



MONETARY POLICY REPORT

MARCH
2019



CENTRAL BANK OF PARAGUAY

Federación Rusa y Augusto Roa Bastos

www.bcp.gov.py

Asunción - Paraguay

Executive Summary*

World growth

Annual change, percent

	December 2018		March 2019		
	2018	2019	2018	2019	2020
World	3.6	3.4	3.6	3.4	3.3
United States	2.9	2.6	2.9	2.4	1.9
Eurozone	1.9	1.6	1.8	1.2	1.4
China	6.6	6.2	6.6	6.2	6.0
Brazil	1.3	2.4	1.1	2.0	2.5
Argentina	-2.3	-0.6	-2.5	-1.0	2.5
Trading partners	2.1	2.2	2.0	1.4	2.6
World	0.2	1.4	0	0.6	2.4

Source: Bloomberg

Since the publication of the last IPoM, in the international context, global economic activity has continued to show signs of moderation, in the main advanced economies as well as in the emerging ones. The risk factors that gave signs of alert at the end of 2018, as the trade tensions and tightening of financial conditions, although remaining latent, have been attenuated in the last few months due to the satisfactory progress in negotiations between the United States and China, and the more conservative stance of the Federal Reserve. In the region, the economic scenario remains complex, particularly in Argentina, while in Brazil, recovery has become slower and important challenges persist to promote solid growth in the medium-term.

In the United States, economic activity has maintained a positive dynamism, although at a slower pace than observed in the previous quarters. The GDP decelerated in the fourth quarter of the year, a behavior attributed to the effects on demand resulting from trade tensions with China and the waning of fiscal stimulus, and, on the supply side, by the less favorable outlook for agriculture. In turn, leading activity indicators have revealed a similar performance in the first quarter of the year. The manufacturing PMI has remained in the expansion zone, although showing weaker dynamics, while the labor market has continued to exhibit historically low unemployment rates. In this context, growth prospects for this year have been reduced with respect to the estimates showed in the previous report. As regards prices, the different inflation measures have stood below the foreseen levels, standing around the medium-term target (2%). The Federal Reserve, in consideration of all relevant data about both the economic situation in the United States and global economic and financial performances, has maintained the range of the monetary policy interest rate with no variation at all its meetings held this year. In addition, the Federal Reserve has announced that during 2019 it will be more patient deciding on future adjustments of its reference rate.

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

	2018	2019(f)	2019(i)
Primary Sector	2.2	-1.8	-0.2
Agriculture	3.3	-3.0	-0.3
Livestock	-2.4	2.0	0.0
Forestry, fishery and mining	3.2	0.0	0.0
Secondary Sector	2.6	2.6	0.9
Manufacturing	3.7	3.5	0.7
Construction	0.2	5.0	0.3
Electricity & water	1.5	-1.4	-0.1
Tertiary Sector	5.1	4.5	2.2
Public Administration	6.0	5.0	0.4
Trade	7.4	2.4	0.3
Other Services	4.0	5.2	1.5
Taxes	2.7	5.1	0.4
GDP at market prices	3.7	3.2	3.2
GDP w/o agriculture and binationals	4.0	4.3	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

In the Eurozone, the economic activity has continued with the downward trajectory observed since the beginning of 2018. The more moderate growth observed in the fourth quarter was due, mainly, to the weakening of manufacturing and trade. Likewise, the leading indicators have revealed a similar behavior in the first quarter of this year; among these, the PMI indicator has stood within the contraction zone since February. Meanwhile, in the labor market, the unemployment rate has continued to decrease, standing at historically low levels. In this scenario, GDP growth in the Eurozone in 2019 has been revised downward. As regards prices, since the previous report, annual inflation has decreased, standing at 1.5% at the close of March, below the inflation target (2%). Concerning monetary policy, the Governing Council of the European Central Bank (ECB) has maintained the reference interest rates, with no variations, during the first quarter of this year.

