 0.9 |
| Construction | 0.5 | 3.7 | 0.2 |
| Electricity & water | -8.0 | 2.5 | 0.2 |
| Tertiary Sector | 3.3 | 4.2 | 2.0 |
| Public Administration | 6.5 | 4.0 | 0.4 |
| Trade | -2.3 | 3.1 | 0.3 |
| Other Services | 4.5 | 4.6 | 1.4 |
| Taxes | -0.5 | 4.0 | 0.3 |
| GDP at market prices | 0.2 | 4.1 | 4.1 |
| GDP w/o agriculture and binationals | 1.7 | 4.1 | |

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

capital formation, while the external sector and inventories decreased. As regards the manufacturing indicator (PMI), it continues to stand in the contraction zone, but it did improve in November to stand at 46.9 (as compared to 45.9 in October), since the drops in output and new orders were less pronounced. In this context, growth prospects have increased slightly for 2019 with respect to the last IPoM report, with a rate of 1.2% y-o-y. Growth prospects for 2020 remain at 1%. As regards prices, total inflation indicators increased in November, following several months of deceleration, standing at 1.0% annually; a rate of 1.2% is estimated for the end of the year. Concerning monetary policy decisions, the European Central Bank (ECB) has maintained the interest rates applicable to refinancing operations, the marginal lending facility, and the deposit facility interest rate during the fourth quarter.

In China, the economic activity data for the third quarter indicated a GDP growth rate of 6.0% y-o-y, below the growth rate in the previous quarter (6.2%). The lower performance in this period was consistent with a deterioration of the manufacturing sector, as the PMI has stood in the contraction zone since May. However, in November this indicator stood marginally above the contraction zone (50.2). Likewise, the deteriorated external sector might show signs of recovery after reaching a preliminary agreement with the United States with respect to the trade dispute. As regards the growth forecasts for 2019, these have decreased slightly to 6.1% annually, as compared to the data given in the previous IPoM (6.2%), while for 2020 they remain stable at 5.9%.

In Brazil, GDP growth registered a rate of 1.2% y-o-y, in the third quarter, slightly above the rate observed in the second quarter (1.1%). The better result was due to the increases in gross fixed capital formation and household consumption, while governmental expenditures decreased and the external sector deteriorated. As regards the short-term indicators, the manufacturing PMI continues to be in the expansion zone (52.9 in November). Concerning growth projections, the prospects have improved in comparison to the previous report, increasing from 0.9% to 1.0% for 2019, and from 2% to 2.1% for 2020. As for prices, the inflation measures remain in the lower zone of the target range, despite the rebound in November, a month in which an inflation rate of 3.3% y-o-y was observed. In this context, the

Economic growth and current account

Annual change, percent

| | 2018 | 2019 | 2020 (f) |
|--------------------------------------|-------------|-------------|------------|
| GDP | 3.4 | 0.2 | 4.1 |
| Domestic demand | 5.8 | 0.9 | 3.7 |
| Gross capital formation | 11.9 | -1.5 | 3.5 |
| Gross fixed capital formation (GFKF) | 6.9 | -1.5 | 3.5 |
| Total consumption | 4.1 | 1.7 | 3.7 |
| Private consumption | 4.3 | 0.8 | 3.7 |
| Public consumption | 3.0 | 6.5 | 4.0 |
| Exports of goods and services | 1.8 | -5.1 | 4.8 |
| Imports of goods and services | 8.9 | -3.4 | 3.7 |
| Current account (% of GDP) | -0.2 | -1.5 | -0.6 |
| GFKF (% of nominal GDP) | 19.9 | 21.3 | 21.6 |

Source: Central Bank of Paraguay

Central Bank of Brazil's Monetary Policy Committee (Copom) has reduced the SELIC rate twice during the fourth quarter, to stand at 4.50% annually.

