MONETARY POLICY REPORT

June
2020

CENTRAL BANK OF PARAGUAY
Federación Rusa y Augusto Roa Bastos
www.bcp.gov.py
Asunción - Paraguay

Executive Summary*

World growth
Annual change, percent

	March 2020		June 2020		
	2019	2020	2019	2020	2021
World	2.9	-1.5	2.9	-3.8	5.1
United States	2.3	-3.5	2.3	-5.6	4.0
Eurozone	1.2	-5.3	1.3	-8.1	5.5
China	6.1	2.0	6.1	1.8	8.0
Brazil	1.1	-2.5	1.1	-6.5	3.5
Argentina	-2.2	-5.0	-2.1	-9.1	3.7
Trading partners	0.5	-2.9	0.5	-6.3	3.7
Mercosur partners	-0.6	-3.6	-0.4	-7.7	3.7

Source: Bloomberg

Since the March IPoM, the prospects for global economic growth have deteriorated again, mainly due to the prolonged effects of the Covid-19 pandemic. During the periods of total quarantine, the short-term economic indicators registered significant falls. With the gradual reopening of certain economic sectors, a recovery of these indicators has been observed. Notwithstanding, a slowdown in the recovery process is foreseen, with the extension of containment measures beyond the second quarter, as the phase of acceleration of coronavirus contagion persists in some regions. The international prices of commodities registered minimum levels in April, although signs of recovery have been noted following that period. The global outlook continues to be marked by uncertainty, affecting the international financial conditions.

In the United States, Gross Domestic Product (GDP) registered an annualized contraction of 5.0% in the first quarter of 2020, a rate far below the one observed in the previous quarter (2.1%). This result was explained mainly by the deterioration of household consumption, private investment and residential investments in fixed assets, inventories, and exports. In the second quarter of 2020, the PMI (Purchasing Managers' Index) stood in the expansion zone in June, after having registered its lowest point in April. Despite the improvements at the margin, growth prospects for 2020 have weakened as compared to the previous IPoM report, going from -3.5% to -5.6%. Regarding prices, there has been a decrease in inflation in the second quarter, standing at 0.6% in June (below the 2% target). In this context, the Federal Reserve (Fed) has maintained the range of reference rates at 0.0% - 0.25% and adopted unconventional measures to support the economy.

In the Eurozone, the annual GDP variation in the first quarter of 2020 was -3.1%, well below the rate of 1.0% registered in the fourth quarter of 2019. As regards the second quarter of 2020, the manufacturing indicator (PMI) has remained in the contraction zone, reaching its lowest point in April and reporting an improvement in the

* The Spanish version prevails.

Gross Domestic Product by sectors
Annual change, percent

	2019	2020(f)	2020(i)
Primary Sector	**-3.6**	**8.0**	**0.9**
Agriculture	-4.9	10.5	0.8
Livestock	1.3	5.0	0.1
Forestry, fishery and mining	-2.6	-6.0	-0.1
Secondary Sector	**-3.1**	**-2.3**	**-0.7**
Manufacturing	-1.0	-3.5	-0.7
Construction	1.1	3.5	0.2
Electricity & water	-11.2	-4.0	-0.3
Tertiary Sector	**3.2**	**-6.7**	**-3.3**
Public Administration	5.1	4.0	0.4
Trade	-0.4	-3.1	-0.3
Other Services	4.0	-11.3	-3.3
Taxes	-1.7	-5.0	-0.4
GDP at market prices	**0.0**	**-3.5**	**-3.5**
GDP w/o agriculture and binationals	1.5	-4.8	

Source: Central Bank of Paraguay
(f): Forecast.
(i): Incidence.

following months. Given this context, growth prospects for 2020 have been reduced, standing at -8.1%, annually (-5.3% in the previous IPoM). Regarding prices, inflation stood at 0.3% y-o-y in June, with a reduction in the inflation indicators as compared to the end of the first quarter (0.7%) and remaining at low levels in relation to the target. In this context, the European Central Bank (ECB) has maintained the interest rates applicable to refinancing operations, the marginal lending facility, and the deposit facility during the second quarter of the year, and has deepened the assets purchase program to ensure the liquidity in all the Eurozone member countries.

