



MONETARY POLICY REPORT

SEPTEMBER
2019



CENTRAL BANK OF PARAGUAY

Federación Rusa y Augusto Roa Bastos

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Asunción - Paraguay

Executive Summary*

World growth

Annual change, percent

	June 2019			September 2019	
	2018	2019	2020	2019	2020
World	3.6	3.3	3.3	3.1	3.1
United States	2.9	2.5	1.8	2.3	1.7
Eurozone	1.9	1.2	1.3	1.1	1.0
China	6.6	6.2	6.0	6.2	5.9
Brazil	1.1	1.0	2.2	0.9	2.0
Argentina	-2.5	-1.2	2.5	-2.5	-1.1
Trading partners	2.0	1.1	2.5	0.5	1.4
Mercosur partners	0.0	0.0	2.3	-0.8	0.7

Source: Bloomberg

Since the publication of the last IPoM report, global economic growth prospects have decreased for this year as well as for the next one, mainly because of the weakness of international trade, lower manufacturing output, and a reduced level of investment. In addition, growth forecasts maintain a downward bias, the realization of which depends essentially on advances in trade negotiations between the United States and China and the evolution of geopolitical tensions. In this more complex scenario, the monetary policy orientation of both advanced and emerging countries has become more accommodative in the last few months.

In the United States, Gross Domestic Product (GDP) registered an annualized growth rate of 2.0% in the second quarter, below the 3.1% rate observed in the first quarter. This lower dynamism was explained mainly by the reduction of inventory investments, the decrease of exports, and less fixed capital investments. However, consumer spending and the expenditures of state governments showed a positive performance. The manufacturing Purchasing Managers' Index (PMI) stood in the contraction zone, starting in August, mainly due to a drop in new export orders. In this scenario, growth prospects for this year and the next one have decreased with respect to the previous report. On the other hand, inflation measures have remained relatively stable during the third quarter, and most of them are below the 2% target. In this context, the Federal Reserve (Fed) lowered the target range for the federal funds rate in July and September, and additional cuts in the fourth quarter are not ruled out.

In the Eurozone, annual GDP growth in the second quarter was 1.2%, slightly lower than the 1.3% registered in the first quarter. A favorable result of investments, household consumption, and government consumption has been observed; however, exports and imports have decreased. As regards the manufacturing indicator (PMI), it continues to stand in the contraction zone, primarily because of less dynamism in international trade, the uncertainty generated by Brexit, and lower production of the automobile sector.

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

	2018	2019(f)	2019(i)
Primary Sector	1.2	-4.7	-0.5
Agriculture	2.0	-6.2	-0.5
Livestock	-2.4	-0.5	0.0
Forestry, fishery and mining	2.4	-1.4	0.0
Secondary Sector	2.6	-2.4	-0.8
Manufacturing	3.7	-1.0	-0.2
Construction	0.2	0.5	0.0
Electricity & water	1.5	-8.0	-0.6
Tertiary Sector	5.3	3.3	1.6
Public Administration	6.0	6.5	0.6
Trade	7.4	-2.4	-0.3
Other Services	4.2	4.5	1.2
Taxes	2.7	-0.5	0.0
GDP at market prices	3.7	0.2	0.2
GDP w/o agriculture and binationals	4.1	1.6	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

Thus, growth prospects have been revised downward for 2019 and 2020. As regards prices, inflation indicators have decreased, with respect to the previous report, and remain at low levels in relation to the target. Concerning monetary policy decisions, the European Central Bank (ECB) has maintained the interest rates applicable to refinancing operations and the marginal lending facility unchanged, during the third quarter. However, it reduced the deposit facility interest rate in September.

In China, the data at the end of the second quarter indicate a GDP growth rate of 6.2% y-o-y, according to what was expected by the market, although below the rate for the first quarter (6.4%). The lower performance is consistent with a deterioration in the manufacturing sector, as its PMI has stood in contraction zone since May. Likewise, a deterioration in foreign trade was observed, resulting from a drop in imports in the second quarter and the unfavorable performance of exports in June. In this scenario, growth forecasts for 2019 have remained unchanged (6.2%), with respect to the previous monetary policy report (IPoM).

In Brazil, GDP growth registered a rate of 1% y-o-y, in the second quarter, above the rate observed in the first quarter (0.5%). This better result was due mainly to the positive performance of the manufacturing sector and of services. Regarding the short-term indicators, the manufacturing PMI stands in expansion zone. As concerns growth projections, the prospects have been slightly reduced in comparison to the previous report, dropping from 1.0% to 0.9% for the year 2019. As for prices, the inflation measures remain in the lower zone of the target range. In this context, the Central Bank of Brazil's Monetary Policy Committee (Copom) reduced the SELIC rate twice in the third quarter.

