



# MONETARY POLICY REPORT

March  
2020



**CENTRAL BANK OF PARAGUAY**

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Asunción - Paraguay

## Executive Summary

### World growth

Annual change, percent

	December 2019		March 2020		
	2019	2020	2019	2020	2021
World	3.0	3.1	2.9	-1.5	3.6
United States	2.3	1.8	2.3	-3.5	3.8
Eurozone	1.2	1.0	1.2	-5.3	4.5
China	6.1	5.9	6.1	2.0	8.0
Brazil	1.0	2.1	1.1	-2.5	2.8
Argentina	-2.8	-1.7	-2.2	-5.0	2.0
Trading partners	0.4	1.1	0.5	-2.9	2.7
Mercosur partners	-0.8	0.4	-0.6	-3.6	2.4

Source: Bloomberg

Since the publication of the last Monetary Policy Report (IPoM), the prospects for global economic growth have decreased significantly, mainly due to the worldwide effects of the Covid-19 pandemic. The first quarter of the year was marked by less manufacturing output, lower production of services, less global demand, a reduction in the prices of commodities, and greater risk aversion. Uncertainty about the duration of the pandemic and the corresponding containment measures maintains the downward bias in global growth forecasts. Given this deteriorating situation, the central banks, both in advanced and emerging economies, have reduced the monetary policy reference interest rates and have employed various additional instruments to ensure the availability of liquidity in their respective markets.

In the United States, Gross Domestic Product (GDP) registered an annualized growth rate of 2.1% in the fourth quarter of 2019, the same rate as in the third quarter. This increase was explained by the growth in household consumption, governmental expenditures, net exports, and private investments. On the other hand, in the first quarter of 2020, the Purchasing Managers' Index (PMI) stood in the contraction zone in March, mainly because of the halting of activities due to the pandemic. In this scenario, the growth prospects for this year reverted with respect to the previous IPoM, dropping from 1.8% to -3.5%. Regarding prices, a decrease in inflation was observed, standing below the 2% target in March. In this context, the Federal Reserve (Fed) reduced the range of reference rates by 150 basis points in March, to stand at 0%-0.25%, and implemented unconventional monetary policy measures to stimulate the economy.

In the Eurozone, annual GDP growth in the fourth quarter of 2019 was 1.0%, slightly below the 1.2% registered in the third quarter. In the first quarter of 2020, the manufacturing indicator (PMI) has continued to stand in contraction zone, with a greater slowdown in March, stemming from the pandemic. In this context, the growth prospects for 2020 have decreased drastically, to stand at -5.3% annually (1% y-o-y, in the previous IPoM). As regards prices, there has been a reduction in inflation indicators in March in comparison to the

\* The Spanish version prevails.

### Gross Domestic Product by sectors

Annual change, percent

	2019	2020(f)	2020(i)
<b>Primary Sector</b>	<b>-3.6</b>	<b>6.4</b>	<b>0.7</b>
Agriculture	-4.9	8.5	0.7
Livestock	1.3	1.5	0.0
Forestry, fishery and mining	-2.6	0.0	0.0
<b>Secondary Sector</b>	<b>-3.1</b>	<b>-0.9</b>	<b>-0.3</b>
Manufacturing	-1.0	-0.5	-0.1
Construction	1.1	0.0	0.0
Electricity & water	-11.2	-2.5	-0.2
<b>Tertiary Sector</b>	<b>3.2</b>	<b>-5.2</b>	<b>-2.6</b>
Public Administration	5.1	5.0	0.5
Trade	-0.4	-2.4	-0.3
Other Services	4.0	-9.4	-2.8
<b>Taxes</b>	<b>-1.7</b>	<b>-5.0</b>	<b>-0.4</b>
<b>GDP at market prices</b>	<b>0.0</b>	<b>-2.5</b>	<b>-2.5</b>
<b>GDP w/o agriculture and binationals</b>	<b>1.5</b>	<b>-3.5</b>	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

end of 2019, remaining at low levels in relation to the target. To face the pandemic, the European Central Bank (ECB) has maintained the interest rates applicable to refinancing operations, the marginal lending facility, and the deposit facility rate during the first quarter of the year and has implemented unconventional monetary policy measures to ensure liquidity in all Eurozone countries.