In China, the economic activity data for the first quarter of 2020 shows a retraction of 6.8% in inter-annual terms, reverting the result of the previous quarter (6.0%). The lower performance is explained by the outbreak of the Covid-19 pandemic, which mainly affected the services, retail sales, and construction sectors. On the other hand, the second quarter data shows a recovery of the manufacturing sector, which stands in the expansion zone. The growth forecasts for 2020 were revised slightly downwards, going from 2.0% (in the previous IPoM) to 1.8% annually.

In Brazil, GDP growth in the first quarter of 2020 registered an inter-annual contraction of 0.3%, below the growth rate of 1.7% registered in the previous quarter. This deterioration was mainly due to the fall in household consumption, although the result was attenuated by increases in gross fixed capital formation. The data gathered in the second quarter of 2020 showed a significant contraction of economic activity in April (15.1%), while the manufacturing PMI showed a relative improvement in June. Concerning growth projections, the prospects for 2020 have been revised downwards as compared to the previous report, falling from -2.5% to -6.5% annually. As for prices, inflation measures indicate a deceleration in June (2.1%), standing below the lower limit of the target range, which for 2020 is 4% +/- 1.5 p.p. In this context, the Central Bank of Brazil's Monetary Policy Committee reduced the SELIC rate in May and June, to stand at 2.25% annually.

In Argentina, the GDP in the first quarter of 2020 registered a decrease of 5.4% y-o-y, below the rate registered in the previous quarter (-1.1%). In the second quarter of 2020, the most recent economic activity data revealed an inter-annual

Economic growth and current account
Annual change, percent

	2019	2020 (f)
GDP	**0.0**	**-3.5**
Domestic demand	**0.7**	**-3.7**
Gross capital formation	-3.0	1.5
Gross fixed capital formation (GFKF)	-6.6	1.5
Total consumption	1.9	-5.2
Private consumption	1.3	-7.0
Public consumption	5.1	5.0
Exports of goods and services	**-2.9**	**-4.5**
Imports of goods and services	**-0.9**	**-5.1**
Current account (% of GDP)	**-1.0**	**0.3**
GFKF (% of nominal GDP)	18.5	20.2

Source: Central Bank of Paraguay

contraction of 26.4% in April, with negative performances in all the economic sub-sectors. The manufacturing indicator exhibited a significant reduction in industrial output in both April and May. In this context, the economic growth prospects for 2020 have been adjusted downwards to -9.1% y-o-y, below the forecast of the previous report (-5.0%). As regards prices, a moderation of inflation has been observed (42.8% y-o-y in June), but even so it remains high. It is noteworthy to mention that, in the second quarter, the Argentinean government presented proposals for the restructuring of Argentina's foreign debt. Given this scenario, the Central Bank of the Republic of Argentina (BCRA) maintained the lower limit of the LELIQ rate at 38% annually.

In the local context, economic activity and demand continued to show a positive dynamism in the first quarter of 2020, mainly due to the results observed in the first two months of the year. In the first quarter, GDP increased 3.5% y-o-y, explained largely by the favorable performance of agriculture, services, and construction (supply). On the expenditure side, the components with the highest positive incidence were private consumption, gross capital formation, and governmental consumption. However, net exports registered a negative variation. Starting in March, with the implementation of the needed social containment measures to avoid the massive spreading of the coronavirus, the real sector indicators deteriorated significantly, especially in April. In this sense, a considerable contraction is expected for the second quarter of the year.

As regards the evolution of prices, since the previous IPoM, the inflationary pressures have remained limited, mainly due to the strong impact of both internal and external demand generated by the Covid-9 outbreak at the local and global levels and by the measures implemented to contain its spread. Thus, during the second quarter of 2020, total inflation and the underlying measures have decreased to stand below the lower limit of the target range. On one hand, the reduction in the prices of fuels, strongly conditioned by the international price of crude oil, is highlighted, as this motivated the reduction in the prices of urban bus fare. On the other hand, the decrease of the prices of beef, due to lower internal and external demand, which led to an excess of local supply, is also noted. The averages for the general CPI registered an inter-annual variation of 1.1% during the

Inflation projection

Annual change, percent

	2019	2020(f)	2021(f)	2022(f)
Average CPI inflation (*)	2.4	1.1	3.7	
December CPI inflation (**)	2.8	1.2	3.8	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	2.3	1.3	3.7	
December underlying CPI (**)	2.8	1.1	3.8	
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.

