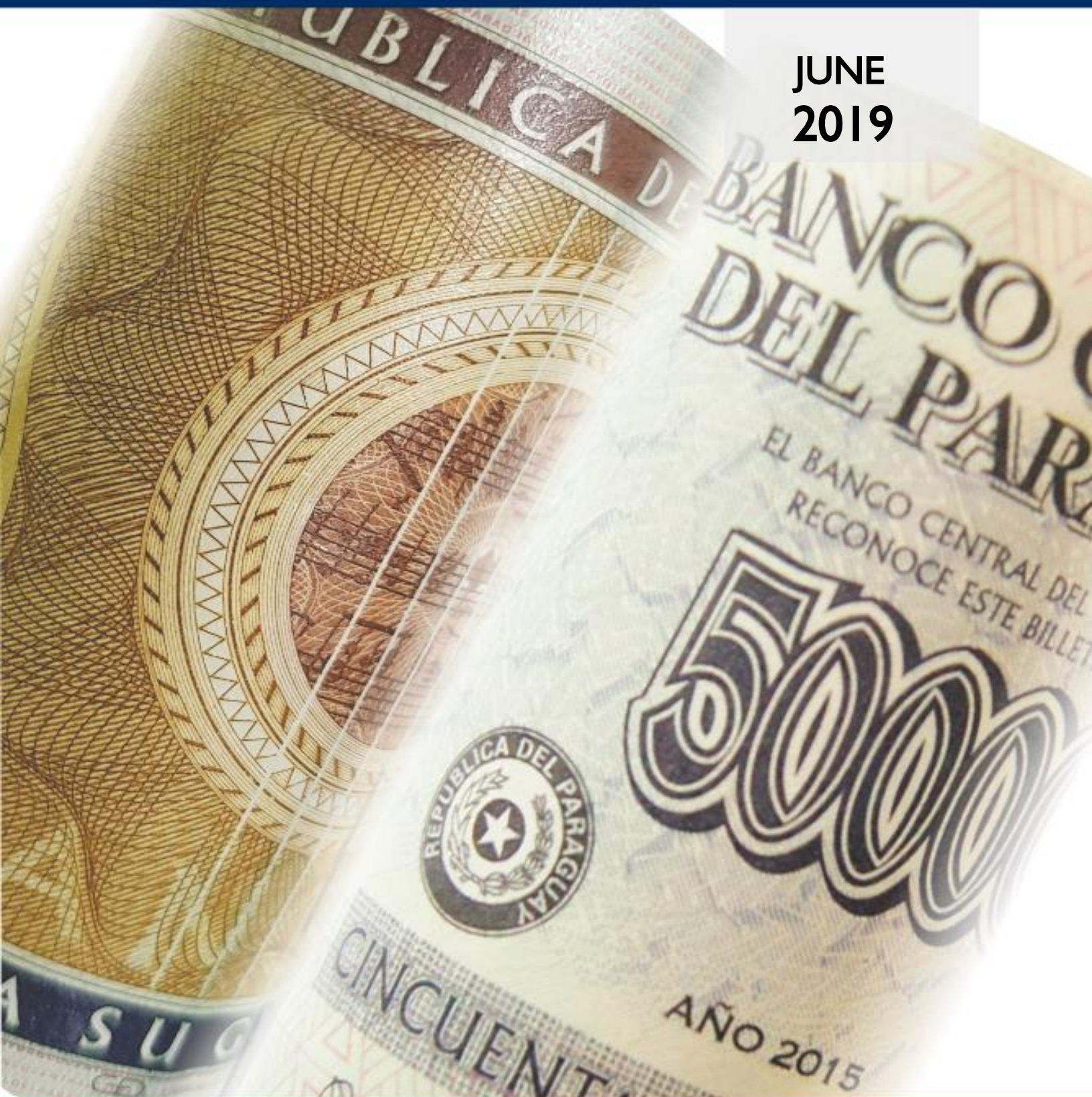




MONETARY POLICY REPORT

JUNE
2019



CENTRAL BANK OF PARAGUAY

Federación Rusa y Augusto Roa Bastos

www.bcp.gov.py

Asunción - Paraguay

Executive Summary*

World growth

Annual change, percent

	March 2019			June 2019	
	2018	2019	2020	2019	2020
World	3.6	3.4	3.3	3.3	3.3
United States	2.9	2.4	1.9	2.5	1.8
Eurozone	1.8	1.2	1.4	1.2	1.3
China	6.6	6.2	6.0	6.2	6.0
Brazil	1.1	2.0	2.5	1.0	2.2
Argentina	-2.5	-1.0	2.5	-1.2	2.5
Trading partners	2.0	1.4	2.6	1.1	2.5
Mercosur partners	0.0	0.6	2.4	0.0	2.3

Source: Bloomberg

Since the publication of the last IPoM report, in the international context, global economic activity has shown signs of moderation, mainly as a consequence of the decreased dynamism of international trade, weak manufacturing output, and a reduced level of investment during the first semester of the year. The uncertainty worldwide has been a constant phenomenon, affecting both consumers' confidence and investors at the global level. However, some progress has been made in negotiations to end the trade conflict between the United States and China. During the second quarter this year, the risk factors related to the tightening of financial conditions have been mitigated, given the prospects of the implementation of a laxer monetary policy, especially of the Federal Reserve (Fed). On the other hand, in the region, the economic scenario remains complex. Argentina continues to show a deterioration of its manufacturing activity and high levels of inflation, while in Brazil, there has been a weakening of economic activity during the second quarter of 2019.

In the United States, economic activity indicators registered a positive performance in the first quarter of the year, while a certain deceleration has been observed in the recent period. The GDP expanded beyond the expected level in the first quarter, boosted mainly by the contribution of non-residential fixed investments, inventory investments, exports, and private consumption. During the second quarter, leading activity indicators, such as the manufacturing PMI and the creation of new jobs, have decelerated, although the unemployment rate continues