



MONETARY POLICY REPORT

September
2020



CENTRAL BANK OF PARAGUAY

Federación Rusa y Augusto Roa Bastos

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Asunción - Paraguay

Executive Summary*

World growth

Annual change, percent

	June 2020		September 2020		
	2019	2020	2019	2020	2021
World	2.9	-3.8	2.9	-3.9	5.2
United States	2.3	-5.6	2.2	-4.0	3.7
Eurozone	1.3	-8.1	1.3	-8.0	5.4
China	6.1	1.8	6.1	2.1	8.0
Brazil	1.1	-6.5	1.1	-5.3	3.5
Argentina	-2.1	-9.1	-2.1	-11.5	4.7
Trading partners	0.5	-6.3	0.5	-7.1	4.4
Mercosur partners	-0.4	-7.7	-0.3	-8.3	4.2

Source: Bloomberg

The growth prospects of various economies have been revised upwards as compared to those of the previous Monetary Policy Report, mainly due to the favorable results of the short-term economic indicators, after the flexibilization of the quarantine confinement measures. Even though second waves of COVID-19 contagion have been observed, especially in Europe, the progress made in treatments and vaccine trials has allowed for the moderation of global uncertainty. The monetary policy measures of both advanced and emerging economies continue to have an expansionary profile to support economic reactivation, while, in the international financial markets, a greater dynamism of stock markets has been observed in the third quarter. As regards the international prices of raw materials, there was a generalized increase of the quotes for agricultural commodities.

In the United States, Gross Domestic Product (GDP) registered an annualized contraction of -31.4% in the second quarter of 2020, a greater fall than the one observed in the previous quarter (-5.0%). This result was explained mainly by the deterioration of household consumption, exports, investments in fixed assets, private investment in inventories, and both state and local government expenditures, and was attenuated by the increase in federal government expenditures and the reduction of imports. In the third quarter of 2020, the PMI (Purchasing Managers' Index) stood in expansion zone, reaching 55.4 in September. Thus, the growth prospects for 2020 have been revised upwards as compared to the previous Report, from -5.6% to -4.0%. Regarding prices, there has been an increase in inflation in the third quarter, and in September it stood at 1.4% y-o-y (although still remaining below the 2% target). In this context, the Federal Reserve (Fed) maintained the range of reference rates at 0.0% - 0.25% and announced strategy changes for its monetary policy, clarifying that it shall seek an average inflation rate of 2% over time and that it will offset the periods that fall persistently below this threshold

* 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	-6.2	-0.1
Secondary Sector	-3.1	-1.1	-0.4
Manufacturing	-1.0	-2.5	-0.5
Construction	1.1	7.0	0.4
Electricity & water	-11.2	-4.5	-0.3
Tertiary Sector	3.2	-3.6	-1.7
Public Administration	5.1	4.5	0.4
Trade	-0.4	-6.0	-0.6
Other Services	4.0	-5.2	-1.5
Taxes	-1.7	-3.5	-0.3
GDP at market prices	0.0	-1.5	-1.5
GDP w/o agriculture and binationals	1.5	-2.4	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

by allowing a moderately greater inflationary index “for a certain period of time”.

In the Eurozone, the annual GDP variation for the second quarter of 2020 was -14.7%, far below the rate of -3.1% registered in the first quarter of the year. This drop was especially due to the reduction of expenditures for final household consumption and gross fixed capital formation. As regards the third quarter of 2020, the manufacturing indicator (PMI) remained in expansion zone, reaching a level of 53.7 in September. This has permitted a slight upward adjustment of growth prospects for 2020, in spite of the second waves of coronavirus contagion, going from -8.1% (in the previous Report) to -8.0%. Regarding prices, inflation in September stood at -0.3% y-o-y, showing a reduction as compared to the end of the second quarter of 2020 (0.3%). 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 continued the assets purchase program to ensure the liquidity in all the Eurozone countries.

In China, the data for the second quarter of 2020 shows a GDP expansion of 3.2% in inter-annual terms, surpassing the retraction of 6.8% observed in the previous quarter. The better performance is explained by the rebound of manufacturing and construction activities. The indicators for the third quarter show that the manufacturing sector remained in expansion zone, closing September with a PMI of 51.5. Growth forecasts for 2020 were revised upwards, going from 1.8% (in the previous Report) to 2.1% annually.