In China, economic activity data for the fourth quarter of 2019 showed a growth rate of 6.0% y-o-y, the same rate as in the previous quarter. The result in the last quarter of the previous year was favored by the Phase One agreement concerning the trade dispute with the United States. On the other hand, in 2020, the performance of the manufacturing sector was strongly affected by the spreading of the new coronavirus, registering a historical low value in February. Thus, the growth forecasts for 2020 were revised downwards, falling from 5.9% (in the previous IPoM) to 2%.

In Brazil, GDP growth in the fourth quarter of 2019, registered a rate of 1.7% y-o-y, above the rate of 1.2% observed in the third quarter. This better result was mainly due to the increases in investment and household consumption. Data gathered at the beginning of 2020 showed an economic growth rate of 0.6% y-o-y in January and a contraction of the manufacturing PMI in March. Concerning growth projections, the prospects have reverted for 2020 in comparison to the previous report, decreasing from 2.1% to -2.5% annually. As for prices, inflation measures have remained in the lower zone of the target range, which is 4% +/- 1.5 p.p. for 2020. In this context, the Central Bank of Brazil's Monetary Policy Committee (Copom) reduced the SELIC rate in both February and March, to stand at 3.75% annually.

In Argentina, quarterly GDP in the fourth quarter of 2019 registered an annual variation of -1.1% y-o-y, a lower drop than the one registered in the previous quarter (-1.8%). In 2020, the most recent data of economic activity showed a contraction of 1.8% y-o-y in January, especially due to the falls in the construction, financial intermediation, agriculture, and livestock production sectors. Manufacturing activity also showed deterioration in January, registering a reduction in output of 0.8% y-o-y. Taking into account these preliminary data and incorporating the expected effects of the pandemic, the growth prospects for 2020 have been revised downwards from -1.7% y-o-y (in the previous IPoM) to -5.0%. It must be noted that, in the first quarter, the Argentinean government has made progress in the renegotiation of Argentina's external debt. Given this scenario, the Central Bank of the Republic of

### Economic growth and current account

Annual change, percent

	2019	2020 (f)
<b>GDP</b>	0.0	-2.5
<b>Domestic demand</b>	0.7	-4.0
<b>Gross capital formation</b>	-3.0	-3.5
Gross fixed capital formation (GFKF)	-6.6	-3.5
<b>Total consumption</b>	1.9	-4.1
Private consumption	1.3	-6.6
Public consumption	5.1	10.0
<b>Exports of goods and services</b>	-2.9	-1.5
<b>Imports of goods and services</b>	-0.9	-5.7
Current account (% of GDP)	-1.2	0.7
GFKF (% of nominal GDP)	18.5	20.3

Source: Central Bank of Paraguay

Argentina (BCRA) continued to decrease the lower limit of the LELIQ rate, to stand at 38% annually in March.

In the local context, economic activity continued to show favorable dynamics until the end of 2019. In the fourth quarter, GDP grew 3.5% y-o-y, after the 2.6% rate reported in the previous quarter. On the supply side, the year on year rate was explained by the favorable performance of the services sector, agriculture, construction, and to a lesser extent by manufacturing. On the expenditures side, private and public consumption were the factors with the greatest incidence for growth in the fourth quarter. Gross fixed capital formation registered a slight growth rate in comparison to the same period in 2018, while a contraction of net exports was observed. According to the data registered as of February 2020, the economic activity has maintained a positive pace of growth. However, starting in March, this impetus was significantly curtailed by the sanitary emergency and the social containment measures, as well as a more deteriorated external scenario.

As regards the behavior of prices, total inflation and trend measures have increased slightly with respect to the previous IPoM, although they remain in the lower zone of the target range. In the January-March period, average total inflation was 2.6% y-o-y, above the 2.4% rate observed in the fourth quarter of 2019. This result was explained mainly by a greater increase of the year on year rate of the prices of food items (excluding fruits and vegetables), other consumer basket goods (non-food items), and rentals, while the y-o-y variation of the prices of services was similar to those reported in the previous quarter. The averages for underlying inflation, underlying X1 inflation, and core inflation, during the January-March period, increased to 2.8%, 2.9%, and 2.4%, respectively (2.3%, 2.6%, and 2.3%, in the previous report). In March, some sub-sectors affected by the sanitary measures (tourism, hotels, etc.) began to show drops in their prices, a situation that is expected to persist in the coming months, given the current economic outlook.