to stand at historically low levels. In this scenario, the growth outlook for this year have increased marginally with respect to the previous report. As regards prices, the different inflation measures have decreased since the last IPoM report. At its meetings held in the second quarter, the Federal Reserve has maintained the range of the monetary policy interest rate unchanged. Notwithstanding, the

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

	2018	2019(f)	2019(i)
Primary Sector	1.2	-3.7	-0.4
Agriculture	2.0	-4.0	-0.3
Livestock	-2.4	-1.3	0.0
Forestry, fishery and mining	2.4	-5.9	-0.1
Secondary Sector	2.6	-0.5	-0.2
Manufacturing	3.7	-0.1	0.0
Construction	0.2	3.1	0.2
Electricity & water	1.5	-4.2	-0.3
Tertiary Sector	5.3	3.9	1.9
Public Administration	6.0	6.5	0.6
Trade	7.4	-2.2	-0.2
Other Services	4.2	5.4	1.5
Taxes	2.7	2.5	0.2
GDP at market prices	3.7	1.5	1.5
GDP w/o agriculture and binationals	4.1	2.5	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

monetary authority posed the possibility of a reduction of references rates during the second semester this year.

In the Eurozone, the economic activity indicators have continued growing at moderate rates. The annual GDP growth in the first quarter of 2019 was at a level similar to the one registered in the last quarter of the previous year. On the other hand, the manufacturing PMI indicator, while still standing in a contraction zone, has remained relatively stable in the second quarter, after the downward trajectory shown during the year 2018. The labor market has remained robust, with a historically low unemployment rate. In this context, growth prospects for this year have been maintained with respect to those presented in the previous report. As regards prices, by the end of June, the inflation rate has decreased slightly since the previous report and still remains below the inflation target (2%). Concerning monetary policy, the Governing Council of the European Central Bank (ECB) has maintained its reference interest rates during the second quarter of this year. However, like the Fed, it is expected to adopt a more accommodative stance during the second half of the year.