In Argentina, economic activity registered an annual expansion of 0.6% in the second quarter and a variation of -0.3% y-o-y with respect to the level observed in the first quarter. The lower performance for the quarter was explained by a fall in imports, a low level of public consumption, and a deterioration of manufacturing activity; notwithstanding, the result was attenuated slightly by an increase of exports and of activity in the agricultural and livestock sectors. On the other hand, in the third quarter, the economic scenario has become more complex, due to the political uncertainty generated after the primary elections.

Economic growth and current account

Annual change, percent

	2017	2018	2019 (f)
GDP	5.0	3.7	0.2
Domestic demand	5.9	6.0	0.9
Gross capital formation	12.7	12.8	-1.5
Gross fixed capital formation (GFKF)	5.9	1.5	-1.5
Total consumption	4.2	4.2	1.6
Private consumption	4.5	3.9	0.8
Public consumption	2.1	6.0	6.5
Exports of goods and services	8.3	2.7	-5.1
Imports of goods and services	12.0	9.6	-3.4
Current account (% of GDP)	3.1	0.0	-1.1
GFKF (% of nominal GDP)	18.6	18.2	17.9

Source: Central Bank of Paraguay

As for prices, the inflation rate has accelerated in the recent period. In this context, the Central Bank of Argentina (BCRA) has decided to modify its plan for the growth of monetary aggregates. Thus, growth prospects for 2019 have been revised downward again, currently standing at -2.5%.

At the domestic level, economic activity has remained weak, explained in part by the impact of supply shocks (climatic factors) and those of the complex external environment, above all within the region. In the second quarter, the GDP registered a variation of -3.0% y-o-y (6.9% in second the quarter 2018). On the supply side, this result was explained by the declines observed in agricultural production, electric energy, construction, and manufacturing, while the services sector continued to show a positive performance. On the expenditures side, the GDP decrease has been related mainly to internal demand; with investment being the component with the greatest incidence for the fall in annual growth. According to the short-term indicators, a more favorable economic performance is expected in the third quarter.

As regards prices, since the last IPoM report, total inflation and the different trend measures have decreased, standing below the medium-term target. Average total inflation, between July and September, stood at 2.8%, below the rate observed in the previous quarter (3.2%), and explained mainly by a smaller increase of prices in the transportation category. Likewise, in this period, underlying inflation (which excludes fruit and vegetables) and underlying X1 inflation (which, in addition to fruit and vegetables, excludes tariffed services and fuels) averaged annual rates of 2.7% and 2.5%, lower than the rates registered between April and June (3.1% and 2.8%, respectively). Core inflation presented an average annual rate of 2.7%, below the level registered in the second quarter 2019 (3%).

With respect to monetary policy, at the meetings held in August and September, the Monetary Operations Executive Committee (CEOMA) decided to reduce the monetary policy rate (MPR) by 25 basis points at each meeting, to stand at 4.0% annually. In relation to this decision, the Committee highlighted that the downward risk in global economic growth prospects still persists, in an environment of rising uncertainty due to the trade conflict between the United State and China, and the geopolitical tensions in the

Inflation projection

Annual change, percent

	2018	2019(f)	2020(f)	2021(f)
Average CPI inflation(*)	3.8	2.8	4.0	
December CPI inflation (**)	3.2	3.2	3.9	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	3.9	2.7	4.0	
December underlying CPI (**)	3.6	3.1	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 third quarter of 2021.

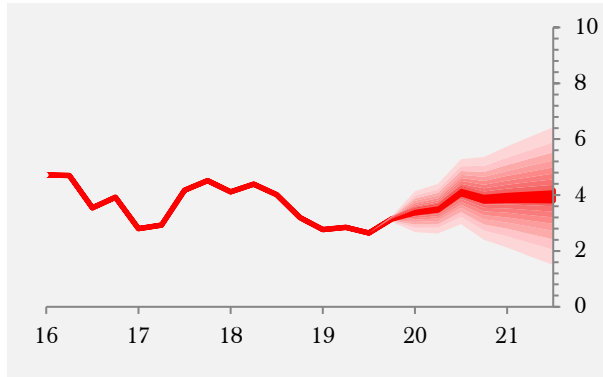
United Kingdom and, more recently, in Saudi Arabia. At its July and September meetings, the Federal Reserve has adopted a laxer monetary policy stance, with two cuts of the reference interest rates range, to stand at 1.75%-2.00% annually. In the region, the economic scenario remains complex, especially due to the economic situation in Argentina. At the domestic level, economic activity and demand indicators have shown better performance, at the margin; however, the cumulative growth rates continue to be negative. As regards prices, total inflation and its underlying measures have remained in the lower zone of the target range. Furthermore, according to the different scenarios of the projection model, no inflationary pressures were foreseen for the next months.