Regarding monetary policy decisions, at the meetings held in January and February, the reference rate remained unchanged at 4.0% annually. However, in March, after the confirmation of cases of Covid-19 in Paraguay and following the announcement of sanitary measures to mitigate the pandemic's effects, the Monetary Policy Committee (CPM) deemed it appropriate to decisively ease the monetary conditions of the economy. The Committee considered that the inflationary pressures, which had remained limited, might become even more moderate in the next months due to the retraction of economic activity and internal demand, as well as less external impulse. In this

### Inflation projection

Annual change, percent

	2019	2020(f)	2021(f)	2022(f)
Average CPI inflation (*)	2.4	2.2	3.7	
December CPI inflation (**)	2.8	2.4	3.7	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	2.3	1.9	3.7	
December underlying CPI (**)	2.8	2.0	3.7	
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.

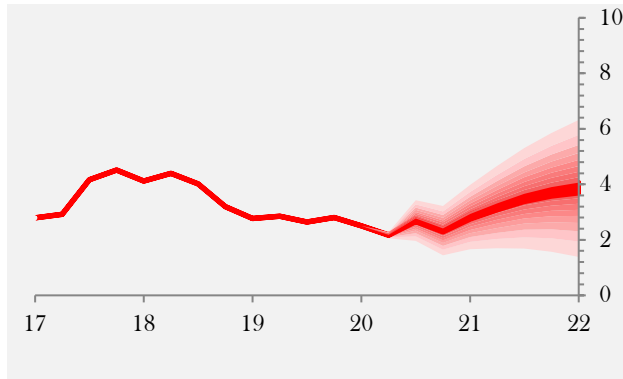
(\*\*\*) Corresponds to the projected inflation for the first quarter of 2022.

manner, at three meetings held in March (one ordinary and two extraordinary), the CPM reduced the Monetary Policy Rate (TPM) by 175 basis points, while in April the cut was of 100 basis points, thus adding an overall reduction of 275 basis points; the reference rate stands at 1.25% annually.

In the baseline scenario, the GDP annual growth projection reveals a significant downward revision, falling from 4.1% (December IPoM) to -2.5% for 2020. On the side of supply, the primary sector shows an improvement in the projection in comparison to the previous estimate, as a better performance of both the agricultural sector (soybeans) and livestock production is expected. However, the secondary sector and particularly the tertiary sector have been very much affected by the Covid-19 pandemic and the social containment measures. The manufacturing and construction sectors will contract, and this will be compounded by the fall in the generation of electricity by the Bi-national entities due to the lower flow of the Parana River. In the services sector, a significant impact on the performance of hotels, restaurants, trade, transport, and services provided to businesses and households is expected, while general government activities and telecommunications will remain dynamic. On the side of expenditures, internal demand will be the most affected component, especially private consumption, which is expected to contract by 6.6%. This behavior implies, on the one hand, a reduction of income (households and businesses) and the deterioration of expectations, thereby leading to less demand of both goods and services. However, it is expected that the Government's social assistance programs will contribute towards the mitigation of this effect. Gross fixed capital formation will also register a drop (3.5%), due to the halting of works, especially in the private sector, together with the decrease of the imports of capital goods. Notwithstanding, public consumption will have an important rebound, taking into account that a significant increase in the purchase of goods and services tied to the health sector is expected. On the side of external demand, the estimate of exports points towards a 1.5% decrease, mainly due to the important contraction that the principal trade partners, especially Brazil, will experience, which negatively impacts re-export operations. Furthermore, the currencies of these countries registered a significant depreciation vis-à-vis the United States dollar. Imports will register a 5.7% drop, explained mainly by the strong contraction of imports under the Tourism Regime and a deteriorated domestic demand. However, the import of goods related to the health sector, food items, and cleaning items will offset a greater fall.