In Argentina, economic activity has continued to show signs of deterioration. GDP in the third quarter registered a fall of 1.7% y-o-y, explained by the contraction in manufacturing output, construction, trade, and financial intermediation, among other factors (on the side of supply). On the side of expenditures, the negative contribution was due mainly to reductions in private sector consumption and investments. Likewise, the Monthly Estimator of Economic Activity (EMAE) contracted 0.9% y-o-y in October, while the manufacturing sector's indicator decreased 2.3% y-o-y in the same month. As for prices, following a period of deceleration, inflation rebounded again in November, standing at 52.1%. Since the beginning of December, the political scenario has changed and the new governmental administration announced new policy measures to face the complex economic situation. In this context, growth prospects for 2019 have been revised downward again, currently standing at -2.8% for 2019 and -1.7% for 2020 (-2.5% and -1.1%, respectively, in the September IPoM).

In the local context, economic activity has begun to show signs of recovery, starting with the beginning of the second quarter, as noted in the previous report. In the third quarter, the annual variation of GDP stood at 2.8%, after two consecutive quarters of interannual drops. On the supply side, the economic activities with the greatest incidence for growth were the services sector, construction, and agriculture. However, the generation of electric energy has continued to decrease. On the expenditures side, private and public consumption were the main components that explained the annual growth rate in the quarter. Both gross fixed capital formation and net exports showed a contraction. According to the short-term indicators, the economic activity is expected to expand in the fourth quarter.

As regards the behavior of prices, total inflation and the different trend measures have continued to show a downward trajectory, standing near the lower limit of the target range. Between October and November, average total inflation was 2.2% y-o-y, below the 2.8% rate observed in the third quarter. This decrease was explained mainly by the

Inflation projection

Annual change, percent

| | 2018 | 2019(f) | 2020(f) | 2021(f) |
|--|------|---------|---------|---------|
| Average CPI inflation(*) | 3.8 | 2.4 | 3.8 | |
| December CPI inflation (**) | 3.2 | 2.8 | 3.9 | |
| CPI inflation in around two years (***) | | | | 4.0 |
| Average underlying CPI inflation(*) | 3.9 | 2.2 | 3.8 | |
| December underlying CPI (**) | 3.6 | 2.7 | 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 2021.

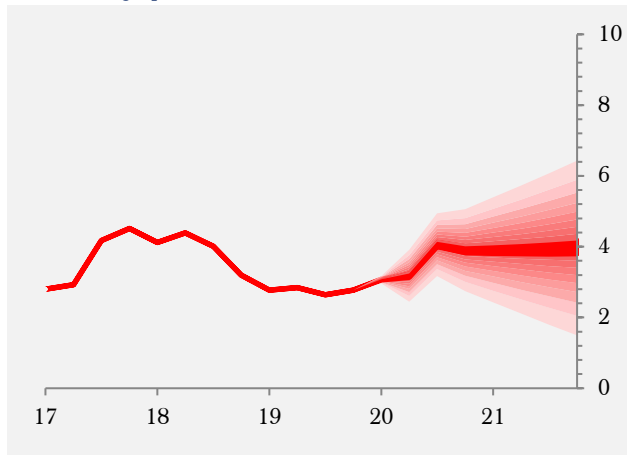
lower rate of variation y-o-y for the prices of services, food items and energy. The averages for October and November for underlying inflation, underlying X1 inflation, and core inflation decreased to 2.1%, 2.4%, and 2.3%, respectively (2.7%, 2.5%, and 2.7% in the September report).

With respect to monetary policy decisions, at the meetings held in October, November and December, the Monetary Operations Executive Committee (CEOMA) maintained the reference rate at 4.0% annually. The Committee has highlighted in its press releases the synchronized moderation of global economic growth and the complexity of the regional economic scenario, marked by political and social tensions observed in the recent period. In the case of Argentina, growth prospects remain fragile; however, as regards Brazil, the latest records of economic activity have improved, while the growth estimates point towards greater expansion in 2020. Global uncertainty, which has remained at high levels, chiefly because of the trade conflict between the United State and China de-escalated towards the end of the year, following a preliminary trade agreement between these two countries. At the domestic level, economic activity and demand indicators have shown signs of recovery in the third quarter, while the different inflation measures continued at low levels. However, given the expected scenario for the macroeconomic variables, the projection models point out that the current stance of monetary policy, with the 4.0% reference rate, is consistent with the convergence of inflation to the target over the projection horizon.