In China, the economic activity and manufacturing sector indicators have continued to show signs of the slowing down of the economy. In the fourth quarter 2018, the GDP grew at a more moderate rate than in the previous quarters, explained especially by the drop in investments. In a similar manner, the manufacturing PMI remains persistently in the contraction zone, reflecting the weak performance of the sector. With respect to this, the Chinese government introduced fiscal and monetary measures to attenuate the deceleration of the economy. In this context, the growth forecasts for the year 2019 have remained with no changes (6.2%), with respect to the previous report. As regards the risk factors, the uncertainty with respect to the outcome of trade tensions with the United States persists, as well as concern about the effects of the stimulus measures in the Chinese economy, which already has a high level of indebtedness.

As regards the region, in Argentina the macroeconomic conditions continue to be fragile, in a context of growing inflation and a high fiscal deficit. As concerns economic activity, the GDP decreased by 2.5% in 2018, a greater contraction than observed in the previous year and market's expectations. So far this year, the short-term indicators for both economic activity and the manufacturing sector have continued to show a strong annual contraction. This situation has led again to the downward revision of growth

Economic growth and current account

Annual change, percent

	2017	2018	2019 (f)
GDP	5.0	3.7	3.2
Domestic demand	5.9	5.9	3.4
Gross capital formation	12.7	12.2	3.5
Gross fixed capital formation (GFKF)	5.9	1.5	3.5
Total consumption	4.2	4.2	3.4
Private consumption	4.5	3.9	3.1
Public consumption	2.1	6.0	5.0
Exports of goods and services	8.3	3.1	1.5
Imports of goods and services	12.0	9.6	2.0
Current account (% of GDP)	3.1	0.4	-0.4
GFKF (% of nominal GDP)	18.6	18.2	18.3

Source: Central Bank of Paraguay

prospects for this year. As regards monetary policy, the Central Bank of Argentina has been implementing the control of the monetary aggregates scheme since October 2018, seeking greater efficiency in the control of inflation, a variable that has been showing an upward trend since the middle of 2018.

The Brazilian economy grew 1.1% in 2018, a lower rate than foreseen in the previous report (1.3%). In the first quarter of the year, economic activity indicators continue to present a moderate growth, while manufacturing indexes have shown a certain improvement with respect to the levels reached in the second semester of last year. In spite of this, the economic recovery, which is slower than what had been expected a few months ago, has led to the downward correction of growth prospects for this year. As regards prices, annual inflation has increased with respect to the end of 2018, standing around the 4.5% target. In this context, the Central Bank of Brazil's Monetary Policy Committee (Copom) maintained the Selic rate at 6.5% annually, a level that has undergone no changes since April 2018.

With respect to the domestic economy, the moderate pace of growth in the last months of 2018 has persisted, explained in part by adverse external shocks and internal supply factors. Thus, the GDP registered an expansion of 1.2% y-o-y, in the fourth quarter, boosted primarily by the service sector, and to a lesser extent by electricity and water, and by agriculture. Manufacturing, construction, and livestock production registered drops during the reference period. On the expenditure side, total consumption (private and public) was the main component with incidence on annual growth, given that gross capital formation showed a retraction. As regards external demand, imports as well as exports reported positive variation rates. For the first quarter, the short-term indicators show that dynamism remains moderate, and that this behavior would continue until the end of the first semester, after which an upswing of annual rates is expected.

As regards prices, total inflation, as well as its trend measures have stood below the rates observed at the end of the last report. Average annual inflation fell from 3.8% to 2.6% in the fourth quarter, largely due to the smaller price increases of transportation, food items, maintenance costs,

Inflation projection

Annual change, percent

	2018	2019(f)	2020(f)	2021(f)
Average CPI inflation(*)	3.8	3.5	4.0	
December CPI inflation (**)	3.2	3.9	4.0	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	3.9	3.2	4.0	
December underlying CPI (**)	3.6	3.7	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 first quarter of 2021.