### CPI inflation forecast

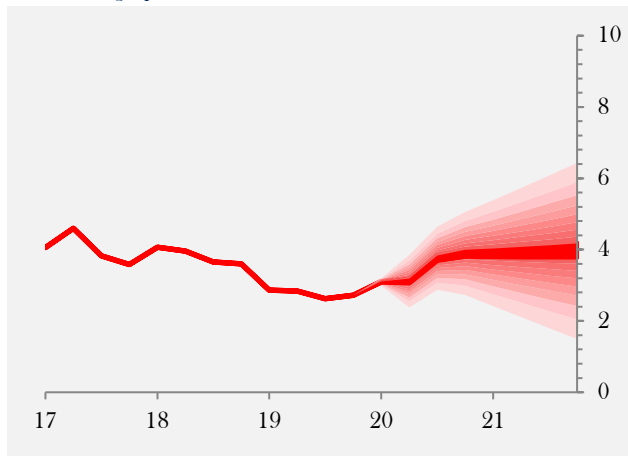
Annual change, percent



Source: Central Bank of Paraguay.

### Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

The baseline scenario for inflation contemplates a convergence to the 4% target over the policy horizon at a much slower pace than estimated in the December 2019 IPoM, a behavior observed for total inflation as well as underlying inflation. This trajectory of inflation is explained mainly by a significant deterioration of domestic demand, in all its components, which implies a much broader negative GDP gap for this scenario. While the economic activity data from the first months of the year show a recovery that is consistent with the previous estimates, the economic stagnation since the middle of March implied less year on year growth in the first quarter of 2020, which is reflected in a wider output gap for this period. A significant deterioration in the second quarter is assumed with a gradual recovery starting in the third quarter of this year. This recovery encompasses, on one hand, the strong monetary stimulus, and on the other, the positive effect that the mitigation measures adopted by the authorities would have on the income of both households and businesses. In addition to this, the trajectory of inflation in the medium term is influenced by a lower expectation regarding the depreciation of the exchange rate, reflected in an appreciation of the real exchange rate with respect to its equilibrium value as an initial projection assumption. In line with the expected evolution of the indicated variables, inflation will show a downward trajectory near the lower range of the target, to end the year with total inflation standing at 2.4% and underlying inflation at 2% annually. For both inflation measures, convergence to the target would occur towards the end of the projection horizon, in the first quarter of 2022.

With respect to risks scenarios, at the international level, there are possibilities of a greater deterioration of the prospects of global economic growth. The Covid-19 pandemic may last longer than expected, and the impact on economic activity and on financial markets could worsen. The effects could be disproportionate for the developing economies, as fiscal and financial spaces are exhausted to attenuate the economic shock. Furthermore, the recent plummet of the prices of crude oil will have important consequences for both the producers and net exporters of petroleum.

WTI crude oil quotes are expected to remain low for the rest of the year. This could have an incidence, at some point, on the prices of fuels traded domestically, as stocks of products are depleted. Likewise, some of the prices of commodities of relevance for the Paraguayan economy (soybeans, corn, and beef) have decreased, although to a lesser degree as compared to the price of petroleum, which would buffer the negative impact on the terms of trade. As for exports revenues, the

lower international prices of commodities, particularly of soybeans, would be offset by the greater production registered in the 2019/2020 harvest season.

As regards international financial conditions, although central banks have reduced the reference interest rates and adopted various measures to ensure liquidity, the spreads of the sovereign bonds in emerging markets and those of commodity exporters have increased significantly, worsening international financial conditions.

In the region, a marked deterioration of economic activity is expected due to the pandemic. This further complicates the outlook for those countries with macroeconomic imbalances, which in the face of such an emergency count with a limited fiscal capacity for buffering the economic impact. For Brazil and Argentina, the weakening of their economies might bear a significant incidence on the exports of items manufactured or assembled in Paraguay (especially the output of *maquila* enterprises). Additionally, the greater depreciation of the currencies of neighboring countries may reduce the competitiveness of Paraguayan exports.

At the local level, the strict quarantine is expected to become more flexible at the beginning of May, whereby the economic sectors that have been especially affected, on the side of supply, could rebound to some extent (construction work, commercial establishments, the manufacturing sector, etc.). The recovery of the economic activities that have experienced a significant curtailment in terms of demand (hotels, restaurants, and tourism) might be delayed for a longer period of time. One risk arising from the more flexible sanitary quarantine is that an acceleration of the contagion of Covid-19 could occur. This would provoke an abrupt halting of activities once again, in an economic scenario that would be much more complex and with a more limited fiscal space.