In the baseline scenario, GDP annual growth forecast for 2019 was maintained at 0.2%, explained mainly by the tertiary sector (government and other services) and by internal demand (private and public consumption). For 2020, the initial growth projections stand at 4.1%. On the side of supply, the foreseen expansion was due largely to the recovery of agricultural production, the generation of electricity, manufacturing, and construction. In addition, the services sector will register greater growth, due to the better performance expected for commerce and other services. On the side of expenditures, a rebound in private consumption and investments is expected, together with a positive contribution of net exports. Although it will

CPI inflation forecast

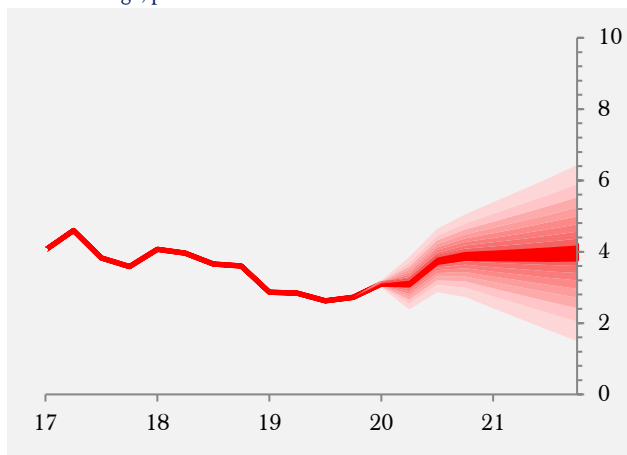
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

continue to grow, public consumption is expected to have less incidence in 2020.

In the baseline scenario for inflation, the projection of the annual variation of total CPI for 2019 has been reduced from 3.2% to 2.8% annually. This is due, mainly, to the volatile prices of the consumer basket in the fourth quarter, which stood below the estimate for that period; this also explains a lower inflation rate than the one presented in the previous report. The three-decimal-point adjustment of the underlying inflation estimate for 2019 is explained basically by an effective depreciation of the nominal exchange rate in the last quarter, which is below the data forecasted in the previous report. This fact has been reflected in lower increases in the prices of imported goods, in comparison with the previous quarter. For 2020, the forecasts for total inflation and underlying inflation stand at 3.9% annually. The speed of convergence of inflation is consistent with the following: the recovery of economic activity (with a slightly positive product gap), a real exchange rate trajectory above its equilibrium value until the middle of next year, and a real monetary policy interest rate that is below the neutral level (expansionary real monetary conditions). Considering the assumptions most likely to have an incidence on the future behavior of the internal and external macroeconomic variables, inflation will increase gradually in the next months to stand at around 4.0% towards the middle of next year, remaining at that level until the relevant monetary policy horizon, in the fourth quarter of 2021.

With respect to risk scenarios, at the international level, some of the main sources of uncertainty that have affected the growth prospects of the global economy have been mitigated. As regards trade and geopolitical tensions, the United States and China have reached a preliminary “Phase One” agreement, while, following the elections in the United Kingdom, a “softer” Brexit (with an agreement) is expected. These advances could reduce the levels of global uncertainty, boost international trade, and become a favorable factor for commodity prices. In addition, the more accommodative monetary policy stance of the main central banks worldwide will continue to make its contribution, in an environment of laxer external financing during the next months. This scenario implies a more encouraging external outlook for the Paraguayan economy, given that greater foreign demand and/or relatively lower interest rates would



benefit Paraguay directly, as well as having a potential positive effect on the country's trade partners.

On the one hand, in South America, a series of episodes of social and political instability has emerged recently; this has caused disruptions in the productive activity of certain countries, thus generating a greater perception of risk in these economies. As regards Paraguay's main trade partners in the region, in Argentina the growth prospects remain weak, while in Brazil the economic scenario has improved and greater expansion is expected for 2020. In addition, the new Argentinean government has adopted economic policy measures that may continue to affect border trade negatively. In contrast, the Brazilian government increased the limit for purchases made by Brazilians in border zone cities, from USD 300 to a maximum of USD 500 per person. This will be a positive factor for commercial activities in Paraguayan cities located along the border with Brazil.

Evaluating 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 the target of 4.0% annually, over the relevant projection horizon.