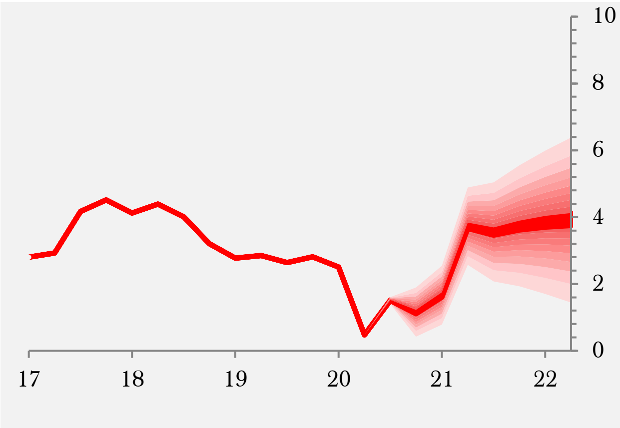
(***) Corresponds to the projected inflation for the second quarter of 2022.

second quarter, lower than the mean of 2.6% reported during the first quarter of 2020. Underlying inflation, underlying X1 inflation, and core inflation stood at 1.3%, 2% and 1.6%, respectively, below the rates observed in the first quarter (2.8%, 2.9% and 2.4%).

Regarding monetary policy decisions, the Monetary Policy Committee (CPM) reduced the reference range by 50 basis points at its June meeting, thereby totaling a cut of 325 basis points since the outbreak of the Covid-19 pandemic at the local level. At the close of this report, the monetary policy rate (TPM) stands at 0.75% annually. The Committee's decision was mainly based on the lessened pressures on both observed and expected prices, considering the greater deterioration of the external scenario, together with the weakening of internal demand. The CPM deemed it appropriate to further ease the accommodative monetary policy stance to a level compatible with the convergence of inflation to the target over the monetary policy horizon.

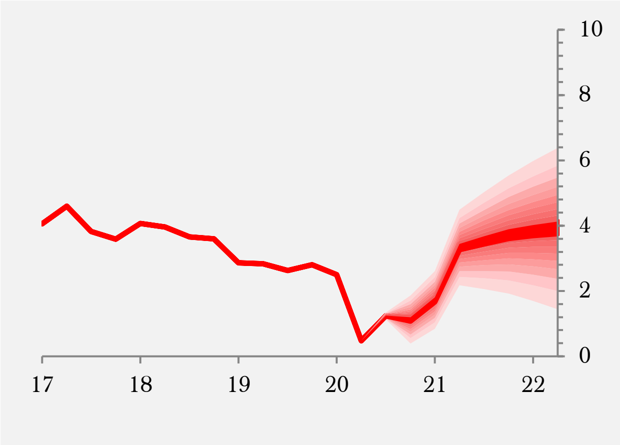
In the baseline scenario, the GDP annual growth projection for 2020 has been adjusted downwards, dropping from -2.5% to -3.5%, taking into account the latest observed records of sectorial performances, as well as the most likely evolution of the economic indicators over the next few months. On the supply side, the correction was largely due to the tertiary and secondary sectors, while the estimates for the primary sector have been adjusted favorably. In the services sector, the negative impact was significant on activities tied to tourism and those that involve crowds of people (hotels, restaurants, public transport, cross-border trade, shows and recreational events, movie theaters, etc.). Given the epidemiological situation of the country and that of the neighboring countries, the outlook remains complex for these segments of the economy. In this regard, the retractions expected for commerce and other services are greater than anticipated in the previous IPoM report. In the secondary sector, the observed data for some manufacturing sub-sectors, such as the production of chemicals, beverages, tobacco, and textiles, stood below the forecasts in the previous report, thus accounting for the lower estimate of the manufacturing industry. Likewise, the generation of electrical power was lower than expected, explained by the reduced water flow of the Parana River and a lessened demand by Brazil. However, the construction indicators have shown a significant rebound after the quarantine confinement stage,

CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast
Annual change, percent



Source: Central Bank of Paraguay.

and therefore the estimate for this sub-sector has been adjusted upwards. In contrast to the two previous sectors, the outlook for the primary sector has improved as compared to the previous estimate, due to an upward revision of the growth rates for both agriculture (soybeans) and livestock production.