In China, the economic activity and manufacturing sector indicators show less dynamism with respect to the levels observed in the last few years. In the first quarter of the year, GDP growth y-o-y stood below the rate registered in the first quarter of 2018. For the second quarter, it is expected that the pace of economic activity will moderate slightly, despite the different stimulus measures launched by the government. In the manufacturing sector, the PMI has presented a weaker performance so far this year. However, the growth forecasts for the year 2019 have remained with no changes (6.2%), with respect to the previous report, although the uncertainty concerning the outcome of trade tensions with the United States continues.

In the larger economies of the region, the economic scenario continues to be complex. In Brazil, annual GDP growth in the first quarter of the year contracted, attributed in part to the weakening of manufacturing output and the diminished dynamism of foreign trade. As regards the short-term indicators, the manufacturing PMI, although it continues in the expansion zone, has decreased compared to the data

Economic growth and current account

Annual change, percent

	2017	2018	2019 (f)
GDP	5.0	3.7	1.5
Domestic demand	5.9	6.0	1.9
Gross capital formation	12.7	12.8	1.0
Gross fixed capital formation (GFKF)	5.9	1.5	1.0
Total consumption	4.2	4.2	2.2
Private consumption	4.5	3.9	1.4
Public consumption	2.1	6.0	6.5
Exports of goods and services	8.3	2.7	-4.7
Imports of goods and services	12.0	9.6	-3.9
Current account (% of GDP)	3.1	0.5	-0.2
GFKF (% of nominal GDP)	18.6	18.2	18.1

Source: Central Bank of Paraguay

presented in the March IPoM. In the labor market, the unemployment rate remains at a high level. In this context, the growth projections for the Brazilian economy for 2019 have been revised downward again. As for prices, at the end of June, total inflation has decreased due to the reduction of energy prices. For its part, the Central Bank of Brazil's Monetary Policy Committee (Copom) has maintained the Selic rate at 6.5% annually, the same level that has been observed since April 2018.

In Argentina, the economic and financial conditions have remained weak, while the uncertainty in the political environment persists. In the first quarter, the GDP registered a variation of -5.8% y-o-y, explained largely by private consumption and gross capital formation. Likewise, the leading indicators for both economic activity and the manufacturing sector corresponding to the second quarter continue to show a drop in annual terms, although lower in relation to the rates observed in the first quarter. Given these results, the growth prospects for this year have been revised downward again. As regards monetary policy, the Central Bank of Argentina has maintained its inflation control plan based on a monetary aggregates scheme. Notwithstanding, high inflation rates have persisted during the second quarter. At the same time, since April 2019, the Central Bank has changed its intervention scheme in the foreign exchange market.

With respect to the domestic scenario, the economic activity has continued to show a lower dynamism in the first months of 2019. This is partially explained by the adverse weather conditions that affected some sectors, added to the impact that the deterioration of economic conditions in neighboring countries has had for both border zone trade and the various subsectors related to tourism. Furthermore, it is important to point out the high basis of comparison for the first quarter that will be maintained until the end of the second quarter. In the first quarter, the GDP registered a variation of -2.0% y-o-y (5.3% in the first quarter of 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 registered a positive variation. Thus, the GDP that excludes agriculture and electric power registered a slight growth rate of 0.8%. On the

Inflation projection

Annual change, percent

	2018	2019(f)	2020(f)	2021(f)
Average CPI inflation(*)	3.8	3.1	4.0	
December CPI inflation (**)	3.2	3.7	4.0	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	3.9	3.0	4.0	
December underlying CPI (**)	3.6	3.6	4.0	
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 second quarter of 2021.