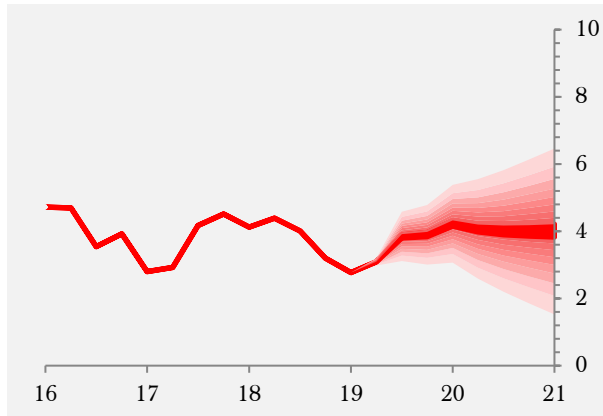
and home repairs. Likewise, underlying inflation, underlying X1 inflation, and core inflation stood at were 2.9%, 2.6% and 2.7%, respectively, below the rates registered between October and December (3.9%, 2.8%, and 3.1%, respectively).

At its monetary policy meetings in the first quarter, the Monetary Operations Executive Committee (CEOMA) pointed out that, in the international scenario, while the global economy continued to grow, the external momentum was lower than expected. In addition, the Committee noted that the Federal Reserve had adopted a more conservative stance in relation to the foreseen cycle of adjustments of its interest rates range. With respect to the region, the Committee highlighted that the macroeconomic scenario in Argentina remained complex, and that in Brazil the economic recovery had become slower. Regarding the domestic scenario, the economic activity and demand indicators continued with a moderate dynamism, while underlying inflation measures have registered a downward trajectory for several months, standing at levels below the target. In consideration of this data, the CEOMA deemed it timely to adopt a more accommodative monetary policy stance, in order to assure the convergence of inflation to the target over the policy horizon. At the meetings held in both February and March, the Committee decided to cut the monetary policy rate (MPR) by 25 basis points, thus decreasing from 5.25% to 4.75% annually.

In the baseline scenario, the GDP growth estimate for 2019 was corrected from 4.0% to 3.2%, taking into account both the recent evolution and the prospects of the different economic sectors. On the side of supply, the most important adjustments took place in agriculture and the generation of electricity, sectors that have been affected by adverse weather conditions (drought), while manufacturing, commerce and the other sectors were also revised downward, although to a lesser degree. However, forecasts for livestock production, construction and the general government sector were revised upward. On the side of expenditures, the internal demand projection was reduced, particularly the private consumption and investment components, while public consumption will have a greater expansion. Net external demand will have a greater negative

CPI inflation forecast

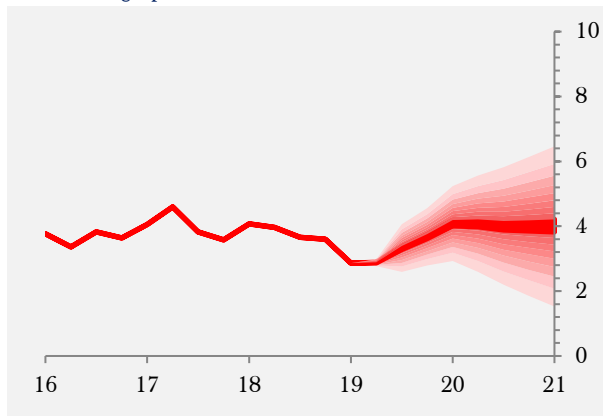
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

incidence than projected in the previous report, explained by a greater cut in the estimate of the level of exports in relation to imports.

In line with the recent and the expected evolution of the economy, the projection of total inflation for 2019 was adjusted downward from 4% to 3.9%. Likewise, the underlying inflation estimate was revised downward from 4% to 3.7%. These changes are explained mainly by a negative internal and external gap that is greater than what was foreseen in the previous report, as well as by observed inflation data that stand below the predicted for the first months of the year. However, this baseline scenario contemplates a greater level of depreciation with respect to the estimates provided in the December 2018 IPoM report, in line with the recent evolution of the nominal exchange rate, the impact of which has been reflected in the dynamics of the inflation of imported goods. According to the most likely trajectory of the internal and external macroeconomic variables, inflation will remain at low levels in the second quarter, and afterwards will converge gradually towards the target over the relevant monetary policy horizon (first quarter 2021).