On the expenditure side, both private and public consumption have been revised downwards, while a recovery is foreseen for investments, explained mainly by the greater impulse of the construction sub-sector. Internal demand will register a lower fall than the one presented in the previous IPoM report. As regards external demand, the forecast for the reduction of exports have been revised downwards, due to a greater contraction of re-export operations expected, considering that the closing of borders will persist in the coming months. Imports will experience a lower contraction, in line with the estimate of a milder drop in internal demand. Notwithstanding, the incidence of external demand will be positive, although below the level foreseen in the previous report.

In the baseline scenario provided in the previous IPoM report, a significant deterioration of the output gap had already been assumed, mostly due to a considerable drop of domestic demand. In this IPoM, it is assumed that the GDP gap is wider (more negative), the effect of which is also reflected in the downward revision of the GDP projection for 2020. This greater easing capacity implies an important reduction of the inflationary pressures, which has likewise been verified in the low levels of inflation so far this year. The central projections of total inflation and underlying inflation for 2020 stand at 1.2% and 1.1%, respectively, below the estimates in the previous report, and converging to the target of 4% annually over the monetary policy horizon, in the second quarter of 2022. The greater pace of the convergence of both inflation measures over the monetary policy horizon is based on a more rapid closing of the output gap than had been anticipated in the last IPoM. This is explained, partly, by a more expansive monetary policy which, together with the fiscal stimulus provided by the government, will contribute towards the gradual recovery of economic activity. In addition, in line with the behavior of the currencies in the region, it is assumed that the exchange rate will stand above the level estimated previously.

With respect to risk scenarios, at the international level, a slower recovery process than anticipated has been observed, whereby some risks of the greater deterioration of the economic growth prospects stated in the previous IPoM have materialized. In the second semester of the year, it is foreseen that in spite of the gradual lifting of the confinement situation, some measures will continue in place to a certain extent, particularly social distancing, the restrictions imposed on certain activities, and the needed implementation of sanitary measures that limit the production of some economic sectors. An acceleration of the spreading of coronavirus could once again set back progress, further deteriorating the macroeconomic outlook. In turn, the slowing down of economic recovery will require countercyclical fiscal policies to mitigate the effects of the loss of income, thus putting further pressure on the fiscal accounts and the levels of indebtedness of countries. Notwithstanding, the eventual development of an effective vaccine to prevent the contagion of the new coronavirus could accelerate the recovery of the global economy.

Relative improvements in international trade have been observed recently, generating a slight rebound of the international prices of commodities. However, the projections for the main primary materials, including those with most relevance for the country's export revenues (soybeans, corn, and beef), indicate that the average prices of these commodities will stand below the averages registered in the previous year, especially the quotes for petroleum. The lower prices of crude oil would continue to bear incidence on fuel prices in the domestic market, pushing total inflation downwards.

As regards international financial conditions, while the Emerging Market Bond Index (EMBI), the principal country risk indicator, decreased since the publication of the previous report, the prolonged extension of the sanitary crisis could further stress the financial systems and the possibilities of external financing. This would worsen the perception of risks in both emerging and developing economies.

In the region, the epidemiological situation in Argentina and Brazil has worsened since the last IPoM, while the economic deterioration has been greater than anticipated, resulting in the significant cut of the growth forecasts for

2020. This scenario, together with the closing of international borders, will continue to hamper efforts to boost exports, especially re-export operations (border zone trade) and the export of items manufactured under the outsourcing maquila regime. At the same time, the greater competitiveness of the neighboring countries' products (due to greater depreciation vis-à-vis the United States dollar) implies less external impulse for economic activity as well as lower pressures on local prices.

At the domestic level, together with the flexibilization of the quarantine, an accelerated increase in the contagion rates has been observed; therefore, progress to the last phase has been postponed in certain zones of the country. In this sense, the risk persists that in the case of a massive increase of the number of persons infected with Covid-19 and the limited response capacity of the health care system, there might be a hardening of the sanitary measures again, and/or a greater deterioration of the confidence of both consumers and investors might take place, thus impeding a more rapid recovery of the economy in the coming months.