In Brazil, the quarterly GDP registered an inter-annual variation of -11.4% in the second quarter of the year, below the -0.3% growth rate observed in the previous quarter. This deterioration was mainly due to the fall in household consumption and gross fixed capital formation. The available indicators for the third quarter of 2020 showed a 3.9% contraction of economic activity in August, while the manufacturing PMI exhibited a significant improvement, standing at 64.9 in September. Concerning growth projections, the prospects for 2020 have been revised upwards as compared to the June Report, going from -6.5% to -5.3%. As for prices, inflation increased with respect to the previous quarter (2.1% in June), standing at 3.1% y-o-y in

Economic growth and current account

Annual change, percent

	2019	2020 (f)
GDP	0.0	-1.5
Domestic demand	0.7	-3.6
Gross capital formation	-3.0	-5.4
Gross fixed capital formation (GFKF)	-6.6	5.1
Total consumption	1.9	-3.1
Private consumption	1.3	-4.6
Public consumption	5.1	5.2
Exports of goods and services	-2.9	-5.6
Imports of goods and services	-0.9	-12.1
Current account (% of GDP)	-0.5	0.7
GFKF (% of nominal GDP)	18.5	20.4

Source: Central Bank of Paraguay

September. In this context, the Central Bank of Brazil's Monetary Policy Committee reduced the SELIC rate to 2.0% annually, in August, to support economic recovery.

In Argentina, the GDP for the second quarter of 2020 registered an inter-annual decrease of 19.1%, surpassing the reduction of 5.2% registered in the previous quarter. In the third quarter of 2020, the most recent economic activity data revealed a contraction of 11.6% y-o-y in August, with negative performances mainly in transport, communications, and services. The manufacturing indicator exhibited a reduction in industrial output, registering a rate of -7.1% in August. As regards prices, a moderation of inflation has been observed (36.6% y-o-y in September), although it remains high. It is noteworthy to mention that the Argentinean government has achieved the restructuring of Argentina's foreign debt, whereby decreasing the perception of its country risk. The Central Bank of the Republic of Argentina (BCRA) maintained the lower limit of the LELIQ rate at 38% annually for the third quarter. On the other hand, the measures implemented by the government that restrict the use of foreign currencies have recently led to a greater depreciation of the Argentine peso. In this context, the economic growth forecast for 2020 was adjusted to -11.5%, below the forecast of the previous Report (-9.1%).

At the local level, economic activity and demand deteriorated significantly in the second quarter of 2020, particularly in April, due to the implementation of the preventive sanitary measures to contain the COVID-19 pandemic. In the aforementioned quarter, GDP contracted 6.5% y-o-y, due to the retraction of the services sector, manufacturing, and the generation of electric power. Notwithstanding, the fall was attenuated by the favorable performance of the primary sector, especially agriculture. On the side of expenditures, the components with the greatest negative incidence were private consumption and gross capital formation. On the other hand, net external demand registered a positive contribution, explained by the greater decrease of imports in relation to the retraction of exports. According to the short-term indicators, both economic activity and demand have shown better results in the third quarter, consistent with the economy's greater

Inflation projection

Annual change, percent

	2019	2020(f)	2021(f)	2022(f)
Average CPI inflation (*)	2.4	1.7	3.7	
December CPI inflation (**)	2.8	1.6	3.7	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	2.3	1.7	3.6	
December underlying CPI (**)	2.8	1.5	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 third quarter of 2022.

openness because of the flexibilization of the isolation measures.

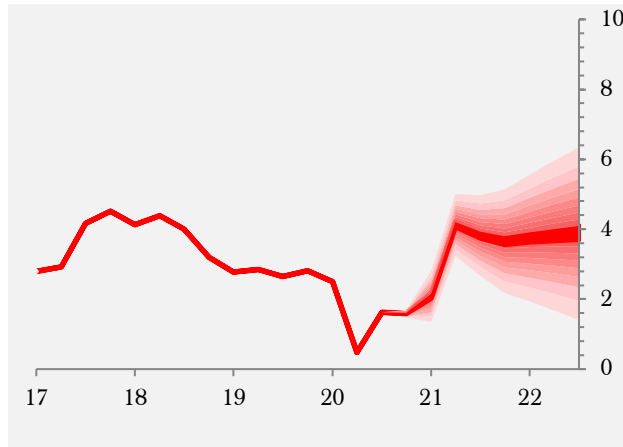
In this context, total inflation and inflation trend measures showed an increase as compared to the previous Monetary Policy Report, although it should be mentioned that they still remain at low levels. In the third quarter, the averages for total inflation stood at 1.4%, above the rate of 1.1% observed during the second quarter. Likewise, underlying inflation (which excludes fruits and vegetables) and underlying X1 inflation (which, in addition to fruits and vegetables, excludes tariffed services and fuels) averaged inter-annual rates of 1.5% and 2.6%, respectively, above the rates registered in the previous quarter (1.3% and 2%). Core inflation, in the same period, averaged a rate of 1.6% y-o-y, similar to the rate observed in the previous quarter.