In the baseline scenario, the GDP annual growth forecast for 2019 has been reduced from 1.5% to 0.2%. While the short-term indicators have shown better results in the last months, the weak performance in the first quarter largely conditioned the expansion that had previously been expected. On the side of supply, the most important adjustment was registered in the secondary sector (electricity and water, construction, and manufacturing). In the primary sector, a greater drop in agriculture is estimated, although this would be compensated, partially, by forecasts of less contraction of livestock production, and of the forestry, fishing, and mining subsectors. In the tertiary sector, downward adjustments were observed in commerce and other services. On the side of expenditures, the cut is explained, mainly, by the downward correction of the growth rate of internal demand (private investment and consumption), while net exports are expected to have a greater negative incidence than had been estimated in the previous IPoM report.

As regards total inflation, the projected baseline scenario envisions a reduction from 3.7 to 3.2%, while the underlying inflation estimate was revised downward from 3.6% to 3.1%. These changes are explained mainly by the negative domestic product gap, which continues with a greater magnitude than forecasted in the previous report. In addition, observed inflation data has stood below the estimates for the third quarter. Even though the foreign exchange rate increased during the recent period, also observed in the region, this has attenuated to a certain extent the downward correction of inflation projections, and the

CPI inflation forecast

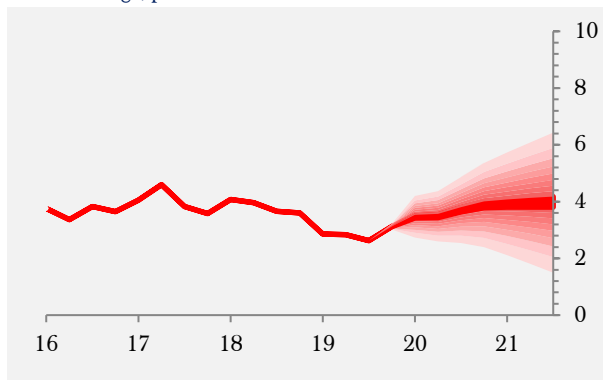
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

effects of eased capacity are prevalent. For this reason, the prospects of inflationary pressures in the medium-term have been limited. Given this context, the monetary policy flexibilization measures implemented in the last few months assure the convergence of inflation to the target over the projection horizon. According to the most likely scenario for the evolution of the internal and external macroeconomic variables of relevance for the dynamics of local prices, inflation will increase gradually in the next months, to stand at around 4% in mid-2020, remaining at that level until the relevant monetary policy horizon, this time, the third quarter of 2021.

With respect to risk scenarios, at the international level, the growth prospects of the global economy decelerated in the last few months and they remain with a downward bias. These adjustments are explained, largely, by the effects of the trade tensions between the United States and China that, in addition to affecting international trade negatively, have undermined the confidence of both consumers and investors around the world. In recent days, there has been progress regarding a potential agreement between the United States and China; however, it is still too early to anticipate an outcome, considering recent experiences. In addition, geopolitical tensions and the specific factors in each country have contributed to the deceleration of growth prospects. On the other hand, the more accommodative monetary policy of the main central banks worldwide has partially buffered the slowdown of economic activity.

On the one hand, if the complexity of the global economic situation persists in the next months, this would imply a smaller boost of external demand for commodity exporting countries. In the case of Paraguay, the direct effects could stem from lower commodity prices resulting from the greater slowdown of the global economy, and particularly, due to the deepening of the deceleration of the Chinese economy. In addition, some indirect effects might be observed, to the extent that this more complex context affects Paraguay's main trade partners. On the other hand, an element that could contribute favorably to economic activity is the laxer monetary policy of the United States' Federal Reserve. This stance would provide a context of eased financial conditions for external funding and might imply fewer pressures for the weakening of the currencies of emerging countries in comparison to the U.S. dollar, as long

as global uncertainty does not signify a sudden shift in the attitude towards risks in emerging countries.

In Argentina, the economic outlook has become much more complex after the acknowledgement of the primary elections results, with a significant reaction of the markets, reflected in a substantial increase of the country risk premium, a fall in the stock market, and a significant depreciation of the foreign exchange rate. This depreciation of the Argentinian peso has again translated into a greater price differential in border zones, with respect to prices in Paraguay, thus reducing the competitiveness of products sold in local businesses. However, to the extent that this depreciation of the Argentinian peso is transferred towards inflation in Argentina, the price differentials should begin to decrease in the next months.

In Brazil, the growth prospects for 2020 indicate a greater expansion in comparison to those expected for 2019. The more expansive stance of monetary policy and the recent approval of the pension system reform bill generates a more favorable scenario for medium-term growth. This more promising context could contribute to a greater boost for Paraguayan exports that country, particularly as regards re-export operations.

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.