With respect to risk scenarios, at the international level, the downward bias of growth prospects persists, taking into consideration that the short-term indicators in the main advanced and emerging economies stand below the market's expectations. In the United States, economic activity continues to expand at lower rates than previously expected, while concerns about the trajectory of inflation seem to have dissipated. In this context, the Federal Reserve (Fed) has given clearer signs that it will maintain a more patient attitude before implementing its next monetary policy measures. In the Euro zone, growth prospects remain weak, as the region is in the midst of a complex scenario of Brexit negotiations, the resolution of which has been delayed by the lack of agreement within the British Parliament. In the same lines as the Fed, the European Central Bank has assumed a more lax position with respect to the future evolution of monetary conditions, thereby deferring the first increase of interest rates until the end of 2019 or even until March 2020. On one hand, the downward revision of global growth prospects would represent less boost of external demand for

emerging countries. On the other hand, the more conservative positions of the main central banks worldwide would imply more favorable international conditions (together with less pressure on world currencies than initially foreseen), as long as this scenario of slowdown and global uncertainty is not translated into a lower appetite for risk-taking.

In China, the latest economic data are reflecting a loss of dynamism that exceeds expectations, which has led authorities to expand the fiscal stimulus measures in order to avoid an abrupt adjustment of growth. However, the vulnerabilities derived from corporate indebtedness and shadow banking, as well the high public debt, represent an obstacle for a much more aggressive stimulus strategy in the short-term. The growth target of the Chinese government for the year 2019 stands between 6% and 6.5%, below that of 2018 (6.6%). As regards the trade tensions with the United States, the imposition of tariff hikes has been postponed again because of the satisfactory progress of negotiations aimed at reaching an agreement between the parties, even though international trade remains weak due to this dispute. The scenario of a more rapid slowing down of the global economy –particularly the economy of China– implies downward pressures on commodities prices. However, a favorable resolution of the trade conflict could contribute towards attenuating or offsetting that effect.

In the region, the economic outlook in Argentina continues to be uncertain. The economic activity and confidence indicators remain weak, while inflation has continued to climb in recent months. Likewise, the Argentinian peso has depreciated further since the last IPoM report. An improvement of the economy is expected in the second semester, explained in part by the recovery of agricultural production, which had been adversely affected by a drought during 2018. One source of uncertainty that is important for the prospects of economic recovery stems from the political environment. The social costs of the process of correction of macroeconomic imbalances has debilitated the popular support for the current government. In this sense, doubts arise with relation to the continuity of these adjustment programs implemented in the framework of the *Stand-By* agreement signed with the International Monetary Fund, in

the case that election results do not favor the Presidential candidate of the ruling party. As concerns Paraguay, the economic deterioration and currency depreciation in Argentina has notably reduced the flow of tourists, mainly affecting trade in border zone cities and activities tied to the tourism sectors. The latest depreciation data for the Argentinian peso imply a greater appreciation of Paraguay's bilateral real exchange rate. However, the increase of inflation in Argentina, as well as the depreciation of the Paraguayan Guaraní (in line with the dynamics of the regional currencies of the countries with solid macroeconomic foundations), have attenuated that effect.

In Brazil, while the prospects of recovery remain, they are less positive in relation to the initial forecasts. The short-term indicators and consumer confidence indicators have maintained an upward behavior at the beginning of 2019, while inflation has been kept close to the target. However, the less favorable external environment represents a downward pressure on short-term growth. On the other hand, the government's reform agenda, from its beginning, has been well received by the market and this has been reflected in the country risk and stock market indexes. However, following the presentation to Congress of the Pensions Reform draft bill, and as the date for its consideration approaches, social unrest and protests have intensified, which could complicate its approval. In this scenario of less optimism, it is likely that a less ambitious pensions reform law will be approved, which to a certain extent could contribute to lessen the pace of indebtedness, even though new fiscal adjustments may be required in the near future. With respect to Paraguay, the growth of economic activity in Brazil (although less than expected) would by all means imply a positive factor for local dynamics in the short term, as compared to a result that could have been more adverse.

On the other hand, the increase of crude oil prices in international markets, together with the depreciation of the local currency, imply pressures on fuel prices in the domestic sphere, and in consequence on inflation, due to the potential second round effects. Notwithstanding, it is appropriate to



point out that, in accordance with the evidence of the last few years, the effects on underlying inflation and total inflation have been moderate.

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.