Given this scenario, the Monetary Policy Committee (CPM) deemed it necessary to continue with the expansionary monetary policy stance during the third quarter, maintaining the reference rate at 0.75% annually, to assure the convergence of inflation to the target over the monetary policy horizon. The CPM, while observing some signs of improvement in the international economy, highlighted that recovery still depends on the evolution of the COVID-19 pandemic and the progress made in the development of vaccines. In the local economy, activity and demand indicators have also shown better results, following the record lows observed in April, but even so, these indicators stood far below the levels foreseen for the period prior to the outbreak of the pandemic. As regards prices, the Committee pointed out that the different inflation measures stand at low levels and, in accordance with the different scenarios assumed, the forecast models foresee no short-term inflationary pressures.

Taking into account that both economic activity and demand have recovered at a faster pace than previously foreseen, in the baseline scenario, the GDP annual growth estimate for 2020 was revised upwards, from -3.5% to -1.5%. This adjustment is explained mainly by a lower retraction of the services sector, particularly for the other services category, a segment in which are included such sub-sectors as hotels & restaurants, household services, and services provided to businesses, among others. Initially, the estimate envisioned a greater impact of the pandemic on these

CPI inflation forecast

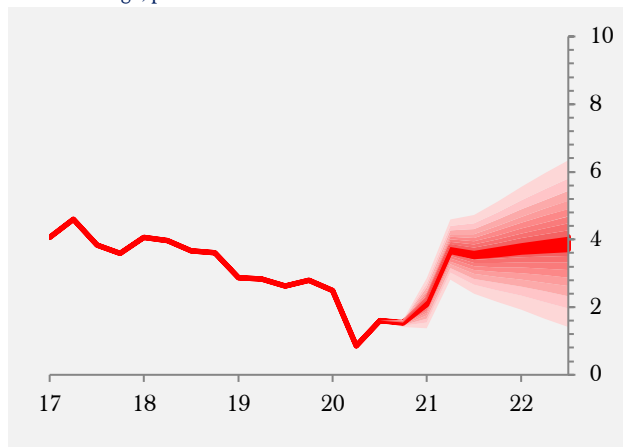
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

sectors, considering that the nature of their activities implied greater social interactions. At the same time, the supply of some of these sectors was limited by sanitary restrictions. However, the latest data has shown an important and swifter rebound than had been anticipated, resulting from the flexibilization of sanitary measures. Contrasting with this, a greater degree of retraction is foreseen for the commerce subsector. In the secondary sector, the significant recovery of construction indicators has motivated an upward correction of the estimate. Likewise, certain manufacturing sub-sectors linked to the production of food items and goods tied to construction have recently shown a favorable performance, thereby leading to an upward correction of the subsector's forecast (a lower fall). The electrical power and water subsector was revised downwards, explained by the lower water flow of the Parana River and less demand by Brazil. As regards the primary sector, the same rate of expansion announced in the last Report is maintained, explained mainly by the positive results for agriculture. On the side of expenditures, private consumption and the gross fixed capital have been adjusted upwards, consistent with the rebound of sales and construction indicators. On the other hand, the downward correction of imports was greater than that of exports, whereby net external demand will have a higher positive incidence as compared to the June Monetary Policy Report.

The June Report showed a significant deterioration of economic activity in the second quarter, reflected in the significant openness of the output gap. In addition, the projections foresaw a gradual recovery, starting as of the third quarter, incorporating the assumptions of the decrease of preventive sanitary measures and the reopening of some economic sectors. In the current Report, a similar trajectory is assumed; however, the effective indicators of both activity and demand, in the second quarter, revealed a better performance than had been foreseen previously. Given these results, a more closed output gap (less negative) is registered as compared to the forecast of the previous Report. Looking forward, in line with a greater dynamism of consumption, boosted by an expansive monetary policy – together with the results of the income support programs and the reopening of economic activities – the gap shall narrow towards the second semester of 2021. This result is consistent with the upward revision of the GDP projection for this year. Notwithstanding, the gap maintains a considerable negative

magnitude, in terms of historical levels. While the capacity gaps in the labor market will continue to be broad due to the loss of jobs, and assuming that this situation will endure for a long period of time, the assumption is likewise included that they will be reduced gradually, in the extent to which economic activities of the various sectors are reinstated. As regards the most likely scenario for the future variations of prices, both the projection of total inflation and that of underlying inflation for the close of the year stand at 1.6% and 1.5%, respectively. These rates are above the ones foreseen in the previous quarter, in line with the domestic demand that has given signs of recovery as compared to the preliminary forecast, and with an exchange rate that stands at a greater level than anticipated previously. The convergence of inflation to the 4% target will occur gradually towards the third quarter of 2022.