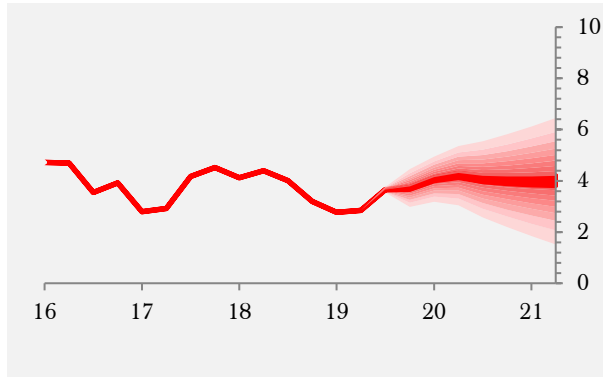
expenditures side, the components with the greatest negative incidence on annual growth were net exports and gross fixed capital formation, while governmental consumption registered a positive contribution.

As regards prices, since the last IPoM report, total inflation and the different trend measures have increased slightly compared to the rates observed in the first months of the year, although they have remained below the medium-term target. Average total inflation, between April and June, stood at 3.2%, above the 2.6% observed in the first quarter of 2019. 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 3.1% and 2.8%, higher than the rates registered between January and March, which were 2.9% and 2.6%, respectively. Core inflation, for its part, registered an average annual rate of 3% (2.7% during the first quarter of 2019).

With respect to monetary policy, at the meetings held in April, May, and June, the Monetary Operations Executive Committee (CEOMA) decided to maintain the monetary policy rate (MPR) at 4.75% annually, whereas at its July meeting the Committee reduced the MPR by 25 basis points, to stand currently at 4.50% annually. In relation to this decision, the Committee highlighted that domestic economic activity has remained weak, due to the lower performance of both the primary and secondary sectors that have been affected by adverse weather conditions; although, this was offset, in part, by the positive growth of the tertiary sector. Additionally, at its last meeting, the Committee pointed out that demand indicators report a moderation in the dynamism of private consumption and investment. As regards prices, it has been observed that the different inflation measures have remained at levels below the target for several months and, in the recent period, inflationary pressures derived from the external environment have been attenuated by the more accommodative monetary policy stance of central banks, especially that of the Federal Reserve. Given this scenario, the convergence of projected inflation to the target over the policy horizon could be affected; therefore, the CEOMA deemed that an easing of the monetary policy might provide an additional boost to the

CPI inflation forecast

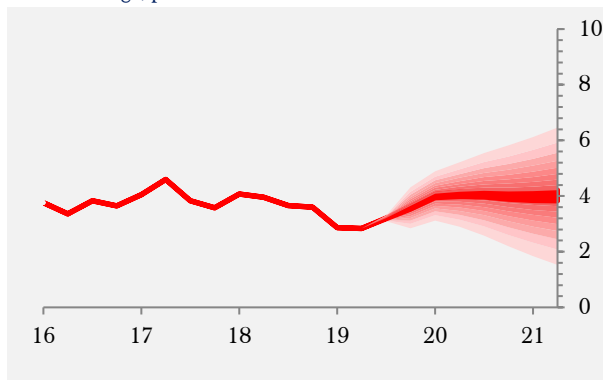
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

economy, compatible with the convergence of projected inflation to the target of 4% annually in the medium term.

In the baseline scenario, the GDP growth forecast was adjusted from 3.2% to 1.5%, considering both the recent dynamics and the prospects of the different sectors of the economy. On the side of supply, the correction is explained largely by the secondary sector (manufacturing and the generation of electricity), and to a lesser degree by the primary sector (agriculture and livestock production) and the tertiary sector (commerce). As regards the construction sector, while its performance has been weak in the first months of the year, greater dynamism is expected for the second semester, to the extent that the economic reactivation plan announced by the government is implemented according to the established schedule. From the perspective of expenditures, the adjustment is due mainly to the reduction in internal demand growth, specifically private consumption and investment, while the expansion of public consumption was revised upward. On the other hand, net external demand was also corrected downwards, due to the greater cut in the variation rate of exports compared to imports.

As for total inflation, the forecast for the end of 2019 has been adjusted downward from 3.9 to 3.7%. Likewise, the underlying inflation estimate was revised downward from 3.7% to 3.6%. On the one hand, these changes are explained mainly by the negative domestic output gap, which is currently more pronounced than the one forecasted in the previous report. On the other hand, the pressures on the exchange rate have moderated in the last weeks, and this scenario is expected to persist in the coming months, taking into consideration the more accommodative stance of the Federal Reserves' monetary policy. In this context, the assumptions about an expected depreciation have eased, which also explains the reduction in the forecasts. Furthermore, observed inflation data in the second quarter, while having increased with respect to the previous quarter, stand slightly below the estimates provided in the March IPoM report. According to the most likely trajectory of the internal and external macroeconomic variables, inflation

will converge gradually towards the target in 2020 and will remain around the target over the monetary policy horizon.

With respect to risk scenarios, at the international level, the downward bias of the global economy's growth prospects persists, stemming particularly from the uncertainty regarding the outcome of the trade impasse between the United States and China. The markets are aware that even though the truce agreed upon in June was a positive occurrence, the negotiation process is still in a complicated phase. Although the current real sector records in the United States appear robust, inflation has decreased and the expectation of growth deceleration in the next few years continues to be relevant. Likewise, in the Eurozone, inflation data have not rebounded, in the midst of the deceleration of economic activity. In this context of the slowdown of global economic activity, the main central banks have turned to a more accommodative orientation of their monetary policy. As regards the Federal Reserve, there is an almost generalized expectation regarding a cut of benchmark interest rates, at the July meeting. Along the same lines, representatives of the ECB have shown greater propensity to the provision of greater monetary stimulus to the Eurozone. Another important risk factor, which remains latent, refers to the exit process of Great Britain from the European Union (Brexit).

On the one hand, the more complex outlook for the world economy would imply a smaller boost of external demand for the exporting countries and could affect the domestic economy either directly or indirectly (by the weakening of the trade partners). On the other hand, the more expansive bias of the monetary policy of the principal central banks represents laxer international financial conditions for the emerging economies (with respect to those anticipated previously) and lower downward pressure on their currencies. This scenario might offer these emerging economies (and also Paraguay) a wider margin for the implementation of economic policies that stimulate internal demand.

Among the emerging economies – although it is expected that the Chinese economy will continue to grow – uncertainty remains in regards to the growth prospects.

While the short-term risks have moderated with the recent trade truce, in the case that the trade dispute was to intensify, a sharper than expected deceleration could affect the future evolution of the prices of commodities relevant for Paraguay.

In Brazil, the recovery of economic activity has decelerated in recent months, in the midst of global deceleration and the uncertainty with respect to the reforms needed for rechanneling the deteriorated fiscal situation. However, the Chamber of Deputies made important progress with the recent approval of the Pensions Reform bill (although with some modifications of the draft bill presented by the ruling party). This new context seems more promising for the growth prospects of the Brazilian economy, as well as for the maintenance or strengthening of the value of its currency (relative to the US dollar). In the case of Paraguay, these developments could favor local economic activity, particularly trade performance in the border zones.

In Argentina, economic activity and the labor market continue in a fragile situation. Likewise, the outlook remains complex, due to political instability and its related risks regarding the continuity of the process of correcting macroeconomic imbalances. Notwithstanding, a positive aspect pointed out in the previous IPoM report is the stabilization of the foreign exchange market, where an appreciation of the Argentinian peso was registered towards the middle of June. This appreciation of the peso and the high inflation rate in Argentina may contribute towards the minimization of price differentials in the border cities, which could benefit trade in all the zones bordering with Paraguay. After the primary elections, the scenario will have greater clarity about the macroeconomic prospects of this neighboring country, and which to some extent will be relevant for the growth forecasts of the local economy.

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 4.0% annually over the relevant projection horizon.