With respect to risk scenarios, at the international level, the economic growth prospects of diverse countries have improved and a faster recovery than anticipated in the June Monetary Policy Report is expected. This improvement is due to the more favorable results of the short-term indicators and less global uncertainty. While the situation of COVID-19 contagion continues to worsen in various regions, the advances in more efficient treatments and in the development of vaccines have contributed to boost greater confidence in the economies. In Europe, the risks of second waves of contagion materialized. Notwithstanding, lower mortality rates have been registered and the lessons learned have permitted authorities in various countries to avoid the total halt of activities. On the other hand, the risk of a Brexit without an agreement has risen again, due to recent discrepancies. In the United States, the Presidential election is upcoming, the result of which could have implications regarding the economic policies to be implemented.

As for international prices, a mixed behavior has been observed recently, with the deterioration of the prices of precious metals and petroleum, while agricultural commodities have registered quote increases. As concerns the most relevant raw materials for the Paraguayan economy, the increase of the prices of soybeans must be highlighted. This has been boosted by the high demand of China and the downward revision of the 2020/2021 soybean harvest in the United States, which is the main producer of this oleaginous crop. Furthermore, the risks derived from

the climatic phenomenon known as “La Niña” could provoke additional disruptions in production, whereby reducing the supply of soybeans. On the other hand, the second waves of COVID-19 contagion might deteriorate the prices of petroleum, in the case of new restrictions on the circulation of people.

As regards international financial conditions, it is expected that the central banks will maintain an accommodative monetary policy stance to continue to boost the recovery of the economy and employment. In this regard, the United States’ Federal Reserve, through a change of its monetary policy strategy, will guarantee low interest rates “for a certain time” and then will allow inflation levels that are moderately above the 2% target. However, the risk of a worse sanitary situation at a global level and/or a delay in achieving a suitable vaccine continues. This could have implications in terms of the perception of risks of both emerging and developing countries, and consequently have incidence on external financing conditions.

In the region, a great level of new coronavirus contagion persists, with a high fatality rate. Notwithstanding, the gradual return of activities with sanitary measures has allowed the improvement of short-term economic activity indicators. As anticipated, the more favorable results reflected in these indicators explain the upward slant of growth prospects for the region, in accordance with what has occurred worldwide. Argentina has been one of the exceptions in the region, with a new cut of its growth forecasts. However, the progress obtained through the restructuring of its debt has permitted Argentina to improve the perception of risk in the country. In Brazil, the growth prospects have improved, yet there are long-term risks stemming from the substantial increase of its foreign debt and short-term risks due to uncertainty about the continuation of fiscal support to face the effects of the sanitary crisis. As regards Paraguay, although an agreement has been reached for the gradual reopening of international borders, a greater deterioration of the Brazilian economy or a greater depreciation of Brazil’s currency vis-à-vis the United States dollar could represent a major obstacle for the recovery of trade in cross-border zones.

At the domestic level, a significant risk factor will be the evolution of climatic developments in the next months, in



light of the need for enough rain. Rainfall will have a determinative importance for agricultural production, particularly the 2020/2021 soybean harvest, and it will be gravitating to increase the water flow of Paraguay's rivers, thereby allowing for both a greater generation of electricity and more favorable conditions for the fluvial transport of cargo. Finally, climate behavior is also the key factor for the performance of livestock production during the coming months. At the close of this Report, the climatic conditions have improved partially, while an adequate level of precipitation is projected for November.

Since the beginning of September, the quantity of new cases of COVID-19 contagion has stabilized. In this context, authorities have continued to lift the limitations of certain sanitary measures in order to allow the renewed operation of some economic sectors that had previously been restricted. Furthermore, as has been stated, the government has ordered the gradual reopening of the borders with Brazil. These actions represent favorable factors for economic activity and demand. However, it must be emphasized that the risk associated with an eventual acceleration of new cases of contagion – that would saturate the limited capacity of the health care system – still cannot be discarded. Given such a scenario, new measures for focalized confinement might be implemented again.